



BDCs And Middle-Market Credit Can Solve Rising-Rate Puzzle

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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 the structure of business-development companies – which allows assets to increase in value when interest rates rise, while keeping liabilities fixed, thereby raising spreads – makes them particularly attractive to investors looking for better real yields in a rising-rate environment.



Oberbeck explains, generally, how BDCs will be able to weather the first rate increase, whenever it happens, with much less impact than most income investments will experience.

Chris Oberbeck

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 Corp. is here and we're talking about why business-development companies may be in the sweet spot for today's rising rate environment, 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's brought to you by the Active Investment Company Alliance, 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's going to point you in the right direction. And today it's pointing us in the direction of Chris Oberbeck, chairman and chief executive officer at Saratoga Investment Corp, which is a business-development company. And I said we're going to talk about why BDCs are in the sweet spot, that's not necessarily like a big honkin' commercial, "Go look at his BDC." But if you want to, SaratogaInvestmentCorp.com is the website. Chris Oberbeck, it's great to have you back on The NAVigator.

CHRIS OBERBECK: Thank you.

CHUCK JAFFE: First off, when people are talking about this rising-rate environment, I want to make sure that they understand the business-development company structure and why you think that's particularly good right now for the assets that you're buying. So in other words we need a little bit of an explanation of the business and how it works so that folks understand why this is a good time.

CHRIS OBERBECK: Sure, a couple of things. I guess by and large most business-development companies' assets are senior or second-lien loans, and generally they're priced on a floating-rate basis, so it'd be a LIBOR plus a spread. LIBOR plus five, LIBOR plus seven, depending upon what kinds of risks profiles and leverages are involved. So on the asset side, the assets float, so as rates rise, the base reference point of their assets also rises. So the assets increase as the interest rates increase, so that's number one. And you contrast with that, if you were to own a high-yield bond fund or something like that, if rates go up, their rates don't change, they're all fixed-rate instruments. So the floating-rate aspect of the assets of a BDC is the number one most important element is to why a BDC is a good vehicle in a rising-rate environment. The second piece is the liability side. Different BDCs are structured differently. Some BDCs might have a floating-rate asset cost, so at the worst case they'll be doing a spread business. So the assets would rise and your liabilities would rise, but the spread would remain. So you'd still be earning a spread, you don't get squeezed. Certain other BDCs, like ours, Saratoga for example, most of our liabilities are fixed rate, we have five to seven to 10-year fixed-rate liabilities. So when rates rise the assets would go up in value, but the liabilities stay at the same pricing point, they're at the same interest rate and so we have an increasing spread in a rising-rate environment. So at the heart of the matter, that's why a BDC is a very

good instrument and a very good place to be in a rising-rate environment like we have coming right now.

CHUCK JAFFE: Is there a flip side? I mean, if this is a notably good time to be in BDCs and somebody says, "Yeah, I want to go in that direction," is there another time where they go, "Okay, and when conditions change this might be when I'm looking to see where the exit signs are"?

CHRIS OBERBECK: The main time for an exit sign is probably in a radical across-the-board economic decline of credit, a huge credit downturn. But barring that, in other words, as long as companies are in good shape and the economy's in reasonable shape, which in inflationary environment generally speaking they are, it's not a huge recession. So the inflationary environment with rising rates, the underlying businesses are going to do fine. So you have to make sure that the credit quality underlying all the loans that the BDC is making is intact. In a rising-rate and a falling-rate environment. But that spread business, that idea that the assets float and they go up and down, that same spread when rates come down, yeah, depending on the liability structure you could get a decrease in spread, that's true.

CHUCK JAFFE: So if I heard you correctly, what it really means is that the first couple of rate hikes really aren't going to wind up affecting the company. I mean, they may affect the credit quality but they're not going to affect my earnings as a shareholder.

CHRIS OBERBECK: Again, this is all a question of degree and sort of a very fine inside baseball kind of analysis. But basically most of the senior loans, they have a LIBOR spread, and sometimes, and actually most of the time the LIBOR itself is a threshold. So LIBOR might be 1.5% for example, and LIBOR is less than that. So LIBOR, it has to rise to 1.5% to get to the floor before it starts increasing the value of the asset base. So the first 25 basis points of rate increase is probably not going to make as big a difference as the next 75 basis points if you will.

CHUCK JAFFE: That's what I thought I heard.

CHRIS OBERBECK: Yes.

CHUCK JAFFE: Let's then bring into the underlying assets, because at Saratoga you guys are lending to middle-market companies.

CHRIS OBERBECK: Correct.

