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Q1 2019 Oaktree Strategic Income Corporation Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

Michael Mosticchio *Oaktree Strategic Income Corporation - IR*

CONFERENCE CALL PARTICIPANTS

George Bahamondes *Deutsche Bank AG, Research Division - Senior Research Analyst*

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

PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Fiscal First 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 all of you who have joined us for today's call to discuss Oaktree Strategic Income Corporation's 2019 Fiscal First Quarter Financial Results. Our earnings release, which we issued this morning, and the slide presentation that accompanies this call, can be accessed on the investor 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 first quarter earnings conference call. We appreciate your continued interest and support.

OCSI produced solid earnings in the quarter, reporting net investment income per share of \$0.17 as we continue to defensively position the portfolio for improved performance and attractive risk-adjusted returns for our shareholders.

In addition, we further reduced the overall risk in the portfolio, exiting approximately \$11 million of non-core investments during the quarter, bringing our total non-core positions to less than 10% of the portfolio.

We originated \$93 million of new investments in the first quarter, and first lien originations accounted for 93% of these commitments.



We remain cautious in our investment approach, and we are actively avoiding taking on too much risk by primarily investing in first lien loans to larger, more diversified companies.

And finally, we ended the quarter in a conservative financial position by reducing our borrowings to maintain flexibility in light of the broader credit market volatility experienced during the quarter.

Before I go into more detail on our investments and portfolio composition, I want to take a minute to address the middle-market lending environment. The substantial volatility that had impacted the equity and high-yield markets in December also spilled over into the broadly syndicated loan market. This volatility was technically driven by investor outflows from bank loan mutual funds and ETFs in record amounts. These technical pressures caused spreads to widen in a corresponding decline in loan values, and as a result, we recorded price declines on certain of our liquid investments at quarter end. We view these price declines as temporary and due to general market sentiment, rather than an indication of any broad-based deterioration in the underlying portfolio.

Due to the December volatility and the portfolio's related loan price declines, the net asset value per share declined 6% in the quarter. I want to emphasize that the write-down was almost entirely unrealized, and we have seen encouraging signs of improvement in market conditions in January and February, including some related recovery in the prices of these debt investments.

And despite the decline in NAV, OCSI's credit quality remains solid. We believe the continued defensive posture of the portfolio effectively positions it to preserve capital, while generating stable income and attractive risk-adjusted returns, even if the broader market volatility persists.

Now turning to our portfolio. At December 31, the portfolio was well diversified with a fair value of \$553 million invested across 79 companies, with an average investment size of \$6 million. Over 99% of the portfolio consisted of debt investments and more than 95% was in first lien senior secured loans, excluding the Glick JV. We are receiving a 7.8% weighted average yield on our debt investments.

We continue to target larger, more mature businesses that operate in noncyclical, defensive or structurally growing industries. These tend to be diversified companies with lower amounts of leverage that help further minimize the risk of credit impairments in the portfolio. The median portfolio company EBITDA was \$125 million at the end of the first quarter, nearly double the amount since we began managing OCSI and now approximately 61% of our borrowers have EBITDA levels greater than \$100 million. Additionally, the average leverage at our portfolio companies has declined to 4.2x from above 4.7x a year ago, compared to the overall middle market leverage multiples which remain elevated from historical norms.

With respect to our repositioning efforts, we monetized approximately 20% of our non-core holdings in the quarter and have reduced them by 84% since we took over management of the portfolio over 15 months ago.

Of the \$47 million in non-core investments left, approximately \$12 million are in publicly-quoted liquid loans. The remaining \$34 million consist of private loans and represent only 7% of the portfolio. We remain focused on working through each of these remaining investments and intend to opportunistically exit these positions when we believe their values have been maximized.

While the market for direct lending is competitive, we remain in a strong position to selectively capitalize on the solid level investment opportunities in our pipeline.

In the first quarter, we funded a total of approximately \$88 million, including \$57 million in 12 new portfolio companies and \$30 million in 7 existing portfolio companies. These investments were well diversified across 15 industries, ensuring that we are not reliant on any one sector. We also continued to focus on lending to larger, more diversified borrowers.

Looking ahead, we continue to play close attention to the market environment and will deploy capital in a disciplined and deliberate manner. We will evaluate opportunities across multiple sectors with an unwavering focus on generating attractive risk-adjusted returns over the long term.

