2021 AICA Business Development Company (BDC) Fall Forum Day 2 Panel #2; "Unique Use of the BDC Structure"

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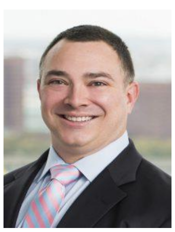
Kenneth Burdon, Counsel, Investment Management with Skadden, Arps, Slate, Meagher & Flom LLP moderates the second panel of day 2 of the 2021 AICA Business Development Company (BDC) Fall Forum; "Unique Use of the BDC Structure". Read the transcript below to hear the discussion among Mr. Burdon and panelists Chris Oberbeck from Saratoga and Michael Sarner from Capital Southwest.


Kenneth Burdon


Chris Oberbeck


Michael Sarner

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Kenneth Burdon: All right, welcome everyone. I'd like to welcome everyone to the panel, which is the "Unique Use of the BDC Structure". I think we've got a great panel to offer today with robust experience in unique applications of the BDC structure. So to kick it off I'd like to invite each of our panelists here to provide a brief introduction to the audience. I'll start with Chris.

Chris Oberbeck: Hello everybody, and thank you for coming today. My name is Chris Oberbeck, chairman and chief executive officer of Saratoga Investment Corp. We are a New York Stock Exchange traded business-development company, we have a market cap of around $300 and every day it bounces a little over $300 million. And we have trading range, actually pretty wide this year just looking at it, sort like $18 to $30, so there's lots of entry points in the past year. I think we have pretty good analyst coverage. We have coverage from B. Riley, Compass Point, [inaudible] Group, Oppenheimer, Ladenburg Thalmann, Maxim Group, and Raymond James. And we've been very happy with that coverage.

In terms of some distinctive features of Saratoga, I think given our size and the market that we focus on, smaller middle market, we're often able to get equity stakes in addition to our loans. Sometimes we're a first lien, sometimes we're a first out, last out, mezzanines, strip, all those kind of things, but we also get equity participations. And over time that has allowed us to grow our net asset value. And I think if you look at a lot of BDCs, most of them go public at $15 a share. And sort or shorthand for what's happened is where's the stock price relative to $15 a share?

Our price is up in the high 20s, our NAV is around $29 a share. So we've accreted quite a bit of value over time. And principally that accretion I think is number one, is from lack of credit losses, which we'll get into a little later. And then number two is gains on equity participation. So I think that's something about that a smaller BDC can do. Usually when you're in the larger market there's no equity opportunity. So I think that's one of the distinguishing features of a smaller middle market company and I think Michael's got a similar opportunity set as we do, so it's nice to be on a panel with a fellow equity investor in a BDC.

We've had a very good record in terms of our return on equity. It's been double digits consistently for five plus years, and mid to high double digits in the last couple of years. We've had a couple of very good equity performances which has helped us with that. I think probably the most distinguishing feature of ours is our management's ownership. Our management ownership is 15%, and 15% is pretty sizeable. I think it's the largest insider ownership in the industry, and so as Warren Buffet says, we eat our own cooking. And we're very focused on the shareholder returns both in the short term but also very much so in the long run. I'll stop there and we can let Michael carry on.

Michael Sarner: Thanks Chris. Yeah, I'm also excited to be here, thank you very much for the opportunity. So I'm the CFO at Capital Southwest, we're based here in Dallas, Texas. I joined Capital Southwest in 2015 with my partner and CEO of the company Bowen Diehl, to re-launch a very old BDC which I'll get into detail later. This company was founded in 1961, so it's one of the oldest companies, certainly the oldest BDC. Capital Southwest relaunched itself in 2015 as a middle market lender.

From my own career I've spent pretty much my entire adult career in the BDC space. Prior to joining Capital Southwest I worked for American Capital from its inception, post IPO, until right before it was sold to Ares Capital. So I have had a pretty long run in the BDC space having worked for one of the initial BDCs, with ACAS being one of the first of three BDCs that existed in the early 2000s. It was a very different market back then. They were all internally managed BDCs. The rush of external managers didn't show up till much later.

