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Q1 2019 Oaktree Specialty Lending Corp Earnings Call

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## PRESENTATION

**Operator**

Welcome, and thank you for joining Oaktree Specialty Lending Corporation's First 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.

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

Thank you, operator, and welcome to Oaktree Specialty Lending Corporation's First Fiscal 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 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 a solicitation of an offer to purchase any interest in any Oaktree funds. 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 Edgar Lee.

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

Thank you, Mike, and welcome, everyone, to our first quarter earnings conference call. We appreciate your interest in OCSL.

We are pleased to report another strong quarter of financial performance.

NAV per share increased $0.10 or 1.6% from the previous quarter, marking the fourth consecutive quarter of NAV growth.

Our strong and diversified investment portfolio led to net investment income per share of $0.12 in the first quarter. We maintained this momentum even against the backdrop of a widespread sell-off in the equity and credit markets, including a 3% decline in the broadly-syndicated bank loan market.

In addition, we continue to reduce the overall risk in the portfolio, exiting $30 million in non-core investments during the quarter, including $18 million of non-income generating equity positions. Since January 1, we've exited another $56 million of non-core investments, including a significant recovery on our investment in Maverick, which I will talk about in more detail later.

And finally, we originated $231 million of investment commitments with attractive yields.

Delving further into the environment for direct lending, the volatility that impacted the equity and high-yield markets spilled into the broadly-syndicated loan market late in 2018. This resulted in spread widening and a corresponding decline in loan values. The impact on middle-market loans was less significant due to the typical lag between the direct lending and broadly-syndicated loan markets.

The debt and equity markets partially rebounded in January, but many institutional investors remain cautious, given where we are in the economic cycle. Against this backdrop, we remain highly selective and deliberate in our origination and underwriting with a continued emphasis on risk management.

All of that noted, I wanted to emphasize that we are also well positioned to continue capitalizing on new and interesting investment opportunities in our pipeline.

At the end of the first quarter, OCSL had $1.4 billion invested in 109 companies, excluding the Kemper joint venture, with 87% of that total in senior secured loans. OCSL's diversity ensures that we are not reliant on any single sector of the economy and our focus on loans at the top of the capital structure demonstrates our commitment to credit quality.

We continue to target larger, more mature businesses that operate in non-cyclical, defensive or structurally growing industries that tend to be diversified companies with lower amounts of leverage that help further minimize the risk of credit impairments in the portfolio.

The median portfolio company EBITDA has steadily climbed over the past year, rising from $54 million as of December 31, 2017, to $117 million at the end of the first quarter. Additionally, the average leverage on these companies has declined during the same period from 5.1x to 4.9x, while overall middle-market leverage remains elevated relative to historical norms.

Expanding upon our portfolio repositioning efforts, we exited $30 million of non-core investments during the quarter, including $18 million from equity investments. Despite this progress, our non-core holdings actually increased by $23 million to $347 million at quarter end, primarily due to the write-ups of our investments in Maverick Healthcare Group and Dominion Diagnostics, which totaled $52 million.

I'd like to spend a few moments discussing these write-ups in more detail.

Maverick Healthcare Group, a provider of home health care products and services, has been on nonaccrual since we took over management of the portfolio and was one of the largest investments originated by the previous manager. The company had been facing ongoing challenges resulting from adverse changes in Medicare reimbursement rates and was highly levered. Despite those challenges, we believed that the company still had value as an ongoing entity. We worked with the management team and the private equity sponsor, incentivizing them to restructure the company and develop a plan to maximize value. In early 2018, Maverick sold a division and paid down $9 million of its outstanding debt to us. We continued to work closely with management on its ongoing plan to sell the entire company. And in December 2018, the process entered its final stages, giving us confidence to write-up the investment by $42 million.

As I mentioned earlier, the sale process was successful, and we expect to recover our full principal balance plus accrued interest. Last week, we received $64 million or 97% of the outstanding balance, which represents an additional $12 million over fair value marks as of December 31. And we expect to receive the remaining balance of $2 million over the next several quarters.

This is an excellent example of how, as one of the premier distressed debt investors in the world, we utilize our skills and expertise to proactively manage underperforming investments in order to maximize recoveries and deliver positive outcomes for our shareholders.

