Saratoga Investment Corp

A Growth Oriented BDC with an Attractive Dividend Yield

Introduction:

Saratoga Investment Corp (SAR) is a diversified, business development company and a CLO manager that has experienced strong portfolio and dividend growth over the last several years. This article provides a background on the company, analyzes its past performance and finally concludes with our opinion on whether investors should consider making an investment in the stock.

Key Takeaways:

- Diversified, Closed End Business Development Company (BDC) and CLO Manager
- Consistent history of growing assets and dividend
- Focus on credit quality and not just on asset growth
- Attractive dividend yield for a dividend grower with earnings cushion

Overview:

Saratoga Investment Corp. (SAR) is a business development company and CLO manager incorporated in March 2007. It primarily invests in senior, unitranche leveraged loans and mezzanine debt of private U.S. middle-market companies having EBITDA between $2mn and $50mn. As on February 28, 2019, the company had a portfolio of $470.7 million invested in 31 companies consisting of 50.5% of first lien term loans, 31.3% of second lien term loans, 0.5% of unsecured term loans, 8.8% of structured finance securities and 8.9% of equity interests. Business Services industry accounted for 62.8% of the overall portfolio, while Healthcare industry was at 14.3%.

SAR's subsidiary is licensed by the Small Business Administration (SBA) under its Small Business Investment Company (SBIC) program to lend money to lower middle market businesses. SBA under the public-private partnership plan provides attractive funding to SBIC licensed companies such as SAR's subsidiary to support small businesses in the US.

The company also acts as a manager of a collateralized loan obligation (CLO) vehicle and receive income as an equity tranche holder in the CLO. The weighted average yield of the CLO investment was around 16% as of Q1 FY20.

What Is A Business Development Company (BDC)?

A business development company is a closed end investment company that invests in privately owned, middle market companies, providing them capital to grow or recapitalize.

What Are the Advantages of Investing via a BDC?

- High dividend yield as BDCs are required to distribute 90% of their profits to shareholders as per the governing law.

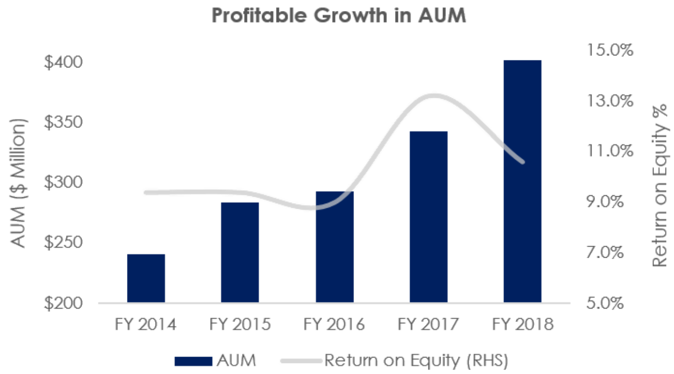
- Being a regulated investment company, a BDC is not required to pay corporate income tax on profits.
- They offer diversification as the portfolio consists of companies belonging to varied industries.
- Experienced Investment management teams
- Fair amount of liquidity and transparency as BDCs are traded on public exchanges, unlike venture capital funds which are privately placed.
- As they are traded on stock exchanges, period of volatility can lead to shares of BDCs trading at attractive discounts to NAVs.

Key Portfolio Investments

Company	Business Description	Percentage of Net Assets
FMG Suite Holdings LLC	FMG Suite is a SaaS fintech company and provides marketing platforms to financial advisors via websites, multimedia content and other digital marketing & communication tools.	12.3%
Easy Ice LLC	Easy Ice LLC provides ice machine solutions in the form of machines, bins, and dispensers. It also provides machine maintenance, cleaning, and breakdown solutions.	11.8%
Key Software Inc	Key Software Inc provides administration oriented software solutions to healthcare industry.	11.5%
Censis Technologies Inc	Censis Technologies Inc offers software solutions to the surgical industry in the form of surgical inventory management software, instrument level tracking & other web based software solutions for surgical asset management.	10.7%
Apex Holdings Software Technologies LLC	Apex Software Technologies LLC offers HCM (Human Capital Management) solutions to businesses.	9.7%

Stellar operational performance and a quality portfolio

SAR has seen its assets under management increase an astounding 67% over the last four years to just over $400 million in 2018. While such a rise in assets can sometimes lead to dilution in quality and profitability of investments, SAR has in fact improved its profitability as evidenced by improvement in its return on equity.