So when I joined Capital Southwest, I kind of viewed myself as a grandfather in the space joining a smaller BDC in its nascent stage. I had been through a lot in terms of change in the BDC space over the last 20 plus years working in it. So clearly it was very interesting for me to get the opportunity to start a BDC from scratch after having spent 15 plus years prior to this adventure seeing when things go well and things don't go too well in the BDC space.

Kenneth Burdon: All right, great. Thank you, Chris and Michael. And for the audience, I'm Ken Burden, I'm a counsel at Skadden Arps and I'll be moderating today here. I'd like to remind everybody that questions can be submitted through the Q&A function on the right of your screen. We really want this forum to be interactive and please don't hesitate to ask any questions and participate in the discussion. We've also formally allocated 10 minutes at the end of our 45 minute timeslot here to address any questions, so please keep the questions coming.

So with that, thank you for the great introductions to each of your firms. I know, Chris, there was kind of a bit of additional history in how your firm got to where it is and some takeover and repackaging situations. Do you want to talk about that as history for where you got to where you are now?

Chris Oberbeck: Sure. Our history at Saratoga, we were originally part of Dillon Reed, we're the corporate buyout group at Dillion Reed when we sold Dillon Reed to Swiss Bank and then merged with UBS. I think we're the last Glass-Steagall forced investiture you know because there were banks who couldn't own private equity firms, so we spun out as an independent private equity firm in 1998. About 10 years later we got very interested in looking at the credit side of life and that was a pretty pregnant moment in December of 2008 and 2009 there was a lot of carnage out there in debt markets, quite a crisis.

And we came across this entity, it was part of Greenwich Street Partners at the time, and it was publicly traded BDC but it had a lender that was out of formula during this period of time. I think as those of us who remember, being a lender to a lender at that moment was probably one of the worst things you could be from a point of view of bank regulation, etcetera. And so the senior secured lender to the entity was forcing a liquidation. They had an investment banker, they went out to everybody and people were bidding cents on the dollar on the assets and cents on the dollar on the senior loan.

We looked at it, and again we looked at it from a private equity mindset. We were like, wait a second, why is this thing being liquidated? This thing needs to be recapitalized. And so we came up with recapitalization plan where we put money into it. At the time nobody was going to lend money to a lender, but there was like one entity in the whole world that was Madison Capital. At the time most lenders were sourcing their money from wholesale sources and those had all dried up, commercial paper, etcetera, it's not working. But New York Life, the parent of Madison, people that are still paying their life insurance premiums they actually had a lot of money and they knew the space and we'd had a long-term relationship with both the parent and Madison. And so we teamed up with them, we put together a rescue package. We put together an equity amount and then a debt amount, and we took out the senior lender, had a little capital to grow on, and then we took over the management of the company.

It was kind of an innovative deal we thought at the time, and we had to write the whole thing up and put it in a proxy. And then when we put in the proxy, everybody saw what we were doing. The board, I think at least twice a week, three, four, five times a week they would get people trying to overbid us for what we did, and we had to hang in there. Thanks to the investment Company Act and those little nuances in the Investment Company Act, no one entity can own more than 3%, no fund can own more than 3%. A lot of people thought, “Oh, we’re going to do the same thing.” It’s like, you need 15 funds to do what they did or something like that.

And so we were able to skate through all that and our deal closed in the summer, in July of 2010. So that’s officially when we took over management. We were fortunate that the world got better also when we did it. We had a bunch of legacy things we had to work out of the portfolio and then we built a team from scratch, started out as Saratoga. It was sort of like “Saratoga, who?” So we had to identify who we were and set a course for ourselves for what kind of a BDC we were going to be. In the beginning we were sort of catch as catch can, asking to participate in peoples’ deals and things like that. But as time went by we developed momentum, we were able to raise capital, baby bonds and things like that, and we reinvested a lot of our own equity in the company and we were able to generate a bunch of different themes that then allowed us to become lead underwriters ourselves and took us to where we are today.

I think when we did the recapitalization our NAV was $50 million and today it’s $330 million. So we’ve grown our NAV tremendously since that time, our assets have grown, so it’s been kind of a good run. I think our team, we were able to build a really strong team, which is I think is really what it’s all about. We have a very good team, all the way from our investment professionals to our operations staff. Being a BDC we’re highly regulated, we have SBIC subsidiary, we have a CLO. Our CFO will tell you, I think he does between six and 10 audits a year. It’s a big job. I think Michael probably can elaborate if you want to hear about that. I’m not sure anyone wants to hear about that, but it’s a fact of life.