Dominion Diagnostics, a specialty toxicology laboratory, is a large legacy investment that faced headwinds following the Medicare reimbursement rate changes in 2015, resulting in the previous manager placing the subordinated term loan on nonaccrual in March 2016. Following improved performance, the company embarked on a sale process in late 2018 that is currently ongoing. Given the significant initial indications of buyer interest, we are comfortable writing up this investment to $56.4 million. While there can be no assurances that the sale will close, we are cautiously optimistic that there could be further upside in the value of this investment.

At December 31, 74% of the portfolio consisted of core investments at quarter end with the remaining 26% in non-core. Excluding Maverick and Dominion, non-core holdings would have accounted for 19% of the portfolio as of quarter end.

Looking ahead, we will continue to be diligent in our efforts to maximize the value of the remaining non-core investments, and we look forward to providing you with an update on our progress on our next earnings call.

One of the differentiating features of Oaktree is our ability to source and structure unique transactions away from the crowded market for private equity sponsored-backed financing. The broad reach of our investment and sourcing professionals enables us to identify and assess nontraditional or infrequent borrowers that may require a highly structured financing. This is often a less competitive sector of the market, where we can structure transactions that lead to strong risk-adjusted returns for our shareholders.

During the first quarter, we originated $231 million of new investments, of which we funded $165 million. We achieved an attractive weighted average yield of 10% on total originations, meaningfully higher than our average debt portfolio yield of 8.7%.

I'd like to give you a couple of examples from the quarter that highlight OCSL's ability to coinvest alongside other Oaktree funds and demonstrate both the value of the outsourcing capability of Oaktree and our ability to provide compelling capital solutions to borrowers.

In one instance, Oaktree originated a $75 million senior secured loan to U.S. Well Services, a provider of high-pressure hydraulic fracturing equipment and services to oil and gas producers. The company, which operates both conventional and electric fracking fleets, is expanding and sought capital to fund the delivery of 2 new fleets. The loan we provided financed a portion of that purchase.

OCSL was allocated $30 million of the loan, which was attractively priced at LIBOR plus 775 with a 1.5 year maturity. We believe this is an appealing investment because of the significant hard asset value provided by the company's high-quality fracking equipment as well as a healthy equity buffer supported by the company's approximately [$500 million] (corrected by company after the call) public market cap. In addition, the loan has a favorable position in the capital structure with only a revolver senior to our loan.

Another example was Oaktree's $150 million first lien loan to Sorrento Therapeutics, a publicly traded biotech company that develops treatments for cancer, inflammation and infectious diseases. The loan was backed by the company's significant hard assets, which include 4 manufacturing facilities and valuable intellectual property portfolio. OCSL was allocated $37.5 million of this loan, which was priced at LIBOR plus 700. We also received equity warrants as part of the transaction, which could provide upside and generate future capital gains.

Our strong originations coupled with ongoing progress repositioning the portfolio drove solid results in the first quarter and highlighted the clear advantages of Oaktree's platform. We are capitalizing on Oaktree's scale, relationships, track record and adhering to a proven investment philosophy and discipline in investing.

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 $17.3 million or $0.12 per basic and diluted share. This compared to $17 million or $0.12 per share last quarter.

Total investment income of $38.3 million was consistent with the fourth quarter and up 20% from the third quarter of 2018. Contributing to investment income was OID accretion related to our first lien term loan with Dominion Diagnostics. Following the company's improved performance and subsequent write-up, we began recognizing OID income in the first quarter. Given our relatively low-cost basis and short time until the loans contractual maturity in April 2019, this generated $5.6 million of income. Partially offsetting this was a decrease in fee income from last quarter, when, as you may recall, we benefited from the early payoff of Allan Media.

Total expenses, net of waivers, were down $200,000 from last quarter, mostly driven by lower interest expense due to the reduced leverage we carried in the quarter.

During the quarter, we accrued Part II incentive fee expense and an offsetting waiver of $1.8 million. As a reminder, beginning in fiscal year 2019, we're required to accrue Part II incentive fees, which takes into account all capital appreciation and depreciation during the period, including unrealized gains. Importantly, these Part II incentive fees are subject to the contractual 2-year fee waiver and therefore, we do not anticipate paying any Part II fees in fiscal year 2019. Additional details regarding the mechanics of our management fees, incentive fees and related waivers are included in Note 11 of our 10-Q.

