Saratoga's Oberbeck: The Fed's Moves Have Put BDCs In A Good Spot

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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., one of the industry's largest publicly traded business-development companies. Read the Q&A below as Chris says that BDCs have been a relative sweet spot during this year's troubled times largely because they benefited from being on the front end of rate hikes and turning them quickly into cash on the bottom line. While the companies must also deal with higher costs, he expects the trend to continue for at least as long as the Federal Reserve keeps projecting higher rates, which he thinks will be well into 2023.

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, chief executive at Saratoga Investment Corp. is here and we're talking about floating-rate investments in a rising rate environment, 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'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 we're looking in the direction of business-

development companies with Chris Oberbeck, he's chairman, chief executive officer, and president at Saratoga Investment Corp., which is a large BDC that trades on the New York Stock Exchange under ticker symbol SAR and which you can learn about online at SaratogaInvestmentCorp.com. Chris Oberbeck, welcome back to The NAVigator.

CHRIS OBERBECK: Thank you, nice to be back.

CHUCK JAFFE: These are times that you can certainly make a case that business-development companies are really showing their mettle, because we are in a rising rate environment. We've had a stock market that is troubled, we've got bonds falling, we're not getting much out of gold, et cetera. You may not be getting great returns out of BDCs but you're finding some safe haven, that BDCs have been doing better than the rest of the market. Tell us why that is, because it's not just yours, it is kind of the BDC entirely, right?

CHRIS OBERBECK: Look, I think if you look out across the landscape today, how many companies are reporting rising earnings? How many revenues are increasing? Obviously there's some inflation effects, but generally speaking there's a lot of decline out there and you're seeing the stock market anticipating even more decline. However, the BDC space, one of the characteristics of BDCs is generally they have floating-rate assets. In other words, they make loans and the loans are the spread over LIBOR or SOFR, and as LIBOR and SOFR rises, and it's risen a lot this year, that impacts the spread, the absolute revenue amount that the BDCs are receiving, so they're having a rising revenue stream. Now depending on the BDC, the liability side, which is the other side of it, if it's a total match, in other words if they have floating-rate liabilities and floating-rate assets, you get an increase in revenues but you also have an increase in costs. Certain BDCs like our company Saratoga, the lion's share of our liabilities are fixed, and so what's happening is you're getting a rising rate, all the assets are producing increasing revenues and the liabilities are stable, and therefore it's driving increased margins and increased profits.

CHUCK JAFFE: What has enabled Saratoga, but BDCs in general, to deliver yields that are superior here when chasing yield is always a little bit scary? How come we haven't seen the bad effects that rising rates can cause on any sort of rate environment? Is it simply because it's floating rates and there's more flexibility, or is there more to it?

CHRIS OBERBECK: If you're an investor, it depends how you invest, but it's quite difficult to find a floating-rate assets to invest in. You can buy high-yield bond funds, there's also the

Lehman Indices and things like that, but to actually get floating-rate exposure you've really got to buy a specific floating-rate fund, and that's a broadly syndicated market. The BDCs address a very specific market that you really can't get access to through the stock market on a diversified basis except by investing in BDCs, which is largely private credit. So these are credits, these are bank loans, senior loans, sometimes subordinated united tranche loans, but these are loans made to private companies that are not public, and so you can get access to that except through buying a BDC. in principle, buying a BDC stock gives you access to those loans, and those loans, generally speaking, are floating-rate loans. So this is like an only in BDC land can you get access to this simply and easily.

CHUCK JAFFE: One of the things that you threw out earlier, you talked about the LIBOR rate. I've got an interesting question about the LIBOR, because it wasn't that long ago, like as we got around Labor Day, that the LIBOR was at 3%, and now it's at like 4.5%. Now I recognize that in real terms that's just a 1.5 percentage point increase, but that is about 50% higher.

CHRIS OBERBECK: That's correct.

CHUCK JAFFE: When we start talking about rates rising by 50%, does that make your shop crazy? Are people, "The sky is falling," "This is opportunity knocking", what is going on, because that's not an environment we've been in for a long time. And that's just the most recent couple of months, that's not what we've been seeing with rates going up this whole year.

