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NEWS - Q2 2016 NewStar Financial Inc Earnings Call

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CORPORATE PARTICIPANTS

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

John Bray *NewStar Financial, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the NewStar Financial second quarter 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)

As a reminder, this conference call is being recorded.

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

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

Thanks, Kaylee, and welcome to our earnings conference call where we will discuss NewStar's second quarter 2016 results. We're pleased you could join us.

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

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 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 at 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 growth and expense reductions, 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, our ability to integrate acquired businesses, and other investment opportunities available to us as well as the impact of laws and regulations that govern commercial lenders, investment managers, and businesses generally.

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

We plan to file our Form 10-Q with the SEC on or before August 9, 2016, and we urge shareholders to refer to that document for more complete information concerning the Company's financial results.

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.

As Rob mentioned, we have posted a slide presentation on our website, and I will refer to a few pages during my remarks. I will focus my comments on our second quarter results and market conditions. John Bray will then discuss our financial results in more detail, and I will close with an update of our outlook for the rest of 2016.

Our results in the second quarter reflected solid core operating trends including an increase in investment activity, stable core revenue, improved credit performance, and continued progress on our strategic goals. Earnings increased 30% from last quarter and 5% from the comparable quarter last year. We also increased book value per share by $0.28 to $14.12 through a combination of earnings retention and accretive share repurchases.

Although loan volumes remained below target levels for the first half of the year, investment activity improved in the second quarter against the backdrop of relatively weak loan demand from M&A activity as continued economic uncertainty weighed on market sentiment.

Core revenue remains steady at $25 million excluding non-recurring items despite the loss of revenue contributed by the ABL business which, as you know, we sold in the first quarter.

After several challenging quarters, the credit markets began to improve through much of Q2 only to soften again in late June after the Brexit vote was announced. As a result, we saw some pressure on asset values at the end of the quarter which led to $2.1 million of marks on loans held for sale that are expected to be temporary and recovered in future periods. Those marks cost us about $0.03 of EPS after tax.

Capital markets revenues increased from the prior quarter but were somewhat below our target levels due to the slower market activity. Although deal flow and loan demand had been relatively soft in the first half, market conditions and bid levels are clearly improving while spreads are tightening as lenders compete for deals.

Looking past the seasonally slow summer months, we expect to see a pickup in deal flow that should lead to attractive opportunities for growth in AUM. So we remain cautiously optimistic about market trends through the end of the year.

As expected, credit costs normalized in the second quarter and asset quality remains solid. We reduced non-performing assets by 16% in the quarter and sold $34 million of real estate loans reducing our remaining real estate exposure to about $42 million.

We also continued to make progress on key priorities as we returned almost $8 million of capital to shareholders through accretive stock repurchases. We also worked to streamline the business and reduce expenses as we focus on growing our middle market leverage finance and asset management activities. We reduced operating expenses by 25% from the prior quarter through the sale of the asset-based lending business and other cost initiatives.

As a result, our expense ratio decreased to 1.3% of average balance sheet assets in the quarter down from 1.7% in 2015. We have identified additional opportunities to reduce total run rate expenses further by the end of 2016 as we narrow our focus to markets where we avoid competing with banks and generate higher margin and better returns. We believe we can drive the expense ratio down towards 1% of assets on the balance sheet over the next year.

So to recap the key drivers of our results in the quarter, we maintained core revenues despite the loss of income from the ABL business and reduced operating expenses by 25% while credit performance normalized within expected ranges.

I am pleased how we were able to maintain business momentum and achieve multiple objectives in the quarter despite some market challenges. Although M&A activity and related loan demand remains somewhat weak, I believe we are well positioned and we have seen signs of improvement that should provide some tailwinds as we head into the second half of the year.

