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Q4 2020 Oaktree Strategic Income Corporation Earnings Call

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CORPORATE PARTICIPANTS

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Matt Pendo *Oaktree Strategic Income Corporation - President & COO*
Mel Carlisle *Oaktree Strategic Income Corporation - CFO & Treasurer*
Michael Mosticchio *Oaktree Strategic Income Corporation - IR*

PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Fiscal Fourth Quarter and Full Year 2020 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 fourth fiscal quarter and full year conference call. Our earnings release issued this morning and the slide presentation that accompanies this call can be accessed on the Investors section of our website at oaktreestrategicincome.com.

With us today are Armen Panossian, Chief Executive Officer and Chief Investment Officer; Matt Pendo, President and Chief Operating Officer; and Mel Carlisle, Chief Financial Officer and Treasurer. We will be happy to take your questions following their prepared remarks.

Before we begin, I want to remind you that comments on today's call include forward-looking statements reflecting our current views with respect to, among other things, the timing or likelihood of the merger closing, the expected synergies and savings associated with the merger, the ability to realize the anticipated benefits of the mergers and 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 and further detail. 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 OCSI 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 website.

With that, I would now like to turn the call over to Matt.

Matt Pendo *Oaktree Strategic Income Corporation - President & COO*

Thank you, Mike. And welcome, everyone, to our fiscal fourth quarter earnings conference call. We appreciate your ongoing interest in OCSI, and we hope everyone listening is well.

OCSI generated strong results for the quarter, highlighted by solid earnings, origination activity and credit quality. Risk sentiment further improved during the quarter and credit markets largely continued to rebound from their lows last March when the pandemic took hold. Higher credit spreads in the liquid loan market drove higher valuations in our portfolio in the September quarter, boosting NAV per share by 7% to $9.05 per share, approximately 93% of its pre-pandemic level.

Net investment income for the fourth quarter was $0.13 per share, up 18% from the prior quarter, driven by higher yields on new originations as well as higher make-whole interest and prepayment fees.

Based on the strength of OCSI's earnings, our Board of Directors declared a cash dividend of $0.145 per share, an increase of 16% from the prior quarter's distribution. This distribution represents approximately 100% of OCSI's taxable income in the quarter.

Given our focus on larger and more resilient companies, credit quality remains strong. Importantly, we remain well capitalized and have ample liquidity to continue to invest and to meet our funding needs. At September 30, liquidity included $25 million of cash and $83 million of undrawn capacity on our credit facilities.

While we were mindful of pandemic and the economic uncertainty it created, we continued to identify attractive investment opportunities with favorable yields in the fourth quarter. We originated $54 million of new investment commitments across 12 companies during the quarter, 86% were in first lien loans. The weighted average yield was 9.5%, which compares favorably to the approximately 5% weighted average yield on the investments that we fully exited during the quarter.

With a healthy pipeline, we continued to selectively deploy capital. Our ability to invest alongside other Oaktree funds gives us additional confidence that we will be able to participate in additional opportunities going forward.

Before I turn the call over to Armen, I wanted to highlight OCSI's plan to merge with and into Oaktree Specialty Lending Corporation, an affiliate business development company that's also managed by Oaktree. We believe this merger represents a great opportunity for shareholders of both OCSI and OCSL. It will create a larger, more scaled BDC that we expect will have increased trading liquidity. The merger could potentially broaden the combined company's shareholder base, and it may improve access to lower cost sources of debt. We also anticipate that it will drive NII accretion over both the near and long term, benefiting shareholders.

We believe now is the right time to move forward with this merger. Both portfolios are in great shape and our transition out of non-core assets that we've been working on since 2017 is nearly complete. As you know, we have also focused on defensively positioning both portfolios by lending to more diversified businesses with little exposure to cyclical industries, companies that we believe will be resilient through the pandemic. We appreciate all the support that we have received to date.

In terms of next steps, we anticipate filing the N-14 joint proxy statement in the coming weeks and expect the transaction will close in the first calendar quarter of 2021, subject to shareholder approval and satisfaction of the closing conditions as outlined in the merger agreement.

All told, we are pleased with our fourth quarter results, especially given the economic uncertainty caused by the pandemic. While it is difficult to determine the duration and ultimate impact of COVID-19, we are proactively investing and managing risk, and we believe OCSI is well positioned to continue to deliver attractive risk-adjusted returns to shareholders.

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

Armen Panossian ***Oaktree Strategic Income Corporation - CEO & CIO***

Thanks, Matt. After the March quarter's historic sell off in risk assets, credit and equity markets bounced back in the June quarter and the recovery continued into our fiscal fourth quarter. Improving economic conditions and consumer sentiment, reports of progress on COVID-19 vaccines and extraordinary fiscal and monetary stimulus fueled the rebound. These catalysts also boosted investor confidence, liquidity and the availability of credit.

