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Q3 2018 Corporate Capital Trust Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to Corporate Capital Trust's Third Quarter 2018 Earnings Conference Call. (Operator Instructions) Please note that this conference is being recorded.

I will now hand the call over to Danny McMahon, Head of Investor Relations for CCT. Danny, please go ahead.

Danny McMahon ***Corporate Capital Trust, Inc. - Head of IR***

Thank you. Good morning, and welcome to Corporate Capital Trust's third quarter 2018 earnings conference call.

Please note that Corporate Capital Trust may be referred to as CCT or the company throughout the call. Today's conference call is being recorded, and an audio replay of the call will be available. Replay information is included in the press release that CCT issued on November 7, 2018.

In addition, CCT has posted on its website a presentation containing supplemental financial information with respect to its portfolio and financial performance for the quarter ended September 30, 2018. A link to today's presentation is available on the Investor Relations section of the company's website at corporatecapitaltrust.com under Events & Presentations. Please note that this call is the property of CCT. Any unauthorized rebroadcast of this call in any form is strictly prohibited.

I would also like to call your attention to the customary disclosure in CCT's filings with the SEC regarding forward-looking statements. Today's conference call includes forward-looking statements and we ask that you refer to CCT's most recent filings with the SEC for important factors that could cause actual results or outcomes to differ materially from these statements. CCT does not undertake to update its forward-looking statements unless required to do so by law.

In addition, this call will include certain non-GAAP financial measures. For such measures, reconciliations to the most directly comparable GAAP measures can be found in CCT's third quarter earnings supplement that was filed with the SEC yesterday. Non-GAAP information should be considered supplemental in nature and should not be considered in isolation or as a substitute for the related financial information prepared in accordance with GAAP. In addition, these non-GAAP financial measures may not be the same as similarly named measures reported by other companies. To obtain copies of the company's latest SEC filings, please visit CCT's website.

I'd now like to turn the call over to Todd Builione, Corporate Capital Trust's President.

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

Thanks, Danny. Good morning, everyone, and thank you for joining us.

As usual, I'm joined by Dan Pietrzak, CCT's Chief Investment Officer, Ryan Wilson, CCT's Chief Operating Officer and Associate Portfolio Manager, Brian Gerson, Head of Private Credit at FS Investments, and Thomas Murphy, CCT's CFO.

On today's call, I'll review a few key year-to-date performance highlights. I'll then provide an update on the merger with FSIC and touch on a few strategic items we're reviewing. Ryan will then discuss our financial results and then Dan will review the lending environment and our recent investment activity.

To begin, I thought it would be helpful to take a step back and review the progress we've made this year against our stated core objectives, particularly given our current trading price, which we are of course not happy with.

As we've reiterated since CCT's listing last November, our number one objective is capital preservation. To start 2018, CCT's NAV was $19.55 per share. And this morning we reported $19.44 per share. It's important to point out that during 2018 year-to-date we paid a special dividend of $0.10 per share, announced during 2017 in conjunction with our listing. And we've also had $0.06 per share of one-time FSICCCT merger-related costs. Excluding these extraordinary items, our NAV is up $0.05 per share year-to-date.

Our second core objective is to deliver a competitive and stable dividend. This year we've executed on a number of levers to achieve this objective. First, our sourcing breadth has enabled us to be highly selective, which is always important, and even more so given today's credit environment. To give you a sense for the scale of our sourcing, KKR has reviewed 990 originated private credit deals year-to-date. On an annualized basis that's more than 1,300 deals compared to 760 for all of 2017.

Of the 990 investments we reviewed year-to-date, we've invested in a mere 3%, which is lower than our long-term average of 5%. Despite this high degree of selectivity our total BDC franchise deployed $2.1 billion in originated strategy investments the past two quarters versus $1.9 billion in sales and paydowns.

For CCT specifically, we've deployed $838 million year-to-date in our originated strategies, more than offsetting $655 million in paydowns and sales. CCT's portfolio at the end of Q3 was over 80% deployed in originated strategies, including our joint venture. We've expanded the assets in our joint venture -- a yield enhancer - by approximately 15% this year, now nearly $600 million in fair value, with a path to continued growth. And we've also lowered our cost of financing to 4.4% from 4.5% despite LIBOR increasing 70 basis points year-to-date. This has allowed us to reach run rate NII coverage, with line of sight to over-earning the dividend.

Now let's shift gears and review the merger of CCT and FSIC, which we're focused on successfully completing. We believe that merging CCT and FSIC will provide business and operational synergies in the near and longer term that will expand shareholder value. Specifically, we expect the combination to reduce administrative costs, further expand and diversify the investment portfolio, improve trading liquidity, which should help attract more institutional buyers, and optimize our capital structure, with lower borrowing costs.

