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SUNS - Q4 2019 Solar Senior Capital Ltd Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Quarter 4 2019 Solar Senior Capital Ltd.'s Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Michael Gross, Chairman and Co-CEO. Thank you. Please go ahead.

Michael Stuart Gross - *Solar Senior Capital Ltd. - Chairman, President & Co-CEO*

Thank you very much, operator. Good morning, everyone. Welcome to our earnings call for the fiscal year ended December 31, 2019. I'm joined here today by Bruce Spohler, our Co-CEO; and Rich Peteka, our co -- our Chief Financial Officer.

Rich, would you please start off by covering the webcast and forward-looking statements.

Richard L. Peteka - *Solar Senior Capital Ltd. - CFO, Treasurer & Secretary*

Of course. Thanks, Michael. I'd like to remind everyone that today's call and webcast are being recorded. Please note that they are the property of Solar Senior Capital Lid. and that any unauthorized broadcasts in any form are strictly prohibited. This conference call is being webcast on our website at www.solarseniorcap.com. Audio replays of this call will be made available later today as disclosed in our press release.

I would also like to call your attention to the customary disclosures in our press release regarding forward-looking information. Statements made in today's conference call and webcast may constitute forward-looking statements, which relate to future events or our future performance or financial condition. These statements are not guarantees of our future performance, financial condition or results and involve a number of risks and uncertainties.

Additionally, past performance is not indicative of future results. Actual results may differ materially as a result of a number of factors, including those described from time to time in our filings with the SEC. Solar Senior Capital Ltd. undertakes no duty to update any forward-looking statements unless required to do so by law. To obtain copies of our latest SEC filings, please visit our website or call us at (212)-993-1670.

At this time, I'd like to turn the call back to our Co-CEO, Michael Gross.

Michael Stuart Gross - *Solar Senior Capital Ltd. - Chairman, President & Co-CEO*

Thank you, Rich. We are pleased to report a successful quarter -- fourth quarter 2019 for Solar Senior Capital, which culminated another year of continued solid operating performance. Net asset value was $16.32 per share at December 31 consistent with the prior quarter and GAAP net investment income of $0.35 per share. Overall, the fundamentals of our portfolio companies remained strong, and SUNS' portfolio was 100% performing at December 31.

At year-end, our comprehensive portfolio was approximately $665 million, in line with the prior quarter. Importantly, almost 99% of our comprehensive portfolio investments are in first lien senior secured loans, of which 49% are in first lien specialty finance loans, 50% are in first lien cash flow loans and just over 1% consists of 1 second lien cash flow loan.

We're pleased with the progress we have made in our efforts to evolve SUNS into a diversified specialty finance company. Recent recession concerns have abated due to continued overall positive investment data.

Cash flow lending remains competitive given the persistent supply-demand imbalance, fueled by inflows of capital to private credit funds and reduced year-over-year middle market transaction volume. We believe it is paramount to maintain our discipline in cash flow lending in the face of continued aggressive structures, tight pricing and elevated overall risk. Should U.S. economic condition deteriorates, our conservative 100% performing portfolio and access to capital should enable us to continue to maintain an attractive portfolio.

While facing frothy market conditions and cash flow lending, our specialty finance businesses, namely Gemino Healthcare, North Mill Capital and Life Science Lending provide investments with collateral coverage, strong structural protection and low double-digit asset level yields. These niche businesses have high barriers to entry rather than cash flow lending.

Having specialized and experienced teams across the specialty finance asset classes provides a competitive advantage for SUNS, creates a wider origination funnel and enhances the flexibility to allocate capital to the most attractive risk-reward opportunities. Over the past year, we have grown our specialty finance ABL portfolio by 28%.

The asset coverage modification provides SUNS with additional flexibility and capacity to make controlled equity investments in specialty finance businesses. We continue to evaluate additional portfolios of asset-based loans and specialty lending platforms to acquire.

During 2019, we enhanced platform scale of company's investment adviser, Solar Capital Partners. Last week, we had a final closing on approximately $1.2 billion of incremental investable capital for an institutional private credit fund, which will co-invest alongside SUNS.

With the final closing of this fund, SUNS' investment adviser now manages over $6.5 billion of investable capital, solely focused on first lien cash flow and specialty finance investment opportunities. The enhanced scale is particularly important given our investment preference for larger middle market companies, who we believe are better resourced to withstand an economic decline than their smaller peers. Hold size of up to $200 million across the platform creates a competitive advantage while it allows us to maintain appropriate portfolio diversification.

The increased scale of our platform has already positively impacted our origination efforts, and we expect Solar Senior Capital to significantly benefit from this development.

