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OAK - Q2 2018 Oaktree Capital Group LLC Earnings Call

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CORPORATE PARTICIPANTS

Andrea Williams *Oaktree Capital Group, LLC - Head of Corporate Communications and IR*

Jay Wintrob *Oaktree Capital Group, LLC - CEO*

Bruce Karsh *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Dan Levin *Oaktree Capital Group, LLC - CFO*

CONFERENCE CALL PARTICIPANTS

Gerald O'Hara *Jefferies LLC - Analyst*

Michael Carrier *BofA Merrill Lynch - Analyst*

Alex Blostein *Goldman Sachs - Analyst*

Chris Harris *Wells Fargo Securities, LLC - Analyst*

Michael Cyprys *Morgan Stanley - Analyst*

Robert Lee *Keefe, Bruyette & Woods - Analyst*

Ken Worthington *JPMorgan - Analyst*

PRESENTATION

Operator

Welcome, and thank you for joining the Oaktree Capital Group's second quarter 2018 conference call. Today's conference call is being recorded. (Operator Instructions).

Now I would like to introduce Andrea Williams, Oaktree's Head of Corporate Communications and Investor Relations, who will host today's conference call. Ms. Williams, you may begin.

Andrea Williams - *Oaktree Capital Group, LLC - Head of Corporate Communications and IR*

Thank you, Laura. Welcome to all of you who have joined us for today's call to discuss Oaktree's second quarter 2018 financial results. Our earnings release issued this morning detailing these results may be accessed through the Unitholders section of our website. Our speakers today are Oaktree's Chief Executive Officer, Jay Wintrob; Co-Chairman and Chief Investment Officer, Bruce Karsh; and Chief Financial Officer, Dan Levin. We will be happy to take your questions following their prepared remarks.

Before we begin, I want to remind you that our comments today will include forward-looking statements reflecting our current views with respect to, among other things, our operations and financial performance. Important factors could cause actual results to differ, possibly materially, from those indicated in these statements. Please refer to our SEC filings for a discussion of these factors. 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 a solicitation of an offer to purchase any interest in any Oaktree fund. Investors and others should note that Oaktree uses the Unitholders section of its corporate website to announce material information. Accordingly, Oaktree encourages investors, the media, and others to review the information that it shares on its corporate website at ir.oaktreecapital.com.

During our call today we will be making reference to certain non-GAAP financial measures. For a reconciliation of each non-GAAP financial measure to its most directly comparable GAAP financial measure, please refer to our earnings press release, which was furnished to the SEC today on Form 8-K, and may be accessed through the Unitholders section of our website at www.oaktreecapital.com.

Today we announced a quarterly distribution of $0.55 per Class A unit, payable on August 10 to holders of record as of the close of business on August 6. Finally, we plan to issue our second quarter Form 10-Q next week.

With that, I'd like to turn the call over to Jay.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Thank you, Andrea, and thanks to everyone joining this call. The second quarter was a volatile period for financial assets, with US stock and bond prices moving in opposite directions. Lifted by the strong tech sector, the S&P 500 bounced back from a weak first quarter and was up 3%, shrugging off the threat of trade wars with China and others. At the same time, rising interest rates prompted a selloff in the investment-grade bond market. Furthermore, emerging markets volatility and foreign exchange tumults picked up late in the first quarter and have not abated.

In this uncertain environment, Oaktree performed well, and we've continued to provide our clients with solid, risk-adjusted returns for our strategies across Credit, Private Equity, and Real Estate. Looking back over the last year and a half, our closed-end fund strategies have harvested $19 billion of proceeds while investing only $11 billion, which we believe has been the right thing to do, given the favorable selling and financing environment for Distressed Debt, Emerging Markets Debt, and European and US Private Equity assets.

We will continue seeking investment opportunities around the globe and deploying capital across all our strategies in a disciplined and cautious manner with a focus on controlling risk and limiting downside.

Our financial performance in the second quarter of 2018 reflected our posture as a net seller in recent periods, with total AUM and management fee-generating AUM remaining roughly flat versus a year ago. Adjusted net income and distributable earnings were both down substantially year-over-year; a tough comparison, given the record incentive income in the second quarter of 2017, mainly due to our Principal Opportunities Fund IV generating considerable proceeds in that period. Conversely, we grew our net accrued incentive balance in 2Q18 based on strong investment performance, and made progress in moving closer to recognizing significant incentive income in the coming quarters.

We had a good quarter of fundraising, with gross capital raised of $3.3 billion, bringing this figure for the trailing 12 months to $9.6 billion. In the second quarter, capital raised for closed-end funds included closes for Transportation Infrastructure Fund of $1.1 billion, Special Situations Fund II of $700 million, and Real Estate Debt Fund II of $225 million, bringing that latter fund close to the $2 billion mark.

Specifically for Special Situations Fund II, we expect fundraising will continue throughout the balance of this year, bringing us near our $1.75 billion target by year end. The pipeline of opportunities for this fund looks strong, and the team expects to draw initial capital for the fund later this year.

