Saratoga's Oberbeck On The State Of Private Credit Ahead Of Interest Rate Cuts

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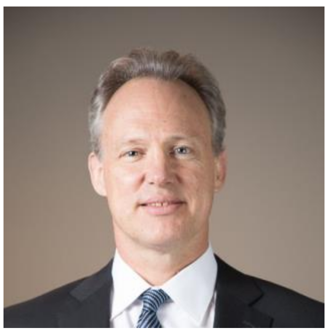

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Chris Oberbeck, Chairman and Chief Executive Officer at Saratoga Investment Corp. Read the Q&A below as Chris says that private credit, which has been on the rise for several years, is being challenged by a cooling market for mergers and acquisition activity. That has put pricing pressure on managers, which should ease a bit as rates come down and mergers and financing deals become easier to do.

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

CHUCK JAFFE: We're talking private credit with Chris Oberbeck, chairman and chief executive officer at Saratoga Investment Corp., welcome to The NAVigator. This is 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, a unique industry organization representing the entire closed-end fund industry. It's from users and investors to fund sponsors and creators, and if you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. Today we're looking in the direction of private credit with the help of Chris Oberbeck, he's chairman and chief executive officer at Saratoga Investment Corp., which trades on the New York Stock Exchange under ticker symbol SAR, and which provides debt financing and equity capital to middle market companies. You can learn more about the firm at SaratogaInvestmentCorp.com, and you can learn more about Chris at his personal website

ChrisOberbeck.com, and if you want to learn more generally about how business-development companies and closed-end funds work, check out AICAlliance.org, that's the website for the Active Investment Company Alliance. Chris Oberbeck, welcome back to The NAVigator.

CHRIS OBERBECK: Thank you.

CHUCK JAFFE: We are at a really interesting time when it comes to credit in general, we're about to see the interest rate cycle change and interest rates seem to be ready to start declining next month. But in private credit, well, you don't just have to worry about interest rates, you have to worry about supply and demand, so help us understand what you're seeing right now in the private credit space. Where are we, where do we stand, and how well positioned are we for whatever's coming next?

CHRIS OBERBECK: Well, I think that's a very pertinent question at this moment in time. Private credit has had a very, very good record for quite a while now, it's attracted a lot of funds, and so a lot of people are investing new funds in private credit and so the amount of private credit raised has been very substantial. At the same time, the M&A environment has cooled quite a bit as the amount of transactions that are taking place are a lot fewer than there were in the years past, and so as a result there's a buildup of private credit supply relative to the demand in terms of deals done, and M&A is generally the largest driver of private credit activity and so it's really important for investors to make sure they're with a manager that's been through these types of cycles and has a strategy and an approach that's kind of an all-weather approach that's very defined and very focused.

CHUCK JAFFE: Generally speaking, does the amount of merger and acquisition activity change with the interest rate cycle? Like if I told you that we're going to see rates go on a relatively protracted but slow, steady decline, what would you anticipate that means for merger and acquisition activity in the private equity space?

CHRIS OBERBECK: Well, I think conventionally speaking you've sort of seen that happen, right? As interest rates has risen, the M&A volume has declined, and on a sort of level one, simplistic basis, higher interest rates makes it a lot more expensive to acquire a business, and so the cost of capital goes up and therefore the price that a buyer can pay generally goes down. And so what's happened in the past recent time is that buyers and sellers, there's a bid-ask spread that's become quite wide, so the sellers aren't getting what they want and the buyers aren't going to pay what the sellers want, and so there's been this gap and that's really led to the decline in M&A volume. A lot of it's about interest rates, but also its underlying what interest rates are going to cause, is there a recession coming, there's an inversion in the yield curve, those types of things make people a lot more cautious, increases the level of uncertainty about the future.

CHUCK JAFFE: Speaking of uncertain futures, when we saw rates going up the expectation was we would see a wave of defaults, at least in conventional credits, at least junk bonds and the rest. We never really saw a big wave, a big expansion, and I don't believe we've seen a wave of it necessarily in private credit either, but rates have been higher for longer and there have been plenty of people who've said we're going to see some of those things still even as rates start to go down. So is there any sort of default wave going or being forestalled by what's happening with rates?

CHRIS OBERBECK: Well, again, we live in a very complicated and sort of elaborate economy out there, and so yes in certain areas, like retail's under a lot of stress, there's certain types of the consumer, the less wealthy consumer is very stretched right now because of interest rates and so there's all sorts, certain elements in the luxury sector are getting pressure, so yes, we are seeing some impacts of that. Default rates are ticking up, I mean, they're not at high, high levels but they're up from where they were, so there is some impact there. But also I think that one thing is that society evolves, restructuring evolves, so there's actually quite a few restructurings going on that aren't so evident in the default rates, if you will. There's a lot of liability management going on where people are restructuring their loans without a lot of public fanfare, so I think there's a lot of that going on.

