REFINITIV STREETEVENTS

EDITED TRANSCRIPT

CGBD - Q2 2022 Carlyle Secured Lending Inc Earnings Call

EVENT DATE/TIME: AUGUST 10, 2022 / 2:00PM GMT

CORPORATE PARTICIPANTS

Linda Pace Carlyle Secured Lending, Inc. - Chairperson & CEO

Taylor Boswell Carlyle Secured Lending, Inc. - CIO, President & Director

Thomas M. Hennigan Carlyle Secured Lending, Inc. - CFO & Chief Risk Officer

Daniel Hahn Carlyle Secured Lending, Inc. – Managing Director

CONFERENCE CALL PARTICIPANTS

Finian Patrick O'Shea Wells Fargo Securities, LLC, Research Division - VP and Senior Equity Analyst

Melissa Wedel JPMorgan Chase & Co, Research Division - Analyst

PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Carlyle Secured Lending Second Quarter 2022 Earnings Call. (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. You may begin.

Daniel Hahn Carlyle Secured Lending, Inc. – Managing Director

Good morning, and welcome to Carlyle Secured Lending Second Quarter 2022 Earnings Call. Last night, we issued a press release and earnings presentation outlining our quarterly results, both of which are available on the Investor Relations section on 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 that 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 our Chief Executive Officer, Linda Pace.

Linda Pace - Carlyle Secured Lending, Inc. - Chairperson & CEO

Thank you, Dan. Good morning, everyone, and thank you all for joining us to discuss another strong quarter of performance. With me on the call today is our President and Chief Investment Officer, Taylor Boswell; and our Chief Financial Officer, Tom Hennigan.

Before we begin, I'd like to highlight a few key themes that you will hear from us throughout today's call. First, we remain committed to our goal of delivering sustainable income by constructing a diversified portfolio of senior secured floating-rate loans to high-quality sponsors and borrowers. Second, we are pleased to announce the increase of our base dividend rate starting in the third quarter. Third, we are well positioned to continue increasing our base dividend over the coming quarters.

Turning now to my usual quarterly remarks, I'll focus on 3 topics. I'll start with an overview of our second quarter financing results. Next, I'll touch on our credit performance and investment activity, and finally, I'll conclude with a few thoughts on how we are approaching the current investment environment.

We generated solid net investment income of $0.40 per share despite our LIBOR floors limiting the earnings benefit from higher base rates during the quarter. We declared total third quarter dividends of $0.40 per share, consisting of our newly increased $0.34 per share base dividend plus a $0.06 per share supplemental dividend.

Our net asset value for the second quarter was $16.81 per share, approximately 1.8% lower than the prior quarter's NAV. This decline was almost entirely driven by the impact of widening market yields. Importantly, our NAV remains 1.5% above our pre-COVID NAV in Q4 2019, reflecting strong through-cycle performance. We repurchased an additional $7 million of our common stock during the quarter, resulting in $0.03 of accretion to our net asset value per share. Once again, we were active repurchasers of our stock during the quarter based on its valuation and the attractiveness of the returns for our shareholders. In total, we have repurchased over 10 million shares or 17% of our float since the commencement of our share repurchase program.

The Board of Directors approved a $50 million increase to the program and extended it through November 2023. This stock repurchase program represents just one aspect of our firm and continued commitment to creating value for our shareholders.

Turning now to the portfolio. We continue to see positive credit performance in our portfolio, especially in our watchlist names. As Tom will discuss further, we expect to see a lower level of nonaccruals in third quarter. We funded $199 million of new investments in the second quarter, essentially all of which were in a first lien position. Total repayments and sales in the second quarter were $161 million. We ended the quarter with just under $1.9 billion of investments, roughly in line with the prior quarter.

Looking ahead, we feel very good about our positioning of the portfolio, our funded asset level and leverage being at the lower end of our target range. This will allow us to selectively deploy capital into attractive opportunities in this favorable investment environment.

With that, I'd like to hand the call over to our President, Taylor Boswell.

Taylor Boswell - Carlyle Secured Lending, Inc. - CIO, President & Director

Thanks, Linda. It's been an eventful several months since our last quarterly call, and today, I'll provide an update on 2 topics: the current deployment environment and how we assess the progression of fundamental credit performance against an evolving economic backdrop.

