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PRESENTATION

Operator

Welcome, and thank you for joining Oaktree Specialty Lending Corporation's First Fiscal Quarter 2020 Conference Call. Today's conference call is being recorded. (Operator Instructions)

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

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

Thank you, operator, and welcome to Oaktree Specialty Lending Corporation's 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 Armen Panossian, Chief Executive Officer and Chief Investment Officer; Matt Pendo, President and Chief Operating Officer; and Mel Carlisle, Chief Financial Officer and Treasurer. 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 fund. Investors and others should note that Oaktree Specialty Lending uses the Investors section of its corporate website to announce material information. The company encourages investors, the media and others to review the information that it shares on its corporate website.

With that, I would now like to turn the call over to Matt Pendo.

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

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

We are off to a solid start to fiscal year 2020, with a stable NAV, portfolio appreciation, strong investment activity and continued progress reducing our non-core investments.

We reported first quarter NAV per share of $6.61, up $0.01 from the previous quarter. This marked our eighth consecutive quarter of increased NAV and, again, demonstrated the consistency of our performance. Our cumulative NAV growth over the past 8 quarters was $0.79 per share or 14%.

Adjusted net investment income was $0.10 per share for the first quarter, down modestly from the prior 2 quarters, when we experienced a number of nonrecurring events, including strong prepayment fees from U.S. Wells Services and other investments, as well as higher OID accretion on certain investments. In addition, interest income was lower due to declines in LIBOR during the quarter.

That noted, we generated $134 million of originations in the quarter. The majority of our first quarter investments were private placement transactions, where we co-invested alongside other Oaktree funds. Importantly, robust origination activity continued into January, giving us a great start on the current quarter. Armen will discuss this in more detail in a few moments.

As a result of these investments, we ended the quarter with leverage of 0.58x. That was up from 0.51x last quarter, but it was still short of our target range of 0.70 to 0.85x. So we have plenty of runway ahead of us.

We also continue to reduce risk across the portfolio and position it for stronger long-term performance by further exiting non-core investments.

We monetized $26 million across 3 names in the quarter. Following these exits, non-core investments accounted for 13% of our overall portfolio at the end of the quarter, down from 16% at September 30, 2019. Non-core investments have declined from $893 million to $174 million since we began managing OCSL more than 2 years ago.

We continue to work diligently on maximizing the values of remaining non-core investments, which will occur over time and are dependent on each specific situation.

With respect to our capital structure, we've recently received positive news. Both Moody's and Fitch assigned OCSL investment-grade ratings, citing our successful progress to date in exiting non-core investments, the strength and quality of Oaktree, and our low leverage relative to peers.

Additionally, we amended our credit facility to allow for the full 2:1 leverage, and we received unanimous support from our banking partners to make this change.

This provides us with greater flexibility and it is an important milestone as we continue to evaluate ways to optimize and enhance our capital structure.

With that, I will now turn the call over to Armen.

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Thanks, Matt, and good morning, everyone. I'd like to start by sharing our view on the overall market environment.

The loan markets rallied in the quarter, buoyed by improving investor sentiment as positive macroeconomic conditions endured, including ongoing job growth and GDP expansion. This helped drive some appreciation of our portfolio and supported the increase in NAV. That said, direct lending continues to be highly competitive given the abundance of capital that private credit funds raised over the past several years to meet demand from institutional investors, including BDCs, CLOs and other private lending vehicles.

Private equity purchase price multiples continue to be at all-time highs, and spreads are historically tight. Intense competition continues to produce terms and conditions that, overall, favor borrowers.

Against that backdrop, we remain mindful of relative value and are investing where we can find the best risk-adjusted returns. As many of you know, here at Oaktree, we are able to source from multiple origination channels, including middle market sponsor and non-sponsor lending, as well as broadly syndicated loans and bonds. This provides us with a unique and wide array of investment opportunities.

Overall, borrowers' financial health and their ability to repay are both stable, in concert with the growing U.S. economy. But we continue to see one-off instances of deterioration in certain loans held by a number of direct lending funds. We believe that this could create more attractive investment opportunities for OCSL in the future.

Despite competitive challenges and our conservative posture, we were able to capitalize on the Oaktree platform to originate $134 million of new investment commitments across 13 issuers. One of these transactions was an add-on investment to support the growth of an existing portfolio company, while the remaining were new portfolio company investments made across the primary market. Of our first quarter originations, $98 million, or 73%, were privately placed.

I'd like to provide you with a few prominent investment examples from the first quarter. To start, Oaktree was the sole lender of a $35 million first lien loan made to Chief Power Finance, a power plant operation that generates and distributes energy to customers in the Midwest and the Northeastern U.S. OCSL was allocated $23 million of the deal, and the loan is priced at LIBOR plus 6.50%.

