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Q4 2018 Oaktree Strategic Income Corporation Earnings Call

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PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Fourth Fiscal Quarter and Full Year 2018 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 Fourth Fiscal Quarter and Full Year 2018 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 Edgar Lee, Oaktree Strategic Income's 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 fourth quarter and fiscal year-end earnings conference call. We appreciate your continued interest in OCSI and your participation in today's call.

We are proud of the progress we have made since we took over management of OCSI just over one year ago. Our team has successfully executed against our strategic initiatives by positioning OCSI's portfolio for improved performance and enhancing the return on equity for our shareholders.

Our portfolio repositioning efforts reflect our late-cycle approach to investing in private credit, as we have reduced the overall risk of the OCSI portfolio by shifting into investments that are better aligned with Oaktree's investment philosophy. We have exited most of our non-core positions and are actively investing in larger, more diversified companies. As of September 30, 2018, non-core investments represented only 12% of OCSI's portfolio, a decrease from 58% as of September 30, 2017.

During the last fiscal year, we also made great strides in enhancing OCSI's borrowing capacity and lowering our cost of capital. In the third quarter, we amended our credit facility with East West Bank and in the fourth quarter, we amended, expanded and extended our secured revolving credit facility with Citibank. We also redeemed our 2015 debt securitization and replaced it with a new and more flexible credit facility with Deutsche Bank. All of these actions resulted in lower interest rate margins.

Also in the fourth quarter, we received overwhelming support from our shareholders to allow for increasing leverage, which we plan to prudently deploy over the next several quarters as we selectively add investments that are well suited to support higher leverage.

And finally, we successfully integrated OCSI into Oaktree's operational platform, realizing cost savings and efficiencies. Through this integration, we upgraded OCSI's accounting, valuation, compliance systems and processes, as well as our information technology functions.

The momentum we built throughout the year continued in the fourth quarter and this was evident in our improved financial performance. In the fourth quarter, we delivered net investment income of $0.19 per share, a 27% increase from the first quarter. Our NAV per share at fiscal year-end was $10.04, up 1% from the prior year. Importantly, NAV was stable throughout the year.

Turning to the fourth fiscal quarter, we successfully continued our portfolio repositioning efforts, with core holdings now representing 88% of the portfolio at September 30 compared to 42% at the beginning of the fiscal year. The remaining 12% of the portfolio was non-core, but performing, and there were virtually no investments on non-accrual status.

During the fourth quarter, we exited $20 million of non-core investments, which in total were realized above their previous fair value marks.

With respect to our remaining non-core assets, we expect to continue exiting these investments at a steady pace, while also maximizing value for our shareholders. Approximately $18 million of the investments that are non-core are publicly quoted liquid loans. With respect to the remaining $39 million of private loans, we intend to opportunistically exit these positions when we believe their values have been optimized.

I'll turn now to the current market environment. Direct lending remains highly competitive. We continue to see an oversupply of funds in the marketplace competing for transactions, even as signs emerge that borrower demand is moderating from the strong pace of the last couple of years.

The current economic cycle is long by historical standards, but there are still no widespread signs of credit deterioration. That said, there has been some recent volatility in the equity, high-yield bond and broadly syndicated loan markets, largely driven by concerns about higher interest rates, global geopolitical issues and weakness in energy-related commodities. We haven't seen this volatility spread into the direct lending market, but we are monitoring the situation closely.

Against this backdrop, we continue to position our portfolio defensively, taking a highly selective and disciplined approach when evaluating new opportunities. At September 30, the portfolio was well diversified with a fair value of $557 million invested across 75 companies, resulting in an average investment size of $7 million or 1.3% of the portfolio at fair value. 95% of the overall portfolio, excluding our investments in the Glick JV, were in senior secured, first lien floating-rate loans.

