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Q3 2019 Oaktree Strategic Income Corporation Earnings Call

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PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Fiscal Third Quarter Conference Call. Today's conference call is being recorded. (Operator Instructions) Now I would like to introduce Michael Mosticchio of Investor Relations, who will host today's conference call. Mr. Mosticchio, you may begin.

Michael Mosticchio ***Oaktree Strategic Income Corporation - IR***

Thank you, operator, and welcome to Oaktree Strategic Income Corporation's fiscal third quarter financial results. Our earnings release, which we issued this morning and the accompanying slide presentation can be accessed on the Investors section of our website at oaktreestrategicincome.com.

With us today are Edgar Lee, Chief Executive Officer and Chief Investment Officer; Mel Carlisle, Chief Financial Officer and Treasurer; and Matt Pendo, Chief Operating Officer.

We will be happy to take your questions following their prepared remarks.

Before we begin, I want to remind you that our comments today will include forward-looking statements reflecting our current views with respect to, among other things, our future operating results and financial performance. Our actual results could differ materially from those implied or expressed in the forward-looking statements. Please refer to our SEC filings for a discussion of these factors. We undertake no duty to update or revise any forward-looking statements.

I'd also like to remind you that nothing on this call constitutes an offer to sell or solicitation of an offer to purchase any interest in any Oaktree fund. Investors and others should note that Oaktree Strategic Income uses the Investors section of its corporate website to announce material information. Accordingly, the company encourages investors, the media and others to review the information that it shares on its corporate website.

With that, I will now turn the call over to Edgar.

Edgar Lee ***Oaktree Strategic Income Corporation - CEO & CIO***

Thank you, Mike, and welcome, everyone, to our third quarter earnings conference call. We appreciate your ongoing interest in OCSI. We are pleased to report another solid quarter highlighted by strong earnings and stable NAV and credit quality.

We reported net investment income per share of $0.20 for the quarter, up 17% from a year earlier and up 13% from the second quarter. The quarter-over-quarter increase was primarily driven by call protection and prepayment fees related to the exit of our $12 million investment in U.S. Well Services, a provider of fracking services in oil and gas basins.

As you may recall, this investment was part of a $75 million, one-year loan that Oaktree made to the company, which OCSI participated in, along with other Oaktree funds. During the quarter, our loan was refinanced, generating an IRR of over 60% and a money multiple of 1.17x in just over five months.

Total investment income was $0.47 per share, up 18% year-over-year and 11% quarter-over-quarter. The year-over-year increase was driven mostly by a larger average portfolio, combined with higher interest and fee income. The quality of earnings continue to be strong as interest income represented 98% of total investment income for the third quarter.

Net asset value per share decreased slightly from the previous quarter affected by mark-to-market valuation adjustments on some of our investments. These marks were more reflective of general market movements than company specific events, as the overall credit quality of our portfolio remains sound. In addition, we maintained the size of our portfolio by adding nearly $39 million of new investments across nine companies in the third quarter versus payoffs and exits of $43 million.

Consistent with our late cycle investment approach, all of these were first lien loans primarily made to larger companies with lower amounts of leverage.

Now I would like to share our view on the overall market environment. The competitive lending environment we experienced earlier in the year continued through the most recent quarter. There is a tremendous amount of capital targeting direct lending opportunities, extending a borrower-friendly environment in which some direct lending funds are approaching deals aggressively and taking on excessive risk. This translates into credit spreads that continue to be tight and generate covenant structures and terms that we find less attractive. While we are not seeing widespread signs of credit deterioration, an increasing number of direct lending funds are experiencing deterioration in several of their loans. These pressures may eventually help encourage a rebalancing of the direct lending market and create more attractive opportunities.

In keeping with our strategy, we continue to favor larger, more diversified companies with lower overall leverage and those that are in non-cyclical, defensive or structurally growing industries. We also continue to focus on investments that put us at the top of the capital structure.

OCSI's portfolio characteristics were generally stable from the prior quarter. At June 30, the portfolio was well diversified with $589 million invested at fair value across 82 companies in 32 industries. The portfolio almost entirely consisted of debt investments with 88% in first lien loans, 2% in second liens and 9% in our investments in the Glick JV.

We continue to weigh the portfolio toward larger middle market companies with lower amounts of leverage. The median annual EBITDA of companies in our investor portfolio increased to $139 million in the quarter, nearly double the amount since we began managing the portfolio and now over 60% of our borrowers have EBITDA levels greater than $100 million.

