TRESVISTA TALK WITH TOM INGLESBY: THE STATE OF THE CORPORATE CREDIT MARKET

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Abi: What is your view on the state of the corporate credit market today at a broader level?

Tom: *When we look across the landscape today, we see remarkable access to capital from a variety of industries that might have seemed unthinkable a couple of months ago. We have seen the Fed step-in with unprecedented liquidity to limit the panic. When we go back two months, we saw an unprecedented amount of corporate loan downgrades across all sectors. One would have expected to have a recession, the same or worse than 2008-2009 but that really has not happened because of the Fed, the flexibility of investors & their willingness to take risks, and perhaps because of the lack of other alternatives.*

Abi: In the last financial crisis, back in 2008, the rating agencies were criticized for being slow to respond and have the ratings reflect the reality of what was going on but, maybe, this time they were more reactive. How do you view their positions currently? Do you see them reversing some of the downgrades or removing companies off the watch list or do you see more downgrades coming?

Tom: *What we saw was a significant number of downgrades which, in 2009, led to a very significant number of defaults. We are only two months past but, right now, the default rate is behind the downgrade rate. When you look closely at the portfolio, there are certain companies in the industries which have had horrible results. Even then, a lot of the travel, hotel, and leisure businesses are still getting liquidity as they are gaining liquidity from some of the government programs.*

Abi: Defaults are likely to bring increased scrutiny to the duties and conduct of CLO collateral managers and, as we know, the CLO collateral manager is responsible for selecting and managing the collateral that produces the income necessary to repay CLO investors. How do you think the managers are reacting?

Tom: *Managers are reacting the way investors want them to. For the managers that were able to generate liquidity, most of the reinvestment has been focused on higher-rated loans, i.e., the ones that best support the structure of the portfolio and at least partially offset the deterioration of the average ratings of the CLO that had been caused by the downgrades. I think the best managers are now going to hold onto their lower-rated collateral and let the market come back.*

Abi: Can you give us a background of how you work with investors and manage the company's CLO investment activities?

Tom: *We are a niche fund manager and have a certain number of investors to whom we send out letters each quarter when we review the fund. We talk to investors on an ad-hoc basis and give presentations to certain investors on a periodic basis at their request. When we manage a fund, we always have a clear idea of what we are looking for in companies, how we get our alpha, what we should avoid and, what perceived risks that we are willing to undertake.*

Abi: What mistakes do you see younger professionals, who are too young to understand the implications of the last financial crisis make in this go-around that maybe a veteran like you is spotting?

Tom: *The credit selection at the top of the market is what usually separates the repeat managers from non-repeat managers. There is always a lot of pressure from the equity investors on the payments. You are always tempted to purchase something to stay invested. At the end of the day, every manager needs alpha from somewhere and so to get that alpha in a fund, the largest managers might have the lowest liability costs and can buy the most liquid assets which have lower spreads because of the low liability costs. Other managers might pick things like second liens with higher spreads, even though, in a downturn, there is a big risk of recovery. Other managers might pick more cyclical industries or industries which have a greater risk of concern when the markets change.*

Abi: Which innings do you think we are in today in terms of how much more we might see the loan prices falling and downgrades?

Tom: *There is a growing consensus that we should open the economy in the U.S. and in certain parts of the world. In the U.S., one wonders what is going to happen with some companies and consumer spending once the short-term liquidity infusions have worn off. Most of the companies that are going to suffer from what has happened to the businesses have, at least from a CLO manager's perspective, already faced downgrades. If they were to default or restructure, it would not be a large incremental difference from where we are. In terms of the immediate effect, I am going to say that we are in the fifth innings.*

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Abi: How do you view the risk in your portfolio today?

Tom: *We are watching everything very carefully. I would say we have been gratified by the amount of liquidity in the market caused by the Fed. The ability of a lot of troubled companies to get immediate financing in the fixed-rate market, whether or not they are repaying their loan or just adding to their cash troughs, they are still giving themselves some liquidity. I am pleased by the earnings of most companies outside of the affected industries. Also, the value and prices at which the loans have been trading have remained higher than they might have on a strictly credit fundamental basis in that investors are looking primarily whether these companies have liquidity and have a viable business strategy once we are past the pandemic.*

Abi: Looking into the future, how do you see the fundraising environment for CLO managers?

Tom: *We are hopeful that the markets will heal. I think the mezzanine debt market will probably be a little less levered and a little more expensive, which can make the equity distributions less attractive unless they can purchase assets at great prices. I would not want to be in the market raising a new CLO now as the ones that I have seen tend to have financing costs which are much higher on average and the alpha for equity investors is sort of buying loans at a discount and hoping that they run-up in price which is hard to predict.*

Abi: What Saratoga is doing differently than its competitors to position themselves for success?

Tom: *We have some experienced people in our firm that have been through three or four risk recessions and downturns. We have tried to not make the same mistake twice. When you look through our portfolio what you do not see is a lot of retail, shale, and cyclical investments. We performed very well in 2015 when CLOs suffered because of their exposure to energy as we did not have any exposure. Also, we do not have a lot of second lien investments because of low recoveries.*