We remain focused on investing in larger and more diverse companies that operate in non-cyclical, defensive or structurally growing industries, with lower overall amounts of leverage. The median debt portfolio company EBITDA has increased by over 50% since we began managing the portfolio. And now over half of our borrowers have EBITDAs greater than $100 million. The underlying leverage at our portfolio companies has declined to 4.2x from 5.4x one year ago, a stark contrast to the increasing leverage levels we have observed in the middle market over the past year. We believe investing in larger, more diversified companies with lower amounts of leverage will help reduce the risk of credit impairment in the portfolio.

During the fourth quarter, we originated $92 million of new commitments across 15 companies and 12 industries. Virtually all were first lien floating-rate loans, and the median portfolio company EBITDA was approximately $110 million, reflecting our approach to investing in private credit. In addition, $70 million of these investments were made in conjunction with other Oaktree funds.

While the market for direct lending remains competitive, our investment team has been able to uncover unique opportunities away from the private equity-owned segment of the market. The less competitive, non-private equity-backed segment allows us to structure transactions with more creditor-friendly terms while also generating strong risk-adjusted returns for our shareholders.

A great example of this was the Allen Media loan we originated in March. As you may recall, Oaktree originated a $310 million first lien loan to Allen Media to fund the acquisition of a well-known media asset, of which OCSI provided $24 million. During the fourth quarter, our loan was refinanced by debt issued in the public markets, generating a gross unlevered IRR of over 50% in the short time we held it.

This transaction demonstrates our ability to leverage the Oaktree platform to source unique investment opportunities and our ability to provide desirable capital solutions to private companies.

Looking ahead, we will continue to evaluate opportunities across all segments of the market that we believe will generate the best risk-adjusted returns over the long term. However, we remain cognizant of the frothy market environment and are focused on deploying capital in a disciplined and cautious manner.

In summary, we are pleased with our fourth quarter and year-end results and the significant progress we have made in optimizing the portfolio over the past year. We believe we have constructed a high-quality portfolio at OCSI and look forward to carrying this momentum into 2019.

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

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

Thank you, Edgar. We generated solid fourth quarter results and maintained our portfolio's excellent credit quality. Net investment income in the fourth quarter was $5.6 million or $0.19 per basic and diluted share. This was up from $5.1 million or $0.17 per share in the third quarter. The increase was mainly driven by higher investment income and partially offset by higher operating costs.

Total investment income of $14.7 million increased $3.1 million from the June quarter. This was mostly due to higher prepayment fees and OID acceleration on loan payoffs.

Net expenses were $9.2 million, up from $6.6 million last quarter. The increase was mainly due to higher part 1 incentive fees, net of fees waived and an increase in interest expense due to a $2 million non-cash write-off of unamortized financing costs. These costs were related to the 2015 debt securitization, which was redeemed during the quarter.

Credit quality remains solid. We have only one very small investment on non-accrual, which represented just 0.01% of the debt portfolio at fair value at September 30.

NAV increased 1.3% from the June quarter to $10.04 per share, mainly due to the higher net investment income and write-ups on portfolio investments. On Page 14 of the earnings presentation, we have provided a bridge that explains the key factors that led to the increase in NAV.

Cash and cash equivalents were $16.4 million at quarter-end and we had $180 million of undrawn capacity on our credit facilities. Total debt outstanding was $275 million with a weighted average interest rate of 4.3%.

Our leverage ratio increased slightly to 0.93x from 0.89x at June 30, reflecting higher borrowings on our credit facility. We plan to gradually expand our leverage over the next few quarters as we add senior secured investments to the portfolio.

Unfunded commitments outstanding at quarter-end were $22.8 million. These commitments are mostly related to portfolio companies with revolving credit facilities or delayed draw term loans.

Turning to the Glick joint venture. At September 30, the JV had $166 million of total assets invested in senior secured loans to 31 companies. This compares to $182 million of total assets invested in senior secured loans to 32 companies last quarter. These decreases reflect four early loan payoffs in the fourth quarter. At quarter-end, our leverage ratio at the JV was 1.4x, unchanged from the prior quarter and our credit facility had $30.7 million of undrawn capacity.

