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Q4 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 fourth quarter conference call. Today's conference call is being recorded. At this time, all participants are in a listen-only mode, but will be prompted for a question-and-answer session following the prepared remarks. 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 fourth quarter financial results. 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 information that it shares on the corporate website.

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

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

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

We are pleased to report a solid finish to the full year, highlighted by net investment income growth, continued progress repositioning the portfolio, and excellent credit quality.

Importantly, we reported net investment income per share of $0.72 for fiscal 2019, a 7% increase from the prior year. Successful investment exits and realizations along with overall higher levels of investment income resulting from a larger average portfolio helped drive the annual growth.

For the fourth quarter, net investment income per share was $0.17, down from $0.20 the prior quarter, primarily driven by higher prepayment fees and OID acceleration of $1.4 million in the prior quarter resulting from the exit of our investment in U.S. Well Services.

Total investment income for the full year rose 4% to $49.6 million, thanks to our larger investment portfolio and fees received from successful investment exits. The quality of earnings continues to be strong, as interest income represented over 99% of total investment income for the fourth quarter.

Our net asset value per share for the fourth quarter decreased slightly from the previous quarter, affected in part by mark-to-market valuation adjustments on some of our investments due to spread widening. These marks were more reflective of market pricing than company-specific events.

Reflecting our ongoing commitment to reduce risk in the portfolio, we made continued progress repositioning it over the course of the year, while at the same time producing stable income and attractive risk-adjusted returns. We reduced non-core investments by $16 million across five companies in 2019. Since quarter end, we have exited another $7 million in two portfolio companies at par. Including these exits, only four non-core investments remain in the portfolio, which account for 7% of the total value of our holdings. We continue to work diligently on maximizing the values of our remaining non-core investments, which we expect will continue to occur over time.

During the quarter, we were able to selectively identify defensive investment opportunities and originated $51 million in new commitments. We received $40 million of proceeds from exits, prepayments and other paydowns. And we have ample liquidity heading into 2020, with $160 million of undrawn capacity on our credit facilities.

As a result of this conservative approach to investing, we operated below our target leverage range - and finished 2019 at 1.04x versus a target of 1.2 to 1.6x. In addition, the credit quality of the portfolio remained solid as no new non-accruals were added in fiscal 2019, and we ended the year with no investments on non-accrual.

In fact, our disciplined investing defined the year. We increasingly favored larger, more diversified companies with lower overall leverage and those that are non-cyclical, defensive or structurally growing industries, and we focused on investments at the top of the capital structure.

During the year, we also successfully enhanced the capital structure at the Glick joint venture. We amended terms, extended the maturity, and lowered the pricing on its credit facility, enhancing the JV's financial flexibility.

Finally, as you know, on September 30, Armen Panossian was appointed CEO and CIO of OCSI.

Armen has assumed portfolio management responsibility for Oaktree's BDCs and Strategic Credit, the team that is responsible for managing OCSI's portfolio.

Armen is a respected investor with extensive experience in opportunistic and performing credit. He joined Oaktree in 2007 as a member of our Distressed Debt investment team, where he focused on many of the group's successful credit investments.

In 2014, he moved on to our U.S. Senior Loans strategy, where he assumed portfolio management responsibilities. In this role, Armen built an impressive track record that included improved performance and growth in our U.S. Senior Loans strategy and strong returns in Oaktree's CLOs.

Armen's background, investment acumen, and significant leadership experience make him the ideal leader for OCSI. We are fortunate to have a deep bench of highly talented investment professionals and leaders to draw from at Oaktree, and we are confident that Armen will lead the

Company to its best years ahead.

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

Armen Panossian

Thank you, Matt.

Before discussing the market environment and the portfolio, I'd like to say that I am thrilled to be part of OCSI's management team and to lead the Company's continued progress. I look forward to meeting with many of you over the weeks and months ahead.

As Matt mentioned, I've been at Oaktree for nearly 13 years, starting in our Distressed Debt group, and then went on to run our U.S. Senior Loan group. While I manage a different strategy, I am quite familiar with the Strategic Credit investment team and the BDCs.

Throughout my career at Oaktree, I've spent a lot of time working with the Strategic Credit team, oftentimes investing alongside them. In fact, I have even hired some of the professionals who are now on that team.

I'm fortunate to join and manage a very strong team that has done an outstanding job in repositioning and managing OCSI's portfolio over the past two years. I look forward to building upon all of their great work.

Now I'll update you on our view of the middle-market lending environment. We continue to see elevated levels of competition in the direct lending and syndicated loan markets. There continues to be an abundance of capital willing to invest in this space, which is mainly driven by ongoing demand from institutional investors, including BDCs, CLOs, and other private lending vehicles.

Against that backdrop, competition remains intense and borrower-friendly terms persist. We continue to see tight spreads in both the direct lending and broadly syndicated loan markets, with spreads in the direct lending market tightening relative to the broadly syndicated loan market.

Meanwhile, borrower fundamentals remain relatively stable alongside the ongoing U.S. economic expansion. We are, however, identifying pockets of vulnerability, including isolated and company-specific credit deterioration in certain loans held by a number of direct lending funds. This reaffirms why we remain disciplined and defensive in our investment approach.