As for the current deployment environment, to put it simply, it is a highly attractive time to be a provider of capital. While private credit pricing and terms lagged liquid market signals early in the sell-off, June produced a sharp reset in favor of lenders. The market reset performed as it always has in private credit, reliably a little slow but reliably there. Today, pricing, leverage and terms are all very lender-friendly.

At the same time and perhaps more surprisingly, our pipelines remain robust, with continued transaction activity in noncyclical sectors paired with a pronounced rotation of opportunities from dislocated liquid markets into healthier private credit markets. As such, it is not only an attractive environment for deal terms but also one for credit selectivity.

Our strong balance sheet with leverage towards the lower end of our target range allows us to continue to invest through this market without taking elevated cyclical risk. We're confident this vintage of investments will position the portfolio well with sustained performance in future periods.

Of course, the bulk of our attention today should focus on the existing portfolio and how we see credit performance progressing in the coming quarters. Allow me to reiterate our message from last quarter. We have transitioned from one-way economic and liquidity conditions to a far more complex credit environment. That complexity principally stems from several well-known dynamics.

First, as described on our last call is the broad-based rising operating costs and resulting price increases at our borrowers produced by this inflationary environment. We have previously said the net impact of these factors will require several quarters to fully flow through their results, and that remains the case.

Of course, this does not mean we are merely passive observers. Rather, we are fully engaged on the topic with various interim signposts on which to report. That report, for certain, says not every borrower is recovering every dollar of increased costs. But as we assess this dynamic today, the aggregate data across our portfolio remains supportive of the continued performance for our senior secured credit investments.

Second, while aggregate demand has remained strong in recent quarters, we are seeing signs of sharp rotations in the nature of demand in certain sectors as we exit COVID-impacted periods, generally from goods into services. But thankfully, our portfolio's current exposures position us to be net beneficiaries of this rotation. We remain disciplined through the COVID up-cycle, cautiously underwriting COVID bumps with a through-cycle perspective that accounted for demand and/or margin retrenchment. Meanwhile, we're seeing increases in demand for some of our borrowers, most notably direct travel, which should accrue to the benefit of our shareholders over time. We currently feel well positioned against this dynamic.

Third, borrower liquidity. Of course, our floating-rate loans mean rising rates are beneficial to returns, but they also mean our borrowers must come up with more cash to service their debt. Given the mechanics of interest payment, the full impact will begin to flow through to borrowers in the coming quarters.

To frame the risk, for the average borrower to fall to free cash flow neutral, we would require approximately a sustained 6% SOFR environment, nearly double current expectations. In addition, our portfolio is currently in a strong liquidity position, with revolver draws standing under 20%, well below the peak usage of over 60% during the COVID crisis. With this setup, we feel our portfolio has significant cushion to absorb increasing interest rates or other unexpected liquidity draws which may arise.

Add it all up and companies are certainly facing more challenges than they have since the depths of the COVID crisis. In response, as these high-quality businesses pass through this moment of significant macroeconomic transition, we are seeing appropriate efforts and strong support from both management teams and owners across our portfolio. Our current assessment of these dynamics is that they are creating a choppier environment for fundamental corporate performance. But on the whole, they are not creating broad-based issues for senior credit performance.

Finally, a quick note on general recessionary risks. Our strategy and our portfolio have always been and continue to be built with a through-cycle perspective. We understand that each loan could be outstanding for 5, 6 or 7 years, periods of time long enough to be surprised many times over by changes in any of the macroeconomic, market, industry or company prospects. That's why we stay senior in the capital structure of high-quality businesses. That's why we build portfolios with far less cyclicality than traditional fixed income markets. That's why we lend to borrowers of scale that they can withstand surprises. That's why we invest with top quality owners who support their businesses in the event of those surprises. And that's why we run highly diversified portfolios by industry and borrower.

This discipline, deployed over the course of years, allows us to feel confidently positioned to perform through-cycle on an absolute and relative basis, including in a recessionary environment, should one emerge.

With that, I'd like to turn the call over to Tom.

Thomas M. Hennigan - Carlyle Secured Lending, Inc. - CFO & Chief Risk Officer

Thank you, Taylor. Today, I'll begin with a review of our second quarter earnings, then I'll provide further detail on our balance sheet positioning and conclude with a discussion of our portfolio performance. As Linda previewed, we had another strong quarter on the earnings front. Total investment income for the second quarter was $45 million, down from $48 million in the prior quarter. Importantly, core investment income was actually up $1 million, driven by both higher outstanding investment balance and the benefit of rising benchmark rates.

