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OCSL - Q3 2018 Oaktree Specialty Lending Corp Earnings Call

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PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Specialty Lending Corporation's Third Quarter 2018 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 Third Quarter 2018 Conference Call. Both our earnings release, which we issued this morning, and the accompanying slide presentation can be accessed on the Investors section of our website at 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 post -- after today's call. I'd also like to remind you that nothing on this call constitutes an offer to sell or a 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 material.

With that, I would now like to turn the call over to our Chief Executive Officer, Edgar Lee.

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

Thank you, Mike, and welcome, everyone, to our third quarter 2018 earnings conference call. We appreciate your continued interest in OCSL and your participation in today's call. Our primary focus since Oaktree's acquisition has been to stabilize and reposition our inherited portfolio by exiting



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noncore assets while expanding the amount of core assets in the portfolio. We continue to closely monitor the direct lending landscape for new investment opportunities that align with Oaktree's underlying philosophy of controlling downside risk. The ultimate goal of this -- these repositioning efforts is to improve ROE for our shareholders.

We have made significant progress in repositioning our portfolio and stabilizing NAV since we began managing OCSL last October. Over a period of just 9 months, we had refinancings and repayments of almost \$1 billion of assets in our portfolio. During that same time, we reduced our noncore asset exposure by 60% or \$536 million. At the end of the third quarter, only 26% of the portfolio at fair value remained in noncore investments, many of which have been demonstrating stable operating trends.

It is especially noteworthy that \$536 million of the noncore assets we exited were spread across 55 individual positions, many of which were illiquid and challenged. In addition, we exited the vast majority of these investments either at par value or above their previous fair value marks, demonstrating our ability to maximize value for our investors. I am very proud of our team's hard work in successfully monetizing these assets.

Over the same period, we also doubled the amount of core investments that we hold, as we added nearly \$786 million of new investments across 52 companies to the portfolio. \$380 million of these new assets were added in the third quarter. As of June 30, core investments totaled over \$1 billion in market value and represented approximately 75% of our portfolio.

I'm pleased with the outcome of our repositioning efforts, which includes the stabilization of our portfolio's NAV. During the third quarter, NAV increased for the second consecutive quarter to \$5.95 per share, up from \$5.81 at the end of December.

As of June 30, the portfolio had a fair value of \$1.5 billion invested across 116 companies. Approximately 53% of the portfolio was invested in first lien loans, 23% in second lien loans, 11% in unsecured bonds, 9% in the Kemper JV and the remaining 4% in equity or limited partner interests. 83% of our debt investments had floating interest rates.

As previously indicated, at the end of the third quarter, almost 75% of the portfolio was comprised of core investments. Another 18% was noncore yet still performing, and the remaining 8% was noncore and underperforming.

We expect to continue exiting noncore assets at a robust pace while also maximizing value for our investors. Of our \$357 million noncore portfolio, we anticipate over half of these investments will be liquidated over the next few quarters as many of these investments are liquid loans or are in active sales or refinancing processes. We expect to hold approximately 1/4 of these investments over a longer period as these portfolio companies are generally performing well, and we intend to opportunistically exit these positions when we believe their values have been optimized. With respect to the remaining investments, we are actively working with management teams and their financial advisors to implement asset sales, balance sheet restructurings or other monetization events.

During the quarter, we exited of our investments in Metamorph and Traffic Solutions and received the final proceeds from the sale of Ameritox. We also made significant progress reducing our equity and limited partnership interests as we sold \$34 million of these assets during the quarter. Importantly, we monetized these positions at or above their fair value marks, underscoring the proactive approach we have taken in managing underperforming credits. Given Oaktree's deep restructuring experience and expertise, we led the sale processes of these transactions, which allowed us to maximize recovery values.

With respect to our remaining underperforming investments, we believe the marks on these investments reflect their fair value, given each company's underlying business trends, many of which are showing signs of improvement. We have received a number of bids for these assets, and therefore, we are cautiously optimistic that it could lead to further upside in recovery values.

Turning to the current market environment, there is a tremendous amount of capital being raised to target direct lending opportunities. This has created a highly competitive, borrower-friendly climate, where direct lending funds and BDCs are aggressively competing in the private-equity-backed segment of the market. As more capital has flown into the direct lending space, investments have become more commoditized, leading to spread compression and less-attractive covenant structures across the board.

