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Q4 2024 OAKTREE SPECIALTY LENDING CORP EARNINGS CALL

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CORPORATE PARTICIPANTS

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- **Christopher McKown** *Oaktree Specialty Lending Corp - CFO & Treasurer*

CONFERENCE CALL PARTICIPANTS

- **Operator**
- **Paul Johnson** *KBW - Analyst*
- **Melissa Wedel** *JPMorgan - Analyst*

PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Specialty Lending Corporation's fourth fiscal quarter conference call. Today's conference call is being recorded. (Operator Instructions)

Before I pass the call over to the Oaktree team, I want to remind you that comments on today's call may include forward-looking statements reflecting Oaktree's current views with respect to future operating results and financial performance.

Actual results could differ materially from those implied or expressed in the forward-looking statements. Please refer to OCSL's SEC filings for a discussion of these factors in further detail. Oaktree undertakes 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.

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

Dane Kleven *Oaktree Specialty Lending Corp - Senior Vice President and Head of Investor Relations*

Thank you, operator, and thank you all for listening in. We very much appreciate your support of Oaktree Specialty Lending Corporation.

I'd like to welcome you to our earnings call for the fourth fiscal quarter of 2024. 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. We encourage investors, the media, and others to review the information that is shared on our website.

Joining us on the call today are Armen Panossian, Chief Executive Officer and Co-Chief Investment Officer; Matt Pendo, President; and Chris McKown, Chief Financial Officer and Treasurer.

With that, I would now like to turn the call over to Matt to discuss our results.

Mathew M. Pendo *Oaktree Specialty Lending Corp - President*

Thanks, Dane, and welcome, everyone. Our adjusted NII for the fiscal fourth quarter ended September 30, 2024, was $45 million or $0.55 per share, which was consistent with our third-quarter results. NII for the quarter reflected our healthy origination and repayment activity, combined with the decrease in net expenses driven by our lower management fees that went into effect on July 1 and interest expense. This was partially offset by a modest decline in adjusted total investment income as certain investments were moved to nonaccrual status.

Full-year fiscal 2024 adjusted NII was $179 million or $2.23 per share compared to $178 million or $2.47 per share for fiscal year 2023. The dollar increase was driven by higher investment income generated from a larger average investment portfolio following last year's completion of our merger with Oaktree Strategic Income II, Inc., or OSI II impact of higher base rates and an increase in the prepayment fees and OID acceleration from successful investment exits.

These drivers were offset by an increase in investments placed on non-accrual status and higher interest expense, primarily due to our floating rate liabilities. The year-over-year per share decrease in adjusted NII reflects a higher share count from the issuance of common shares.

During fiscal 2024, we continue to rotate into primarily first lien loans. Our first lien investments increased to 82% from 76% at fiscal year-end 2023. Concurrently, second lien investments decreased from 10% to 4%. Investments on non-accrual status at quarter end were 4% at fair value and 4.9% at cost compared to 3.7% and 5.7% last quarter.

During the quarter, we successfully restructured two investments and removed them from nonaccrual. However, we placed three additional investments on nonaccrual status and took some further write-downs on certain investments.

Our net asset value per share decreased slightly to $18.09 from $18.19 last quarter. We are working closely with each company and using our resources and expertise to achieve successful outcomes for our shareholders.

Given that these non-accruals and additional write-downs had an impact on our earnings and net asset value, we waived $1.2 million of Part 1 incentive fees for the quarter. This is in addition to the $3.2 million of Part 1 incentive fees that we waived last quarter and $1.3 million of additional discretionary fees waived since the OSI II merger in January of last year.

As a reminder, we implemented a permanent reduction in the base management fee from 1.5% to 1.0% of gross assets effective July 1, 2024. We hope these actions reflect our ongoing commitment to our shareholders.

Turning to investment activity. We originated $259 million in new investment commitments during the fourth quarter at a weighted average yield of 9.9% compared to 11.1% in the prior quarter. We were pleased with this level of activity, albeit at lower yields, reflective of the current market environment.