Anyways, that’s kind of what brought us to where we are today. We’ve established ourselves as a solutions-oriented capital provider. That’s what we think we are, that’s what we present ourselves. So we’re not senior lenders, we’re not equity, we’re not anything. We’re like, “What do you need to get your deal done?” And we want to be your partner to figure out how to get it done. Sometimes we’re 100% senior, sometimes we’re 60% of the equity and a bunch of the senior, and everything in between. But we want to be, how do we help sponsors and unfunded sponsors get their transactions completed and add value?

Kenneth Burdon: Thanks, that’s wonderful. Michael, I think you have a pretty good story to tell too with a history dating back to the early 60s. Maybe it would help to tell a little bit of that story and how you got to where you are now. In particular, what’s interesting and unique? How you use equity in addition to the debt positions and how you think about that as well.

Michael Sarner: Sure, sure. So I was saying earlier this company went public in 1961 it raised $15 million in equity capital as an SBIC. Moving forward to 2012, the company never raised another dollar of equity or debt for that matter. And it grew that $15 million in capital by investing in control equity positions to $1.2 billion. So very successful investors. The problem was of that $1.2 billion, half of it was in two portfolio companies that appreciated. So a problem for a BDC. In the early years before the BDC industry took shape, that wasn’t a problem. But when all the other BDCs came to pass, now you had a non-dividend paying stock living in a dividend yield world. Additionally, due to BDC diversification requirements, it was locked in its own structure in terms of additional control investing, and it traded somewhere in the 35-45% discount range.

So that discount persisted until 2012 when one of our largest investors, but back when was an angry investor, was basically an activist, sent a letter to the board basically telling them they needed either to fix the company or sell it. So the board got together, put together a management team of myself and Bowen, put together a new board to try to figure out what to do. And what to do was to spin out those large equity holdings into essentially a diversified holding company, and then the other half of the portfolio which essentially was pubic equities, to sell those for cash. We formally launched the new BDC in 2015 with $285 million in cash from the sale of those public equity positions.

Today, we have 25 employees, and only three employees here today were part of CSWC in 2015. So it was a complete reboot of the infrastructure. At the moment that we did the spinoff we unlocked $300 million in value for shareholders. We started to gain a little bit of credibility but we had to go out to our existing shareholders and explain what the new strategy was going to be. Which was going to be a traditional middle market lender, which is what we are today. Our investment strategy is $3 million to $15 million in EBITDA companies. We invest basically 90% of our assets in first lien assets. We opportunistically invest, like Chris in his business plan, equity co-investments alongside our debt. Our typical makeup might look like a $15 million first lien asset with a million or a million and a half dollars in equity alongside it.

From where we started in 2015, we set out to invest the $285 million in portfolio companies and get to the place where we could have a credit facility and start levering up the balance sheet. So we spent a lot of time building that infrastructure, bringing in lenders. I'll can tell you one of our strengths on the capitalizations side, having created flexible sources of capital. We first set out to put in a line of credit, which we grew from $75 million with three investors to eventually we have a $350 million credit facility with 10 lenders. We did a baby bond once we grew up a little bit, then we moved up in the world to be able to do institutional bonds. And then more recently we've put the SBA in place, so we have our first SBIC license.

When we were looking at the capital markets, and I think I've learned this probably over the last 20 years, the markets shut down at points in time, so you need to have flexibility in your capital structure. The first market to always shut down is the equity markets. As soon as there's a hiccup in the market, any ability to tap the equity markets usually goes away, followed by the bond markets. The more reliable markets is the bank market, and seems like the most reliable market is going to be the SBIC, that's a commitment you get and it's available to invest. I think putting that structure alongside of how Bowen and I invest being as investment committee members, which is we lock hands on the assets and the liabilities. So we make certain that the capital structure is set in a way that it maximizes the most efficient use of the assets.