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We continue to observe frothy valuations and an increased appetite for risk in this cycle, which is long by historical standards in spite of the absence of widespread credit deterioration. Against this backdrop, we are currently focused on defensively positioning the portfolio by investing in larger, more seasoned businesses that operate in noncyclical, defensive or structurally growing industries.

We remain committed to our long-term strategy, and we'll continue to evaluate opportunities in both the sponsor- and nonsponsor-owned segments of the market that we believe will generate the best risk-adjusted returns over the long term. We are taking a highly selective and patient approach to evaluating potential investments and maintaining investment discipline. Although this approach has muted the overall yield on your investments, we believe a more defensive posture is the best way to generate income in the near term.

All told, I'm pleased with the significant progress we've made since we began managing OCSL 9 months ago and believe we are very well positioned to navigate evolving market conditions to deliver attractive returns to our shareholders.

I'll now turn the call over to Mel Carlisle to review our financial results in more detail.

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

Thank you, Edgar. We had a good quarter, and we are pleased with our improving financial performance. Net investment income in the third quarter was \$14.4 million or \$0.10 per basic and diluted share. This was down slightly from \$15.3 million or \$0.11 per share last quarter, mainly due to reduced investment income and partially offset by lower interest expense.

Total investment income for the quarter was \$31.8 million, down from \$34.8 million in the March quarter. This was primarily due to decreases in PIK interest and both fee and dividend income. The decrease in dividend income was partially due to the Kemper joint venture not paying a dividend this quarter. I will discuss our Kemper joint venture in more detail shortly.

Cash interest income was flat for the quarter despite a slightly larger portfolio. This was mainly due to a quarter-over-quarter decrease of \$1 million related to an investment placed on nonaccrual status, and a \$400,000 decline in original issue discount income due to fewer loan repayments during the quarter. In addition, a significant number of monetizations occurred at the beginning of the quarter. We reinvested those proceeds toward the end of the quarter, creating a drag on interest income. These items were partially offset by higher rates following the LIBOR reset in March.

Interest expense declined approximately \$250,000 in the third quarter, mainly driven by lower average borrowings and partially offset by higher average interest rates.

Net operating expenses for the quarter were \$9.1 million, down from \$10.9 million last quarter, reflecting lower professional fees, G&A expenses and incentive fees.

Now turning to credit quality. At June 30, 4.6% of our debt investments at fair value were on nonaccrual status. One investment, currently valued at \$38 million, was moved to nonaccrual status following a payment default in the third quarter. At June 30, we wrote down the value of this investment by an additional \$4 million, marking it to approximately 73% of cost. We are in communication with this borrower and a recapitalization plan is underway. There were no other material write-downs, and net unrealized appreciation was \$1 million for investments held at the end of the quarter.

Net realized gains for investments exited during the quarter were \$8 million as the majority of our investment sales during the quarter were above their March 31 fair value marks.

As Edgar mentioned, net asset value increased for the second consecutive quarter to \$5.95 per share at quarter-end. This compares to \$5.87 per share at March 31. On Page 12 of the earnings presentation, we have provided a bridge that explains the key factors that led to the increase in NAV.



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At June 30, total debt outstanding was \$607 million at a weighted average interest rate of 5.5%. Our leverage ratio increased slightly to 0.73x from 0.71x at March 31, reflecting higher borrowings on our credit facility at quarter-end.

In July, we amended our credit facility with ING. As part of the amendment, we reduced our interest rate on amounts drawn by 25 basis points.

At quarter-end, cash and cash equivalents were \$57 million, and we had \$389 million of undrawn capacity on our \$600 million credit facility.

Unfunded commitments outstanding at quarter-end we're \$64 million, mainly related to portfolio companies with revolving credit facilities or delayed draw term loans.

Before I turn the call over to Matt, I want to provide an update on our Kemper joint venture. During the third quarter, we continued to optimize the JV, adding \$91 million of new investments across 10 companies with a weighted average yield of 6.6%. At June 30, the JV had total assets of \$357 million, a leverage ratio of 1.1x and a credit facility with \$35 million of undrawn capacity. We expect to continue to expand our debt capacity over time as we add first lien, senior secured investments to the portfolio.

