SARATOGA INVESTMENT CORP.

Research Studies and Opinions

Higher Interest Rates Will Change Middle-Market Financing

A Q&A

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Question: How will an interest rate rise change middle-market financing?

It depends on a company's financial structure. If a company has floating-rate debt obligations, of course, those rates would rise with rising rates. And, if the company had fixed, they wouldn't. However, if a company wanted to do a recap and fixed rates were higher, that would impact the amount of capital and credit available for them. A rise in interest rates would cost leveraged companies more money to borrow. It also might drive refinancings into more fixed-rate obligations than floating to combat the impact of further rate rises.

With regards to BDCs, it depends on their asset mix. You have to look at the percentage of assets and fixed-income obligations vs. floating rate. A lot of their assets are floating rate, so with rising rates, all things being equal, the income they would get on loans would rise. They would have higher revenues. However, there is a caveat. A number of companies have LIBOR floors in their debt structures. If you have a LIBOR floor at 2 percent and LIBOR is 50 basis points, interest rates could rise 150 basis points from 0.5 percent to 2 percent and the company's interest rate wouldn't rise at all. Whereas a BDC might have liabilities and bank loans that are floating off of LIBOR without a floor. So, BDCs could see the cost of their liabilities go up, while their assets might not be responsive until the rise in interest rate goes through the LIBOR floors. Then they would all rise together. With that said, by and large, BDCs have a fair amount of floating-rate debt obligations, so they are reasonably adjustable at a higher interest rate.

Question: How will this affect financing of middle-market companies?

The absolute amount of leverage will probably go down if this were to occur. If you're paying 5 percent interest and 1:1 fixed-charge coverage, and all of a sudden you've got 8 percent interest, you can't borrow as much because you can't cover as much. It is the cost of borrowing. The absolute amount of leverage would go down from the historically high levels that we're at right now.

I think a lot of companies will find themselves in a position where when their debt becomes due they might not be able to refinance all of it because the new credit reality might be more expensive than what their current financing structure is. They might be forced to sell the company because they can't refinance it and pay all of that debt.

Question: What will be the role of BDCs in a higher rate market?

They will provide the same flexible financing. One of the benefits of BDCs is their flexibility. They can provide fixed-rate or floating-rate debt to their companies. Whereas banks, generally speaking, lend principally on a floating-rate basis. A BDC can give you a fixed-rate loan, which has an implicit hedge on rising rates.

Question: Should companies be financing now to avoid inevitable rate increases?

On a fixed-income basis, if you can borrow 10-year money at today's interest rates, that would appear to be a good strategy to lock in fixed-rate financing. If you borrow at floating rates, it may not help you as much. On a fixed-rate basis it would make sense, if you believe rates are going to go up, to borrow as long as you can.

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