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Q2 2020 Oaktree Strategic Income Corporation Earnings Call

EVENT DATE/TIME: MAY 07, 2020 / 4:30PM GMT

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PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Fiscal Second Quarter 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 second 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. Our speakers 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 a 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.

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

Thank you, Mike. And welcome, everyone, to our fiscal second quarter earnings conference call. We appreciate your interest in OCSI. We hope everyone listening is safe and in good health. We understand that these are challenging and unprecedented times and we wish to extend our sincere thoughts to those impacted by the COVID-19 virus. We want to assure you that Oaktree and by extension OCSI has taken several measures to keep its employees safe and business functions operational. Oaktree has implemented a firm-wide continuity plan, operating successfully as a virtual company after seamlessly transitioning to a remote working environment in mid-March. We are capitalizing on Oaktree's first rate technology platform and are fully operational and well positioned to safely and effectively manage the portfolio for the duration of this public health crisis.

As you've heard us discuss many times, we have defensively positioned OCSI's portfolio over the last 2.5 years with the knowledge that we were in the late innings of the credit cycle. We would never have imagined that a global health crisis would serve as the catalyst for the end to that cycle.

Net investment income for the second quarter was $0.15 per share, down $0.01 from the prior quarter. The decline was primarily due to lower LIBOR and a restructuring that we implemented in the Glick JV, which Mel will discuss in more detail in a few minutes. Additionally, in light of the lower investment income, Oaktree fully waived incentive fees for the second quarter.

We entered the second quarter with nearly all of our debt investments at the top of the capital structure, a very small number of noncore holdings remaining and none of our holdings are nonaccrual. However, the market environment grew challenging in March, and our portfolio wasn't immune to the market disruption volatility that occurred across risk assets, causing their valuation to deteriorate with historic speed.

As a result, we reported second quarter NAV per share of $7.17, down from $9.71 per share in the previous quarter. Over the past 2.5 years that we have been managing OCSI, we've found attractive relative value opportunities in publicly traded liquid debt securities, and as a result, our exposure to these types of investments has been higher than that of a typical BDC.

While we generally invest with the expectation that our investments will be held to maturity, one of the benefits of having liquid debt investments is that it allows us to actively manage risk in the portfolio and move in and out of positions when we believe it is optimal. One drawback to this active management approach is that our portfolio is notably impacted by mark-to-market volatility as we experienced in the March quarter.

Following the sharp price declines in the leveraged loan and bond markets resulting from the pandemic, the price of our liquid debt investments declined 13% during the March quarter, which impacted NAV by $50 million, or $1.69 per share.

Another driver of the decline in NAV during the quarter was OCSI's investments in the Glick JV. As a reminder, the joint venture primarily invests in liquid first lien loans and it utilizes leverage to increase its investment capacity. The JV's underlying portfolio experienced unlevered mark-to-market price declines of 14% in March, and when factoring leverage, which was 1.6x at December 31, OCSI's investment in the JV declined by $60 million, or 30% during the March quarter.

Following the broader credit market rally in April, we have experienced some recovery in the prices of our liquid debt investments, which rebounded by approximately 3% during the month of April. As a result of the uncertain environment due to the pandemic, the recent decline in LIBOR and our desire to be more cautious, the Board decided to reduce our dividend to $0.125 per share. We believe that this reduction is prudent and will help OCSI to navigate the current environment.

Importantly, we have liquidity to meet existing funding needs and continue to opportunistically invest. Prior to the volatility in March, we were under-levered relative to our target range. We also continued to receive support from our lenders. And in late March, we amended our credit facility with Deutsche Bank to extend the maturity date.

We actively invested during the quarter, particularly in March, when the market was dislocated. New investment commitments totaled $94 million, all of which were first lien loans. We continue to evaluate opportunities in our pipeline and selectively deploy capital. We have continued to opportunistically invest post quarter end. And as a result of our ability to invest alongside other Oaktree funds, we believe that we will participate in additional opportunities going forward. While the market continues to evolve, and it is difficult to determine the time frame and ultimate impact of COVID-19, we are committed to proactively investing in managing risk in situations that may arise in our portfolio.