Leverage at our portfolio companies was 4.3x at quarter end, well below the overall market leverage levels of over 5.5x, and down nearly a full turn since we started managing OCSI. The weighted average yield on debt investments was 7.8%, which is down slightly from the prior quarter. New originations came in at modestly lower yields than our loans that were paid off during the quarter.

Turning to our repositioning efforts, non-core investments continue to represent a small portion of the portfolio, as just $45 million remain across eight investments as of June 30. Of these remaining non-core investments, approximately $12 million are publicly quoted liquid loans, one investment is on nonaccrual with $0 of fair value and the rest are performing private loans. We are working diligently to maximize the value of these investments and intend to methodically exit these investments over time when we believe that their values are optimal.

Given our conservative posture and disciplined investment approach, we identified fewer origination opportunities in the third quarter that met our standards. While we evaluated more than 200 potential transactions, we originated $39 million of new investments across five new and four existing portfolio companies, down from $64 million in the prior quarter. Consistent with our late cycle investment approach, all of our new investments were first liens and leverage was relatively low at just 4.0x.

Looking ahead, we will continue to deploy capital in a disciplined and cautious manner with risk under control, focusing on opportunities that will maintain our defensive portfolio and generate strong risk-adjusted returns over the long term.

In summary, we are pleased with our progress in maintaining a high-quality portfolio at OCSI.

I'll now turn the call over to Mel Carlisle to review our financial results in more detail.

Mel Carlisle ***Oaktree Strategic Income Corporation - CFO, Principal Accounting Officer & Treasurer***

Thank you, Edgar. We again reported strong investment income in the third quarter, while maintaining the portfolio's solid credit quality.

Net investment income in the third quarter was $5.9 million or $0.20 per basic and diluted share. This was up from $5.2 million or $0.18 per share in the previous quarter. The quarter-over-quarter increase in net investment income was primarily due to higher total investment income, which was $13.8 million, up from $12.5 million in the second quarter. As Edgar mentioned, the increase was due to higher interest and fee income, mainly related to call protection and prepayment fees received from the exit of U.S. Well Services.

Operating expenses, excluding management fees and interest expense, were $1.1 million, up slightly from the prior quarter, and down $233,000 from the same period one year ago.

Turning to net asset value. NAV was relatively stable at $9.71 per share compared to $9.74 per share as of March 31. The slight decline was due to mark-to-market valuation adjustments on some of our holdings. However, net investment income in excess of the dividend partially offset these adjustments.

The credit quality of the portfolio remains solid as no new investments were added to non-accrual in the quarter. 100% of our debt portfolio at fair value was performing.

With respect to leverage, our leverage ratio was essentially flat at 1.08x as compared to 1.07x on March 31, reflecting the fact that our portfolio size was also relatively flat over the same period.

As of June 30, total debt outstanding was $308 million and had a weighted average interest rate of 4.5%, down from 4.6% in the prior quarter. As a reminder, our debt is 100% floating rate that is tied to LIBOR, which will partially offset the potential impact that lower LIBOR will have on investment income.

Cash and cash equivalents, including restricted cash, were $14 million at quarter end, and we had $147 million of undrawn capacity on our credit facilities.

Moving to the Glick joint venture. At June 30, the JV had $164 million of total assets, including senior secured loans to 35 companies. The portfolio was relatively stable from the prior quarter, and $19 million in originations were partially offset by payoffs and pay-downs.

At quarter-end, the leverage ratio at the JV was 1.4x, unchanged from the prior quarter, and the credit facility had $39 million of undrawn capacity.

Now I will turn the call over to Matt.

Mathew M. Pendo ***Oaktree Strategic Income Corporation - COO***

Thank you, Mel. We continue to execute on our plan to grow OCSI's ROE, which has resulted in improved returns to date.

First, while leverage was unchanged during the quarter, we intend to gradually increase leverage closer to our long-term target ratio of 1.2x to 1.6x. We will continue to take a cautious but deliberate approach on this front pursuing only opportunities that meet our high standards and that are consistent with the Oaktree investing philosophy. Long-term, additional leverage will contribute to further portfolio diversity and help enhance returns.

Second, we intend to utilize additional investment capacity of approximately $39 million at the Glick JV. During the quarter, the JV originated $19 million, in line with pace of exits in the quarter and contributed $1.5 million of interest income to OCSI. While leverage is relatively flat at 1.4x in the quarter, we expect that, over time, the JV will increase leverage as it incrementally utilizes its remaining investment capacity.

Third, we can opportunistically invest in additional second lien loans to drive higher returns. With the exit of U.S. Well Services, second lien loans now make up only 2% of the total portfolio, leaving us plenty of opportunity to increase exposure.

