S&P Global
Market Intelligence

Carlyle Credit Income Fund NYSE:CCIF

Q1 2024 Earnings Call Transcripts

Friday, March 1, 2024 3:00 PM GMT

Table of Contents

Call Participants

EXECUTIVES

Jane Cai
VP & Senior Product Specialist - Investor Relations

Lauren Michelle Basmadjian
CEO & Trustee

Nelson Joseph
Principal

Nishil Mehta
Portfolio Manager

ANALYSTS

Mickey Max Schleien
Ladenburg Thalmann & Co. Inc., Research Division

Mitchel Stuart Penn
Oppenheimer & Co. Inc., Research Division

Presentation

Operator

Good day, and thank you for standing by. Welcome to the Carlyle Credit Income Fund First Quarter 2024 Financial Results and Investor Conference 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, Jane Cai from Investor Relations. Please go ahead.

Jane Cai
VP & Senior Product Specialist - Investor Relations

Good morning, and welcome to Carlyle Credit Income Fund First Quarter 2024 Earnings Call. With me on the call today is Lauren Basmadjian, the Fund's Chief Executive Officer; Nishil Mehta, the Fund's Portfolio Manager; and Nelson Joseph, the Fund's Chief Financial Officer.

Last night, we issued a press release and corresponding earnings presentation discussing 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 the Form and CSR. These risks and uncertainties could cause actual results to differ materially from those indicated. Carlyle Credit Income Fund assumes no obligation to update any forward-looking statements at any time.

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

Lauren Michelle Basmadjian
CEO & Trustee

Thanks, Jane. Good morning, everyone, and thank you for joining CCIF's second earnings call. I would like to start by reviewing the fund's activities over the last quarter. We leveraged the fund through the issuance of 8.75% Series A preferred stock due 2028. We issued $52 million total through the issuance of $30 million on October 18, an incremental $2 million through underwriters partially exercising the greenshoe and a $20 million add-on price on November 21.

We increased the monthly dividend by 5.6% to $0.105 per share, which is now declared through May 2024, equating to a 15.9% annualized dividend based on the share price as of February 28, 2024. We expect the higher monthly dividend will be covered by CCIF's net investment income. We estimate the fund will be able to generate net investment income per quarter of $0.33 to $0.36, which is higher than our forward quarterly dividend of $0.315 per share.

New CLO investments during the quarter were over $40 million, with a weighted average GAAP yield of 26%. The new investments increased the portfolio's weighted average GAAP yield to 20.3% as of December 31.

Switching gears, I'd like to discuss the current market environment for both senior secured loans and CLO equity. Carlyle is one of the world's largest CLO managers with $53 billion of assets under management, slightly less than 1/3 of Carlyle Credit's AuM of $188 billion, providing us with differentiated insight into the senior secured loan and CLO market.

2024 is off to a busy start. CLO issuance had a record January as liabilities tightened significantly and the arbitrage for new CLOs increased to the highest that it's been in 10 months. Loan issuance has been robust, starting with a repricing wave, then extensions of existing capital structures and, finally, true net new issuance in the form of add-ons for existing borrowers to fund tuck-in M&A, dividend deals and a number of private credit loans pivoting to the liquid market so that they could cut their interest expense.

In the fourth quarter of 2023, many banks predicted a significant increase in defaults and lower CLO issuance for 2024. We think this is likely incorrect and are only expecting a small increase in defaults this year. Additionally, we anticipate an increase in new CLO issuance and resets and refinancings of older CLOs.

As of now, approximately 40% of the CLO market has passed its reinvestment period, a phenomenon that the CLO market has never experienced before. But as old deals get called or refinanced, we expect that to change.

As far as company performance, we're still getting fourth quarter numbers for our private borrowers, but we're encouraged by third quarter results. We saw 68% of borrowers increased sales, 65% increased EBITDA and, most importantly, 73% produced free cash flow in the quarter. Though interest expense has increased due to higher rates, we see management teams focused on producing and conserving cash and expect this to continue over the near term. When we look at the over 600 U.S. borrowers that Carlyle managed CLOs lend to, less than 4% have interest coverage under 1x.

Carlyle's house view is, so we are likely to see rate cuts this year? We will be operating in a higher rate environment for some time. We think this is a positive for CLO equity distribution as they benefit from higher base rates as long as defaults don't pick up significantly. That said, we continue to see reading agencies downgrade companies, oftentimes focused on borrowers' interest coverage contracting, and we are unlikely to see this reverse until rates start to decline. This could put pressure on CCC tests and CLOs and highlights the importance of understanding the individual credits and the risk in each CLO equity position.

I will now hand the call over to Nishil Mehta, our Portfolio Manager, to discuss our deployment and the current portfolio.

