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Q2 2019 Oaktree Strategic Income Corporation Earnings Call

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Welcome and thank you for joining Oaktree Strategic Income Corporation's Fiscal Second 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 all of you who have joined us for today's call to discuss Oaktree Strategic Income Corporation's 2019 Fiscal Second Quarter Financial Results. Our earnings release issued this morning and a slide presentation that accompanies this call 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. Following their prepared remarks, we will be happy to take your questions.

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. 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 Lee.

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

Thank you, Mike. And welcome, everyone, to our second quarter earnings conference call. We appreciate your ongoing interest in OCSI.

We delivered strong second quarter results with higher net investment income, a rebound in NAV, further portfolio repositioning and prudent portfolio growth. We reported net investment income per share of $0.18 for the second quarter, an increase from $0.17 the previous quarter and up 14% from a year earlier. We continue to generate high-quality earnings with cash interest representing 99% of total investment income. Further, our net asset value per share increased by $0.31 or 3.3% from the previous quarter, primarily driven by a rebound in credit markets and corresponding mark-to-market increases across the portfolio. And since quarter end, we have seen further price appreciation in the portfolio as prevailing market conditions have continued to improve. Of course, markets can change and we make no assurances that these positive trends will persist through quarter end.

We are selectively and prudently growing the portfolio. During the quarter, we added $64 million of new investment commitments across

14 companies. All were first lien loans. The overall size of our portfolio also grew as funded investments exceeded payoffs, paydowns and exits by $29 million.

Consistent with prior quarters, we continue to defensively position the portfolio and reduce its risks. We exited 1 small noncore investment during the quarter, and noncore investments now represent 9% of the portfolio. Only 8 noncore investments remain.

Before I get into more detail on our investments and portfolio composition, I'll update you on our view of the middle market lending environment. Following the steep downturn last December, both equity and credit markets experienced a strong rally in early 2019. This rebound was driven by several factors, including a favorable outlook for corporate earnings, heightened optimism for a potential U.S.-China trade deal, and importantly, messaging from the Federal Reserve that interest rates were unlikely to rise further in the near term. These positive events helped provide support for a broad rally in the credit markets, and OCSI's portfolio benefited from a related recovery in loan prices.

Although market conditions improved, we also experienced a corresponding return of aggressive competition in direct lending. Borrower-friendly terms have reemerged as funds continue to saturate a marketplace that is experiencing a relatively low level of supply of high-quality investment opportunities. While the market is very competitive, our experienced investment team, combined with Oaktree's extensive resources, enable us to identify several investments during the quarter. Against this backdrop, we remain highly selective in new originations, and as always, are focused on conservative underwriting and risk management, which are hallmarks of our investment approach. Our defensive posture has and will continue to position the portfolio to preserve capital while producing stable income and attractive risk-adjusted returns.

To this end, we continue to favor larger, more diversified companies with lower overall leverage and generally those that are in non-cyclical, defensive or structurally growing industries. OCSI's emphasis on portfolio diversity bolsters credit quality by ensuring we are not dependent on any given investment or sector.

At March 31, the portfolio was well diversified with a fair value of $592 million invested across 81 companies. The entire portfolio consisted of debt investments with 94% in first lien loans, excluding the Glick JV. We had an 8% weighted average yield on our debt investments, which is up slightly from last quarter, as our new originations came in at modestly higher yields than our loans that were paid off during the quarter.

The median portfolio company EBITDA was $125 million at the end of the second quarter. This metric has more than doubled since we began managing the portfolio over 18 months ago, and now over half of our borrowers have EBITDA levels greater than $100 million. Additionally, the average leverage at our portfolio companies has declined to 4.1x from above 5.4x over the same time period, while average middle market leverage multiples have remained elevated at around 5.4x.

Shifting to our repositioning efforts. We have reduced noncore holdings by 84% since we commenced management of the portfolio. And core investments now represent $490 million or 91% of the portfolio. Of the $46 million in noncore investments left, approximately $12 million are publicly quoted liquid loans. The remaining $34 million are private loans that represent only 6% of our portfolio. We expect to systematically exit these positions over time based on each individual circumstance, when we believe that their values are optimal.

