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Research Studies and Opinions

Part 1

BDC: The CFO and the Capital-raising Process

A Q&A with

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Question: What kind of CFO should know about a Business Development Company?

HS: The CFO looking for financing that is either greater than a bank would allow under asset-based lending rules, or to whom a bank is unwilling to loan because it is a smaller middle market company. Either way, the CFO is in the market for alternative funding sources to meet his company's growth needs. Business Development Companies serve smaller middle-market companies with revenues of $8 million to $150 million and EBITDA of $2 million or greater.

Question: What is a BDC?

HS: Congress enacted legislation creating Business Development Companies in 1980 as an amendment to the Investment Company Act of 1940. The idea was to create a regulated entity to focus on the capital needs of smaller middle-market companies. Since January 2007, BDCs have grown from 16 to more than 50 companies. They serve an estimated 65,000 businesses in the US with revenues in the range of $8 million to $150 million, the overwhelming majority of them privately held and family owned. These companies have significant capital needs, but because they work in a highly fragmented marketplace, they are underserved by banks, and often not served at all.

Question: What do BDCs look for in deciding to fund a company?

HS: A leading market position or niche with sustainable competitive advantages – preferably a "secret sauce." An exceptional management team with

a meaningful stake in the business. Growth prospects in healthy end markets. An ability to withstand business cycles. Strong margins and free cash flow. Recurring revenues and stable historical performance. Modest capital expenditure and working capital requirements.

Question: When should a CFO begin the search for funding?

HS: As soon as possible, because the more time the CFO has, the more negotiation flexibility he has to get the right deal. The worst thing for a borrower is to run out of time. For CFOs of smaller middle-market companies considering the use of a Business Development Company as a source of funds, it is important to understand what a BDC does and how it operates. Many CFOs in smaller middle-market businesses do not understand BDCs well. They do not understand how a BDC assesses a credit opportunity. They might not have encountered a BDC until this point because banks have met their companies' limited financial needs. But now, with plans to expand to the next level, their banks are unable to provide sufficient capital.

Question: What are the first steps a CFO should take?

HS: Step one is to assess his need. He should know what he is trying to achieve with funding, the use of proceeds and how to maximize the return on the money. He should learn the prevalent covenants in the industry and calculate the cost of funds compared to the return the borrowing will generate. The return should be sufficient for both the expense and effort of getting the loan. This requires slicing data in a way that he can identify all business drivers. However, for many smaller middle-market companies, it is a job just to pull the basic numbers together to complete an income statement and balance sheet. They often operate on very basic accounting systems with limited data-analysis ability.

Question: How should the CFO learn about BDCs?

HS: The world of BDCs and of smaller middle-market private equity firms is diminutive. There are conferences and events that bring most of the industry's participants together. For example, there is the annual Sutherland BDC Roundtable where up to 85 percent of the industry is represented.

At these events a CFO has a number of networking opportunities through which he can meet BDC financiers to learn about the market space and to acquaint himself with sponsors and firms able to raise money. In addition to the Sutherland conference, there are 15+ conferences a year that borrowers can attend. Many of these are industry-specific and are hosted by the Small Business Administration, providers, vendors and investment banks. Conference themes vary from regulation, rules and compliance, to market conditions, market factors and what's happening in the middle-market lending space at the moment. In addition to conferences, there are also many train-

ing opportunities provided by a group of specialized service providers.

Question: How does a CFO know which BDC to choose?

HS: CFOs generally don't seek out a specific BDC. They rely on referrals from sponsors -- bankers, lawyers and accountants. The sponsors have a list of firms and based on the CFO's need, they recommend a BDC that might be a good fit to finance it. Banks provide this service because they cannot finance all of the needs these middle-market companies have. On the other hand, if the CFO is looking for a Small Business Investment Company (SBIC), which can be a subsidiary of a BDC, he should go on the Small Business Administration's website where SBICs are listed and contact them directly. SBICs, however, are limited to small businesses with a net worth of up to $18 million.

Question: How does a CFO work with a BDC?

Borrowing from a BDC is not as straightforward as a CFO might think. BDCs need financial information that makes sense and can be analyzed. Often smaller middle-market companies don't have systems that are set up to pick apart financial information. So, early on the CFO needs to assess his firm's key performance indicators and determine the systems the company has and what he might need post-transaction to generate financial information for the BDC and to meet loan covenants.

