



Saratoga's Oberbeck: Headline Troubles Aren't Signaling Systemic Credit Issues

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Chuck Jaffe, in this episode of The NAVigator podcast interviews Chris Oberbeck, chairman and chief executive officer at Saratoga Investment Corp. Chris says that increases in default rates are more of a return to normal than a sign of trouble for business-development companies or the economy. While stories like the First Brands bankruptcy and fraud case have market watchers looking for more trouble, the rest of the headlines in the industry are much more routine, which leads

Oberbeck to think that recent activity is more a hangover coming from a time of particularly low defaults rather than a sign of the start of a bad business cycle.

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CHUCK JAFFE: Chris Oberbeck, chairman and chief executive officer at Saratoga Investment Corp. is here, we're delving into the news in and around private credit markets, 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, which is a unique industry organization representing the full spectrum of the closed-end fund business from investors and users 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 going back in the

direction of private credit, this time with Chris Oberbeck, he is chairman and chief executive officer at Saratoga Investment Corp., which is a business-development company that trades on the New York Stock Exchange under the ticker symbol SAR. You can learn more about it online at SaratogaInvestmentCorp.com. Chris Oberbeck, great to have you back on The NAVigator.

CHRIS OBERBECK: Great to be back, thank you.

CHUCK JAFFE: Let's start with current events. Private credit has been in the news lately for reasons that nobody particularly wants to make the news, we had First Brands Group, which is an auto parts supplier that filed for bankruptcy protection last fall, where executives were just charged at the end of January with committing a multi-billion dollar fraud by deceiving direct lenders and banks. There were some other less dramatic bankruptcies, there's been questions about software loans and AI exposure and other things, so is this an unusual event or is this part of the cycle? And if it's part of the cycle, what does it tell us about what's happening in the cycle?

CHRIS OBERBECK: Those are very good questions. I think as someone who's been in the business for quite a long time, we really haven't had a credit cycle per se for a very long time. If you take Covid out of the mix, which is an unusual event, we really haven't had one since the Great Financial Crisis, so predicting and calling a cycle is one thing, let's just talk about what credit is in general. Most high yield or yieldy type of private credit instruments have kind of a core assumption of a 2% default rate give or take, 1-2% is generally what's modeled in all the time, we're really coming out of an era in Covid where interest rates got so low, people refinanced at such a low rate that the default rates were abnormally low during that period of time. Since that time, in the last few years, interest rates have stepped up and people have gotten past their refinancing, their loans have been maturing, and then when you've got to refinance in a higher interest rate environment, that's a whole other step function up. So I think what we're seeing today is kind of like an extension of the normal default rates that you would have had but you didn't have, so right now we're running at maybe 4-5% default rates, and that seems very high, but I think if you averaged it out over the last several years, it's not really that high. And so defaults are a normal part of private credit, there's a reason why you get a premium from lending to these type of companies, is because stuff happens like with First Brands. Now First Brands, I think a lot of people when

that happened, there's a big selloff and people thought, oh, this is part of the trend, and I think Jamie Dimon famously said, "If you see one cockroach, there's others," but I'm not sure that that's the case. We really haven't seen any other "cockroaches" since then, so maybe this is just an idiosyncratic one-off event, and arguably people should be comforted that it's fraud as opposed to something fundamental with the economy, that makes it even more so a one-off-type of event. So you're always going to have credit events, just we didn't have one for a while, so I'm not trying to say there's not problems in credit land, there are defaults running in the 4-5% kind of rate, and there are bankruptcies, but that's also kind of part of the fabric of what really goes on in business and leveraged transactions. I'm not sure that this is the beginning of some very bad kind of cycle or anything like that, I think it just may be a few idiosyncratic situations and maybe a hangover coming from a period of time where we had fewer defaults than we might have had otherwise. Now with regard to software loans, we live in a highly reactive world, if you look at what happened in the stock market in the last few weeks, it's sort of amazing, where you went from the Magnificent 7 to the Magnificent 2, all these darlings, all the software darlings are now down 30, 50, 70%, and then all the small caps and international stocks and Dow Jones hitting records while software index is going down, so everybody hates software today and everybody loved software a month ago or two months ago, and then AI is obviously the new threat on the scene, but like everything, is it going to be as bad as the reaction? I personally think it's a bit of an overreaction. I'm not saying AI isn't amazing and isn't going to replace a lot of things, but again it's kind of like, maybe for an analogy, maybe like the self-driving car, I think everybody's been talking about the self-driving car and there's been all sorts of panics about taxis and Uber and all those other types of things, but it's still a long time coming. Now is it going to be here in a very large way? Maybe, but it hasn't been as dramatic as maybe people thought it was several years ago, even Elon Musk was predicting self-driving cars everywhere a bunch of years ago. And then back to the self-driving car analogy, if you have software running your bank, for example, you're not going to replace that with a Claude bot anytime soon, there are so many highly specific, highly regulated, really, really, really important checks and balances built into a very intricate software system, so the idea that somehow AI's going to replace all that in the very near term, like in the next several years, is pretty remote. Will it replace it ultimately? Will software have to evolve? Will every software have to be rewritten? Probably

yes, but what's the timeframe that takes place in? And then how much does that affect the equity in those deals versus the debt in those deals is an important question. I would personally say that I think the selloff in the loans side is probably overly done, I think the selloff on the equities, you have to look at what the value is right now, a lot of these companies are still trading at significant multiples of earnings, so it's not like they don't have intrinsic value, it's just they don't have this supercharged value that they had in the future and people are questioning are these going to be worth as much in five or seven years as we thought they were? And the answer is today, well, we don't think so.