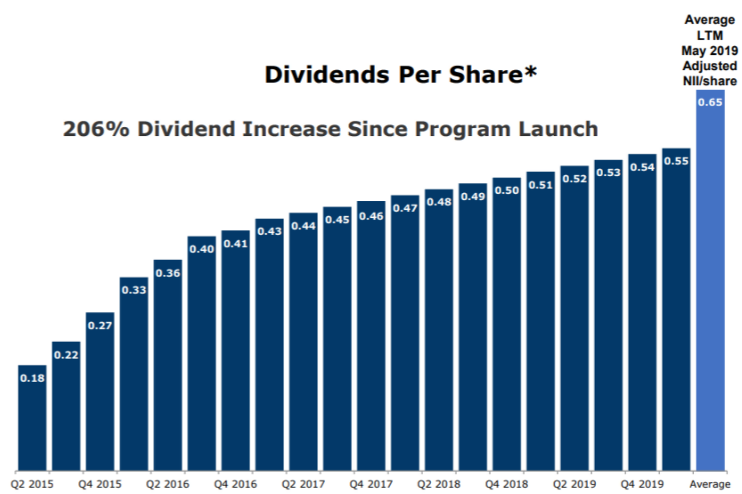
Source: Saratoga Investment Corp, Blue Harbinger Research

In fact, according to the Q1 FY20 earnings report, only 2.4 million or 0.6% of the company's BDC portfolio features in the "red" or default category as per SAR's credit and monitoring rating system (CMR).

"We continue to progress on our long-term goal to expand our asset base without sacrificing credit quality, while benefiting from scale."

- Christian Oberbeck, CEO on Q1 FY20 call

As a result of growth in asset base as well as strong investment income trends, the company's earnings base has expanded considerably, resulting in a growing dividend stream. In fact, dividend per share has grown from $0.33 per share in Q1 FY16 to $0.55 per share in Q1 FY20. Despite the rise in dividends, the company continues to maintain a strong dividend coverage.



Source: Saratoga Investment Corp

Strong coverage coupled with dry powder lead to our confidence in the safety of future dividends

The company's dividend coverage has averaged an industry leading 118% over the last 12 quarters. The strong dividend cushion exists despite the company growing its dividend from $0.44 per share in Q2 2017 to $0.55 per share in Q1 2020, a 25% increase. As of Q1 2020, the company has close to $107 million in funding available to invest in high yielding assets. The additional funding implies that the company can grow its AUM further by 26%. Assuming the company does not raise equity funds in the near future, a 26% increase in the company's AUM will likely result in a commensurate increase in its investment income and dividends, further providing a catalyst for its shares.

"We, as I mentioned before, feel really good about our pipeline and our ability to deploy the capital over time. We mentioned that we've closed, you know, just in July on a couple of new deals and feel very good about our prospects for deploying that capital. One of the nice things about that is that it's just pure math as we deploy that capital and its cash, we're not borrowing so it – the earnings from the asset deployment fall straight to the bottom line. So, we enjoy a pretty healthy spread between our NII and what our dividend rate is. As we deploy that cash capital that spread, we would expect to grow."

- *Michael Grisius, President and CIO* on Q1 FY20 call

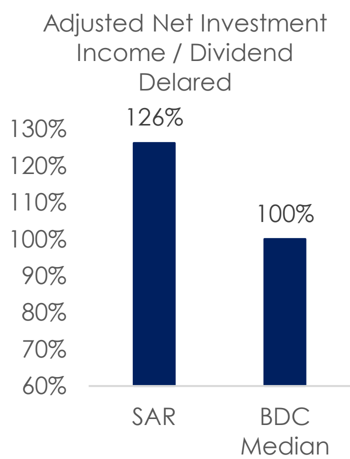
(As of May 31, 2019)		Total Borrowing Capacity	Outstanding	Available Liquidity	Remaining Maturity Period	Fixed / Floating Rate
Secured Revolving Credit Facility		$45.0 million	$0.0 million	$45.0 million	6 Years	Floating
SBA Debentures		$150.0 million	$150.0 million	$0.0 million	4-10 years	Fixed
Publicly-Traded Notes (at fair value)	SAB	$76.8 million	$76.8 million	$0.0 million	5 Years	Fixed
	SAF	$60.7 million	$60.7 million	$0.0 million	6 Years	Fixed
Cash and Cash Equivalents		$62.1 million	$0.0 million	$62.1 million	-	-
Total Available Liquidity (at quarter-end): $ 107.1 million						

