Carlyle Credit Income Fund NYSE:CCIF

Q3 2024 Earnings Call Transcript

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Presentation

Operator

Good day, and thank you for standing by. Welcome to the Carlyle Credit Income Fund Third Quarter 2024 Financial Results and Investor Conference Call. Please be advised that today's conference is being recorded. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Jane Cai.

Jane Cai
VP & Senior Product Specialist - Investor Relations

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

Last night, we issued our Q3 financial statements and a corresponding press release and 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 semi-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
CEO & Trustee

Thanks, Jane. Good morning, everyone, and thank you all for joining CCIF Quarterly Earnings Call. I would like to start by reviewing the Fund's activities over the last quarter. We maintained our dividend at $0.105 per share, which is now declared through November 2024, equating to a 14.8% (sic) [14.81%] annualized dividend based on the share price as of August 20, 2024. The monthly dividend is supported by $0.81 of recurring cash flows.

New CLO investments during the quarter totaled $12.2 million with a weighted average GAAP yield of 19.5% (sic) [19.49%] The aggregate portfolio weighted average GAAP yield was 20.3% (sic) [20.26%] as of June 30.

I would like to highlight what Carlyle has accomplished since July 14, 2023, the date that we took over as the investment adviser of CCIF. We rotated the portfolio into a diverse pool of CLO equity positions, generating a GAAP yield of 20.3% (sic) [20.26%], with no CLOs that have an over-collateralization cushion of less than 3%. We met the Fund's leverage targets by issuing flexible and long-term preferred stock, without any financial covenants or mark-to-market provisions. We increased the dividend from 8% to 16.5% based on the Fund's net asset value as of July 31, 2024.

Pivoting to the current market environment, I'd like to discuss what we've observed in both the loan and CLO equity markets over the quarter. Continued tightening in CLO liability spreads has supported the arbitrage for CLO equity, resulting in higher new issue volumes. CLO market activity accelerated this past quarter with $53 billion of issuance, which is the most active quarter on record. CLO issuance through June totaled $101 billion, an increase of 80% year-over-year.

We believe the continued tightening of CLO liabilities has fueled heightened CLO refinancing and reset activity. Year-to-date through June, CLO refinancing and reset volumes of $39 billion and $73 billion have materially outpaced 2023's $5 billion and $20 billion. As a reminder, refinancings reduced the financing cost of the CLO, while resets extend the reinvestment period to refresh 5 years typically.

Within CCIF portfolio, we have completed 6 resets year-to-date through June, extending the reinvestment period of these CLOs. Despite the increase in CLO reset activity, 32% of the CLO market is still out of their reinvestment period. The CCIF portfolio only has 2 CLO positions outside of the reinvestment period, both of which were opportunistic purchases.

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While the implications of elevated interest rates may pressure borrowers' ability to service existing debt, Carlyle's U.S. loan portfolio of over 600 borrowers has remained resilient in the first quarter and is a valuable proxy for assessing the overall health of borrowers in the broadly syndicated loan market.

While the average sales growth in the loan portfolio decreased versus the prior quarter, EBITDA growth of 9.5% is the second highest quarter that we have experienced since the Russian invasion of Ukraine in 2022. We believe this trend indicates that management teams are focused on cost containment and cash preservation as they operate in a higher rate environment.

The LSTA index default rate, excluding distressed exchanges, declined to 90 basis points at the end of July, compared to 1.1% at the end of March. While we believe restructuring risk remains at approximately 4.4% of loan market trades below 80, the loan default rate inclusive of distressed exchanges also moderated from 3.5% at the end of March to 3.3% by the end of July. We anticipate loan defaults will remain manageable for CLO managers, including and excluding distressed exchange activity.

Retail loan inflows and robust CLO new issuance activity of the LSTA index closed at a 2-year high of 96.99 in mid-May before declining to 96.59 by the end of June.

Performing issuers capitalized on market conditions and year-to-date through June, loan repricing activity totaled $383 billion, which accounts for about 30% of borrowers in the loan market. So through these repricings, borrowers have reduced spreads on the underlying loans by an average of 54 basis points year-to-date.