Our ability to provide larger commitments and offer attractive unit (inaudible) solutions often in conjunction with GSO has enabled us to continue to gain market share. The additional liquidity generated from the sale of ABL and potential future actions will allow us the flexibility 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 banks, leverage lending activity, and growing interest among institutional investors in middle market private debt. We plan to take advantage of those trends by raising additional third-party assets under management in the second half of the year.

Before I turn the call over to John, I also wanted to touch on previously disclosed changes in the management structure of the Company. As you know, we announced Peter Schmidt-Fellner's retirement from the Company both in his role as Chief Investment Officer and as a member of the Company's Board of Directors. Although he is retiring, he will remain involved with the Company as an external advisor available to me and to the risk policy committee of the Board of Directors.

Our current Chief Credit Officer, Dan McCready, has succeeded Peter as Chief Investment Officer and assumed his role on the investment committee. Since joining NewStar in March of 2013, Dan has led our leverage finance credit team and played a key role in all related credit decisions. He has more than 30 years of experience in leverage finance and joined NewStar as Chief Credit Officer from CIT where he was their Chief Credit Officer for corporate finance. Prior to that, he held senior positions at GE, Bankers Trust, and Bank of America.

Peter played a pivotal role in building the Company and establishing our credit track record. He helped build a world-class credit organization with deep expertise and a disciplined credit culture and his leadership helped guide us through one of the most challenging business cycles of our lifetimes. I'm very confident in our current credit team and excited about the opportunity to work even more closely with Dan as we continue to build an outstanding track record and further develop our credit investment capabilities.

After John takes us through the financial results in some more detail, I will comment on our outlook for 2016 then we'll take some questions. John?

John Bray - *NewStar Financial, Inc. - CFO*

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

Net income for the quarter was $5.2 million or $0.11 per basic and diluted share compared to $4 million or $0.09 per basic and diluted shares in the prior quarter and up from $5 million or $0.10 per basic and diluted share in the same period last year.

Book value per share increased by $0.28 to $14.12 in the quarter reflecting the impact of earnings retention, accretive share repurchase, and unrealized gains on securities recorded and other comprehensive income.

Basic shares outstanding as of June 30, 2016 decreased by approximately 975,000 shares due primarily to stock repurchases. Outstanding shares at the end of the first quarter were 46.7 million and average basic and diluted shares were 46 million, respectively.

Page 7 highlights our financial performance for the second quarter and includes a summary of our balance sheet, income statement, and key ratios for each of the three most recent quarters and the second quarter of last year as well as the most recent fiscal year for comparison.

New investment activity totaled $476 million in the quarter up from $300 million from the prior quarter but down from $1 billion the same period last year due to slowdown in overall market activity as Tim described earlier.

New middle market loan investments totaling approximately $99 million were allocated to managed funds with co-investment strategies and $377 million was retained and held for investment. Of that, $107 million of loan investments were allocated to the new Arch Street fund which employs a liquid loan strategy and is managed on our NewStar Capital platform.

Investments allocated to manage funds in the quarter were all leveraged financed loans and the mix of investments retained on the balance sheet included $259 million of leveraged finance loans, $107 million of liquid loans in Arch Street, and $11 million of equipment loans and leases.

Total managed assets were relatively consistent with prior quarters at approximately $6.6 billion. Compared to the same period last year, managed assets increased by $2.4 billion due to acquisition activity and organic growth.

Total assets held by our managed funds were approximately $2.8 billion at the end of the second quarter, which was consistent with the prior quarter as the amortization of managed CLOs was offset by asset growth in the Arch Street fund.

Total revenue decreased by $16.4 million to $25.3 million for the quarter due primarily to the impact of the $22.5 million gain on the sale of our asset-based lending business recognized in the first quarter, which was partially offset by a $6.1 million loss in total return swap.

Excluding those non-recurring items, core revenue in the second quarter was consistent with prior quarters. Interest income decreased to approximately $2.6 million in the quarter to $59.4 million due to primary lower average loan balances driven by the same of the ABL business.

