THOMSON REUTERS

EDITED TRANSCRIPT

Q2 2019 Oaktree Specialty Lending Corp Earnings Call

EVENT DATE/TIME: MAY 08, 2019 / 3:00PM GMT

CORPORATE PARTICIPANTS

Edgar Lee *Oaktree Specialty Lending Corporation - CEO & CIO*
Mathew M. Pendo *Oaktree Specialty Lending Corporation - COO*
Mel Carlisle *Oaktree Specialty Lending Corporation - CFO & Treasurer*
Michael Mosticchio *Oaktree Specialty Lending Corporation - IR*

CONFERENCE CALL PARTICIPANTS

Finian O'Shea *Wells Fargo Securities, LLC, Research Division - Associate Analyst*
Richard Shane *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*
Ryan Lynch *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Specialty Lending Corporation's Second Fiscal Quarter 2019 Conference Call. Today's conference call is being recorded. (Operator Instructions)

Now I would like to introduce Michael Mosticchio of Investor Relations, who will host today's conference call. Mr. Mosticchio, you may begin.

Michael Mosticchio ***Oaktree Specialty Lending Corporation - IR***

Thank you, operator, and welcome to Oaktree Specialty Lending Corporation's Fiscal Second Quarter Conference Call. Our earnings release, which we issued this morning and the accompanying slide presentation can be accessed on the Investors section of our website at www.oaktreespecialtylending.com.

Our speakers today are Oaktree Specialty Lending's Chief Executive Officer and Chief Investment Officer, Edgar Lee; Chief Financial Officer and Treasurer, Mel Carlisle; and Chief Operating Officer, Matt Pendo. We will be happy to take your questions following their prepared remarks.

Before we begin, I want to remind you that comments on today's call include forward-looking statements reflecting our current views with respect to, among other things, our future operating results and financial performance. Our actual results could differ materially from those implied or expressed in the forward-looking statements. Please refer to our SEC filings for a discussion of these factors in further detail. We undertake no duty to update or revise any forward-looking statements.

I'd also like to remind you that nothing on this call constitutes an offer to sell or solicitation of an offer to purchase any interest in any Oaktree fund. Investors and others should note that Oaktree Specialty Lending uses the Investors section of its corporate website to announce material information. Accordingly, the company encourages investors, the media and others to visit our corporate website to obtain investor-related materials.

With that, I would now like to turn the call over to Edgar Lee.

Edgar Lee ***Oaktree Specialty Lending Corporation - CEO & CIO***

Thank you, Mike, and welcome, everyone, to our Second Quarter Earnings Conference Call. We appreciate your interest in OCSL.

In the second quarter, we continued to deliver on our strategic plans producing strong investment performance and results for our shareholders. NAV per share increased $0.36 or 6% from the previous quarter representing our fifth consecutive quarter of NAV growth. This increase was driven by a combination of factors, including realizing sizable gains due to the monetization of a number of non-core investments and increasing valuations on certain of our equity positions and private loans. Additionally, the broad market rally experienced in the second quarter following the decline in late 2018 led to a healthy rebound in the values of our syndicated loans.

Further, our diversified investment portfolio produced net investment income per share of $0.13 in the second quarter, up from $0.12 in the first quarter. Consistent with prior quarters, we continue to defensively position the portfolio and reduce portfolio risk. In the second quarter, we received $78 million from exits of non-core investments, including $64 million from Maverick Healthcare Group, which we discussed in detail on last quarter's call. These realizations contributed $20 million to the increase in NAV. With Maverick, we work with the management team and the private equity sponsor to navigate a successful sale process, and as a result, received par value and accrued interest for the entire investment. This positive outcome for our shareholders demonstrates our abilities to expertly manage underperforming investments and maximize recoveries. We also amended, extended and upsized our revolving credit facility in the second quarter. We received a positive reception from the lending group adding 2 new participants and we successfully lowered our interest rate margin by 25 basis points and extended the maturity by over 2 years. We believe these amendments validate the progress we have made on repositioning the portfolio since taking over management.

Before I go into more detail on our investments and portfolio composition, I'll update you on our view of the middle market lending environment. Following the steep market downturn last December, both equity and credit markets experienced a strong rally in early 2019. This rebound was driven by several factors, including a favorable outlook for corporate earnings, heightened optimism for a potential U.S.-China trade deal, and importantly, messaging from the Federal Reserve that interest rates were unlikely to rise further in the near term. These positive events helped provide support for a broad rally in the credit markets and OCSL's portfolio benefited from a related recovery in loan prices. Although market conditions improved, we also experienced a corresponding return of aggressive competition in direct lending. Borrower-friendly terms have reemerged as funds continue to saturate a marketplace that is experiencing a relatively low level of supply of high-quality investment opportunities.