At December 31, the company is in a strong liquidity position with net leverage of 0.78x debt to equity. We intend to move closer to our target leverage range of 1.25 to 1.5x debt to equity, but only with investments that meet our strict underwriting criteria. We will continue to be highly disciplined in deploying our available capital.

At this time, I'll turn the call over to our Chief Financial Officer, Rich Peteka.

Richard L. Peteka - *Solar Senior Capital Ltd. - CFO, Treasurer & Secretary*

Thank you, Michael. Solar Senior Capital Ltd.'s net asset value at December 31 was $261.8 million or $16.32 per share. This compares to a net asset value of $261.6 million or $16.31 per share at September 30, 2019.

Solar Senior's balance sheet investment portfolio at December 31, 2019, had a fair market value of $460.3 million in 48 portfolio companies operating in 21 industries compared to a fair market value of $469.2 million in 50 portfolio companies operating in 19 industries at September 30.

At December 31, 2019, SUNS' net leverage was 0.78x compared to 0.80x for the prior quarter. As a reminder, Solar Senior's target leverage is 1.25x to 1.5x net debt to equity under the reduced asset coverage requirement.

In December of last year, the DBRS Morningstar assigned a long-term issuer rating and a long-term senior debt rating of BBB to the company with a stable trend on both ratings. This rating positions SUNS to diversifying its liability structure.

From a P&L perspective, gross investment income for the 3 months ended December 31, 2019, totaled $9.5 million versus $10.4 million for the 3 months ended September 30, 2019.

Net expenses for the 3 months ended December 31, 2019, were $3.8 million compared to $4.7 million for the 3 months ended September 30.

Accordingly, net investment income for the quarter ended December 31, 2019, was $5.7 million or $0.35 per average share as compared to $5.7 million or $0.35 per average share for the 3 months ended September 30.

For the quarter ended December 31, 2019, the investment adviser voluntarily waived fees of $671,000 compared to $602,000 waived for the quarter ended September 30.

Below the line, Solar Senior had a net realized and unrealized gain for the fourth fiscal quarter totaling $0.1 million compared to net realized and unrealized loss of $0.5 million for the 3 months ended September 30.

Accordingly, Solar Senior had a net increase in net assets resulting from operations of $5.8 million or $0.36 per average share for the 3 months ended December 31, 2019. This compares to a net increase in net assets resulting from operations of $5.2 million or $0.32 per average share for the 3 months ended September 30.

Lastly, our Board of Directors declared a monthly distribution for March 2020 of $11.75 per share payable on April 30 -- I'm sorry, payable on April 3, 2020, to stockholders of record on March 19, 2020.

At this time, I'd like to turn the call over to our Co-CEO, Bruce Spohler.

Bruce John Spohler - *Solar Senior Capital Ltd. - COO, Co-CEO & Director*

Thank you, Rich. Before I give a portfolio update, I'd like to take a moment to highlight our 4 core strategies. First is investing in first lien senior secured cash flow loans to upper middle market, sponsor-owned companies. Second strategy is to invest in first lien asset-based loans secured by accounts receivable to midsize companies operating exclusively in the health care industry through our Gemino subsidiary. Third, investing in first lien asset-based loans and factoring facilities secured by accounts receivable to midsized companies operating primarily in the manufacturing, services and distribution industries through our subsidiary, North Mill. And finally, highly structured first lien senior secured life science loans primarily to late-stage development public life science companies.

We just recently started to breakout our life science business as a separate unit late last year. As a reminder, the increased scale of the SCP platform that Michael mentioned, which allows larger investment sizes, combined with expanding our 30% nonqualified basket has enabled SUNS to invest selectively in senior secured loans to larger enterprise value life science companies.

We believe the life science senior secured lending asset class provides a differentiated growth opportunity in a niche, which offers attractive risk-reward characteristics and further diversifies SUNS' portfolio and enhances the opportunity to increase its investment income.

Additionally, we're actively evaluating opportunities to further expand our specialty finance business lines, both through controlled equity stakes in new specialty finance businesses as well as through organic growth.

In the aggregate, at year-end, our portfolio across our 4 businesses totaled $665 million, encompassing 227 different issuers. The portfolio is highly diversified with an average investment of just under $3 million or 0.4% of the portfolio. Measured at fair value, 99.9% of our portfolio consisted of senior secured loans, of which 50% are first lien senior secured cash flow loans, 48% are first lien specialty finance loans and approximately 1% is invested in 1 second lien secured cash flow loan. We expect to be repaid on this loan this year. Our equity exposure was de minimis at less than 10 basis points of the portfolio.