While a decrease in underlying asset spreads negatively impact CLO arbitrage, including a 15 basis point year-to-date decline in the weighted average spread of CCIF loan portfolio, these impacts were partially offset by continued tightening in liability spreads. Furthermore, we remain encouraged by CLO equity's attractive cash-on-cash distributions. Median CLO equity payments in July totaled 4.1%, a slight decline from April payments, but still higher than the 10-year average of 3.8%.

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

Nishil Mehta
MD & 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 with a 15-year track record of investing in third-party CLOs to manage a diversified portfolio of CLO equity investments. As of June 30, our portfolio comprised 41 unique CLO investments managed by 24 different collateral managers, sourced primarily 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 in the secondary market. Given continued spread compression and support of CLO arbitrage, we've also assessed CLO equity primary investments, given these loan portfolios are generally cleaner than those sourced in the CLO secondary markets.

We continue to leverage our in-house credit expertise of 23 U.S. and 9 European credit research analysts to complete bottoms-up fundamental analysis on the underlying loan portfolios of CLOs.

As Lauren mentioned, the CLO market was impacted by the record repricing wave, which has reduced the weighted average spread of CCIF's portfolio by 10 basis points over the quarter and 15 basis points year-to-date and loan prices declining by 15 basis points over the quarter. The combination of these 2 factors resulted in a decline in CLO equity prices across the market, including CCIF portfolio.

We do not believe the quarter-over-quarter decline in net asset value raises any concerns for our existing portfolio. And we remain pleased with the high-quality positions that we have invested in across Tier 1 and Tier 2 CLO managers.

The following represents some key stats on the portfolio as of June 30. The portfolio generates a GAAP yield of 20.26% on a cost basis, supported by cash on cash yields of 31.68%, on CLO investment quarterly payments received during the quarter. The weighted average years left and reinvestment period is approximately 2.4 years, providing CLO managers the opportunity to capitalize on periods of volatility to improve portfolios or reposition them.

We believe the weighted average junior overcollateralization cushion of 4.17% is a healthy cushion to offset a gradual increase in defaulted loans, with 0 CLOs with an overcollateralization cushion of less than 3%. The weighted average spread of the underlying portfolios was 3.55%.

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The percentage of loans rated CCC by S&P was 6.3%, below the 7.5% CCC limit in CLOs. As a reminder, once a 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 the radiancy recovery rates and reduces the overcollateralization cushion. The percentage of loans trading below 80 was limited at 4.2%.

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 third quarter earnings. Total investment income for the third quarter was $7.4 million or $0.58 per share, compared to $7.3 million or $0.61 per share in the prior quarter. Total expenses for the quarter were $3.4 million compared to $3.3 million in the prior quarter. Total net investment income for the third quarter was $4 million or $0.32 per share, compared to $4 million or $0.33 per share in the prior quarter. Net asset value as of June 30 was $7.68 per share compared to $7.88 per share in the prior quarter. Our net asset value and valuations were based on a bid side mark we received from a third party on 100% of the CLO portfolio.

We continue to hold one legacy real estate asset in the portfolio. The total fair market value of the loan is $2.2 million. The third party we engage to sell our position continues to work through the process to maximize proceeds.

During the third quarter, we sold 680,000 of our common shares in connection with the ATM offering program at a premium to NAV for net proceeds of $5.5 million, resulting in a $0.01 per share increase. We view the ATM program as an efficient and accretive way to grow the fund. The cash on cash yield of 31.68% on the CLO investment quarterly payments resulted in $0.81 of recurring cash flow. Quarterly cash payments received in July totaled $10 million or approximately $0.77 per share, compared to $4 million of dividends paid in the quarter or $0.315 per share.

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

Lauren Michelle Basmadjian
CEO & Trustee

Thanks, Nelson. We continue to believe that CCIF is well positioned to provide investors with an attractive dividend yield and total return. We remain focused on applying a disciplined CLO investment and monitoring process to analyze the underlying collateral in each CLO equity position in which we invest.
I'd now like to hand the call over to the operator to take your questions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from Mickey Schleien with Ladenburg.