Total expenses increased modestly in the quarter from $23 million to $24 million as higher interest expense was partially offset by lower incentive fees. The result was net investment income for the second quarter of $21 million or $0.40 per common share. That's in line with our core earnings over the last few quarters and exceeds the guidance we provided on last quarter's call. As a reminder, the second quarter was expected to be a low point for our earnings as we lost the impact of LIBOR floors.

On August 8, our Board of Directors declared the dividends for the third quarter of 2022 at a total level of $0.40 per share. That's comprised of our new $0.34 base dividend, up from the prior level of $0.32 plus a $0.06 supplemental, which is payable to shareholders of record as of the close of business on September 30.

In terms of the forward outlook for earnings, based on the combination of lower nonaccruals, attractive economics on new investments and higher benchmark rates, we see a near-term path to materially grow earnings in coming quarters. We expect third quarter results to benefit from an improvement in nonaccruals, specifically Derm Growth. This should contribute at least $0.01 of incremental earnings per share each quarter. And as I noted on prior calls, for every 33 basis points of additional increase in LIBOR, SOFR, we'll experience a $0.01 increase in NII each quarter.

All told, we see NII for the second half of the year in the $0.43 to $0.44 per share range, with a number of potential factors that would generate further upside, to remain highly confident in our ability to comfortably meet and exceed the new $0.34 base dividend and continue to pay out sizable supplemental dividends each quarter. And based on this anticipated increase in earnings in the coming quarters, we intend to evaluate and consider incremental increases to the base dividend level each quarter.

On valuations, our total aggregate realized and unrealized net loss was $17 million for the quarter. Yes, this breaks our streak of 8 consecutive quarters of positive NAV and valuation migration, but this decline was almost entirely driven by the increase in market yields, not credit. In fact, our 2 watchlist investments experienced a net positive of $7 million for the quarter, and our June 30 NAV remains 1.5% above the December 2019 level.

Next, I'll touch on our financing facilities and leverage. We continue to be very well positioned on the side of our balance sheet. Statutory leverage was about 1.3x, while net financial leverage ended the quarter up slightly at 1.05. So we remain at the bottom end of our target leverage range, which bodes well, given the attractive yields and terms available for new investments in the current market.

During the quarter, we also had positive developments related to our financing lines at the BDC and JV level. In conjunction with closing the regular annual extension on our revolving facility, we're successful in reducing the interest spread from 2.25% to 1.875%. And we also closed extensions for the core credit facilities at each JV, positioning those vehicles for continued stable earnings generation.

I'll finish with a review of the portfolio and related activity. We continue to see overall stability in credit quality across the book and improvement in positions historically with credit issues. The total fair value of transactions risk-rated 3 to 5, indicating some level of downgrade since we made the investment, was roughly flat on the quarter. Total nonaccruals increased modestly to 4% based on fair value, but this was due to higher valuations on both Derm Growth and direct travel, and important to highlight, there were no new nonaccruals during the quarter.

Also very pleased to report that Derm Growth we placed back on partial accrual status effective July 1. That should reduce net nonaccruals from 4% to under 3% and also contribute about $0.01 to quarterly NII. This leaves direct travel as our largest nonaccrual position. That borrower continues to move in the right direction recovering from the pandemic-driven declines in air travel, leaving more potential positive news in the near term on the nonaccrual front.

With that, back to Linda for some closing remarks.

Linda Pace - Carlyle Secured Lending, Inc. - Chairperson & CEO

Thanks, Tom. Before opening it up for your questions, I'll say again, we feel very good about our prospects for Carlyle Secured Lending. With the combination of lowered net nonaccruals, a favorable investment environment and earnings upside from rising base rates, we expect to meaningfully grow our earnings and dividends over the coming quarters.

Thank you all for joining us today, and we hope you and your families all enjoy the remaining weeks of summer. I'd like to now hand the call over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Finian O'Shea from Wells Fargo Securities.

