Economic Conditions Have Given Private Credit Lenders More Power

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Chris Oberbeck, chairman and chief executive at Saratoga Investment Corp. Read the Q&A below as Chris says that the balance of power in the lender-borrower relationship has shifted dramatically in the last 12 to 24 months, with banks now pulling back, which is leaving private lenders with better terms and more power to insist on superior deals. Oberbeck notes that those conditions are putting BDCs generally – but Saratoga specifically, thanks to an all-weather portfolio of loans – in a better position to minimize any damage that might be done if the economy goes through a recession.

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Chris Oberbeck

CHUCK JAFFE: Chris Oberbeck, chief executive officer at Saratoga Investment Corp. is here to talk about the market for private credit, this is 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, if you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we're looking at developments in the private credit market with Chris Oberbeck,

chairman and chief executive officer at Saratoga Investment Corp., a publicly traded business-development company that trades on the New York Stock Exchange under ticker symbol SAR, and which you can learn about at SaratogaInvestmentCorp.com. You can also learn more about Chris at his personal website, ChrisOberbeck.com. And to learn more about business-development companies, interval funds, and closed-end funds in general, go to AICAlliance.org, the website for the Active Investment Company Alliance. Chris Oberbeck, welcome back to The NAVigator.

CHRIS OBERBECK: Well, thank you, nice to be back.

CHUCK JAFFE: Let's talk just a little bit about the private market, what Saratoga does in terms of your space there and how that space has been affected by market conditions.

CHRIS OBERBECK: Saratoga, our focus is on the smaller middle market, and that can be broadly defined as companies with less than $20 million of EBITDA, sometimes not even positive EBITDA. We focus a lot on companies getting their first institutional capital, we often make first-lien senior secured loans, and also accompanied by equity investments. So we're a total partner with this companies, both in the debt and the equity in many instances, and we are solution-oriented capital, so what we say often is we start where the banks stop. So if you're a smaller company, banks and traditional sources of capital don't get you very far, and a lot of these companies are growing very rapidly and they don't necessarily want to sell more equity and dilute the equity stakes of the founders but they also want to make sure they have enough capital to take full advantage of their market opportunities. And so our focus is pretty much on secular growing smaller businesses, and we're providing capital solutions to those companies.

CHUCK JAFFE: You mentioned you pick up where the banks leave off, but we've seen a banking crisis that a lot of people don't think is done just yet. Has the situation in the banking business affected at all the private credit market and the companies you're dealing with?

CHRIS OBERBECK: Oh, absolutely. Go back to 12 to 18 months ago, the banks were incredibly aggressive, in many of our deals we were either completely taking out of the deals or very marginalized by very aggressive bank lending. But now with this banking crisis, the banks are pulling way back and they're going back to maybe a traditional level where they draw a line behind how far they'll lend, and that line is often not enough for the sponsors. So we have several ways we do this, sometimes we'll completely take a bank out, but other times

we'll work with an existing banking group where we'll in effect stretch the banks. So if a bank is saying, "Okay, well, I'm going to lend to X," and the company wants 2X, we can say, "Okay, we'll do the second X," and we'll pick up where the bank stops and we'll be either a second out inside of a first-lien lending package or a second-lien loan. That's often how we would work with banks. But your point is a very good one, that not only for existing deals, since we're getting a lot of opportunity to come into existing deals and basically allow banks to lower their exposure leverage-wise, but in new deals banks are very conservative and so we're seeing a lot more opportunity for our type of lending because of the pullback in banking.

CHUCK JAFFE: You talk about your type of lending. Now BDCs aren't the only ones who are sources of private credit, so how does a BDC differ or how is it differentiated from the other ways that a company could look to access the private credit markets?

CHRIS OBERBECK: One of the important characteristics of a BDC is we're a publicly traded closed-end fund and so we don't have a finite life. Many sources of private capital are in funds, and then the funds, it might be an interval fund or different types of funds like that, they might have an investment period of one to three years and then a wind-up period of maybe another two to three years, so the purpose of the fund is they want to make loans today and then get repaid within a three to seven year horizon perhaps. So basically once they've made their initial loans, they're not really making new ones out of that particular fund, where a BDC, we have permanent capital, so our horizon is essentially infinite. So we're not necessarily looking to get paid back, and we have companies that we've been invested in for over 12 years and they haven't paid back our capital and we don't require it to be paid back. Where if you borrow from a bank, often they want all their money back in five years and they want it amortized along the way. Most of the companies that we deal with, they're trying to invest in their business, so every dollar that they spend amortizing debt, they'd rather invest in growth and create more enterprise value, and de-lever by creating enterprise value as opposed to de-levering by paying bad debt. And so what we can offer is we offer is we offer debt with no amortization, bullet maturities, and then we're often very accommodating, as long as the credit's holding, up with extending and modifying to accommodate the business needs.

CHUCK JAFFE: In this market have lending standards been tightening up or have they been loosening up? Obviously everybody's getting paid more for when they're putting their money to work, but what has that done for the lending standards and your ease of finding the right kind of deals?