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

You mentioned in your prepared remarks that weakness in CLO equity valuations has been partially driven by lower loan spreads. But as we know, CLOs are naturally hedged and CLO equities are still delivering strong cash yield. So what do you think it will take for the CLO equity market to finally show some strength?

Nishil Mehta
MD & Portfolio Manager

Yes, Mickey, it's Nishil. So look, I would say CLO equity markets, we still think, are showing strength. You have seen a slight decline with the combination of the repricing waves that we've seen in the market. As Lauren mentioned, about 30% of the borrowers in loan market have repriced our loans, that reduces the weighted average spread. And then just through the end of the quarter, at 6/30, you saw loan prices also declined, about $0.10 to $0.15.

With that being said, the April payment dates, quarterly payments, were the highest that we had seen since the third quarter of 2016. You saw some decline in the July payment dates, but it was still very healthy. I think overall, we still remain very positive on the CLO markets. Given credit, we believe, remains relatively stable. We believe defaults remain relatively manageable. And so we continue to believe CLO equity remains attractive.

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

And Nishil, if I can follow up on what you just said, what was the main cause for the July payments to be lower than the April payments?

Nishil Mehta
MD & Portfolio Manager

Yes. I think it's 2 factors. One, as these repricings -- with 30% of the market repricing, that reduces the weighted average spread on the underlying loan portfolios in CLOs and that ultimately results in a reduction in the quarterly payments.

The other is, you do have kind of seasonality variance and the fact that, on average, CLOs hold around 2% to 3% of bonds. Those bonds typically pay on a 6-month cycle. And so most bonds paid as part of the April payment date. And so you may see an uptick in the October payment date just from the bonds paid on their 6-month cycle.

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

Yes, I understand. I've seen that in other funds. One last question for me. Nishil, we saw the dynamic between 1-month and 3-month LIBOR, which is announced so far, obviously impact CLO equity cash flows as the Fed tightened. Now that it seems fairly certain the Fed will start to loosen monetary policy, how should we think about that 1-month, 3-month spread impacting CLO equity cash flows as the Fed starts to cut rates?

Nishil Mehta
MD & Portfolio Manager

Yes, it's a great question because like it's the first time we're going to be in a potentially prolonged rate cut environment since 2008, so about 16 years ago. If you think about it, when rates were increasing, I think we had the issue that 3-month LIBOR or SOFR was significantly higher than 1-month. Now you're seeing the inverse of that. I think today, 3-month SOFR is locked in at 14 basis points. As a reminder, all of the liabilities are typically paid at 3-month LIBOR -- 3-month SOFR, excuse me, whereas, I think, anywhere from 60% to 70% of the underlying loans are based off 1-month SOFR.

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And so you may see a slight mismatch occur again. Right now, it's somewhat favorable since our assets are using a higher SOFR rate, but it's really going to come down to the timing of the rate cuts and to the extent of the rate cuts, where you can see some impact. We're not expecting rate cuts of 75 basis points, at least for the foreseeable future, obviously, things might change. So I don't think we're going to see the same impact that we saw when rates were increasing pretty substantially.

Operator

[Operator Instructions] Our next question comes from Matthew Howlett with B. Riley.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

First, on primary versus secondary. We've heard some market participants sort of come out and say secondary spreads have just tightened, we're just focused on primary. You seem to be pretty much -- are the spreads that wide? Or just give us an update on what you're seeing in each channel?

Nishil Mehta
MD & Portfolio Manager

Yes, Matt, I think the one, that I'd start off in saying is, we try to avoid making just generic statements across both markets because there's obviously a lot of different profiles and different type of opportunities between primary and secondary. I think we'd concur that primary is attractive. Now that the CLO debt costs have continued to decline over the year in line with the spread tightening we've seen across fixed-income markets, that's helped improve the equity arbitrage. So that's made primary attractive, again, so we continue to look at that.

