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Carlyle Credit Income Fund (CCIF)

Q4 2023 Earnings Call

CORPORATE PARTICIPANTS

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Nelson Joseph
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OTHER PARTICIPANTS

Mickey M. Schleien
Analyst, Ladenburg Thalmann & Co., Inc.

Matt Howlett
Analyst, B. Riley Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and thank you for standing by. Welcome to the Carlyle Credit Income Fund Fourth Quarter ending September 30, 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 today's conference is being recorded.

I would now like to hand the conference over to Jane Cai from Investor Relations. Please go ahead.

Jane Cai

Vice President & Senior Product Specialist-Investor Relations, Carlyle Credit Income Fund

Good afternoon and welcome to Carlyle Credit Income Fund's fourth quarter 2023 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 filed our N-CSR and 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 N-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

Chief Executive Officer & Trustee, Carlyle Credit Income Fund

Thanks, Jane. Good afternoon everyone, and thank you for joining CCIF's first earnings call. The fourth quarter represented a period of transition as Carlyle took over as investment advisor of the Fund on July 14, 2023. In connection with this change, the Fund's name was changed to Carlyle Credit Income Fund and the Fund's investment mandate changed to focus primarily on investing in the equity tranches of CLOs.

In the first four months since taking over as investment advisor, we have successfully transitioned the Fund, including completing the following: Carlyle successfully deployed the initial cash proceeds into a diverse pool of CLO equity, generating a GAAP yield of over 18.16% on a cost basis. Carlyle declared a monthly dividend of $0.0994, equating to 14.2% annualized dividend based on NAV at September 30, higher than the 12% target dividend yield previously disclosed to investors.

We leveraged the Fund to meet our target leverage of 0.25x to 0.40x through the issuance of 8.75% Series A Term Preferred Stock due 2028. We issued $52 million through the initial issuance of $30 million on October 18, an incremental $2 million through underwriters partially executing the greenshoe and $20 million add-on on November 21.

Carlyle now holds 41% of the common stock of CCIF, following the completion of the $25 million tender offer and $15 million investment via newly issued shares and private share purchase. Carlyle's ownership is held via the public entity, Carlyle Group, and not through a fund managed by Carlyle. This provides significant alignment of interest between the investment advisor and the Fund.

Switching gears, I'd like to discuss the current market environment for both secured loans and CLO equity. Carlyle is one of the world's largest CLO managers with $50 billion of AUM, about one-third of Carlyle Credit's $150 billion of AUM, providing us with differentiated insight into the senior secured loan and CLO markets. Despite inflationary pressures in the economy and higher base rates, the loan market continues to be resilient as evidenced by increased issuance in the third quarter, continued low defaults and underlying earnings growth.

In the third quarter, new loan issuance totaled $76 billion, the highest level since the Federal Reserve began tightening monetary policy in the first quarter of 2022. The LTM default rate of the loan index has decreased to 1.3% from 1.7% in the second quarter, still below the historical average of about 2.5%. During the third quarter, we have seen high-single-digit average EBITDA growth in the roughly 600 companies to which Carlyle's managed CLOs lend to.

However, we continue to see downgrades in the senior secured loan market outpace upgrades, at approximately 25% of the loan market has been downgraded so far in 2023. This has resulted in an increase in loans rated CCC and the average BBB exposure in CLOs is now over 6%. We expect default rates to return to historical averages of 2% to 3%, driven by certain underperforming over-levered issuers with near-term maturities, along with the backdrop of elevated rates.

Turning now to the current CLO market. We believe CLO opportunities remain compelling as they continue to benefit from elevated base rates and attractive pricing in the secondary market. Secondary CLO equity benefits from the rebounding quarterly payments and payments averaged over 4% based on par, which is above the historical average. We have found returns in the secondary market are currently higher than the primary market as the cash-on cash benefits from tighter liabilities.

However, primary CLO equity and specifically print-and-sprint opportunities can be attractive at certain points of time. Elevated base rates have helped to offset tighter arbitrage and we continue to see a good pace of CLO issuance as the US CLO market saw $28 billion of new issuance in the third quarter and now has exceeded $100 billion year-to-date. Reset and refinancing activity remains limited due to historically wide debt costs. As a result, approximately 40% of the CLO market is expected to be out of the reinvestment period by the end of this year.

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

Nishil Mehta

Portfolio Manager, Carlyle Credit Income Fund

Thank you, Lauren. In connection with Carlyle becoming the advisor of the Fund in July, the prior advisory liquidated 97% of the real estate portfolio at closing. As a result, almost 100% of the Fund's assets was cash on the closing date. We leverage Carlyle's longstanding 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 the cash in CCIF into a diversified portfolio in approximately two months ahead of schedule.

