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# Carlyle Secured Lending, Inc (0CT3YW-E)

## Q2 2023 Earnings Call

# CORPORATE PARTICIPANTS

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**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*

**Thomas M. Hennigan**
*Chief Financial Officer & Chief Risk Officer, Carlyle Secured Lending, Inc*

# OTHER PARTICIPANTS

**AJ Denham**
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**Bryce Rowe**
*Analyst, B. Riley Securities, Inc.*

**Arren Cyganovich**
*Analyst, Citigroup Global Markets, Inc.*

# MANAGEMENT DISCUSSION SECTION

**Operator**: Good day, everyone, and thank you for standing by. Welcome to the Carlyle Secured Lending, Inc. Second Quarter 2023 Earnings Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Daniel Hahn. Please go ahead.

## Daniel Hahn
*Managing Director-Global Credit, Carlyle Secured Lending, Inc*

Good morning and welcome to Carlyle Secured Lending second quarter 2023 earnings call. With me on the call this morning is Aren LeeKong, our Chief Executive Officer; and Tom Hennigan, our Chief Financial Officer. Last night we filed our Form 10-Q and issued a press release with the presentation of our results, which are available on the Investor Relations section of our website. Following our remarks today, we will hold a question-and-answer session for analysts and institutional investors. This call is being webcast, and a replay will be available on our website.

Any forward-looking statements made today do not guarantee future performance, and any undue reliance should not be placed on them. These statements are based on current management expectations and involve inherent risks and uncertainties, including those identified in the Risk Factors section of our Annual Report on Form 10-K. These risks and uncertainties could cause actual results to differ materially from those indicated. Carlyle Secured Lending assumes no obligation to update any forward-looking statements at any time.

With that, I'll turn the call over to Aren.

### Aren LeeKong

*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*

Thanks, Dan. Good morning, everyone, and thank you all for joining. I will focus my remarks on three topics on today's call. I'll start with an overview of our second quarter results. Next, I'll touch on the current market environment. And finally, I'll conclude with a few thoughts on our investment activity and current positioning.

Starting off with earnings, we continued to see the benefit of higher base rates and attractive pricing on new investments, generating total net investment income of $0.52 per share for the quarter, which is up 30% year-on-year. Our net asset value at June 30 was $16.73 per share as compared to $17.09 for Q1. As Tom will detail later, the change in NAV for the quarter was primarily driven by a markdown on one of our health care services investments that was partially offset by earning NII in excess of the dividend.

We declared total Q3 dividends of $0.44, consisting of our $0.37 base dividend plus a $0.07 supplemental, both of which were in line with the prior quarter. Although we are pleased with the quarter's earnings, we remain focused on the credit performance of the overall portfolio.

The credit fundamentals of our portfolio, in the aggregate, have continued to perform well with revenues up more than 30% and EBITDA margins largely flat year-over-year despite inflationary pressures to the economy. And importantly, our borrowers have reported consistent quality results as we've not seen a meaningful increase in non-cash add backs, and interest coverage remained stable. This gives us comfort in the strength of our portfolio.

Turning now to the current market environment. We saw the key trends discussed on our last call continue through the balance of the second quarter. Terms and pricing leaned favorably to lenders, and deal activity in high-yield and syndicated market is still sluggish, with overall net loan supply at 15-year lows. Given these market dynamics, sponsors continued to favor the private credit market to finance a limited number of LBO transactions that have been completed.

While we continue to view the LBO market as a core component of our strategy, we also complemented our traditional sponsor pipeline with other sources of transaction pool. In particular, we've seen attractive sourcing opportunities from three main areas. One, I've mentioned new deal flow from sponsor-backed companies. This is our largest generator of our deal flow, and we've continued to be increasingly selective. Two, Carlyle-generated and non-sponsored deal flow. The One Carlyle Platform provides us access to a wide swath of deal flow.

And three, finally, what I would call forming the portfolio. We are able to leverage our position as an incumbent lender, along with our long-standing relationships with companies and sponsors, to execute collaborative solutions for amendments, extensions, and M&A activity that provide added flexibility to borrowers and attractive incremental economics to our portfolio.