That said, we are mindful of relative value, and we are investing where we identify the best risk-adjusted returns. Because we draw up on Oaktree's extensive resources, we are able to source from multiple origination channels, and this diversity provides us with a unique set of investment opportunities.

During the fourth quarter, we originated $51 million of new investment commitments across eight issuers. One of these was an add-on to an existing borrower.

One of our largest originations this quarter was to PaySimple, also known as EverCommerce, a service commerce platform that provides business management, integrated payments, marketing and other solutions to small and medium-sized businesses. The company was seeking capital to support future growth initiatives and to recapitalize its balance sheet following an equity investment by a prominent private equity firm. In aggregate, Oaktree Funds invested $60 million in the first lien, of which OCSI was allocated $8 million. The loan was attractively priced at LIBOR plus 550 basis points and was supported by a healthy equity cushion of 77%.

The average yield for all of our debt originations was 6.8%, down slightly from the previous quarter and 97% were first lien loans. While our conservative approach has resulted in a slightly lower overall yield on new investments, we are confident that this is a prudent way to invest today, especially given the current competitive market environment.

Looking ahead, despite the broader competitive market dynamics, we are currently evaluating a number of interesting opportunities in our pipeline, including investments in the sponsor and nonsponsor markets that we believe present an attractive risk reward. That said, we continue to be patient, yet opportunistic, in our investment approach, and we believe we are well positioned today with ample liquidity to take advantage of new investment opportunities in our pipeline.

Turning to the overall portfolio. At September 30, the portfolio was well diversified with nearly $597 million invested at fair value across 84 companies. The portfolio almost entirely consisted of debt investments, with 88% in first liens, 2% 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 $158 million at the end of the fourth quarter, which has more than doubled since we began managing the portfolio in 2017. And now 63% 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 7.4% weighted average yield on our debt investments, which is down modestly from the prior quarter, primarily attributable to the decline in LIBOR during the quarter.

Looking ahead, 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, Principal Accounting Officer & Treasurer***

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

Net investment income in the fourth quarter was $5.1 million or $0.17 per basic and diluted share. This is compared to $5.9 million or $0.20 per share in the previous quarter.

The quarter-over-quarter decline in net investment income was primarily due to lower total investment income, which was $12.1 million, down from $13.8 million in the third quarter. This was mainly due to call protection fees and interest earned on the exit of our investment in U.S. Well Services last quarter. In addition, the portfolio generated slightly lower interest income due to the decline in LIBOR during the quarter.

For the full year, net investment income was up $1.4 million or 7%, driven mainly by portfolio growth and higher call protection received on loan payoffs. This was partially offset by higher net expenses, which were mainly the result of higher incentive fees due to improved portfolio performance.

Net expenses in the fourth quarter totaled $6.9 million, down $1 million from the June quarter. The decline was primarily driven by lower incentive fees due to the decrease in investment income. For the full year, operating expenses were down $1.4 million, primarily driven by lower professional fees and G&A expenses year-over-year.

Turning to net asset value. NAV was down slightly at $9.65 per share compared to $9.71 per share as of the end of June. The decline was due in part to mark-to-market valuation adjustments on some of our publicly quoted holdings. However, net investment income in excess of the dividend partially offset these adjustments.

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

With respect to leverage, our leverage ratio was down slightly to 1.04x as compared to 1.08x as of June 30. As of September 30, total debt outstanding was $295 million and had a weighted average interest rate of 4.2%, down from 4.5% in the prior quarter. As we have pointed out on prior calls, our debt is 100% 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 $14 million at year-end, and we had $160 million of undrawn capacity on our credit facilities.

Moving to the Glick joint venture. At September 30, the JV had $180 million of total assets, including senior secured loans to 39 companies. The portfolio grew during the fourth quarter as $22 million in originations were only partially offset by payoffs and paydowns.

At year-end, leverage at the JV increased to 1.5x, up from 1.4x at the end of June, driven by the larger portfolio. The credit facility had $33 million of undrawn capacity.

Now I'll turn the call over to Matt.

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

Thank you, Mel. We continue to focus on several initiatives to improve OCSI's long-term return on equity.

First, while our leverage remains below our target range as a result of our selective approach to new investments, we intend to gradually bring it 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 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 $33 million at the Glick JV. During the quarter, the portfolio grew by $60 million and contributed $1.5 million of interest income to OCSI. We expect ongoing and meaningful contributions from the Glick JV.

Third, while we are defensively positioned, we can opportunistically invest in additional second lien loans to drive higher returns. These loans now make up only 2% of our total portfolio, leaving us ample room for growth. We are highly selective at this stage in the economic cycle, but by leveraging Oaktree's expertise and resources, we are confident we can identify and structure appealing transactions when opportunities emerge. Altogether, we believe these efforts should collectively drive further improvements 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 summary, we maintain a defensive posture, given elevated levels of competition and a protracted cycle. But we also remain active, leveraging Oaktree's platform to further improve returns and generate shareholder value. As we look into 2020, we believe OCSI is well positioned for continued strong results and to deliver attractive risk-adjusted returns 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.

Operator

(Operator Instructions) I am showing no questions at this time. Mr. Mosticchio?

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

Thanks. Thank you for joining us for 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. dollars or 1 (412) 317-0088 for non-U.S. callers, with the replay access code 10135817, beginning approximately 1 hour after this broadcast.

Operator

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