CHRIS OBERBECK: Well, I think that's a very good question. As in all markets, the balance of power shifts, and just picking 12 to 24 months ago, there was a lot of liquidity and a different picture on what things looked like in the economy recovering from Covid, et cetera, and the balance of power was very much in the hands of the borrowers, and so there was sort of a degradation in general of the quality of the terms, the covenants, the pricing, very competitive. You fast-forward to where we are today, it's a very different scenario, where you've got the banks pulling back, which was an enormous source of capital, and not just capital but low-cost capital, so the basic pricing on capital has improved tremendously. And then the terms, like in terms of what kind of covenants you can enforce and things like that, if you have fewer people competing to make a loan, the lender has more ability to insist on more lender-friendly terms than the other. So those are some of the ways that the market has changed, and basically moving the balance of power closer in the favor of the lenders. But with that said, we want to be a constructive lender, obviously we want to protect our credit, but you also want to make sure that you don't make your credit, belt and suspenders too much, so that you impede the fundamental objective of the business which is to be able to grow.

CHUCK JAFFE: There's been a lot of talk about the evils of private equity. Gretchen Morgenson wrote her book, *These Are the Plunderers*, which looks very harshly at the private equity business. Private credit is not private equity, but as you pointed out, you kind of do the whole spectrum. So what's your take on private credit in relation to private equity, and the image, at least publicly, that some private equity seems to have?

CHRIS OBERBECK: Private credit goes hand in hand with private equity, there are some instances where private credit would be financing a publicly traded company, that's not out of the realm of what occurs. But generally speaking, private capital supports private equity, and private equity is one of the oldest forms of finance in the world and so it's been going on for a long time. Now there's been different forms and different players and all that, and I think that people look for a boogeyman and so anything negative about private equity gets a

lot of headlines, gets a lot of attention, but there's also tremendous things that private equity can do that a public equity situation can't do, such as turnarounds, such as growth, building companies. Obviously if you're in AI, it looks like you can raise all the money you want, but there's a lot of growth situations where a lot of the benefit is coming in the future from investments you're making today and you have to really dig deep and roll up your sleeves, do a lot of homework to really figure out if you believe the business plan. That's not really the realm of public financing for example, and so there's a tremendous amount of value that's been created by private equity. Now obviously like with anything there's so-called abuses and there's prominent situations where it looks like some private equity companies didn't re-invest in the company enough or something like that, but as I said, I think private equity's viewed kind of as a boogeyman these days but I think there's a lot of good coming out of private equity.

CHUCK JAFFE: Let's bring this back to the market. There's been a lot of good coming out of the market and yet there's still a lot of nervousness about what could happen next. So what's your take on the potential for recession and what does it do to the private credit market, and how are you at Saratoga prepared to withstand any recession or downturn that we get?

CHRIS OBERBECK: Well, that's sort of a massive question. I think by all measures and public commentary and discussion, we should have had a recession a long time ago with these type of interest rate rises and things like that. And conventionally we would have, so obviously unconventional's going on right now, and I think part of it has to do with the massive amounts of liquidity that had been injected in the system, and so this rapid unprecedented rise in interest rates hasn't dampened the economic activity to the degree that one would have expected looking at historical models. So the question, and the big question is, does that mean we've escaped a hard recession and is a soft landing really in the cards? Or have we simply deferred it until this mound of liquidity that has been built up gets consumed, and then are we going to have a very hard landing afterwards? Those are very difficult questions that a lot of people are spending a lot of time trying to figure out. What we do at Saratoga is we don't pretend to be economists, we don't pretend to forecast global and macro, what we do is we focus on very specific companies and very specific businesses and fund them, and we try and find secular growing companies that, for example, who invest a lot in software as a service. And software as a service companies are very much efficiency companies, in other

words, you implement the software and all of a sudden your costs go down and your efficiency goes up because you control your information better, you save a lot of time, you don't need as much labor per unit of output, those types of things. And so that's something we've been very focused on, is investing in productivity. And even in recessions, obviously a mega recession, no one's seen that for a long time, but in recessions in general it hits the cyclicals, it hits some of the consumer discretionaries harder than it hits other companies. It's not like it doesn't hit some of these secular growers, but their growth might go from 30% to 20% or 15%, in other words, these companies are not really driven by the economy, they're driven by payback on installation. You put this in and it pays back in X amount of time, and that's a good investment. Obviously those kind of investments change a little bit when interest rates go up, but not a lot and not compared to the value-add that they create. So what we do is we really focus on the companies that are kind of all-weather companies, and we also make sure that we're structured reasonably well. We lend to a certain level of value and then we also lend to a certain level of earnings or projected earnings, and as a result of that we feel that we're in a good position in the long run. And sometimes you might have a rough ride, the company might have some payment issues and things like that, but as long as you get the fundamental business value right on the frontend you're going to come out the other end.

CHUCK JAFFE: Well, unfortunately we've come to the other end of our time here, but this has been great, Chris. I have more questions, but like I said, I'm out of time so we'll just have to chat with you again and pick this up down the line. Thanks for joining me on The NAVigator.

CHRIS OBERBECK: Well, thank you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe and I'd love it if you check out my hour-long weekday show at your favorite podcast app or by going to MoneyLifeShow.com. To learn more about business-development companies, interval funds, and closed-end funds go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. And thanks to my guest, Chris Oberbeck, he's chairman and chief executive officer at Saratoga Investment Corp., which is ticker symbol SAR on the New York Stock Exchange and which is online at SaratogaInvestmentCorp.com. You can learn more about Chris at ChrisOberbeck.com and on Twitter @ChrisOberbeck. The

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