Moving to credit quality, as of December 31, 9.6% of our debt investments at fair value were on nonaccrual status compared to 7% for the prior quarter. The increase was mainly due to the write-ups of Maverick and Dominion. This was partially offset by $4 million in additional write-downs on two investments due to recent developments. Excluding Maverick and Dominion, nonaccruals would have been 6.2% of our debt portfolio at fair value.

Turning to net asset value. NAV increased to $6.19 per share from $6.09 per share on September 30, also mainly due to the write-ups on Maverick and Dominion. Additionally, net realized gains on investments we exited during the quarter totaled $1.8 million. The increase in NAV was muted by lower mark-to-market adjustments on our broadly-syndicated loans. The majority of these write-downs were directly tied to the market sell-off in December. Based on January's market performance, we have seen a rebound on the amount written down.

Moving on to leverage, our leverage ratio decreased to 0.70x from 0.75x on September 30, reflecting our decision to conservatively position the portfolio. Funded originations in the quarter of $165 million were exceeded by $208 million of proceeds from prepayments, exits and other paydowns.

With respect to OCSL's capital structure, we are planning to repay the 2019 bonds, which are due at the end of the month, with our credit facility. Looking ahead, we are evaluating longer-term financing options in order to further diversify our capital structure.

As of December 31, total debt outstanding was $613 million, and we had a weighted average interest rate of 5.3%.

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

Shifting now to the Kemper joint venture. As of December 31, the JV had $285 million of investments in senior secured loans to 42 companies. This compared to $295 million of investments in senior secured loans to 40 companies last quarter.

Leverage was down slightly from last quarter due to some portfolio exits, and the JV credit facility had $57 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 are proud of our progress in executing our strategic plan to position OCSL for improved performance and returns. While we have experienced improvements to date, we remain focused on a number of initiatives to further enhance OCSL's long-term return on equity.

First, we will continue to rotate out of non-income generating investments in order to grow our base of earning assets. During the quarter, we received proceeds of $25 million from six of our equity and limited partnership investments. Since quarter end, we exited our investment in Maverick, receiving $64 million of proceeds that we can now reinvest in income-producing assets. I'd like to illustrate the impact that redeploying these proceeds can have on the earnings power of the portfolio. Assuming existing conditions and that we are able to invest $64 million at our current debt portfolio yield of 8.7%, OCSL's return on equity would increase by approximately 40 basis points annually.

Second, we believe we can continue to improve the overall yield on the portfolio by rotating out of lower-yielding, broadly-syndicated loans. As we have stated on previous calls, we used the broadly-syndicated loan market as a tool to manage our liquidity. During the first quarter, we temporarily increased our holdings in these investments given our defensive posture. These loans are to large companies and are highly liquid. Over time, we plan to replace these investments with higher-yielding, Oaktree-originated proprietary investments.

Finally, I want to emphasize that we're making meaningful progress in optimizing the Kemper JV, and we have additional investment capacity there. As you may recall, we have taken a number of steps to reduce costs and position the JV for future success. Leverage at December 31 was a conservative 1.0x, and we expect to grow the portfolio over time as incremental investments are added to the joint venture.

Now turning to the dividend. As noted in our press release, our board approved a $0.095 dividend today, which has been stable for the last four quarters. Our goal remains to pay sustainable and consistent dividends supported by portfolio performance.

Before I turn the call over to Q&A, I'll provide an update on our capital structure. We are currently in discussions with our banking partners to refinance our credit facility, including amending certain terms and extending the maturity. As part of this process, we have also decided to modify our asset coverage limits and initial conversations with our credit providers have been positive.

We've pursued this change to ultimately provide us with additional operating flexibility to deploy capital if the market becomes more favorable. We do not plan to deviate from our current investment approach nor do we anticipate increasing our actual leverage beyond our target leverage of 0.70 to 0.85x at this time.

Last week, our board approved the asset coverage modification. And since we do not currently intend to seek shareholder approval on this matter, the new asset coverage requirements will go into effect one year from now on February 1, 2020. In addition, we intend to reduce our base management fee to 1% on all assets financed using leverage above 1.0x debt-to-equity once these leverage limits are in effect.