Given our conservative posture and commitment to prudent risk management, we continue to take a highly selective approach to new investments. And therefore, we identified fewer origination opportunities in the second quarter that met our standards. As a result, we originated $64 million of new investments across 9 new and 5 existing portfolio companies, down from $93 million in the prior quarter. The investments were well diversified across 9 industries, ensuring that we are not reliant on any one sector.

We also continue to focus on lending to larger, more diversified borrowers. Looking ahead, you can expect a consistent and steady continuation of our proven approach to investing. We will deploy capital in a disciplined fashion, assessing opportunities across several sectors with an enduring emphasis on risk-adjusted returns over the long term.

In summary, we are pleased with the quarter and our continued momentum in developing a high-quality portfolio at OCSI.

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

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

Thank you, Edgar. We generated steady investment income in the second quarter while maintaining the portfolio's solid credit quality. Net investment income in the second quarter was $5.2 million or $0.18 per basic and diluted share. This was up from $4.9 million or $0.17 per share for the previous quarter. The quarter-over-quarter increase in net investment income was primarily due to higher interest income and lower operating expenses.

Total investment income of $12.5 million increased from $11.3 million in the previous quarter, mostly driven by a slightly larger portfolio and higher reset rates on our variable-rate portfolio. Net expenses excluding interest expense were $3.5 million, down slightly from the prior quarter. This was due to lower G&A expenses partially offset by higher net incentive fees due to improved portfolio performance.

The credit quality of the portfolio remains strong, and we only had 1 investment on nonaccrual. We are attributing zero balance sheet value to this investment as it has been fully written down.

Net asset value per share was $9.74, increasing from $9.43 per share for the December quarter, mainly due to higher mark-to-market adjustments on a number of our liquid debt investments following the market recovery earlier this year.

Page 13 of the earnings presentation provides a bridge that explains the key factors affecting the changes in NAV. At the end of the quarter, cash and cash equivalents totaled $2.9 million, and we had over $145 million of undrawn capacity on our credit facilities. Total debt outstanding was $308 million with a weighted average interest rate of 4.6%. Our leverage ratio increased to 1.07x at quarter end, up from 0.94x last quarter as we prudently grew the portfolio.

Moving to the Glick joint venture, at March 31, the JV had $168 million of total assets, including senior secured loans of 34 companies. The portfolio grew by $6 million during the quarter mostly due to the rebound and valuations and net portfolio growth. During the quarter, we extended the reinvestment period of the JV's credit facility to 18 months and lowered the interest rate by 35 basis points. The leverage ratio at the JV was 1.5x at March 31, up slightly from 1.4x for the prior quarter. And its credit facility had $31 million of undrawn capacity.

With that, I'll turn the call over to Matt.

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

Thank you, Mel. We continue to reposition the portfolio and execute on our strategic plan to enhance shareholder returns. While the progress to date has been substantial, we continue to identify several ongoing opportunities to increase OCSI's long-term return on equity.

First, we intend to grow the portfolio and move within a long-term target leverage ratio of 1.2x to 1.6x debt-to-equity. We're in the process of carefully deploying leverage towards our longer-term target range. The additional leverage will help us grow and further diversify the portfolio, enhancing returns. That noted, we will carefully manage through market conditions and pursue only opportunities that are consistent with the Oaktree approach.

Second, we can put to work additional investment and capacity in the Glick JV, assuming 2x leverage. The JV generated income of $1.5 million for OCSI during the second quarter.

Third, we're going to structurally invest in additional second lien loans, drawing upon Oaktree's expertise and resources to identify and structure transactions. Second lien loans made up only 5% of the total portfolio leaving us plenty of room for increased allocation.

And fourth, we can rotate into higher-yielding investments. Our exposure to broadly syndicated loans priced lower than LIBOR plus 4% totaled $75 million or 13% of the portfolio at the close of the second quarter. We intend to exit more of these loans in the coming quarters and reinvest into higher-yielding proprietary loans. This should positively impact our net investment income. All told, we expect these catalysts to further enhance ROE.