So we feel like our story is pretty good in terms of we took this company with a pesky 40% discount in 2015 and today, the company trades at a 65% premium to book. We do think a lot has to do with the things I just mentioned, but also we believe it's the transparency we provide to our shareholders. We went in front of our investors and said, "This is what we plan to be when we grow up. This is how we're going to do it." We laid out that strategy and we've executed upon it. We take a very transparent approach to try to provide as much detail as possible and communicate our plans as we move forward.

Kenneth Burdon: Yeah, Michael that's a great story. You started talking about capital structure and leverage and how that can be beneficial. Chris, do you want to chat a little bit about how Saratoga has approached that with its CLO, which has been a successful strategy? And how think about that and how that plays into what you're trying to do in terms of returns?

Chris Oberbeck: Sure. Before I do that, just quick. Michael, so what were the two stocks that appreciated so well? What companies were those?

Michael Sarner: I'm drawing a blank right now. I'll get back to you.

Chris Oberbeck: Okay, so anyways. That's quite amazing. Each of us have an amazing story, I'd be very curious to hear that one, those two stories. Okay, so I think one of the things Michael was talking about, our stories have got some similarities, our two companies. And one of the themes that was coming out of Michael's talk there, and I think it's one of the aspects of a BDC that is quite attractive, which is a BDC has got a lot of things it can do, it's got a lot of sources of capital. I think as Michael said, SBIC, so we're on our second SBIC fund. So that's a subsidiary and then you can put equity in that subsidiary. Given the BDC structure, in effect you're equity that's going into that BDC which is levered 2:1, your equity can be levered 2:1 depending on how you structure yourself.

So there's a lot of leverage that can show up in that place, but the SBIC funds, they're 10-year covenant-free, low interest rate facilities, so it's incredibly attractive capital. You have some constraints about the size of the company that you invest in, but we like those sized companies and we're used to investing in those companies. It takes a lot of underwriting heft because they're not as packaged up. They don't have as broad, as diversified as some of the larger companies, but again there can be some tremendous returns and some really tremendous companies. And importantly some really tremendous people involved with them that you can make long-term relationships with that lead to more and more in the future.

Ken, you were asking about the CLO. When we got involved with Saratoga, they'd had the CLO. The history of our CLO being part of the BDC goes to when it was going to its initial public offering in 2008. And in 2008 they were going to go public, and at the time the markets were pretty robust but they were only robust for a little while. Michael, as you said, they can get pretty finicky. And right as they got finicky, the market wasn't so receptive to giving a blind pool to somebody and they wanted to see more assets. And so the parent company managed a number of CLOs and so they contributed a whole CLO and a manager into the BDC as part of the IPO process. That all got grandfathered in from the get-go through the SEC and all that type of thing, and so 100% equity interest in a CLO was part of the original package that went public.

When we came in to do our rescue financing, the CLO it had gone through a couple of essentially defaults or triggers that turned off the equity flows, the dividend flows to the equity temporarily. I think it was just two or three quarters worth. But then it recovered from there. And so since that time, a CLO, I don't know how much everyone knows about CLOs, but CLOs are very interesting investment vehicles. They're very particular.

I think structured financial vehicles got blamed for the whole crash of 2008, but the truth is nobody in any of the CLO equity ever lost any money if they'd have held on. If you had sold, you got killed. But if you held on all the CLOs worked out. And curiously the most successful CLOs were the ones that were issued in 2007, if you can believe it. And part of the reason for that is that there were really no defaults. The default fears never showed up, and a lot of the companies got recapitalized and restructured over time, and the cost of liabilities was very low.

But one of the differences between a CLO and a BDC, so our BDC we've got close to $700 million in assets in our BDC and we've got about $650 million in our CLO which is a subsidiary. So combined we're over a billion but we position that with about $50 million of equity, so there's a lot of embedded equity leverage in our CLO. But our investment strategy is pretty much, it's not dissimilar to a lot of other CLOs but it's a broadly syndicated loan. So you're buying rated Moody's and S&P rated paper, B handle ratings, B zone. But highly diversified. So generally speaking a half to 1% positions in a very diversified portfolio of leveraged loans.