We continue to identify compelling investment opportunities across sponsored and non-sponsored companies as well as an undervalued publicly traded credits, while maintaining our disciplined and selective investment approach in a competitive environment.

Paydowns and exits in the quarter generated $338 million in proceeds, up from $186 million in the third quarter. With refinancing activity increasing across the broader market, we have experienced higher levels of paydowns. We believe this speaks to the strength of our overall portfolio as well as our due diligence and investment process. These paydowns demonstrate the ability of our portfolio companies to successfully execute their business plans, positioning them to refinance debt at more attractive prices, reduce leverage or sell their businesses.

Turning to the liability side of our balance sheet. At fiscal year-end, we had substantial liquidity to fund our investment commitments and future investment opportunities. This included $908 million of undrawn capacity under our credit facilities and unrestricted cash and cash equivalents of $64 million.

Total debt to equity was 1.12 times and net debt to equity was 1.07 times after adjusting for cash and cash equivalents. With respect to the dividend, our Board approved a quarterly dividend of $0.55 per share, consistent with prior quarterly distributions. This dividend is payable in cash on December 31, 2024, to stockholders of record on December 16, 2024.

With that, I will turn the call over to Armen to provide more details on our portfolio and the market environment.

Armen Panossian *Oaktree Specialty Lending Corp - Chief Executive Officer, Chief Investment Officer*

Thank you, Matt, and hello, everyone. Before I review our portfolio activity, I'd like to provide a quick update on our leadership team.

I'm excited to announce the appointment of Raghav Khanna as Co-Chief Investment Officer for OCSL. Raghav joined Oaktree in 2012 as a member of our Global Opportunities Group before becoming a founding member of the strategic credit strategy in 2014, where he now serves as a co-portfolio manager and an investment committee member. His dedication and strategic insights have been instrumental in driving the growth of our platform, and I am looking forward to working alongside him as co-CIOs of OCSL.

With that, I will now turn to our portfolio activity for the quarter and concluded observations in the current market environment. Our portfolio remained well diversified across 144 companies with a fair market value of over $3 billion at the end of the fourth quarter. In line with our objective to lend to the -- at the top of the capital structure, at quarter end, 82% of our portfolio was invested in first lien debt, which, as Matt mentioned, is up from 76% one year ago.

To mitigate risk in the current environment, we are pursuing and investing in a diverse group of industries and larger companies. In the fourth quarter, the median EBITDA for our portfolio of companies was $140 million and the median leverage was 5.2 times.

This leverage ratio is roughly in line with the prior quarter, yet notably below the average for middle market companies. Our portfolio companies continue to perform well with a weighted average interest coverage ratio using current base rates at 2.3 times. During the fourth quarter, we invested $259 million into a diverse set of 9 new and 10 existing portfolio companies.

Now I will provide details of a few key investments. I will begin with Legends Hospitality, a premium experience company that delivers holistic solutions, sports and entertainment organizations and venues.

Legends was founded in 2008 by the ownership groups of the New York Yankees and Dallas Cowboys to manage concessions for two new stadiums. In August, Oaktree co-led a new $2 billion credit facility to support Legend's acquisition of ASM Global Parent, which provides venue management services to a global portfolio of over 350 stadiums, arenas, convention centers, and theaters.

Oaktree provided $145 million of the term loan, $17 million of the revolver, and $8.5 million of a delayed draw term loan. The term loan has a coupon of SOFR plus 5% and 2 points of OID. OCSL participated in $31 million of this deal.

Next, Integrity Marketing is a leading independent marketing organization and omnichannel insurance technology company that focuses on life, health and wealth products with an emphasis on the senior market. In the fiscal fourth quarter, Oaktree participated in a new $6.5 billion credit facility to support Integrity's debt refinancing, future M&A pipeline and working capital.

Oaktree provided $194 million of the term loan, $25.6 million of the revolver, and $137 million of the delayed draw term loan. The term loan has a coupon of SOFR plus 5% and 1 point of OID. OCSL participated in $36 million of this deal.