In another deal, we were allocated $12.5 million of a $40 million Oaktree commitment to help finance a private equity firm's acquisition of TEG, an Australian-based provider of ticketing, promotions, venue operations and data analytics to the growing live entertainment industry. This second lien loan was a club deal and was attractively priced at LIBOR plus 8.00%.

And lastly, we co-invested with another Oaktree strategy on a $43 million first lien loan priced at LIBOR plus 5.75% to Corrona, a provider of real-world observational data for autoimmune diseases used to support the pharma industry. OCSL was allocated $16 million of this loan.

As Matt noted, the pace of originations remained strong. We have closed $112 million in 6 deals to date in January. In total, these deals were attractively priced with a weighted average yield of 8.7%, and 94% were first lien loans.

Among these originations was a $31 million first lien loan to CIG Logistics, a provider of logistics services to the energy sector. Oaktree was the sole lender in this $100 million deal, which was well structured and priced at LIBOR plus 8.50%.

Another deal that funded in January was a $39 million investment in Olaplex, a leading global specialty hair care product company with a proprietary patented formula that repairs and strengthens damaged hair. Oaktree committed $139 million in total to this first lien loan, which was priced at LIBOR plus 6.50%. The CIG and Olaplex investments, coupled with the first quarter deals I shared, demonstrate our capabilities to identify unique and attractive opportunities across multiple industries and origination channels.

Importantly, we also continue to identify timely and profitable exits that help position us for continued growth. Early this calendar year, for example, we completed the process of selling our position in YETI. This highly accretive exit allowed us to convert equity to cash that we can redeploy into interest-earning investments over time, one of our ongoing objectives towards improving our ROE.

Looking ahead, we are patiently, yet opportunistically, evaluating a range of interesting investment possibilities in our pipeline that we believe present an attractive risk/reward. We believe we are well positioned with ample liquidity to take advantage of attractive opportunities.

Now turning to the overall portfolio. We remain focused on defensively positioning OCSL's portfolio by maintaining diversity across issuers and borrowers, focusing on senior secured opportunities and lending to larger and more diversified businesses with lower leverage levels. The portfolio's characteristics were relatively stable from the prior quarter. We held $1.5 billion of investments across 106 portfolio companies. 80% of our investments were senior secured, of which 57% were first lien. This slight increase from 54% the previous quarter continued a gradual migration to more first lien positions. The remainder of our investments consisted of 5% unsecured debt, 7% equity and LP interests and 9% investments in the Kemper JV. The median portfolio company EBITDA was flat at $156 million, and leverage was 5x at the close of the first quarter, below overall middle market leverage levels, which remain elevated.

Turning to the non-core portfolio. We continued to make meaningful progress, reducing exposure to non-core investments in the first quarter. The $26 million of non-core positions that we monetized in the first quarter brought the non-core portfolio down to $174 million or 13% of the portfolio.

In summary, we are pleased with the ongoing progress of reducing the size and risk in the non-core portfolio, and we are confident that we are well positioned to deliver attractive risk-adjusted returns to our shareholders throughout 2020.

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

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

Thank you, Armen. For the first quarter, OCSL reported net investment income of $7.8 million, adjusted net investment income of $14.1 million or $0.06 and $0.10 per share, respectively.

As a reminder, we define adjusted NII and NII excluding capital gains incentive fees or Part II incentive fees. Including the impact of a 2-year contractual fee waiver expiration, which ended on October 17, OCSL accrued a total of $6.3 million in Part II incentive fees during the first quarter. This amount was composed of a nonrecurring $5.2 million reversal of previously accrued fee waivers, stemming from the October 17 waiver expiration, and $1.1 million of accrued Part II incentive fees related to net appreciation in the portfolio during the first quarter.

Ultimately, the $6.3 million Part II incentive fee accrual recognized this quarter was primarily driven by unrealized gains in the portfolio, and it is important to know that while GAAP requires us to take unrealized gains into account when accruing Part II incentive fee expense each quarter, OCSL will only pay Part II incentive fees annually and to the extent that it has realized gains that exceed realized and unrealized losses.

During the quarter, the total investment income was $31 million, down from $34.5 million in the previous quarter. The $3.5 million decline was due to lower interest and fee income, partially offset by higher dividend income. Interest income was down by $2.3 million quarter-over-quarter, mainly due to the decrease in LIBOR, resulting in downward pressure on interest income from our floating rate investments.

We recorded $1.5 million in lower fee income quarter-over-quarter, mostly due to higher loan prepayment fees that we received last quarter relative to this quarter.

