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OCSI - Q3 2018 Oaktree Strategic Income Corporation Earnings Call

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PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Strategic Income Corporation's Third 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 - *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 third 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 Financial Officer and Treasurer, Mel Carlisle; and Chief Operating Officer, Matt Pendo. 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. Accordingly, the company encourages investors, the media and others to review the information that it 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 third quarter 2018 earnings conference call. We appreciate your continued interest in OCSI and your participation in today's call. The primary objective of Oaktree Strategic Income is to generate a stable source of income for our shareholders by investing primarily in first lien floating rate senior secured loans in the private placement and syndicated markets.

Since assuming the management of OCSI less than a year ago, we have executed on a number of fronts to enhance the company's return on equity. These include expanding our base of core investments, exiting many of our non-core positions and most recently receiving strong shareholder approval to increase our leverage limit. Importantly, the credit quality of the portfolio remains solid.

Let's now turn to the quarter. We are pleased with our third quarter results. Our net investment income increased for the second consecutive quarter, reflecting the meaningful progress we've made towards optimizing the portfolio and capital structure. When we began managing the company last October, nearly 58% of the portfolio or $294 million was in non-core assets. Over a period of just 9 months, we reduced our non-core asset exposure by over 70%.

At the end of the third quarter, only 15% of the total portfolio at fair value remained in non-core investments. It is especially noteworthy that the $216 million of non-core assets we exited were spread across 34 individual positions, many of which were illiquid. We monetized the vast majority of these investments at par value or above their previous fair value marks, demonstrating our ability to maximize value for our investors.

Over the same period, we also more than doubled the amount of core investments, adding nearly $344 million of new investments across 47 companies. In the third quarter, we added $114 million of new assets, 96% of which were first lien loans. As of June 30, core investments represented 85% of the portfolio. The remaining 15% of our portfolio was comprised of non-core investments spread across 14 different companies that are performing within our expectations.

We anticipate approximately 60% of these investments will be liquidated over the next 2 quarters as many of these investments are liquid loans or are in active sale or refinancing processes. We expect to hold the remaining 40% of the non-core investments over a longer period as these portfolio companies are performing well, and we intend to opportunistically exit these positions when we believe their values have been optimized.

During the quarter, we exited virtually all of our investments on nonaccrual. We sold our investment in Metamorph and received the final proceeds related to the investment in Ameritox. There is now only one investment on nonaccrual, which represents less than 0.01% of our portfolio. As of June 30, the portfolio had a fair value of $571 million invested across 72 companies. Approximately 86% of the portfolio was invested in first lien loans, 4% in second lien loans, 10% in the Glick JV and less than 1% in equity interests. The entire debt portfolio consisted of floating rate loans. The weighted average yield on our debt investments was 7.9%, unchanged from March 31.

Turning to the current market environment. There's a tremendous amount of capital being raised to target direct lending opportunities. This has created a highly competitive, borrower-friendly climate where direct lending funds and BDCs are aggressively competing in the private equity-backed segment of the market. As more capital has flowed into the direct lending space, investments have become more commoditized, leading to spread compression and less attractive covenant structures across the board. We continue to observe frothy valuations and an increased appetite for risk in this cycle, which is long by historical standards in spite of the absence of widespread credit deterioration.

Against this backdrop, we are currently focused on defensively positioning the portfolio by investing in larger, more seasoned businesses that operate in non-cyclical, defensive or structurally growing industries. We remain committed to our long-term strategy and will continue to evaluate opportunities in both the sponsor and non-sponsor owned segments of the market that we believe will generate the best risk-adjusted returns over the long term. We are taking a highly selective and patient approach to evaluating potential investments and are maintaining investment discipline.

In summary, I'm pleased with the progress we've made since we began managing OCSI 9 months ago and believe we are very well positioned to continue delivering improved returns to our shareholders. 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 had a good quarter and we are pleased with our improving financial performance. Net investment income in the third quarter was $5.1 million or $0.17 per basic and diluted share. This was up from $4.6 million or $0.16 per share in the second quarter, mainly due to higher investment income and partially offset by higher operating expenses.

Total investment income in the third quarter was $11.7 million, up from $10.6 million in the March quarter. The increase was driven by higher rates, following the LIBOR reset in March and higher average leverage throughout the quarter. Net operating expenses for the quarter were $6.6 million, up from $6 million last quarter, reflecting higher interest expense based on higher LIBOR and higher incentive fees due to improved portfolio performance, partially offset by lower professional fees.