On the secondary side, we still find pockets of opportunity. We're not buying every single secondary opportunity that we see. But every so often, we do find secondary opportunities that we continue to believe are attractive. I do agree that overall, you've seen some tightening and the overall expected returns for secondary CLO equity, largely in line with the tightening we've seen throughout the year across fixed-income markets. But we still find opportunities that we think present good relative value and risk-adjusted returns.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

Great. And just on a side note, with the primary market picking up [a bit], are you guys to start doing like accumulation facilities? We've seen that with some of the other folks out there, I mean, in big size?

Nishil Mehta
MD & Portfolio Manager

Yes. So as we do primary, we will enter into the loan accumulation facilities. You'll probably see -- I think we're currently in 1 or 2 right now. So we expect that to increase as we increase activity in the primary market.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

Okay. And it sounds like that's going to be enhanced returns. It seems like it's a real boost to the other folks that do it in bigger size, but just something to look forward to.

Second question is, what is the refi reset opportunity today in the portfolio? What -- can you quantify a lot of 22 -- that seems like that's the sweet spot. But what can you tell us in terms of the opportunity here as you look down the pipeline?

Nishil Mehta
MD & Portfolio Manager

Yes. So look, out of the 41 CLOs that we hold, we have refinanced or we sought 6 of them. We actually maintain trackers that we update on a periodic basis, trying to identify which refis and resets make sense. And we updated it based on movements in CLO financing costs. So we are in active dialogue with a handful of the managers where we hold positions within CCIF, so we expect to continue activity in the reset and refi market for this portfolio.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

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Great. So you said only 6 of the 41?

Nishil Mehta
MD & Portfolio Manager

Yes. And I think that's largely a function of the fact that this is a relatively newer rent portfolio. So compared to some of our peers that have more seasoned portfolios, a higher percentage of their portfolios that are out of reinvestment period. We only have 2 of those, which we opportunistically invested in taking advantage of our bottoms-up approach in terms of analyzing the underlying loans.

So I think just the overall opportunity set within our portfolio, maybe smaller than our peers just because our portfolio is less seasoned. And given its less season, there may be fewer refinancing and reset opportunities.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

Got you. Okay. And then the next question, the OC level looked like it picked up in July, I mean, pretty significantly. Any rationale for that? And just...

Nishil Mehta
MD & Portfolio Manager

Yes. I think it's like, as Lauren mentioned, we think credit fundamentals continue to remain stable. And so with the portfolio that we hold and the managers that we've partnered with, they continue to maintain what we consider to be very strong OC cushions, over 4%. None of our CLOs have a OC cushion of less than 3%. And so I think it's -- you're always going to see slight variations quarter-over-quarter. But I don't think there's anything specific pointing to the increase.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

Great. Last question, look, you've done a great job rotating the portfolio. I guess you had just one more small real estate assets to sell. You've lowered your cost of capital. I look at that preferred bond [indiscernible] '26, I mean, when can you call that? If it's an 8.75% coupon? Is this 2 years away? I mean, how long can you call that and refinance it? I mean your -- obviously, your cost of capital should keep on going down and that's going to really accelerate growth. But when can you call that?

Nishil Mehta
MD & Portfolio Manager

Yes. So when we issued that last October, I believe, market standard is for a 5-year bond issuance have a 2-year non-call. So it's something that we will look at closer to the fourth quarter of 2025. We agree, it looks very expensive. But I think it's still very attractive given the 5-year tenor and a lot of flexibility it provides us. Obviously, spreads have tightened in since then. And as we've seasoned as a fund as we've taken over, you've seen the trading price increase pretty substantially. So it's yielding substantially lower than the current coupon.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

Well, that's not that far away. It's a little over a year. That's going to be a big impact, if you could do something well below 8% or even low 7s. So it's something to really keep an eye on because I think it's going to be able to have a huge boost to earnings. If you can get in. So we'll look forward to that. Great quarter, keep up the good work.

Operator

Thank you. I would now like to turn the call over to Lauren Basmadjian for any 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 thanks again for all the support.

Operator
Thank you. This concludes the conference. Thank you for your participation. You may now disconnect.

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