Regardless of sourcing channel, we focused our efforts in Q2 on opportunities that were accretive to the portfolio's return. One example of this was that our average spread at origination on new deals improved by approximately 100 basis points, compared to this period last year. In addition, as previously mentioned, we generated significant incremental value from our existing borrowers from amendment activity, which has driven tighter documentation, incremental fees, additional equity contribution from sponsors, and spread increases. In the second quarter alone, approximately 16% of our loans saw an improvement in one or more of these areas due to amendment and other related activity.

I'll now hand the call over to our CFO, Tom Hennigan.

### Thomas M. Hennigan
*Chief Financial Officer & Chief Risk Officer, Carlyle Secured Lending, Inc*

Thank you, Aren. Today, I'll begin with a review of our second quarter earnings. Then I'll discuss the portfolio performance, and I'll conclude with detail on our balance sheet positioning.

As Aren previewed, we had another strong quarter on the earnings front. Total investment income for the second quarter was $60 million, up 3% from the prior quarter. This increase was primarily driven by higher benchmark rates. Total expenses increased in the quarter from $33 million to $34 million. Similar to last quarter, the increase was primarily driven by higher interest expense from rising base rates. The result was total net investment income for the second quarter of $26 million or $0.52 per share, up 4% versus prior quarter. Importantly, this recent level of earnings is materially above our quarterly core earnings from 2022.

Our board of directors declared the dividend for the third quarter of 2023 at a total level of $0.44 per share. That's comprised of $0.37 base dividend plus the $0.07 supplemental, which is payable to shareholders of record as of the close of business on September 29. This total dividend level of $0.44 allows us to build NAV in the face of an increasingly complex macroeconomic environment. At the same time, it also represents an attractive yield of over 10% on NAV and over 11% on the latest share price. And the $0.52 of NII that we earned this quarter equates to a 12% plus return on 06/30 NAV.

In terms of the forward outlook for earnings, we see stability at this $0.52 level based on the combination of current benchmark rates and attractive economics on new deals. So we remain highly confident in our ability to comfortably meet and exceed our $0.37 base dividend and continue paying out supplemental dividends each quarter.

On the valuations, our total aggregate realized and unrealized net loss was about $22 million for the quarter. The decrease was driven by a markdown on one of our health care services named American Physician Partners. As we've noted in the past, the health care services sector has faced headwinds from labor shortages, wage inflation, and regulatory changes in the US. However, recent financial performance of our other health care services [ph] named (00:08:29) has trended favorably, and we see valuation and earnings upside in these other investments.

Additionally, one of the key tenets to our strategy is an acute focus on portfolio management and construction. Maintaining a highly-diversified portfolio that is conservatively marked with a prudent use of leverage has allowed us to deliver consistent dividends. Part of our strategy also has been retaining NII. We've retained 15% of NII or $0.32 per share during the LTM period to act as a buffer to NAV volatility. This also has resulted in a dividend coverage ratio of over 140%.

Outside of APP, we continue to see overall stability and credit quality across the book. The total fair value of transactions risk rated 3% to 5%, indicating some level of downgrades since we made the investment, was down slightly from last quarter. Total non-accruals decreased from 3. 5% to 1.8% based on fair value, aided by the completion of the [ph] Pro-PT (00:09:35) restructuring this quarter.

Aren noted that most of our portfolio companies have weathered the inflationary environment well. And of note, we continue to see financial performance improvement and positive valuation migration in investments like Direct Travel and Dermatology Associates.

I'll finish by touching on our financing facilities and leverage. We continue to be well-positioned on the right side of our balance sheet. Statutory leverage was about 1.3 times, and net financial leverage ended the quarter slightly lower at 1.1 times, comfortably within our target range. This positioning allows us to effectively deploy capital, given the attractive yields and terms available for new investments in the current market.

With that, I'll turn it back to Aren.

### Aren LeeKong

*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*

Thanks, Tom. I would like to finish by highlighting the consistency of our investment approach and reiterate our overall strategy. We are focused on primarily making investments to US companies, backed by high-quality sponsors in the middle market. The median EBITDA across our core portfolio at the end of the first quarter was $72 million. Our approach allows us to remain focused on disciplined underwriting, prudent portfolio construction, and conservative risk management. Our portfolio remains highly diversified and is comprised of over 170 investments in 130 companies across over 25 industries. The average exposure to any single portfolio company is less than 1% and 94% of our investments are in senior secured loans. So we feel very well-positioned in the current environment.

I'd like to now hand the call over to the operator to take your questions. Thank you.

