AICA NAVigator Interview-Chris Oberbeck, Chairman of the Boar, CEO & President @ Saratoga Investment Corp. on Private Credit

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Chris Oberbeck, sat down with Jane King on November 1st for a NAVigator Interview and explained the Private Credit Markets.

Saratoga Investment Corp: **saratogainvestmentcorp.com**
SAR$: **cefdata.com/funds/sar/**

Chris Oberbeck

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Chris Oberbeck, Chairman of the Boar, CEO & President @ Saratoga Investment Corp. on Private Credit - AICA (aicalliance.org)

Jane King: Chris Oberbeck has over 36 years of experience in leveraged finance including acquisition financing, distressed investing, and private equity. He is the founder and managing member of Saratoga Investment Services as CEO, and chairman of that as well. So Chris, welcome, very curious to hear about private credit and all the different areas of finance that you're involved in. So let's start with the private credit market, how do you see that right now?

Chris Oberbeck: Sure. Well, I think one way to look at the markets today is in essence we've got a 5% risk-free rate right now, that's the current rate and longer rate and all that, so you can get 5% and sleep very well at night. So what do you need from your portfolio? If you're investing in the equity market, with all the risks in the equity market you probably need to have low to mid-teens returns to justify taking the downside risk to get the upside risk relative to the 5% rate. In private credit today, you can get those same returns without the downside risk if it's properly underwritten.

And so in our company for example, our portfolio yield right now is around 12%; so we're getting 12% rates in mostly first-lien loans, credits that we think were good underwriters and were underwritten very, very well. And so what you can get today, the question is what do you think the stock market's going to do if that's your alternative? And you say, "Okay, is the stock market going to be able to deliver to me 12% gross returns over the next several years?" and are you comfortable with the risk? But private credit can give you that with a lot less risk.

Jane King: Without the risk, interesting. And that's better than our inflation rate, so you're still making money.

Chris Oberbeck: Yes.

Jane King: And not taking the risk.

Chris Oberbeck: Correct.

Jane King: Okay, so let's talk about the valuation pressures that you've seen on financials, and banks in particular, with the interest rate environment that we've been in over the past year and a half or so.

Chris Oberbeck: Yes, as we all know, from 1980 until just recently we were in a very declining interest rate environment, and right now we're in a rising rate environment and the question is how much more are they going to go up and then how long are they going to stay up? And so you're going from having a tailwind to most financial investments, fixed-income investments, real estate investments, equity investments and all that to kind of having a headwind. A 5% rate is a pretty substantial headwind relative to zero just a few years ago, and so valuations are having to adjust.

In the banking system, obviously we saw runs on banks, most famously Silicon Valley Bank, and banks have had some challenges because. Let's just take mortgage lending for example, residential mortgage lending, a lot of residential mortgages are fixed-rate instruments for 30 years. If they did a loan for a fixed-rate instrument two years ago, the 30-year rate might be 3%, but if you wanted to do that loan today it might be 7 or 8%, and therefore if you tried to sell that 3% loan today, you'd probably have a loss approximating 30% maybe, or more depending.

And so a lot of banks and financial institutions have loans like that, there's other classes of those loans, on their balance sheets, but banks are able to hold that in a classification where they're held to maturity so they don't have to mark the losses they hold at a cost. But there's a lot of that on their balance sheets, and if they hold it to maturity, if the credits are good they'll get paid back, the problem is the marketability if they had to mark it to market and sell it today.

And so there's a lot of worry about that particular aspect, and that's kind of what took down Silicon Valley Bank and First Republic, forced their merger with J.P. Morgan, was that kind of concept. And so that's kind of hanging over the banking sector, could that happen again? Is that present in some of the larger banks? There's this view of too big to fail, but even if you are too big to fail, the bank might not fail but the investors might have losses.

Jane King: Well, that's true. And is the government in a position to come in and bail these banks again like we did? They may not have that flexibility like they did.

Chris Oberbeck: I think essentially they kind of always will.

Jane King: They always will, okay.

Chris Oberbeck: One way or another they probably will.

Jane King: They'll figure it out.

Chris Oberbeck: But the real question I think for investors is what happens to them? In other words, the banking institution will probably survive, it's the investors and their different classes of securities, are they going to get to zero or something like that? I think that's the real concern.

But anyways, so this is hanging over the financial industry, but all lenders are not the same. And BDCs like we run are very different from the banks, we've got a very different capital structure. We have permanent capital as opposed to deposits, which can leave quickly. So we have permanent capital, we're less leveraged, banks are 10+ to 1, we're 2 to 1 at max type of leverage. We have fully underwritten loans, we have a lot of covenants and a lot of ability to take control if we had to, or at least have a seat at the table to help guide companies when they have problems and setbacks and support them and that type of thing, so we're much closer to our portfolio.

Jane King: I got it. So let's talk about those a little, BDCs, so business-development companies. And you explained a little bit how that's different than the banking industry, but what are some of the ways that investors might be interested in taking a look at this? I don't think it's really well known among investors that these exist.

Chris Oberbeck: Yeah, BDCs are like a real estate investment trust in that it's a closed-end fund structure, it doesn't pay taxes at the fund end at any level, and differentiated from real estate investment trusts, it invests in business loans primarily but also business equities. And then I think from a retail investor standpoint and small institution standpoint, it provides a unique window into private credit investing.

Private credit generally speaking is the province of very sophisticated large pension funds, endowment funds, institutions, super high net worth individuals. But lower down the scale, how do you access this private credit to smaller middle market companies that provides first-lien loans with low teens returns? You get that through investing in a business-development company, a BDC, because that's what we do. So in effect what we're doing is we're making private loans, but the stock is public, so they can buy a publicly traded stock. We trade on the New York Stock Exchange, you could buy and sell all day, every day, get in, get out if you'd like, and you have access to these private credits.

Jane King: Okay, and these are small to middle sized companies?

Chris Oberbeck: Correct.

Jane King: Do you do the vetting of these companies?

Chris Oberbeck: Yes.

Jane King: How do you find the ones that you invest in?

Chris Oberbeck: We have a team and a portfolio and we've been doing this for a long time, and so we have a tremendous amount of relationships. We have financial sponsors, private equity firms that we work with, we have individuals that don't have funds, CEOs and the like, and we work with them to help finance the companies. And so we have people out going to conferences and calling on people all the time and we're getting a lot of feedback, and then we have transactions we've done, we get referrals. So we have this substantial pipeline of private equity opportunities, and then out of that pipeline we do our due diligence and we work with the people. It's a very involved due diligence, our memos are like a little thesis, 35 pages long and that type of thing.

Jane King: I'm sure. How does somebody invest in one of these? They go through you or how does that work?

Chris Oberbeck: Call your broker. There's a whole industry, BDC industry. Saratoga Investment Corp., our stock symbol SAR, we trade on the New York Stock Exchange, that's one avenue, and one way to do it is just through your retail broker.

Jane King: Yeah. Okay, very interesting. Thank you for being so generous with your thoughts and your insight into this industry, so thanks so much, Chris.

Chris Oberbeck: Thank you.

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