SARATOGA INVESTMENT CORP.

Research Studies and Opinions

Middle-Market Recapitalizations

A Q&A

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Question: When does a recapitalization benefit a Middle-Market company?

If you look at recapitalizations being done today, there are two basic kinds. One is if there is an equity realignment. You might have a retiring shareholder who would like to be cashed out. He might have a management team that wants to invest further in the company, and there is not enough capital in the company to manage the equity realignment. So, you do a recap and borrow money at the same time, leveraging the company more than it had been.

The second type is when companies perform well, and they've achieved a measure of success that allows them to borrow more money than they're borrowing right now. They might recap in order to provide a dividend to their shareholders -- a return on capital. This allows them to realize some of the value creation in their investment without selling the company. They can stay with the company and do it again. As the company continues to improve it allows them to realize a return on their investment without having to sell.

Question: Why should these companies consider using a BDC for funding?

BDCs are quite flexible in terms of the type of financing they can provide. Generally speaking, when business owners are doing a recap they talk to banks, and BDCs work with banks. Sometimes a bank might lend, say two times EBITDA, but in order to effect the recap, the company might want to go to four times EBITDA. So, the CFO approaches a BDC to stretch what the bank will do from two to four times. Sometimes a bank might only do 1.5 times and a solution from a BDC might be a Unitranche fund. That is, instead of having senior and subordinated debt, the company would just have one class of security, a Unitranche, that would lend four times EBITDA to the company, and there would be no bank at all, since all the funding would come from the BDC. BDCs can provide a competitive cost of funds relative to alternatives in the universe of debt possibilities.

Question: What does a BDC bring to middle-market financing that a larger institution might not?

If that larger institution is a bank, BDCs are not regulated the same ways that banks are, so they have more ability to be flexible. BDCs can customize transactions. They can invest in common equity, preferred equity, mezzanine, second lien, first lien, real estate, sale leasebacks, equipment leasing… A BDC can look at the totality of assets and cash flows of a company and come up with a custom package of credit where larger institutions tend to be a bit more cookie-cutter. Now, this applies to the smaller companies, sub $50 million EBITDA companies. Once you get to be larger than that -- in the range of $50 million to $100 million EBITDA -- the large institutions become more competitive because they can provide low cost of financing. If you're in a position where you qualify for cookie-cutter debt, that debt can provide the cheapest, most liquid, most common type of security out there. It is a spectrum of relative competitiveness. The smaller the company, the more customized solution the company needs to reach its financing goals.

Question: When is the best time to finance a recap?

When you can, because sometimes when you need to, you can't. A lot of companies wanted to do a recap in 2009, for example, and couldn't. You need to act when markets are favorable. You want to do it from a position of strength, not weakness.

Question: How should a company proceed with recap?

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Question: Is there a process a CFO should go through to get a recap started?

Sometimes companies call an investment banker to represent them in a recap. That's one way to do it, but it's not essential. A CFO could contact BDC lenders directly if he wants to.

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