SARATOGA INVESTMENT CORP.

Research Studies and Opinions

Five years and Counting

A Q&A

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Question: Saratoga Investment Corp. has had a successful five-year run. How would you characterize it?

Answer: One way to look at it is a comparison of Saratoga's performance with that of a BDC index. For the same five years, the BDC average total return (stock price + dividends) was 76.6 percent. Saratoga Investment Corp.'s total return was 154.2 percent. And, that performance is continuing. The average BDC's total one-year return was 3.9 percent, while Saratoga's was 26.9 percent. In our first quarter of fiscal 2016, ended May 31, 2015, our return on equity was 24 percent. We also established a quarterly cash dividend policy on Sept. 24, 2014 and have paid increasing dividends since then. We paid $0.18 per share for the quarter ended Aug. 31, 2014; $0.22 per share for the quarter ended Nov. 30, 2014; $0.27 per share for the quarter ended Feb. 28, 2015; $0.33 per share for the quarter ended May 31, 2015, and a special dividend of $1.00 a share, paid on June 5, 2015.

Question: How did this happen?

Answer: We bought a failing BDC and turned it around. In the summer of 2010, GSC Investment Corp., the name of the company before it was changed to Saratoga Investment Corp., had been in default for a year on debt from its senior lender because of weak credit underwriting and valuation declines when the financial markets contracted in late 2008. GSC accepted our plan for a $55 million recapitalization that included new equity of $15 million and new credit of $40 million from Madison Capital Funding LLC.

Saratoga's new team employed conservative underwriting practices, based on thorough due diligence. We focus lending to companies that banks are less able or willing to accommodate. Saratoga lends on a business' cash flow, not just its hard assets that can be collateralized to satisfy a bank's onerous credit standards. Saratoga also extended its lending capacity by obtaining a Small Business Investment Company license (SBIC) from the U.S. Small Business Administration (SBA) in March 2012. The company now is in the process of applying for a second SBIC license.

Question: How big is Saratoga's investment team now?

Answer: As of May 31, 2015, we doubled the number of investment professionals in place from 2010, when we took over GDC Investment Corp. They are all experienced in middle market lending and understand how to evaluate a company, its opportunities and risks. They work directly with our President and Chief Investment officer, Michael Grisius, who himself has more than 23 years of experience in leveraged finance and private equity.

Question: How big is Saratoga's loan portfolio now?

Answer: We have more than 35 investments in portfolio companies now, and we're making three to five investments per quarter. This is in a competitive market where money is chasing deals and transactions are becoming increasingly highly leveraged. We look at many deals before we find one that meets our stringent investment criteria. Our due diligence is based on the health of a company and its position in the market. We look for niche players who can sustain growth in a down economy.

Question: Isn't that what banks do?

Answer: Banks are being forced out of the smaller middle market where we focus our attention. They are constrained by leverage rules, resulting from the Dodd-Frank legislation. If a loan is beyond four times EBITDA in leverage -- i.e., a company has $5 million in EBITDA and the loan is in excess of $20 million -- new bank rules consider that a highly levered transaction. The bank, therefore, is required to put more equity in reserve to support that loan. In addition, for smaller companies banks prefer asset-based loans, whereas we do cash flow lending. BDCs, such as Saratoga, are used to a broader range of business models and are more comfortable looking beyond traditional asset-heavy manufacturing businesses. BDCs are much more comfortable with service business models and asset-light models that predominate in today's economy. One of the appeals of Saratoga is its willingness to "invest" along with the company for the long run, instead of a bank's often shorter term view. A bank will loan you money, but it generally wants to be repaid in a near-term period of time and to secure the loan with collateral and other guarantees. With a BDC like Saratoga, there is much more of a dialogue and understanding of the business and, in a way, a partnership. Business owners may pay a little more for a loan from Saratoga versus a bank, but they are happy to do so because of the flexibility they receive. They are also able to have real time discussion with us about their business plan and decisions that need to be made without necessarily being a captive to loan documentation.

Question: How will Saratoga continue its successful growth curve?

Answer: We will continue to operate conservatively with a diversified portfolio. We will concentrate on superior shareholder returns, improving financial performance and credit quality, which will help us to grow assets under management and expand our long-term liquidity base as well as borrowing capacity. Our net income yield has increased to approximately 9 percent from roughly 5 percent in 2010. More than 95 percent of our investment portfolio holds the highest possible credit rating, up from 29 percent when Saratoga took over in 2010. We are working now to secure a second Small Business Investment Company license that will add $75 million to our borrowing capacity in addition to the $150 million in borrowing capacity that we received with our first SBIC license.

Question: Where do you see Saratoga Investment by 2020?

Answer: Hopefully, we see it being bigger and stronger than we are now. We have an excellent team and ample liquidity, but it's too early to forecast performance for the next five years. The markets and economy might change with an increase in interest rates. The Federal Reserve has been considering this conundrum for several years now. I believe middle market companies will be able to pass through interest rate increases because the economy has a better employment picture than in 2008, but there is no way of knowing for certain. Saratoga Investment needs to maintain disciplined investment no matter what financial scenario develops, and I'm confident we can and will do that.

Question: Do you foresee continuation of intense competition?

Answer: Some competition might lessen with a rise in interest rates, but it's too early to know what the impact will be in terms of money chasing deals. The market is extremely competitive now, which makes disciplined investing harder. However, if we can remain strong and competitive through this period, we will be in an excellent position when the market turns and there is a more favorable supply and demand equation. There are also more than 50 BDCs in the market now, up from a handful 10 years ago. We can expect to see more of them being created and, along with that, certainly more competition.

Question: How would you summarize Saratoga's first five years?

Answer: It was a period of transformation. We had to work very hard to turn the company around and build a culture and brand, but we succeeded and the results are showing in our financials. We are now in a period of growth, which has its own challenges. We must not let our standards slip while we increase deal flow and diversification of our portfolio. I'm confident that with the team we now have in place we will do both.

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