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Q3 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 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 third fiscal quarter conference call. Our earnings release, which we 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 impression that it shares on its website.

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

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

Thank you, Mike, and welcome, everyone, to our fiscal third quarter earnings conference call. We appreciate your ongoing interest in OCSI. We hope everyone listening is well. The health and safety of our team and the effective management of our portfolio remain top priorities as we navigate the COVID-19 pandemic. We are capitalizing on Oaktree's first-rate technology platform and while the team continues to work remotely, we have been very successful to date as a virtual company and will remain fully operational for the duration of this public health crisis.

Turning to our results. The June quarter stood in contrast to the March quarter as global risk sentiment improved significantly and equity and credit markets partially rebounded from their lows. While our portfolio was not immune to the extreme market disruption in March, tighter credit spreads in the liquid loan market drove higher valuations in our portfolio in the June quarter, leading to an 18% increase in NAV per share. This represented a $39 million recovery of the March quarter NAV write-down.

As we detailed on our call last quarter, our portfolio has a large exposure to liquid loans. One of the benefits of having these liquid debt investments is that it allows us to actively manage risk in the portfolio and move in and out of positions opportunistically. One potential drawback to this approach is that our portfolio from time-to-time will be impacted by mark-to-market volatility, which is what we experienced in the March quarter. However, following the rebound in the liquid credit markets, the prices of these investments increased by 9%, which contributed $31 million to the improvement in NAV. These liquid debt investments continued to experience price appreciation of approximately 1.5% during the month of July.

Also contributing to the NAV increase were our investments in the Glick JV, which were written up by $8 million or 21%, reflecting improvements in the underlying investment portfolio, which is primarily composed of liquid first lien loans.

Our earnings for the quarter were primarily impacted by lower LIBOR, which has declined by over 150 basis points this calendar year and lower original issue discount income acceleration resulting from prepayments. As a result, net investment income for the third quarter was $0.11 per share, down from $0.15 the prior quarter. Our Board of Directors declared a cash dividend of $0.125 per share, consistent with the prior quarter's dividend.

Given our focus on larger and more resilient companies, our credit quality remains strong. Only one new investment was placed on nonaccrual status during the quarter. Excluding the Glick JV, nonaccruals represented 0.5% of the debt portfolio cost and 0.4% at fair value.

Importantly, we remain well capitalized and have ample liquidity to continue to invest and to meet our funding needs. At June 30, liquidity totaled $123 million, including $30 million of cash and $93 million of undrawn capacity on our credit facilities.

While we remain very disciplined in our investment approach, given the current level of economic uncertainty, we continued to identify attractive investment opportunities with favorable yields in the third quarter.

We originated $42 million of new investment commitments during the quarter, virtually all in first lien loans. The weighted average yield was 9.5%, which compares favorably to the approximately 5.5% weighted average yield on the investments that we exited during the quarter. Our pipeline is strong, and we continue 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 provide an update on a new initiative that will enhance our firm-wide sourcing efforts. In June, Oaktree announced the formation of a new group to source and originate private credit opportunities across all of Oaktree's strategies in North America. This new team will support our existing sourcing and origination function going forward, which will facilitate and deepen Oaktree's already strong reputation as a go-to lender. We believe that this will continue to widen the funnel of opportunities that OCSI will see, enabling us to selectively grow our portfolio and deliver improved returns.

All told, we are pleased with our third quarter results in light of the economic uncertainty caused by the pandemic and significant decline in LIBOR. While the market continues to evolve, and it's difficult to determine the time frame and ultimate impact of COVID-19, we are proactively investing and managing risks that may arise in our portfolio and 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 following extraordinary fiscal and monetary stimulus actions, which boosted liquidity and the availability of credit, thereby supporting individuals, businesses and markets.

In the credit markets, both high-yield and leveraged loans rallied from their March lows, responding to the market's confidence in the implicit backstop provided by the Federal Reserve, given its commitment to ensure the markets remain liquid and functioning in an orderly manner.

We maintain a conservative posture, however, because the optimism evident in the markets, in our view, doesn't align with company fundamentals or the current state of the broader economy. In the U.S., the pandemic remains a highly fluid public health crisis.

Confirmed cases and hospitalizations have continued to rise across much of the country, halting or reversing re-openings. With an uncertain path to recovery, companies may make temporary or permanent cuts to payroll or capital expenditures. We expect numerous industries to experience several years of stress and distress as companies reassess their business models, including how they use real estate, who they employ and where, and how they distribute their products. Consumer sentiment and spending, which is a major driver of the economy, will be closely linked to job and income prospects. And aside from the pandemic, the potential impact of the upcoming U.S. election represents another area of uncertainty.