Notably, much of the direct lending issuance in the quarter was done in sponsor-driven club deals in which a few large investors co-invested in transactions, essentially bypassing the traditional syndication market. Given Oaktree's size and ability to respond quickly, we participated in 2 such transactions. In this competitive environment, we remain highly selective with new originations and, as always, are focused on conservative underwriting and risk management, which are hallmarks of our investment approach.

We believe our defensive posture has and will continue to position the portfolio to preserve capital, while generating attractive risk-adjusted returns. To that end, we continue to place strong emphasis on 5 near-term investment objectives: 1, maintaining diversity across companies and industries; 2, focusing on the top of the capital structure opportunities; 3, lending to larger more diversified borrowers; 4, seeking lower levered borrowers; and 5, maintaining ample dry powder.

At the end of the second quarter, the portfolio was well diversified with a fair value of $1.5 billion invested across 110 companies. Nearly 80% of the portfolio was invested in senior secured loans. The portfolio is increasingly weighted towards larger middle market companies with approximately 58% of our borrowers generating EBITDAs in excess of $100 million.

In addition, we continue to target lower-levered companies. The average leverage at our portfolio companies has declined from 5.5x to 4.8x since we began managing the portfolio, while average middle market leverage multiples remained elevated at around 5.4x. While we remain patient and mindful that attractive opportunities will vary from quarter-to-quarter, we are well positioned for growth. We had over $250 million of liquidity at quarter end, more than enough dry powder to take advantage of new investment opportunities.

Moving on to our portfolio repositioning efforts, non-core positions decreased to $296 million or 21% of the portfolio, primarily due to the exit of Maverick Healthcare. We also received $9 million from the exit of one of an equity position in Comprehensive Pharmacy Services, which contributed an additional $7 million to NAV in the quarter.

Core investments represented over $1 billion or 79% of the portfolio at March 31, an increase of approximately 50% from the same period 1 year ago. Given our conservative posture and commitment to prudent risk management, we continue to take a highly selective approach to new investments, and therefore, we identified fewer origination opportunities in the second quarter that met our standards. As a result, we originated $100 million of new investments across 6 transactions, down from $231 million in the prior quarter. 95% of our originations in the quarter were first lien investments. As mentioned previously, 2 of our investments were in sponsor club deals, where Oaktree's size, reputation and ability to underwrite and fund quickly enabled us to participate. These transactions highlight our ability to source investments from multiple origination channels, including the sponsor-lending market. The remaining 4 new investments were broadly syndicated transactions. The average yield for all our originations was 8.7%, reflecting healthier valuations and more defensive investments.

In summary, we are very pleased with our strong second quarter results. Our portfolio was positioned appropriately for where we are in the economic cycle. We also remain well capitalized with ample liquidity to take advantage of new investment opportunities in our pipeline. Oaktree's platform is a significant competitive advantage for OCSL. Its scale, relationships and broader reach bolster our abilities to identify and assess investments that lead to strong risk-adjusted returns for our shareholders.

With that, I'd like to turn the call over to Mel to discuss our financial results in more detail.

Mel Carlisle ***Oaktree Specialty Lending Corporation - CFO & Treasurer***

Thank you, Edgar. OCSL reported another quarter of solid earnings. Net investment income was $17.7 million or $0.13 per basic and diluted share. This compared to $17.3 million or $0.12 per share last quarter. Total investment income of $38.2 million was consistent with the first quarter and up 10% from the second quarter of 2018. Contributing to the strong investment income was OID accretion of $6 million, mainly related to our first lien term loan with Dominion Diagnostics.

PIK interest income increased to $2.3 million, primarily due to income from Maverick and our investment in Alvotech. Dividend and fee income, when combined, was consistent between quarters.

Total operating expenses were up $5.9 million from last quarter, mostly driven by higher management and incentive fees due to improved financial performance. In addition, like the first quarter, we accrued Part II incentive fee expense of $8.2 million, all of which was included as part of the accrued waiver. Excluding management fees and incentives, our operating expenses were down $750,000 from the prior quarter, driven by lower administrator expense and professional fees.

Moving to credit quality - as of March 31, 6.1% of our debt investments at fair value were on nonaccrual status, down from 9.6% for the prior quarter. The decrease was mainly due to the exit of Maverick.