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

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

Thank you, Mel. We made great progress executing on our strategic plan to enhance returns to our shareholders over the past year. While we're encouraged by the advances to date, there continues to be a meaningful opportunity for us to further increase OCSI's long-term return on equity.

In July, we received strong shareholder approval to increase our leverage limit. Since then, we have completed all the necessary amendments from our credit facility providers to allow for higher leverage. We plan to prudently deploy leverage up to our target range of 1.2x to 1.6x over the next several quarters as we selectively add investments that are consistent with our investment philosophy. We believe that additional leverage will allow us to grow and further diversify our portfolio while enhancing our return on equity.

In addition, during the fiscal year, we successfully rotated out of $6 million of non-income generating investments, including two loans on non-accrual. At September 30, we held one equity position valued at $1.8 million, which was sold in October.

As we rotated out of various non-core positions over the past year, we accessed the broadly syndicated loan markets to help us redeploy assets due to the elevated pace of loan repayments. Our exposure to broadly syndicated loans priced lower than LIBOR plus 400 totaled $51 million as of September 30. Depending on market conditions, we expect to continue temporarily investing in these liquid loans to earn spread income during quarters of elevated repayments.

OCSI continues to benefit from rising interest rates given that our debt portfolio is entirely comprised of floating-rate loans. We expect to benefit if rates continue to increase in 2019.

Finally, we expect to modestly increase the amount of second lien investments in the portfolio over time. At quarter-end, second lien loans made up only 5% of our portfolio, excluding our investments in the Glick JV, providing ample capacity to increase their allocation should we find compelling investment opportunities.

Taken in aggregate, we expect these actions to be further accretive to ROE.

Now turning to the dividend. As noted in our press release, we declared a $0.155 dividend today. We remain focused on maintaining a distribution level that is sustainable and based on the earnings capability of our portfolio.

I'll conclude by saying that we're very proud of the progress we've made in our first year of managing OCSI. We start a new fiscal year with our portfolio performing well. Looking ahead, we will continue to leverage Oaktree's substantial resources and expertise to further enhance our return on equity and deliver 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 lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from Mickey Schleien of Ladenburg.

Mickey Schleien ***Ladenburg Thalmann & Co. Inc., Research Division - MD of Equity Research & Supervisory Analyst***

I wanted to ask you despite the markets move yesterday, at least to me it still looks like the Fed will raise rates several more times through next year. So I'd like to ask you how the average interest coverage ratio is trending in the portfolio and how are you managing that risk?

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

No, I'd say sort of a general statement, so far, companies have continued to experience improving cash flow profiles and therefore, that coverage ratio -- despite interest rates going up, that coverage ratio has stayed relatively constant thus far across the portfolio. There will be individual names that are doing slightly better and worse, but on average, it's been pretty constant.

Mickey Schleien ***Ladenburg Thalmann & Co. Inc., Research Division - MD of Equity Research & Supervisory Analyst***

Okay. Are there any particular areas of risk in the portfolio that may be increasing with the change in control of the House next January? For example, aerospace, I see is an important sector for you and there was a case to be made that growth in defense spending may decrease. So any particular areas that you're concerned of from a sector perspective?

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

Specifically, with respect to OCSI, there aren't any general trends or high-level concerns that we have as it relates to the change in the House -- or control of the House. The portfolio does have exposure to aerospace and defense, but most of that exposure is in the aerospace sector and most of those borrowers are under long-term contracts, that will go on for a number of years.

More broadly in the marketplace overall, I think government spending is an area to focus on and one that we're closely monitoring and particularly in places like aerospace and particularly defense, but the other place would be in health care and pharmaceuticals. The portfolio today doesn't have a material amount of exposure in that area, but it is an area that we're watching closely as well.

Mickey Schleien ***Ladenburg Thalmann & Co. Inc., Research Division - MD of Equity Research & Supervisory Analyst***

I was actually going to ask about health care because you could make a case that perhaps health care spending will go up if you stay away from reimbursement risk. Is that a sector that actually may become more interesting to you?