For the balance of 2018, we'll continue raising capital for Special Situations Fund II, Transportation Infrastructure Fund, Real Estate Debt Fund II, and our Middle-Market Direct Lending Fund, which today stands at about $720 million and has already begun to deploy capital. Also, we've launched Power Fund V with a target of $1.25 billion, and are in the market with various income-oriented Real Estate and Emerging Market Debt vehicles. And we'll continue to engage in fundraising for our various evergreen strategies: Strategic Credit, Value Opportunities, and Value Equities.

Turning to investment performance, Oaktree closed-end funds generated an aggregate gross return of 4% in the second quarter, bringing the trailing 12-month return to 13%. Driving the strong 4% aggregate return were Distressed Debt at 6%, Real Estate strategies at around 4%, Special Situations Fund at 11%, and Power Opportunities at 7%. These returns, coupled with continued solid performance across our evergreen strategies such as Strategic Credit and Value Opportunities, at 4% and 5%, respectively, highlight the power of our incentive-creating fund platform. In the second quarter, we created net incentives of $61 million, and net accrued incentives have increased by 4% over the past 12 months, despite our having recognized $204 million in net incentive income in that same period.

Separately, an area of underperformance in the quarter was Highstar Fund IV, which we inherited when adding the Infrastructure team back in 2014. That fund began its investment period in 2010 and has performed below expectations, especially recently, based on the returns of its energy holdings, and now has a gross IRR of 6%. While the performance of Highstar Fund IV has not met our expectations, we believe we are moving in the right direction for Oaktree's Infrastructure business with a strong first close this quarter of $1.1 billion for our Transportation Infrastructure Fund and several interesting investments in the pipeline. We've recently made some changes to the team, creating a more appropriate structure for the opportunities we see in the transportation sector, and we are no longer pursuing a co-mingled energy infrastructure fund at this time.

Turning to open-end funds, investment performance versus benchmarks was mixed in the second quarter. As lower-quality high yield bonds continue to outperform B and BB issuers, our High Yield strategies have not fully participated in these benchmark performance drivers. Against a mixed backdrop for industry mutual fund flows in our asset classes, we experienced modest net outflows across our open-end funds of roughly $300 million in the quarter. More specifically, net outflows in High Yield Bond and Senior Loan funds were somewhat offset by net inflows to Emerging Markets Equities and the Global Credit Fund.

Focusing on Oaktree as an enduring institution has been a main focus of our leadership team since my arrival. We've made some important strides recently by naming Co-Portfolio Managers in two of our larger investment strategies: Real Estate and European Private Equity. John Brady, Portfolio Manager of all Oaktree Real Estate strategies - Opportunistic, Debt and Income; and Caleb Kramer, Portfolio Manager of European Principal Opportunities and European Capital Solutions, have both grown substantial platforms from what were both single stand-alone strategies initially.

By naming four co-PMs to manage Real Estate Opportunities, Real Estate Debt, and Real Estate Income alongside John, and by elevating three co-PMs alongside Caleb to manage European Principal Opportunities and Capital Solutions, we are continuing our recent trend toward having co-PMs managing most investment strategies.

It also reflects the natural progression for an enduring business. These promotions of long-tenured and highly proven investment professionals are a natural step in the continuing build-out of Oaktree's talent, resources, and capabilities.

So to sum up my remarks, halfway through 2018, our investment teams are doing a good job of navigating the uncertainty in this late cycle market. Investment performance remains strong in our closed-end and evergreen funds. And our pace of investment reflects our belief that we need to move forward cautiously and maintain risk control as the key component of our investment process. Fundraising is going well for the strategies that focus on some of the best investment opportunities in the current market, such as Special Situations Private Equity, Transportation Infrastructure, and multi-asset solutions such as the Global Credit Fund.

We are very well positioned with ample dry powder of over $20 billion at the fund level as well as ample liquidity on our balance sheet, should the market environment give us more and better opportunities. And importantly, we continue to make good progress in creating a more scalable and enduring platform for producing superior investment results.

And with that, I'll hand it over to Bruce.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Thanks, Jay, and hello, everyone. Since I last participated in a quarterly earnings call in April of last year, it is interesting to observe how few things have changed in the last 15 months. Despite recent volatility in emerging markets, the markets generally remain quite strong; credit fundamentals are good; default rates remain at historic lows; and our investment opportunities, at least in the Distressed Debt Opportunities funds, continue to be more attractive outside of the United States.

Importantly, investors seem to feel increasingly uncertain as to when this cycle will turn. As Howard analogizes, we may be in the late inning of a ballgame that could go on into an unknowable number of extra innings. What we also observe today, despite investor uncertainty, is their tolerance for risk. The divergence of returns by rating highlights the strong demand for risk that exists in the credit markets. CCC rated US senior loans outpaced BB and B rated loans by nearly 100 basis points in the second quarter. And retail was the top performing sector for the first half of 2018, illustrating the heightened appetite for risk.