Going forward in fiscal 2019, we are excited about the opportunity to continue to 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 up the lines.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) And the first question will come from Christopher York of JMP Securities.

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

So Matt or Edgar, just continuing the question on your last topic of the reduction in asset coverage or increase in balance sheet leverage. Do you have any preliminary target balance sheet leverage that you would take it up to in February 2020 or after February 2020? And then, how are you thinking about the total return expansion potential under this scenario?

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

So, Chris, thanks for the question. Yes. As we said in our prepared remarks, our target ratio is not changing now nor a year from now when this goes in effect nor are we changing our investment strategy for the portfolio. So we did this -- to give you some color, we did this -- we've been watching it since it went into effect and watching the market reaction, what it appears to be doing, how the banks respond to it, the rating agencies, et cetera, all the different constituencies, and discussed it with our board. Earlier this year, within the last year, we also started thinking about amending or extending our revolving credit facility because we were within two years of ending the investment period. And when put altogether, it seemed that the appropriate thing was to amend and extend the revolving credit facility and as part of that, also modify the asset coverage. Yet not change our target leverage nor how we invest, but we thought it gave us more flexibility. It is something the market has seen and accepted. The banks were supportive. So as long-winded answer to say, we really don't plan to change how we invest or our leverage a year from now when it goes into effect.

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

Okay. And this also may be preliminary and it seems like it might not be applicable considering that your target balance sheet leverage would stay flat a year from now. But did you have discussions potentially about implementing a share repurchase program with the expanded leverage capacity? Because as you know shares have traded below book value and then book value has been up for the last 4 quarters. So empirically, it would've been nice accretion potential. So any thoughts on how that may have changed?

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

Chris, its Edgar here. If I can just add something to what Matt said and then I'll have Matt address your question around share repurchases. You had mentioned a year from now the intent is to leave the target leverage levels at the same levels they are today or we would see an expansion in the balance sheet. I'm not sure that's a fair characterization of it. I guess, how I'd dimensionalize this is that it really does depend on the market environment and what the opportunity set looks like at that point in time, which is hard for us to predict and look into our crystal ball today to determine that. I would say that we don't have an aversion to using the incremental leverage capacity that the board has approved for us to utilize a year from now, but we wouldn't be irresponsible or reckless in terms of how we utilize it and it would really be driven based on what the opportunity set is at that point in time. I'll get back to Matt to talk about shares.

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

So Chris, on the share repurchase topic, that is something we continue to look at and discuss with our board. We haven't done it to date, primarily for two reasons. One is we're focused on the liquidity on the underlying stock. So this will, obviously, reduce that. We hear a lot of comments on that. And the second is, that a share repurchase increases leverage. That's something that the rating agencies view negative. One of our objectives is to get an investment-grade credit rating or BB+ from S&P. We've discussed both with S&P and Moody's and Fitch our credit and opportunity. So for those reasons, we haven't done it yet, but we continue to look at it every quarter with our board.

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

Got it. Clarification from Edgar was very helpful and so was the color on the buybacks. Switching gears, new investments are again strong, highlighting the strength of your platform on the direct lending side. So what was the sponsor of -- or the mix from a sponsor, non-sponsor perspective? And then where are you seeing that you are taking share? May be meaning where did the borrower previously have a relationship?

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

I'm sorry, on that last part, where the borrower had a previous relationship with Oaktree or?

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

No, from their lender.

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

I'm sorry. So in terms of -- I'll give you a little bit of color. Just in terms of our new originations, just around 60% of our new originations or new commitments were to non-sponsored companies versus sponsored companies. And as you know, we've talked about this in the past. We do place an emphasis on trying to go into less competitive areas of the marketplace. And right now, we just think that's in the non-sponsor, non-acquisition financing area of the marketplace. So we'll continue to spend a decent amount of our time and resources focused on that space. And we think that gives us an advantage and we can see that in the numbers if we look at our new commitments; the yield on our new commitments is up about 10%, and that's really when compared to sponsor financings, materially higher than what you can achieve on first liens on the sponsor acquisition financing market. And we think that's a reflection of just a less competitive area of the marketplace. In terms of our new originations, in fact -- and also, in terms of originations, and commitments more broadly, very few, if any of them, are related to existing Fifth Street borrowers. That doesn't mean that we're not -- that doesn't stop us from working with those same private equity sponsors, but we have very limited exposure to lending to Fifth Street borrowers.