As of September 30, our portfolio consisted of 24 unique CLO equity investments, managed by 19 different Carlyle managers sourced entirely in the secondary market. We targeted 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 their reinvestment periods, payers can look to take advantage of periods of volatility to improve portfolios or reposition them. We utilize our in-house credit expertise, including over 20 credit analysts and portfolio managers to complete bottom-up fundamental analysis on the underlying portfolios of the CLOs.

The following are some key stats on the portfolio as of September 30. The portfolio generated GAAP yield of 18.16% on a cost basis, supported by cash-on-cash yields of 26% on the October quarterly payments based on CCIF's purchase price. We expect cash yields to remain strong, we see elevated base rates to increase the weighted average spread of the portfolios as limited new issued volume is at higher spreads.

The weighted average years left in reinvestment period is three years. The weighted average junior overcollateralization cushion of 4.98%, a healthy cushion, also the expected increase in the [ph] corporate loans (09:00). The weighted average spread on underlying portfolio was 3.7%.

The percentage of loans rated CCC by S&P was 5.7%, providing a fair amount of cushion below the 7.5% limit in 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 fair market value and [ph] radiancy (09:28) recovery rates and reduces overcollateralization cushions. The percentage of loans trading below 80 was limited at 3.7%.

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

Nelson Joseph

Chief Financial Officer, Carlyle Credit Income Fund

Thank you, Nishil. Today, I will begin with a review of our fourth quarter earnings. Total investment income for the fourth quarter was $2.2 million or $0.20 per share. Total expenses for the quarter was $3.6 million. Total net investment loss for the fourth quarter was $1.4 million or $0.14 per share.

Net asset value as of September 30 was $8.42 a share, a 1.8% increase from the $8.27 when Carlyle took over as the investment advisor. 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 are currently in discussions with several parties to exit this position while maximizing proceeds.

Subsequent to fiscal year-end, we put into place an at-the-market offering program that will allow us to efficiently and accretively issue common stock once the stock trades above the net asset value. Fourth quarter earnings do not represent the expected earnings for CCIF on a go-forward basis due to the following. First, we ramped the initial portfolio throughout the fourth quarter, therefore, all of our investments have now earned a full quarter's worth of income.

We did not achieve our leverage target of 0.25 times to 0.40 times debt plus preferred-to-total assets until late November. The issuance of the Series A Term Preferred Stock is very accretive as the coupon is 8.75% while our portfolio GAAP yield is 18.16%. The preferred is also flexible capital with a five-year maturity and no financial covenants.

CCIF incurred significant non-recurring expenses in the conjunction with the transaction totaling $1.9 million. Such non-reoccurring expenses included legal, accounting and advisory fees. We estimate operating expenses, excluding management fees, incentive fees and cost of preferred will be in the $0.5 million to $0.6 million range per quarter going forward.

We expect that the current dividend policy of $0.0994 per month will be covered by our GAAP net investment income on a go-forward basis. The monthly dividend is further supported by cash-on-cash yield of 26% received on the October quarterly payments based on CCIF's purchase price. The quarterly October cash payments totaled $5.81 million compared to $1.17 million payment for the October 2023 dividend.

With that, I will turn it back to Lauren.

Lauren Michelle Basmadjian

Chief Executive Officer & Trustee, Carlyle Credit Income Fund

Thanks, Nelson. We believe the Fund is now positioned to provide CCIF investors with an attractive dividend yield that is expected to be fully covered by GAAP net investment income through exposure through a diversified portfolio of CLO equity positions. Our approach allows us to remain focused on disciplined underwriting, prudent portfolio construction and conservative risk management.

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

QUESTION AND ANSWER SECTION

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

Mickey M. Schleien
Analyst, Ladenburg Thalmann & Co., Inc.
Q

Good afternoon everyone. First question relates to the outlook for the Fund in terms of – well, more specifically your outlook for the CLO equity market and loan markets for 2024. You did mention that you expect default rates to regress towards historical averages. But what other trends are you expecting for next year?

Lauren Michelle Basmadjian
Chief Executive Officer & Trustee, Carlyle Credit Income Fund
A

Sure. So we do expect default rates to increase to historical averages, so closer to the 2% to 3% and we're also expecting continued downgrades in the market. That said, where loan prices are trading today, if you look at where they were before Ukraine, we're still at a significant discount. So there's probably room for price appreciation during 2024 in the loan market.

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund
A

Yeah. And, Mickey, good to hear from you. On the CLO side, given our expectation that we're going to see defaults increase to historical averages, at least in the first half of the year, we expect CLO spreads to stay relatively flat. That's what most of the industry analysts – excuse me, research analysts are predicting. So based on that, we think the current arbitrage on primary equity is going to continue to be on the tighter end of the historical range. But we still think that there will be periods of volatility, which will allow for more print and sprints on the primary side.