We made another significant investment in Everbridge, a global software company that provides critical event management solutions to global corporations, government agencies, and non-profit institutions with security management solutions that help with incident preparedness, risk monitoring, and service reliability.

In September, Oaktree co-led a new $1.35 billion credit facility to fund a sponsor's acquisition of Everbridge. The facility consists of $1 billion first lien term loan, a $100 million revolving credit facility and a $250 million delayed draw term loan. Oaktree provided $159 million of the term loan, $16 million of the revolver, and $40 million of the delayed draw term. The term loan has a coupon of SOFR plus 5% and 0.5 point of OID. OCSL participated in $27 million of this deal.

These investments demonstrate the power of the Oaktree platform, which is a key competitive advantage that gives us access to compelling investment opportunities as well as the ability to invest in larger transactions.

Now let's take a closer look at the credit quality of the portfolio. As Matt noted, we experienced an increase in the net number of non-accrual loans during the fourth quarter. While our team successfully restructured two investments that were previously on non-accrual status, we added Telestream Holdings and the second out tranches of Astra Acquisition Corp and nThrive to non-accrual status during the quarter.

Looking at the new additions, I'll begin with Astra Acquisition Corporation. Astra Acquisition Corporation is a provider of cloud-based software solutions for higher educational institutions. Our original investment in Astra was a first lien term loan that was exchanged into a Term Loan A and Term Loan B through a restructuring that closed in April of 2024.

Recently, bookings have trended lower, negatively impacting the company's EBITDA and the price at which these loans are quoted in the secondary market. These events caused us to put the Term Loan B, which is a second out tranche on non-accrual. We are working closely with management and the lender group to address Astra's declining revenue with the goal of maximizing value of our debt position.

Now I will discuss nThrive, a software company that helps healthcare clients manage their revenue and cash flow, in which we hold both a first lien and second lien term loan position. The second lien term loan was placed on non-accrual as a result of declining bookings and lower retention rates. We continue to closely monitor this name.

Next, Telestream Holdings is a video software platform that provides on-demand, digital video tools, and workflow solutions to a diversified customer base. Our investment in Telestream includes a first lien term loan and a small revolver. Although there was no valuation change at quarter end, we proactively placed both loans on non-accrual due to liquidity constraints at the company and concerns about collecting coupon interest.

Finally, as Matt mentioned, we restructured two names previously on our non-accrual list, Pluralsight and Impel. For Pluralsight in August, along with other lenders, Oaktree completed a recapitalization of the company equitizing part of our former position, receiving some take-back debt and providing additional capital to the company in the form of a delayed draw term loan and a revolving credit facility. We are working with management and the other lenders post reorganization and are confident in our ability to work through situations like these.

In the case of Impel, the company's primary product, Trudhesa, was acquired by a third party, who will be seeking to monetize the drug through a reinvigorated sales effort. In connection with the acquisition, OCSL and other debtors received a cash payment and the right to receive future payments if the acquirer achieves certain sales milestones.

Now turning to our view of the market environment. Although the fixed income markets have recently benefited from lower short-term interest rates, we remain in an elevated interest rate environment, which has materially increased the cost of debt capital especially for highly levered companies. Against this backdrop, we are in constant communication with our portfolio of companies to evaluate their businesses, end markets, and ability to navigate the current interest rate environment.

Our goal is to identify any potential issues as early as possible and to work collaboratively with our borrowers to resolve them. During the fiscal fourth quarter, credit markets continue to rally as the Fed initiated its easing cycle with a 50 basis point cut to the Fed funds target rate in September and another 25 basis point cut earlier this month. Base rates declined from the prior quarter and credit spreads continue to tighten.

The more active broadly syndicated loan market in combination with large amounts of capital is driving lenders to aggressively compete for new opportunities, which is also improving deal terms for borrowers. This has driven an increase in repricings and refinancing for many issuers in the private credit space.

M&A activity has continued to trend higher and the industry continues to be optimistic regarding future volume, anticipating increased activity in early 2025. Private market borrowers generally remain healthy, demonstrating stable revenues and EBITDA growth.