Additionally, at almost $2.6 trillion, the amount of US leveraged debt outstanding has doubled since the end of 2007.

Finally, the average purchase and leverage multiples employed for LBOs are at historic highs. Not surprisingly, our Distressed Debt Opportunities funds were net sellers in the second quarter, as opportunities to buy publicly traded instruments remains scarce. In the quarter we remained focused on monetizing assets from legacy funds as well as investing a modest 4% from Opportunities Fund Xb, given that Opportunities Fund Xa is fully committed.

What could cause investors to change to a more risk-off psychology? The possibilities could include any number of factors, but we do know that rising interest rates and tariffs will bring increased pressure on highly leveraged businesses as well as businesses reliant upon international trade.

As Jay mentioned, we've seen a strengthening dollar in 2018; and, thus, emerging markets volatility has picked up. While these factors are by no means proof of an impending turn of the credit cycle, they have typically preceded increases in the supply of attractive distressed debt opportunities in the emerging markets.

Emerging markets debt generally continues to be overvalued, and vulnerable to domestic and exogenous shocks after a long period of easy credit provided by yield-seeking investors. We feel very well positioned to take advantage of opportunities in emerging markets because we have teams with expertise in Latin America, Europe, and Asia that are dedicated to finding these opportunities.

Over the past year and a half, I've been spending a good deal of time helping to launch a new multi-strategy credit platform called Global Credit. The Global Credit strategy's objective is to generate attractive current income and total returns while limiting volatility through diversification and rebalancing of asset allocation.

Based on our assessment of relative value, we can invest flexibly among Oaktree's 10 credit strategies to take advantage of changing market conditions. Our performance since inception has been encouraging, and client reaction has been strong. We are aware that a three-year track record can be important in marketing a product like Global Credit to intermediary channels, so we're taking a patient and long-term approach to building this business.

I look forward to answering your questions, but now I'm delighted to turn the call over to Dan.

Dan Levin - *Oaktree Capital Group, LLC - CFO*

Thanks, Bruce, and good morning, everyone. Financial results in the second quarter reflected strong investment performance, solid closed-end fundraising, and continued positioning as a net seller of assets across our closed-end funds. Net accrued incentives and shadow AUM both increased in the quarter and over the past 12 months, while strong realizations of $2.5 billion in the quarter continued to create a headwind for management fees. Management fees in the second quarter declined $7 million or 3% from the same period a year ago as benefits from our BDC acquisition, additional deployment activity, and market value gains were offset by realization activity in our closed-end funds.

Our closed-end fund management fees were down $15 million or 11% over the past year, as our net selling resulted in a $22 million decline in the fee basis of our closed-end funds in liquidation, which was only partially offset by the $7 million of incremental fees we have earned from new funds starting their investment periods or deploying additional capital.

Moving on to expenses, compensation and benefits increased $4 million to $104 million, and general and administrative expenses increased $7 million to $39 million in the second quarter from the same period a year ago.

A primary driver of these increases were higher expenses, which I previewed on the fourth quarter call, related to the Highstar Infrastructure team that Oaktree acquired in 2014. In 2017, a portion of the expenses attributable to that team had been paid by a legacy Highstar fund. That fund stopped paying management fees in the fourth quarter, and thereafter Oaktree became responsible for all the expenses of the team.

General and administrative expenses were also impacted as a result of increased product development costs. Looking forward, we continue to be highly focused on prudently managing our expenses while continuing to invest in our investment strategies.

Fee-related earnings were $51 million in the second quarter, down $18 million from the same period a year ago as a result of the decline in management fees and increasing expenses that I just mentioned.

Incentive income totaled $51 million in the second quarter, a decrease of 89% from the year-ago period as this year the strong realizations and distributions occurred primarily in funds that were not yet paying incentives. Additionally, we faced a challenging comparison with a record second quarter of 2017 which benefited from a Private Equity fund realizing large gains in going through the catch-up layer.

Investment income declined by 37% in the second quarter to $26 million. While investment performance was strong across most asset classes in the quarter, we did experience declines in Emerging Markets Equities and Japanese equities holdings.

Moving on to DoubleLine, AUM grew by 1% in the second quarter, and 10% over the past 12 months. Fund performance continued to be excellent, with the vast majority of mutual funds with three year or more track records outperforming their benchmarks. Over the last 12 months, DoubleLine has contributed $71 million to our fee-related earnings and $73 million to our distributable earnings.

Adding it all up, for the second quarter, we generated $91 million of adjusted net income or $0.51 per Class A unit, and $114 million of distributable earnings or $0.69 per Class A unit. We declared a distribution of $0.55, which brings our distributions over the last 12 months to $2.83.

We raised $3.3 billion of gross capital in the quarter, of which $2.4 billion was in closed-end funds. This capital caused shadow AUM, which is how we refer to committed capital that has not yet started generating management fees, to grow to $14.1 billion at the end of the second quarter, up 10% from a year ago.