Net expenses for the first quarter totaled $23.1 million, up $4.9 million sequentially. The increase was primarily driven by higher accrued Part II incentive fees, including the nonrecurring impact of the 2-year contractual fee waiver expiration. This was partially offset by lower interest expense due to the decrease in LIBOR and lower Part I incentive fees, mainly due to the decrease in investment income.

Turning to net asset value. NAV was $6.61 per share at quarter end, up slightly from its level at September 30. Market appreciation on a number of portfolio investments benefited NAV in the first quarter. This was offset by the increase in accrued Part II incentive fees that I previously mentioned.

Moving to credit quality. As of December 31, only $451,000 of debt investments at fair value were on nonaccrual status, which represents less than 0.1% of the total portfolio.

Turning to the balance sheet. Our leverage ratio increased 0.58x from 0.51x on September 30 as the portfolio grew modestly during the quarter. We funded $136 million in investments, which was greater than the $97 million in payoffs and exits.

As of December 31, total debt outstanding was $539 million and had a weighted average interest rate of 4.5%, down slightly from the September quarter. Cash and cash equivalents were $21.5 million. There was $322 million of undrawn capacity on the revolving credit facility.

Last week, we announced that we will redeem the 5.875% 2024 notes in full on March 2. As you know, we are always focused on improving our capital structure and reducing our cost of funding. To that end, we believe that repaying these notes will be accretive to shareholders.

Shifting now to the Kemper joint venture. As of quarter end, the JV had $352 million of assets invested in senior secured loans to 51 companies. This compared to $361 million of total assets invested in the same number of companies last quarter. Leverage at the JV was 1.3x at December 31, up from 1.2x last quarter, and its credit facility had $60 million of undrawn capacity at quarter end.

Now we'll turn the call over to Matt.

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

Thank you, Mel. We are proud of the progress we have made in delivering improved performance and returns since we took over management of OCSL in late 2017. We continue to believe that we have additional runway in front of us to further enhance our ROE, while maintaining our conservative approach to managing the portfolio. We have discussed these initiatives in the past, and we have made important progress in all of them.

One way that we will be able to drive higher returns is by deploying more leverage at the portfolio level. We have made some progress on this during the quarter as we selectively grow our portfolio with what we believe to be attractive yet conservative investments, given where we are in the economic cycle. That said, we are still operating below our long-term target of 0.7x to 0.85x. So we do have the ability to enhance returns as we continue to make investments and deploy higher leverage.

However, we will only grow the portfolio as we find opportunities that are consistent with our investment approach and that we believe offer attractive risk-adjusted returns.

In addition, we continue to exit noninterest-generating investments and redeploy the capital into core earning assets.

At quarter end, we had approximately $100 million of noninterest-generating investments, which we recently just reduced by $15 million with the exit of our YETI stock.

Finally, our efforts to optimize the Kemper JV are contributing positively to our results. The JV added $44 million in first lien investments across 9 companies during the quarter, and the weighted average yield on the portfolio was 6.5%. As Mel mentioned, the JV's leverage at quarter end was 1.3x, well below the longer-term target of 2.0x. We expect that over time, the JV will increase leverage as it incrementally adds attractive investments.

Turning now to the dividend. This morning, we announced a $0.095 dividend that is consistent with our prior 7 distributions. We intend to continue paying sustainable and consistent dividends that are supported by portfolio performance.

In conclusion, we are pleased with our overall performance for the first quarter. We remain confident that we will strategically leverage Oaktree's significant platform to identify attractive risk-adjusted investment opportunities that deliver improved returns to our shareholders.

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

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

QUESTIONS AND ANSWERS

Operator

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

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

I'd like to sort of delve into footnote 3 in the press release related to the reversal of the fee waivers. It implies that there is about $3.9 million of waived fees that remain sort of subject to this reversal going forward. I'm curious what the triggering events for that will be, the time line and whether or not that is a liability that shows up on the balance sheet anywhere.

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

Thanks, Rick. That's a good question. This is Mel. The $3.9 million is permanently waived as it related to gains that occurred during the waiver period. So to put it in context, going forward, we'll look at the cumulative realized gains, unrealized losses and realized losses. And that $3.9 million will be netted against that. So there's not a future liability there. It's already taken into account when we calculate future Part II incentive fees.

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

Mel, I misunderstood that. So the -- I thought the $9.1 million was net of the $3.9 million. You drew $5.2 million against it this quarter, and there was $3.9 million remaining. I understand now. So basically, the $9.1 million was allocated, $3.9 million permanently waived, $5.2 million expensed this quarter.

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

Yes. $5.2 million related to the reversal of the waiver that expired on October 17. That's correct.

Operator

Our next question comes from Kyle Joseph of Jefferies.

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

Kyle, you might be on mute.