We have a very good record in our CLO. And part of that being a smaller CLO, our CLO itself is actually kind of large for a CLO, but in terms of our total complex it's not that large. And so we're able to focus, much like we do in the BDC, we kind of focus on a little of the smaller, less liquid end of the broadly syndicated market and we feel that there's outsized returns available there. Little more due diligence, a little more research to get to the bottom of all that. That's worked out quite well for us.

We've actually reset our CLO, actually I forget exactly, like five times now or something. Because the CLO has an investment period of sometimes two years, sometimes three years, sometimes five years. Then when it expires, usually what happens is the CLO gets liquidated and then a new CLO is formed with different equity investors. Because we own 100% of the equity, we just have refinanced in effect our portfolio and grown it over time, and so now we have what we have.

We find that there's some intrinsic value to the CLO and the returns we're getting, which is probably one of our highest returning allocations of assets is to the CLO. But we also have some crossover, and from time to time there are some very interesting desk bot securities that actually fit the criteria at the BDC. So sometimes we have excess cash, sometimes we actually find in and of themselves interesting pieces of larger syndicated instruments that fit our BDC. So it fits strategically, it gives us a very large breadth of exposure to both the credit markets and the liability markets. Because we're borrowing at AAA rates, AA, all the way down, so we have a whole series of liabilities that keeps us in touch with insurance companies and all kinds of entities that provide that kind of capital, that also have some crossover with other aspects of BDC capital.

Kenneth Burdon: Yeah, absolutely. Going on to talk more about where you're focusing on deploying your capital, Michael, how is Capital Southwest than many of the other BDCs that we see? BDC are all middle market lenders. You all focus more on the lower middle market. In your view how is that differentiating your product as unique? And how can that fit into somebody's portfolio instead of looking at somebody who's more focused 98% into upper middle market, easy floating rate loan credits?

Michael Sarner: I start off by saying BDCs are dividend vehicles, and so statutorily we need to distribute all of our earnings. Starting right there, people looking for fixed income, it's where you would go. Now in terms of the lower middle market versus the other markets, what we enjoy in the lower middle market is these are directly led proprietary deals, so you're giving a value add to public shareholders looking to invest in private companies. And in the negotiations with these companies we're able to get a full set of covenants, which you don't otherwise see in the upper middle market. You have fixed charge coverage, you have leverage coverage, you have amortization and cashflow sweeps that are negotiated.

As part of the due diligence process, the amount of work that's done reviewing a lower middle market company is much more substantial than an upper middle market, you have much more access to deep dive of their financials. You have access to management for interviews and you have a sponsor that's working alongside of you. Even potentially another lender next to you. So those all I think provide the ability for investors to have more confidence in the level of diligence that's being done.

The gestation period for a lower middle market deal is 90, maybe up to 120 days from the time the deal shows up on our screen to when we close it. Our deal process is a one pager that comes in front of our investment committee to see if we have interest. It goes through to have a deep dive with the deal team to determine whether they want to put in an indication of interest to sponsors. Then a diligence process that ends in an 80-page memo that goes in front of the investment committee for review and eventually confirmation of the investment. So it's a lot of work that goes into these assets.

Again we also have the ability to invest equity, as we've discussed all along, I think Chris noted it. For us that's a way for us to mitigate losses on debt. It's a way to have upside to NAV. We have utilized gains in the past for significant distributions to shareholders. We've had several gains. We had two sizeable gains. We had one company that we exited in 2018 after it was previously on non-accrual. We eventually resuscitated the company from an $8 million cost basis written to zero, eventually it was sold for an $18 million gain, then we were able to pay that out as a special dividend. We also had a $5 million equity investment that we made, that proceeded Bowen and I, but when we took over it was worth $20 million. When we eventually sold it in 2019 it was worth $50 million. And that actually provided us a nice bedding for a supplemental dividend program that we paid to shareholders over time.

Also oftentimes we get board observation rights in the lower middle market, so we're getting a real time look at some of these portfolio companies. And we compare that with the large syndicated deals where you're more of a stuffie. So you're sort of along for the ride when things go wrong. I think Chris noted it, and we see this oftentimes, where if something goes sideways with a lower middle market investment, we are going to be at the table as first lien lenders. We are usually the only lender or one of a few lenders that are able to actually control the destiny of where the credit goes.