SUNS' weighted average asset level yield on a fair value basis was 9.7%. For the first -- for the full fiscal year, including investments and repayments across the 4 business lines, originations totaled just under $260 million and repayments totaled $185 million, resulting in $72 million of net portfolio growth, which was almost entirely invested in our specialty finance businesses. Given the continued heated market environment in cash flow lending, we chose not to increase our allocation to that asset class.

Now I'd like to provide an update on the credit quality and earnings power of the portfolio. At year-end, 100% of our portfolio was performing. Our internal risk assessment on a weighted average basis was approximately 1.8, based on our 1 to 4 risk rating scale, with 1 representing the least amount of risk.

At year-end, our watch list represents a historical low for SUNS with only 1.8% of the total portfolio, which, at this stage of the credit cycle, highlights our strong underwriting and positions us solidly for the future.

Now let me provide a brief update on each of our investment verticals. Cash flow segment. At year-end, our cash flow portfolio totaled just under $340 million, representing just over 50% of the total portfolio. The cash flow portfolio is comprised of loans to 36 borrowers with an average loan of $9.4 million. The weighted average asset level yield of the portfolio was 7.2%. In addition, the majority of our cash flow loans have LIBOR floors. Our weighted average floor is 1%.

Our second lien exposure is down to 1 issuer, representing approximately $8 million principal amount of our $665 million total portfolio. Again, we expect to be repaid on this investment this year.

At year-end, the median EBITDA of our first lien cash flow investments was approximately $80 million. The first lien leverage through our security was 4.7x and the interest coverage was 2.4x. The weighted average LTM revenue growth was over 6% and EBITDA growth was over 3.5% with the portfolio of companies, reflecting lower top line growth but increased cash flow generation relative to the prior quarter.

For the first -- for the full fiscal year, we had $98 million of cash flow loan originations and $93 million of repayments.

During 2019, SUNS benefited from SCP -- the SCP platform's ability to take larger investment positions across the platform, which SUNS participates in. This should enable them to better withstand a downturn. With our recent fundraising efforts, we expect this trend to continue with SUNS having access to larger investment opportunities.

Now let me turn to Gemino. At year-end, Gemino's portfolio was just over $131 million, which is an all-time loan -- high loan balance for the company. It represented just under 20% of SUNS' total portfolio. It's comprised of loans to 34 borrowers with an average loan of approximately $4 million. The weighted average asset level yield of Gemino's portfolio was 11%.

During the fourth quarter, we funded $17 million of new investments and had repayments of approximately $1.5 million. Net portfolio growth for the quarter totaled just under $16 million, which is an approximately 14% increase from the prior quarter. For the full year, Gemino funded $40 million of new investments and had exits of $17 million, representing an increase of 21% in the portfolio on a year-over-year basis.

For the fourth quarter, Gemino paid SUNS a cash dividend of $900,000, which equates to an 11% annualized dividend yield, consistent with the prior quarter.

Now let me turn to North Mill. At year-end, North Mill's portfolio was just over $170 million, which represented 25% of our total portfolio at SUNS. For 2019, North Mill funded approximately $100 million of new asset-based loans, including its acquisition of Summit Financial Resources. They experienced $57 million of repayments, which resulted in net portfolio growth of $42 million. The portfolio consists of approximately 150 borrowers with an average investment of $1 million. The weighted average yield for North Mill's portfolio was just under 14%. This increase in yield was driven in part by the acquisition of Summit, which has higher-yielding factoring assets.

While it's still early in the integration of North Mill's capital acquisition of Summit, we are encouraged by the broader geographic coverage and expanded pipeline of opportunities across both asset-based and factoring. We view factoring as a highly attractive asset class in this portfolio as well as the addition of the Summit team increases North Mill's exposure to and expertise in the factoring asset class.

Summit team has a very strong credit culture, consistent with North Mill's, and we anticipate their addition will result in continued portfolio growth for North Mill.

For the fourth quarter, North Mill paid a cash dividend of $1.4 million.

Now let me touch on Life Science. At year-end, our portfolio was $23 million or 3.5% of the total SUNS' portfolio. For the fourth quarter, we funded just over $5 million in 2 life science companies and had $7 million of repayments. For the full year, we funded $20 million of life science loans and had $18 million of repayments, resulting in portfolio growth of $3 million. The Life Science portfolio has 7 different borrowers with an average investment of $3.3 million and a weighted average yield of 10%, which excludes any exit fees or warrants. The Life Science business contributed 7.5% of SUNS' income for 2019, which reflects the higher yields of this asset class.

As Michael mentioned, the middle market cash flow lending environment remains frothy. We benefit at SUNS from our diversified origination sources across both cash flow and asset-based lending verticals, which allows us to allocate capital to investments that meet our strict underwriting criteria and offer the best risk-reward.