# QUESTION AND ANSWER SECTION

**Operator**: Thank you. [Operator Instructions] One moment while we compile the Q&A roster. And our first question comes from the line of Melissa Wedel with JPMorgan. Please proceed.

### AJ Denham

*Analyst, JPMorgan Securities LLC*

Q

Hey. This is AJ on for Melissa. I have a question on capital returns. First, how are you all thinking about share repurchase going forward? And then, given that you're out earning the dividend, could we see a special dividend at the end of the year?

### Thomas M. Hennigan

*Chief Financial Officer & Chief Risk Officer, Carlyle Secured Lending, Inc*

A

Good morning. Hi, it's Tom. On the share repurchases, we take a close look at where our current trading price is, and that's certainly a big factor in evaluating the level of repurchases. You can see this last quarter, we're trading up in the 90%, 95% of NAV territory. We've stated in the past, if we get that level, we'd certainly look to curtail the buybacks. And that's really what you saw this past quarter. We'll continue to evaluate, where the stock is trading, as well as looking importantly at our overall float. That's something we keep a close eye on, and we want to be mindful of.

When we talk to investors, some of them say, [indiscernible] (00:12:44) those buybacks, yes, depending on the level of accretion, but we also want to make sure we've got good float in that stock. So historically, we've purchased over $150 million. We've been very supportive over the years. I think based on the current level of trading, we're simply going to look to modify – mitigate that a little – maybe a little bit smaller, just based on the current trading levels.

In terms of the dividend, we've noted we're focused on retaining some of that NII, and that's what we've done historically. When you look at the – our level of returns, we feel really good at that $0.44 level in terms of delivering really solid returns on both NAV and on the current share price. As we, say, stockpile some of that NII, we're going to look at do we potentially – it wouldn't be – it wouldn't potentially be this year, but perhaps next year that we may be required to pay a special dividend just based on the 90% payout requirement.

So that's something we're going to take a look at. But otherwise, I think we'll continue to retain that NII payout at $0.44 based on what we see as a – feeling pretty good about assuming benchmark rates stay where they are [ph] at (00:13:52) earning $0.50 to $0.52 per share.

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**AJ Denham**
*Analyst, JPMorgan Securities LLC*
Q

Okay. Got you. And then just one more. Can you walk us through the Bayside restructuring?

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**Thomas M. Hennigan**
*Chief Financial Officer & Chief Risk Officer, Carlyle Secured Lending, Inc*
A

Sure. That was a transaction – it's a typical restructuring where the lenders took a write-off of debt in exchange for majority equity in that company. So that you'll see that there's multiple levels of debt now on the SOI, as well as equity that we're marking at zero. There are the different tranches. There's that holdco loan and – as well as two different loans at the operating company level, so you see the multiple line items in that capital structure.

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**AJ Denham**
*Analyst, JPMorgan Securities LLC*
Q

Great. Thank you.

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**Operator**: Thank you. One moment for our next question, please. It comes from the line of Bryce Rowe with B. Riley.

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**Bryce Rowe**
*Analyst, B. Riley Securities, Inc.*
Q

Thanks a bunch. Good morning. I wanted to maybe ask about portfolio activity, originations and repayments here for the quarter. Just kind of curious how the pipeline looks and the repayment and sales activity, exceeding originations. Just curious how kind of intentional that was or that – was that kind of a more normal course, in terms of the repayment activity?

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**Thomas M. Hennigan**
*Chief Financial Officer & Chief Risk Officer, Carlyle Secured Lending, Inc*
A

Hey, Bryce. Good morning. I'd say I'd characterize it just as normal course.

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**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*
A

So, hey, it's Aren LeeKong. Nice to meet you. So I would say, look, we view the world – there are some strategic decisions that we make at any given moment. We have a portfolio. Today, I've mentioned in the – in my opening remarks, if you think of sort of the three big places that we're focused: we're focused on farming the portfolio so that we can get more out of it; we're focused on, the One Carlyle sourcing opportunities; and we're being exceptionally picky when it comes to just regular way sponsor finance.

Now if our goal today and you'll see, I think, year-to-date, our average spread that we have originated transactions on is somewhere between 6.70%, 6.80%, significant premium to last year. Our goal is focused on improving the portfolio at every moment. So whenever we're thinking about what's being repaid and – over the next year, we have a fairly detailed model. Everything that is up for maturity, we're at all times thinking about replacing what's being repaid which, on average, has a five handle on it with, sort of 6.50% to – and above spreads with fairly [indiscernible] (00:16:52).