Kyle M. Joseph ***Jefferies LLC, Research Division - Equity Analyst***

Apologies. I was going to say congratulations on the investment-grade rating. I just wanted to get your initial sense of any sort of outlook on the right side of the balance sheet. And how the investment-grade rating would impact that from your perspective? I know you guys did mention you're going to redeem some of the 2024 notes. But from a longer-term perspective, how you envision the right side of the balance sheet now that you guys are investment grade?

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

Thanks, Kyle. It's Matt. So a couple things. As you mentioned, we did receive investment-grade ratings from both Moody's and Fitch, which is good news. That was very strategically important to us and a very good milestone. We also, as you mentioned, announced the redemption of our 5 7/8% notes, debt redemption, March 2. We have a shelf on file, and we'll continue to evaluate opportunities in the markets. Our other notes are redeemable at par with 30 days' notice. We have not announced that redemption. But those are kind of the pieces that we have, and we'll continue to look at the market and evaluate opportunities there.

Kyle M. Joseph ***Jefferies LLC, Research Division - Equity Analyst***

Got it. That's helpful. And then just one follow-up from me. Just in terms of the originations in the December 31 quarter. Could you give us a sense of timing? And were any of them back weighted? Just to get a better sense for the yield dynamics in the quarter.

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Yes, Kyle, this is Armen. I think your instinct is correct. A good amount of the originations were more in the second part of the quarter rather than the first part. And some of our repayments were a little bit front-end loaded. So there was a little bit of intra-quarter timing there, and we found that some of our originations got pushed later into the quarter and into January, frankly, that we had been working on in the fourth quarter.

Operator

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

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

Just a first question to expand on the fee waiver. It sounds like you partially reversed what you waived that you would have accrued. But just a bit of a surprise given it was a waiver and it sounds like you weren't counting the capital gains incentive fee part of that waiver. So is this sort of -- I'll ask it this way: Why the $3.9 million out of the $9-or-so million you were entitled to from what would have been a capital gains fee accrual over this period?

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

Sure. This is Mel. Let me take you through it. The thing that's driving the difference that I think that you're getting caught on is the inclusion of unrealized gains. Under GAAP, we're required to take into account not only realized gains but unrealized gains over realized and unrealized losses. And that's different than the way that we calculate on an annual basis under the investment management agreement. Under the investment management agreement, we are taking into account realized gains over realized losses and unrealized losses, so the gains that are related to the $5.2 million reversal are unrealized gains. So at $9.3 million for the fiscal year-end, we calculated under the investment management agreement, the incentive fees, the Part II incentive fees that would be due to Oaktree. And as part of that, realized gains that occurred during the waiver period, $3.9 million was permanently waived. And hopefully, that math gets you there.

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

And so the -- that is helpful. And -- but the unrealized part, those weren't ever really being waived because you reversed -- is that correct to say that you reversed that...

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

They were being waived during the waiver period. So we would otherwise have accrued higher Part II incentive fees. But for the waiver, we were accruing under GAAP during the waiver period.

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

Okay. Appreciate the color. And one more on demand diagnostics. This is, I think, your major remaining legacy name. That it looks like you moved the rate this quarter. It's still past maturity. The sub-debt was -- a few moving parts. The sub-debt was written down. The first lien is still pretty full. Can you explain, to the extent you can, what's happening in that credit?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Sure, Fin. This is Armen. We are in the midst of closing a restructuring transaction there. We have signed an agreement with the company and other stakeholders. So it is a little bit of a fluid situation. We'll have more to report on our next quarterly call. But right now, there isn't much more that I could say beyond that at right this second.

Operator

Our next question comes from Ryan Lynch of KBW.

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

First question has to do with the originations that you guys have made in calendar 2020. You guys have really strong originations so far quarter to date. Was that simply due to you mentioned some investments that you were maybe hoping to close in calendar fourth quarter that spilled over? Or should we view that as a sign of a growing pipeline and increased deal activity that you guys are seeing to start off the year?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Thanks for the question, Ryan. I think that maybe one or two of the deals, we had thought could close later in the year and they slipped. But I would say, generally speaking, the trend in the fourth quarter and into this year that we're seeing is a byproduct of kind of expanding our funnel, looking at a lot more sourcing and origination opportunities leveraging the entirety of the Oaktree platform. We've talked about this in the past as an opportunity that we think we could mine a little bit further and deeper at Oaktree, and we've done that. And so working in concert with other strategies at Oaktree, leveraging our trading desk, frankly because as there is potentially volatility in the markets, we're able to do some interesting things in the secondary market. So just kind of thinking more broadly, I don't want to give any sort of forward-looking guidance about originations, but we are pleased with some of the progress we've made to date and hope to continue to expand our efforts there.

