SARATOGA
INVESTMENT CORP.

Research Studies and Opinions

B.D.C.

Working with a BDC

A Q&A

Tom Cunningham (CEO) & Carter Hertzberg, (COO)
Nauticon Imaging Systems, Inc.

Nauticon Office Solutions is a locally owned Toshiba and Xerox authorized office equipment dealer serving customers in Washington DC, Maryland and Virginia since 1997.

Question: Why did you decide to borrow from a BDC, particularly Saratoga?

Tom: We had borrowed from an SBIC in 2008 and we needed to refinance that in 2013. We had some familiarity with the BDC concept. The original debt was used for an acquisition.

Why Saratoga particularly? Word of mouth. We thought the best way to do this was a BDC. We explored bank financing, but the economics were more attractive with a BDC. And, so we went looking and Carter, through a number of connections and some interviewing, came up with Saratoga.

Question: I assume the SBIC was unwilling to roll over the note?

Tom: I don't know that they were unwilling, but we were in their first fund, and they were not permitted to roll it over in that fund because it had a timeframe on it. They were actually looking to have their limited partners get a realization on the investments. Saratoga has more ability and flexibility to do add-ons and refis, and they don't have a statutory time limit on investments.

Let's assume we wanted to refinance. I believe we could do that with Saratoga sometime down the road. And they also have more flexibility in bringing additional funds, if we said we needed to do a deal or wanted to do a deal that required more funding than the folks we were with originally. That is pretty damn attractive to the borrower.

Question: When you stated that the economics of a bank were not adequate, what exactly did you mean?

Tom: We negotiated the amount we wanted to borrow to refinance, but the bank required a specific amortization. So even though the interest rate was lower, the cash flow is significantly better for us with the BDC financing than it would have been with bank financing.

So if the bank had said, "We're going to lend you $5 million, and we want the principal paid back over five years," that means a principal payment of $1 million a year, which is not tax deductible. But the lower interest rate, let's say 5%, is deductible. If you compare that to a $5 million loan from a BDC, let's assume that it is at 10% interest, the full $500,000 in interest is deductible -- and it's the only payment you'll make. There is no forced amortization.

From a cash flow point of view that is significantly more attractive. Effectively, it's costing 50 cents on the dollar for the interest, and your cash flow is more than twice as good. Now having said that, under our agreements if we get to the end of each year and we have excess cash, we're permitted to pay down the debt, but we're not required to pay it down as you would in a bank financing. It's a significantly better cash flow arrangement.

Question: And, Saratoga's debt can run as long as mutually beneficial, right?

Tom: We actually had an event in the last year where we paid down a significant amount of debt, which they agreed to and we negotiated, and they couldn't have been more helpful. We have an understanding that if we need to borrow more in the future they would be eager to lend. There is no five-year requirement.

Question: Saratoga has explained to us that it wants to keep money at work vs. a bank that wants to be repaid.

Tom: Right. When they find an investment like us, they do a lot of work upfront to determine whether or not we're a good credit risk. To the extent we are and we make our interest payments, they're making a significant return on those dollars, so they would just as soon keep them with us. And, if tomorrow we said we want to borrow $5 million for an acquisition, their experience with us and the relationship is such that they would be pleased to do that. They would rather lend us the $5 million because they already know we are a good risk and they don't have to do the due diligence from the beginning.

Question: How rigorous was the due diligence with Saratoga by comparison to a bank?

Carter: I would say the front end is similar to a bank. They want to make sure that the entity they're getting into has the horsepower to service the debt they're looking to put in place. But, I would say the ongoing due diligence, provided that the portfolio company performs, is significantly less. There is more flexibility with a BDC. There is less reporting, etc.

Question: Are the Saratoga people available if you want to talk to them about issues?

Carter: Absolutely. We have a wonderful working relationship with them. I don't think we could ask a lot more from our financing partner in terms of being there when we need them, and not being there to bother us when we don't need them.

Tom: Now, admittedly, we're really good clients. They are wonderful. They don't waste our time asking about stuff. We deliver the numbers, our performance is quite good, we're timely, we're accurate, we've done what we said we were going to do and when there have been a few hiccups we have been quick to anticipate their questions and concerns. So, as a result, they don't waste our time and we don't waste theirs.