In the draconian scenario where the sponsor has to walk away and toss the keys to us, we then become the equity holder and we're able to provide an uplift to value in the form of appreication. Essentially whatever unrealized appreciation we see on the debt, we were looking to make that up in terms of equity appreciation going forward. I think those are the strengths of the lower middle market versus the upper middle market.

Kenneth Burdon: And that's a great explanation of what you all are doing, Michael. I'm going to throw out a couple of questions that have come in because they're very timely here. So I'm going to combine two here. First is, how do you decide what your loan requirements are or what standard you're focused on? Then flowing from that, while successes are great, how do you deal with bad investment decisions and the steps you take to navigate the solution? Michael, I think you were already starting to talk about that a bit there. Chris, how do you think about those issues?

Chris Oberbeck: We'll start with the first part which is how do we come up with our debt requirements? Our investment process and considerations, I think obviously that's at the heart of everything. In our business, if you don't get the credit right you're not going to be around for very long. And then focusing on the lower middle market, picking up on some of Michael's observations. The lower middle market, I think you can get away with, like in our CLO-- I'm not saying get away with, but our CLO is broadly syndicated loans, they're rated by Moody's and S&P, they're big companies.

Occasionally they get into trouble, it's like a 1-2% default rate kind of thing, which you can sort of take in stride. Part of the reason is your attachment points are like four points down, four multiples down or three multiples down. It's secured, you're the most senior. You don't get great covenants anymore. But in a way actually paradoxically not having good covenants, what it's done is it's destroyed the vulture business because they can't go buy into defaulted companies and force them to do things. Scare everyone away and reap their value. It allows companies the flexibility and the time to recover and handle a big hit and so something better.

So let's contrast that world with the smaller middle market world. In the smaller middle market world, you've got to underwrite the entire company. So even if you're lending four or five times, some company's got $3 million of EBITDA, that can go to zero in a hurry. And so all of a sudden, what's your multiple? You've got to underwrite the entire company kind of like an equity investor. And so I think this mindset of merchant banking, private equity mindset is really important when you're dealing with these companies. I think that's what makes us, and it sounds like Michael if I were an entrepreneur I'd be very interested in you guys, the equity mentality I think is what's really important for the smaller middle market companies because they're all trying to get somewhere.

Most of the companies we invest in are growing or they want to grow, they have something. Either they're growing through acquisition or organically or something, and a lot of times we get cycled out because they get sold. We don't really get refinanced out of that many of our portfolio companies. We usually are out because they're sold. And they're sold generally on the up, they're up from where they went. And so a lot of times we're the first institutional capital in some of these smaller companies, helping them making that leap from small company to institutionally structured and financed company, and then into their ramp.

So we're looking for companies that are on the move. We're not looking at distressed necessarily. I suppose if the world got distressed, we'd start looking at distressed. But that's not what we're looking at, we're looking for growth. We're looking for highly defensible market positions. We have a lot of our portfolio in software as a service companies. These are like mission critical, high retention, the customers don't leave, they actually upsize so that you're net retention's actually higher than 100%. So we wind up with some very good solidity in the revenue sources. And then on the earnings sources, margins and things like that, you want companies that are really into commodity type businesses. They've got defendable margins.

So a lot of these criteria are very much the private equity criteria. And I think that if you can align yourself with the equity appreciation as you're going in to do your credit work, that's going to help a lot. And then especially if you take an equity position on top of it. So I guess the overarching thing I would say is that we really underwrite the whole company. And there have been instances where we said, "Okay well, we'll do the senior credit and we won't do the equity." That's pretty rare but we've done that. Then other times where we'd love to do the equity and there's none available, so we get what we can get. And other times we've done a lot of the equity. So we work a lot with unfunded sponsors.

We really like that business because you're dealing with the entrepreneur, entrepreneur-manager type, and generally speaking they need a lot more support than maybe a sponsor. The sponsor's deals are quite well packaged. Obviously the sponsors get paid a lot and they do a lot, and so when they have a deal it's really buttoned down. Whereas sometimes the unfunded sponsor, it would be buttoned down if there wasn't just one guy working on it. They've got a lot of wood to chop to get one of those things over the line.