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

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

Thanks, Matt, and hello, everyone. Before I share our view on the overall market environment, I'd like to amplify Matt's opening message. We hope everyone listening is healthy and managing well through this challenging period. The unprecedented events that slowed economic activity in March roiled markets, businesses and daily life for people around the globe fallout from the pandemic froze more than 1/4 of the U.S. economy. Investor sentiment soured as macroeconomic conditions grew weaker. Risk assets in both equity and fixed income markets sold off quickly in March amid worries about business closures, spiking unemployment rates and expectations for steep GDP contraction. The liquid credit markets sold off dramatically as the high-yield bond in the leveraged loan markets were both down over 12% for the March quarter, as measured by their most widely followed indices. As Matt noted, this weighed on our portfolio and caused a sudden downward pressure on our NAV.

Extraordinary fiscal and monetary stimulus actions, however, have since provided equities a boost and lifted some credit sectors from their lowest points. As a result, we experienced some recovery in prices of our liquid debt investments through the end of April. That said, the pandemic has not run its course, and the timing of recovery remains unknown.

Sustained volatility in the liquid credit markets also continues to keep deal activity in private credit and direct lending relatively light. M&A activity is essentially on hold, and we believe that most of the investment opportunities in this segment of the market will be highly structured financings, involving businesses that are in need of liquidity or that are seeking to bolster their balance sheets. This is especially apparent in the non-sponsored space, where traditional capital market avenues may not be available to certain borrowers.

Now turning to the overall portfolio. We are generally confident in the quality of our portfolio, given its defensive posture prior to the pandemic. The portfolio consists predominantly of first lien positions to larger, more diverse companies that we believe can bridge the gap to recovery. However, market pressures have affected companies within the portfolio, and we are closely monitoring all of our positions. Our analysts are carefully tracking each credit, speaking with management teams, private equity sponsors, industry experts and advisers.

Fortunately, we have mostly avoided significant levels of holdings in industries that are facing challenges as we have instead been lending the companies that we believe operate in less cyclical or structurally growing industries. Our largest concentrations are in software, information technology services and commercial services and supplies. Energy was limited to 5.1% of the portfolio at fair value at quarter end in three portfolio companies. The bulk of our current holdings are in large diversified businesses operating in the midstream and refinery sectors, which, we believe, have limited downside due to strong structural protections, significant asset coverage and generally low commodity risk. Leisure and entertainment positions collectively accounted for approximately 3.4% of the total portfolio at fair value at March 31.

Turning now to investment activity. The second quarter was strong overall, with the $94 million of new investment commitments, as Matt noted. These new investments were diversified across 27 borrowers operating in 20 different industries, and all were first lien loans. In January and February, our originations were marked by mostly privately placed club transactions, some of which were highlighted on our last earnings call. As the volatility took hold in March, we became more active in the public market via our trading desk, and made opportunistic purchases across the primary and secondary markets and in industries such as health care, pharma, infrastructure and telecom.

In total, we deployed $31 million in the secondary market during the month of March. While we are maintaining modest overall exposure to virus impacted sectors, we have identified some unique, highly selective opportunities in these industries with very attractive risk-reward profiles.

A case in point is our recent investment in Airbnb. OCSI was allocated $5 million of a $120 million Oaktree investment in a $1 billion first lien club transaction to Airbnb, the platform that connects travelers or property owners for bookings. The company decided to bolster liquidity to provide a cushion as a result of COVID. The transaction priced at 97.5% with a LIBOR plus 750 coupon has a very good structure, including 2-year call protection. While this business is, of course, under near term pressure, we believe the company's best-in-class platform, popularity and strong growth profile prior to the pandemic provided a solid foundation for recovery when travel resumes.

We believe the coming weeks and months will provide OCSI with additional opportunities in both public and private investments. 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. Net investment income in the second quarter was $4.6 million or $0.15 per share. This is compared to $4.7 million or $0.16 per share in the previous quarter. The slight decline was due to lower investment income and partially offset by lower net expenses. Total investment income was lower quarter-over-quarter, mainly due to the restructuring that we implemented at the Glick JV, which resulted in placing our subordinated note investment in the partnership on nonaccrual. In addition, investment income was negatively impacted by downward pressure on the average yield of our floating rate debt investments mainly due to continued decreases in LIBOR.

To expand on the actions taken at the Glick JV, we restructured our subordinated notes in order to realign the vehicle for current market conditions. As part of this, we extended the maturity date of the notes to October 2028, reduced the spread from 6.5% to 4.5% and we elected to forego payment of the April 15, 2020 and July 15, 2020 scheduled interest payments.