We believe the growth of SCP's platform has and will continue to result in more investment opportunities across both cash flow and specialty finance assets for SUNS. We will continue to be prudent and highly disciplined in deploying our available capital.

Now let me turn the call back to Michael.

Michael Stuart Gross - *Solar Senior Capital Ltd. - Chairman, President & Co-CEO*

Thank you, Bruce. In closing, we have always maintained an investment philosophy of assuming that we are late in the credit cycle and believe it pays to be cautious in a period of sustained frothy credit markets. We have purposely taken a defensive approach to investing, focusing on protecting capital to investments in senior secured floating rate cash flow and asset-based loans. The result is a conservative 100% fund portfolio that provides a strong foundation for future portfolio growth. We are confident our disciplined approach, differentiated origination platform and diversified portfolio position us well to navigate in any environment.

At approximately 0.8x debt to equity, we are under-levered compared to our target range of 1.25 to 1.5x net debt to equity.

We have substantial dry powder to deploy via our differentiated investment verticals, and we continue to actively evaluate additional portfolios of asset-based loans and specialty lending platforms to acquire.

When the credit cycle does shift, we believe our history of conservatism will enable us to outperform on both a relative and absolute basis, and we will be well positioned to take advantage of market dislocations. We believe that our adviser's ability to hold up to $200 million across its platform provides a competitive advantage that will increasingly benefit SUNS.

With the final closing of Solar Capital Partners institutional private fund just this month, the increased scale it provides should positively impact SUNS in the form of incremental investment opportunities through an enhanced origination effort. The result should both -- be both increased diversification and even greater ability to be highly selective across our asset classes.

At last night's close of $18.16 per share, SUNS carries a dividend yield of 7.8%, which represents a significantly higher rate of return than the 5.6% implied yield of the S&P/LSTA Leveraged Loan 100 Index. Given the overall credit quality of SUNS' diversified portfolio, our differentiated origination engines and our disciplined investment philosophy, we believe SUNS continues to represent an attractive investment on both a relative and absolute value basis.

We thank you for your time this morning.

Operator, would you please open up the line for questions?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Chris Kotowski from Oppenheimer.

Christoph M. Kotowski - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Just a little confused about the fee waivers because it looked like this quarter, there was a -- like an $850,000 fee waiver backing into the numbers on the base management fees and kind of a reversal of some of the earlier fee waivers on the incentive fees. And I guess, just generally, why do you -- I mean, I realize that some fee waivers are necessary to cover the dividend, but what does make you decide to waive even the base fees or the incentive fees? And how do you allocate it? And what should we expect going forward?

Richard L. Peteka - *Solar Senior Capital Ltd. - CFO, Treasurer & Secretary*

Yes. No. I appreciate your question, Chris. Yes, between last quarter and this quarter, there was some reclassification that you're seeing between the incentive fee and the management fee. It had 0 effect on the P&L. It's just a classification between management and incentive fees.

So if you want to think about it for modeling purposes, we are first waiving incentive fees to the extent we need to and then to the extent that the incentive fee is not sufficient, then we would waive management fees. And so that's how we think about it going forward.

Christoph M. Kotowski - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. And I guess, I think, is it the intent to continue? I mean you've been -- obviously been waiving fees whenever you had to. I mean, what -- when do you anticipate that at some point, SUNS will be capable of covering the dividend on a fully fee-loaded basis? And kind of what has to happen to get to that?

Bruce John Spohler - *Solar Senior Capital Ltd. - COO, Co-CEO & Director*

Sure. So yes, we have been an active waiver of fees historically to demonstrate our support and our commitment. It is our decision to remain under-levered at 0.8x versus the target of 1.25 to 1.5. So I think that we have continued to put growth engines in place as you hear our commentary around not only the growth we're starting to see at Gemino and North Mill, both organic as well as through our acquisitions as well as the opportunity set that's (inaudible) for SUNS through the Life Science segment. We think we have the growth engines in place, together with the increased scale, so that selectively, we can also find, even in this frothy environment, good cash flow opportunities (inaudible) loans and that SUNS investment platform will invest in. So it's just a matter of those engines continuing to take hold. And you will see the waivers, obviously, decline as the NII grows on a sustainable basis. But we have and continue to be supportive.

Operator

(Operator Instructions) I'm showing no further questions at this time. I would now like to turn the conference back to Michael Gross, Chairman and Co-CEO.

Michael Stuart Gross - *Solar Senior Capital Ltd. - Chairman, President & Co-CEO*

Again, we thank you for your time this morning and look forward to talking to you next quarter or if you have any questions, please feel free to call any of us. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may all disconnect.