So the bottom line is, we're not – I know that, this is a constant conversation on private credit land. We are focused on quality and portfolio construction. So, to be fair, and the previous question also touched on this, we're fine holding a little bit more cash to make sure that we have a very steady, battle-tested, kind of cap structure and balance sheet here, and we're improving our portfolio. So, yeah, we're – as things come off, we don't have – we're focused on quality, not quantity.

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**Bryce Rowe**
*Analyst, B. Riley Securities, Inc.*
Q

Okay. And then – and kind of reading into that, is there an expectation that, maybe we see balance sheet leverage compress a little bit more, versus re-levering up over the – I don't know, over the next six months or so?

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**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*
A

So, it's great question. So when we think about – and we can obviously talk about this offline as well in further detail, but this is sort of a – kind of a 3-D chess match that we're playing. So we're thinking about, Tom just mentioned that we bought, over the course of last year and a half, two years, almost, a little over 23% of our float back. It was $0.65 in total accretion. We've held back on NII and been able to take the leverage down a little bit, so that we can actually have more dry powder but also take less risk in this market.

We've tried to focus on, higher-quality names and while – while repaying some of the older vintages. So to the point, we are, quite frankly, thinking about all of it and trying to create the best portfolio we can, but – so the answer is, we are – all of these things are under consideration.

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**Bryce Rowe**
*Analyst, B. Riley Securities, Inc.*
Q

Got it. Appreciate that, Aren. And then, maybe last one for me. Just thinking about capital structure, seeing, debt capital markets kind of start to open back up here. Really, over the last month, you've got maturities at the end of next year, so a decent ways away. But just kind of curious how you're thinking about capital structure, maybe any commentary around the preferreds, too, within that would be helpful.

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**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*
A

You must be sitting here in our office in our planning sessions. I think you're [indiscernible] (00:19:16). Tom, do you want to start and I'll [indiscernible] (00:19:22)?

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**Thomas M. Hennigan**
*Chief Financial Officer & Chief Risk Officer, Carlyle Secured Lending, Inc*
A

Yeah, sure. We're in constant dialogue with our banking relationships and [indiscernible] (00:19:27) was – we had a meeting less than two months ago. It was like, hey, the public market is shut. Well, guess what? It's opened very quickly. So we're certainly considering those options. We're mindful of those maturities at the end of 2024, always looking at what's the best – optimizing the capital structure – diversified capital structure, looking at the prefs, looking at potential public bond offering, and getting the right mix in the capital structure. It's something that we have constant dialogue in, and we'll continue to assess and do what's best for our shareholders.

**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc* A

And in terms of [indiscernible] (00:19:59), as Tom said, we're kind of focused holistically and everything I've mentioned and Tom mentioned kind of all worked together. And the prefs, we're in constant contact and dialogue with Carlyle proper, as well as the board, and thinking about, how to think about that as a long-term part of our cap structure.

Right now, if you look at the comparable preferred trades in the market, quite frankly, our pref is at 7%, which is about 200 basis points cheap to what the comparable trades are today, so it's actually a pretty good piece of paper as it stands. But we are, along with the unsecureds, thinking about long-term shareholder value. So stay tuned.

**Bryce Rowe**
*Analyst, B. Riley Securities, Inc.* Q

Got it. Okay. Appreciate the comments, guys.

**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc* A

Appreciate you.

**Operator**: Thank you. One moment for our next question. [Operator Instructions] Our next question is from Arren Cyganovich with Citi.

**Arren Cyganovich**
*Analyst, Citigroup Global Markets, Inc.* Q

Thank you. Maybe you can talk a little bit about your investment pipeline and how that's flowing in in the competitive environment you're seeing from other BDCs or non-bank competitors.

**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc* A

So I'm going to take your question because I like your name, you're Arren [indiscernible] (00:21:17). So I'd say, if you think about – I mentioned it two questions ago, if you think about the three sleeves of where we source capital. One, you have the sponsor market. Sponsor market is quite busy. Obviously, the BSL market is still choppy. High-yield market is coming back a little bit, but it is quite busy.

I'd say our average deal in our portfolio is kind of low $70 million of EBITDA. I'd say the – the large market transactions that we've seen are priced a lot more competitively today. And, we – so we are kind of shying away from those to be able to get better terms and better rate down in our core mid-market. But we are being quite selective in terms of sponsor.