And so we can come in and be a partner early, help them solidify their letter intent, help them organize themselves and get going. And so that's another thing we look for, obviously when you underwrite the whole company you underwrite the management team. So a lot of times in larger credits you're not really as focused on management because you're focused on the business. Is this business going to stay in business? But in a small company you've got to have the management and the business. And so those are kind of the big picture aspects.

And then our investment memos are like 35 pages, they cut, slice, they've got projections, downside, all that. There's a lot of work that goes into the credit decision from the bottoms up. Sort of from the top down, that's that perspective. I think just very quickly, you said what do you do when something gets in trouble? I can tell you theoretically, we've been blessed not to have one of our major investments get into trouble for the whole time we've been there. We do have one sore spot, but it was Michael, I think would you say when you're a stuffie?

We were a participant in a larger mezzanine tranche and there was a lead that didn't lead as well as we should have. We couldn't really lead it from where we were, and we didn't. We wound up just getting drifted along into a very bad place. We don't really like that. That's not what we like to do. We like to be, as Michael said, if something happens we want to be at the table. We're solution oriented, we've got more capital. In the Covid downturn we lent more money to almost all our companies. We want to support them, we want to be there in times of trouble, but we need to understand it.

Michael said it. Like he said, we had board observation rights a lot on our companies. The closer we are to the company, we believe the more value we can add when they want to do something offensively like they have to do an acquisition quickly or invest in something quickly. Or if they have a problem. One of our companies, they called us up, they said, "We've got payroll on Friday," I think it was Wednesday. "We've got payroll on Friday and we just got defrauded of $2 million." We're like, "Okay." So we sort of did a little homework real quick and wired them the payroll. That's the kind of closeness that we try have with our companies.

Now we don't get it all the time, but that's what we prefer. And I think that kind of closeness to the company, because the last thing you want to do is hear from a company when they've got a very well matured problem. When the problem's emerging, there's many more chances to help solve it or mitigate it. But once it's done they call up, they go, "Oh, this happened," as opposed to, "This is happening." That's a big difference. And again, that comes to being close to the company, and then being an equity investor in the company and have board observation rights or being very close to them. Those are very important aspects when you're lending to the smaller middle market.

Kenneth Burdon: That's wonderful insight, Chris. Michael, did you want to expand upon a little bit more of your philosophy there in terms what your loan requirements are and what you think about in terms of preparing for something to potentially go bad or if it goes bad? And then from there, maybe how are you positioning yourself for the future in terms of the economic environment you see now, the potential rise of inflation? How is that playing into your thought process.

Michael Sarner: First of all I will say Chris' synopsis is very similar to our approach. Every time we do a loan, when we're looking at a new company, we're saying to self, "Are we prepared to own this?" We may be putting in first lien senior but that's sort of the barometer in which we're measuring all of these investments. And similar to what Chris said, 75% of the cases we want equity, there's 10% of the time where we don't see the growth story. And we'll say, "You know what, we think this is a great sleep at night credit but don't want to invest equity alongside."

Because look, at the end of the day, we are managing to maintain 90% of our investment portfolio in yielding assets to make certain that our dividend is growing. Where we don't see the story, we won't invest equity. But of the 75%, probably only about half the time we actually get a check from the sponsor. A lot of times these are larger sponsors, in the lower middle market these are small checks for them and they're not going to share it with us. I'm sure Chris has the same issue at times.

But when we look at a loan, we're looking at similar things that Chris mentioned. The leverage of this particular loan, the lien position. We want to look at the attachment point. We're going to look at its cashflow, it's the history of performance. Certainly Chris noted management. We certainly are going to take a hard look and make sure that this is a management team that doesn't just have one professional in place but it has bench strength. Because that is one of the key things we always discuss when we're in the boardroom. Which is, "So if this person gets hit by a bus, what is going to happen to this organization?"

Or another way to think about it is, when these companies, these are small companies. So a lot of time this is a founder that when they sell their company they're getting a $30, $50, $70 million dollar check. They have instant country club money. And then the question is are they going to be as motivated tomorrow as they were today so that we're hitting the initiatives, the growth story that we're projecting? Are they still in it mentally? So you need to make certain that there's rollover equity that's involved in these deals so that we feel that everybody's rowing in the same direction. Or you're making certain there's an equity program underneath the CEO or founder so that the company continues to thrive.

