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CGBD - Q3 2022 Carlyle Secured Lending Inc Earnings Call

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CONFERENCE CALL PARTICIPANTS

Melissa Wedel JPMorgan Chase & Co, Research Division - Analyst

PRESENTATION

Operator

Good day, and welcome to Carlyle Secured Lending's Third Quarter 2022 Earnings Call. (Operator Instructions) As a reminder, this call may be recorded. I would now like to turn the call over to Daniel Hahn, Head of Shareholder Relations. You may begin.

Daniel Hahn Carlyle Secured Lending, Inc. - Managing Director

Good morning, and welcome to Carlyle Secured Lending's Third Quarter 2022 Earnings Call. With me on the call this morning is our Chief Executive Officer, Linda Pace, and our Chief Financial Officer, Tom Hennigan. 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. We're extremely pleased with our third quarter results, with growth in core earnings and net asset value, a lower level of nonaccruals and another 6% increase in our base dividend rate. These results demonstrate the power and resiliency of our platform and our ability to deliver on our objectives of generating sustainable income levels well above our base dividend and a stable NAV.

With that said, I would like to focus my remarks on three areas for today's call. I'll start with an overview of our third quarter financial 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.

In Q3, we generated net investment income of $0.58 per share which included $0.14 per share of one-time income from restoring Direct Travel to accrual status. Net of this one-time income, core earnings for the quarter was $0.44, which benefited from both the continued resolution of our nonaccrual credits and higher base rates. We declared total fourth quarter dividend of $0.44 per share, consisting of our newly increased $0.36 per share dividend, plus an $0.08 per share supplemental dividend. We have now increased our base dividend rate in 2022 by a total of 12.5%.

Our net asset value increased by over 2% in the third quarter to $17.16 per share. This increase is primarily driven by our NII outpacing our dividend and higher valuations from credit improvements across watch list credits, which Tom will discuss later in further detail. We repurchased an additional

$7.1 million of our common stock during the quarter, resulting in $0.03 of accretion to our net asset value per share. In total, we have repurchased almost 11 million shares or 17.5% of our float since the commencement of our share repurchase program, resulting in $0.60 of total accretion to our net asset value per share.

Now as for the current market, the macro environment remains complex and continues to evolve with a broad range of factors driving volatility across the global debt and equity capital markets. Fed rate hikes aimed at lowering inflation have increased the cost of borrowing and strengthened the U.S. dollar. Geopolitical risks remain elevated from the Russia-Ukraine conflict and disruptions in the global supply chain. With this as the market backdrop, we feel it's important to remind investors how we think about constructing our portfolio. We prioritize floating rate investments at the top of the capital structure of high-quality U.S. middle market companies that are scale to withstand market disruptions and backed by leading private equity sponsors with a track record of supporting businesses. We utilize our competitive edge, the OneCarlyle approach, leveraging the knowledge and expertise across our broader platform at each stage of our investment process.

Turning now to the portfolio. Despite the complexities in the market environment, we continue to be pleased with the financial performance and liquidity positions of our portfolio companies. We have yet to see any meaningful uptick in either amendment activity or drawdowns of revolver capacity by our borrowers beyond the ordinary course. We also continued to see positive credit performance across our book during the third quarter, especially in our watch list names. That said, given the significant increase in benchmark rates, we have been increasing our focus on assessing both current and future cash generation and interest coverage metrics across all positions in the portfolio.

As for investment activity, we funded $268 million of new investments in the third quarter, essentially all of which were in a first lien position. In addition to our regular sponsored deal flow, we were able to leverage the sourcing capabilities of Carlyle's broader credit platform for several attractive investments during the quarter. Total repayments and sales in the third quarter were $212 million. We ended the quarter with approximately $1.9 billion of investments, slightly up from the prior quarter.

Lastly, I want to address the leadership transition announced during the quarter. As reported in September, Taylor Boswell has decided to leave Carlyle to pursue other opportunities. On behalf of Carlyle, I want to thank Taylor for his leadership and invaluable contributions to Carlyle Secured Lending and the broader Carlyle Direct Lending business. I'm extremely grateful for the work that Taylor and the entire Direct Lending team have done over the past couple of years to reshape our investment process. As a result of the team's substantial efforts, I believe we are well positioned to continue creating long-term value for our shareholders for many years to come.