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

Got it. And then a clarification, maybe not a clarification, but -- so you talked about the U.S. Well's loan with a maturity of 1.5 years. Was there any upfront or OID fees associated with that origination that could be meaningful?

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

There were OID fees associated with it.

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

Was it 2 points, 5 points? Just kind of trying to get a basis.

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

I don't know if that's been publicly disclosed, Chris, so I don't want to get too far ahead of myself since U.S. Well is a publicly listed equity here. How I would characterize it is, this was a bridge loan that we made to U.S. Well Services. We do have certain features in the loan that encourage them to refinance us out. But if they do refinance us out, we will receive additional economics beyond what the coupon is. And I think as we've talked about in the past, we are very focused on making sure not just to collect a coupon for a short period of time, but rather to make sure that our shareholders actually generate material dollars from any capital outlays.

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

Very thoughtful answer. Lastly, and then I'll jump back in the queue. So on Dominion, where is your mark, if you can talk about it, related to the range of initial indications of interest?

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

So it's a great question, but as I'm sure you can guess, there's a very limited amount that I can comment around it because it is an active sale process today. Let me characterize how we think about valuation at Oaktree, especially for companies that are going through a sale process. Our valuations, depending on what we think the public market valuations are for these types of assets. If we think that an M&A process could lead to an outcome that exceeds maybe where the asset would trade in the public markets, we will try to reflect that accordingly in the valuation. However, every M&A process has a certain level of uncertainty associated with that. And our valuation process is such that we will take some discount potentially, when appropriate, to reflect an uncertainty around a process. That doesn't mean that we don't think the process will be successful, but rather just taking a balanced approach to valuation, we feel it's appropriate to always try to consider embedding in valuations a certain level of uncertainty associated with the processes.

**Operator**

The next question will come from Paul Johnson from KBW.

**Paul Conrad Johnson** ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

I wanted to ask you, the OID that you guys mentioned for Dominion Diagnostics, do you expect that to continue into the current quarter essentially until you sell business? Is that something we can expect essentially to be recurring?

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

Paul, this is Mel. I'll answer that. At September 30, we had about $11.5 million of unamortized discount. And given the maturity of April of this year, we expect to accrete a similar amount this quarter.

**Paul Conrad Johnson** ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

Great. That's great color. And then my second question, I just want to make sure I'm thinking about this right. You mentioned in the -- in your presentation that you exited Maverick and U.S. Fitness for about $67 million, post quarter end. And we're looking at the fourth quarter -- or your fiscal first quarter fair value marks about $57 million. I know you mentioned you had about a $12 million gain on Maverick. So I think that implies probably like a $2 million loss or so on U.S. Fitness. But am I thinking about those numbers right? Is the $67 million basically a realized gain over the $57 million fair value mark that you previously had?

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

No. So I'll let Mel add comments, but how I'd characterize it is just take Maverick alone. So the transaction for Maverick, the sale actually closed this past January of this year. At that time, we received a cash pay down equivalent to about 97% of our debt investment in the company. The other $0.03 or so we anticipate receiving sometime either at the end of Q1 or Q2. As any sale process, there's typically an escrow associated with it that releases at some point and that would get us back to par on the loan. And if you take that into account, then you'll see that on the other investment there is a gain there. So Mel, if there's anything else?

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

No. That's correct. That's the way to look at it.

**Paul Conrad Johnson** ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

Okay. So we're basically not expecting like a $10 million gain in the first quarter this year on those 2 exits?

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

We will receive an additional gain on Maverick of approximately $12 million in Q1.

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

Calendar Q1.

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

Sorry. Thank you, sorry, calendar Q1, fiscal quarter two.

**Paul Conrad Johnson** ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

Sure. Okay. I understand. And then my last question, I just wanted to confirm you're in discussion with your credit facility providers and potentially looking at restructuring the facility. Do you guys have any one-to-one covenants on that facility currently?

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

We do in the revolver, yes. As part of this, we would amend that provision as well as a number of other provisions to extend the maturity and some other things.

**Paul Conrad Johnson** ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

And for the bonds as well, are there one-to-one covenants on those?

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

There is in one of the baby bonds.