I think you mentioned, also you wanted to touch on inflation. The way we look at it, and it's interesting to see if Chris has the same situation, our portfolio, 99% of our assets are floating, and on our liability side 60% of our liabilities are fixed. And we have LIBOR floors, so our LIBOR floor is about 1.25% on our assets. So between where we are today at 25 basis points on three-month LIBOR relative to our floor, as inflation hits and rates rise there'll be some level of compression. But once you get past those floors, for most BDCs I would imagine, you'll see expansion on earnings and the dividend.

Where inflation does have an impact is on our portfolio companies. I think they've seen historically low rates and so they've been paying very little in interest costs. But what we have seen is a lot of portfolio companies with the stimulus packages, have had trouble either attracting or retaining employees. And so we've seen SG&A go up in some portfolio companies over the past I guess 18 months. So I think as that stimulus money goes away you'll see those costs come down, and then if LIBOR increases you'll see that cost go up. But all in all I think the portfolio companies will be stable. And as I said, I think that we're prepared to benefit based on our capital structure.

Chris Oberbeck: If I could follow on that. Clearly inflation, when I was a lot younger inflation was a very big deal. But from the 80s onward it was just a less and less and less and less a big deal. And it's still not a big deal till this month, all of a sudden boom. Even the democrats are waking up and they're starting to have a schism in their party saying, "Yeah, this isn't transitory inflation, this is real inflation."

And inflation is just not a great thing, it's like a fire. It starts in one place and it goes to another place. You think it's contained and then all of a sudden you realize it's not contained. And when it's not contained it can be devastating and very difficult to put out. I remember the days Paul Volcker, he just shut everything down to put out the inflation fire once and for all. I don't think anybody's got the guts in government to do that again. Once it starts it's going to be very difficult to put out just because the pressures and the deficits and all those type of things.

I think Michael articulated it very well. I think the BDC industry in general, and I think certainly Michael's company and ours, we're largely fixed-rate liabilities and we've been structured for rising interest rates forever. It's not like we're hoping for them, we've just been prepared for them. It's like Outward Bound, always take an umbrella and a raincoat or something. We'll take a raincoat as insurance against bad things happening. We've always been insured against these bad things happening.

So I think the idea of having fixed-rate liabilities and then floating-rate assets, which most BDCs have, and the fixed rate is to a greater or lesser degree. But even if they have floating rate, generally it's a spread business. So it's very well structured for rising rates. I think the danger, and this is like more of a macro point, I think the danger is that we're getting inflation but we're not getting rising interest rates. So there's a lot of deterioration in the value of currencies, the value of a lot of things. If you wind up with a stagflation, a stagflation with low interest rates is not a great environment. So I don't know what we're doing in there.

But with all that said, I think the relative opportunity of a BDC in the ugliness of an inflationary environment, I think it's quite a good vehicle. In other words if you're picking vehicles, do you want to be in a junk bond fund in a rising rate environment? I don't think so. There's a lot of places you do not want to be. Where a BDC is kind of idealized for it because, and again a good BDC well managed like Michael's firm, a well-managed BDC, you have a management team that can adjust to what's going on. And the portfolios turnover, they have floating rates, they have fixed rates, they can bob and weave and they can take care of and manage through whatever the scenarios that are coming on a diversified basis. And you're getting good current income, which is more important than income deep in the future that may be highly discounted.

So I think a well-managed BDC really should be part of anyone's portfolio anyway. And I think an inflationary environment you might want to have an overweighting in BDCs just because I think they're very well suited and very well structured to handle certainly a rising rate environment, but I think also an inflationary environment.

Kenneth Burdon: Great. Chris and Michael, this has been a wonderful conversation with a lot of wonderful insights. Thank you both very much for spending the time here with us today, it's been a great panel. Please hang out at the tables in case anyone has any questions. And with that I think we're going to go back to the floor now and everyone can have a little bit of networking for the next 10 or 12 minutes before the next panel starts. Thank you again.

Michael Sarner: Thank you.

Chris Oberbeck: Thank you all.

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