Interest coverage ratios continue to be a focus in the market. And with spreads tightening and SOFR rates declining, the average interest coverage ratio is expected to increase. Additionally, the fair value of direct lending investments increased from last quarter due to tighter credit spreads and overall solid fundamental company performance.

Turning to the impact of the US election. President-elect Trump is widely regarded as a pro business leader. He has committed to lowering corporate taxes, reducing regulation, and easing restrictions on energy production. These measures are generally favorable for corporate profitability. Moreover, we anticipate a surge in M&A and IPO activity under Trump's administration. This uptick in dealmaking is likely to create a strong pipeline of deals in 2025.

As I said earlier, we remain focused on the inherent risks of the current market. While the emergency inflation rate hike cycle is over and short-term rates have declined recently, we do not believe the Fed will take rates back to the ultra-low levels of the last decade. In other words, rates are likely to remain higher for an extended period, and this could be challenging for companies with elevated debt levels.

While inflation has recently subsided, high costs remain a challenge for companies and consumers. The environment appears to be improving. However, we believe it is prudent to remain cautious. We are closely watching market conditions and lenders' appetite to refinance companies with maturing debt as we believe companies refinancing needs, they have difficulty obtaining cost-effective capital and credit becomes less available.

Now I will turn the call over to Chris to discuss our financial results in more detail.

Christopher McKown *Oaktree Specialty Lending Corp - CFO & Treasurer*

Thank you, Armen. As Matt noted for our fourth fiscal quarter, we reported adjusted net investment income of $45.2 million or $0.55 per share, which was consistent with the prior quarter ending June 30, 2024.

Adjusted total investment income for the quarter declined $0.6 million or about $0.01 from the prior quarter. This was driven by a $2.7 million decrease in interest income resulting from placing certain investments on nonaccrual status, smaller average portfolio size and the impact of spread compression. These factors were partially offset by increased OID acceleration in connection with repayments.

We also had a $0.3 million decline in dividend income from the Kemper JV. These decreases were offset by a $2.4 million increase in fee income, which was primarily driven by pre-payment and exit fees.

Non-recurring income generated in connection with successful investment exits did have a larger than neutral impact on our results this quarter. To give you a sense of magnitude, our non-recurring income in the September quarter was about $0.09, whereas we generally see nonrecurring income in the neighborhood of about $0.03 to $0.05 per share per quarter.

Net expenses declined $0.6 million from the prior quarter, driven by a $2.5 million decrease in management fees, net of fees waived. $0.5 million of lower interest expense from lower average borrowings and $0.2 million of lower professional fees, partially offset by $2.6 million of higher Part 1 incentive fees, net of fees waived.

Now moving to our balance sheet. OCSL's net leverage ratio at quarter end was 1.07 times, down from 1.10 times at the end of the third quarter. Repayments and sales of $338 million outpaced our newly funded investments of $233 million. This, in combination with the markdowns this quarter resulted in a slight decline in the size of our portfolio.

Our net leverage remained within our targeted range of 0.9 times to 1.25 times. As of September 30, total debt outstanding was $1.66 billion and including the effect of our interest rate swap agreements had a weighted average interest rate of 6.7%, which is slightly down from last quarter.

Unsecured debt represented 57% of total debt at quarter end, up marginally from the prior quarter. Our liquidity remains strong, including $64 million of cash and $908 million of undrawn capacity on our credit facilities. Unfunded commitments excluding those related to the joint ventures were $284 million with approximately $248 million eligible to be drawn immediately. The remaining $36 million is subject to certain milestones that must be met by portfolio companies before the funds can be drawn.

Now turning to our two joint ventures. Together, the JVs currently hold $454 million of investments primarily in broadly syndicated loans spread across 49 portfolio companies. For the quarter, the JVs again generated attractive annualized ROEs, which when combined, were approximately 11.2%.

Leverage at the JVs was 1.4 times in aggregate at quarter end, flat with the last quarter due to a slight increase in unrealized depreciation in the underlying portfolios partially offset by repayments received from portfolio companies during the quarter.