Net accrued incentives grew by 4% sequentially in the second quarter to $900 million or $5.72 for operating group units. We have created $236 million of new, net incentives over the last 12 months. Of the total net accrued incentives balance, 80% resides in evergreen funds and closed-end funds that are in liquidation, boding well for future distributable earnings and for equity distributions. This pool of potential future incentive income is quite diverse, with 39% represented by Distressed Debt strategies, 34% represented by Private Equity, and 19% represented by Real Assets.

In terms of capital management, in the second quarter, we issued our first perpetual non-cumulative preferred units at a rate of 6 5/8%, generating net proceeds of $174 million. This additional liquidity further strengthens our balance sheet and provides us with additional dry powder at the corporate level to invest in the growth of our business.

With respect to the third quarter of 2018, at this point, our known fund-related investment income proceeds are $7 million, and we have no known net incentive income thus far. While it's difficult to predict with certainty, my current expectation is that incentive income in the third quarter is likely again to be modest and below the second quarter total. Looking further ahead, I continue to be optimistic about the outlook for incentive income.

We're making good progress on moving certain of our funds, such as Opps VIII and Mezz III, to the point where they will start paying incentive income. Additionally, as we continue to have strong investment performance in our evergreen funds, which typically pay incentives at year end, I feel the outlook for incentive income over the next 12 to 18 months is positive. Given current trends, we reiterate our comments from prior quarters that we do not expect significant growth in management fees until the onset of Opps Xb's investment period which we still expect to be in the latter half of 2019.

In conclusion, our message is consistent with the past few quarters. We feel good about the strong investment performance across closed-end and evergreen funds, as well as our posture as a net seller of assets at this point in the cycle. We will continue to be cautious and prudent in our pace of deployment if current market conditions continue, and we are well positioned with ample dry powder for when the opportunity set expands.

With that, we are delighted to take your questions. So Laura, please open up the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Gerald O'Hara, Jefferies.

Gerald O'Hara - *Jefferies LLC - Analyst*

If I heard correctly, there was a first close of roughly $1.1 billion for the Transportation Infrastructure Fund. Could you perhaps give us a sense of what the terms look like on that fund, as well as the length of investment period, and what the -- just the overall kind of outlook on the structure of that fund looks like? Thank you.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Thank you, Gerry; appreciate the question. So the Transportation Infrastructure Fund will have a five-year investment period once the investment period starts. I'd rather not get into the specific other terms and conditions of the fund, but we expect it to be a great first Oaktree Infrastructure fund.

As I mentioned in my comments, we've got a nice pipeline of investment opportunities. We'll continue raising throughout the course of this year, and possibly very early next. The main event for us is to ultimately get it closed and to start investing and delivering good investment performance. We have a great roster, by the way, of limited partners in the first close, which is also giving us a lot of optimism.

Gerald O'Hara - *Jefferies LLC - Analyst*

Great, thank you.

Operator

Michael Carrier, Bank of America Merrill Lynch.

Michael Carrier - *BofA Merrill Lynch - Analyst*

Jay, maybe one for you. I understand the dynamics in terms of realizations weighing on the asset base and not deploying as much in this backdrop. I'm just trying to understand, maybe over the next few years, obviously when Xb turns on, you get the inflection on the fees, but it sounds like there's also some new business initiatives that are in place to drive longer-term growth. And I know we can look at the shadow AUM as a partial driver of that.

But I just wanted to get a sense, like over time, do you see enough maybe growth opportunities for Oaktree that you can be growing like the business, the asset, the earnings, obviously with Xb, but even without Xb? And not looking for just the next 12 months, but just a lot of the initiatives that are going to drive longer-term growth.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Michael, thanks. It's a very fair and good question. And the unequivocal answer to the question is yes, I do. A couple of comments on context. It's not just a matter of more realizations than deployment, which has challenged the current management fees, for example, subject to Xb turning on, but also we have a reasonable amount of AUM that charges fees on invested capital. So, in a different environment, maybe the environment that turns on Xb, we also expect the pace of deployment in other strategies to increase. That will also help with fees, by way of example.

In terms of some of the other areas that give us a lot of optimism, you mentioned Transportation Infrastructure, it came up in the first question, but also the Real Estate platform continues to grow, and has broadened out to be both opportunistic, but in addition, a pretty extensive debt platform and a growing income platform. The Emerging Markets Debt and Equities platforms continue to grow. Senior Loans, both here and in Europe, will continue to be a growing strategy, especially in the form of CLOs and managing CLOs.

The direct lending area, not only with the BDCs, but with our Middle-Market Direct Lending Fund, European Capital Solutions Fund, and you can see how far along these are invested so there's likely to be follow-on funds, these are all making very good progress. And I think you'll see the direct lending area broadly increase.

And then finally, Bruce can speak about it, but we are patiently, and I think very effectively thus far, building a very strong platform for multi-asset solutions in the form of the Global Credit Fund. The performance track record is strong after a year and a fraction. And as Bruce mentioned, there's a whole intermediary channel that we think will be much, much more stronger and relevant when we get to a three-year track record. And that's not to say we don't plan to continue growing the Global Credit Fund between now and then.