Also, during the third quarter, we amended and restructured our credit facility under the Kemper JV. We reduced the interest rate on the facility from LIBOR plus 225 basis points to LIBOR plus 185 basis points. We extended the term by 3 years and achieved favorable advance rates and concentration limits. We also restructured the class B note from 15% payment in kind to 10% cash pay. This will eliminate PIK interest income related to the Kemper JV going forward.

Now I will turn the call over to Matt Pendo, our COO.

Mathew M. Pendo - Oaktree Specialty Lending Corporation - COO

Thank you, Mel. Since the end of the last fiscal year, we have successfully rotated out of over \$60 million of noninterest-generating investments, including equity, limited partnership interests and nonaccrual loans. This amount includes \$40 million from the sale of the majority of our limited partnership interests in the third quarter. Importantly, these were sold at a slight premium to their net asset values. As of June 30, we had \$135 million remaining in noninterest-generating investments spread across 42 companies and 4 LP positions.

We continued to benefit from rising interest rates in the third quarter, given that our portfolio consists primarily of floating rate assets with a mostly fixed-rate liability structure. We expect to see more benefits if there are additional rate increases this year.

As Mel highlighted, we continued to optimize our Kemper JV. During the quarter, we grew the joint venture to \$357 million of total assets and lowered borrowing costs by 40 basis points. As we grow the joint venture, we expect it will be further accretive to ROE.

Finally, during the third quarter, we responded to market conditions by temporarily increasing our exposure to broadly syndicated loans to \$57 million as of June 30. We are investing in more liquid loans in order to earn spread income until we can deploy capital into higher-yielding proprietary investments that we want to hold over the long term. We felt this was an appropriate technical move and not a change in our strategy.

Taking a prudent and selective approach to investing is paramount in the current environment. As such, we're confident that by leveraging the Oaktree platform, we will be successful in originating and structuring attractive transactions that ensure downside protection, a hallmark of Oaktree's investment approach, and deliver high yields without assuming additional risks.

Now turning to our dividend. As you saw in our press release, we declared a \$0.095 dividend today. This is unchanged from last quarter, and represents approximately 90% of the net investment income earned in the third quarter.

In conclusion, we are pleased with the significant progress we have made in repositioning the OCSL portfolio and stabilizing NAV. Our team is executing well against all of our key initiatives, and we are making strong progress against our long-term goals of delivering a high single-digit ROE and a consistent dividend.

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Thank you, for your time and attention today. We look forward to keeping you updated on our progress. And with that, operator, please open up the lines to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Chris York of JMP Securities.

Christopher John York - JMP Securities LLC, Research Division - MD & Senior Research Analyst

Maybe, Edgar, could you provide us an update on your thoughts for pursuing leverage above your current target of 0.85x, given your progress of exiting noncore investments? And then the portfolio growth this quarter, which Matt did say included some DSLs, and then also expanded leverage?

Edgar Lee - Oaktree Specialty Lending Corporation - CEO & CIO

Thanks for the question, Chris. Right now, we don't have any intentions to adjust leverage at this time. But together with the board, we continue to evaluate our leverage position and where we may take that over time. Right now, we're comfortable with the current leverage position, and we feel that we have ample capacity on our existing facilities as we're only levered 0.73x right now as well as we have capacity in our Kemper joint venture. Having said that, we're considering a number of different factors that -- and weighing those as we consider what to do with respect to leverage long-term. And those also include our cost of capital and the impact on our credit ratings.

Christopher John York - JMP Securities LLC, Research Division - MD & Senior Research Analyst

Got it. Let's see, weighted average yield. I'm looking to try to get that number for your exits. I know we've got 8.1% for yield on new investments, and I'm conversely trying to find the number. I probably can pull it up, but maybe, Mel, do you have that for us?

Mel Carlisle - Oaktree Specialty Lending Corporation - CFO & Treasurer

8%. Yield on the exit was 10%, sorry.

Christopher John York - JMP Securities LLC, Research Division - MD & Senior Research Analyst

Yes, makes more sense. Okay. And then I'm aware that Allan Media is in the market with Deutsche and Jefferies seeking new term financing. So do you expect to be refinanced out of your term loan this quarter?