The merger remains on track, and we expect to close by the end of the year subject to shareholder approval and of course the satisfaction of other closing conditions. I'd like to reiterate the CCT Board's recommendation of voting for each of the proposals set forth in the proxy. As a reminder, this will be a NAV for NAV transaction, with CCT shareholders receiving an equal value of FSIC's common stock based upon the NAVs of each fund at the time of closing.

Upon or prior to closing, CCT will declare a special distribution to its shareholders, representing any previously undistributed taxable income and net realized capital gains. The distribution will help ensure that CCT maintains its treatment as a RIC during the tax year ending with the day of the merger and to eliminate any U.S. federal income tax on its taxable income.

Let's now turn to share repurchases. Since listing last November, CCT's total share count has been reduced by roughly 9% through a combination of repurchases and a tender program. To be clear, we believe the current share price presents an attractive opportunity to repurchase more of our common stock - and that share buybacks would be accretive. As such, we've been investigating the viability (from a regulatory perspective) of share repurchases during this proxy solicitation period. We've been advised by counsel that it would be imprudent to announce or execute share buybacks until after the merger with FSIC has closed.

I'll note that historically we announced a share repurchase program when our shares were trading at a meaningful discount to NAV. And when we announced the program we aggressively fulfill the entire amount. Our philosophy has not changed.

Finally, we, the FS/KKR Advisor, have historically discussed a strategy to consolidate the non-traded funds in the platform into one publicly traded entity as a means to create value for both our public and non-traded shareholders. Given recent trading performance of both FSIC and CCT, we do not believe current conditions support such a consolidation. And even when these conditions improve, let me be clear by saying that consolidation of these non-traded BDCs with our listed BDC will need to be accretive to CCT shareholders, position the public traded vehicle for success and be in the interest of all shareholders.

With that, I'll now turn the call over to Ryan to discuss this quarter's results.

Ryan L.G. Wilson ***Corporate Capital Trust, Inc. - COO and Associate Portfolio Manager***

Thanks, Todd.

I'll provide a summary of the results for the third quarter. You can find this information beginning on Slide 7 of the earnings presentation.

For the third quarter, net investment income was $0.40 per share, pro forma for the exclusion of $0.05 per share in one-time merger-related expenses. This compares to $0.40 per share pro forma for last quarter and $0.36 per share for the third quarter of 2017. Net realized and unrealized losses on investments were $12.4 million in Q3, resulting from $13 million of net unrealized gains and $25.4 million of net realized losses. In total, this quarter's activity led to earnings per share of $0.25 compared to $0.30 last quarter and $0.33 for the third quarter of 2017.

Turning to dividends. For the quarter we paid a regular dividend of $0.40 per share, representing an attractive 11% annualized yield based on Tuesday's closing share price. We expect to declare a fourth quarter dividend of at least $0.40 per share, subject to Board approval. Assuming the merger with FSIC closes in Q4 following the satisfaction of all conditions, the size of the dividend will also be designed to distribute any undistributed taxable income and net realized capital gains, as Todd mentioned.

Net asset value as of the end of the third quarter was $19.44 per share compared to $19.58 per share at the end of the second quarter. The main drivers of this change to NAV can be seen on Slide 10. One-time merger expenses and net realized and unrealized losses were the key components of this quarter's reduction.

Turning to the balance sheet. We have ended the quarter with net investments at a fair value of $4.1 billion, total cash of $159 million and total assets of $4.4 billion. Investments at fair value increased approximately 1% quarter-over-quarter, driven largely by origination activity, which Dan will touch on shortly. Investment purchases of $279 million outpaced sales and prepayments in the quarter, which we highlight on Slide 14.

Moving to the right-hand side of the balance sheet. As a reminder, in August, CCT closed a $1.45 billion revolver as part of a $3.4-plus billion five year omnibus revolving credit facility that is being used by CCT, FSIC I, II and III. The revolver has allowed us to consolidate our existing leverage facilities, extends the maturity of our revolver by two years, while significantly lowering the cost of financing. Q4 will be the first full quarter that fully realizes the savings from this revolver.

On Slide 17 you will see our weighted average cost of debt was approximately 4.4% at quarter-end, down roughly 30 basis points from the prior quarter, providing $7 million to $8 million of annualized interest expense savings.

Our balance sheet continues to be asset sensitive. As you will see on Slide 16, using our balance sheet as of September 30th and assuming a 100 basis point increase in LIBOR, our net investment income would increase by approximately $10.6 million or $0.09 per share.