With that, we appreciate your participation on the call today and for your interest in OCSL. We are happy to take your questions now. Operator, please open the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Paul Johnson, KBW.

Paul Johnson *KBW - Analyst*

Thanks. Good morning. Thanks for taking my questions. Just on the incentive fee waiver this quarter. Just trying to understand if this is going to be something that the adviser is committed to on a go-forward basis to the extent that NII trends below the $0.55 dividend?

Mathew M. Pendo *Oaktree Specialty Lending Corp - President*

Hey, Paul. It's Matt Pendo. Thanks for the question. So the -- this quarter, we announced a -- we described it as a discretionary fee waiver of $1.2 million. As you mentioned, last quarter, there was another -- the quarter prior to that, there was another discretionary fee waiver of $3.2 million.

We view those as discretionary, not permanent. So that's kind of how we're looking at it kind of quarter to quarter. This -- the July -- starting July 1 is when the management fee was reduced to 1%, that was permanent. So that's kind of how we approach the incentive fee waiver. And then obviously, the 1% management fee is permanent.

Paul Johnson *KBW - Analyst*

Got it. Thanks for that. And then just on a few credits in the portfolio. The nThrive obviously going on non-accrual this quarter, but it looked like it was just marked incrementally higher in the quarter. Thrasio also on non-accrual looks like it's still had a fairly strong mark quarter over quarter.

How do you feel, I guess, in terms of how comfortable are you with where either of those loans are having -- especially Thrasio which has been on non-accrual a little bit longer, I mean are we -- is that investment approaching point of resolution anytime soon? Is there any sort of update there?

Armen Panossian *Oaktree Specialty Lending Corp - Chief Executive Officer, Chief Investment Officer*

Thanks for the question. This is Armen. On Thrasio I think, look, this is an execution story that's going to take another few quarters. I wouldn't say that it is close to a resolution that we would think is value maximizing in the near term.

For FinThrive or nThrive, as it's known, there is public information out there that -- a press release that was disclosed yesterday, which we think is actually positive for the company and its stability. And we think that, that business is well positioned. But certainly, has some execution to do, and it's -- and has a lot of engagement from its sponsor. We are watching it closely, but I think FinThrive or nThrive and Thrasio are in very different positions.

Paul Johnson *KBW - Analyst*

Appreciate that. That's helpful. And then on Pluralsight, I realize at this point, after being restructured, it's not as large of an investment in the portfolio. But I was wondering if you could tell us, I mean, within the delayed draw or the revolver, I should say, is there -- the loan is still on PIK at this point. I mean is there anything that restricts the borrower from borrowing on the revolver to pay the interest on the restructured loan?

Armen Panossian *Oaktree Specialty Lending Corp - Chief Executive Officer, Chief Investment Officer*

I mean the revolver does have covenants and restrictions. I would need to give you a more detailed answer with the legal REIT. But that isn't the intention to draw on the revolver to pay the coupon. The revolver is meant to support the business as it repositions itself or strengthens its position, it's not meant to pay coupon interest.

Paul Johnson *KBW - Analyst*

Got it. And last one for me. If we get -- if 2025 next year ends up being a good year, and we have a very good wave of activity in the market. I mean how do you feel about kind of terms and covenants in the market? Do you think that direct lenders are going to be able to hold the line on kind of further covenant and term erosion? And kind of where do you think we stand in terms of how documents are going to be holding up in the market?

Armen Panossian *Oaktree Specialty Lending Corp - Chief Executive Officer, Chief Investment Officer*

Sure. I think in the lower middle market and the core middle market, so lower middle market between -- being companies with $20 million of EBITDA or lower, core middle market being $20 million to $70 million of EBITDA. I think in those two categories, we should expect to see reasonably good covenants, tested quarterly reasonably good protections in terms of stripping collateral away from lenders.

I think as you get larger as you get to $100 million, $150 million, $200 million of EBITDA, those businesses or those borrowers, comp their leverage terms to what could be available in the broadly syndicated loan markets, which are much weaker covenants. And therefore, I think there has been covenant erosion in that very large end of the market.