Edgar Lee - Oaktree Specialty Lending Corporation - CEO & CIO

The transaction with -- that has been contemplated by Allan Media in the marketplace today hasn't closed yet. Should they raise the capital that they're seeking to raise, we'd anticipate being refinanced out of that loan.

Christopher John York - JMP Securities LLC, Research Division - MD & Senior Research Analyst

Okay. And then the mark at quarter-end, in my view, doesn't imply any prepayment penalties or premiums associated with that. Is that fair?



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

So what I would say is we don't typically comment on the structures of our loans due to certain confidentiality provisions. But as a general matter, I would say that all of our proprietary loans typically have a meaningful prepayment premium as well as a -- typically a 1-year noncall period. Therefore, in our standard loans, anyone who refinances us in that 1-year noncall period would typically have to pay us a make whole premium as well.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Got it. Okay, that's very helpful. And then lastly on the Kemper JV. You took that down. You talked a little bit about the performance and views longer-term there. But do you see any recovery value in your equity as spread income potentially returns?

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

Yes, we've taken steps to optimize our Kemper JV, and adding \$91 million during the quarter. When we took over the vehicle, it was underinvested. That's why you saw the equity being taking down. But over time, as we ramp the vehicle and optimize it, we expect that value to recover.

Operator

You're next question comes from Christopher Testa of National Securities.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

So just curious, you guys noted that you have \$104 million of underperforming noncore and only \$67 million of that are on nonaccrual. So the delta between those two, I'm just curious, how many portfolio companies comprise that difference? And is that confined to a certain problematic sector in the inherited portfolio, like healthcare? Or is it just more spread out?

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

It's not confined to a specific sector. It is more broad-based and company-specific. So it's less about the specific industry of these investments and much more about the specific -- company-specific issues there.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Got it. And Edgar, how many companies comprise of the difference that are not yet on nonaccrual?

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

There are -- there's 1 company right now that's not nonaccrual.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Oh, no, no. I meant between -- so you have \$104 million underperforming and then there's \$67 million on nonaccrual. So the difference between the \$104 million and \$67 million, like how many companies are within that underperforming but not yet on nonaccrual status bucket?

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

It's 1 company.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Oh, that's still 1? Okay. Apologies. And I know you guys had previously talked about Fifth Street's health care book had a lot of reimbursement risk and other issues. Just wondering if there's been any noticeable difference in the trend for any of these, whether positive or negative, over the last quarter?

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

I would say it's a mixture. When we -- as a general matter, the legacy Fifth Street portfolio, many of those companies we've already exited. Those that were in health care did have some challenges with reimbursement risk. We did manage to move a number of those positions out of the portfolio already. As we look at this bucket of underperforming companies in health care, for example, I would say, generally, the health care companies have had pretty balanced performance with at least one of them experienced relatively positive trends more recently.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Got it. Okay. And looking at the nonaccruals, I know that Garrison Film resolution was added, and that's also a position in the JV. Previously Ameritox and Metamorph were on the balance sheet and in the JV. Is your policy going forward to have the Kemper JV have completely a totally different investment mandate? So should we expect there to not be co-investment between that and the on-balance-sheet portfolio? Or will you opportunistically put them in bolt buckets as well?

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

I would expect that, over time, the Kemper JV portfolio will start to look slightly different than the overall portfolio over time. But there will continue to be some level of overlap between the JV and in the main BDC.

Operator

(Operator Instructions) Our next question will come from Ryan Lynch of KBW.

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

One question on the leverage. You mentioned you guys were at about 0.73x debt to equity today. But if I look at your balance sheet, you guys have about \$167 million payables on unsettled transactions on the balance sheet, which I'm assuming have closed post-quarter. And if you add those to your current leverage, you guys would be at about 0.92x debt to equity. So that's outside of your normal kind of targeted debt-to-equity range. So can you just talk about were you guys expecting some big prepayments or repayments early in the third quarter to offset those? Or did you guys sell some noncore BSL loans? Or just kind of how that's working?