CHUCK JAFFE: One of the other things that's been going on that has created at least a little bit of public fanfare has been there's been some media attention to private credit and private equity, as we wind up seeing them become more popular investment places, they've gotten more scrutiny. And one of the worries has been, that at least in publicly traded closed-end funds, et cetera, you've got things that are being kept on books and going into net asset value calculations, different, I'll point out to the audience, than a BDC like Chris runs, where there are valuation concerns, where if something is here today and there's a problem, you could see a big swing when they revalue and mark it to market at a much lower price. Do you worry that there will be some kind of incident that, obviously striving to make sure it never happens to you, but that in the industry space, et cetera, as this becomes a more popular asset class, that in the growing pains it's going to be some sort of a blow up that gives private credit a black eye?

CHRIS OBERBECK: Again, I think you have different circumstances that come and go. I think very prominently, Blackstone had a private credit fund that allows redemptions on a quarterly basis, and I think a year or so ago they weren't able to fulfill the redemption rate and that got a lot of press and had the beginnings of making a black eye, but they did a number of things and made some adjustments and the people looking for redemptions declined. That situation has kind of resolved itself, so there was kind of a moment where that looked like it was going to happen and it didn't, but that's always a possibility. You're starting to see that a lot in real estate for example, there's a lot of funds out there where people are looking to get redemptions, looking to redeem their money and then the funds aren't apply to comply because the capital isn't there. I think in real estate they're starting to see a lot of problems that you're not necessarily seeing in the corporate loans. I think the corporate America is not quite as leveraged as the government or real estate, and so I think going into this higher for longer interest rate environment the corporations have not been super highly leveraged relative to their earnings, that's allowed us to get through without a high level of defaults even though interest rates have gone up.

CHUCK JAFFE: I guess the other thing would be that at some point, and this may be what distinguishes you from your competitors, it's about the documentation, it's about having a better understanding. I mean, there's got to be something there that you're demanding or looking at that helps you make sure that you're not walking into that trouble, and maybe it's the scope of the deals that you're doing or the involvement that you have, but help us understand what that is. Because it's not simply for you guys, "Here, we're making a loan to you," there's a lot more that goes beyond it.

CHRIS OBERBECK: That speaks to the strategy of the manager and the approach to all the companies that we get involved with. Our focus is on secular growing companies, and companies like, for example, software as a service has been a big area of ours. In essence, software as a service is productivity, it's whatever people pay for that software, it results in an enormous cost savings, a huge payback if you will, on the investment, and therefore that kind of business is what we're looking for, right? Where if there's a recession or no recession, people are still going to want to implement these types of programs because they increase productivity, lower cost, et cetera. And then we also work on buildups, we have dental practice buildups for example, and education, and in all these markets the drive is how do you create synergies and efficiencies? And so that's what we look to find in our companies, and that'll happens regardless of the level of interest rates, and if there's a recession and the economy's down a few percentage points or something like that, that generally won't have a massive effect on these companies. It might have a minor effect, but it's not going to affect the basic trajectory, and that's what we're looking for.

CHUCK JAFFE: And in there you pretty much answered where I was going to go towards the end, which is here we are with an election on the books, we've got a rate cycle that is changing, there's a bunch of stuff that's happening at the macro level, but fundamentally private credit, unless maybe something happens that changes the landscape in Washington or what have you, at least as you practice it, private credit should be mostly unaffected by the macro stuff other than rates, correct?

CHRIS OBERBECK: Well, in theory that's where we try to focus. I think that to say private credit broadly won't be affected I think is maybe a large statement, I think each private equity manager has its own portfolio and its own portfolio approach, and certain of those portfolios may have more exposure to retail, may have more exposure to energy or something like that that might have more of a cyclical component. As I said, we try and focus on more secular growing areas, and it's not to say that they're not affected by macro elements, but you might have a growth rate that's like 20% and then the macro might make it decline to like 10% or something like that, but it's still going to have growth, still going to have persistency. That might result in some adjustments that you have to make to the credit structure, but that's what we do, we try and work with our companies over long cycles of development for them and if they have challenges and things like that we can adjust. As a permanent capital vehicle, we don't have any particular timeframe that we have to get our capital back in, and so we can work with companies over the longer term objectives that they have and adjust the credit structures as needed. But if you have a fundamentally good business, you can run into some headwinds or some difficulties, but you can make it through if you have the ability to adjust.

CHUCK JAFFE: A pretty good lesson in there for all investors, this has been a lot of fun. Chris, thanks so much for joining me on The NAVigator.

CHRIS OBERBECK: Thank you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and I am Chuck Jaffe and I would love it if you would check out my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about business-development companies, closed-end funds, and interval funds check out AICAlliance.org, that's the website for the Active Investment Company Alliance, which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest Chris Oberbeck, the chairman and chief executive officer at Saratoga Investment Corp., which is on the New York Stock Exchange under ticker symbol SAR. It's a business-development company that provides debt financing and equity capital to middle market companies, you can learn more about it at SaratogaInvestmentCorp.com, and you can learn more about Chris at his personal website, ChrisOberbeck.com, and you can follow him on X, formerly known as Twitter, @ChrisOberbeck. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following along on your favorite podcast app. We'll be back next week with more closed-end fund fun, and until then, happy investing everybody.

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