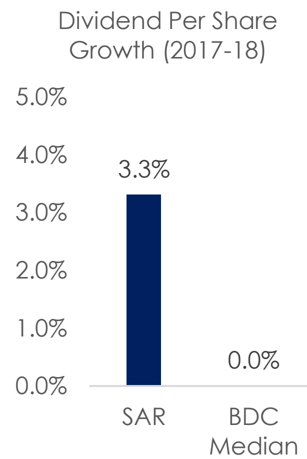
Source: Saratoga Investment Corp

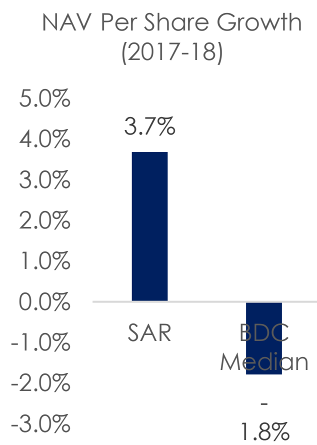
Additionally, the company holds a Small Business Investment Company (SBIC) license from the Small Business Administration (SBA) which provides funding to SBICs at attractive rates. SAR received approval in relation to its second SBIC license on August 21st, 2019. The company will now have access to $175 million additional debt funding at attractive rates to invest in high yielding loans of small businesses, further boosting investment income and dividend potential.

Attractive dividend yield despite industry beating metrics

As evident in the charts below, SAR significantly outperforms the industry in terms of returns to shareholders. Over the last two years, it has grown dividend per share by 3.3% as compared to flat dividends for the industry. The company's NAV per share has grown 3.7% over the same period as opposed to the industry experiencing a decline of 1.8%. Finally, it achieved a dividend coverage of 126% in 2018 vs the industry barely covering its dividend from internal earnings.

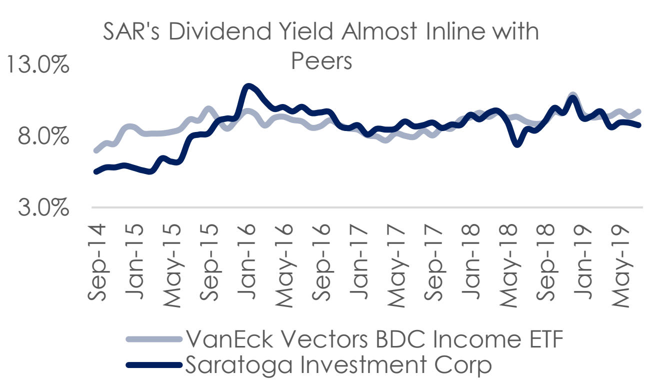


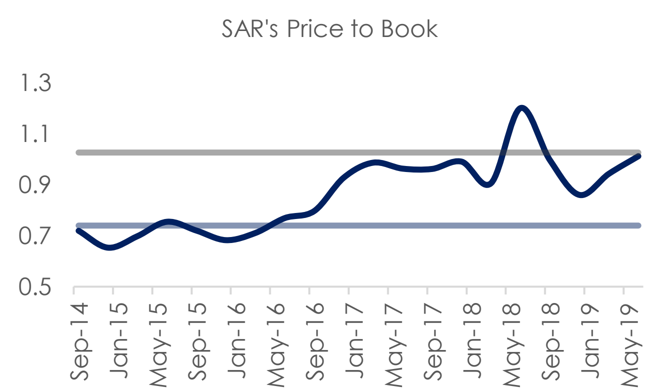




Source: Saratoga Investment Corp, Individual Company Reports, Yahoo Finance

Despite the company's far superior dividend coverage and growth metrics, SAR yields an attractive 8.7%, just 100 bps lower than industry mean of 9.7%. While the company's price to book is closer to the higher end of its historical band, given its turnaround in execution and portfolio performance, the increase in valuation is understandable.





Source: Saratoga Investment Corp, Yahoo Finance

Risks

Lower interest rates could hurt investment income

Lower interest rates in the economy can have an overall negative impact on the company's earnings power. Majority of the company's portfolio investments (84%) have yields tied to market interest rates such as LIBOR. At the same time, a large portion of the company's liabilities are fixed in nature and as such the company's interest payments on its debt don't see a commensurate decline. As a result, a rapid decline in interest rates can lead to compression in the company's net interest margin. It is important to note however that the company negotiates interest rate floors on most of its floating rate investments in order to minimize any earnings erosion from interest rate declines.

Macroeconomic Headwinds

Over the last 12 months, global economic conditions have deteriorated as the trade war has impacted business sentiment and capital expenditure plans. Given the company's focus on small, middle market businesses, its portfolio companies maybe more impacted by macro headwinds. Having said that, the company's focus on first and second lien debt investments and a rigorous investment due diligence process provides us comfort in the company's ability to navigate through a difficult business climate.

Conclusion:

Saratoga Investment Corp (SAR) is smaller sized BDC with an excellent track record of asset base, income and dividend growth post reorganization in 2010. Given the dry powder available to company as well as potential for additional funding from SBIC program, SAR is well positioned to grow its dividend and earnings while continuing to maintain a strong dividend coverage.