Finian Patrick O'Shea - Wells Fargo Securities, LLC, Research Division - VP and Senior Equity Analyst

A couple on Derm Growth, which looks like it had some positive developments there. Can you expand on how the partial accrual works? Does the limitation there have to do more with its overall valuation or the income it's producing? And then sort of how do you weigh this against, say, paying down the principal with those proceeds as its income presumably improves?

Thomas M. Hennigan - Carlyle Secured Lending, Inc. - CFO & Chief Risk Officer

It's Tom. Let me -- I'm a little bit guarded on what I can say about that situation because it's still developing. And I would say that this is phase 1 of multiple phases in resolving that credit. We had a favorable amendment, and based on that amendment, we're comfortable with part of that tranche -- part of that loan being cash pay, and therefore, that will be on accrual status. And then we anticipate, as the company continues to perform, not there yet but in the future, potentially full recover on that loan.

Again, that's not today, what we're seeing in the numbers but in the future. And that's why we're comfortable with the current status, there's a partial accrual and then in the future, in anticipation, as the earnings continue to grow, the potential for full recovery of that loan and full accrual status.

Finian Patrick O'Shea - Wells Fargo Securities, LLC, Research Division - VP and Senior Equity Analyst

Okay. That's helpful. I appreciate that and the limitations of discussion on individual name. Can you talk a bit more about the base dividend? You -- as you outlined in your presentation that this may see more upside, just sort of any context there? You still earn well above that amount, but does this mean maybe a higher payout or you're still under-earning because of your leverage profile or however we should think about that?

Thomas M. Hennigan - Carlyle Secured Lending, Inc. - CFO & Chief Risk Officer

Yes, what I'd say is we've been saying for the last almost 8 quarters that when we -- from the time when we set the $0.32 basis, that we always felt very comfortable that we were going to meet and exceed that level. Now we have -- and we were very comfortable earning that $0.38 to $0.40 over the last number of quarters.

Now as we look at our forward earnings, really 3 drivers that we feel quite comfortable that we're going to be able to exceed that $0.38 to $0.40. Number one, nonaccruals; number two, more favorable spreads in the investment environment; and then number three, out of our control but we don't want to put too much stock in but rising benchmark rates. Certainly can reverse, but right now, the crystal ball says that those are obviously -- they're headed up and they're going to be headed up higher.

So you put those 3 together and as we noted, we feel comfortable with a $0.43 to $0.44 of third quarter and future earnings based on where we see those 3 dynamics right now. So with that, we're comfortable -- very comfortable with $0.34 base. And we'll continue to evaluate, each quarter, incremental increases to that number.

Operator

(Operator Instructions) And your next question comes from Melissa Wedel from JPMorgan.

Melissa Wedel - JPMorgan Chase & Co, Research Division - Analyst

I just wanted to clarify. It looks like with the upsizing of the repurchase authorization, that would leave about $60 million of capacity available in total through November of '23. Is that right?

Thomas M. Hennigan - Carlyle Secured Lending, Inc. - CFO & Chief Risk Officer

Melissa, that's right.

Linda Pace - Carlyle Secured Lending, Inc. - Chairperson & CEO

Yes.

Melissa Wedel - JPMorgan Chase & Co, Research Division - Analyst

Okay, appreciate that. And then just thinking about your comments about the attractiveness of the investment environment, the -- operating at the lower end of your leverage target range. It sounds like it's fair to say we should expect a more rapid pace of capital deployment into the back half, even aside from the normal December quarter seasonality. I guess, one, is that fair to assume? And then two, that's on the deployment side in terms of repayments. Is there anything that you're anticipating or aware of that we should be thinking about?

Linda Pace - Carlyle Secured Lending, Inc. - Chairperson & CEO

Yes. Melissa, it's Linda. Thanks for the question. And I do think you're spot-on. We're seeing good investment opportunities and ones that where we can be really selective and employ the -- all the resources that Carlyle brings to bear to take advantage of some kind of unusual market opportunities that we're seeing, given the limited capital being deployed in the liquid loan and bond markets. So seeing things that we're pretty excited about and will be nicely accretive to our portfolio.

You should expect for us to have a pretty nice robust investment number coming into the third quarter. Hard to look out too much past that, quite frankly. Things seem to be moving pretty quickly. And repayments have slowed so we're cognizant of that as well. But we have capacity to add to our portfolio when we see really nice opportunities. And this is a great environment for us to put money to work, albeit selectively, given all of the macroeconomic challenges that are out there these days.