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

Okay. That's helpful. And then I think you guys mentioned about 90% of your new investments originated this quarter were also investments held by other Oaktree funds. Can you just give us a reminder of the different Oaktree funds that OCSL can invest with across the platform? And what sort of size in AUM you guys have at your capacity that you guys can invest? And what can Oaktree kind of hold in the kind of middle-market direct lending across its platform that OCSL could participate in?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Sure. I can give you a sense for what those other strategies are. But by and large, several strategies at Oaktree are able to invest in different parts of what we would consider the middle market. Our Opportunities funds to the extent that these are more storied credits, they have capital available to invest in the middle market as well. We have a Special Situations group that invests in the middle market more on a control-oriented style, but they participate as well, and there are sometimes situations that may be unearthed through their activities that may inure to our benefit or vice versa, opportunities that we find that, frankly, are probably too high risk, and we show it to them. And we also have a middle-market sponsor finance team that also invests in both mezzanine and middle-market direct loans that are sponsor-backed. That's probably the most center of the fairway, middle-market direct lending activities that we have at the firm.

And then finally, our Strategic Credit strategy, which is a strategy that I am the portfolio manager of. This is Armen speaking. We are looking for middle-market direct loans and, frankly, are more specialized in highly structured non-sponsor deals. That's where I think our competitive strength is given the background of that team, being from -- in large part from our distressed debt team, our Opportunities funds, where structure matters a lot and deep analytics matter a lot. And so we think that we have a competitive advantage there, and frankly, are most excited when we see deals that meet that description.

I would direct you to our website for AUM details. But those strategies are the ones that are most applicable to what we do in the middle market. And as you know, Oaktree is predominantly a credit-oriented and below investment-grade credit-oriented shop with a significant amount of AUM, in total about $120 billion. So there are a lot of pockets of information and opportunity that we could tap for the benefit of OCSL shareholders, and it's something that I'm very focused on expanding.

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

Okay, that's helpful color. And then one more. Oaktree has done a really good job since taking over as the manager of this entity, I think some of your accomplishments you've done a good job of stabilizing stressed investments, reducing some non-core investments, growing NAV, improving the JV, and I know on your Slide 16, you guys have some areas that you guys are looking to continue to improve. But even having said all those accomplishments you guys have done since taking over the BDC, this quarter, your adjusted NII was a 6.1% operating adjusted ROE, which is far below the BDC average. So how do you guys plan on improving that ROE? And what do you think is a reasonable expectation for an ROE that OCSL should generate once you've accomplished those strategies?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

This is Armen. I'll take a crack at that. So we are very focused on improving ROE, but it isn't a single lever that we can pull to get us there quickly and predictably. One of the levers Matt discussed, which is the investment-grade rating and bringing down our cost of debt, that's been a very prime area of focus that over the medium to long term should inure to the benefit of our shareholders through higher ROE.

Working down our non-core assets are, as Matt mentioned, about $100 million at quarter end of non-yielding assets. Turning those into cash so that we could redeploy into yielding instruments, that takes time, but we've done, as you mentioned, done a good job of doing that. We don't want to rush that. We want to maximize recoveries and improve NAV. And that's the other lever. I mean, we've had several consecutive quarters of NAV growth, and that's been because of our patience in working out some tough situations. We still have a few tough situations to go, and we don't want to be hasty about converting those type of situations into a lower than what we think is optimal cash amount because we are in a rush.

In addition to that, we do want to be prudent in our investing. We're not looking to increase leverage for leverage sake and just to drive up ROE and dividends in an imprudent fashion. Our leverage levels are quite low relative to the rest of the BDC universe as well. That explains a lot of why ROE is lower than the rest of the market, and we don't have any intentions of massively increasing leverage, but we are meaningfully below our target range. And as we find good businesses that, in our estimation, do not have meaningful cyclical issues and are well-structured investments, then we will add them to the portfolio, and hopefully, we will increase the portfolio size overall to get a little bit closer to our targeted leverage levels, and thereby increase ROE that way as well. So I can't give you a sense for timing or an estimate on ROEs. But you should just know that we are pushing forward all of the various tools we have at our disposal to increase shareholder value by increasing NAV, ROE, et cetera.

Operator

Our next question comes from Chris York of JMP Securities.

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

First one is just kind of a housekeeping one for Mel. Will you guys be taking a Part II incentive fee on the YETI exit in this quarter?

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

So under GAAP, we're required to, as I stated before, we are required to accrue Part II incentive fees on both realized and unrealized gains, but we will only pay at the end of the fiscal year. And although YETI would be included in that calculation, we would also include any realized or unrealized losses at that time.

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

Understood. And then would you consider making any discretionary adjustments at year-end for waivers?

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

We don't have any plans to do that. We had the 2-year waiver period, during which we permanently waived $3.9 million of Part II incentive fees for fiscal 2019.