In the credit markets, both high-yield and leveraged loans rallied further from their March lows, responding to the market's confidence. Spreads of both high-yield bonds and senior loans continued to tighten from the wide levels of March. It has not necessarily been a smooth upward trajectory, however. September and October were relatively challenging as a standstill in Washington on additional fiscal stimulus and the U.S. elections created uncertainty for investors.

Additionally, increased COVID cases and hospitalizations raised new concerns about the intensity and durability of the pandemic. That noted, news this month that a vaccine may soon be available, coupled with the culmination of the presidential election, fueled new momentum in the equity and credit markets. The economy, too, continues to forge ahead, albeit gradually and with occasional setbacks.

Against that backdrop, we maintain a conservative posture. In the U.S. and overseas the pandemic remains a highly fluid public health crisis and the economic recovery is likely to span several quarters. Elevated unemployment and muted GDP growth are likely to persist. Consumer sentiment and spending, which is a major driver of the economy, will be closely linked to job and income prospects. More than ever, it is important to be wary of market exuberance and to avoid chasing risky investment opportunities. We remain focused on protecting the downside in our investments and seeking appropriate compensation for risks taken.

We are focused on maintaining our high-quality and conservatively positioned portfolio. We continue to rotate out of names and sectors that could be challenged as the recovery slows. We are being cautious and disciplined about deploying capital, reserving dry powder where possible so we can go on offense quickly as investing opportunities emerge. We are also tracking themes in uncorrelated areas of the market, including life sciences investments and companies benefiting from societal shifts caused by COVID, including businesses in software and information technology.

Now turning to the overall portfolio. We feel very good about the overall credit quality of our mostly first lien portfolio. As Matt noted, since we took over management of OCSI in 2017, we have defensively repositioned the portfolio by lending to businesses that we believe will be resilient through an economic downturn. We've increased the overall size of our borrower, focusing on larger, more diversified businesses with little exposure to cyclical industries. To that end, the median portfolio company EBITDA is approximately $140 million, which is higher than that of a typical middle market company.

We have and intend to continue to selectively rotate out of lower-yielding investments and into new higher-yielding opportunities as we identify them. We are carefully tracking market conditions and maintaining close contact with our management teams and private equity sponsors. And generally, our portfolio companies have the necessary liquidity to navigate the environment in the near term. All of that noted, we are actively identifying new opportunities to create value for our shareholders.

I'd like to take a moment to discuss in more detail a couple of these types of investments that we made in the September quarter.

NeuAG is a fertilizers and agricultural chemicals company in Texas. It is the exclusive service provider to produce and distribute ammonium sulfate on behalf of BASF, North America's second largest producer and marketer of chemicals. NeuAG sought a construction loan to build a new facility that will serve as collateral for the loan, in addition to a guarantee backed by BASF.

Oaktree underwrote the entire $135 million first lien loan, of which OCSI was allocated $10 million. In addition to the downside protection, the 4-year first lien loan was attractively priced at LIBOR plus 5.5% cash and 7% PIK.

Immucor is a manufacturer of transfusion and transplant diagnostics products used by hospitals, donor centers and reference labs worldwide. Its products are used in tests performed in the typing and screening of blood, organs or stem cells to ensure donor recipient compatibility. The company operates manufacturing facilities in North America and has both direct and third-party distribution arrangements worldwide. Oaktree was asked to participate in a new $650 million first lien and $375 million second lien refinancing of the company's debt.

OCSI was allocated $8 million total, including $2.5 million of the first lien loan priced at LIBOR plus 5.75% and $5.5 million of the second lien loan priced at LIBOR plus 8% cash and 3.5% PIK.

Notably, we received $72 million of proceeds from prepayments, exits, other paydowns and sales in the fourth quarter, primarily driven by active sales of lower-yielding investments. We saw more value in selling these loans as their prices rebounded, generating proceeds that we can redeploy into private opportunities. We believe the months ahead will continue to provide OCSI with ample opportunities in both public and private investments. And we are confident that with Oaktree's resources behind us, we will be able to identify attractive transactions.

In summary, the overall credit quality of our mostly first lien investment portfolio remains in excellent shape despite the uncertain economic environment. With a solid balance sheet and ample liquidity to support our investment plan, we believe OCSI is well positioned to provide attractive risk-adjusted returns to shareholders.

Now I will turn the call over to Mel to discuss our financial results in more detail.

Mel Carlisle ***Oaktree Strategic Income Corporation - CFO & Treasurer***

Thank you, Armen. OCSI delivered another quarter of strong financial performance which also contributed to solid full year results.

For the fourth quarter of fiscal year 2020, we reported net investment income of $3.7 million or $0.13 per share, up from $3.2 million or $0.11 per share for the third quarter. The increase was the result of higher investment income and slightly lower net expenses.