Turning to the dividend, as noted in our earnings press release, we declared a $0.155 dividend today. We intend to pay a sustainable dividend that is based on the earnings of our portfolio.

Finally, I want to give you some detail on the pending Brookfield transaction with Oaktree and how it affects OCSI. As you know, the parent company to our investment advisor, Oaktree Capital Group LLC, entered into a transaction with Brookfield Asset Management, whereby Brookfield will hold an approximately 62% economic interest in Oaktree's business, and Oaktree's founders and certain other members of Oaktree's management and employees will own the remaining 38% when the initial transaction closes. The transaction is structured such so that Oaktree's current management will maintain actual control of the management of Oaktree, subject to certain limited consent rights by Brookfield for an initial period of 7 years or more upon the closing of the deal unless certain conditions are triggered.

We do not believe the consummation of the merger with Brookfield would be deemed an assignment of the investment advisory agreement between Oaktree and OCSI for purpose of the Investment Company Act of 1940, although such determination is inherently uncertain. In accordance with the 1940 Act, however, the current investment advisory agreement would automatically terminate upon its assignment.

To prevent any potential disruption in our ability to provide services to OCSI once an assignment is deemed to occur, whether as a result of the merger closing; or later on, as a result of Brookfield exercising actual control of Oaktree, we recommended to our Board, and the Board approves taking share of the approval of a new investment advisory agreement between Oaktree and OCSI. As such, yesterday, we filed a preliminary proxy statement. The terms of the investment advisory agreement remain unchanged from those in the existing agreement other than changing the date of its effectiveness.

In closing, I want to reiterate that we maintain a defensive posture and a concentration of risk management. We'll continue to leverage Oaktree's platform to further improve returns and deliver even more value to our shareholders.

Thank you all for joining us today. We look forward to updating you again soon. And with that, operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will be from Bill Calvert with UBS.

William Calvert

You mentioned that you're seeing "aggressive competition" for direct lending. How are you seeing that impacting your investments? Are you seeing spread compression, change in covenants or any other factors?

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

I think all of the above. And thanks for the question. It's Edgar here. I would say all of the above that you just mentioned. So spread compression occurs. You see covenant deterioration occur. Third is that you'll also start to see velocity of the financing start to pick up as well as borrowers start to look at more borrower-friendly opportunities to refinance their capital.

Operator

(Operator Instructions) The next question comes from Jim Young with West Family Investments.

James Young ***West Family Investments, Inc. - VP & Investment Analyst***

It pertains to the marks that you have for your noncore portfolio. With the $34 million in your 3 companies, how comfortable are you with those marks? And could you just give us a -- like OCSL, you had a very large gain to recognize -- could you just give us a sense as to the marks relative to where you think actually that you will see this transition in? Lastly, how long do you think it will take until you can fully exit your noncore portfolio?

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

So with respect to marks, our general view and policy is to mark securities and investments based on what we think the fair market value is of those investments. I would say that in terms of how we view, based on the current information that we have, how we view these investments evolving is reflected in the marks that you see today. Could circumstances change to make us more constructive or less constructive on an investment in the future quarters? Absolutely. But I would say that generally, those marks today reflect our views on the investments.

In terms of time frame for exiting these investments, there's only a small number of investments in the noncore book and in OCSI right now. We don't give guidance as to timing, in part because there's just a lot of moving pieces on any one investment. Any time frame that I would provide would be speculative, and honestly changes often times from conversation to conversation, from data point to data point. And as you can see in OCSL, for example, sometimes we're surprised with the upside, sometimes they take a little bit longer than we anticipate. But you should know that the team here is working very hard to monetize these assets as soon as possible and at the most reasonable price possible.

Operator

At this time, I'm showing no further questions. So I'd like to turn the conference back over to Mr. Mosticchio.

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

Thank you again for joining us for our earnings conference call. A replay of this conference call will be available for 30 days in Oaktree Strategic Income'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 10130351, beginning approximately 1 hour after this broadcast.

Operator

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