I'll now turn it over to Dan Pietrzak, CCT's Chief Investment Officer.

Daniel Ryan Pietrzak ***Corporate Capital Trust, Inc. - CIO***

Thanks, Ryan.

I will provide a few highlights of what we're seeing in the market and provide an update of our portfolio and recent investment activity. Deal flow in the U.S. remained strong in Q3, increasing from the already active levels at the beginning of the year. While we are seeing ample competition in new financing activity, we are focused on situations where we can differentiate ourselves with the size and scale of our platform, our solutions-driven origination approach and our deep diligence capabilities.

The syndicated market has seen an expanded pipeline of opportunities, which is causing some pushback on pricing levels and terms for the harder credit stories, which we think benefits the certainty provided by directly placed private credit solutions.

We continue to remain focused on maintaining an expansive sourcing effort so that we can source situations in which we have an underwriting advantage. We look at opportunities through a fundamental credit lens and we continue to focus on structural protections such as cash flow sweeps, covenants and equity cushions, often rejecting deals that do not afford us appropriate downside protection. By remaining disciplined in our underwriting standards, we believe when a downturn inevitably occurs we will be well positioned to protect the capital entrusted to us.

Turning to Q3. Total purchases during the quarter were $279 million, 71% of which were in senior secured debt investments. Offset by $242 million in sales and redemptions, including sales to our JV, CCT generated net investment activity of over $50 million in Q3. In total, we provided capital to six portfolio companies in our originated strategy in the quarter, with an average EBITDA of $80 million. This drove our debt to equity ratio up to 0.75x as of quarter-end.

Now let's look at Page 12, which provides a snapshot of CCT's portfolio at quarter-end. A few items worth noting: 74% of our investments are in senior secured debt; our originated strategy portfolio companies have a median annual EBITDA of $58 million, which size generally means less risky business models, less concentration risk on the customer and supplier side and better corporate governance; our portfolio is 75% floating rate, beneficial for investors given today's rising rate environment.

We are well diversified in terms of sector exposure and we are focused on driving and maintaining ball control in transactions, as shown by the 91% number, where we have been the lead, the co-lead or the sole lender on our originated strategy investments. Our intention is to be a partner of choice for issuers seeking flexible capital solutions and alternative sources of financing. In terms of return profile, the gross portfolio yield prior to leverage and excluding non-income producing assets, was 10.4%, in line with the prior quarter.

As of September 30th, we had five companies on non-accrual, which in aggregate represented 1.3% of the portfolio based on fair value, down from 1.5% last quarter. We are constantly working on our non-accrual positions to maximize value and total recovery.

Now turning to Slide 13. At the top we have summarized our product suite and target investment size with the continued focus on the upper end of the middle market. We thought it would again be helpful to review a few key highlights of transactions that occurred in the quarter, as outlined on the bottom half of the page.

Let's start with Reliant Rehab, which provides outsourced physical, occupational and speech therapy to patients recently discharged from hospitals. In August, CCT invested $50 million to support Reliant's refinancing. KKR Credit's total investment consists of 100% of the $240 million first lien term loan. The term loan is priced at LIBOR plus 675 basis points, with 2 points upfront between OID and structuring fees.

Now let's turn to review one of our asset-based finance opportunities that reflects the risk return available in this space. K2 Aviation is a joint venture launch between KKR and an industry third party. K2's mandate and focus is to purchase a portfolio of mid-life aircraft with a target IRR in the mid-teens. This is an area we have a fair amount of focus on and one that we think provides real downside protection while producing the target returns mentioned. CCT funded $19.8 million into this joint venture during the quarter and expects to continue to ramp in Q4 2018 and Q1 2019. And as an aside, K2 is listed as KKR Zeno Aggregator in our 10-Q.

And finally, in August we provided $16 million to Rise Baking, a manufacturer of baked goods for the foodservice and convenience store markets. KKR Credit committed $67.5 million of the $87.5 million tranche. The loan is priced at LIBOR plus 800 basis points, with 2 points upfront between OID and structuring fees. Our investment was premised on the company's exposure to the fast-growing and highly profitable in-store bakery market, its low-cost, non-discretionary leaning product offerings as well as the company's longstanding relationship with blue chip customers.

As we mentioned before, the competitive environment continues to intensify. In this market, where upper middle market borrowers have access to the capital markets and there is strong competition in the lower middle market, we believe that it's critically important to have broad origination capabilities, to be highly selective and have the ability to provide a wide range of creative solutions to sponsors and their portfolio companies.