Turning to net asset value. NAV increased to $6.55 per share from $6.19 per share on December 31, mainly due to 3 factors: first, the realized gains we recorded from our noncore exits;second, increased valuations on several private loans and equity positions; and third, the increased valuations on our syndicated loan portfolio.

Moving on to leverage - our leverage ratio decreased to 0.64x from 0.70x on December 31, reflecting our very selective approach to new investments as well as growth in NAV. Investment fundings in the quarter were $111 million and we received $121 million of proceeds from prepayments, exits and other pay downs. In February, as Edgar mentioned, we amended, extended and increased the size of our credit facility. Total capacity, including additional commitments made subsequent to quarter end, is now $700 million, up $100 million and we were successful in lowering the interest rate by 25 basis points.

On March 1, our 2019 notes matured and we paid off the remaining balance of $229 million. We funded this maturity with incremental borrowings on the credit facility. Our next unsecured debt maturity is 5 years away when the $75 million 2024 notes are due. As of March 31, total debt outstanding was $598 million and had a weighted average interest rate of 5.1%, down from 5.3% in the prior quarter.

Cash and cash equivalents were $13 million at quarter end, and we had $275 million of undrawn capacity on revolving credit facility, including commitments made subsequent to quarter end.

Shifting now to the Kemper joint venture - as of March 31, the JV had $347 million of total assets invested in senior secured loans to 49 companies. This compared to $310 million of total assets invested in 43 companies last quarter. Leverage at the JV was 1.3x at March 31, up from 1.0x last quarter due to the growth in the portfolio. The JV credit facility had $15 million of undrawn capacity at quarter end.

Now I will turn the call over to Matt.

Mathew M. Pendo ***Oaktree Specialty Lending Corporation - COO***

Thank you, Mel. We continue to build momentum and position OCSL for stronger returns. As we outlined on previous calls, we are executing on multiple initiatives that we believe will increase ROE over time, and our performance over the last 3 quarters has demonstrated our progress in these efforts. Importantly, we continue to rotate out of nonincome-generating investments and build a strong foundation of earning assets. We received proceeds of $64 million from the exit of Maverick, $53 million of which was on nonaccrual status at par and $9 million from one of our equity investments. Our remaining nonincome-generating investments are $156 million, which represents ongoing opportunity to increase overall portfolio yield.

During the second quarter, we also had $32 million of lower-yielding, broadly-syndicated loans with yields below LIBOR plus 400 basis points. We intend to replace these investments with higher-yielding proprietary investments over time, further positioning the portfolio for improved yields.

Finally, we are steadily progressing in our efforts to optimize the Kemper JV. The JV added $62 million in investments across 12 companies during the quarter. All of these were first lien positions. We have over $100 million of additional investment capacity, assuming we are able to increase leverage up to a longer-term target range of 2.0x. We have plenty of runway before us and expect it will be accretive to ROE as incremental investments are added over time.

Now turning to the dividend. We announced today our Board approved a $0.095 dividend. OCSL has maintained this level for the last 5 quarters. Our goal remains to pay sustainable and consistent dividends supported by portfolio performance.

And lastly, I'll provide an update on the pending Brookfield transaction with Oaktree as well as some corporate governance initiatives we are undertaking. As you know, the parent company to our investment adviser Oaktree Capital Group, LLC entered into a transaction with Brookfield Asset Management Inc. whereby Brookfield will hold an approximately 62% economic interest in Oaktree's business and Oaktree's founders and certain other members of Oaktree's management and employees will own the remaining 38% when the initial transaction closes. The transaction is structured so that Oaktree's current management will maintain actual control of the management of Oaktree, subject to certain limited consent rights held by Brookfield for an initial period of 7 years or more upon the closing of the deal or less if certain conditions are triggered. We do not believe the consummation of the merger with Brookfield will be deemed an assignment of the Investment Advisory Agreement between Oaktree and OCSL for purposes of the Investment Company Act of 1940, although such determination is inherently uncertain. In accordance with the 1940 Act, however, the current Investment Advisory Agreement would automatically terminate upon its assignment. To prevent any potential disruption in our ability to provide services to OCSL once an assignment is deemed to occur, whether as a result of the merger closing, or later on, as a result of Brookfield exercising actual control over Oaktree, we recommended to our Board, and the Board approved, seeking shareholder approval of a new Investment Advisory Agreement between Oaktree and OCSL. As such, yesterday, we filed the preliminary proxy statement. The terms of the Investment Advisory Agreement will remain unchanged from those in the existing agreement, other than changing the date of its effectiveness. At the same time, we will seek shareholder approval to increase our leverage limits by modifying our assets coverage requirements. As you will recall, last quarter, we have received Board approval to increase our leverage effective in February 2020, unless we were to receive shareholder approval before then. While we have no near-term plans to increase our leverage above our target range of 0.7x to 0.85x, this is an opportunity to cost efficiently seek shareholder approval in the events and in the future we deem it appropriate to deploy higher leverage. In connection with this, our base management fee will be reduced to 1% on all assets financed using leverage above 1.0x debt-to-equity once the new leverage limits are in effect.