So I do see, across all of these strategies lots of opportunity, and I do believe we can grow. It won't be as lockstep as what you'll see when we turn on the fees on Opps Xb, obviously. But I do think there's a lot of other strategies that are building strong platforms and will grow more quickly in a different environment.

Michael Carrier - *BofA Merrill Lynch - Analyst*

Okay, that's helpful. And then just on the open-end and evergreen side, it looks like, this quarter, the net flows turned a little bit more favorable. You mentioned some of the ins and outs. But just given what's going on in the market backdrop and given the client base, are you seeing more interest or more demand in some of the product areas that are offsetting some of the outflows that we have seen over the past couple quarters? Just because it does look like, this quarter, things transitioned more towards on the inflow direction.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Yes, we do. And as I mentioned in my prepared remarks, it's really been Emerging Market Equities and the Global Credit Fund picking up the pace, and a moderation, but still some net outflows in Senior Loans, especially I think in Europe this last quarter, and in High Yield.

But underlying all of that, Michael, is the fact that right now, our risk control focus, which we strongly believe in, knowingly doesn't allow us to capture all of the upside in some of these asset classes, in exchange for what we believe is very prudent limiting of the downside. And in a market where CCC bonds, for example, have for some period of time now outperformed B and BB, we are not surprised by the results we've seen thus far. But for the moment, Emerging Market Equities and Global Credit Fund are picking up the pace and helping to offset some of the outflows in those other classes.

Michael Carrier - *BofA Merrill Lynch - Analyst*

Okay. Thanks a lot.

Operator

Alex Blostein, Goldman Sachs.

Alex Blostein - *Goldman Sachs - Analyst*

So maybe just to build on Mike's question, a little bit of a strategic angle here. So clearly the ins and outs of FRE growth near-term are pretty clear. But Jay, as you step back, how do you feel about M&A? And I ask only because a lot of the initiatives you are building out are fair and potentially taking some time. But the balance sheet is very strong and Dan mentioned you issued preferred, which you already have a lot of liquidity on the balance sheet, so help us think about the opportunities on the M&A front for Oaktree.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

I think in terms of being interested potentially in some M&A, our interest continues. M&A involves markets and valuations, and the same conditions that have got us focused on realizations of assets makes some of the acquisition opportunities a lot less attractive. For us, a lot of it is about value, most of it is about value. At these levels I think it's challenging to find very attractive M&A opportunities, although I think there are some individual circumstances we continue to work on that are very interesting to us. So the interest is there, but again, valuation is key.

And it's also very -- I'll mention something that's probably obvious, I think the competitive situation is very strong, not only from some of our public alt competitors and other funds, but obviously the growth of the large secondary funds, several of which are focused on purchasing GP stakes -- minority GP stakes. And those transactions, though most of them are not public, seem to be getting done at extremely high values so that's also impacted the market. I think in a different environment, opportunities will grow significantly and I think we'll be prepared.

Alex Blostein - *Goldman Sachs - Analyst*

Understood. Great.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Let me add a little bit to that. One area that we all know is seeing explosive growth over the last five years is direct lending. I think it's an area that is prime for having real issues over the next couple years. You know we bought our BDC platform, and I think that would be a great basis for doing more acquisitions of troubled BDCs and other issues that are going to, I think, surface over the not-too-distant future, say a year or two, in direct lending.

Alex Blostein - *Goldman Sachs - Analyst*

Great, thank you. And then, Bruce, as we have a benefit of you being on the call, and you started to answer part of my second question, but you're right, there has obviously been a ton of growth in direct lending, and a majority of the public firms obviously talk about the opportunity set there. If you were to think about areas that seem a little overextended to you from the terms of the valuation perspective within the direct lending space, what would they be? I guess Either by sector, geography, or size, any of the areas that are starting to flash yellow for you?

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

We'll start with just sponsored deals. I think there's been a huge, huge incentive for people to just put money out. And you're seeing, as I mentioned in my prepared remarks, leverage ratios, purchase multiples, at all-time highs. I think you're going to see a lot of issues. But the flip side, of course, is that we've got an economy in the US that's very strong, aided by the Tax Act and deregulation. I am not saying it's going to happen tomorrow, but the signs are all there, the seeds have been planted for a great opportunity for folks like Oaktree to take advantage of what are going to be real issues in direct lending.

Alex Blostein - *Goldman Sachs - Analyst*

Great, thanks. And just a cleanup question for -- Dan, for you. So management fee sounds like a similar message as last quarter. As we think about the margins -- obviously margins ticked down this quarter, quarter-on-quarter; and obviously, for the first half, down year-over-year. Anything you could do to help protect the bottom line on FRE until Xb turns on? Or the margins are probably going to continue to face some downside pressure?