Question: What kind of systems?

HS: The CFO might need a general ledger, a management information system and an operations system or combination thereof. CFOs often start thinking about them only after a deal is done, but they shouldn't wait. For example, we are still doing due diligence on a company we are working with, but we've already advised them of their system needs. CFOs should investigate all these different system requirements and factor them into their cost and returns to make sure BDC funding still makes sense. This can be hard on a CFO who has done a good job without these systems. But, it is no longer good enough to close the books once every three or six months like some do. The BDC will require a monthly close.

The CFO might need a consulting firm to help him identify and evaluate different systems. A BDC can often provide counsel in finding the right one. These should be IT consultants with a project management background. They identify system needs, negotiate with vendors, then lay out a project plan, time tables, deliverables, and execute. We're doing a deal now where part of the covenants require the company to put in a new system, and if the system goes in before 12 months have passed, the covenant doesn't penalize them. But, it's important that before a CFO closes a deal, he knows his company's needs.

Question: Why go through the extra work and expense to get a BDC loan?

HS: A CFO would not go through this if he could get adequate funding through an asset-based loan, but banks will not make cash-flow loans to many of these companies because of their size and where they are in the life cycle of their business. A point to remember is that smaller middle-market companies have stretched resources to get where they are, but if they are to grow larger they need to expand infrastructure and reach scale. This requires the CFO and CEO to see eye to eye on systems and the need to produce timely and higher quality reports. We see investments where companies spend quite a bit of capex to expand, but at the same time they're cutting costs in other areas. So, it is not always a huge ramp in costs to install new systems. Sometimes it is an assessment of resource re-allocation that leads to increased efficiency. CFOs need detailed information before taking on a borrowing, to avoid suddenly discovering they can't deliver and tripping a covenant.

Question: What other information does a CFO need to provide a BDC?

HS: Securing funds from a BDC is not just taking out a loan. It is making a long-term commitment to achieve their projections and reach their objectives. And, the CFO is committing to a new partner in the process, because a BDC is a lender that will be a partner with company management in the future of the company.

Question: Does this mean the BDC will take equity?

HS: A BDC's commitment to a company extends to taking equity in it whenever possible. It signifies the BDC's confidence in the growth of the company and its future success. It is a tribute to management that a BDC desires to have a stake. This is why the borrower should not view a BDC as just the lender he has to pay every month. A CFO should view the BDC as a partner, as someone he can reach out to. He should be proactive in updating the BDC on material developments, not because he is scared about what the BDC's reaction will be, but because the BDC can help in various ways with what they are doing and what they're going through.

Question: How should a CFO keep a BDC informed?

HS: At least quarterly, the CFO should do a forum for the BDC where he presents the summary of the quarter and highlights positives and negatives in an interactive session. It should not just be "here are our financials." It is "come in and spend a couple of hours," during which the CFO walks the BDC through the financials and what's happening in his business and industry.

The CFO should tell the BDC about negative developments as early as possi-

ble, so that the BDC can assist wherever possible. He should not feel that the moment he tells the BDC he is in the penalty box.

At times, the BDC will be either on the company's board or have observer rights during board meetings. So the BDC stays engaged in that way. This can be a mindset shift with the CFO who might feel the BDC is big brother watching him. If the CFO is suspicious or doesn't want anyone interfering in his business, there is an inherent problem from the beginning. If the CFO is eager to learn and willing to listen to others, this fosters a much better on-going relationship.

Question: How many companies can a BDC counsel effectively?

HS: At the moment Saratoga has more than 40 portfolio companies. There is a deal manager who stays engaged with each company. We do quarterly evaluations of every single investment because that is mandated by the SEC. There is no upper limit to the number of companies a BDC can serve.

Question: What else is there to know about a BDC?

HS: Financing with a BDC is a different experience for CFOs who have only dealt with traditional lenders, but it needn't be worrisome. BDCs are set up to make their portfolio companies successful. That is how BDCs grow and make money. It is a symbiotic partnership designed to help companies reach the next step in their growth cycle. The better a CFO understands this, the easier it is to work with a BDC.