In conclusion, we are well positioned for continued strong earnings and will methodically leverage Oaktree's expertise and resources to identify attractive risk-adjusted investment opportunities that deliver value to our shareholders.

Thank you for joining us on today's call and for your continued interest in OCSL.

With that, we're happy to take your questions. Operator, please open the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Rick Shane of JPMorgan.

Richard Shane ***JP Morgan Chase & Co, Research Division - Senior Equity Analyst***

Just want to think about dividend and capital policy. Obviously, you carried the dividend forward for the next quarter. Given the NAV accretion today that we saw, I'm curious if at some point will you consider buying back shares or instituting some sort of repurchase program? I realize that there are liquidity challenges, I realize that it's still a relatively small capital base. But given the opportunities that you're describing, does it make sense to start returning capital that way?

Mathew M. Pendo ***Oaktree Specialty Lending Corporation - COO***

It's Matt. Thanks so much for the question. I think we discuss it every quarter with our Board. I think the point you made regarding liquidity, just to emphasize, that's liquidity in underlying shares not liquidity of the company. We focus on liquidity in underlying shares, we also focus on our credit rating and the share repurchase impact to that. For those reasons to date, we haven't done anything on the share repurchase side but continue to talk to the Board about it. In terms of the dividend, we were -- as we discussed, we were focused on sustainable cash earnings and the dividend is generated from -- that came from the portfolio to pay out the dividend. As Mel mentioned, during the quarter, there was about $6 million of OID primarily from Dominion. So we're thoughtful about that as we think about our dividend and capital strategy.

Edgar Lee ***Oaktree Specialty Lending Corporation - CEO & CIO***

Rick, it's Edgar here. If I can just add to what Matt mentioned. One other consideration is, we consider our availability under our revolving credit facilities and our other facilities as an asset for shareholders. You can imagine in the environment that we're experiencing right now where equities are swinging 400 points in a day that should we have a sustained sell-off in the equity markets that led to a sustained sell-off in the credit markets that it could create great opportunities to extend capital to various companies out there. And so preserving that dry powder is very valuable to us and while we want to make sure that we're efficient to round our capital structure and cost of capital, we also are mindful of where we are in economic cycle and credit cycle and making sure that we have the capital available to actually make great investments when others can't.

Richard Shane ***JP Morgan Chase & Co, Research Division - Senior Equity Analyst***

Totally get it. Look, it's a difficult -- it's a balancing act, we get that. And we also realize, ultimately, I don't think your intention -- your long-term intent would be to grow the capital base. I'm just trying to figure out if it makes sense to take a step or 2 back to take several steps forward down the road. And you're right, if there's opportunity that presents itself, a month from now, then that's a missed window, but there is value on the table right there today too.

Edgar Lee ***Oaktree Specialty Lending Corporation - CEO & CIO***

Absolutely, and we don't disagree with your thoughts around that. It is a complex equation with a lot of inputs and various constituencies that we think about, but as Matt mentioned, it's something that we talk about at all of our board meetings and consider, and something that we wouldn't rule out. But again, as you mentioned, it's just the math of it all and being thoughtful about how and when -- if we were to do something like that.

Operator

(Operator Instructions) Our next question comes from Finian O'Shea from Wells Fargo.

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

Just to follow, and touch on the dialogue you were just having on buybacks is another element here of how might think of your current portfolio given the outcomes you've had? You can look at names now like Cenegenics or Advanced Pain and maybe you view these as assets you're going to get paid back on. Any commentary on how that might play into you delaying a potential buyback in your strategy?

Edgar Lee ***Oaktree Specialty Lending Corporation - CEO & CIO***

No, no, if that would be the main driver of it, but definitely it's a consideration about the amount of proceeds we receive back from any one given quarter in our net deployment and what our outlook is for the near-term and medium-term investing environment. So I would say that your observation generally about the pace at which we have a return of capital from various investments would factor in, but wouldn't be the only driver there.