The One Carlyle sort of sourcing channel, there's been some transactions that we've announced over the last week or two. Those were – those transactions are less sponsor-driven and more One Carlyle-sourced, so sourced from other teams within Carlyle. That sourcing channel is fairly robust today. Folks trying to partner with Carlyle as a whole and as Carlyle, that's just direct lending. But our other partners are showing up to be a solution provider. So I would expect that to be a much bigger contributor.

And then the last piece, which I view as the highest ROIC segment today, which, again, after this call, we're happy to get on the phone and walk through things, is literally farming the portfolio. There's a pretty significant portion of this portfolio and – that we're going after that have the yield that can be improved, stocks that can be improved. Amendment fees, they can be taken. The cash, they can be contributed by sponsors in order to better extend the transactions and do what's right for the company. The solution provider to the sponsors; but also actually improve our current portfolio with credits we're already very familiar with. And any changes to the current portfolio that – those improvements drop straight to the bottom line.

So if you were inside of our offices, I guess two or three weeks ago when we did our Q2 review, you would have kind of heard that message probably ad nauseum, which is let's focus on our portfolio and trying to – trying to be solutions providers but also, grab value and extract value for our current shareholders because, quite frankly, that's the best risk we have – loans that we are already quite familiar with and in improving those terms. So I'd say those are the three – those are the three general buckets. Was that helpful?

**Arren Cyganovich**
*Analyst, Citigroup Global Markets, Inc.*

Q

Yeah, yeah. Thank you. And then on the American Physician breakdown; that seemed to kind of move relatively quickly from, I guess, the beginning part of the year to the markdown last quarter. What happened there? What's more specific to that investment versus some of the other health care investments?

**Thomas M. Hennigan**
*Chief Financial Officer & Chief Risk Officer, Carlyle Secured Lending, Inc*

A

Yeah. Arren, this one remains an active and sensitive situation, so we can't get into too many of the deal-specifics of that transaction. But I think that some of the broader items we've highlighted across the industry are inherent here. As we discussed, health care services, the headwinds in the industry, labor shortages, wage inflation, regulatory changes, specifically the No Surprises Act.

In summary, costs have gone up dramatically, and the top line has been squeezed. When you were getting last – two years ago, you were getting $150 million per encounter and now it's $130 million, while you're faced with wage inflation, that results in a pretty sharp compression of your earnings. And, it is just really industry-wide. We've seen it with other large cap health care firms, for example, Envision Health is in a similar space.

What I'll note is, we've [indiscernible] (00:25:33) – we've actually – compared to our peers, we value this one relatively conservatively. Last quarter, we were 20 points lower than other BDCs, marking this one. The good and bad now is we have – the zero valuation right now, full non-accrual, so the current NAV and the $0.52, that's fully reflective of any negative of this particular position.

**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*

A

And look, the – I think everyone has asked great questions today because they're all kind of actually related, Arren. And so, for us, we have a super – that's a technical term, a superdiversified portfolio for average positions less than 1%. The goal of keeping leverage low, maintaining – kind of preserving NII just in the event that there's any bumps in the road, managing portfolio risk and trying to improve each quarter, that allows us to, quite frankly, mark a little bit more conservatively.

So for us, we marked conservatively last quarter. We are – we've decided that it was most prudent to mark this position even more conservatively here. The goal of a direct lending portfolio is to have a diversified portfolio that also has predictable and sustainable cash flow. So for us, it isn't really about the position, it's about kind of the overall portfolio management, so we are trying to be very conservative here. But we're taking a – we, quite frankly, took a much larger portfolio view as to how conservatively the market.

**Arren Cyganovich**
*Analyst, Citigroup Global Markets, Inc.*

Q

Thanks. Appreciate it.

**Aren LeeKong**
*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*

A

Appreciate you.

**Operator**: Thank you. And as I see no further questions in queue, I will pass it back to Aren LeeKong for closing comments.

## Aren LeeKong

*President, Chief Executive Officer & Director, Carlyle Secured Lending, Inc*

Everyone, have a great morning. Thank you. We look forward to speaking to you – some of you next quarter. We look forward to speaking to some of you over the next few days to go deeper on the story, and thank you all for your support. Have a great rest of your summer.

**Operator**: Thank you all for your participation in today's conference. This does conclude the program and you may now disconnect.