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

Okay. Some questions for Armen. So you've been in your role here for CEO for, I think, 6 months. So could you explain where you have spent the most amount of your time since being brought into the run to run the direct lending business since Edgar's departure?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Thanks for the question, Chris. Yes. I think where I've been spending most amount of time is working with the team on originating and analyzing loans. I would say I'm spending almost as much time understanding and working through some of the tougher assets that remain in OCSL. I think we have a very, very strong team that's been doing some great things for the last 2-plus years. And so I'm not looking to get in the way of that. But I do want to, for the benefit of our shareholders, understand what's going on in our tougher situations. I think my highest and best use vis-à-vis OCSL is to make sure that we're seeing as many deals as possible, expanding our funnel as wide as possible so that we could be very selective in what we do put into the portfolio and still be able to ramp. And that's where I've been spending most of my time, just with the analyst team with our originators, with other strategies at Oaktree that are looking at credit. Frankly, as you know, Oaktree has a very close relationship with Brookfield, understanding where there may be opportunities there as well that could benefit OCSL. There's a lot of potential there, and it just takes time and effort to work all of those different opportunity sets and that's my area. Those are my areas of focus.

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

Got it. Understood. Just kind of in light of that, obviously, change worries investors. So what expectations should investors have about the change in leadership and then maybe your proprietary expertise or relationship? You talked a little bit about focusing on the funnel. So maybe how does the change translate into better portfolio outcomes for shareholders?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Yes, it's a great question. So by way of background, Edgar Lee and I joined Oaktree within a couple of weeks of each other, both in our Distressed Debt group. We have a very similar background from an investment standpoint, and our career trajectory at Oaktree has been identical. When he left our Distressed group to start our Strategic Credit strategy, I also left our Distressed group to build out our Senior Loan strategy and Structured Credit strategies. And so we interacted at least weekly, if not daily, on many situations as we both departed our Distressed group. During our distressed days, we restructured and invested meaningful amounts of capital in a meaningful situation, learned a lot, compared notes a lot. So I don't think that from a background perspective and downside-oriented investing perspective, Edgar and I are any different. We were kind of cut from the same cloth and built within the DNA of Oaktree and specifically within the same group of Oaktree within Oaktree.

Where we may differ is, at this point, I'm also the head of performing credit at Oaktree, which means that all of our liquid and illiquid strategies report to me. I work very closely with all of those portfolio managers in a variety of different contexts, but what I am most interested in, in terms of leveraging that position, is to make sure that we are benefiting from the analytics that are available through all of those different strategies at Oaktree, for example, emerging markets, high-yield bonds, convertibles, structured credit. There's a lot of information that is developed at Oaktree and can be delivered for the benefit of OCSL shareholders, and I'm very focused on making sure that we see that information. There's also deal flow that under our prior leadership, we did not really see, and we probably didn't do as much as we could have in terms of leveraging some of those other strategies for that deal flow. And now with sort of the combination of all of those strategies under one umbrella, I've made it very clear that it is in everyone's best interest to work with each other to share information, analytics and opportunities. And we're doing a lot in that regard. In our sourcing and origination efforts, we are making sure that all of our sourcing and origination folks at Oaktree that up until now have been very focused on individual strategies are working across strategies now. Such that when we do have somebody who is looking for more opportunistic credit, higher-yielding equity-like returns to the extent that they did see something that was interesting for OCSL that we see that opportunity. And that wasn't something that was emphasized in the past, and it's being emphasized right now in meaningful ways. And so the dialogue has increased significantly, and that's probably the biggest difference. I can't give guidance on when that will materialize into meaningful and significant or appreciable value creation, but I think we're on our way, and I'm encouraged by what I'm seeing in terms of engagement across the firm and the opportunity set that we have been seeing in the fourth quarter and in January.

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

That's great color. Again, very helpful for us to have some visibility and understanding of where you're focusing your time. A follow-up to that would be kind of maybe on sourcing. So I'm not entirely sure if Edgar was responsible for sourcing unique deals, maybe like Sorrento, as an example. But should investors expect that you'll be instrumental in sourcing unique direct deals for Oaktree and then that could end up in the portfolio at OCSL?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Yes. I mean, so first, I would say we have a very, very strong team at Oaktree in the Strategic Credit team, and our middle-market direct lending team, as well as the other strategies at Oaktree. It has never been a one-man show at Oaktree in any strategy. Edgar is an amazing talent, very smart, great relationships and had created a lot of value and still does. Frankly, on Sorrento, he continues to serve on the Board of Sorrento representing Oaktree. So there continues to be a relationship with Edgar, but I would say that a lot of the origination that you've seen in OCSL and frankly, across Oaktree, it's really been driven by a variety of different individuals. We have a lot of talented individuals there, each with their own relationships and perspectives, and so I'm not concerned about loss of origination. Edgar was not an originator per se. He is an analyst like me, and as a result of just being in the markets as I've been as well, there are relationships and opportunities that you see. And so I don't see that losing Edgar is going to be an impediment that way. I would also say that a lot of what I see or what Edgar saw, we see it because we're at Oaktree. Oaktree has a reputation in the market for understanding tough situations, getting to a structure or a resolution that works in a very time-efficient manner. And that cannot be delivered by one individual. It has to be delivered by an institution, and the institution is as strong today than ever has been.

