SARATOGA
INVESTMENT CORP.

Research Studies and Opinions

Part 3

The Relationship Between a BDC and Portfolio Company

A Conversation with

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Question: What should the relationship between a BDC and portfolio company be?

HS: We are a financial partner and corporate finance expert. We have invested in what they're doing because we believe in their vision and their future. We prefer to communicate regularly with management and understand what they are doing and where they're going. We also like to participate in some of their discussions and decision-making and figure out either how we can help them or how we might bring other partners to the table to assist them. However, I don't want to overstate our involvement. In most cases, we are not a control investor. We're thrilled to help when asked, and offer managerial assistance whenever possible. The nature of our relationship also depends on whether or not the company is sponsored by a private equity firm.

Question: How so?

HS: In a deal sponsored by private equity, a BDC tends to be more of a passive investor and in a non-sponsored deal BDCs tend to be more active. Sponsors are responsible for the operational and finance side of their portfolio companies. They view a BDC as a bank even though we're obviously not, particularly in our role as required by the Investment Company Act. In the sponsored deal, we more often interact with the sponsor than with the portfolio company. Typically we will attend board meetings as an observer. To the extent we have experience in the market or the space the company is in, we might contribute thoughts. Sometimes we're able to make introductions to adjacent potential M&A opportunities or to make introductions to help augment the management team or the board.

Question: With whom do you work in a non-sponsored portfolio company?

HS: It depends. CFOs deliver the compliance reports, so we have regular interaction with them. But often, in smaller companies the CFO function is more like a controller than the strategic function it is in larger companies. We take our cues from the companies themselves and how they are organized. In some cases the CFO might be our primary contact, in other cases the CEO, and in some cases it might be the Chairman of the Board or the President. We work with whoever owns the capital relationship the company has with Saratoga. Through the course of the investment process we spend most of our time with the CEO, the CFO and whoever is in charge of marketing. Those tend to be the people driving the growth of the company and its access to the capital markets. Generally, on the Saratoga end it is our deal leads who interact with our portfolio companies, not I, as they know management well, have done the work on the company and have built strong relationships through the investment process. It is more a question of the way the working relationship evolves than any kind of defined formula.

Question: What happens when a relationship goes bad and becomes toxic?

HS: We haven't seen one of those. In general, our borrowers are either in compliance or not. They're either maintaining their compliance with the credit test we impose on them and have made their interest payments, or they have missed one. A miss can be either be a technical default, which means they just missed a metric but they're still meeting their interest payments, or a payment default, which is the worst. We haven't had a meaningful payment default. That is usually the grounds for a strained relationship.

It often never reaches this point, though, because we receive regular financial information, and tend to work closely with the portfolio companies to resolve issues before they arise. We're able to work together to get through them. That's the key to any good working relationship.

In general when you look at our business we are either the lead lender or sole lender. Alternatively, we can be co-lender with one or two other lenders. In some cases, we take equity in the company. We have invested enough capital that our borrowers are trying to make us happy and keep positive relationships.

If we discover, as part of our due diligence or underwriting process, that we can't work with the management team, that would be a strong reason why we wouldn't do an investment. So we generally don't get surprised after we close a deal.

Question: How would you summarize the BDC-portfolio company relationship?

HS: We are lenders and we're always happy to add as much value as we can. However, management knows the business best. They have made the company into the success we like, and so it is not our place to be driving the business. We are always delighted to help when asked, but it's a fine line that we tread.

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