Tom, do you want to give a little bit more specifics around that?

Thomas M. Hennigan - Carlyle Secured Lending, Inc. - CFO & Chief Risk Officer

Yes. I would echo what you said, Linda. Definitely, repayments tough to forecast but lower. And I would say we're surprised to see still a very robust deal environment but we're being highly selective. And it's those deals that were -- that same deal that was priced L plus 5.50% 6 months ago or even 3 months ago, perhaps is now L plus 6.50%, with instead of a [98] OID, it's [97] OID. And terms are tighter in terms of legal documentation. So from that perspective, we're being selective but certainly, we're seeing reasonably positive move in terms for new deals.

Linda Pace - Carlyle Secured Lending, Inc. - Chairperson & CEO

Yes. The middle market private credit market took a while to catch up to where yields were going in the liquid markets. But over the recent 30, 60 days, we've really started to see that move in a lender-friendly way. So as Tom said, yields are increasing and not just because of the increase in the base rates but the actual spreads are increasing.

And we finally are getting some better terms, I think, kind of going back to types of terms and the credit agreements that we really want to see. So from that, that's one of the main reasons we think it's an attractive environment to put money to work.

Melissa Wedel - JPMorgan Chase & Co, Research Division - Analyst

I appreciate that context. It's really helpful. I guess one last question for me, if I could. I think what you're saying is very much echoing the sentiment that we've heard from a lot of other management teams about the relative attractiveness of the environment. How do you weigh the opportunity set against sort of the uncertainty of the environment? And does that impact your thinking about where you want to operate portfolio leverage within your target range?

Linda Pace - Carlyle Secured Lending, Inc. - Chairperson & CEO

Yes, I'll start and then Tom can jump in. It's -- I think, yes, that is the balance. We really try to need to think about and strike. We like a lot of the deals that we're seeing but we also don't like a lot of the deals that we're seeing. So when you think about our funnel of deal flow, our hit rate is still kind of -- we'd close 3% to 4% of all the deals that we see. And I think that's the right approach because as we look at the new deals that are coming in the pipeline and we look at our own portfolio, we're still in discovery mode, right, and how companies are going to perform, how they're going to be able to pass along the increased cost.

The top line seems to be pretty good and that's echoed everywhere, right? That's echoed in the stock market, the Fortune 500, the syndicated market. Second quarter looked pretty good, but third quarter is, obviously, going to have more uncertainty. So we want to be kind of -- we're optimistic about the environment but we're also cautious, so cautiously optimistic. To use that phrase, I guess, is appropriate.

So we're -- as it plays into where we think about leverage in the portfolio, we'd be comfortable taking it up moderately, but you shouldn't expect us to go back to the top end of our leverage. There's just, I think, too much macroeconomic volatility and uncertainty out there. And we don't want to be caught in an overlevered situation if things start going the wrong way fundamentally. So I think we have room to move it up a bit, which obviously we'll do as we see opportunities to make good investments in the portfolio. But you won't see a drastic uptick in leverage from us.

Tom, fair?

Melissa Wedel - JPMorgan Chase & Co, Research Division - Analyst

Got it.

Thomas M. Hennigan - Carlyle Secured Lending, Inc. - CFO & Chief Risk Officer

Yes, I agree. And 2 points I'll add is that we're still trying to be balanced with our approach. It's an attractive market. But instead of a 2% position, we may make a 1% position. And we're also focused on borrowers we know and like. If I look at our current pipeline, there are 4 different transactions that we're working on that we're going to be closing that are existing portfolio companies in our BDC or existing portfolio companies that Carlyle has invested in and knows well from long history with those businesses. So it's investing in areas we know and in businesses we know and like.

Operator

And there are no further questions at this time. I will turn the call back over to the presenters for closing remarks.

Linda Pace - Carlyle Secured Lending, Inc. - Chairperson & CEO

Great. Well, thank you, all, for joining today and appreciate your questions. And if there's anything further, you know how to reach us. And apologies that you didn't hear from Taylor on the Q&A. He had some technical difficulties. So -- but obviously, if there's any specific questions for him, we'll get him back on to you.

So have a great rest of your summer and look forward to talking to you next quarter.

Operator

This concludes today's conference call. You may now disconnect.