On the secondary side, we think it's a very attractive environment given cash-on-cash yields are elevated on a historical basis and we think the periods of volatility will create opportunities to make investments at discounted prices.

Mickey M. Schleien
Analyst, Ladenburg Thalmann & Co., Inc.
Q

Nishil, in terms of the primary market, the bulk of the activity this year has been in what some folks refer to as captive funds. Besides tighter spreads amongst the CLO liabilities, which may or may not happen, are there other factors that you're watching that could unlock a more normalized primary market?

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund
A

Yeah. So to think about that there's two ways to really generate the return for CLO equity. One is just the spread between the underlying loans and the CLO debt. So you can either have CLO debt tighten, or conversely you have loan spreads increase. We're already at – seeing elevated levels on the primary market, on the loan side, but it's limited issuance. We don't think that part of the equation is really going to materially change from here.

The other thing that could happen and what we saw a fair amount of it in 2022 and pockets in 2023 is when you have periods of volatility where loan prices decline and the CLO managers are able to ramp portfolios at discounted prices which can create attractive opportunities for CLO equity.

Mickey M. Schleien
Analyst, Ladenburg Thalmann & Co., Inc.

Q

That's a good point. Nishil, in terms of the outlook for the Fund, I realized the advantages or the attractiveness of investing in positions that still have a long reinvestment period. But what sort of cash yields are you seeing in positions for post-reinvestment CLOs and is that something you're considering adding to the portfolio?

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund

A

Yeah. That's a really good question. So, one, I want to mention that our cash-on-cash yields based on the October payments that we received, as a reminder CLO equity typically pays two to three weeks after quarter-end. So most of our existing positions receive payments on October. Cash-on-cash yield was around 26%. Now, the deals that we invested in were primarily longer-dated CLOs, typically have two-plus years left in reinvestment. I believe the average in our portfolio was three years.

On shorter-dated deals or deals that are out of reinvestment period, the cash-on-cash yield can be somewhat volatile depending on where in the lifecycle that the deal is out of reinvestment, has it already amortized down significantly or is it just exiting reinvestment. But you can see even more elevated cash-on-cash yields for deals out of reinvestment. But those typically lasts for a short period because, over time, repayments and prepayments do come in the underlying portfolios will start paying down the debt and will start suppressing your cash-on-cash payments.

So we do think it's part of the market that's typically not focused on by many investors. It's something that we're taking a closer look at because we think the relative risk-adjusted returns can be attractive versus longer-dated. And the fact that Carlyle is one of the largest CLO managers so we have significant credit expertise in-house. We can do the bottoms-up analysis on that type of profile, which we do for longer-dated as well. But for shorter-dated deals, the portfolio has sort tended to become a little more static. So it's even more important to do the fundamental analysis on the portfolio.

Mickey M. Schleien
Analyst, Ladenburg Thalmann & Co., Inc.

Q

Understand. Thanks for that, Nishil. My last question relates to the dividend. Your portfolio is generating yields sort of in line with your peers. Your operating expenses will ultimately be similar to theirs as well. I do understand that your cost of debt capital is higher than theirs, given that they issued when the markets were more borrower-friendly. But do you see a path for your dividend yield to climb towards what they're offering since your fund is currently the lowest yielding or your stock is the lowest yielding investment in the CLO closed-end space?

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund

A

Well, look, Mickey, right now we have a dividend yield. I think it's around 15.5%, 16.0% depending on where the stock price is. You're correct that Eagle Point, [ph] Australian (20:12), our two peers, are trading at wider levels, but we looked at it on a historical basis over the past two years. I think the average for both those funds was probably more in the 15% to 16% range on the dividend yield standpoint.

So we've based our current dividend policy based on where they've historically traded, just looking at two year's data. Right now, I think the sub-industry is trading at historically higher dividend yields. So can we achieve dividend yields of where our peers are? I don't think we can comment there or – but I don't think we need to be there because we think the markets do normalize.

And this is looking at data starting in 2022 that's [ph] compared to (21:00) volatility. So if our peers start trading at levels that we've seen over the past two years back to the average, we think our stock compares well to those numbers.

Mickey M. Schleien
Analyst, Ladenburg Thalmann & Co., Inc.
Q

I appreciate that, Nishil. Those are all my questions this afternoon. Thanks for your time.

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund
A

Thank you, Mickey.

Operator: [Operator Instructions] Our next question will come from the line of Matthew Howlett with B. Riley.

Matt Howlett
Analyst, B. Riley Securities, Inc.
Q

Hey, thanks. Thanks for taking my question. Hey, look, it's a great time to be deploying capital in this environment. And you mentioned really the up in quality focused Tier 1 and Tier 2 managers. Can you maybe just comment on in those buckets what you look for in a manager? I mean, is it track record? Is it what the sectors that they're focused on, sectors they stay away from? Just a little more color on the up in quality and why you feel that Tier 1 and Tier 2 is the place to be?