In general, we are highly selective regarding second lien loans given where we are in the economic cycle. However, we will make the most of Oaktree's expertise and resources to identify and structure appealing transactions, should they arise.

And fourth, over time, we will rotate into higher-yielding investments. Our exposure to broadly syndicated loans priced lower than LIBOR plus 4% totaled $67 million at the close of the third quarter.

As we exit more of these loans in the coming quarters, we intend to reinvest in proprietary loans with higher yields to positively impact net investment income. In total, we believe these efforts should collectively drive further improvement to ROE.

Next, I'll discuss the dividend. As noted in our press release, we declared $0.155 dividend today, consistent with the prior three quarters. We continue to intend to pay a sustainable dividend that is based on the earnings of our portfolio.

Before I conclude, I'll update you on the proxy initiative that we put before our shareholders regarding the pending Brookfield transaction with Oaktree. As you may recall, in light of Brookfield Asset Management's merger agreement with the parent, our inventor advisor, Oaktree Capital Group, we sought a shareholder approval of a new investment advisory agreement between Oaktree and OCSI. The new investment advisory agreement will become effective when the merger closes. Notably, other than changing the date of its effectiveness, the terms of the new investment advisory agreement remain unchanged from those in the existing agreement. We are pleased to report this received overwhelming approval from shareholders. And we thank all those that voted their shares and participated in the meeting.

In summary, we are pleased with OCSI's strong third quarter results, which reflect the significant progress we have made to date and highlight our ability to find differentiated investments that can generate strong returns. As we look to the remainder of the fiscal year and into 2020, we believe OCSI is well positioned for continued strong results and will deliver attractive risk-adjusted returns to our shareholders.

Thank you all for joining us today. We look forward to updating you again soon.

With that, we are happy to take your questions. Operator, please open the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from George Bahamondes of Deutsche Bank.

George Bahamondes ***Deutsche Bank AG, Research Division - Senior Research Analyst***

I was just wondering if you can help quantify the amount of prepayment fees that were included in interest income this -- net investment income this quarter?

Mel Carlisle ***Oaktree Strategic Income Corporation - CFO, Principal Accounting Officer & Treasurer***

Sure. This is Mel. I'll take that question. There was about $157,000, call it, $158,000 OID acceleration. Actually, there was $410,000 of OID acceleration and $158,000 of prepayment fees.

George Bahamondes ***Deutsche Bank AG, Research Division - Senior Research Analyst***

Great. That's helpful. Second question. It seems like you're being very prudent around capital deployment. Just wondering if you can provide some high-level thoughts around maybe some of the broader, kind of, macro signals that you need or maybe changes to the competitive landscape or just any sort of color around what might result in maybe accelerated capital deployment? And kind of how you're thinking about the investment environment and some of the factors that would play into Oaktree maybe deploying a bit more capital than you've done more recently? I understand we are late in the credit cycle here and I'd imagine that as the opportunities to look a bit more attractive. You will deploy incrementally more capital, but I was just wondering how are you thinking about those things? Any sort of color that you can provide just so that we can be mindful of some of the factors that might play into increased capital deployment in coming quarters?

Edgar Lee ***Oaktree Strategic Income Corporation - CEO & CIO***

George, it's Edgar. Thanks for the question. So as you know, Oaktree over the years has commented that our investing activity isn't necessarily driven by the macro environment, although we keep an eye on the macro environment. That doesn't necessarily drive whether we deploy capital or not.

So let me start in a different direction and say, let's look at an individual company. What do we have to see at an individual company level? And how does that roll up then into a broader view about the markets? So when we look at the individual companies and compare and contrast, so in today's environment, there are number of opportunities that get presented to us, that we find, and we evaluate. When we evaluate these companies, we really look at these companies from the perspective of what is their core business and what is the core value proposition and value that they are delivering to their customers. And we look at who their customers are and the cyclicality associated with those customers. So companies that may, for example, be -- are businesses that are more -- that are oriented towards more selling services or goods that are oriented toward capital activity of customers that -- and their customers tend to be more cyclical in nature and volatile in nature, we may steer away from those businesses because we then translate that cyclicality into what do we think is the near-term core EBIDTA of the business and what is the liquidity profile of that business and its ability to support the capital structure that's being put in place. And we really look at it, as we've talked about in prior calls, in terms of cash EBITDA and not some heavily adjusted EBITDA, but we really look at cash EBITDA, and again, the liquidity of the company.