In summary, we are pleased with our ongoing progress in building a high-quality portfolio at OCSI.

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, Edgar. We produced a solid level of investment income in the first quarter and maintained our portfolio's excellent credit quality.

Total investment income of \$11.3 million decreased from \$14.7 million in the previous quarter, but increased from \$10.7 million in the year-ago quarter.

Net investment income in the first quarter was \$4.9 million or \$0.17 per basic and diluted share. This was down from \$5.6 million or \$0.19 per share for the prior quarter, and up from \$4.5 million or \$0.15 per share a year earlier.

The quarter-over-quarter decrease in both total and net investment income was due to the fact that the prior quarter's results included the early payoff of Allen Media.

Net expenses were \$6.4 million, down from \$9.2 million in the prior quarter. The decrease was mainly due to a \$2 million one-time write-off of previously unamortized financing cost related to the redemption of the debt securitization that occurred during the quarter ended September 30. A decline in Part 1 incentive fees of \$800,000, net of fees waived, also contributed to the lower net expense level.

Credit quality remains very strong. We have only one small investment on nonaccrual, which represented just 1 basis point of the debt portfolio at fair value at December 31.

Net asset value per share was \$9.43, a decrease from \$10.04 per share from the September quarter. As Edgar mentioned, the decline was mainly due to lower mark-to-market adjustments on our liquid debt investments associated with the market sell-off in December.

On Page 13 of the earnings presentation, we have provided a bridge that explains the key factors that led to the decrease in NAV.

Net realized and unrealized losses on the investment portfolio for the quarter were \$18.1 million or \$0.62 per share, that were mostly driven by the markdowns in our broadly syndicated loan portfolio.

As of December 31, cash and cash equivalents were \$15 million, and we had \$193 million of undrawn capacity on our credit facilities. Total debt outstanding was \$262 million, with a weighted average interest rate of 4.5%. Our leverage ratio was 0.94x debt-to-equity at quarter end.

Turning to the Glick joint venture. At December 31, the JV had \$159 million of total assets including senior secured loans for 32 companies. This compared to \$166 million of total assets invested in senior secured loans to 31 companies last quarter.

At quarter end, our leverage ratio at the JV was 1.4x, unchanged from the prior quarter. And our credit facility had \$35 million of undrawn capacity.

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

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

Thank you, Mel. We have made excellent progress executing on our strategic plan to reposition the portfolio and enhance shareholder returns. While we are very pleased with the advances made to date, there are a number of opportunities for us to further increase OCSI's long-term return on equity.

First, we can increase the size of the portfolio to operate within our long-term target leverage of 1.2x to 1.6x debt-to-equity, a range that



is notably above the 0.94x level at December 31.

We plan to carefully deploy leverage up to our target range over several quarters as we navigate market conditions and selectively invest in new opportunities that are consistent with the Oaktree philosophy. We believe that additional leverage will allow us to grow and further diversify our portfolio, contributing to enhanced return on equity.

Second, we can utilize additional investment capacity at the Glick JV. Since we took over management of OCSI, we have made meaningful progress optimizing the JV, growing investments by 38% since September 30, 2017, to \$151 million as of December 31, 2018. Despite this, the JV still has approximately \$50 million of remaining investment capacity, assuming 2.0x leverage. As the portfolio grows in coming quarters, we expect it will provide a further lift to earnings.

Third, we can enhance our return by opportunistically increasing our exposure to second lien loans as we did in the first quarter, capitalizing on Oaktree's expertise and resources to identify and structure compelling transactions. At quarter end, second lien loans made up only 4% of our total portfolio, leaving ample capacity for increased allocation.

And finally, we believe we can continue to improve the overall yield on the portfolio by rotating out of lower yielding, broadly syndicated loans priced lower than LIBOR plus 4%. As we have stated on previous calls, we use the broadly syndicated loan market as the tool to manage our liquidity. During the first quarter, we temporarily increased our holdings in these investments. Importantly, these loans are to large companies and are highly liquid. As we exit these loans and redeploy the capital into higher-yielding, proprietary assets in coming quarters, we anticipate a boost to our net investment income.

Collectively, we expect these drivers to be further accretive to ROE.

Turning to the dividend. As noted in our press release, we declared a \$0.155 dividend today, which has been stable for the last 3 quarters. We remain focused on maintaining a dividend that is sustainable and based on the earnings of our portfolio.