**Operator**

And next we will have a question of Rick Shane of JPMorgan.

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

And I'm going to need you to follow my logic here for a little bit, but I'm basically trying to figure out, does it make sense, you've got the 2019 notes maturing and you talked about potentially issuing -- going back into the market and issuing additional notes or bonds there. When I look at the idea that you're going to pay those off using the credit facility, a year from now, you're probably not going to be significantly larger, so you don't need additional capacity on the credit facility. And when we look at the opportunity ahead of you in terms of moving towards investment-grade, continuing to revitalize the portfolio and look at where the baby bonds are trading, probably 150, 200 basis points above the credit facility, I'm kind of curious why you would do that now, especially given the flattening for a grade environment.

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

Sorry, I don't -- you had me until when you said do what now.

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

Sorry, yes. I'm curious why you would look to go to the fixed -- into -- why you would go into the notes market as opposed to just carry the borrowings on your credit facility for the next 12 months?

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

Yes. I think you're reading too much into Mel's comments on we always look at financing options, we look at various -- all the markets available to us. We want to have a diverse balanced capital structure. So that's something we'll continue to look at, look at where the market is, look at our capital needs, et cetera. So you shouldn't interpret that, like, we're going to go into the unsecured borrowing market. To your point, given where we're running leverage now, where we see opportunities, we have plenty of capacity under our revolver, which we're, as I mentioned, amending. And we'll look at all those things. But I think getting to Mel's point, we want to be thoughtful and have a diverse, well-structured capital structure.

**Operator**

And our next question comes from Finian O'Shea of Wells Fargo.

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

Just looking at the success you have this quarter and congratulations on that with Maverick and Dominion. Kind of reflecting back from when you took over this book and there were, of course, big write-downs, can you kind of first break down for us how big of it was of a surprise versus what you thought you could turn around versus -- or what you thought would actually turnaround? And then just thinking about the rest of this distressed or nonaccrual book, as you work through that, can we expect a few more quarters of gains going forward as you perhaps work on moving these names off the book?

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

Let me answer it, it's Matt. So I think we have confidence in our abilities as a manager to work through assets, to manage the BDC well -- we have the skill and expertise to do that. How the timing and the format and how everything works out, you don't know until it's actually done. So I we have confidence in our ability, but we can't predict what's going to happen with everything. But we feel good about where we've come out. There's more work to do. There is not a ton more work to do. It's pretty limited to the names you can see. But that's how I'd look at it. Edgar, you probably want to add something to it.

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

I appreciate the question. Pausing here, because it's an interesting question. Look, I'd take a step back and say that in investing, whether it's in the distressed world, par lending, whatever asset class, whatever part of the marketplace, luck does matter quite a bit in investment outcomes. What we can do today based on our skills and expertise is position an investment to basically, hopefully, benefit from luck in some ways, and we can do the best we can to influence the outcomes as best as we can. Sometimes, investments are evolving stories and certain events occur that may lead us to be more constructive or less constructive on certain investments. And part of that, because of the nature of these legacy investments, part of our views on an investment from quarter-to-quarter, or from the point at which we underwrote the investment is based on how negotiations go.

And I would say there's been a tremendous amount of energy spent by Oaktree's investment professionals to engage in pretty extensive and intensive negotiations with borrowers, especially assets that are more troubled, and that influences a little bit of our view of what we think we can accomplish and what we cannot accomplish.

In both Maverick and Dominion, there was a tremendous amount of resources and time spent on these two investments. We knew that there was a fair amount of work that needed to be done. We benefited from some improvements in the operations and in many ways congratulations to the management teams there for their tremendous work they did to really stop the downward trends in these two businesses. In addition to our investment folks negotiating deals with the private equity owners and the borrowers to help encourage and induce them to pursue sale processes. And then we've benefited from, just as we've talked about before, a generally robust equity market, notwithstanding what's happened in December.

When we initially underwrote this portfolio, part of the reason that we were more constructive generally around the portfolio and our beliefs about turning over the portfolio was in part a belief that, given where we were in the economic cycle and equity valuations, that if we pushed quickly, we would be able to capitalize on generally a robust equity market and a strong appetite by strategic corporations and private equity firms to bid for these types of assets, which has benefited us. So in that sense there's a little bit of the "we got lucky", I would be lying if we didn't have some luck on our side. But there was also definitely a deliberate effort to turn these portfolios over quickly and in some cases engaging in very intensive negotiations with borrowers to help accelerate the turnover of these investments.