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

Thanks for the question. So one item to keep in mind as that we did have cash on the balance sheet as well. There was just timing around proceeds coming in and capital going out. And so we would imagine that you'd see our leverage within the range -- target range that we've been -- we have

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mentioned in the past. Again, it's just really a timing item here as we don't anticipate moving materially out of our target ranges in the quarter. Since the beginning of the third quarter, we have had some monetization events occur. But we anticipate that, that'll continue to occur throughout the quarter, and we've been deploying capital as well during the quarter. So you can imagine that, just basically for your modeling purposes, expect that leverage will stay in line with our historical levels.

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

Okay, that's good to know. And then -- and you guys done -- have done a really great job of monetizing a lot of noncore assets. Even in the most recent quarters, you guys had substantial decrease. You still have about \$350 million of noncore investments. I would think that monetizing -- I guess, early on in the monetization process of reducing noncore investments, I think it would -- seems like it would be easier to monetize some of those investments, maybe pick off some of the low-hanging fruit as we start to get down to the bottom end of these noncore investments. Should we expect a lengthy period from now to reducing those \$360 million -- or \$350 million of remaining investments?

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

I wouldn't necessarily characterize it that way. I think if you've looked historically at assets that we've monetized, a number of those assets were challenged as well. So I don't know if it's really a fair characterization to assume that the balance of these investments are the most challenged investments that we originally identified in the noncore buckets, but rather it's been relatively spread out. As we go forward, if we were to break down the noncore bucket, I think one way to look at it is about half of those investments are in assets that are either liquid investments where we do have an active bid in the marketplace where we can sell those assets, and I'll come back to the reasons why we haven't necessarily move those right away. Two, they're -- that also includes assets that we are actively selling right now where we may have restructured our own -- the company today, and we are actively marketing and selling those companies, or 3 companies where we are actively trying to sell the debt investments. And lastly, investments where we have received notice that the company or the borrowers want to refinance our loan. There's always uncertainty in those latter 3 buckets around timing and when that can occur. But I would say that for about half of that bucket, or a little over half of that bucket, there's active activities going on to further reduce our noncore exposure.

There's also a portion of investments in the portfolio, about a 1/4 of that noncore bucket that are equity investments. Those include equity co-invests as well as LP interests. We've monetized a significant portion of those LP interests over the last quarter. We do have the ability to monetize the balance of those LP interests, but we do think there's additional upside, potentially, in those LP interests. We've made the determination that we think it's advantageous for shareholders if we hold onto those investments and see if we can harvest some of that additional upside. There are also co-investments in the portfolio, a number of those that our being monetized over time as the private equity firms that own these specific companies look to monetize these assets. So we would expect over the coming quarters that we'll see the equity portfolio be reduced in size purely because the borrowers look to monetize those assets. So we anticipate there's going to be a fair amount of additional monetizations coming in the quarter. I should have mentioned just on the liquid portion of the portfolio, there's a portion of that -- over 50% that are more liquid loans that we could monetize. Part of that is just a function of timing. Those companies tend to be companies that are performing well but may not necessarily reflect the type of companies we would prefer to lend to. But again, those companies are performing well, and it's just managing the timing of monetization. One thing to note in this past quarter was that over 2/3 of our monetizations came in at the first half of the quarter. But our new investments over -- well over half of them were in the second half of the quarter. So you start to end up with a little bit of a timing mismatch at points of times. And while we'd prefer for the timing to be more even throughout the quarter, we thought it was more prudent to take advantage of what we consider a very robust marketplace and monetize a disproportionately larger amount of the noncore investments sooner rather than later. But as we move forward, we anticipate it may be slightly more balanced. So the impact will be a little bit less pronounced.

Operator

Our next question will come from Fin O'Shea of Wells Fargo.



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

I'll go to a portfolio name. Think-5, I believe, was a new nonaccrual, and that's kind of been glided down a bit under your tenure as manager. Can you kind of give us a feel of the -- what's going on underneath there? And understanding that it might have -- just kind of looking at the business, their customers, I believe, are major hotel chains. Is there a customer concentration issue there?