Carter: I would add to what Tom said: We have a very open communication with them. When something is on the horizon we are quick to bring it to their attention, and I think they appreciate that. I think we've built some good will. If you're a good communicator and your business is performing, a BDC is a great partner. We haven't been on the other side of that, busting covenants and trying to hide, so I don't know how that kind of relationship goes.

Tom: It probably goes about the same way it does with bank when you miss your numbers. They put you in a room with no windows and broken plastic chairs. I've been there. {laughing} I've done that. I know that.

I think Carter is probably right. It's probably not the right vehicle for everybody. I think the test of the relationship is the following.

We had some pointed conversations with Saratoga back in March. We were trying to determine whether we were going to sell a division, which was the subject of the original borrowing eight to 10 years ago. That meant we were going to pay them off significantly. We had some good conversations about whether we should sell, whether it was the right deal, if we didn't’ sell would they renegotiate, which they did discuss. If we did sell, we were going to pay them down. In all of those conversations, which were lengthy and direct, because it was as important to us as it was to them, they never once colored their position based on getting paid off. They were really accommodating. They made a fair proposal for us if we didn’t sell, as how they might restructure our position, but they were perfectly happy to have conversations about why selling might make sense, even though that might have cost them some money. They’re still talking to us today, and we paid them largely off.

If I had to go out and borrow money today I don’t think we’d go to somebody else to test the market. I think we’d just go back to them and say, this is what we want to do and assuming they’d lend it to us, we’d take it from them.

Question: What kind of a business is not ready for a BDC or may be premature?

Tom: A startup. If you’re not cash flow positive, you probably can’t do this. I would say that they’re great for growth, probably good for a liquidity event. In other words, if I decided tomorrow that I wanted to retire and Carter was going to stay and run the business, would they fund that? Yeah, because we have a pretty stable business. That is attractive from their position.

There is an argument to be made that if you borrowed money from them and you did it on the interest only and you can deduct the interest and reduce your cash flow out, that would be attractive. But, at some point they’re going to want their money back. So as a startup it would be a little unnerving for me to be taking this over some other form of dollars, like equity. When you’re a startup, the unknowns far outweigh the knowns and I think that is the concern. It is pretty painful if you don’t make your numbers.

Carter: The one thing that we didn’t hit on is that BDCs do have a small equity component along with their interest coupon. So that does help align the BDC a little bit more with the company’s interest than maybe a bank would be.

Question: We didn’t realize they had equity in your company.

Carter: They have a warrant in the low, single-digit percentage, but it’s enough to keep them interested.

To simplify it, if you send the reports on the last day of every month and you make your numbers and they get your cash, they are remarkably easy to deal with.

Question: How easy was it to find Saratoga?

Tom: They were referred to us when we were looking around. I would say the biggest challenge facing an entity like us that needs or wants money is the frustration of the marketplace.

You read it all the time. There is so much money on the sidelines. There is so much money that wants to go to work, and that is true. You run into SBICs, and private equity firms, and angel investors, and there is all this money over here on one side of the fence. There are creditworthy companies on the other side of the fence who need or want money and it's very inefficient bringing the two together. Every private equity and SBIC and BDC has a certain size, a certain industry or industries they're interested in, a certain geography they might be interested in. And your company, or in this case my company, has to find the ones that are interested in a deal of this size, and this geography representing this industry. It's not very efficient.

Question: If you knew somebody who was running a company that needed capital and was a good candidate for it who asked you for advice, what would you tell that person?

Carter: I would just refer them to the people we know and let them start connecting.

Tom: If somebody calls us we would give them to the people we've dealt with, because they know more about who they compete against and what deals they're doing than we could find out. But that is terribly inefficient. I think there is a lot of money out there. I think there are a lot of companies out there who would like the money, who could use the money, who don't know how to find it.

Question: Sounds like a business opportunity.

Tom: There are brokers, but frankly we dealt with a couple of guys who claimed to be matchmakers, and they were awful. It's self evident that there might be a better way to do this. A clearing house, a website, a broker, or some resource like match.com.

There are a lot of companies that I know that might benefit from these funds, and they just go to their bank. The bank will only do so much, and it gets harder and harder these days for banks to do things. By the same token, the SBICs and the BDCs are looking for opportunities and how would they find me?

# # #