And what we are seeing in today's environment versus what we've seen in other periods is that, right now the companies that we are seeing today tend to be more cyclical in nature. They tend to be more marginal businesses in nature, meaning by their existence, if they didn't exist tomorrow, their customers and that industry would continue to move on just fine. So these companies tend to be more marginal in that sense. They tend to be overly levered relative to what we think is their normalized EBITDA. And they tend to have EBITDAs that are overly adjusted. And when we un-adjust those EBITDAs and get to their cash EBITDA, the liquidity tends to be more constrained. That is causing us generally to slow our investment activity and pace of investing. When we look at these individual opportunities, we're seeing more and more opportunities that fall into that bucket.

And when you roll that up into more of a background view, that's just a reflection of the competitive environment, not just a competitive environment in private lending, but generally across the credit markets. And as we see treasury rates go to 1.6% today, and even despite the pretty heavy equity sell-off, equity valuations are fairly robust. Investors are looking for places to generate yield and return and so they've gone into the non-investment grade part of the marketplace and you're seeing more and more capital flow there, and that has really led to less desirable companies being able to access credit. And that is really then filtering through in terms of the types of companies that are accessing the direct lending market in the private credit marketplaces, which is causing us to see companies that are less desirable and, therefore, curtail our activity. When we start to see those sort of micro characteristics change, in a much broader sense, you'll start to see our activity of capital deployment pick up.

George Bahamondes ***Deutsche Bank AG, Research Division - Senior Research Analyst***

Got it. That's helpful. Let's assume you are finding some companies that meet the overall cash EBITDA profile, leverage profile, liquidity profile that you would typically look before making an investment, are you finding that just given that there is excess liquidity in the market and maybe covenant packages that you aren't necessarily comfortable with, are you seeing that some of those yields might maybe slip away because folks are willing to provide terms that you are not necessarily comfortable with? Or are you mainly able to close on those transactions because you do like the profile of the company despite the fact that the terms might not be consistent with what you would be looking for given that there is so much capital that's trying to be deployed into, say, some of these more proactive companies?

Edgar Lee ***Oaktree Strategic Income Corporation - CEO & CIO***

It's a great question. So it's not mutually exclusive. They're tied to each other. So that if we find a company that's particularly attractive, the business we think is the one that has great growth characteristics, ability of cash flow, ability to service its debt, and we have confidence in their ability to refinance their debt, and that, if we had to own the company because of some very deep recession that we feel very comfortable about finding an M&A outcome to sell the business away, in those situations where we feel incredibly comfortable, there may be, in some cases, other market participants who are also looking at that transaction, that will lead to some compression of terms generally. And in some situations, we will follow and compress our terms and that's just a reflection of we have such conviction in that company that to give up a little bit of rate of return, for example, is worthwhile because we think the downside protection is that good.

In other situations, there may be no one else looking at that opportunity because that is something where we've actually created the opportunity. And in which case, we can really drive terms, especially in situations that are non-sponsored, where the borrower may not be accessing the capital markets all that frequently and, therefore, have more limited knowledge of what might be market terms. And, therefore, we think that, that is a more balanced situation and we don't have to necessarily take less desirable terms, but it really depends.

Mel Carlisle ***Oaktree Strategic Income Corporation - CFO, Principal Accounting Officer & Treasurer***

Just to follow-up on the U.S. Well's payment. In total, it contributed about $1.2 million. There was also a make-whole interest payment included, that was about $600,000. So that should get you to the $1.2 million.

Operator

(Operator Instructions)

There are no questions at this time. This concludes our question-and-answer session. I would like to turn the conference back over to Michael Mosticchio for closing remarks.

Michael Mosticchio ***Oaktree Strategic Income Corporation - IR***

Hey, I'll pass it over to Matt for concluding remarks.

Mathew M. Pendo ***Oaktree Strategic Income Corporation - COO***

Thanks, again, everyone for joining the call today. And just to reiterate, we felt OCSI delivered a very strong quarter, strong earnings, solid portfolio performance, net investment income increased to $0.20 per share, or 17% from the same period [last year] (added by company after the call). So it was a very strong quarter, very stable NAV. And again, we appreciate you taking the time today. Mike?

Michael Mosticchio ***Oaktree Strategic Income Corporation - IR***

Thanks, Matt, and thanks, everyone, for joining us on today's call. A replay of this call will be available for 30 days on OCSI's website in the Investors section or by dialing (877) 344-7529 for U.S. callers or 1 (412) 317-0088 for non-U.S. callers, with the replay access code 10133107, beginning approximately 1 hour after this broadcast.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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