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

Yes, I think investors know that Oaktree is a very strong institution. Appreciate that. Last question is, with significant available capital, you're obviously operating below peer leverage. Investors have been patient for a while on redeployment and they've been incurring an opportunity cost. So what conditions specifically do you need to see in the market to be more opportunistic with capital? And could you provide a frame for maybe what the return expansion potential looks like when you are opportunistic?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Yes. So I would say there are 3 big-picture opportunity sets that I think OCSL could participate in. The first are middle-market sponsor financed deals. We've done some of those to date. Frankly, we are a little bit concerned about some of the lending practices and deterioration in credit quality, legal protection, et cetera, that we see broadly in that space. So we are not all of a sudden going to hit the gas and put in a bunch of middle-market sponsor financed deals just to be able to get more invested or more levered in the structure. However, if we do see middle-market sponsored deals that are noncyclical, well structured and offer appropriate compensation given the risk, then we'll take a very close look and add those to the portfolio, and we did some of those deals over the last few months. So that's kind of the first broad area. And I would say that's going to be unitranche deals, that's going to be first lien deals, maybe some second lien as well. But I would say, predominantly first lien and unitranche in that space. But we're not going to stretch for risk, and we're not going to take on deeply cyclical businesses to get invested, especially considering the leverage levels creeping higher and higher in that area.

The second area is the non-sponsor area. These are the bespoke financings that are industries or businesses that are either harder to understand by traditional cash flow lenders or have been shunned by the markets. And in those situations, oddly enough, the debt-to-total enterprise value tends to be much lower than even in the middle-market sponsor area. And the challenge is maybe they have a cash flow issue, maybe they need a bridge from their current situation through a cyclical issue that they're seeing. There are a lot of storied credits out there that could use a highly structured solution. We have done a few of those as well. I mean, we mentioned Chief Power, CIG Logistics. Both of those are situations where we took a very tight view of credit. We worked very closely with the borrower on structure, and we're able to deliver returns there, or yields there, that I think are better than average with a lot of downside protection. And so those types of deals are harder to predict in terms of timing, but when we see them, we know what we like about them, and we get a pretty good sense pretty quickly whether there's an opportunity there because we are very quick to turn around a term sheet that is quite deep in terms of its legal protections and other structural considerations. And to the extent the borrower doesn't need it or doesn't want it, then we're fine with moving on, but those are the opportunities that will be most differentiated for us vis-à-vis a lot of other BDCs you might see in the market, and we're looking to do as much of that as possible. And I think being at Oaktree, puts us in a very strong position to be able to find that type of deal flow.

The third area are middle market and other loans that have been syndicated, and we do take a look at that market. That market is trading very rich right now. The loans that we would find interesting, by and large, are trading at or near par. So there isn't much to do there, but there are periods of time where rating-sensitive owners of loans have some technical flow problems, and that creates a technical dislocation in the broadly syndicated markets or the tradable loan markets that we could find interesting from time to time. And we do participate in that area. We did buy some secondary loans in the last few months that had traded off for what we think were more momentary or technical issues rather than fundamental longer-term problems. And so we benefit from having a trading desk and a trading operation here that's servicing billions of capital in our opportunistic funds and in our other strategies, and therefore, our market connectivity is very, very high, and we get treated very, very well in the secondary and primary markets in the tradable credit markets as well.

So we're tapping all three of those opportunities. At different points in time, there may be one or two of those opportunities that are more attractive than the third, but by and large, where we get most excited is when the markets are in the greatest amount of trouble, both in terms of secondary trading and in terms of these bespoke financings, where the capital markets are shut down. And we are -- our capital is patient or has been patient, and we're able to take advantage of those opportunities.

I can't dimensionalize or give forward guidance on what returns should look like, but you could see that from some of our more opportunistic deals, like a CIG Logistics at LIBOR plus 8.50%, those types of opportunities are out there. Our Sorrento investment, as you know, we did a highly structured loan in that situation. It comes with some equity upside as well. And that was done because we have talented individuals here that understand life sciences, understand that clinical-stage development process and how to value technology that is developed through that process. And so we will take advantage of our depth and expertise both in terms of structuring and in terms of particular industries. I just can't predict the timing of it, and I can't predict the outcome of it. But when we do see it, like a Sorrento, like a CIG, like others, we are able to get meaningfully better unlevered returns or asset yields on those types of loans.