On the last point, forgoing this interest allows us to keep the JV's cash-based net investment income related to the March and June quarters in the JV to support NAV. As a result, we did not recognize income from the JV during the March quarter and placed our $38 million subordinated note on nonaccrual status at quarter end. The JV represented OCSI's only nonaccrual.

Net expenses for the quarter totaled $5.8 million, down $1.1 million from the previous quarter. The decline was due to lower incentive fees, which were down $721,000 on a gross basis and were further reduced by $272,000 permanent waiver of second quarter fees. Interest expense was up slightly due to modestly higher average borrowings, partially offset by a lower average interest rate paid on those borrowings due to lower LIBOR.

Turning to credit quality. Excluding the Glick JV, all of our portfolio companies made their scheduled interest payments during the quarter with the exception of two companies, representing $20 million of fair value, that modified their interest payments to PIK in order to preserve liquidity.

Moving to the balance sheet. As Matt noted, our leverage ratio increased to 1.55x from 1.07x at December 31. After taking into account nearly $22 million in unrestricted cash on our balance sheet at quarter end, our net leverage ratio was 1.44x.

We funded $101 million in investments and received $84 million in payoffs and exits during the quarter. While net debt only increased by approximately $9 million, our leverage ratio was driven higher during the quarter, mainly due to the reduction in our NAV.

As of March 31, total debt outstanding was $327 million and had a weighted average interest rate of 3.8%, which is down from 4% at December 31 due to lower LIBOR.

At quarter end, we had total liquidity of approximately $100 million, including $22 million of unrestricted cash and $78 million of undrawn capacity on our revolving credit facilities. Our total liquidity at April 30 remained at approximately $109 million. As Matt said, in March, we amended our credit facility with Deutsche Bank, extending the revolving period and maturity date and reducing the total size of the facility to $200 million. Now I'll turn the call back over to Matt.

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

Thank you, Mel. We entered this crisis in solid financial shape. The defensive repositioning we carried out over the last 2.5 years has largely been completed. Given the significant size and scale of Oaktree's investment platform, we are well positioned to invest in this market environment as opportunistic, special situation credit lending is a hallmark of Oaktree's investment approach.

However, we will remain patient, disciplined and defensive in our deployment of capital as we believe there will be an increasing number of opportunities that will arise over time as the crisis persists and the economic fallout continues. That said, we will continue to focus on investments at the top of the capital structure. While we are maintaining our leverage target of 1.2x to 1.6x, we expect to keep our current net leverage ratio near where it was at quarter end. As we invest in new opportunities, we will likely rotate out of our existing positions rather than increase overall leverage. We believe that this is prudent given the uncertainty over the duration of the current economic pullback.

In conclusion, 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.

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?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Jon Glaser of JMP Capital.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

A couple of questions. First of all, are there -- are any of the borrowers, if you look through their actual businesses right now, do you have any borrowers who are basically at zero revenue businesses? Or similar to -- you don't have any restaurants, but sort of that as an example, do you have any companies that really are doing no business right now?

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

We do have a couple. We have a business called CircusTrix that does -- it's kind of like indoor trampoline parks, obviously, that's impacted. I would say, by and large, though, our portfolio has more moderate or low impact from coronavirus, but there certainly are something like maybe 10% -- 10% to 20% of the portfolio that has a more direct impact. But very few that I could think of that are truly zero businesses because we really haven't been in retail or restaurants. So it's not going to be material.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

And is that trampoline business, a private equity sponsored business?

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

It is. It's...

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

Palladium. It's Matt. Palladium Equity Partners.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Okay. And then what is the -- and 2 questions related to the JV. One is I didn't see in the queue, the unfunded commitment amount in Glick. And then the second question would be, if you look at your -- the leverage in Glick, are you including that in your total leverage number? Because it seems like prior year, we were looking at like 1x levered. But if Glick is 1.5x or 1.6x, is -- was that included in your total leverage number? Or because it's off balance sheet, it's not included?

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

It's not included. It is the equity investment in the JV is an asset of the BDC, but the leverage of the JV is not consolidated into the BDC.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Got it. Okay. And do you know what the unfunded commitments are in the JV?

