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Q1 2020 Oaktree Strategic Income Corporation Earnings Call

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PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Fiscal First 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 fiscal first quarter financial results.

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 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 Matt Pendo.

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

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

We are pleased with our solid start to the year, highlighted by stable NAV, excellent credit quality and continued progress as we move through the final stages of repositioning the portfolio. We remain committed to reducing risk in the portfolio while producing attractive risk-adjusted returns.

During the quarter, we exited 2 additional non-core investments at par for a total of $7 million; only 4 non-core investments remain, accounting for just $36 million or 7% of the total value of our holdings. We continue to work diligently to maximize the values of our remaining non-core investments. Importantly, the overall portfolio is in excellent health with no investments on nonaccrual. We continue to be highly selective with new investments, prudently evaluating every opportunity with an understanding that we are in the late innings of the credit cycle.

For the first quarter, net investment income was $0.16 per share, down slightly from the prior quarter, primarily due to a decline in LIBOR, combined with modestly lower average investment balances. On a quarter-over-quarter basis, 1-month LIBOR was down approximately 40 basis points on average, and 3-month LIBOR was down 25 basis points, adversely affecting interest income on our floating rate loans.

During the quarter, we identified additional defensive investment opportunities and originated $35 million in new commitments. We received $46 million of proceeds from exits, prepayments and other paydowns and sales. And we have ample liquidity heading into 2020, with nearly $149 million of undrawn capacity on our credit facilities. Reflecting our conservative approach to investing, we operated below our target leverage range and closed the first quarter at 1.07x, up modestly from the prior quarter, but below our target range of 1.2 to 1.6x. We have plenty of room to increase leverage as attractive investment opportunities emerge this year.

As we evaluate deals, we continue to favor larger, more diversified companies with lower overall leverage and those that are in noncyclical, defensive or structurally growing industries. And we continue to focus on investments at the top of the capital structure, as 94% of our new investments during the quarter were in first lien loans. We believe this approach positions OCSI very well to deliver strong risk-adjusted returns to our shareholders. With that, I will now turn the call over to Armen.

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

Thank you, Matt. And again, welcome to everyone who joined us.

I'll begin with our assessment of the middle market lending environment. Competition in the direct lending and syndicated loan markets remains intense. A great deal of capital continues to flow into the space to address ongoing demand from institutional investors, including BDCs, CLOs and other private lending vehicles. As a result, terms continue to favor borrowers, and spreads are tight. As such, we are intensely focused on identifying unique investments with strong risk-adjusted returns. Oaktree's extensive resources enable us to source from multiple origination channels, including middle market sponsor and non-sponsor lending as well as broadly syndicated loans and bonds.

While borrower fundamentals remain relatively stable, reflecting U.S. economic conditions, we continue to see company-specific credit deterioration in certain loans held by a number of direct lending funds. This helps explain why we remain defensive. Even as we maintain discipline, we are finding attractive opportunities.

During the first quarter, as Matt noted, we originated $35 million of new investment commitments. These investments were spread across 11 companies; 2 of them were add-ons to existing borrowers. One of our prominent originations in the first quarter was to Chief Power Finance, a power plant operation that generates and distributes energy to customers in the Midwest and Northeastern U.S. OCSI was allocated $3.5 million of the $35 million first lien loan. Oaktree was the sole lender in this deal, and the loan was priced at LIBOR plus 6.50%.

Looking ahead, despite the broader competitive market dynamics, our pipeline is solid and includes potential investments in the sponsor and non-sponsor markets that we believe present an attractive risk/reward. We are well positioned to strategically capitalize on these new investment opportunities.

In January, notably, the pace of originations remained strong. We have closed $41 million in 5 deals to date. In total, these deals were attractively priced with a weighted average yield of 8.6%, and all were first liens.

Among these originations was a $13 million first lien loan to CIG Logistics, a provider of logistics services to the energy sector. Oaktree was the sole lender in this $100 million deal, which was well-structured and priced at LIBOR plus 8.50%. We also made a $10 million investment in Olaplex, a leading global specialty hair care product company, with a proprietary patented formula that repairs and strengthens damaged hair. Oaktree committed $139 million in total to this first lien loan, which was priced at LIBOR plus 6.50%. Both the Olaplex and CIG investments were privately placed transactions, demonstrating our ability to identify attractive opportunities across multiple industries and channels.

I'll turn now to the overall portfolio for the first quarter. At December 31, the portfolio was well diversified, with nearly $585 million invested at fair value across 84 companies. The portfolio almost entirely consisted of debt investments with 88% in first liens, 3% in second liens and 9% in our investments in the Glick JV.

We continue to weigh the portfolio towards larger borrowers with lower amounts of leverage. The median portfolio company EBITDA was $153 million at the end of the first quarter. This has more than doubled since we began managing the portfolio in 2017. And now 65% of our borrowers have EBITDA levels greater than $100 million. Leverage at our portfolio companies has declined to 4.6x from 5.4x over that same time period, while average middle market leverage multiples have remained relatively elevated.

As of quarter end, we had a 7.2% weighted average yield on our debt investments, which is down modestly from the prior quarter, primarily attributable to the decline in LIBOR.

Looking out on 2020, we will deploy capital opportunistically, but conservatively, evaluating investment opportunities across several sectors to maintain diversity and our focus on risk-adjusted returns over the long term.

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

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

Thank you, Armen.

Net investment income in the first quarter was $4.7 million or $0.16 per share. This is compared to $5.1 million or $0.17 per share in the previous quarter. The sequential decline in net investment income was primarily due to lower total investment income, which was $11.6 million, down from $12.1 million. This was primarily due to the decline in LIBOR during the quarter as well as a modestly smaller average portfolio.