In closing, I want to emphasize that we believe OCSI's portfolio is well positioned to provide solid 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.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from George Bahamondes of Deutsche Bank.

George Bahamondes *Deutsche Bank AG, Research Division - Senior Research Analyst*

I just have a few questions here. Just want to make sure I got this down right. Interest expense was down roughly \$2 million because of one-time items last quarter that were not realized this quarter. Is that right?

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

That's correct. This is Mel. Yes, that's correct. We had paid off our CLO that was maturing this year.

George Bahamondes *Deutsche Bank AG, Research Division - Senior Research Analyst*

Right. Okay -- no, great. I just wanted to confirm that. Next question I have is related to the liquid investments in the portfolio. I know that, here, looking at the slide deck, looks like \$12 million of liquid loans to the non-core portfolio. Is it fair to categorize any liquid loans in your portfolio as non-core? Or are there liquid loans that are, maybe, a part of the core portfolio?



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

There are liquid loans that are part of the core portfolio. Or at least if they're not, rather than using the term liquid, they're at least quoted in the public markets.

George Bahamondes *Deutsche Bank AG, Research Division - Senior Research Analyst*

Got it. Can I have a sense for, roughly, what percentage of your total portfolio would be tied to the loans that are, I guess, quoted in the public markets?

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

Yes. It's over 50% of the portfolio today that has some sort of public market quote.

George Bahamondes *Deutsche Bank AG, Research Division - Senior Research Analyst*

Got it. That's helpful. I guess, as we think about some of the volatility that we saw last quarter, just given capital markets activity in December, have you -- can you, I guess, give me a sense of how much now NAV may have, maybe, rebounded since the end of last year, quarter to date?

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

I'd characterize it as a meaningful portion, without getting into specific numbers. It's been a meaningful portion of the portfolio that has rebounded, but I would caution and say it hasn't been 100%. And a little bit of that is just a reflection of the LIBOR forward curve, which influences how loans are quoted. And again, even though a loan is quoted, it does not necessarily mean it actually trades. And it doesn't mean that we necessarily bought it as a "syndicated loan." Just certain loans do get quoted by various institutions.

George Bahamondes *Deutsche Bank AG, Research Division - Senior Research Analyst*

I see. Okay. That's helpful. Great. That was it for me. Really, I was just trying to get a sense as to how much volatility in the syndicated loan market would continue to impact NAV on a go-forward basis. And I understand that what we saw in December is more of a, I would guess, I'd categorize it as an anomaly, but these things do happen from time to time. So the color that you provided today was helpful. I appreciate that.

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

And George, one thing I would add is, I wouldn't view that necessarily as a long-term negative for the portfolio. Rather, it creates opportunities for us because of our large trading operation here at Oaktree, to try to take advantage of those moments in ways that other managers may not be able to.

George Bahamondes *Deutsche Bank AG, Research Division - Senior Research Analyst*

I see. So while there might be maybe near-term NAV impact, there is some opportunity there for you guys to realize, just given the robust operations at Oaktree? Is that fair?

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

I think that's right.

Operator

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

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

I just wanted to follow up on the topic of volatility at the end of last year and how that volatility impacted the valuation for your debt investments for which you use the market yield approach? If we look at things like the S&P leveraged loan index, its yield widens over 150 basis points in the quarter. Does that widening go directly into your market yield calculation? Or do you look at other metrics to set your valuation for your more liquid paper?

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

That is one variable. So for private market valuation purposes where we do have third parties valuing those loans, that is one element of their valuation process. Other elements would be what is a comparable universe of companies, how have their yields trended during that period of time, as well as company-specific items, whether it's financial and operating trends or other one-time events that may have occurred to the company, and whether it's either positive or negative. Those are some of the other factors that would impact valuation.

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

And I assume you also look at bids. But I'm hearing that the bids at the end of last year, many of them just didn't really have any volume behind them. So how do you handle something like that?

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

So we have a procedure at Oaktree where any of our investments that are quoted in the public markets, if we can find multiple institutions that quote those investments, we will take the market quotes, and we will not necessarily adjust those quotes. So if there is just one institution, or for example -- if there are 3 institutions that, for whatever reason, are not necessarily trading the loans, but quoting them down, materially, that will be reflected in the fair market valuations here.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to 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 the replay access code 10127880, 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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