Dan Levin - *Oaktree Capital Group, LLC - CFO*

Yes, as you think about margins, the biggest driver of our margins are going to be our management fees. As we go through and look at the outlook for our management fees, we likely will see a little bit of pressure from the trends that we're talking about, being net sellers. As we look into 2019, I'm optimistic that the closed-end fundraising that we're doing this year, funds like Special Situations II, Power V, should start their investment period, start paying fees on committed capital, and offset or somewhat offset the pressure that we're seeing.

In terms of expenses, our G&A expenses were a little high this quarter relative to what I would describe as a run rate. We had some either non-recurring or episodic items that hit G&A this quarter. I would note that as you think about G&A, we did have modest placement fees this quarter.

As I look out to the end or the rest of 2018, what you could see is you could see placement fees rise a little bit; run rate, other than placement fees, decline. That's the outlook for the rest of the year. We look at placement fees as good things, because they are reflecting the fact that we are going to have future management fees related to them. And obviously we only enter into placement fee arrangements that we think are highly accretive to the business.

Alex Blostein - *Goldman Sachs - Analyst*

Great. Thanks for taking all the questions.

Operator

Chris Harris, Wells Fargo.

Chris Harris - *Wells Fargo Securities, LLC - Analyst*

I wanted to ask you a question on what you talked about in terms of what you're seeing in emerging markets. Really wondering how nimble you are able to be if things really started deteriorating over there. That's the first part of the question. Second part is are you starting to see defaults rising in parts of the emerging markets?

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Well, it's a good question, and that's ground zero for an area that's primed to really experience problems, and it's already starting to happen. We haven't necessarily seen the kind of defaults, anywhere near the kind of defaults that we expect to see, but you had over-exuberant, yield-hungry investors put way too much money into that area. As I mentioned in my prepared remarks we're primed and positioned to take advantage.

Now, in terms of how nimble can we be, just to give you an example, in Global Credit Fund last year, Emerging Markets was the --top performing credit strategy of the 10 credit strategies that make up Global Credit. At the height, it probably was 12% of our Global Credit Fund, and by the end of last year, beginning of this year, notwithstanding the great performance, we ratcheted that down to 1.5%. We actually got as low as almost 1%.

At least in the Global Credit Fund product, we can move. Also, Julio Herrera, who manages our debt products, has done a great job of managing his assets there, realizing, generating exceptional returns, much better than the indices, and, even on an absolute basis, very attractive. It harkens back to the question that I answered with Alex, which is we do direct lending, too. In fact, we have a group that does sponsored loans in direct lending, but I have very much confidence in our group that we are patient, disciplined.

As Buffett likes to say, when the tide goes out, we find out who's swimming with bathing suits and who's not. I'm confident that our sponsored direct lending group is swimming with bathing suits, and I know that our Emerging Markets group is as well. I have even greater confidence that there are many, many folks out there who aren't.

Chris Harris - *Wells Fargo Securities, LLC - Analyst*

Okay, great. Makes perfect sense. Dan, a quick question for you. The ENI in the quarter, $0.68, certainly not a bad result at all, but down at a bit from a few of the quarters last year. You had cited some good returns in some of your debt funds. Is the offset, or at least a partial offset, some of the performance in listed equities you had talked about earlier, like EM and Japan equities?

Dan Levin - *Oaktree Capital Group, LLC - CFO*

Our listed equities is really an impact to our balance sheet because the listed equities are open-end strategies primarily - we don't have a lot of evergreen capital in that area so it doesn't really impact the mark-to-market on our incentives created. Really the driver was just the mix of funds that are generating incentives, whether funds are going through a catch-up phase or not. Some of those details drive the quarter-to-quarter variance in incentives created. We think about it as a pretty healthy quarter for incentives created, driven by pretty strong fund performance.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Chris, I want to put in a good word. Bruce spoke about the Emerging Market Debt platform, but also we have a significant Emerging Market Equities business, and there are many of our clients who have an allocation to equities in emerging markets. I think we have done well, performance-wise. As I mentioned earlier, some of the flows there helped to offset some of the net outflows in a couple of other classes.

But more importantly, the investment philosophy of Oaktree generally also permeates the Emerging Markets Equities team. I think that they will do well if we have a different and more challenging environment in the emerging markets, which should bode well long-term for the development of their business.

Operator

Michael Cyprys, Morgan Stanley.

Michael Cyprys - *Morgan Stanley - Analyst*

I just wanted to circle back on some of the commentary on the BDC platform. Just curious if you could update us on how you are transitioning the platform, how you are building out the BDC business from here.

Bruce, just given some of the commentary you gave earlier in terms of some of the risks out there, how are you investing today in the direct lending space, given some of those risks? Are you more focused on non-sponsored deals? Is that mix shifting at all?

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

I'll start and then I'll turn it over to Jay. But we are focused on non-sponsored. First of all, on the BDC, when we inherited it, we found a lot of issues and concerning investments that had been made, but we've done -- our team there, led by Edgar Lee, has done a great job in an environment that fortunately was sanguine and gave us the opportunity to do so, to clean it up, if you will. We are quite comfortable with the BDC portfolios that we have now. We weren't when we first inherited them. It's really just a function of putting the Oaktree touch on it and getting the portfolios in a mode where we feel comfortable that they will withstand the turn of the cycle, and presumably, hopefully outperform others.

