SARATOGA INVESTMENT CORP.

Research Studies and Opinions

BDCs as investment vehicles

A Q&A

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Question: Even many sophisticated investors don't know much about publicly traded BDCs as investments. What are they?

Answer: Investors may think of a BDC's stock as just equity, but it is really much more than that and provides investors investment opportunities they might not normally have. BDCs function like REITs – real estate investment trusts – but instead of investing in portfolios of properties they invest in small- to middle-market commercial loans that they underwrite directly. Both BDCs and REITs are variable-income distribution mechanisms, with at least 90% flow-through of earnings in the form of dividends. The BDC or REIT assembles and manages the portfolio, a collection of loans to small- and middle-market businesses or a basket of commercial property holdings, to provide consistent returns. And the full portfolio of loans is fully disclosed so the investor can see exactly what they are investing in.

Question: Is a BDC an asset class?

Answer: Yes, and it should be considered by investors to diversify fully their portfolios. Along with an allocation to domestic stocks, international stocks, small cap, large cap, fixed income, treasuries and cash, etc., BDCs provide exposure to returns from smaller, middle-market loans. What the investor gets through that investment is a managed portfolio of diversified loans to smaller businesses that pay a bigger spread than is available elsewhere. The spread is larger because the loans are illiquid, and they are smaller than debt to larger businesses, but the net effect is that the overall risk-adjusted return is much better than a comparable fixed-income investment, with a lot of transparency.

Question: To what can one compare a BDC investment?

Answer: BDC yields compare favorably to high-yield bonds, to bond indices, to hedge funds.

Question: Have BDCs been ignored by sophisticated investors?

Answer: They have. One reason BDCs are overlooked is confusion in the marketplace. In June 2015, the SEC said the Russell stock indices for the 1000, 2000, 3000 had to remove BDCs from their indices because BDCs charge fees, as opposed to being integral companies. BDCs have also been lumped in with Master Limited Partnerships, and MLPs have done badly. Then, there is the fact that certain BDCs have performed badly with write-downs while charging high fees. Finally, mutual funds might not buy a BDC because of the BDC's fee structure. A mutual fund charges a percentage of its assets as fees, but with a BDC's fee added in, the mutual fund's cumulative fee structure might seem too high.

Question: Why do BDCs charge fees?

Answer: BDCs use the fees they charge to do the hard work of sourcing and vetting loans, maintaining diversification and building a good, credit-worthy portfolio. Fees are high only if a BDC doesn't hire enough credit analysts, if it doesn't do the homework and if it doesn't say no to would-be borrowers in order to ramp up loan assets.

Question: Are BDCs good investments for both retail and institutional investors?

Answer: They definitely are, but BDCs face two challenges. The first is that some are thinly traded and an investor might not be able to sell shares in a BDC easily if a quick sale is necessary. Second, the entire BDC market, while having grown impressively, now still only has a total capitalization of $65 billion – too small for large institutions, which need to take large positions and need large, liquid markets. BDCs are best owned by smaller institutions, family offices and other small funds. As the BDC marketplace continues to grow and mature, however, there will come a time when large institutions will buy in.

Question: **What is the risk profile of the BDC against other asset classes?**

Answer: One could do a Sharpe ratio, such as return versus volatility, but the challenge with BDCs is that they are not alike. There are large, medium and small ones, all using different strategies. A more reasonable way to look at BDCs is through indices of performance, although the indices aren't memorable at this time.

Question: Where does Saratoga Investment fit in a BDC index?

Answer: Our performance places us in the top decile of BDCs based on total return for the past one-, three and five-years. We are running the business very well in a difficult macro environment, which tempts those trying to grow rapidly to take huge risks. We're not willing to do that. We're being very careful. We have had no realized losses since we took over the management of the BDC. We have zero loans on non-accrual. And our credit profile is at its strongest level ever. As a result, we're attracting small institutions that appreciate our track record. They like the fact that our management also owns a lot of the stock, one of the most in the industry. Saratoga today is a value investment.

Question: A value investment?

Answer: We're selling at a discount to Net Asset Value (NAV), and we are growing our dividend, one of the only ones in the industry. So the value proposition to invest now is big. But our trading volume is low. Because we don't trade that much, a lot of people are worried that if they buy in, it won't be so easy to get out. We're going to cure that through growth. If we deploy another $100 million in assets, with our operating expenses mainly fixed, all the returns will be incremental and our return on equity is going to grow considerably. We're not at that point because we haven't seen enough opportunities that we like in which to invest. If we had lent an additional $100 million of debt last year just to grow assets, we would be regretting it now because write-downs of 3% to 5% are currently common. We are in a good position now because we have a considerable amount of dry powder. We had redemptions recently that muted our ability to grow assets, but the realized returns were substantial on these redemptions and that was good. Our loans were paid back on good investments, which means we now have that money to put back to work. Several BDCs have maxed their borrowing and investing capacities. We haven't, and we consider that part of our management skill and experience in working in the small- to middle-market a definite advantage.

Question: What else should one consider in determining whether BDCs are a worthwhile investment?

Answer: BDCs are a growing industry. More are being formed regularly. They provide the only way one can invest in a basket of loans to small- to middle-market companies. As such, they should become a normal part of asset diversification in investing. One should welcome well-run BDCs as sources of significant yield that will boost an investment portfolio's overall return.

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