And I would think, though, that as deal flow picks up, that some of those covenants will come back on the large cap end. And on the core middle market and on the lower middle market, and I think they will continue to strengthen a little bit.

I think over the last 12 months or so, there's been a condition where there haven't been that many deals, and there has been a substantial amount of capital chasing those deals. So we have seen a tightening of spreads in the last 12 to 24 months, and we have generally seen a little bit of a loosening of covenants especially in that large cap end of the market.

And I think more deal flow will help to counter some of that. But it won't -- I don't think it will completely undo what has happened in terms of legal protections or spread compression in the market.

Operator

(Operator Instructions) Melissa Wedel, JPMorgan.

Melissa Wedel *JPMorgan - Analyst*

Good morning. If I'm reading between the lines a little bit, regarding your comments on the investment environment right now, it sounds like you're not necessarily expecting a normally large December quarter like we typically see on a seasonal basis, and you're sort of expecting that activity to pick up in early '25. Am I interpreting that right?

Armen Panossian *Oaktree Specialty Lending Corp - Chief Executive Officer, Chief Investment Officer*

Yeah. This is Armen, Melissa. We don't want to make forward-looking statements. And I would say that it's very hard to predict sort of fourth quarter and first quarter sometimes because deals that are slotted to happen in the fourth quarter, sometimes slip into the first quarter. Sometimes they're accelerated into the fourth quarter, which is more rare.

I would just say that over an extended period of time over the next 12 to 24 months with lower rates and with the decline in spreads that we've seen over the last 12 to 24 months, the expectation and some of the conversations that we've been having with sponsors and with non-sponsored companies has certainly picked up. The velocity of those conversations has picked up. It's hard to predict one quarter than the next, though.

Melissa Wedel *JPMorgan - Analyst*

Okay. Fair enough. I also wanted to go back to the JVs. I'm wondering -- we've seen that slip a little bit in terms of portfolio allocation year over year. I'm wondering if you see an opportunity, particularly in a more compressed spread environment to sort of further optimize those JVs and maybe generate some incremental income, and how that might be sized? I appreciate your thoughts.

Armen Panossian *Oaktree Specialty Lending Corp - Chief Executive Officer, Chief Investment Officer*

Sure. This is Armen again. We're always looking at optimizing the JVs. There are ways that we think we could do that. So I do think that there are some ways to get a little bit more return out of them. We have JV partners, however, so we -- and we are in constant dialogue with them, but expansion of those JVs really is a partnership.

And (technical difficulty) at this time about expanding those JVs. But we are constantly looking at the portfolio allocation there, the nature of the portfolio, public versus private positions as well as the quantum and cost of the leverage. So we will always look to optimize those for the JVs and for OCSL.

Melissa Wedel *JPMorgan - Analyst*

A quick follow-up there. In terms of the level of leverage in each of the JVs right now, can you give us just an update on how you're thinking about the current leverage and whether within the existing framework that's there if there's an opportunity to increase the capacity just through higher leverage? Thanks.

Armen Panossian *Oaktree Specialty Lending Corp - Chief Executive Officer, Chief Investment Officer*

Sure. I mean the leverage levels there are in the -- above 1 times. And we think -- sorry, and on a combined basis between the two JVs, it's about 1.4 times. We are looking to take it up over time. It's not going to be a significant and sudden increase, but we do think that there's a little bit of leverage capacity there to increase given the nature of those portfolios on the -- the performing names in those portfolios are largely publicly traded debt that you can get a much higher than 1.4 times leverage multiple on.

And we do have some legacy positions in those JVs that existed prior to Oaktree's assumption of the management of OCSL that we're consistently or constantly looking to restructure and turn into performing credit assets for those JVs. And we will look to rotate out of the privates in there and make it largely a broadly syndicated loan portfolio with some increases in leverage beyond the 1.4 times that there is currently there.

Operator

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

Dane Kleven *Oaktree Specialty Lending Corp - Senior Vice President and Head of Investor Relations*

Thank you all for joining today's call and for your continued interest in OCSL. Please reach out if you have any additional questions. We appreciate your time today.

Operator

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

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