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund
A

Yeah. Matt, nice to hear from you. Appreciate the question. So we spend a fair amount of time dealing with the same kind of the CLO manager universe. There's about 150 different CLO managers in the market today and we look at various different factors. We actually rank CLO managers based on – I think it's 96 different performance metrics at this point.

So we definitely focus on track record. The benefit of CLOs is they're very transparent vehicles. You can pull a track record information from a CLO from this past month, any CLO in the market or you can pull the information and the track record for a CLO that was issued back in 1999. So there's an abundant amount of data.

We do very much focus on track record. Given the CLOs are actively managed vehicles, you're ultimately investing with the manager and looking at consistent performance over periods of volatility and periods of different credit cycles. We look for consistency in management teams as well. So not only is there a consistent track record but making sure that the portfolio managers have longevity in their seats. We look for deep teams, making sure they have a robust industry analyst team supporting that as well. So those are a few things that we look at, but ultimately track record is ultimately what we focus on.

Matt Howlett
Analyst, B. Riley Securities, Inc.

Q

Well, you're capturing the high end. I feel like these are, what, 18% on a cost basis and you're up in quality. It just seems like that's the risk-adjusted return is the place to be.

And then maybe, Nishil, can you comment on, I mean, resets? I mean there's not a lot going on from what we can tell. I mean what – how should investors think about that if that was to open up next year? Is that just embedded upside in the portfolio the way you think about it?

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund

A

Yeah. That's exactly right. So resets have been limited in 2022 and 2023 as CLO debt spreads have widened. So it's really been uneconomical for a vast majority of deals to be reset because you're refinancing your debt at wider or higher price or higher cost and so it's been limited.

So right now 40% of the market is going to be out of reinvestment period by the end of this year. If CLO market and debt spreads do rally and they tighten we do think there's going to be a surge in resets and that's only upside. We don't forecast resets or refinancings in our portfolios. But there are certainly deals that we currently have invested in that would definitely benefit from resets. So I agree. It's just upside from here.

Matt Howlett
Analyst, B. Riley Securities, Inc.

Q

Great. And then I guess just last question, a bigger picture question. I mean Mickey touched on it in terms of differentiation from the exiting peers out there. I mean you have obviously, on one hand, I mean you guys are ramping at this opportune environment so you don't own things at a higher basis like the others. The debt is obviously a little bit higher. But I'm assuming that debt is callable at some point and you become more of an issuer where your cost of capital has got to go down and you get bigger.

Just – we touched on the differentiation with this vehicle. It's Carlyle. We all know the name versus some legacy stuff out there. And is it just cleaner that you're ramping in a better environment and you can pick and choose higher quality managers and still get very great yields? And just a different – and going forward just differentiation. Just maybe highlight on how you're going to differentiate, what you're going to do differently for investors?

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund

A

Yeah. I think you touched on a couple of them. One just being part of the larger Carlyle platform. Carlyle today is close to $400 billion, including $150 billion in Credit and Global Credit. But the fact that Carlyle is one of the largest CLO managers globally, why that's so important is, is the team that manages CCIF.

We can leverage that expertise when analyzing CLOs because CLOs are effectively 200 to 300 – pools are 200 to 300 loans and so we can leverage our industry analysts to do bottoms-up analysis. So I think that's a definite benefit. We have benefited from the fact that we are ramping as a portfolio in periods of volatility and so we've been able to make purchases at historically discounted prices which has been attractive.

I think the other benefit to that is while we mentioned we're in a default rate environment where we think default rates are increasing, a vast majority of those defaults are well-telegraphed. And so when we're underwriting the investments that we've made, we've already identified what positions we expect it to default and so it's the benefit of investing today versus having a more seasoned portfolio.

Three, right now our focus has been on longer-dated CLOs. The average reinvestment period left is three-plus years. We currently do not have any deals that we've purchased to say three, four or five years ago that are now exiting reinvestment period. So that's a differential as well.

Matt Howlett
Analyst, B. Riley Securities, Inc.

Q

Well, that's huge. I mean most companies have sort of 25% of the exited or something like that. That's a huge differentiator. And of course, Carlyle, it's great to see the name out there and the track record and really be able to utilize those resources are terrific. Really appreciate it and look forward [indiscernible] (00:28:11) continued growth.

Nishil Mehta
Portfolio Manager, Carlyle Credit Income Fund

A

Thanks, Matt.

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

Lauren Michelle Basmadjian
Chief Executive Officer & Trustee, Carlyle Credit Income Fund

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 for all of your support. Have a great rest of your year.

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