I generally think there are some additional opportunities, but specifically to the legacy portfolio, it's more limited because we just have turned over such a tremendous portion of this portfolio. And I'd say it's really a reflection of the intensive effort of the investment team here to really quickly turn this over. Assuming Dominion does leave the portfolio and Maverick has now left the portfolio, we really don't have that many additional legacy investments in the portfolio.

Now shareholders here will benefit in the future because we are engaging in new loans that do have the potential to generate equity upside or capital gains. Again, as we've always cautioned folks, there's no guarantee that will materialize but if we're able to find more opportunities, like Sorrento Therapeutics, where we received warrants with the loans. We are able to find more investment opportunities like Alvatec, which is a convertible instrument that we invested in, where we do have the potential to generate meaningful equity upside. We are populating the portfolio with those types of opportunities to continue to generate potential capital gains in the future.

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

Just sort of an extension on that matter, Edgar. I think you've informed me in the past that this workout effort has been in your group and not some other workout group. So I'm assuming you're approaching a freeing up of resources on the human capital side. So in terms of, sort of, what might change there, and perhaps you'll disagree, but I think this quarter's deals sound like a bit farther out on the complexity curve. Should we expect more of a drive there? Or or will this beget sort of a broader fundraise and more deal flow elsewhere at the time being? Any color there would be appreciated.

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

It's hard to know because the opportunity set can change from week to week, month to month. I would say our general bias here is that investors and shareholders invest with us because they want to get access to the type of investments that they might not get access to with other traditional BDCs and those investments tend to have some level of uniqueness to them. It's not always what I would say is complexity. Sometimes they're just unique situations that we have found where they haven't gone through a traditional path of some broker or some private equity firm calling up 20 different BDCs and direct lending funds to competitively bid for the loan opportunity. We are really doing a fair amount of our own self-origination here, which allows us to get to transactions that others are not seeing, which allows us to generate incremental yield.

Now I will caution you that they are hard to find. They are labor intensive to even find the opportunities. But when we do find them, they tend to allow for really attractive risk-adjusted returns, and even more directly, better upside, downside math for us, where we think our risk of impairment, not just because there's a sponsor who will, we think, will put more money in or something of that nature, but rather truly the core business, we think, our downside risk is more limited and we can still achieve very attractive outsized returns to the upside. And you can see that in our numbers. If you look back over time, our originations the prior quarter had a yield in the low 8%. This quarter, they're approaching 10%. And as we've, as you've noted, being able to slowly start to free up resources from really managing legacy investments and trying to work those out, to really going out and hunting more, that is showing up in the numbers and benefiting shareholders here.

**Operator**

And next, we'll have a question from Christopher Testa of National Securities Corp.

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

Just a couple of follow-ups on some things that you already discussed and then just a few other ones, if I may. Obviously, with the 2019 notes coming due, I know another caller had asked about this, but are you looking at this as potentially just taking up the balance with the revolver first and then sort of evaluating the landscape on where baby bonds might be priced, especially given that the Fed has been somewhat schizophrenic in what they might do with rates? So is that a good way to look at it?

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

Yes, I see it slightly differently that 2019s, they have a maturity. We have capacity and an attractively priced revolver to fund the maturity. And then, post that, we'll continue to look at opportunities in the markets to diversify our funding sources. We'll look at our capital needs, and we're going to be thoughtful and if we see a good opportunity, then we'll take advantage of it. If we don't, we're very comfortable with our capital structure, comfortable with the baby bonds, they're callable. So if we felt there was a better source of capital, we can take action there. So it's really just being thoughtful and looking at the markets and if we see a good opportunity, we have the ability to access it. If we don't, we're comfortable waiting.

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

Got it. Okay. That's helpful. And I know you also got asked by Chris York on the repurchases. Looking at, obviously, the volatility that's been recent where the repurchases could have been very accretive and the fact that a lot of what's considered the kind of Tier 1 actors in the space have, at least, the 10b5-1 place. How do you weigh this against the potential obvious negative from the rating agencies? Because on the one instance, you are actually reducing your cost of equity, which is a big part of the component even if the cost of debt theoretically were to go up given any negative actions or negative commentary from the rating agencies. And also on top of that, there are plenty of guys that do have the repurchases that also have an investment-grade rating as well from multiple rating agencies. So I'm just wondering how you holistically look at it in the context of all of that?

