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OCSI - Q2 2018 Oaktree Strategic Income Corporation Earnings Call

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Michael Mosticchio

PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Second Quarter 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

Thank you, operator, and welcome to all of you who have joined us for today's call to discuss Oaktree Strategic Income Corporation's second quarter 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. Our speakers today are Oaktree Strategic Income's Chief Executive Officer and Chief Investment Officer, Edgar Lee; Chief Operating Officer, Matt Pendo; and Chief Financial Officer and Treasurer, Mel Carlisle. 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 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 Corporation uses the Investors section of its corporate website to announce material information. Accordingly, the company encourages investors, the media and others to review the information on its shares on its corporate website.

With that, I would now like to turn the call over to Edgar Lee, Chief Executive Officer.

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

Thank you, Mike, and welcome, everyone, to our second quarter earnings call. I will begin with a brief overview of our recent progress and review of our portfolio. Then Mel Carlisle will review our financial results and capital structure. Finally, Matt Pendo will discuss our dividend and our plans to enhance the company's return on equity.

I want to announce that our board has approved an increase in our leverage limits by modifying our asset coverage requirements, and we will be seeking shareholder approval on this matter. Matt will discuss this in more detail later on the call.

We are pleased with the second quarter results, which reflect the measurable progress we've made, executing on our initiatives to optimize OCSI's portfolio and capital structure. During the quarter, we exited most of our lower-yielding, broadly syndicated loans and redeployed capital into new investments, which we believe will generate attractive risk-adjusted returns. These results can be attributed in part to the significant advantages of Oaktree's extensive platform, including its scale, relationships, track record and flexible approach to credit investing.

Our key accomplishments for the quarter are noted on Page 3 of the earnings presentation.

First, the credit quality of our portfolio remained stable, with NAV increasing 1.5%, or $0.15, from the first quarter.

Second, we continued to reduce our noncore investments, monetizing approximately $40 million during the quarter, primarily consisting of lower-yielding, broadly syndicated loans that we were targeting to sell. The majority of these loans were repaid or sold at or above their December 31, 2017, fair values. Noncore investments represented only 22% of the portfolio at fair value as of March 31, 2018.

Third, we originated $94 million of new investments in 11 companies, 88% of which were first lien loans. Several of these investments were made alongside other Oaktree funds. In order to provide an idea of what we are originating, we will discuss one of these transactions in more detail shortly.

Fourth, the earnings of the portfolio improved, as net investment income increased to $0.16 per share from $0.15 per share last quarter.

Turning to Page 4 of the earnings presentation, we provide a summary of the portfolio as of March 31st. Our portfolio performed well in the second quarter, as the majority of our portfolio companies continued to exhibit stable or improving operating trends.

As of March 31, portfolio had a fair value of $543 million. Approximately 85% was in first lien loans, 4% was in second lien loans, 11% was in the Glick JV and less than 1% was in equity investments. The weighted average yield on debt investments was 7.9%, up from 7.1% at the end of last quarter, reflecting our progress in rotating into higher-yielding investments as well as increasing LIBOR rates.

At quarter-end, our entire debt portfolio was in floating-rate investments, which will continue to benefit from rising interest rates.

Last quarter, we segmented our portfolio into core and noncore investments to help investors track our progress in rotating our portfolio.

At March 31, core investments, excluding our Glick JV, increased by an additional 12% to $378 million, or 78% of the total portfolio at fair value, and represents 45 companies, which is an increase from 41 at the end of last quarter.

At quarter-end, noncore investments were $106 million, or 22% of the total portfolio at fair value, and consisted of $101 million of performing investments and $5 million of nonaccrual investments.

During the quarter, we monetized approximately $40 million, or 27% of noncore investments. Importantly, most of these investments were exited at or above their previous fair value marks.

On Page 6 of the earnings presentation, we provide additional details on noncore performing investments. As you may recall, these investments are performing well, have relatively low leverage and are generally exhibiting stable to improving operating trends. Nevertheless, they are not aligned with OCSI's long-term investment objectives, and thus we classify them as noncore.