Net expenses for the quarter totaled $6.9 million, relatively stable with the level in the previous quarter. Interest expense was down $246,000 due to the decline in LIBOR and was nearly offset by higher part 1 incentive fees and slightly higher professional fees.

With respect to our net asset value, our NAV was up slightly to $9.71 per share compared to $9.65 per share as of the end of September. The increase was mainly due to market appreciation across our publicly quoted holdings.

Moving to asset quality. The credit quality of the portfolio remained excellent as no new investments were added to nonaccrual in the quarter. And 100% of our debt portfolio continues to be performing.

Turning to the balance sheet. Our leverage ratio ticked up slightly from the prior quarter to 1.07x, but remains well below our target range of 1.2x to 1.6x. As of December 31, total debt outstanding was $306 million and had a weighted average interest rate of 4%, down from 4.2% in the September quarter. As we pointed out on prior calls, the debt portfolio is entirely floating rate and is tied to LIBOR, which is partially offsetting the impact that lower LIBOR has had on investment income. Cash and cash equivalents were $18 million at quarter end, and we had $149 million of undrawn capacity on our credit facilities.

While there were no changes to our capital structure during the quarter, we continue to review opportunities to reduce our cost of capital and extend our maturities.

Moving to the Glick joint venture. At quarter end, the JV had $171 million of total assets, including senior secured loans to 42 companies. Originations in the quarter were $25 million at a weighted average yield of 6.9%. Leverage at the JV increased to 1.6x, up from 1.5x at the end of September. And the credit facility had $26 million of undrawn capacity. Now I will turn the call over to Matt.

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

Thank you, Mel.

We are proud of the progress we have made in delivering improved performance and returns since we took over the management of OCSI in late 2017. We continue to believe that we have additional runway in front of us to further enhance our ROE, while maintaining our conservative approach to managing the portfolio.

We have discussed these initiatives in the past, and we have made important progress on all of them. We continue to focus on several initiatives to improve OCSI's long-term return on equity. One way that we will be able to drive higher returns is by deploying more leverage at the portfolio level. We made progress on this since taking over in 2017 as leverage has increased from 0.87x two years ago to 1.07x at quarter end. That said, we are still operating below our long-term target of 1.2 to 1.6x. So we do have the ability to enhance returns as we continue to make investments and deploy higher leverage. However, we will only grow the portfolio as we find opportunities that are consistent with our investment approach that we believe offer attractive risk-adjusted returns.

In addition, our efforts to optimize the Glick JV are contributing positively to our results. As Mel mentioned, the JV's leverage at quarter end was 1.6x, below the longer-term target of 2.0x. We expect that over time, the JV will increase leverage as it incrementally adds attractive investments.

Finally, while we are defensively positioned, we can opportunistically invest in additional second lien loans to drive higher returns. These loans now make up only 3% of the total portfolio, leaving us ample room for growth. While we are highly selective at this stage in the economic cycle, we remain confident that we can identify and invest in appealing transactions when opportunities emerge.

Altogether, we believe these efforts should collectively drive further improvement to ROE.

Moving to the dividend. As noted in our press release, we declared a $0.155 dividend, we intend to pay a sustainable dividend that is based on the earnings capability of our portfolio.

In conclusion, we are pleased with the overall performance for the first quarter. As we look into 2020, we believe OCSI is well positioned as we maintain a defensive posture while continuing to leverage Oaktree's platform to further improve returns and generate shareholder value. 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 is from Fin O'Shea of Wells Fargo Securities.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Just a small one on the slides here. It looks like your post quarter investment activity is virtually the same and, yield-wise, with your sister BDC OCSL. So can you give us any context on say what -- is that more meaningful for one or the other? Are you getting more aggressive here in OCSI? Or less so than the other?

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

Thanks. This is Armen. I think it's more of a coincidence than anything else. There was one credit, CIG logistics, that we put a smaller allocation in OCSI versus OCSL. That is [priced at] (added by company after the call) LIBOR plus 8.50%. And that one is a first lien. It's a very highly structured first lien. It was one of those situations that we thought made sense for OCSI and less scale than in OCSL. But I think we're starting with a pretty small sample size. And therefore, I don't think any meaningful conclusions can be derived.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Thank you for the context there. And just another one is we've discussed there was a fee accrual reversal in the OCSL BDC. And I'm not sure I see one here, correct me if I'm wrong, but was there just not a similar gains experience? Or did that construct -- the fee construct not exist with this BDC?

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

So there was a 2-year waiver period as well for OCSI. The difference here is that there were no part 2 incentive fees for OCSI. And there was about $1.2 million that was waived, and that is a function of the difference in part 1 incentive fees between Oaktree and the former manager. And to be more specific, there's a difference in the catch-up between the two. Under Oaktree, the catch-up is 100% over 6% and the former manager was 50% up to 20%, whereas our incentive fee was lowered to 17.5%. So it's a timing difference with the spread.

Operator

The next question is from [Chris Gastelu], a private investor.

Chris Gastelu

And congrats on another good quarter of progress. Just one quick question on the Glick JV, and I apologize if you've addressed this in the past. But the equity interest has a cost of $7.1 million, and the fair value currently is $0. Could you describe what would need to happen for that to be marked up and work its way back to fair value? What dynamics are there? Because it could be like $0.24 a share of NAV if we got back the fair value to cost?

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

It's Matt. Thanks for the question. It's a function of the performance of the portfolio, the assets in the JV. So that's reflected on the balance sheet. So that type of appreciation in the portfolio would generate that result.

Operator

(Operator Instructions) There are no other questions at this time. This concludes our question-and-answer session. I would like to turn the conference back over to management for closing remarks.

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

Thank you again for joining our earnings conference call. A replay of this conference 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 10138076, beginning approximately 1 hour after this broadcast.

Operator

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