With that, I'd like to hand the call over to our CFO, Tom Hennigan.

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

Thank you, Linda. Today, I'll begin with a review of our third quarter earnings, then I'll provide further detail on our balance sheet positioning, and I'll 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 third quarter was $59 million, up from $45 million in the prior quarter. The primary drivers were the one-time impact of Direct Travel and the benefit of rising benchmark rates. Importantly, improvement in core investment income was aided by lower net nonaccruals.

Total expenses increased in the quarter from $24 to $29 million, primarily as a result of higher interest expense from higher base rates and higher incentive fees. The result was total investment income for the third quarter of $30 million or $0.58 per share and core earnings, excluding Direct Travel, of $0.44 per share, substantially above our core earnings of $0.40 per share earned in the last few quarters.

Our Board of Directors declared the dividends for the fourth quarter of 2022 at a total level of $0.44 per share. That's comprised of our new $0.36 base dividend, up from the prior level of $0.34, plus an $0.08 supplemental, which is payable to shareholders of record at the close of business on December 30.

In terms of the forward outlook for earnings, based on the combination of higher benchmark rates, and attractive economics on new investments, we see continued growth in NII for the fourth quarter, with further upside in 2023 based on the latest rate curves. And as noted on prior calls, for every 33 basis points of additional increase in LIBOR or SOFR, we'll experience a $0.01 increase in NII each quarter. So we remain highly confident in our ability to comfortably meet and exceed the new $0.36 base dividend and continue paying out 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.

On valuations, our total aggregate realized and unrealized net gain was $7 million for the quarter. This increase was almost entirely driven by improvements across watch list credits, a trend that continued from the prior quarter.

Next, I'll touch on our financing facilities and leverage. We continue to be well positioned on the right side of our balance sheet. Statutory leverage was about 1.26x, while net financial leverage ended the quarter up slightly at 1.09x. So while up modestly compared to prior quarter, our leverage remains at the lower end of our target range. This positioning allows us to effectively deploy capital given the attractive yield and terms available for new investments in the current market.

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 performance issues. The total fair value of transactions risk-rated 3 to 5, indicating some level of downgrade since we made the investment, improved by over $60 million this quarter, while watchlist names rated 4 or 5 reduced by about 50%.

In addition, total nonaccruals decreased substantially from 4.4% to 2.3% based on amortized cost, with Direct Travel and the first-out portion of the amended U.S. Derm investment being restored to accrual status.

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 wanted to take a moment to comment on the change in my role at the company. As many of you are aware, I recently announced that I'm stepping down as CEO at the end of the year. I will continue to serve as Chair of the Board of Directors, but I'm pleased to be handing over the reins to the very capable hands of Aren LeeKong. Aren brings a wealth of experience to this role as well as strong knowledge of the company from his time on the board. I look forward to continuing to work with Aren and the entire Direct Lending team.

With that, I'd like to finish by reiterating that we remain highly confident in our strategy and portfolio construction, but cautiously optimistic given the inherent volatility in the current market. I'd like to now hand the call over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Melissa Wedel with JPMorgan.

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

Linda, congratulations on your transition. I'd like to actually start there if we could, given your -- the evolution in your role and then also with Taylor leaving, can we walk through sort of the team who will be filling his shoes? And maybe just dig into the depth of the team a little bit more.

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

Sure, Melissa. Thanks for your question, and thanks for the congratulatory note as well. It's been a terrific kind of double decade-plus career at Carlyle. So I appreciate your thoughts. Yes, just to talk about the team a little bit, and I think team is definitely the right word. We don't want our investors to think that our platform is just one person. There's a whole team of people around the person that has that CEO title.

And just to name out a couple of people to point to, obviously, Tom has been here with us since the beginning. So he's been here for well over a decade. Tom, I think, are you approaching 15 years now? I'm losing track of time. But -- so he's been a long-term member of the team. Also, a gentleman named Michael Hadley, who we recently promoted as Chief Investment Officer, he's been at Carlyle also for about 15 years and has worked -- he originally worked with me on the liquid side of the Carlyle Global Credit platform.

