SARATOGA INVESTMENT CORP.

Research Studies and Opinions

B.D.C.

Financing with a BDC

A Q&A

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Easy Ice was founded to serve customers who need ice constantly available and want the least hassle and cost. Easy Ice has placed more than 7,000 ice machines at a cost of $25 million in restaurants, bars, hotels and other businesses in 45 states. It maintains the industry's only 24 x 7 x 365 call center and has the largest network of service technicians and backup ice makers in the nation.

Question: In planning a refinancing, why did you do business with Saratoga Investment? Why didn't you go to a bank?

Answer: The capital stack, which involves everything from equity through debt, is complex. You don't go to a bank when you're an earlier stage, high-growth company, or not of a certain size, because banks have regulations that limit what deals they can finance. These limits are typically too restrictive for earlier stage companies.

Examples of these limits are: 1) Senior debt leverage ratios (typically capped at 3x EBITDA); 2) Total debt leverage ratios (4x EBITDA); 3) requirement for debt amortization over 7 years; 4) use of trailing 12 months EBITDA vs. run-rate EBITDA.

Saratoga financed us at a 5.5x EBITDA leverage ratio using run-rate EBITDA (which makes sense given we are a recurring-revenue business) with no amortization. So, the big difference between a bank and Saratoga is Saratoga's a lot more flexible and is able to finance businesses at our stage of development. It comes at a higher interest rate, but we are happy to pay it. Access to capital is way more important to us than the cost of capital at this stage.

Importantly, Saratoga understands we are a recurring-revenue business with an upfront investment in machines. This knowledge allowed them to build a debt instrument that meets our needs and gives them a competitive yield. A commercial bank says you've got to fit our model and it's got to be trailing 12 months. Even if the bankers understand our model, they would have to convince the regulators, and nobody is ever going to do that.

Question: So that explains a BDC?

Answer: They are not regulated as closely, and they can lend at a higher leverage ratio and they can make adjustments for things like trailing 12 months vs. run-rate 12 months. It's not like we had a lot of experience in terms of bank debt. Everything I had raised until this point was as a CEO of an internet security company. That had all been done through venture markets. This was my first foray into the debt market.

There is no manual that says, "Don't waste your time on commercial banks unless you have these kinds of characteristics." I was learning as I went. My first debt was with a distressed-debt/mezzanine lender, but it came with 12 covenants – a lot to keep track of and nine more than Saratoga required. It worked but the brain drain was high. We found Saratoga through informal networking. I did not know about BDCs. It just happened that the first BDC we went to was a good fit for us.

Question: What advice would you have for somebody who is in your position but 5 or 10 years behind where you are now, in other words, somebody just thinking about looking for financing and doesn't have that non-existent funding manual?

Answer: It would be great to have a how-to manual that helps guide a startup management team through the process of acquiring debt. It would talk about the layers in the capital stack, and which lenders make sense to talk to depending on the stage that your business is in.

Absent a how-to manual it is best to network with people who have been through the process. Don't waste your time just calling lenders. It is easy to get meetings but really hard to make them productive. What I have learned is that "no" is a much better answer than "maybe". You will waste a lot of precious time on "maybes".

Question: What was the initial experience like with Saratoga?

Answer: It was great. We liked them a lot. They came up to our facility in Upper Michigan (not an easy task) to do some preliminary due diligence. Once they were comfortable they brought in a financial consulting firm out of Maryland who did a quality-of-earnings assessment, which was a much more rigorous diligence process.

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

Answer: Good question. Saratoga understood our business better. They knew which questions to ask. They were far better prepared and came with the right questions, whereas the commercial bank team had less experience which resulted in a much less efficient process.

Saratoga did it twice as fast and had a far better understanding of our business. It was like describing golf to people and they ask, "What's a par? What's an eagle?" That's kind of what it was with the commercial bank, where with Saratoga you're talking to a golf professional. They understood the game from the get-go.

Question: And how is it beneficial on a daily basis working with Saratoga?

Answer: You always know that they've got your back. You do what you're supposed to do. You make your numbers and these guys will be there for you when it comes time to grow and expand. They can act quickly. With a commercial bank you've got to get 12 different guys to sign off, but Saratoga is fast. They stay in tune with what's going on. It's a very positive experience. Very efficient.

Question: Would you recommend working with a BDC to other business owners?

Answer: Absolutely, especially if their business is in the sweet spot for a BDC. A BDC can be the missing link in your growth plans.

Question: What does a business owner need to be taken seriously by a BDC? The background of that question is that a lot of businesses that approach a BDC have never done an audit, don't have proper documents and they're too small to really have a sophisticated financial rigor.

Answer: It helps to know which BDC you're working with and what their expectations are. I'm sure there are BDCs that are more tuned to very early stage, non-audited companies.

In our case, we were audited annually because we were partially owned by a public company. They required audits. We were a good fit for Saratoga in that regard. In general, you will need audited financials. Likely three years' worth. You're going to need to show predictable growth throughout that time. You're going to need a command of the industry, and a position in that industry that is sustainable.

It is important to understand that the amount of effort it takes a lender to do due diligence can be less with a bigger, later-stage company vs. a small, early-stage company because a big company will have the track record and the audits. Saratoga could easily spend less time lending us $10 million than they will with a smaller company that is less sophisticated that only needs $1 million.

So, the amount you want to borrow, how well you know your business, how well you are positioned in your industry, and how good your documentation is will all make a difference. No docs? Small amount of money? And you're just getting started? You're probably wasting your time.

Question: Because they don't want you to waste their time?

Answer: Exactly. Nor would you want them to waste your time either. Their reaction will be, "It looks like you've got a great business here and I'm excited for you, but it's not a fit; it's not our sweet spot. Our sweet spot is guys that have audited financials and need $6-7 million, or whatever, and have been at it for three years."

Question: Is there anything else that you'd like to tell us?

Answer: BDC's like Saratoga are a great partner for businesses in our stage of development. They have the flexibility to provide capital, given the unique nature of our business, whereas most commercial banks simply can't. This capital comes at a price, but it is a fair price given the risk they are taking. At some point we will be able to pursue lower-cost capital from more commercial banks, but until that time comes, we are delighted to work with Saratoga. Saratoga is a step in the process and a great step, and we love them.

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