Nishil Mehta
Portfolio Manager

Thank you, Lauren. We continue to leverage Carlyle's long-standing presence in the CLO market as one of the world's largest CLO managers and 15-year track record of investing in third-party CLOs to deploy a diversified portfolio of CLO equity investments.

As of December 31, our portfolio comprised 36 unique CLO equity investments managed by 21 different collateral managers sourced entirely in the secondary market. We continue to target recent vintages of Tier 1 and Tier 2 managers with ample time remaining in the reinvestment period. Most of these portfolios have attractive cost of capital, and with active management and time left in the reinvestment periods, managers can capitalize on periods of volatility, to improve portfolios or reposition them.

We selectively observed opportunities to purchase shorter-tenor equity at attractive entry points relative to NAV, where cash-on-cash makes a 20% to 30%. We continue to leverage our in-house credit expertise of 25 U.S. and 10 European credit research analysts to complete bottom-up fundamental analysis on the underlying loan portfolios of CLOs.

The following are some key stats on the portfolio as of December 31. The portfolio generates a GAAP yield of 20.34% on a cost basis, supported by cash and cash yields of 25.12%, on CLO investment quarterly payments received during the quarter. The weighted average years left and reinvestment period is approximately 2.5 years. The weighted average junior overcollateralization cushion of 4.77%. We believe this is a healthy cushion to offset a gradual increase in defaulted loans. The weighted average spread of the underlying portfolio was 3.7%. The percentage of loans rated CCC by S&P was 5.2%, providing a fair amount of cushion below the 7.5% CCC limit and CLOs.

As a reminder, once the CLO has more than 7.5% of its portfolio, rated CCC, the excess over 7.5% is marked at the lower of fair market value and [indiscernible] recovery rates and reduces overcollateralization cushions. The percentage of loans trading below 80 was limited to 4.3%.

I will now turn it over to Nelson, our CFO, to discuss the financial results.

Nelson Joseph
Principal

Thank you, Nishil. Today, I will begin with a review of our first quarter earnings. Total investment income for the first quarter was $5.3 million or $0.46 per share. Total expenses for the quarter was $2.5 million. Total net investment income for the first quarter was $2.8 million or $0.24 per share. Net asset value as of 12/31 was $7.99. Our net asset value is based on the bid side mark we received from a third party on the CLO portfolio. We currently have one legacy real estate asset remaining in the portfolio. The fair market value of the loan is $2 million. We have currently engaged a third party to sell our position, while maximizing proceeds.

We put into place an after-market offering program that will allow us to efficiently and accretively issue common stock once the stock trades above net asset value. First quarter earnings do not represent the expected earnings of CCIF on a go-forward basis as we did not achieve our leverage target of 0.25x to 0.4x of debt plus preferred to total assets until late November, and we deployed the proceeds from the preferred issuance through the end of the quarter.

The issuance of the Series A term preferred stock is accretive as the coupon is 8.75%, while our portfolio GAAP yield is 20.3%. Assuming the fund was fully leveraged on the first day of the quarter, pro forma net investment income for the quarter would be an estimated $0.33 to $0.36 per share, above the quarterly dividend of $0.315 per share. We expect the current dividend policy of $0.105 per share per month will be covered by our GAAP net investment income on a go-forward basis.

The monthly dividend is further supported by the cash-on cash yield of 25.12% on CLO investment quarterly payments received during the quarter. The quarterly January cash payments totaled $7.6 million, compared to $3.5 million of dividends paid in the quarter at a rate of $0.0994 per share and $3.7 million of the dividend that would have been paid at the $0.105 per share.

With that, I will turn it back to Lauren.

Lauren Michelle Basmadjian
CEO & Trustee

Thanks, Nelson. Now that our rotation is complete, we've achieved our target leverage, and we are fully invested, we believe that CCIF is well positioned to provide investors with an attractive dividend yield that is expected to be fully covered by GAAP net investment income. Our leveraged loan expertise allows us to analyze the underlying risk in each CLO position, and we remain focused on disciplined underwriting and prudent portfolio construction.
I'd like to now hand the call over to the operator to take your questions. Thank you.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Mickey Schleien with Ladenburg Thalmann.

Mickey Max Schleien
Ladenburg Thalmann & Co. Inc., Research Division

One of the surprises over the last year is in the continuing low level of loan defaults, which I think you mentioned. And that's obviously been for several reasons, but one of those is loose covenants, which have also led to much lower recovery rates than in the past, which are down to around 40% of first lien. So how have the managers in your portfolio performed in terms of their recovery rates? And how do your assumptions for recovery rates in your estimated yields compare to what the market is experiencing?

Nishil Mehta
Portfolio Manager

Yes. Mickey, it's Nishil here. Good morning. Nice to hear from you. So you are correct that default rates have been relatively low last year and continue to do so this year. However, the recoveries have been low. I think that's largely a function of I think we are in a kind of what we would call a small default wave. And typically, at the beginning of the default wave, you see the weakest company defaults. And typically the weakest companies have the lowest recovery rates.

