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NEWS - Q3 2016 NewStar Financial Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the NewStar Financial quarter three 2016 earnings call. At this time, all participants are in a listen-only mode. Later we will conduct a question and answer session, and instructions will follow at that time. (Operator Instructions)

I would now introduce you to your host for today's conference, Mr. Robert Brown, Head of Investor Relations. Sir, you may begin.

Robert Brown - *NewStar Financial Inc. - Head of Strategy and Corporate Development*

Thanks, Donavon, and welcome to our earnings conference call where we will be discussing NewStar's financials third quarter 2016 results. We're pleased you could join us and thank you for participating.

With me today are NewStar's Chairman and Chief Executive Officer, Tim Conway, and our Chief Financial Officer, John Bray.

Before I turn the call over to Tim to discuss our results, I need to remind you that we posted a presentation on the Investor Relations section of our website, newstarfin.com. Also available on our website is our financial results press release which was filed on Form 8-K with the SEC this morning. This presentation and our financial results press release contain additional materials related to the conference call that we may refer to during our remarks today, including information with respect to certain non-GAAP financial measures.

This call is also being webcast simultaneously on our website, and a recording of the call will be available beginning around 1 PM Eastern Time today. Our press release and website provide details on accessing the archived call.

Also before we begin, I need to inform you that statements in this earnings call which are not historical facts may be deemed forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All forward-looking statements including without limitation statements regarding future performance, including expectations regarding expected growth, expense reduction, and planned investitures, involve risks, uncertainties, and contingencies, many of which are beyond NewStar's control and which may cause actual results to differ materially from anticipated results.

Forward-looking statements give our current expectations and projections relating to our financial condition, results of operation, strategic plans, objectives, future performance, financing plans, market conditions, and overall business. As such, they're subject to material risks and uncertainties including the general state of the economy, our ability to compete effectively in a competitive industry, the continued success of our strategic relationships, the market price of our common stock from time to time, and other investment opportunities available to us as well as the impact of laws and regulations that govern non-depository commercial lenders, investment managers, and businesses generally.

More detailed information about these and other risks can be found in our press release issued this morning and in the risk factors section of our annual report on Form 10-K, and that's updated by risk factors contained in our quarterly reports on Form 10-Q. NewStar is under no obligation to update or revise its forward-looking statements whether a result of information, future events, or otherwise except when required by law.

NewStar plans to file its Form 10-Q with the SEC on or before November 9, 2016, and urges its shareholders to refer to that document for more complete information concerning the Company's financial results.

Thanks for your patience. Now I'd like to turn the call over to NewStar's Chairman and Chief Executive Officer, Tim Conway.

Tim Conway - *NewStar Financial Inc. - Chairman and CEO*

Thanks, Rob. Good morning, and thanks for joining our call today.

I'll focus my comments on our third quarter results, market conditions, and the progress we are making on our key priorities including the sale of noncore businesses, cost savings, and exciting growth in our asset management platform. John Bray will then discuss our financial results in detail, and I will close with an update on our outlook for the fourth quarter.

Third quarter results reflected solid core operating trends and a significant increase in earnings driven by strong revenue growth and stable credit performance. Net income was $8.6 million for the quarter, up 65% from last quarter, and 68% from the third quarter a year ago. Pre-tax returns approached 9%, and we increased book value per share by $0.36 to $14.38. Earnings growth was driven by a 40% increase in revenue from last quarter as core interest and fee income grew and loan values recovered.

After a challenging first half of the year, the credit markets improved in Q3 which spreads tightening across the board. As a result, the pressure we saw in asset values, which led to some negative marks in the first half of the year, reversed, and we recognized $3.9 million of unrealized gains in the quarter. We also got a boost from the payoff of a non-accruing loan at par which contributed about $3.2 million to interest income in the quarter.

Although some of our revenue improved, it was driven by those non-recurring items. Core operating revenue was up about 7% over last quarter and 9% in the third quarter last year despite the fact that we have not yet fully redeployed the capital we generated from the sale of the asset-based lending business.

As expected, credit costs remain within normal ranges in the third quarter, and asset quality was solid as we reduced non-accruing loans by another 9%. Strong revenue growth also helped us absorb a $5.2 million increase in operating expenses related to severance costs and non-recurring projects including the potential sale of our equipment finance business.

Market conditions were somewhat mixed during the quarter as loan demand from M&A activity remained relatively weak while asset values recovered. Our loan volume was $427 million compared to $476 million last quarter, reflecting light overall market volumes, seasonal patterns, and our own credit selectivity.