CHUCK JAFFE: It's interesting to watch how that's going to play out. Whether or not the Mag 7 will soon be the Lag 7 is an interesting question itself, but that's for a different discussion than this one. We've got spreads that are at least optically tight across credit, that has made it that there's a little more shopping around in what people are looking for. How has that affected the BDC market, and what is that doing to the opportunities that are ahead?

CHRIS OBERBECK: That's a very good point. If you have a time with elevated default rates, you would think you might have elevated spreads for new transactions, and I think there's several things at work here. One of the things that's at work is that we're coming off a multi-year period of really low M&A activity, and low M&A activity, a big chunk of M&A is driven by private equity, private transactions, which are often financed by private credit transactions, and it's well known that the private equity turnover in their funds is very, very low, and so as a result you have a lot of companies out there that are just not transacting. And as I mentioned, a lot of the companies, they finance themselves very well in the low interest rate environment, but as the years click on they need to refinance, so there's a fair amount of refinancing activity going on right now. When you refinance a company, you don't need to refinance relative to a competitive bid date, like in 30 days or something like that, you can take your time, you can say, "Okay, we'll refinance over the next six months, and you can shop all day long and you can go out and get 12 different bids because you've got all the time in the world, where if you do an M&A transaction you might not have as much time, so I think that the refinancing process lends itself to a much more competitive situation. The other thing is that there's a lot of money that's come into the business, I think that private credit had a very good run for many, many years and it's pretty well known that they're reaching into their more retail RIA marketplace away from the institutions and some very

prominent companies have gotten very large and have got a tremendous amount of capital being raised, so there's a lot of money that's gone into the private credit sector at the same time that the transaction volume has shrunk and has been more of a refinancing market. I think there's a lot of digestion going on where a lot of the available capital has to be put to work, and that's what's driving spreads tighter. So it's a time as a private credit manager, you've got to really pick your spots and be very, very careful about what credits you're getting into and what credits you're avoiding.

CHUCK JAFFE: Picking your spots is an interesting thing as well, because you and I chatted, I want to say it was in 2023, we discussed a changing balance of power between lenders and borrowers that was giving private lenders better terms and more power to insist on superior deals. And so as we're talking about you gotta pick and choose and be a little bit better, is that power dynamic still changing? Because obviously tight spreads and also rising defaults is a very different thing, and even back then you were talking about headwinds facing the industry, I would think the headwinds are even greater now.

CHRIS OBERBECK: Well, I guess let's take that in separate pieces. I think the balance of power probably has relatively, since that time, shifted more in the favor of the borrower because there's more capital in the marketplace and hence the tighter spreads, so I would say as of now that's the case. Now it's pretty well known that M&A activity is picking up, there's some big mega mergers going on now and there's a little more M&A taking place, whether that becomes a full-throated trend or not remains to be seen, but to the extent we get back to a more normal M&A market, that's going to soak up a lot of that capital, and ultimately maybe the spreads will move out to a place where they, in our opinion, but I guess the market has its own view as to what the right spread is, and right now they're viewed as tight. But I think the most important underlying factor here is the economy itself, if we have a weakened economy, that's going to be very bad for credit, you talk about headwinds and tailwinds, but I think the economy is actually fairly strong. The unemployment numbers just came out strong, I think the GDP numbers are going to come out strong, I think there's a lot of stimulus in the system from the bills that have been passed, the tax policies, the massive cap-ex spending across the AI megaverse, so all that I think is adding up to an economy that might be growing 4% or more, and I think that's really the most important thing for credit, is to make sure that you don't have a weakening economy. The economy looks like it's strong,

obviously there's pockets of weakness, and there always are, and there will be defaults, as there always are defaults, but I think as a broad gauged general observation, I do not think we're heading into a down credit cycle.

CHUCK JAFFE: Chris, really interesting. I really appreciate you coming back to The NAVigator, I look forward to doing this with you again down the line as we watch how it all plays out.

CHRIS OBERBECK: Okay, thank you very much.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and yeah, I'm Chuck Jaffe, how about you check out my hour-long weekday show on your favorite podcast app, or you can go to MoneyLifeShow.com. Now to learn more about interval funds, closed-end funds, and yes, business-development companies, go to AICAlliance.org, it's the website for the Active Investment Company Alliance, which brings you The NAVigator. Thanks to my guest Chris Oberbeck, he's chairman and chief executive officer at Saratoga Investment Corp., a business-development company which trades on the New York Stock Exchange under ticker symbol SAR, and which you can learn more about by going to SaratogaInvestmentCorp.com. The NAVigator podcast has something new for you every Friday, so make plans to join us again next week for some more closed-end fund fun, and until then, we hope you and your loved ones have a happy Valentine's Day and some happy investing.

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