CHRIS OBERBECK: That's exactly right. I think this year is the year where the Fed has been raising the rates, and they've been raising them very aggressively, and they're only now coming to fruition, the rate rises. The Fed continues to project rising rates from here as well, so it looks like we're on a trend of an increased rate. So obviously on the front end of these trends, the BDC is a good place to be because you've got this rising revenue stream. And then with fixed-rate liabilities like we have at Saratoga you get a really nice increasing profitability, and looking into the future, the same. I mean, obviously it's not all roses because on the other side of this you have companies that have to pay more interest, so the companies are going to have to pay more out and that's going to impact the credit quality of these companies. And so what you need to focus on are quality BDCs that have a very strong history of high-quality credit.

CHUCK JAFFE: In terms of credit markets generally, everyone is talking like we're going to see a lot more defaults and a lot more trouble. But we haven't, at least yet. Is it coming or is that concern overblown? I mean, are we going to wind up hearing about defaults and credit problems and will they come back and bite BDCs? Or are you priced at a spot where there's enough cushion in there that you're not worried at all?

CHRIS OBERBECK: That's a very significant question and the answer really is fact-specific and BDC-specific and loan by loan-specific, but the rates have been rising just recently and the impact of this will be conventionally six to 18 months from now is when you're going to see much more of the impact. But it's going to depend on the type of company that's in the portfolio, and the company itself's resilience in this economy. So for example at Saratoga, we invest quite a bit in software as a service companies that are mission critical and infrastructure type software that the companies, they need no matter what, no matter what their sales are they need to stay on those things. So it's going to depend on how cyclical and how interest rate sensitive the underlying portfolio is as to how those defaults are going to play out. But again, to answer your question specifically, yes, it is early.

CHUCK JAFFE: The audience to The NAVigator's going to go out and they're going to go to SaratogaInvestmentCorp.com or they're going to look up ticker symbol SAR, and one of the things that they will see is that right now the yield is greater than 10%. We were talking about how much the LIBOR has jumped. Well, your yield has jumped pretty significantly, it's up 25% and you guys just increased it to get it there. I'm curious because a double-digit yield is not something we've seen a lot of necessarily for a long time in the BDC space generally, but we haven't necessarily seen it with Saratoga. So I know you can't overly promote Saratoga and I'm not asking you to do that, but what's the message that's hidden behind the yield being as high as it is in these conditions?

CHRIS OBERBECK: Well, I guess a couple of things, and as you rightly point out, our current quarter we're going to report in early January and so we'll have a full rendition of all our financials, and our last quarter was August 31st. And so when you mention the yield, the reason our yield is 10% is because we just increased our dividend 26%. And the dividend obviously has some relation to earnings but it's not necessarily completely driven by the exact level of earnings, so our yield is really what our dividend rate is and our earnings are generally something else. And historically we've over-earned our dividend, so our earnings

have generally been higher than the dividends that we've paid out. What it really says though is that this year there's been a lot of adjustments and the interest rates have just started, and so this 26% which is a record for Saratoga, I believe it's pretty significant in the history of BDCs, I don't think many BDCs have raised their rates as substantially as that. But you pointed out earlier that the LIBOR rate is up close to 50% just from our last quarter end till now and is expected to increase from there, so we believe we're at the beginning, early in a trend of increased earnings, so the increase in the dividend reflects that. As for the 10% rate, you're correct, we have generally traded in the 7-8% handle yields, and so 10% is quite a bit. But we only just raised our dividend, and sometimes in the BDC market it takes a while for people to adjust and to understand and get to the bottom of what it all means. And again, we haven't released our financials, we've only increased our dividend, and then our full financials that will tell the whole story will come out in early January.

CHUCK JAFFE: Chris, this has been really interesting. I look forward to doing this with you again down the line, thanks for joining me on The NAVigator.

CHRIS OBERBECK: Thank you, much appreciated.

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