As you know, a slow market often leads to tighter spreads and an erosion in the quality of transactions. In this market environment, we are careful to maintain our credit selection discipline even if it results in slowing our pace of investment.

Although there has been downward pressure on spreads, we have originated senior middle-market loans with average yields of 7.4%, 7%, and 6.6% over the past three quarters respectively which we believe offers significant relative value to the liquid loan markets. Looking at the current pipeline, we are now seeing a meaningful pickup in deal flow that should lead to better opportunities for growth in AUM and yields.

While I'm pleased with our financial results, we also made meaningful progress in our key priorities for the quarter. Since the beginning of 2016, we have taken a number of important steps to streamline the business by de-emphasizing areas that became difficult to scale because they compete directly with banks, and reinvesting in our leveraged finance platform where we have seen much less competition from banks over the last few years.

That strategy has led to decisions to wind down our commercial real estate lending, to vest our ABL and equipment finance businesses, and significantly reduce overall headcount and expenses. Cost savings related to divestures, retirements and other initiatives are expected to reduce run rate Q1 baseline expenses by 30% by the end of the year.

After selling the asset-based lending business, we completed a process to explore the sale of our equipment finance business which has led to a LOI with a respective buyer. The transaction is expected to close in the fourth quarter, and like the ABL deal, will be accretive to both earnings and book value.

We also continue to focus on expanding our asset management platform through new fund formation. In the third quarter, we sponsored a new $410 million managed fund, known as Arch Street, which represents our seventh CLO focused on broadly syndicated loans.

Subsequent to the quarter, we also sponsored a new $500 million managed fund, known as the Berkeley Fund, and closed $100 million separate account with investment strategies focused on middle-market direct lending.

We have several other initiatives under way to continue growing third-party assets under management that will also improve our returns.

With projected liquidity exceeding $200 million by year-end, we are positioned to reinvest in our higher-margin core lending and asset management businesses, which we believe are positioned to capitalize on favorable long-term trends, including a reduction in bank's leveraged lending activity and growing interest among institutional investors in middle-market debt. Importantly, we are beginning to see some benefits of these actions in our financial results as pre-tax returns in the third quarter improved 8.7%.

We are also focused on returning excess capital to shareholders. As you know, our Board of Directors approved a $30 million stock buyback in the first quarter, and we recently purchased 2.5 million shares at $8.93 in privately negotiated transactions. This is expected to add more than $0.30 to book value per share.

Lastly, before I turn the call over to John, I also wanted to touch on previously disclosed changes in the management structure of the Company. We announced John Frishkopf's retirement for the Company in his role as Treasurer at the end of the quarter. John was a founding member of the Company and has held the role of Treasurer since NewStar's inception in 2004. Although he is retiring, he will remain involved with the Company as an external advisor available to me in the Risk Policy Committee of the Board.

Our Assistant Treasurer, Mike Eisenstein, has succeeded John as Treasurer and assumed his role on the Underwriting Committee. Mike joined NewStar in 2005 and has served as Assistant Treasurer since 2011 playing key roles in all treasury management activities.

John was one of the true pioneers of middle-market loan securitization, driving innovation, and helping to broaden investor interest in the asset class as the market developed. Working with Mike, he built a world-class treasury organization with unmatched securitization, expertise, and a strong operating platform. We all appreciate his partnership and his many valuable contributions to NewStar.

I'll turn it over to John, and after John takes us through the financial results, I will comment on the outlook for the fourth quarter and we'll take any questions you have. John?

John Bray - *NewStar Financial Inc. - CFO*

Thank you, Tim. My review of the financial results begins on page 6 of the presentation posted to our website.

Our financial performance is strong in the third quarter reflecting solid core operating trends with some offsetting non-recurring items.

Net income for the quarter was $8.6 million, or $0.19 per basic and diluted shares, compared to $5.2 million, or $0.11, from the prior quarter, and $5.1 million, or $0.11 per diluted, in the same period last year.

Book value per share increased by $0.26 to $14.38 in the quarter reflecting $0.19 of EPS and $0.07 of unrealized gains on securities recorded and other comprehensive income for the quarter.

Average basic and diluted shares were $45.8 million for the quarter and outstanding shares at the end of the quarter of $46.7 million.

Our financial performance for the third quarter is highlighted on page 7. It presents a summary of our balance sheet, income statement, and key ratios for the two most recent quarters, the third quarter of last year, as well as the fourth quarter of 2015 for comparison.

As you can see, new funded investment activity totaled $427 million in the quarter, down somewhat from $476 million in the prior quarter and off the $720 million investment pace the same period last year, due primarily to disciplined credit selection amid a slowdown in the overall market activities Tim described earlier.