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

Sure, Chris. A good question. And we look at all of that. I think, that being said, today, we've been focused on and our goal is to get an investment-grade rating. We're close but not quite there yet. If we got there, then that's slightly different. It's a different fact. But we weigh all those things and act accordingly. So that's kind of how we're looking at it.

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

Okay. And I knew you had mentioned in the prepared remarks that the broadly-syndicated spread widening that we saw, which was very material, I think the average bid was down over 5.7% during the quarter. But the middle-market loans are somewhat insulated from that. Should we take that as the middle-market loans were not written down from technical factors at all? Or was it just somewhat muted relative to the, obviously, much higher degree of spread widening in the broadly-syndicated market?

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

In terms of our portfolio, we do mark all of our middle-market private loans on a mark-to-market basis. So we do take into account what is happening in the broader loan market, including the broadly-syndicated market. However, our private loans generally have materially higher spreads relative to the broadly-syndicated market. So there is a little bit more cushion built into those loans relative to might be what you see in the broadly-syndicated market, which helps mute a little bit of it. If we had seen a more severe dislocation in the syndicated market, the broadly-syndicated market, we might see a more pronounced movement in the valuations of our private loans in the portfolio. And it really just depends on a company by company specific set of facts, so I'm just making very general statements. So I wouldn't say that our private loans are not marking down because of that, just it's a little bit more muted because of the nature of those investments.

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

Okay. That's fair. And last one, just touching a bit more on the asset coverage. I know you had said in the remarks that you don't intend to change the leverage profile currently, and obviously, as you're seeking the investment-grade rating, I understand. But looking out into the future, if indeed we go into a multiyear or at least year environment of spreads widening and you're able to get more first lien loans, is this the sort of environment where you would evaluate, maybe, going to 1x or above 1x? Or should we only look at the 1.0 as just merely being the cushion so you're not tripping any asset coverage test?

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

I don't follow exactly the question. I mean, I think right now, as we look at the environment, we don't want to change how we invest, our investment strategy, don't want to change our leverage targets, right? But we think it's prudent and it's a good time as we're doing the revolver to get this flexibility and have the board take action. And the clock starts for year, right? Between now and the next year or past the next year, if the market changes and we come to view it if there is an opportunity where we should take leverage up then we'll potentially do that. If that happens within the first year, we can always go and have a shareholder vote if we deem that's the right thing to do. So it's -- if the environment changes, we think it makes sense to increase leverage above one-to-one or even closer to one-to-one given where our targets are now, we'll obviously look at that. Was that what you were getting at, Chris, sorry?

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

Yes, yes. That is. And just touching on you guys doing the board approval instead of the shareholder vote. Is that just simply because getting shareholder votes with BDCs is kind of like herding cats?

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

I wouldn't say herding cats because there's an expense involved in it and...

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

OK, But more of the expense, got it.

And just on Kemper, obviously, you guys wisely did a lot of investments there with back (inaudible) spreads. You still have a lot of room to run with the capacity there. But again, looking way further out, is this something that you view as potentially upsizing after the remaining capacity is exhausted? Especially if you want to keep the on-balance sheet leverage capped at 0.85, the rating agencies certainly don't seem to frown on economic leverage going above 1x given the JV or SBIC at some of your peers.

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

Yes, thanks for the question, Chris. I would say, one, I want to emphasize, and I think we've said this in the past, our partnership with Kemper has been terrific. And I know they've been incredibly supportive of our efforts and have been good partners here. If the environment is right, we can definitely expand the size of the JV. There are different ways to do that, but we would definitely consider those if we think the opportunity is appropriate.

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

Okay, great. Congratulations on the continued rotation out of legacy assets and non-accruals.

**Operator**

And this concludes our question-and-answer session. I would like to turn the conference back over to Mr. Mosticchio for any closing remarks.

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

Thank you, again, for joining us for fiscal first quarter earnings conference call. The replay for 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 10127865, beginning approximately 1 hour after this broadcast.

**Operator**

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