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Business-Development Companies Offer Unique Opportunities For Yield

Monday, November 4, 2019

Chuck Jaffe, in the NAVigator podcast, interviewed Chris Oberbeck, chairman and CEO at Saratoga Investment Corp. Read the Q & A below as Chuck discusses how and why he and his partners took over a struggling business-development company, and how BDCs by structure and underlying assets make for a unique and diversifying investment.

The podcast can be found on AICA’s website by clicking here: <https://aicalliance.org/alliance-content/pod-cast/>

**CHUCK JAFFE:** Chris Oberbeck, chairman and chief executive officer at Saratoga Investment Corporation, a business development company that provides debt financing and capital to midsized companies. He's here and we're talking about investing in BDCs, today on the NAVigator. Welcome to the NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization that represents all facets of the closed-end fund industry, from users and investors, to fund sponsors and creators. And today we're talking about business development corporations. BDCs are a really interesting type of closed-end fund that is looking to invest in small companies to help them meet their capital needs and more. Chris Oberbeck is chairman and chief executive officer at Saratoga Investment Corp. If you want to learn more, go to SaratogaInvestmentCorp.com. He's on Twitter @ChrisOberbeck. Chris Oberbeck, great to chat with you.

**CHRIS OBERBECK:** Thank you.

**CHUCK JAFFE:** Let's start with the evolution of Saratoga, because this is a case where you guys took over a BDC. So explain the evolution of the business, and then I want to get into what BDCs do.

**CHRIS OBERBECK:** Sure. We officially took over management of Saratoga in July of 2010. The process started at the end of 2009, and I think if people may remember those dark days, 2009 was a very difficult time in the markets, especially in the credit markets. And the predecessor BDC was under a lot of pressure, there was some mark issues in its portfolio that put it out of compliance with its senior lender. And its senior lender was forcing a process to either liquidate the company or to essentially find someone to take them out. We came into the process and we came up with a plan. Most parties were looking to purchase the assets at discount, or purchase the senior loan at a discount, and we came up with a different approach where we offered to recapitalize the company. So we actually put in equity ourselves and borrowed money from a very strong institution that we had a relationship with for a long time that was very well capitalized in that environment; Madison Capital. And we put together a rescue financing package, and basically took out the existing senior loan, invested new equity in the company, and then as part of that recapitalization, we at Saratoga took over the management of the BDC.

**CHUCK JAFFE:** Well, what that really means in plain English, getting the business jargon out of there, is that you were looking to run a BDC to invest in this space at a very time when this space went through about as bad a trouble as you could get into in this business. So you are in the business of making loans or providing equity financing to what would be considered middle market companies, which is not tiny but it's also not the giants out there. That is a different kind of credit risk, so explain how that market is working now, because it was very troubled when you got into it. But of course, we've now seen hyper-low interest rates and a much lower default rate on every other type of credit, has that also played out in your type of credit?

**CHRIS OBERBECK:** Well, a couple of comments actually about when we started, because part of the portfolio actually had some problems; the part of the portfolio related to some cyclical companies and some housing related investments. But the rest of the portfolio really wasn't in trouble, but it was marked as if it was in trouble. So in other words, they were actually good quality loans, it's just they weren't valued very highly at the time and that's what caused the default. Ultimately we were able to, through time and structure, give enough time for the company to work through – and the portfolio companies to work through the temporary issues of the dislocations in that time, and actually quite a number of those loans paid off a hundred percent. And that is what we like about middle market lending, is that while there may be big macro issues, people are concerned about recessions, there may be market dislocations, fundamentally a lot of these companies are not that correlated to the overall performance of the macro economy but have specific niches that they are addressing. And underwritten properly and with proper structure of your credit, these companies are very good credits, and that's what we focus on.

**CHUCK JAFFE:** Let's talk about the BDC structure. Because people hear business development company and they're not thinking closed-end fun, but functionally it is a closed-end fun. Why isn't it just called a closed-end fund? And what are the differences that somebody should be aware of when they're looking at getting into a BDC?

**CHRIS OBERBECK:** The general closed-end fund is often a collection of relatively passive investment interests; in the stock market, municipal bonds, corporate bonds, those types of things. Where a BDC is much more actively involved. A BDC like us, we make senior loans, senior secured loans. We make mezzanine loans and we make equity investments. In many of our investments we are on the board of directors or we have board visitation rights. We're actively involved in the company's business plan and their management. And that's part of the reason it's called a business development company, because we help companies that are growing, and help them recapitalize, fund their growth, acquire other companies, reposition their capital structures. And all that requires an intimate engagement with the companies, and so that's what makes us different from the traditional closed-end fund, is that we have an active engagement and often an equity interest in almost all of our portfolio companies.