In the third quarter, we retained $193 million of middle-market loans for investment and allocated $234 million to new managed funds known as Arch Street. The mixed investments included $419 million of leverage loans and $8 million of equipment loans and leases.

Runoffs from prepayment, sales, amortization, and retained loans total $225 million resulting in net loan growth on the balance sheet of 5.3% compared to prior quarter and up 9.4% from the same period last year.

Total managed assets increased to $6.7 billion from $6.6 billion in the prior quarter. Compared to the same period last year, managed assets increased by $2 billion due to acquisition activity and organic growth, which is partially offset by the sale of the ABL business at the end of the first quarter.

Total assets held by our managed funds increased to $3.1 billion at the end of the third quarter, up from $3 billion in the prior quarter, as amortization of our managed CLOs was offset by asset growth in the Arch Street Fund.

Total revenue increased by $10.9 million to $36.2 million for the quarter due primarily to higher-average earning assets, capital markets related fee income, as well as favorable marks to market adjustments on assets held at fair value, and income recognized in conjunction with the repayment of a non-performing loan at par.

Excluding mark-to-mark adjustments and an accelerated income recognized from the NPA payoff, core revenue in the third quarter increased 7.6% from prior quarters.

Interest income increased by approximately $5.8 million, or 9.7%, in the quarter to $65.2 million due primarily to higher average loan balances and income recognized in conjunction with the payoff of the non-recurring loan at par. The portfolio yield also increased to 6.77% from 6.28% in the prior quarter as a result.

Interest expense increased by approximately $1.4 million, average interest-bearing liabilities increased by approximately 2.1% compared to prior quarters, and the cost of funds edged up slightly to 4.67% from 4.65% as a result. The boost in interest income came primarily from the NPA pay-down in net interest income.

I will discuss the margin later in my remarks.

Non-interest income was strong in the quarter increased by $6.6 million to $11 million due primarily to higher capital market fee-related income, favorable mark-to-mark adjustments on assets at fair value, unrealized gains, and losses. Non-interest income increase by $500,000 in the third quarter was due to higher capital markets fees. So, basically, if you exclude all the one-times, we are still up in non-interest income.

Fee revenue centered in mark-to-mark adjustments totaling approximately $3.9 million reported as unrealized gains and other miscellaneous income as well as asset management fees totaling $3.4 million, fee income from capital markets and agency services totaling $2.9 million, and other miscellaneous income of $800,000.

New middle-market loans and other directly originated credit investments in the quarter had a weighted average yield of 6.6% compared to 7% last quarter reflecting expected pricing environment in a slow-deal market as Tim mentioned.

Operating expenses increased by $5.2 million to $18.1 million in the third quarter primarily due to $4.2 million of severance costs related to cost-savings initiatives and $1 million of other elevated expenses related to projects including potential sale of our equipment finance business.

As Tim mentioned, we expect to have reduced our Q1, 2016 run rate expenses for $17 million, or roughly 30%, by the end of the year, which should have a meaningful impact in our results heading into 2017.

As we discussed last quarter, the saving is driven by a combination of divestures and further streamlining the business as we concentrate our strategic focus on our middle-market direct lending and asset management activities.

An analysis of the net interest margin falls in the next page. As you can see, the margin has widened to 2.5% from last quarter of 2.1%. The margin pick-up was due to the recognition of the interest income on the non-recurring loan, but when you exclude that discreet item out, the margin would have been up 10 basis points from the prior quarter.

As we experience this quarter, the margin remains sensitive to the timing and the magnitude of prepayments and future lending activities. As a result, improving the margin may reflect some of that driven volatility around the positive trend line.

The next slide provides a snapshot of the composition of our loan portfolio by industry vintage as of September 30. As you can see, the portfolio remains highly diversified and is comprised primarily of loans originating the last five years. The portfolio is also highly diversified by obligor. The largest single borrower concentration was less than 1.2%, and the top ten obligors represent approximately 9.4% of the total portfolio as of September 30, 2016.

The energy sector remains significantly underweighted in our portfolio in Q3 at less than $48 million, or approximately 1.2%, which was down slightly from last quarter.

As I previously mentioned, managed loans and investments total $6.7 billion at September 30, 2016. Approximately $4 billion was retained on our balance sheet, and $2.7 billion was managed across various funds and accounts. Managed accounts include CLOs and other advisory accounts, the Arlington and Clarendon fund.

Our liquid loan strategy platform at NewStar capital manages six unconsolidated funds, structures, CLOs, and one consolidated fund, as well as various other accounts.