$31 million of a noncore performing investments are publicly quoted liquid loans. The remaining $70 million are less liquid. However, we expect to monetize a meaningful portion of these loans over the next several quarters, assuming current market conditions continue to be relatively favorable.

As highlighted on Page 7 of the earnings presentation, during the quarter, we originated $94 million of new investment commitments in 11 portfolio companies. 88% of these investments were first lien and 12% were second lien loans.

As I mentioned earlier, one of our new originations included a $310 million first lien loan to a media company that was used to fund the acquisition of a well-known cable network. A number of Oaktree funds participated in this transaction, and a portion of the loan was syndicated to other lenders. OCSI's allocation of the loan was $24 million, and we also received structuring fees for the transaction. This loan was attractively priced at LIBOR plus 925, which is meaningfully higher than new issue yields for comparable credits with similar risk profiles.

Additionally, we were able to negotiate a strong covenant package.

We believe this transaction underscores a significant advantages of the Oaktree platform, including its established relationships with deal sources and the ability to originate and structure large transactions.

We also expanded our origination capabilities through new additions to the strategic credit team as well as a joint venture with an investment bank that operates a leading direct lending origination platform in the middle market.

Before I turn the call over to Mel, I'll provide an update on what we are seeing in the market.

Similar to our comments in prior quarters, the environment for middle market lending remains highly competitive. We continue to see deterioration in loan covenant structures and spread compression. Some lenders are pursuing riskier investments in order to generate loan volume or maintain portfolio yields. Despite these dynamics, we are sticking with our core investment philosophy, which places a significant emphasis on protecting our investors' capital even if that requires sacrificing yield in the short term or moderating our pace of capital deployment. The current credit cycle is long by historical standards. And at some point in the future, the market will likely shift back to a more lender-friendly environment. In the event that a meaningful correction or disruption occurs, we believe that we will be able to take advantage of opportunities that arise, given our demonstrated track record of investing across credit cycles.

And now I'd like to turn the call over to Mel Carlisle, our Chief Financial Officer and Treasurer, to discuss our financial results in more detail.

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

Thank you, Edgar. We are pleased with the improvement in OCSI's financial results for the second quarter.

Net investment income in the second quarter was $4.6 million, or $0.16 per basic share. This was up sequentially from $4.5 million, or $0.15 per share, in the first quarter, primarily due to lower operating expenses.

Total investment income in the second quarter was $10.6 million, down sequentially from $10.7 million in the December quarter. This was primarily due to lower loan prepayments and an approximate $750,000 decline in OID acceleration income. This decline was partially offset by an increase in structuring fees.

Net expenses for the quarter were $6 million, down slightly from $6.2 million last quarter, reflecting lower professional fees and G&A expenses, partially offset by higher incentive fees and interest expense.

Now turning to credit quality. Consistent with last quarter, only 1% of the portfolio was on nonaccrual at March 31. There were no significant net realized gains or losses in the quarter and net unrealized gains were $3.1 million.

Net asset value increased to $9.99 per share at March 31 from $9.84 per share at December 31. Page 10 of the earnings presentation, we have provided a bridge that explains the key factors that led to the increase in NAV.

Second quarter net investment income contributed $0.16, net unrealized appreciation contributed $0.10 and net realized gain contributed $0.03 to our NAV. This was offset by the $0.14 dividend paid during the quarter, resulting in a net increase of $0.15 to NAV.

Total debt outstanding at March 31 was $260 million, with a weighted average interest rate of 3.74%.

Our debt-to-equity ratio was 0.88x at March 31, unchanged from December 31. At quarter-end, cash and cash equivalents were $32 million, and we had $65 million of undrawn capacity on our credit facility and debt securitization.

At the end of the second quarter, there were $39 million of unfunded commitments outstanding primarily related to portfolio companies with revolving credit facilities or delayed draw term loans.

We continued to optimize our Glick JV, adding 5 investments totaling $25 million during the quarter.

Now I'd like to turn the call over to Matt Pendo, our Chief Operating Officer, to discuss our dividend and our progress in enhancing return on equity of our portfolio.