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

I think health care has always been an interesting area for us. Health care, if we think about it, you break it down into three segments: health care services, health care equipment and then life sciences, life sciences being pharmaceuticals and other drugs. In the health sciences, we've been focusing on areas where -- or on companies where they can help actually reduce costs of providing health care services. And then we think there has been a fair amount of shift and risk associated with Medicare and Medicaid reimbursement and CMS codes -- changes in CMS codes and therefore, we've been very cautious about getting overly exposed to the actual service providers and instead have focused more on providers who cut those costs. On the life sciences area, we've been trying to stay away from the generic drug companies. Those are the ones that have come under particular scrutiny from the Trump administration, as well as Congress, and rather focusing more on companies that are focused on developing novel drugs that cure life-threatening diseases, where pricing or high prices can be more readily justified.

Mickey Schleien ***Ladenburg Thalmann & Co. Inc., Research Division - MD of Equity Research & Supervisory Analyst***

That's very helpful. I appreciate that. My last couple of questions relate to oil and gas investments, which are fairly significant at about 7% of the portfolio. So first, I just wanted to understand are these -- any of these legacy investments?

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

None of these...

Mickey Schleien ***Ladenburg Thalmann & Co. Inc., Research Division - MD of Equity Research & Supervisory Analyst***

Like McDermott, Ultra, Vine and Woodford.

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

Sure. None of those are legacy investments. Our energy exposure has actually declined over time, even since the end of the 9/30 quarter. So it has come down meaningfully from there, one. Two, it's important to consider a number of these companies are not energy-related E&P companies, or exploration and production companies, which tend to be the most sensitive to movements in oil prices. Many of these companies are actually the pipeline and midstream companies that enter into long-term contracts that those contracts are take-or-pay contracts. So they're much more stable in their cash flows and look more like infrastructure assets, and therefore, are less sensitive to the recent moves in oil prices. And the third point on that is that some of these assets are natural gas related and not oil related. And if you've watched natural gas prices over the last couple of months, they've gone up quite tremendously because of the anticipated cold winter here and limited amount of gas in storage.

Mickey Schleien ***Ladenburg Thalmann & Co. Inc., Research Division - MD of Equity Research & Supervisory Analyst***

That's very helpful. Did you say that the energy exposure went down since September?

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

It did.

Mickey Schleien ***Ladenburg Thalmann & Co. Inc., Research Division - MD of Equity Research & Supervisory Analyst***

Okay. And talking about valuation of these four companies, price of oil has declined about 30% since September 30. So I just -- I'm not that familiar with your valuation process, but does it look at the valuation as of September 30 or given that it takes a few weeks to put the valuation together, is there a haircut given how steeply oil declined in October and in November?

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

So these securities would be valued as of 9/30. Some of these securities do publicly trade and would reflect that, but the marks on these would be as of the 9/30 quarter end.

Operator

The next question will come from Chris York of JMP Securities.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

So the first question is housekeeping and I suspect I can triangulate the fees from OCSL, but how much prepayment fees did you receive from Allen Media?

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

So that would be $1.9 million. That includes the OID acceleration as well as the prepayment fees.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. And then in your model, what is the reasonable expectation for the time necessary to grow the investment portfolio in new senior secured investments to the low target leverage range of 1.2?

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

So it's going to take several quarters. We've got everything in place obviously from the board and the shareholder vote and all the leverage facilities. We took leverage up a little bit in the quarter versus the previous quarter. But it can take several quarters and we're going to be -- it's really driven by the asset side in terms of where we see investment opportunities and so we have the ability to take leverage up. If we don't find the right assets, then we're just going to be a little more patient. So it'll take several quarters.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay, helpful. And then maybe staying on that asset side, should investors view the consolidation of the Glick balance sheet JV as a likely candidate to be consolidated?

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

I wouldn't consider it likely. I think likely is too strong a word.