As Todd noted, year-to-date, KKR has reviewed 990 private credit deals. This represents an activity level well ahead of last year. The deliberate increase in our screening volumes is the result of both an investment in our team as well as strong deal flow from incumbent relationships. And as said, given where we are in the credit cycle, we're very focused on maintaining our underwriting discipline and focusing on areas that we have a competitive advantage.

With that, I'll now turn the call back over to Todd.

Todd Christopher Builione *Corporate Capital Trust, Inc. - President*

Thanks, Dan, and thank you to everyone for your time today and for your partnership. We appreciate it. Operator, we're now happy to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Fin O'Shea with Wells Fargo.

Finian Patrick O'Shea *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Hi guys, thanks for taking my question. Again, just -- to start out, in light of the context of the FS commentary this morning, that its older vintage, 2013, 2014 would be somewhat of a struggle for some time, can you talk about that? And the merger proposition for CCT shareholders, what it means for economics, allocation to new paper and so forth?

Todd Christopher Builione *Corporate Capital Trust, Inc. - President*

Fin, thanks. This is Todd. Thanks for that question. It's a good one. I'll take it, and then Dan will probably add to it a little bit. So first, just for context, as a reminder, it's a NAV for NAV deal, right. And what that means is that we'll actually strike the NAV two days before closing, once we complete shareholder approval. That NAV will go through the same rigorous process as each quarter-end NAV goes through, so third-party valuation firm on nearly 100% in Level 3 assets, KKR valuation committee, then of course our Board. I think as you know KKR has been involved in the valuations for two quarters now, the end of June, end of September. We definitely understand the challenges in FSIC's book. We've been around the book for more than a year now. That's the context. I think we continue to focus on the strategic drivers of the merger and continue to be quite excited about them. One, greater portfolio diversification. The pro forma portfolio will be $8 billion across 220 companies. Concentration, as an example, for CCT shrinks from top 10 issuers being 35% of the book -- or 27% of the book, sorry, to 18% of the book. Those are based on end of September numbers. We like, for example, how the first lien bucket is going to go up from 39% in CCT today to 51% of the combined company. There will be lower financing costs over time. I don't think it's any secret that bigger BDCs tend to finance more cheaply. Lower operating expenses, we expect at least $5 million to $7 million of run rate operating expenses across the combined business. And then importantly, given where our stock price is today, better secondary market liquidity, we -- average daily trading volume we expect to go to something like $13-plus million. We think that's an invitation for more institutional investors, which we think is a big opportunity for our stock. So that's a bit of context for you. Maybe Dan comments a little bit more about the portfolio.

Daniel Ryan Pietrzak *Corporate Capital Trust, Inc. - CIO*

Yes. Fin, you heard us go into some detail about some of those older vintages positions, some of those challenges in that book are things we'd look to avoid going forward. I think we've been pretty clear and I gave a decent amount of color for specific things in there and as we're thinking about the rest of the portfolio. And we know there is some real work to do there and we've got the resources to address it.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Thank you, guys, for that color. And I just want to expand on one of the main benefits you're outlining, the sort of incremental operating margin, sort of -- and Todd, I think you just gave me a number $5 million to $7 million. Looking at these -- before the merger came forth, the proposition, you guys were both on the very good, and if not exemplary, on the G&A measure. And then it's been going that way with the debt facilities as well with your large family facility. So if I look at the incremental cost as G&A -- this sort of G&A runs off -- how much different is it from your, say 2017 G&A? And then how much more can the debt improve from here as well?

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

Well, a few things. One -- yes, I think you're right. We threw the -- we threw the number out. So $5 million to $7 million is what we think will be incremental run rate operating expense savings. It's from things like duplicative costs, right, legal costs, accounting, audit fees, administrative overhead and so that number is meant to be the combined savings on a pro-forma basis across the business. I think you're right. We appreciate your comments around the work we've been doing on costs, the financing facility -- the revolver that we put in place earlier this year, it's been a big strategic benefit we think to our entire BDC platform. That being said, we will always have continued work to do on financing and we think that it will be a big positive to have the business on a combined basis, have a much larger balance sheet and to be able over time to tap into markets at cheaper rates.

Daniel Ryan Pietrzak ***Corporate Capital Trust, Inc. - CIO***

Yes, and Fin, I'll just add to that. I mean, I think it's -- I think we've been very happy and quite frankly proud of that revolver getting done and the cost savings you saw we talked about in last quarter. Not only is it just a cost point about the size of that balance sheet as Todd mentioned, but just access to the sort of different markets, access to different conversations and anyone likes a broader variety of funding sources.