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

That's great color. Very, very helpful, Armen. So appreciate that. Thanks for giving us a flavor of your approach to portfolio management and then direct lending insights. Last question is: Do you think investors would benefit from consolidating maybe these 2 publicly traded BDCs that are operating below leverage into 1 publicly traded BDC?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Yes. I -- this is Armen again. That's not something that we are considering doing right now. And we are always looking at enhancing shareholder value and liquidity. But from our perspective, OCSI and OCSL have a different positioning. And we think that there's value in having those two disparate strategies in a public format. We would like to improve both of them and enhance shareholder value in both of them, but we do believe that they are distinct. And so there really is no plan right now to merge those two.

Operator

(Operator Instructions) And our next question comes from Bruce Martin of Still Lake Capital.

Bruce Martin

A couple of quick questions. Just from a high level. I know you answered the ROE levers, and you have a slide that talks about all the upsides to the equity. When you look at just how the first quarter is playing out, do you expect to increase leverage in the first quarter as you put on all those loans in January? And if so, if you just looked at a high level for the year in terms of the cadence of those ROE levers for this year, you've got the YETI thing and you may have increased leverage, I'm not sure, how would you sort of lay out how net interest income is looking at this point versus the fourth quarter? And all else equal, if that would be sort of the run rate for the year assuming no other changes, how are we looking now versus where we were last year?

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Sure. This is Armen. In terms of where we are in the year I mean, we are about a month into the year. And our leverage level has crept a little bit higher since December 31. We're at about 0.61x leverage at the end of January. So we are trending higher, but that's just one month, and I cannot predict what's going to happen in terms of repayments or originations for the remaining 11 months out of the year. I would say in terms of the cadence of deployment, we're certainly seeing a lot of deals. We're seeing -- we're seeing a lot coming through our origination channels, both from other teams at Oaktree and from our external-facing resources, but I think we're rejecting a lot. We're seeing a whole lot that we don't like, more frequently than we're seeing what we do like.

I can't really give any guidance on NII going forward. Again, we're only a month into the year, and I wouldn't want to give you guidance that I don't believe in myself or is not set in stone. Unfortunately, I have to decline answering that question.

Bruce Martin

A quick follow-up on the NII and then I have one question about YETI. How sensitive to a 25 basis point cut, assuming LIBOR falls similarly, how sensitive? Are you going to add to that?

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

So if LIBOR goes down, obviously, most of our portfolio is floating rate, it will go down. Most of our liabilities are [floating rate] (added by company after the call) -- obviously, we're redeeming -- we've announced the redemption of one of the 5 7/8% notes. We have one other fixed rate notes. And then we obviously have our revolver, which is floating rate on LIBOR. So that offsets it a little bit. But in general, if LIBOR goes down, our interest income will go down.

Bruce Martin

So basically, by the unlevered portion of the portfolio, I assume that goes down likewise?

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

Yes. And it also is kind of at what point in the month versus when our assets and liabilities we set? Was it 1-month or 3-month LIBOR? So it's not all that simple. There's some other kind of noise around it.

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Yes. And the other...

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

What happens with spreads on new issues to spreads? If LIBOR tightens down, the spreads widen. So it's not a straight line. I'm sorry, Armen.

Armen Panossian ***Oaktree Specialty Lending Corporation - CEO & CIO***

Yes. No. And the only other point I would add is that approximately half of the portfolio does have a LIBOR floor. It is at about 1%. So we could certainly sustain a pretty significant drop in LIBOR before that floor kicks in. But as you think about, just broadly speaking, in middle-market direct lending on a levered basis, whether it's BDCs or otherwise, I think as you model that out, you should probably think about LIBOR floors as well.

Bruce Martin

Okay. And then a quick on YETI. I know the price at the end of the quarter on the stock, it had dropped kind of meaningfully and then it rose kind of meaningfully. Can you give any color or indication as to whether that was above or below where you held it at the end of the fourth quarter where you sold it?

Matt Pendo ***Oaktree Specialty Lending Corporation - President & COO***

So we sold it slightly below our 12/31 mark.

Operator

We have no further questions, Mr. Mosticchio.

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

Thank you, again, for joining us for our first quarter earnings conference call. A replay of this conference call will be available for 30 days on OCSL's website in the Investors section or by dialing (877) 344-7529 for U.S. callers or for -- 1 (412) 317-0088 for non-U. S. callers, with the replay access code 10138082 beginning approximately 1 hour after this broadcast.

Operator

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