As of September 30, 2016, our net loan in the investment portfolio was comprised of loans and leases held for investments totaling approximately $3.2 billion, loans held for sale at $430 million, $91 million of investments in debt securities, and $158 million of equipment loans and leases held for sale.

Loans held for sale were primarily comprised of leveraged finance loans expected to be sold to the new $500 million managed credit fund, known as Berkely, which is expected to close in the fourth quarter as Tim mentioned. That fund will be managed through third-party investors and will not be consolidated on our balance sheet or included in our results.

Equipment loans and leases held for sale reported in assets held for sale on the balance sheet as of September 30, 2016 following completion of review and process to explore the potential sale of the business which led to a non-binding letter of intent from a prospective buyer to acquire the business. The terms of the sale remain confidential and it's expected to close by year-end.

Page 10 provides an overview of our capital structure at the end of the quarter. As illustrated, we have approximately $1.1 billion of committed warehouse credit facilities used to fund new investment activities. That is down by $336 million from the prior quarter due to the repayment of two credit facilities; a $350 million warehouse line used to finance the ramp-up of the Arch Street CLO and the repurchase agreement used to fund commercial mortgage loans.

As a result, borrowings under the warehouse credit facility decreased by $73 million as advances under credit facilities used to support the middle-market direct lending activity partially offset the repayment of the Arch Street warehouse line.

Term debt securitization balances increased by $319 million due primarily to the issuance of $370 million of notes through the Arch Street CLO, which was partially offset by continued amortization of our 2007-1 and 2012-2 CLO as well as our 2015-1 equipment loan and leaseback securitization.

With significant liquidity, warehouse capacity, and $1.3 billion of long-term capital, we believe that our balance sheet is positioned to support our lending activity and provide significant flexibility that will enable us to consider a range of capital management strategies.

Subsequent to the end of the quarter, we repurchased 2.5 million shares at a weighted average cost of $8.93 which on a pro forma basis is expected to add over $0.30 value per share in the fourth quarter.

If you turn to the next slide in the presentation, I will highlight the credit performance for the quarter. As Tim described, credit costs remain stable within expected ranges in the third quarter as provision expense of $3.6 million was consistent with last quarter. Credit costs reflect the usual provisioning activity with $300,000 of general provision and $3.2 million for specific reserves.

Net charge offs was zero in the third quarter, down from $6.9 million in the second quarter. As a result, the allowance for credit losses increased by $2.4 million to $66.4 million compared to $64 million at the end of last quarter.

The provisioning activity and the allowance partially offset by the movement of $1.3 million of reserves due to the reclassification of the equipment finance to assets held for sale. So the allowance ratio increased from 2.09% to 2.29% as provisions for credit losses exceeded charge-offs and reversals in the quarter.

Non-accruing loans decreased 9% to $87.3 million from $96.2 million, or 2.66% of total loans, down from 2.97% last quarter. Since our inception in 2004, we have experienced an average annualized loss rate of 25 basis points of accumulative leveraged finance loans originated, shown in slide 12.

The next slides provide a more detailed breakdown of our balance sheet and income statement for your reference.

I'll now turn it back to Tim.

Tim Conway - *NewStar Financial Inc. - Chairman and CEO*

Thanks, John.

So, I'm on slide 17. You can see our results were generally consistent with our guidance in the third quarter. Deals on new loans were slightly below guidance in Q3, but in line with expectations on a year-to-date basis.

Although we have seen loans tighten throughout the course of the year, we believe the yield should stabilize as deal flow picks up in the fourth quarter.

Portfolio runoff from amortization, exits, and repayments was below expected levels in Q3 due to relatively slow market activity. Although runoff remains below expectations, for the year-to-date, we expect it to be at or near the low end of the range for the year.

Net loan growth picked up in Q3 and was at the low end of the range year-to-date despite the sale of the ABL business in Q1. We expect loan growth to remain at the low end of the existing range through year-end due to potential sale of the equipment finance business.

Net interest margin was at the high end of the range in Q3 due primarily to interest income recognized in connection with the payoff of a non-recurring loan as we've talked about. Margin was 2.25% year-to-date which we expect to hold up through the fourth quarter.

Non-interest revenue exceeded expected levels in the third quarter due to marks held on loans held for sale that are capital markets revenue. Going forward, we remain confident in our guidance and expect non-interest income to come in at or above the high end of the range.

Credit costs were within expected range, and we remain comfortable with the current guidance.

Pre-tax ROE was 8.7% in the third quarter and is expected to be in the 9% area in the fourth quarter.

In summary, our performance in the third quarter was strong by almost every measure. Earnings were up sharply led by significant revenue growth, EPS Speed consensus. Book value per share was up $0.26 to $14.38.