CHUCK JAFFE: Why middle market? And has the middle market been differently impacted by pandemic, recovery, the things that we're looking at than other parts? Because we know if we're looking at the S&P 500, it's the biggest of the big that have been driving that. But that's not your market, so how is your market positioned in these times?

CHRIS OBERBECK: Again, every BDC has got a different set of assets because we're relatively small. So we're not necessarily representative of the entire smaller middle market economy. A big chunk of our portfolio for example is focused on software as a service, SaaS businesses. And those businesses, depending on the sectors they serve, were largely not impacted by the downturn because they're subscription, there are mission critical software, install-base, they were not the things that any of these companies were going to cancel. So that part of our business was able to ride through it. We had some travel related things that had some gaps in their earnings if you will, but all that stuff got covered over and recovered. So we basically had zero Covid related credit events. We wrote our portfolio down substantially when Covid hit, and then we wound up unwinding all that right down over the ensuing 12 to 15 months. So it really depends on what the sector is that the BDC invests in. And one of the ways to tell the credit characteristic and credit quality of the BDC's investment is just to look at their return on equity over the past period of time. And our return on equity is low teens for the last five years, eight years, so we've had a very consistent double-digit return on equity performance over the past years. We think that's probably the most important test of how credit decisions have been made and what the results are.

CHUCK JAFFE: I have long said that good money managers, good stewards of capital understand the role that they're hoping to play in an investor's portfolio. And while yes, obviously you run a BDC, you are talking the book to some extent, what it also sounds like, especially as you're talking about credit quality and the way that different BDCs are going to be into different things, is that for somebody's who's looking at BDCs generally, they might want to own more than one. This is not like, "Okay hey, I'm looking for income so I'll buy a BDC." It's more like, "I want to have this kind of asset and I maybe want to diversify and have a couple players in that portion of my portfolio." Is that how you would hope, that at least the more average investors would be looking at something like Saratoga?

CHRIS OBERBECK: Yes, I think that's very well said on your part. So fundamentally let's just take, so many brokers, you ask them, investment advisors, "What should I do?" They go,

“Okay, 60% equity, 40% say fixed income.” They say income-oriented, they say something like that, right? So let’s focus on the 40%. What did you own in the 40%? If you owned municipal bonds, not only is the absolute rate quite low, they’re fixed income. If you own treasuries, if you own corporate bonds, all of that is a fixed-income number. So the 10-year treasury’s gone up a whole the lot, the rate’s gone up and therefore the value of the treasury has gone down. So some portion of that 40%, and I’m not saying all 40% but some portion of that is your income-oriented investing. And so you should take some portion of that, let’s just for discussion purposes say 10 points of the 40 points, and you say, “Look, I want that in a solid income-producing portfolio that is well structured to absorb a rising-rate environment,” which it kind of looks like we’re headed into. Maybe we’re not but it kind of looks like we have. And there’s been a lot of false starts over the years, this has been coming for a long time, but maybe it really is here now. So you take that portion and say, “Okay, we’re going to invest in BDCs.” But now BDCs are yielding anywhere from seven to 10%, so the absolute yield is quite high, plus as rates rise, because of the floating asset characteristics of it, that yield is going to increase. So some portion of your income-oriented portfolio should absolutely have BDCs as a component. And what BDCs do, it’s a flow-through vehicle, there’s no taxation at the BDC level, what it does is it’s an enabler, right? So you have a liquid investment, if it’s a stock you can buy and sell 25 times a day if you want to, so you can get in and out of it. But the assets that the BDC invests in are private credit investments to smaller businesses, so those smaller businesses have to pay higher rates, and that’s why you can get seven or eight, nine percent yield on a BDC. It’s because they’re lending to these companies that don’t have the same access to credit as a lot of the larger, General Motors, you buy a General Motors bond, you’re probably getting paid 1.5%. So they provide a higher absolute yield, they give you an exposure to the smaller middle-market private credit market, it’s still first lien and still senior secured lending, but higher rate secured. So absolutely, some portion of your income should be focused on BDCs. And yes, you’re right, you should probably own more than one. I think one has to be careful on the index side of it, because there is a BDC index that can be bought, look carefully at it. What happens with the index is it skews towards the very largest BDCs, and sometimes the very largest BDCs don’t have the best performance. So a better way to go about it in my view would be rank all the BDCs by return on equity over the last three to five years, and pick the top 10% of the field and own a basket of those.

CHUCK JAFFE: Chris, great stuff. Thank you so much for joining me to talk about it.

CHRIS OBERBECK: Excellent. Thank you for having me.

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