I would say on the BDC side, there is a focus toward non-sponsored direct lending at this stage.

Jay, did you want to add something?

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Yes, I agree with all those points, Bruce. A couple of other matters - first of all, I think the integration of the BDCs into Oaktree has gone very well from an operational point of view. That platform is strong should other opportunities arise, like Bruce talked about earlier.

Secondly, the shareholders of one of the BDCs, OCSI, has approved increasing leverage in that fund, should the managers led by Edgar Lee choose to do so, consistent with the new regulations on BDC leverage. Then, on what Bruce said, I think that because of the strong market and the capital going into the sector, it's probably allowed us to reposition the portfolio a bit quicker than we anticipated, which is a good thing, and remake more of the portfolio into Oaktree's own image a bit quicker.

I think you'll start to see that, or you've already started to see that, and they have their earnings call next week, in terms of the performance, in terms of earnings, and stabilizing of the NAV and such. We're encouraged by the progress there, and more of the same going forward.

Michael Cyprys - *Morgan Stanley - Analyst*

Great, thanks. And just really quickly just on the leverage ratio, taking that up. Did you mention how much that would be going from to, and how much of assets that could translate into in terms of incremental?

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

I didn't. I think I'll leave that to be earnings call next week, if that's okay. But it's basically -- it can go up to 2 times leverage. Whether that's what the managers will choose to do, that will be their decision.

Andrea Williams - *Oaktree Capital Group, LLC - Head of Corporate Communications and IR*

That earnings call will be in two weeks time, on August 8.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Two weeks. Sorry, Andrea.

Michael Cyprys - *Morgan Stanley - Analyst*

Thank you.

Operator

Robert Lee, KBW.

Robert Lee - *Keefe, Bruyette & Woods - Analyst*

Just a little bit of a modeling, technical question, but if I think of Opps X and Opps Xb, Opps X, I want to make sure I have this right, I I believe their investment period ends in January and I think you may have said you've started to draw down as needed from Xb.

Is Opps X finished investing? And do we see a step down from fees from X, and Xb incrementally will draw capital through the end of 2019 when you are currently thinking you may turn on the rest of it? I'm just trying to get a sense of the pattern of X turning off and Xb turning on, and how fees will flow over time.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Let me take that. X is essentially fully committed at this stage. By the way, we're very proud of the results. The LPs will get our second quarter letter shortly, and see that the fund has a net IRR of running of over 22%. Not surprisingly, they are very happy, Xa LPs there. I think we invested in a tough time for distress, but we did a terrific job and it was all over, it was initially US when we first began Fund Xa, and the handover to Europe and now more recently Asia, is working well.

Interestingly, a lot of the investments that would be realized quickly, the public securities, have been realized already and redeployed and recycled into more longer-term private-type investments.

Even when Fund X'sinvestment period actually ends, I don't think you're going to see a significant realization pattern, distribution pattern in the near term because a lot of the investments we now have in that fund are longer-term, private-type situations that tend to be longer holds for us. That's point one.

Point two, we have started deploying Xb. I think we said something like 4%, but we've got some other things in the hopper, I think I mentioned that our focus is really outside the United States, Europe, there's some interesting opportunities there for us, and Asia I think is going to be much more of a factor as we continue to deploy.

I think we noted that we're not going to change our view about when the fees would be turned on there from middle of next year to maybe a little beyond. The only change to that that I could see is if all of a sudden there's some kind of great buying opportunity on the public side between here and there. Otherwise, we're just going to keep doing what we're doing. Mostly a lot outside the United States in interesting private opportunities that we're accessing and excited about. I hope that gives you a good framework to think about it.

Dan Levin - *Oaktree Capital Group, LLC - CFO*

Just to add, just as a reminder, as you are doing your more technical revisions to your model, our funds do not have a step down in fee rate when they exit the investment period, although the fee basis does change. To Bruce's point, given the amount of investment, and, in fact, the recycling and therefore the cost basis being pretty healthy on Opps X, we don't think there will be a meaningful decline there, and the fee rate will remain the same.

Robert Lee - *Keefe, Bruyette & Woods - Analyst*

Great. And then maybe a follow-up question. Maybe this is just broadly about capital raising and your LP base. You have always had a pretty broad LP base. And one of the things -- and you constantly hear about LPs trying to consolidate the number of managers they're using and you would seem to be the beneficiary of that, but to the extent that you, understandably, hold down a lot of your fund sizes maybe below what you could theoretically raise, do you ever think about running the risk of being relevant to your LPs who have so much capital to commit and are trying to find places to commit it? And that, hey, this is a good strategy, but you're only looking to raise $1 billion, and we just need to deploy more capital. I mean, do you ever think about that push and pull of fund size and being relevant to LPs?