**CHUCK JAFFE:** You talked about how the assets that you got when you were taking over Saratoga were not fully recognized for their market value. Do BDCs like closed-end funds sometimes trade at premiums and discounts?

**CHRIS OBERBECK:** Yeah, that's correct. There's a quarterly valuation process where the entire book of investments are valued. Every single quarter, essentially there's a whole valuation, very rigorous process. And out of that comes what's called "net asset value", which is the net assets after all the debt that's against the portfolio. And that net asset value is marked every single quarter with rigorous private valuation standards. There are some references to public standards. Now the stock market may value BDCs depending on how well the BDC is doing, how well the markets are doing, at different kinds of discounts to that net asset value. We at Saratoga fortunately have been trading above our net asset value for quite a while. A chunk of the industry trades at above net asset value. Part of the industry trades at a discount. And part of industry trades at a significant discount. And for each BDC, there's a story, there's a reason for how it trades. So the answer to your question is yes, BDCs trade at premiums to an asset values, at asset value, and at discounts.

**CHUCK JAFFE:** And in terms of where they fit into a portfolio. I mean, your type of financing is not something where I can easily go out and say, "Oh, I can get a traditional mutual fund that's doing that sort of thing." So where does it fit in a portfolio? And I know you can't give specific recommendations, but how much should an investor allow it to be in terms of, if I'm going to look at BDCs, what portion of a portfolio would I allow BDCs to represent?

**CHRIS OBERBECK:** Well, I think that's a very interesting question, and basically if you bought the Lehman Corporate Bond Index or if you wanted to buy any public grouping of loans, you would have a certain class of loans. Which you wouldn't be able to get through that index, or those ETF's would be loans to smaller middle market companies. Because those loans are generally only done by banks and business development companies, and private capitalized funds. So that asset class is not available in general to the public. Institutions have been accessing that type of thing through private investment funds for long periods of times; those might be pension funds, they might be endowment funds. But for the average investor or any investor, what the BDC offers is its ability through buying the BDC stock, you can buy into a portfolio of loans to smaller middle market companies. And because they're not available, they don't trade publicly and aren't accessible in different places, there's actually a premium return that you receive from that. For example, in our portfolio at Saratoga, we have close to high fifties, close to sixty percent first lean senior secured loan portfolio, and our total portfolio yield – gross yield is north of ten percent. So generally speaking, you can't access those type of yields unless you go through a vehicle such as a private fund or a BDC. The advantage of the BDC is that an individual investor can buy ten shares, a hundred shares, thousand share, ten thousand shares of stock. So that private area of the market is now accessible through BDCs to anyone, any investor. To your second part of the question, how much of your portfolio should you allocate? The BDC is a bit of a hybrid instrument in that it's a portfolio of loans. Certain BDCs like ours, we also have some equity investment. So if you have to divide your portfolio into what is your income producing portfolio, and that income producing portfolio might include high-quality treasury bonds, high-quality corporate and municipal bonds, and yield-oriented stocks. Now BDCs generally trade with somewhere between eight and eleven percent yield, so it's a very high-yielding stock. Our yield at this point in time is just under nine percent. So in terms of how much you wanted to allocate to it, you'd say, "Okay, if I've got a hundred cents in this kind of income producing area, I should have some proportion of that." Maybe it's ten percent, maybe it's twenty-five percent, somewhere in between there might be a place that a BDC would make some sense.

**CHUCK JAFFE:** Chris Oberbeck, this has been terrific. Thanks so much for joining me. I look forward to chatting with you again sometime.

**CHRIS OBERBECK:** Thank you very much.

**CHUCK JAFFE:** Chris Oberbeck is chairman and chief executive officer at Saratoga Investment Corporation, a business development company that you can learn more about at SaratogaInvestmentCorp.com. To learn more about closed-end fund investing and business development companies, go to AICAlliance.org. That's the website for the Active Investment Company Alliance, which is on Facebook and Linkedin @AICAlliance. The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, learn more about my show at MoneyLifeShow.com. On behalf of the AICAlliance, thanks so much for joining us, we look forward to talking with you again next week.

*Recorded on November 4, 2019*   
  
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