That's all to say that we anticipate further volatility in the markets, and we remain focused on maintaining our high-quality and more conservatively positioned portfolio. We continue to rotate out of names and sectors that have outperformed expectations and could be challenged if the recovery slows. We are being cautious and disciplined about deploying capital, reserving dry powder, where possible, so we can go on offense quickly if another buying opportunity presents itself. We are also tracking themes in uncorrelated areas of the market, including life sciences investments, businesses with pent-up demand that will benefit when the economy reopens and companies benefiting from COVID, including businesses in software and information technology.

Now turning to the portfolio. We feel good about the overall credit quality of our mostly first lien portfolio. Since we took over management of OCSI in 2017, we have been focused on defensively positioning the portfolio by lending to businesses that we believe will be resilient through an economic downturn. We have 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 $130 million, larger than the typical middle market company. The downturn, of course, has affected companies within the portfolio, and we are closely monitoring all of our positions. That said, we continue to have limited exposure to industries impacted by the pandemic. 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. Over time, we intend to selectively rotate out of lower-yielding investments and into new higher-yielding opportunities as we identify them.

We were active deploying capital in the June quarter as we were able to find interesting opportunities in companies with attractive risk-reward profiles. OCSI originated $42 million of new investment commitments during the quarter. Aside from a few opportunistic secondary market purchases in April and May, most of our new investment commitments were in the primary and private credit markets. We discussed one of these, Airbnb last quarter. I'd like to take a moment to discuss in detail a couple of these types of investments that we made in the June quarter.

Athenex is a publicly listed global clinical stage biopharma company with an extensive manufacturing and development platform, focused on discovering and commercializing novel cancer treatments. The company was seeking to refinance its existing senior debt and raise additional capital to provide it with runway for the development of new medications. Oaktree underwrote $225 million of 6-year senior secured debt, of which OCSI was allocated $15 million. 40% of this loan was funded at close, and the remaining tranches are subject to certain milestones that must be met by the company. This loan was attractively priced with an 11% cash coupon and includes 3 points of OID and a 2% exit fee at maturity. In early August, we sold 22% of our position to another lender at a modest gain.

William Morris Endeavor is a privately held global entertainment, sports and content company that generates revenue through media rights sales, sponsorships, subscriptions, license fees, ticket sales and pay-per-view programming. Impacted by restrictions put in place to slow the spread of the coronavirus, the company needed a loan to bridge the gap to economic recovery when a post pandemic demand resurgence for live events should drive improved performance and cash flow. The company has significant equity cushion, and our loan was priced attractively at LIBOR plus 8.5%. Oaktree was the largest lender in the $260 million secured debt financing, and OCSI was allocated $8 million.

Payoffs, pay downs and exits for the quarter were $91 million, which included the sale of $76 million of low-yielding investments and opportunistic investments in March. We saw more value in selling these loans as their prices rebounded, and we sought to redeploy the proceeds into private opportunities.

We believe the months ahead will continue to provide OCSI with ample opportunities in both public and private investments, and 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 sound amid the uncertain economic environment. With a solid balance sheet and ample liquidity to support our investment plans, 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. For the third quarter of fiscal year 2020, we reported net investment income of $3.2 million or $0.11 per share down from $4.6 million or $0.15 per share for the second quarter. The decline was due to lower investment income, partially offset by lower expenses.

During the quarter, total investment income was $8.6 million, down from $10.3 million in the previous quarter. Approximately $1.1 million of the decline was driven by lower interest income resulting from downward pressure on the average yield of our floating rate debt investments, due to the decline in LIBOR and a smaller portfolio size. The remaining $600,000 was driven by lower OID income acceleration from prepayments and lower fee income.

Net expenses for the quarter totaled $5.5 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. We also recorded lower management fees due to the smaller portfolio and professional fees and G&A expenses were also down from the prior quarter.

Turning to credit quality. Excluding the Glick JV, only one company was on non-accrual status at quarter-end. This investment is a relatively small position, representing 0.5% of the debt portfolio at cost and 0.4% at fair value, and it was placed on nonaccrual during the June quarter.

Moving to the balance sheet. During the quarter, we funded $35 million in investments, which was less than the $91 million in payoffs and exits. As a result, our net leverage ratio decreased to 1.1x from 1.4x at March 31, reflecting the smaller portfolio as well as the increase in NAV. We are presently just below the low end of our target leverage range of 1.2x to 1.6x.

As of June 30, total debt outstanding was $312 million and had a weighted average interest rate of 3%, down from 3.8% at March 31, primarily due to the decreases in LIBOR during the June quarter. At quarter-end, we had total liquidity of approximately $123 million including $30 million of cash and $93 million of undrawn capacity on our revolving credit facilities. Unfunded commitments were $32 million, although only approximately $9 million of this amount is eligible to be drawn immediately, as the remaining is subject to certain milestones that must be met by portfolio companies.