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

Sure. And then just another on the middle market sponsor club deals you mentioned this quarter. Assuming you found those to be attractive risk-adjusted returns, would you say that, that was sort of a function of the market environment in terms of those assets appearing attractive to you enough to go into the wheelhouse of core middle-market sponsor? Or is this more a function of you migrating that way now that there's been a good amount of rotation?

Edgar Lee ***Oaktree Specialty Lending Corporation - CEO & CIO***

So we've always communicated with investors that we're a little bit different than the traditional BDC in that matter from a number of different perspectives. But in terms of the way that we think about deploying our capital, we not only look at traditional sponsor acquisition financing, but just given the breadth of our platform, that means that we can look at much broader universe of opportunities, including more opportunistic direct lending, whether it's rescue loans, bridge loans, public company loans, loans to family offices. So we have a very broad range of opportunities that we look at. In any given quarter, we see billions of dollars of opportunity and it's not so much that we say we're going to make a macro call on sponsored direct lending looks better than non-sponsored backed direct lending, but rather we're looking at each individual investment one by one and assessing how does that add or subtract from the overall BDC portfolio and making that assessment of whether that is a good fit or not for the BDC. And it just happened to be that we found a couple of opportunities this quarter that were something that we consider were attractive and that we thought would be additive to the portfolio and the mix of risk characteristics that we're trying to manage for in the portfolio.

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

Edgar, just one more, if I may. And forgive me if you mentioned this, the fees waived this quarter, is that fair to think about as offsetting your Part II incentive fee?

Mel Carlisle ***Oaktree Specialty Lending Corporation - CFO & Treasurer***

This is Mel, I'll take that one. Yes. As I stated in my prepared comments, we accrued $8.2 million of Part II incentive fees and we had an equal offset in the form of a waiver.

Operator

Our next question comes from Ryan Lynch of KBW.

Ryan Lynch ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

This is the first quarter that I can remember in a while that you guys have actually had pretty substantial growth in your senior loan fund, obvious the asset classes -- last asset class that goes in is a little bit different than the asset there on your balance sheet. Can you just talk about what you guys were seeing this quarter that allowed you guys you have pretty significant growth?

Edgar Lee ***Oaktree Specialty Lending Corporation - CEO & CIO***

We don't know if there is any one item that we saw, but I'd say, generally there is a couple of factors that fed into our thought process there. One, we are working -- the partnership with Kemper has been great. They've been great partners. We just finished up our quarterly call with them or board call with them. I think both Oaktree and Kemper couldn't be happier with how this partnership is working. So that really sets the tone now that we've had time to work with them is something that we would like to grow with them specifically. Two, I would say that we are mindful of wanting to get back to a position where the vehicle can start making dividend payments, which we think would be highly accretive to our shareholders. And so we have mapped out a plan to get us to a good position there, hopefully, over the coming quarters. And, three, if you look at the overall credit markets, starting in January, or as all of you know, at the end of December, we saw some pretty severe weakness in the credit markets. And many funds were sitting on a significant amount of cash. By the time we got to January, we started seeing a significant amount of that cash needing to be deployed, especially in the high-yield market. And we saw high yield -- fixed-rate high-yield bonds rebound in price quite dramatically and that momentum didn't stop, and obviously, the Federal Reserve's commentary helped propel those fixed-rate bonds forward. But if you look at the overall syndicated loan market, there were significant outflows. That were occurring as there were various investors who took the view that there might be a potential interest rate cut sometime in the latter part of this year or maybe early next year and that really motivated folks to begin liquidating some of their positions in syndicated loans. And we started to see a meaningful number of syndicated loans continue to lag the overall credit markets despite the overall economic environments remaining relatively balanced. Because we didn't see that rebound and we saw some inefficiencies continue to persist in the syndicated loan market, we decided to step in more aggressively and continue to try to take advantage of that dislocation. Now that gap, that dislocation, has significantly closed or whittled down over the last month or so. But we were able to fortunately manage to expand our investments in the JV during the first quarter and take advantage of these dislocations.

Operator

(Operator Instructions) We have no further questions. Mr. Mosticchio?

Michael Mosticchio ***Oaktree Specialty Lending Corporation - IR***

Thank you, again, for joining us for our fiscal second quarter 2019 earnings conference call. A replay of this conference call will be available for 30 days on OCSL's website in the Investors section or by dialing (877) 344-7529 for U.S. callers or 1 (412) 317-0088 for non-U. S. callers with the replay access code 10130349, beginning approximately 1 hour after this broadcast.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.