During the quarter, total investment income was $9 million, up from $8.6 million in the June quarter. The increase was mainly due to higher interest income resulting from higher yields on new originations and higher make-whole interest and prepayment fees.

Net expenses for the quarter totaled $5.2 million, down $300,000 from the previous quarter. The decline was mainly due to lower interest expense resulting from lower average borrowings combined with lower LIBOR. This was partially offset by slightly higher professional fees.

Turning to credit quality, which remains excellent. As of September 30, excluding the Glick JV, we had no investments on nonaccrual, down from one in the prior quarter.

Moving to the balance sheet. During the quarter, we funded $52 million in investments, which was less than the $72 million in payoffs and exits. As a result, our net leverage ratio decreased to 0.9x from 1.1x at June 30, reflecting the smaller portfolio as well as the increase in NAV. We have adjusted our target leverage range lower as a result of the current market environment. We are being very selective on deploying capital due to what we believe to be a disconnect between market valuations and the underlying fundamentals. Our new leverage target range is 1.0x to 1.4x, and we are presently just below the low end of that range.

As of September 30, total debt outstanding was $268 million and had a weighted average interest rate of 2.6%, down from 3% at June 30, primarily due to the decline in LIBOR during the quarter. At fiscal year-end, we had total liquidity of approximately $108 million, including $25 million of cash and $83 million of undrawn capacity on our revolving credit facilities. Unfunded commitments were $34 million, although only approximately $14 million of this amount is eligible to be drawn immediately. The remaining amount is subject to certain milestones that must be met by portfolio companies.

During the fourth quarter, we reduced our borrowing costs by repaying and terminating our $25 million credit facility with East West Bank, as it had a moderately higher cost relative to our other facilities. In addition, we extended our Deutsche Bank facility, pushing the maturity date out by one year and reducing our total commitment to $160 million from $200 million.

Shifting now to the Glick Joint Venture. As of year-end, the JV had $138 million of assets invested in senior secured loans to 40 companies. This compared to $143 million of total assets invested in 41 companies last quarter. Two investments held by the JV, which represented 1.7% of the portfolio at fair value were on nonaccrual status. Leverage at the JV was 1.4x at September 30, down from 1.7x last quarter.

As you may recall, we restructured the Glick JV in the March quarter and placed our subordinated note investment in the partnership on nonaccrual. Although it remains on nonaccrual status, OCSI continues to benefit from the earnings power of the JV's underlying investment portfolio, which generated $1.4 million of net investment income during the fourth quarter, up from $1.1 million last quarter. This income was used to repay outstanding principal in the subordinated notes, of which $1 million was distributed to OCSI in October, similar to the July distribution. These two quarterly distributions each represented approximately $0.03 per share. And although OCSI is still not recognizing interest income, its share of the net investment income generated by the JV effectively translates into below-the-line income at OCSI.

Now I'll turn the call back over to Matt.

Matt Pendo ***Oaktree Strategic Income Corporation - President & COO***

Thank you, Mel. We are pleased with the solid operating results that we generated in the fourth quarter and full year despite the ongoing uncertain environment. We have essentially completed the defensive repositioning that we launched in 2017 and we feel very good about our current holdings.

As Armen noted, our overall pipeline of potential transactions remains strong, and we expect to continue to identify compelling investment opportunities in fiscal 2021. However, we will remain patient and disciplined as we believe there will be an increasing number of opportunities that will arise over time as the pandemic persists. We will also continue to position the portfolio for an improved yield by rotating out of lower-yielding investments priced at LIBOR plus 400 or lower.

During the fourth quarter, we opportunistically sold $14 million of these types of investments. At year-end, we had $52 million of these lower yielding loans, which we plan to replace over time with higher-yielding proprietary investments.

In conclusion, we are proud of our strong fourth quarter and full year results as well as the continued progress we made towards our ongoing strategic initiatives in fiscal 2020. We are also looking forward to the pending merger with OCSL as we believe that this combination benefits both shareholders through scale, portfolio diversity and expected earnings accretion.

We are excited about the future for the combined company and remain confident that we will continue to identify new attractive risk-adjusted investment opportunities that are consistent with Oaktree's disciplined risk controlled approach, enabling us to deliver improved returns to our shareholders.

Thank you for joining us on today's call and for your continued interest in OCSI. With that, we are happy to take your questions. Operator, please open the lines.

Operator

(Operator Instructions) I think no questions. I'll hand it back to Mr. Mosticchio.

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

Great. Thank you for joining us for our fiscal fourth quarter 2020 earnings conference call. A replay of this call will be available for 30 days on 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 10148615, beginning approximately 1 hour after this broadcast.

Operator

Thank you. The conference has now concluded. Thank you all for attending today's presentation. You may now disconnect your lines. Have a great day.