Edgar Lee - Oaktree Specialty Lending Corporation - CEO & CIO

Thanks for the question. There's a limit to what we can comment on with respect prospective Think-5 is, hopefully, you appreciate some of this information is subject to confidentiality arrangements. But I would say about Think-5 is, when we first took over the portfolio, we did identify this as one of the noncore underperforming assets in the portfolio. And so we early on identified that there was an elevated risk associated with this company of default, and therefore, categorized it the way we did. The company itself has experienced some level of softness. It previously had more significant customer concentration. I would say that the company has done a good job of trying to enhance its overall mix of customers, but it has had some softness over the last few quarters here. Hence, why you're seeing it reflected in how we've marked the position. It's really a function of -- it's not significant disjointedness in the cash flow, I would say. I guess, I would characterize it more as there's just generally been softness in that particular situation.

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

Sure. That helps. And then on -- it looks like this quarter, you were able to manage a lot of exits on the LP private equity stakes, all, of course, originated under previous management. Can you give us some color on the marks you were able to exit those at, assuming that you found a secondary buyer or sold them to an agent of sorts?

Mathew M. Pendo - Oaktree Specialty Lending Corporation - COO

Sure. It's Matt. Thanks for the question. We sold them pretty much right at our marks. So it's a very, very robust market out there for these equities -- these positions. So we were really pleased with execution there. And as Edgar said, we kept some of the stake and either some other co-invests we've kept, but probably because we like them. And so some of these investments, even though they're not core, just like Edgar said, if we see more value in holding them than selling them, that's what we'll do. So expect to see that over the next few quarters. And I do think as it relates to the -- kind of the noncore performing, just we -- I think we -- if you look at our -- the deck we posted on Page 7 and 8, I think there's some good detail that people find helpful in terms of how we've provided more information on those type of portfolio.

Operator

The next question will come from Terry Ma of Barclays.

Tengwei Ma - Barclays Bank PLC, Research Division - Research Analyst

So it sounds like from your prepared remarks that you want to remain (inaudible) going forward, and you're just willing to accept the lower yield. So maybe can you just talk broadly about what needs to change for you to be more constructive on the environment or take more risk? Or is this lower-return environment is just the new norm going forward?

Edgar Lee - Oaktree Specialty Lending Corporation - CEO & CIO

I wouldn't say that the lower-return environment is the new long-term norm. I think if you look at the history of the credit markets, they ebb and flow and spreads widen and contract. I think the contracting spread environment is just a reflection of increasing competitiveness in the middle market -- the market for middle market loans. We've seen tremendous amount of capital flow into the direct lending space over the last couple of



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years, and that's led to aggressiveness among direct lending firms for new assets, and that has led to some spread compression. But also, we've had a very strong economic environment, and that's also reflected in credit spreads, which suggest that there's just less risk overall in the marketplace today. Do I think that will correct? It will correct at some point in time. I'm not a forecaster of economic activity, but history suggests that we will see some level of rebalancing in the credit markets at some point in the future. For us, what we're doing right now is, given the breadth of our platform, we're able to not only look at the private equity or sponsor-backed/owned companies, but we're also able to go and source and look at opportunities in the nonsponsor-backed portion of the market place. And we're spending a pretty significant amount of activity in that area of the market because we're just finding less efficiency there and some really interesting opportunities. That doesn't mean that we are avoiding the private equity marketplace. It just means that we're exercising a significant amount of discipline there to make sure that we don't participate in the over robust portions of that part of the marketplace. As it is today, since taking over management of these -- of this BDC, we've increased the nonsponsor portion of the portfolio to approximately 20%. And that's up from about 7% when we initially took over.

Operator

Next, we have a question from Chris York of JMP Securities.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Just one follow-up. So if I look line by line at nonaccruals or even noncore investments, is there 1 investment that you think has the best recovery value in the event, let's say, a couple of bulk case events occurred?

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

We're generally not in the practice of commenting on individual investments. But I would say as a general statement, the -- especially in the noncore underperforming portion of the portfolio, I think we've commented in the past and -- that this portion of the portfolio is marked at an average fair market value of about \$0.38 on the dollar. And while business conditions -- specific business conditions in the market environment could change and lead to some downside there, we think there is the possibility of also generating some significant upside there, just given where those positions are currently carried today.

Operator

We have no further questions, Mr. Mosticchio.

Michael Mosticchio - *Oaktree Specialty Lending Corporation - IR*

Thank you again for joining us for our third fiscal quarter 2018 earnings conference call. A replay of this 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 10121985, beginning approximately 1 hour after this broadcast.

Operator

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



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