But this has been a trend that we've been seeing for a couple of years now. I think it accelerated last year. So I think within Carlyle itself, and the CLO managers that we invest in extremely focus not only on just defaults, but also ultimate recoveries. And so when we're investing in CLOs, we get the benefit of the 35 credit research analysts that we have in-house, plus the 4 portfolio managers. So we get to do the bottom-up formal analysis.

Regarding recovery rates, we run multiple scenarios. So we use different default rate curves, different scenarios for upfront defaults. And then we also use different scenarios for recovery rates as well, especially given the light of the lower recovery rates we saw last year.

Mickey Max Schleien
Ladenburg Thalmann & Co. Inc., Research Division

Thanks for that, Nishil. If I could ask, with the BSL and CLO markets now more open and operating more normally. How do you see the ability of managers to refinance or reset their liabilities or, I guess, the pace of those refis and resets to help offset the loan spread compression that we're starting to see?

Lauren Michelle Basmadjian
CEO & Trustee

Sure. It's Lauren. So we are seeing -- we saw a repricing wave in January for loans. But that said, I think less than 7% of the market repriced before loans started to trade down because of those repricing. So it slowed materially. So we've seen maybe around 5 basis points of spread compression, but we've seen liabilities tighten much faster than what we're seeing on spread compression.

Interestingly, we haven't seen a lot of resets of old vintage CLOs. When I say old vintage CLOs, I'd say 2018 and earlier CLOs. So the reset market has opened back up, it's been for 2019 and later CLOs, for the most part. We are seeing risk analysis come back across all vintages, but I think to see older deals reset, we have to see further liability tightening.

Mickey Max Schleien
Ladenburg Thalmann & Co. Inc., Research Division

Okay. That's helpful, Lauren. And my last question. I think, Nishil, you touched on this. Some of your positions have CCC buckets over 7.5%, which, as you noted, is the typical limit. Does some of that reflect recent underperformance? Or is that more related to the relative trade activity that you're doing in terms of cash returns?

Nishil Mehta
Portfolio Manager

Yes. So there are a couple of positions that have excess of 7.5%. But I think what we focus on is not only the CCC percentage, but also the overcollateralization cushion. Because when you're typically investing in a CLO that has CCCs in excess of 7.5%, that directly impacts your overcollateralization cushion. So for a couple of deals where it's really more of a style of that CLO manager, where they have a history of having elevated CCCs. But offsetting that historically low default rates and low recovery rates, so they've been able to manage that. We are comfortable investing on those deals because of their track record and the fact that the overcollateralization cushions were still fairly robust.

Operator

Our next question comes from the line of Mitchel Penn with Oppenheimer.

Mitchel Stuart Penn
Oppenheimer & Co. Inc., Research Division

You guys talked about averages on the CCC and the OC percentages. Are there any of the CLOs in your portfolio trapping cash for the OC covenant or the CCC covenant?

Nishil Mehta
Portfolio Manager

So currently, there are 0 CLOs that are even close to breaching the overcollateralization cushion. I think the lowest overcollateralization cushion currently in our portfolio for any deal is 3%, which is still fairly robust.

Mitchel Stuart Penn
Oppenheimer & Co. Inc., Research Division

Got it. And what drove the unrealized losses in the quarter?

Nishil Mehta
Portfolio Manager

Yes. So the one thing to keep in mind is our valuation policy. So I think what makes us a little unique is that we use, strictly, a third party to fair market value our portfolio using the bid side mark. And I think just the decline, I think it was really just a function of the overall markets. I think across all of the CLO equity portfolios that we manage within Carlyle, we saw marginal decline in valuation, but that was offset by continued high cash-on-cash proceeds, but not one specific driver. It's just kind of where the market is today or the market decline over the quarter.

Mitchel Stuart Penn
Oppenheimer & Co. Inc., Research Division

So you expect it to reverse at some point?

Nishil Mehta
Portfolio Manager

Look, it's hard to forecast kind of mark-to-market movements for the overall quarter -- for the overall market, excuse me. But I think we feel very comfortable with the portfolio that we have today given the robust overcollateralization cushions and robust cash flows. We do have the benefit of recently purchasing a large percentage of these positions. So we feel comfortable with the portfolio today. But again, it's hard to predict overall movements in the market.

Operator

And I'm showing no further questions at this time. I'd like to hand the call back over to Lauren Basmadjian for closing remarks.

Lauren Michelle Basmadjian
CEO & Trustee

Thank you. We look forward to speaking to everyone next quarter, if not sooner. Please feel free to reach out if you have any questions, and thank you all for your support.

Operator
This concludes today's conference call. Thank you for your participation. You may now disconnect.