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

Thank you, Mel. Let me begin with the dividend. Today, we declared a $0.145 per share dividend payable to shareholders on June 29, 2018. This is an increase of $0.005 per share from last quarter and represents a payout of approximately 93% of the net investment income generated by the portfolio in the second quarter. As we mentioned last quarter, we plan to pay dividends based on the earnings generated by the portfolio.

Now I will provide an update on the initiatives we discussed last quarter to increase our return on equity.

First, we plan to rotate out of lower-yielding broadly syndicated loans and into a higher-yielding loans originated by Oaktree. During the second quarter, we exited $43 million of these lower-yielding loans, reducing the total to $15 million.

Second, we plan to reduce the balance of nonincome-generating investments comprised of equity and nonaccrual loans. In the second quarter, we received approximately $1 million of proceeds as a result of the monetization of certain Ameritox assets and currently hold $5 million of these investments.

Third, we sought to modestly increase the percentage of second lien investments in the portfolio. And during the quarter, we originated $11 dollars of second lien loans.

Fourth, we plan to reduce our borrowing costs. On January 31, 2018, we refinanced our Citibank credit facility, resulting in a reduced spread to LIBOR of approximately 35 basis points, depending on the assets in the facility.

Fifth, given that our entire debt portfolio is in floating-rate investments, we expect it to benefit from higher interest rates, and as LIBOR has increased, our portfolio has benefited. Additionally, the majority of our loans reset at the end of each quarter, so the full impact of the recent LIBOR increase won't be realized until next quarter.

And finally, we are realizing cost savings from leveraging Oaktree's scaled operational platform. In the March quarter, expenses related to G&A and professional fees decreased by approximately $400,000.

Our team has executed well on our initiatives to enhance ROE during the quarter, and we expect to show continued progress going forward.

Now I want to discuss our view on leverage in light of the recent legislation enabling BDCs to increase leverage ratios.

OCSI's portfolio is primarily comprised of first lien, floating-rate loans. Given our plan to continue to maintain a portfolio primarily invested in first lien loans, we believe there is an opportunity to grow our portfolio prudently with additional leverage, as these types of assets are well-suited to support higher levels of leverage.

With no unsecured debt outstanding, we believe we have an appropriate capital structure to support increased leverage. We have been in preliminary discussions with our lenders about modifying our asset coverage requirements, and they are supportive of our plans. We also believe that additional leverage will allow us to grow and further diversify the portfolio and is a new opportunity to enhance our return on equity.

We believe a target leverage ratio in the range of 1.2x to 1.6x is prudent, and we expect it'll take several quarters to reach that level. We estimate that our return on equity can increase by 40 basis points with every 0.2x increase in leverage, assuming our current portfolio yield and cost of financing remain the same.

Last week, we received approval from our board to increase leverage limits by modifying our asset coverage requirements from 200% to 150% and unanimous support from our board to seek approval from our shareholders. To that end, we'll be calling a special shareholder meeting for a vote on the proposal, and we'll be distributing a proxy statement in the near future.

We hope that all of our shareholders will participate in the upcoming special election and support our efforts to modify our asset coverage requirements.

With that, we're delighted to take your questions. So operator, please open up the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Showing no questions, this concludes our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

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

Thanks, everyone, for joining the call today. Just to reemphasize, we continue to execute well on initiatives to enhance ROE and continue to make progress on that. As we discussed, we have received approval from our board to increase leverage and support from our board to seek approval from our shareholders, and we will be calling a special shareholder meeting to vote on the proposal. We think this is a great opportunity to enhance the return on equity, the leverage fits our portfolio, and we've had good discussions with our lenders about increasing the leverage. Thank you.

Michael Mosticchio

And thank you, again, for joining us for our second fiscal quarter 2018 earnings conference call. A replay of this conference call will be available for 30 days on Oaktree Strategic Income's website in the Investors section or by dialing (877) 344-7529 for U.S. callers or 1 (412) 317-0088 for non-U.S. callers with the replay access code 10118713, beginning approximately 1 hour after this broadcast.

Operator

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

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