But given his investment and underwriting and strength, he was originally a head of our credit committee on the liquid side. He moved over several years ago to our BDC and Direct Lending business. And of most -- the vast majority actually of the team of underwriters, which is now approximately 2 dozen people, he has hired. So -- and they all report to him. So he's really a key person in making sure that our investment process is working well, and that our underwriting standards remain high.

Also, we've got a number of people that are executive officials for the company. You can kind of look back in our filings and see all the people that we added. And one thing I want to point out is, we have a really robust investment committee. So we've got about a dozen people on the investment committee from all walks of the Global Credit platform and our risk management platform in Washington.

So we can't get sort of much more talent on that investment committee if we wanted. So if you're ever -- if you ever wanted to talk to anybody specifically, let us know, Melissa, we're happy to put you in contact, but I think you're -- sorry for my long-winded answer, but I think, hopefully, everybody feels comfortable that there are plenty of eyes and ears on the Direct Lending team kind of looking after the portfolio and looking after the new investments that we make.

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

I appreciate that. Very open-ended question. So -- I think it would be helpful to certainly see the trajectory on nonaccruals and watchlist investments, which is fantastic, particularly in this uncertain environment. Across the broader portfolio, I know you talked about seeing stable credit. Are you seeing any -- even at the margin, any erosion and sort of interest coverage ratios or any weakness on top line or softening at least on top line, from any sort of corners of the portfolio?

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

Sure. Tom, do you want me to take that? Or do you want to take it, or both of us?

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

Linda, let me. I'll start. Melissa, if you look at our -- we've got a diversified portfolio, over 100 different borrowers in the portfolio. So certainly, in this environment, you're going to see results that span the gamut. But overall, we're happy to report solid performance across the portfolio. Revenue continues to grow, both organically and via acquisitions. EBITDA and leverage statistics across the broad portfolio continue to be relatively stable, up modestly.

The point on interest coverage is, on a LTM basis, interest coverage still remains north of 2x, but we're really focused on the forward outlook for both interest coverage and overall cash flows. And so certainly, as rates go from up to north of 4%, we're going to see that interest coverage ratio across the portfolio go down. Across the broad portfolio, it's 2x now, it's going to be less than 2x.

But what we're really focused -- keenly focused on is individual credits is there's a gamut in terms of if we have a strong performing credit, maybe Day 1, we started higher leverage. So we're going to be comfortable looking at that portfolio company with a lower interest coverage ratio. It's going to be really the credits that are underperforming that may have EBITDA declines and maybe have a higher interest coverage, but we're going to be more focused on those credits.

So I think it's going to be credit by credit, but we're certainly very focused on interest coverage ratios and then more importantly, just overall free cash flow, looking at working capital, taxes, interest and both LTM basis, but really more importantly, go forward because company may have generated cash in the last 12 months, but certainly, their interest burden is going to go up dramatically in the next 12 months.

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

Yes. Maybe, Melissa, I can just add. We're -- we definitely don't have blinders on, right? This is -- while we love the new opportunities we're seeing in the market, there's going to be some stresses in everybody's portfolios given the increase in input costs across the board. But we do -- one of the assets that we have at Carlyle is an experienced workout team. So to the extent that we do have individual problems in the portfolio, we've got a lot of muscle power to help work those out. And not everyone is going to work out as well as Valero did or Direct Travel, but I think those represent kind of 2 great examples of our workout team really kind of doing a good job to maximize value when things aren't looking so good on individual names.

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

Got it. Maybe I can ask one last question. Given portfolio leverage levels, and certainly, your track record and sort of consistently repurchasing shares when trading at decent discounts to NAV, is it fair to think that you guys are as committed as ever to continuing share repurchase? And could you just quickly recap how much is left on the current authorization?

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

Yes, sure. Melissa, we continue to be steady purchasers in this market. The Board in, I think, last quarter increased the authorization. So we still have over $50 million left under the authorization. We renewed it last -- last quarter, we renewed it through November of '23. So effectively reset the annual renewal last quarter.

Operator

There are no further questions. I'd like to turn the call over to Linda Pace for any further remarks.

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

Thank you, everyone, for your time today, and we look forward to talking to you in the New Year. Enjoy the rest of the year and enjoy your holidays. Take care.

Operator

This concludes the program. You may now disconnect. Everyone, have a great day.