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

Yes, I'd add, Chris, and we always maintain the option there, but it's not one that is currently at the top of our list. I'll just add on to Matt's prior comments about leverage that we've been methodical about increasing leverage and that has actually been very beneficial to us, especially given the recent volatility in the marketplace. And I think because we didn't ramp leverage too quickly, we've been able to avoid some of the challenges a number of other managers may be experiencing today.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Yes, I would agree with that. Staying on that topic of leverage, so on the right-hand side of your balance sheet, think about debt and liabilities, what is the desire and then maybe preference in pursuing term debt facility in your capital structure? How do you weigh maybe flexibility versus term and cost?

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

We weigh everything. So depending on what we think we can get done, we'll look at it. We've got experience at Oaktree. We can do lots of different things, have experience in all of them, have good relationships with the banks. So we look and consider everything and I think what we've done as we took over the management, we did with the various facilities and the JVs, that you can see hopefully a pretty thoughtful pattern of achieving a lower cost, more optimal capital structure.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

I think investors can certainly agree on that. Maybe, Matt, can you remind us of the ROE expansion potential possibly obtained under your target leverage?

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

So I still think we hope to be and expect to be -- our target is the high single-digit ROE. So I don't think that's changed. I think the leverage -- the higher leverage allows us to -- obviously is positive to that. When we get there, et cetera, I don't want to make any predictions on that.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. And then this is a little outside-of-the-box question. You reported a weighted average leverage ratio of 4.2x, now the market is 5.7. Now is that EBITDA a GAAP EBITDA or is it EBITDA with add backs?

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

That is an EBITDA using our adjusted EBITDA. So I would not call that a GAAP EBITDA, nor would I use that as the borrowers adjusted EBITDA.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. So it's a more conservative number. Okay. So presumably, you spread the numbers yourself under conservative Oaktree assumptions. So what is that maybe difference in your underwriting of the core repeatable EBITDA versus the sponsor number because I'm just trying to get a flavor for Oaktree's risk aversion relative to the more generous capital markets.

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

So to the extent there are add-backs where we deem them to have a lower likelihood of where there's more uncertainty, let me put it that way, associated with some of those add backs. We would not necessarily give them full credit for those add backs. So for example, cost savings are more easily achieved is an area that we would focus on and potentially be more constructive on. Revenue synergies are ones where, for example, we would give them less credit. And also to the extent that those add-backs are a significant portion of the EBITDA, for example, we've seen cases where add-backs have been twice as large as the core EBITDA, we'll take a much -- we'll give much more scrutiny and unlikely we will give them all the credit for that.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Got it. My thought process was, if you went through all your portfolio companies, in some maybe they're recorded and add back EBITDA versus the Oaktree EBITDA, what that spread was, what that difference was? (inaudible) lower. So that was just a thought -- outside-of-the-box thought. And then lastly, I know Oaktree has been interested in sourcing direct at originators since acquiring the contracts from Fifth Street Asset Management. How's the progress been on growing out your investment professionals?

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

So we've continued to add investment professionals to the team both on the origination side, as well as on the industry expertise side. As you know, Chris, Oaktree itself is a very large organization with over 250 investment professionals here. So it is a very sizable organization. And I'm just focused on -- my comments are more focused on just those that are specifically day-to-day focused on the BDC, but that doesn't mean that the other 250 investment professionals aren't helping us originate and find and diligence investment opportunities. And that has -- those efforts of adding individuals and getting the larger Oaktree organization focused on the BDCs has really helped us build a much more robust pipeline, which we think you'll see the benefits of -- or investors will see the benefits of in the coming quarters.

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

Chris, it's Mel. I want to correct the Allen Media number. It should be $2.7 million. I read the wrong line.

Christopher York ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. Yes, that seems more consistent with the triangulation from OCSL.

Operator

(Operator Instructions) And we have no further questions, 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 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 replay access code 10125431 beginning approximately 1 hour after this broadcast.

Operator

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