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

Yes, and just because it's been some time since the last call, I mean, if you look at the revolver across CCT and FSIC, the combined entity, we think it will result in something like $9 million to $10 million of annual savings. So it's real.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Thanks, guys. And one more if I may. On the buybacks, appreciating that you have roadblocks there and then both entities were impressive, you -- neither of you were gun shy on the recent buyback program. With that said, curious as to your view on, a, when things are settled if the valuation is still here, do you view a tender offer, just in the spirit of how efficient that can be for a quick discounted repurchase. I think one BDC was very successful in completing that last quarter. Just your high level thoughts on that.

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

Yes, look, I think you're right to point out that we're a bit constrained on this topic, talking about it now overall from a regulatory perspective. I mean, what I would reiterate is that we are very open-minded about all of those things, right. And you saw us, as you pointed out, announce a buyback program earlier in the year when our shares were trading at a discount and you saw us be aggressive about filling that entire amount and our philosophy here hasn't changed. Obviously, more to come when we're in a different position from a regulatory perspective.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

That's all from me. Thank you for the color on everything.

Operator

(Operator Instructions) Our next question comes from Casey Alexander with Compass Point.

Casey Jay Alexander ***Compass Point Research & Trading, LLC, Research Division - Senior VP & Research Analyst***

Hi, good morning. And certainly appreciate the commentary that at least you explored the opportunity of trying to repurchase shares during the proxy period given that the shares were to a certain extent handcuffed to someone else's performance. So I certainly appreciate that. Let me ask you a question about the dividend. You expect to declare a fourth quarter dividend of at least $0.40 a share. I mean, would that -- do you expect to fully bake in a $0.40 per share plus a special before the deal closes? Or would that $0.40 per share be somehow pro-rated based upon the amount of the quarter that's still left to go assuming the merger closes? I'm a little unclear about the mechanics of it.

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

Yes, Casey, it's Todd. We appreciate you asking that question because I think there is a little bit of intricate stuff in there and so it gives us an opportunity to explain it to everyone. Both CCT and FSIC plan to make a regular dividend -- in CCT's case, it will be a regular $0.40 dividend subject to Board approval, as it always is. The intricacy here is that if the merger closes, we will be making, CCT, a special merger-related dividend, which will be designed to distribute the undistributed taxable income and net realized capital gains that we will need to do from a tax perspective. In terms of mechanics, the Board will approve both that regular dividend as well as the special dividend together and we'll make it in one distribution.

Casey Jay Alexander ***Compass Point Research & Trading, LLC, Research Division - Senior VP & Research Analyst***

Okay. And the regular dividend would be coming out of sort of earned income and therefore not be as impactful to NAV as the special dividend, which would be coming out of previously earned income and therefore would be more impactful to NAV. Am I thinking about that right?

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

Another good question. And yes, you are.

Casey Jay Alexander ***Compass Point Research & Trading, LLC, Research Division - Senior VP & Research Analyst***

Okay. And a similar structure for FSIC. And then if I understood what you said previously correctly, everybody revalues their investments two days before the close and we strike new NAVs based upon the revaluation of everyone's investments plus the impact of the special dividends.

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

That's exactly right. I know I said it earlier, but the revaluation will be the same rigorous process that it is at every quarter-end.

Casey Jay Alexander ***Compass Point Research & Trading, LLC, Research Division - Senior VP & Research Analyst***

Awesome. All right. Well, I think I understand it a little bit better now. I certainly appreciate the answers to those. One last thing. CCT probably has more variable rate liabilities and arguably a little bit less floating-rate assets than your average BDC. I know that mix changes after you execute the merger, but how would you expect maybe possibly massaging that somewhat after the merger closes? Or will it be necessary?

Daniel Ryan Pietrzak ***Corporate Capital Trust, Inc. - CIO***

Yes. It's Dan Pietrzak. I think -- couple things. One, the fixed rate debt would have historically come from tapping one form of these unsecured bond market. We were probably in the initial phases out of CCT of doing that. And we've done. We've done a handful of deals. My expectation, though, is just going to your asset side, I mean this is a portfolio that is focused on the upper end of the middle market, which is generally a senior secured loan product which is generally floating rate like at 75%-plus today. I think that number continues and -- I think we're mindful about not trying to make sort of interest rate guessing here. I think we're credit folks and not trying to make directional rate calls. So I think we're going to be mindful about that kind of fixed and floating mix and mindful about what it looks like on the asset side.

Operator

Thank you. Ladies and gentlemen, that concludes our question-and-answer session for today's call. I would now like to turn the call back over to Todd Builione for any further remarks.

Todd Christopher Builione ***Corporate Capital Trust, Inc. - President***

Thanks, everyone, for taking the time and for your good questions. Hope everyone has a great end to the week.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program and you may all disconnect. Everyone have a wonderful day.

Editor

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