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

I hear the same thing you do, Robert, about LPs really wanting to consolidate the number of GPs. They usually say that to us in the mode of 'you are one of the ones we want to consolidate toward, and not away from.' I agree with you that that trend benefits us and has probably benefited us.

To your point about potentially becoming less relevant because we're not taking out all the money we could take, I think the LPs appreciate that. They will appreciate it a lot more in a couple of years when they see how disciplined we have been relative to maybe some of the other folks. I don't get any sense at all that people are -- LPs are unhappy that we maintain caps on some of our funds, that we remain disciplined in how we invest, and the size at which we'll take.

Doesn't feel to me at all, as I travel around the world, whether it's Europe or Asia, that our reputation has been -- I think our reputation is as strong as it's ever been. I think it will be stronger in a couple of years, if, as, and when we go through a cycle.

Dan Levin - *Oaktree Capital Group, LLC - CFO*

Just to add to that, if you dig a little deeper into our fundraising over the last year or two, the largest institutions in the world have been allocating meaningful capital to us. If you think about who might be consolidating their GP relationships, a lot of them are the largest global institutions. As I think about where we have raised capital, including some of the closes we announced this quarter, we're getting our fair share from the leaders globally.

Robert Lee - *Keefe, Bruyette & Woods - Analyst*

Great. That was all I had. Thank you for the added color.

Operator

Ken Worthington, JPMorgan.

Ken Worthington - *JPMorgan - Analyst*

From my perspective, Oaktree is best known as the distressed manager, and you tend to distinguish yourself in the more, or even the most, challenging investment environments. And it's been a particularly long time since the global economy has been in that kind of environment, at least broadly. So what are the challenges you are facing as a management team?

So I think I get the challenges you face as investors in this kind of market. But what are the challenges you as a management team are facing from being the distressed manager in the generally non-distressed market? And how are you guys navigating those issues, if there are any?

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Thanks, Ken, appreciate the question. I don't know if I'd call it a challenge, but I think in times like these, especially on more cyclical strategies, it's a matter of reminding and refocusing ourselves on our investment philosophy and the importance of being disciplined and patient in deploying capital. We keep giving you those numbers each quarter and you can see what the results are. But frankly, we've made tremendous progress over the last five or six years in growing the platform, even against the backdrop that you painted of Oaktree being known more in the distressed side.

If you take a look across Transportation Infrastructure, the Real Estate platform, the Emerging Markets platform, the Senior Loans platform, the Direct Lending platform -- and I could go on -- those have grown dramatically, and just those categories are now north of $35 billion of Oaktree AUM. It wasn't that long ago -- five, six years ago -- that was under $10 billion. We're finding interesting things to do despite the environment that you described. And even in the environment you described, as Bruce mentioned, we're extremely proud of the results in terms of investment performance for Opps Xa, and we know the clients are very pleased with that.

I think that, again, reminding and re-reminding the team, which is not that difficult, frankly, about our philosophy, about the long-term benefits of the primacy of risk control, of making sure our clients are highly educated about our approach to investing, and we have very, very few surprises. Our clients understand that we are not going to capture in several of our open-end strategies, for example, the very top end of performance but that's because we're going to have less risk in our portfolios, as we define risk.

I think the team performs well. I mentioned that in my comments. I think we'll continue to perform well. I think the benefits of our general investment philosophy will become more apparent, as Bruce mentions, probably in the next couple of years. But in the meantime, we'll keep investing; we'll keep deploying in a way that we think we can be successful.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Let me just add that the people who are at Oaktree all understand and have bought into our investment philosophy. I think we continue to be an employer of choice. I know a lot of people would love to be at Oaktree.

My message to people is let's focus on investment performance because as long as we have superior investment performance, all good things will happen over time. Clearly, we'd love to see a cycle unfold here so that our discipline and patience will be highlighted, and we'll shine, and we'll go, at that point, to a higher plateau.

Until that point, there's nothing we can do about the environment. It does get a little frustrating to see a cycle that may turn into the longest in post-war history, but it is what it is. And it's not like we're not continuing to find some good opportunities and to continue to generate good incentive fees and good distributions.

So, our view is: just keep our heads down and continue to put up the great investment numbers. That's really the goal.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Bruce, you'd mentioned earlier, but during this period we've also really globalized the firm and so the investment platform in terms of personnel, resources, relationships, is clearly stronger today around the globe than it was certainly at the start of the cycle.

Ken Worthington - *JPMorgan - Analyst*

Fair enough. Well, thank you very much for the insights.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Andrea Williams for any closing remarks.

Andrea Williams - *Oaktree Capital Group, LLC - Head of Corporate Communications and IR*

Thanks, everyone, for joining us for our second quarter 2018 earnings conference call. A replay of this conference call will be available for 30 days on Oaktree's website in the Unitholders section or by dialing 877-344-7529 in the US, or 1-412-317-0088 outside of the US. The replay access code for this conference call is 10121537. That replay will begin approximately one hour after this broadcast. Thanks, everyone.

Operator

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