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

It's very small. It's around $1 million. Do you have any other questions, Jon?

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

I don't want to take it -- I have a few, but if anyone else has questions, I should go ahead.

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

Go on, why don't you go ahead?

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Okay. So when you say the portfolio, you're up 3% since March, is that on a -- is that the portfolio itself? Or is that NAV, if you take 3% times the leverage? Or should we just look at 3%?

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

It's on the assets, not NAV.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Okay. So if you're -- so we can say you're up 4 or 5, if you include the leverage?

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

That's probably about right.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Okay.

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

Closer to 5% than 4%.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Okay. And then do you own any -- is all your publicly traded stuff in the JV? Or do you have publicly traded stuff outside of that?

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

No, it's in the JV and outside of that. It is about 70% of our BDC portfolio is publicly quoted. So it's a very high percentage of publicly traded loans.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Got it. Okay. And my last question is, you extended up the credit facility, one until the fall and one until next year. September 30 will probably sneak up on us rather quickly. So you anticipate any issues extending that further?

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

Yes, go ahead, Matt. Sorry.

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

The reinvestment period that is September. The maturity is 2021 and then 2023. So the maturity is further. I mean, we've had -- we continue to have very strong relations with Deutsch and Citi, which are the 2 lead banks, and is -- one advantage being part of Oaktree, that this is a kind of a firm-wide relationship. So we don't anticipate any issues with those. But the maturity dates are longer than you referenced.

Jonathan M. Glaser ***JMG Capital Management, LLC - Founder and CIO***

Got it. Okay. And can I just -- I mean, just more of a almost a psychological question. I mean, people investing in OCSI generally were looking at it as a more conservative vehicle than OCSL. And yet [OCL] actually held up better. So I guess it's due to the leverage in the JV. So how do you look at this going forward if it turns out -- the conservative portfolios actually maybe not as conservative as we thought?

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

So it's a few things. I mean, one is the leverage is higher in OCSI. That's certainly a piece of it. The assets are almost entirely first lien, though, as opposed to OCSL, where a considerable portion of second lien and other securities in it. As well as a larger portion of the portfolio that is noncore, essentially inherited from the prior manager. So that's why I -- the statement is true that OCSI is a portfolio that is positioned in a way to have sort of less downside, just given the makeup of the underlying assets.

However, the leverage being higher as well as a larger portion of that portfolio being publicly traded and quoted, the impact that, that has on marks quarter-to-quarter or month-to-month, or that you suffer the impact on NAV on a more real-time basis as opposed to in a largely private credit portfolio, the various valuation processes that take place are more focused on actual fundamental performance or judgment around actual fundamental performance rather than a mark-to-market anticipation -- the market anticipate stress or distressed, and therefore they trade down in advance of seeing the actual performance. So you actually get a pull forward of the impact of coronavirus into the marks sooner than in a private credit portfolio that may not need to be marked because the backward-looking performance is not reflective of future performance. So it's a little -- I would say that's where the disconnect is between a portfolio that is largely private or illiquid versus one that is predominantly publicly traded. I think at the end of the day, the economic impact of these names, whether public or private, aren't going to be meaningfully different within a particular sector. But the timing of experiencing those marks may be different.

Operator

Our next question is from Jim Young of West Family Investments.

James Young ***West Family Investments, Inc. - VP & Investment Analyst***

You had mentioned that the -- since the end of March and the month of April that the assets had tightened in, they're up by about 3%, about 5% on a levered basis. The question is, in the month of April, I believe, in the brief period, we've seen in the month of May, can you give us a sense as to have we seen further tightening in the bonds and the like? Or is it basically been flattish?

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

Yes. I don't have the numbers in front of me. But just generally speaking, in the markets that we are most active and it's been relatively flat. It's only been a few days, but it's been relatively flat.

Operator

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

Unidentified Participant

Just one question. Can you give any guidance on what it would take for the Glick sub notes to go back on accrual status? Is it retention of capital, rebound of market values or some combination or something else?

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

Yes. Sure. This is Mel Carlisle. Our current plan is to retain the cash, net investment income for a couple of quarters, and in connection with the October payment to place it back on accrual. Now giving the uncertainty around the pandemic, that may not happen, but that's our current plan.

Operator

There are 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 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 10141938, beginning approximately 1 hour after this broadcast.

Operator

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