Shifting now to the Glick joint venture. As of quarter-end, the JV had $143 million of assets invested in senior secured loans to 41 companies. This compared to $153 million of total assets invested in 44 companies last quarter. Two investments held by the JV, which represented 1.6% of the portfolio at fair value, were on nonaccrual status. Leverage at the JV was 1.7x at June 30, down from 2.3x last quarter.

As you may recall, in light of the market volatility last quarter, we restructured the Glick JV 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 $1.1 million of net investment income during the quarter. This income was used to repay outstanding principal on the subordinated notes, of which $1 million was paid to OCSI in July.

Now I'll turn the call over to Matt.

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

Thank you, Mel. We entered this crisis in solid financial shape. We have largely completed the defensive repositioning of OCSI's portfolio and we feel good about our current holdings. We continue to be well capitalized and have ample liquidity, which has allowed OCSI to successfully navigate this challenging environment. Oaktree has a proven track record investing in private credit across market cycles, and as a result, we believe OCSI is well positioned to participate in attractive transactions that ensure downside protection.

As Armen noted, we have continued to invest throughout the pandemic, and we expect to remain active going forward. However, we will continue to be patient and disciplined as we believe there will be an increasing number of opportunities that will arise over time as the crisis persists.

We believe that OCSI is well positioned to increase return on equity going forward. We will continue to position the portfolio for improved yield by rotating out of lower-yielding investments priced at LIBOR plus 400 or lower. During the third quarter, we opportunistically sold $36 million of these types of investments. As of quarter-end, we had approximately $70 million of these loans, which we plan to replace over time with higher-yielding proprietary investments.

In addition, we can increase returns by deploying more leverage at the portfolio level. As Mel mentioned, we were operating just below the low end of our long-term target of 1.2x to 1.6x, so we 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 and that we believe offer attractive risk-reward.

In conclusion, we are pleased with our overall performance for the third quarter, given the ongoing uncertainty surrounding the pandemic. We remain confident that we will be able to manage through any challenges that may arise in our portfolio as well as identify new attractive risk-adjusted investment opportunities, 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're happy to take your questions. Operator, please open the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question today comes from Chris Gastelu of CG Advisors.

Chris Gastelu ***CG Advisors***

Congrats on a good quarter. My question relates to the Glick JV. Last quarter, you indicated that it could, and not will, but could potentially go back on accrual, and I believe it was October, and I was just wondering if now with another quarter behind you, if you're still feeling like that's the reasonable time frame. And then if it does go or when it does go back on accrual, is there any recapture of accrued at that time?

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

This is Mel. I'll take that question. Our original plan was for the JV to start paying again in October. However, given the uncertainty, it's hard to say definitively. We'll reevaluate things at the end of the quarter. If we were to put the JV back on accrual status, we'll recognize interest income just for that September 30 quarter. There wouldn't be any recapture.

Operator

(Operator Instructions) The next question comes from Bill Calvert of UBS.

William Calvert ***UBS***

Would you mind expanding a little bit on the (technical difficulty) are you going to have access to a wider network of potential deals?

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

I would say you broke up a little bit. I think you were asking about the sourcing and origination kind of organization changes or was there something else?

William Calvert ***UBS***

No, just the announcement announced within Oaktree in June about the new sourcing network that you're going to have.

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

Sure. So what we did there, we have a variety of sourcing professionals across Oaktree embedded in a variety of different groups here. What we decided to do was to lift out all of those sourcing origination folks to speak for the entirety of the firm rather than for specific strategies. In addition, we are adding members to that team to cover particular industries or geographies. So the overall number of sourcing and origination professionals will continue to grow. The reason to do that was, I think, it gives us a better and more cohesive way of speaking with the market, whereby individuals now speak for the entirety of the firm, all the way -- from lower risk, lower returning funds under management that we have at Oaktree, all the way up to the higher returning and higher risk funds that we have that are equity-like in nature. And offering that suite of solutions across the spectrum, it really provides us the ability to offer a pretty creative set of solutions to the market. And we're seeing a lot more kind of engagement with the market as a result, because we are able to speak pretty cohesively rather than confusing the market with the various different groups and the various different people that have touch points with the market. So the thought is that if we speak in a more unified voice, we bring more assets under management across the firm to invest in further sourcing and origination capacity and resources will really improve how much reach we have for OCSI and for all of our individual businesses as well.

Operator

(Operator Instructions) We have no further questions at this time, Mr. Mosticchio.

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

Thank you for joining us for our fiscal third quarter 2020 Earnings conference 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 replay access code 10145870, beginning approximately 1 hour after this broadcast.

Operator

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