SARATOGA INVESTMENT CORP.

Research Studies and Opinions

Part 2

Working with a BDC. What CFOs Need to Know

by

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Despite high-profile commitments by major banks to small-business lending, overall loan volume to small and middle-market companies has declined. Estimates from the Federal Reserve Bank of Cleveland reveal that small-business lending has plummeted from more than 50 percent of non-farm, nonresidential bank lending in 1995 to less than 30 percent in 2014, with little sign of a reverse. In addition, few banks are willing to make cash-flow loans to smaller middle-market companies, those with EBITDA of less than $10 million.

CFOs looking for capital, especially cash-flow loans, are increasingly discovering alternative sources, particularly Business Development Companies ("BDCs"). In the 1970s, a perceived crises in capital markets led Congress to amend the Investment Company Act of 1940 in 1980. This added a new category of closed-end investment companies known as BDCs. BDCs make cash-flow loans as capital providers to private or thinly traded portfolio companies for the long-term, and BDCs work best when they function as a business partner. There are now about 50 BDCs in the US with more on the way. CFOs of companies with $10 million to $50 million in EBITDA should know how to engage, connect and work with them.

Securing capital is a complex process with numerous work flows

Securing capital is a complicated and often time-consuming process. CFOs should control it from beginning to end, whether seeking funds from a bank, a BDC, a private equity firm or other lenders. It is important that the CFO control and manage the process with detailed project plans that include the various applicable work flows and clearly defined deliverables and timelines. If a CFO fails to secure funding the first time because the process is flawed, subsequent attempts will be more difficult, because lenders will know about the past failure and could draw incorrect conclusions about the creditworthiness and quality of the company.

To avoid dealing with just one lender, CFOs should develop a capital-raising process with the expectation they will contact several lenders to discover the best terms their companies can get. This interview and vetting process should be set-up in an organized and systemic way.

The results of this process will include the following:

- Ensure lenders are aware of their companies' place in the credit markets
- Ensure lenders understand how market trends impact their business
- Ensure lenders receive all information they request. Capital-raising from a BDC is often different from filling out a borrowing-base certificate for an asset-based loan or line of credit. Often a request for a cash-flow loan requires information CFOs should have on hand, plus some they might need to gather
- Provide data in a cohesive package that makes lenders' work easier and facilitates the outcome, and
- Ensure questions are addressed before they are asked by lenders, and is focused on a desired outcome

What information does a BDC need?

CFOs need to supply a total of 10 types of information for a BDC to evaluate their companies' creditworthiness. This intense due diligence is necessary because a BDC judges a company as an ongoing enterprise and often makes an equity investment in its growth. It is focused on enterprise value. In actual fact, better understanding of this thinking often makes the difference between a successful deal or a pass. Hence, a CFO must provide all the information requested so that the BDC can become comfortable with the risks and underlying enterprise value of a company.

At the end of the day, the more focused the data package is, the easier this stressful process will be for everyone.

The information required includes the following:

1. **An executive summary of key information.** This is often the first information a lender will read. The executive summary should include an overview of the:

   - Business
   - Transaction
   - Financials
   - Ownership

   Keep this executive summary at a high level, the sections that follow will drill-down in more detail.

2. **Acceptable financial statements**. Some small-to-middle market firms have never had a financial statement review (much less, an audit) and cannot readily produce the certified information a BDC needs to make an investment decision. An auditor's review is usually good enough. However, an audit focuses on the past and lenders are more concerned about the future. Therefore, a prospective lender may hire a firm to perform what is called a QOE (Quality of Earnings review). This is common.

3. **Reasons why a BDC should invest in the company.** Cash-flow lenders want to see reliable revenue sources, controllable costs and defendable margins. The assumption is that a BDC will remain with the company for five years or more. It wants to be confident during the time span that the company will continue to be profitable and grow, while able to service its debt.

4. **A thorough business overview to help the BDC understand the company**. This part of the narrative works hand-in-glove with the reasons for why a BDC should invest in a company. The BDC is looking for a business with a profitable, sustainable niche, something that makes it interesting, a 'magic ingredient'. Alternatively, a BDC seeks an enterprise, that, should the equity owners sell, will provide decent return to the lender due to company's market dominance. Among items in the business overview are:

   - Company operations and performance
   - Sales and marketing
   - Suppliers
   - Customers
   - Employees

5. **Management bios and background.** Management is often very important in driving lenders final investment decisions. They are, ultimately, the BDC's partner for a lengthy period of time.

6. **Capitalization, and statement of equity ownership.** This breakout provides the principal owners of the company and their percentage investment in it, both pre- and post-investment.

7. **Explanation of the risks of investing, and mitigating circumstances for doing so**. While the BDC will independently assess risks, the CFO can facilitate the process by initially assembling a list. No one knows the risks better than the entity's management themselves.

8. **A discussion of the industry in which the company operates and the competition it faces.** This narrative discusses the marketplace in which the company operates and its position in it. Market share and competition is always a focus for BDCs.

9. **A detailed discussion of sales and marketing.** The BDC will need to know the breakout of sales production by various representative segments; key customers by sales revenue and volume; customer concentrations; customer cancellations per year and reasons for doing so, both current and historically; suppliers and supply arrangements, such as rebates and leasing; production facilities and employees and a discussion of the industry and competition.

10. **Financial summary and projections.** In addition to income and balance sheets, the BDC investment committee will want a detailed cashflow analysis, a worst-case scenario and product and service margins.

The successful completion of a BDC's underwriting process requires a company's CFO to provide needed financial and operational details in a timely fashion. The better the company handles this process, the better the chance of facilitating and succeeding in the financing. BDCs often view the quality and efficiency of the process as a proxy for how the business will operate post-investment. The added benefit to the credit review process is that CFOs gain a deeper understanding of their companies, which will hopefully help to further improve the firm. Finally, through controlling the process from beginning to end, CFOs can be assured that they are getting the best terms available from lenders.

All of these steps and the process as a whole set up the future where the CFO and the BDC lender will be working together for a lengthy period of time – and ultimately both are equally motivated to see the business reach its full potential.