Now turning to credit quality. As Edgar mentioned, the credit quality of the portfolio remains solid as we have now cycled out of nearly all of our nonaccrual loans. One very small investment, representing less than 1 basis point of the portfolio at fair value, remains on nonaccrual. Net asset value in the third quarter decreased slightly to $9.91 per share compared to $9.99 per share at March 31. The decline was mainly due to mark-to-market price changes in 2 quoted investments. Despite these price fluctuations, we remain comfortable holding these positions as both portfolio companies are generating significant levels of free cash flow and have ample cash liquidity on their balance sheets.

On Page 10 of the earnings presentation, we have a bridge that explains the key factors that led to the sequential change in NAV. At June 30, total debt outstanding was $260.6 million at a weighted average interest rate of 4.3%. Our leverage ratio increased slightly to 0.89x from 0.88x at March 31. In July, we upsized our Citibank credit facility to $180 million from $100 million, extending the reinvestment period and maturity date by approximately 6 months. We also amended both our Citibank and East West Bank credit facilities to allow for up to 2x leverage. Matt will discuss our plans for higher leverage shortly.

At quarter-end, cash and cash equivalents were $24.3 million and we had $64.4 million of undrawn capacity on our credit facilities. With the increased capacity on the Citi facility, pro forma availability would have been $144.4 million at the end of the third quarter. Unfunded commitments outstanding at June 30 were $31 million, mainly related to portfolio companies with revolving credit facilities or delayed draw term loans.

Before I turn the call over to Matt, I'd like to provide an update on our Glick joint venture. During the third quarter, we continued to optimize the JV, adding $59 million of new investments across 9 companies with a weighted average yield of 6.9%. At June 30, the JV had total assets of $182 million, including senior secured loans to 32 portfolio companies. The joint venture generated income of $1.6 million for OCSI during the third quarter.

Additionally, during the third quarter, we amended and restructured our JV credit facility. We reduced the interest rate on the facility from LIBOR plus 250 basis points to LIBOR plus 230 basis points. We also restructured the subordinated note, lowering its interest rate from LIBOR plus 800 basis points to LIBOR plus 650 basis points to better match the income profile of the current portfolio. We expect this will meaningfully reduce PIK interest income related to the Glick JV going forward.

Now I will turn the call over to Matt Pendo, our COO.

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

Thank you, Mel. As I mentioned on our last call, we believe we are well suited to support increased leverage as we have a predominantly first lien portfolio. In addition, with no unsecured debt outstanding, we believe that we have an appropriate capital structure to support increased leverage. We also believe that additional leverage will not only allow us to grow and further diversify our portfolio, but it will enable us to simultaneously enhance our return on equity.

Following the strong shareholder support we received, we have started increasing the leverage of our portfolio while strategically adding first lien floating rate investments that are consistent with our overall investment approach. In the near term, we expect debt-to-equity levels to approach 1.2x but anticipate leverage may increase up to 1.6x over time, depending on market conditions.

As Mel noted, our efforts to monetize and redeploy our noninterest-generating investments are now nearly complete. In the third quarter, we redeployed virtually all of the nonaccruals into interest-generating investments. Given that our portfolio is 100% floating rate, we continue to benefit from rising interest rates in the third quarter. We expect to see ongoing benefits if there are additional rate increases this year.

And finally, during the third quarter, we responded to market conditions by temporarily increasing our exposure to broadly syndicated loans by $19 million. These loans are typically liquid, first lien and floating rate loans to large and stable borrowers. We are also actively seeking to invest in higher-yielding proprietary loans originated by Oaktree.

Turning to our dividend. As you saw in our press release, we declared a $0.155 dividend today. This is an increase of $0.01 from last quarter and our second consecutive quarter of dividend increases. Our dividend represents a payout of approximately 90% of our net investment income for the third quarter.

In conclusion, we are pleased with the significant progress we have made in repositioning the OCSI portfolio. Our team is executing well against all of our key initiatives, and we're making strong progress against our long-term goals of increasing ROE and paying a consistent dividend.

Thank you all for your time today. We look forward to keeping you updated on our progress. And with that, operator, please open the line to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Showing no questions, I'd like to turn the conference back over to Mr. Mosticchio. Please go ahead.

Michael Mosticchio - *Oaktree Strategic Income Corporation - IR*

Thanks. Matt is going to provide some closing remarks.

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

So once again, thanks to everyone for joining the call. We're really pleased with the quarter. As you see, we made good progress working through the portfolio. You see what we did regarding the dividend. We got the approval to take up the leverage, all of which we think helps drive a higher ROE over time. So again, appreciate your interest today.

Michael Mosticchio - *Oaktree Strategic Income Corporation - IR*

Thank you again for joining us for our third fiscal quarter 2018 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 10121987, 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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