We continue to take steps to meaningfully reduce operating expenses and that will continue over the coming quarters.

We completed the strategic revenue and related process to explore the process of our quick advance business and it's resulted in a potential transaction that we think is attractive, and we expanded our asset management platform sponsoring two new managed funds and adding a separate account targeting aggregate investment portfolios of more than $1 billion.

So with that I will wrap up the presentation, and answer any questions you may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Steven Kwok; KBW.

Steven Kwok - *Keefe, Bruyette & Woods, Inc. - Analyst*

Thanks for taking my questions. The first one I have is around the sale of the equipment finance business; any way to size how big the gain will be? What do you intend to do with the proceeds? How should we think about that? Thanks.

Tim Conway - *NewStar Financial Inc. - Chairman and CEO*

Thanks, Steven. We can't say; it hasn't been disclosed so we can't say. We will say there is a premium, and in my presentation, I think I said that it's in many ways similar to the asset-based lending transaction. Our plan is to reinvest the proceeds in the businesses that we're now focused on which we think will generate higher returns.

Steven Kwok - *Keefe, Bruyette & Woods, Inc. - Analyst*

Great. Then as a follow-up, you mentioned that you expect a meaningful pick-up in the volume origination in the fourth quarter. Can you talk about what are the trends that are driving that and how sustainable that is going forward?

Tim Conway - *NewStar Financial Inc. - Chairman and CEO*

Yes. I think we're well into the quarter now, and we've seen a significant uptick across the board. It's been really slow, I'd say for most of the year, in terms of new M&A activity; I think it's mostly a disconnect between buyers and sellers.

I think that there's a lot of money to be put to work in the private equity markets and deals are starting to happen now. So, coming out of the summer, we saw significant pick-up, and I'd say we're opportunistic that that will continue.

I think, long-term, we think that fundamentally, in the middle-market, there's a lot of private equity to invest; there certainly is a liquid leverage market in order to finance those deals. So we continue to be bullish long-term on the amount of volume and the supply/demand characteristics in the middle market, but as all of these markets, it varies from quarter to quarter. But we're seeing in real-time, an uptick right now.

Steven Kwok - *Keefe, Bruyette & Woods, Inc. - Analyst*

Got it. Lastly, you talked about the 9% pre-tax ROE in the fourth quarter. Does that contemplate the gain from the equipment finance business?

Tim Conway - *NewStar Financial Inc. - Chairman and CEO*

No.

Steven Kwok - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great. Thanks for taking my questions.

Operator

(Operator Instructions) John Rowan; Janney.

John Rowan - *Janney Montgomery Scott - Analyst*

Good morning, guys. I just want to be clear on the cost savings because, Tim, I think you said in your prepared remarks -- well, your (inaudible) said 25% to 30%, but then you said off of the run rate from the first quarter, but in the press release it says the full year of 2016 run rate of approximately $60 million for operating costs. I just want to make sure I understand what baseline assumption is correct for operating costs and how that will be phased in if it's fully implements for 2017.

John Bray - *NewStar Financial Inc. - CFO*

I would say it's Q1 run rate as you've just mentioned, and it's phased in. I'd say all will be achieved by the end of the year, and it's been phased in, I'd say in Q2, mostly Q3, and it really breaks down into some retirements of senior people, some streamlining of the business which made us more efficient, and some cutbacks in some areas, and then the sale of the two businesses and real estate which were sub-scale and so net-net, they saved us a lot of expenses.

So I'd say that by the end of the year, all of those costs that we're talking about in the 30% number will have been realized. So going into next year, we'll have the full benefit of that.

John Rowan - *Janney Montgomery Scott - Analyst*

So we're talking about a 30% reduction in the $17 million of operating expense that was reported in the first quarter. I just want to make sure I'm --

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John Bray - *NewStar Financial Inc. - CFO*

Yes.

John Rowan - *Janney Montgomery Scott - Analyst*

Okay. Just to make sure I understand, how many loan -- what's the size of the equipment finance business and was it all -- you said something in the press release about it being classified as held for sale. I just want to make sure I understand where those loans are and how much is it going to leave if you sell it?

John Bray - *NewStar Financial Inc. - CFO*

Yes, John, it's John Bray. What we did is we -- in assets for sale, that number represents both cash, restricted stock, and the loans and leases. The loans and leases for this analysis, for what you're doing, and -- you'll see it in our queue, is we'll break it out in detail, but it's about $135 million.

John Rowan - *Janney Montgomery Scott - Analyst*

All right. Thank you very much.

Operator

(Operator Instructions) I'm not showing no further questions at this time. Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone have a great day.