Although the portfolio has remained stable at 6.28%, yields on interest earning assets decreased due to lower yields on excess cash generated from the sale of ABL.

Interest expense decreased by approximately $1 million as average interest-bearing liabilities decreased by approximately 4.2% compared to the prior quarter. The cost of funds increased to 4.65% from 4.56% due primarily to the impact of full quarter interest expense recognized on subordinated notes totaling $25 million, the issuance of a new CLO during the first quarter, as well as a shift in the mix of debt reflecting the impact of the ABL sale. As a result, net interest income decreased $1.6 million to $20.9 million in the second quarter as compared to $22.5 million for the first quarter.

I will discuss the margin in more detail later in my remarks.

Non-interest income decreased by $14.8 million to $4.4 million for the quarter due primarily to the gain on the sale of the asset-based lending business recognized in the first quarter.

Excluding that gain and the loss on the swaps [on] these two discrete items, non-interest income increased $1.7 million in the second quarter despite the loss of the ABL fee revenue due primarily to lower unrealized losses, recognized loans held for sale, and higher capital markets related fee income.

Non-interest income for the quarter was centered in asset management fees totaling $3.5 million, fee income from capital markets and agency services totaling $1.7 million, and other miscellaneous income of $1.3 million which was offset by $2.1 million of unrealized losses on loans held for sale.

New middle market loans and other directly originated credit investments in the quarter had a weighted average yield of 7% compared to 7.4% last quarter reflecting a somewhat more competitive pricing environment in a slow deal market as Tim mentioned.

Operating expenses decreased by $4.2 million or 25% from the prior quarter due to the sale of the ABL business and other cost-saving initiatives. As Tim mentioned, we had also identified other opportunities to reduce expenses further by the end of 2016, which should have meaningful impact on run rate expenses heading into 2017. The cost savings are expected to result from further streamlining of the business as we concentrate on our strategic focus on middle market direct lending and asset management activities.

An analysis of the net interest margin follows on the next page. As you can see, the margin narrowed to 2.1% for the quarter compared to 2.21% last quarter. The margin pressure was due to the combination of [these] factors but was driven primarily by the impact of the sale of the ABL business. The ABL sale at the end of the first quarter generated significant cash proceeds which were initially employed to reduce borrowings in our warehouse facilities, invest in low-yielding liquid loans as part of the Arch Street fund strategy. As a result, the overall yield on the interest-earning assets decreased by approximately 10 basis points.

As a result, we expect to see a positive trend in the interest income component of the margin in the future quarters as this capital is rotated into higher yielding, new middle market loan origination. So going forward, we expect the margin to trend slightly wider as the yield on interest-earning assets improves and future growth is funded by lower cost CLO and warehouse debt.

As we have experienced in prior quarters, the margin remains sensitive to timing and nature of funding activities. As a result, improving the margin may reflect some of that driven volatility.

The next slide provides a snapshot of the composite of our loan portfolio by industry and vintage as of June 30, 2016. As you can see, the portfolio remains highly diversified by industry and more than 96% is comprised of loans originated since 2008. The portfolio is also highly diversified by obligor. The largest single borrower concentration is less than 1.2%, and the top ten obligors represent approximately 9.6% of the total portfolio as of June 30, 2016.

Exposure to the energy sector was limited to approximately 1% down slightly from last quarter. As I mentioned previously, managed loans and investments totaled $6.6 billion at June 30, 2016. Approximately $3.8 billion was retained on our balance sheet; $2.8 billion was from managed funds across 14 funds or accounts. The managed accounts include CLOs and other advisory accounts, the Arlington and Clarendon funds, as well as the credit opportunity (inaudible) which is nearly (inaudible) down.

NewStar Capital manages six unconsolidated fund structures as CLOs and one consolidated fund. As of June 30, 2016, our loan and investment portfolio was comprised of loans and leases held for investments totaling approximately $3.1 billion, loans held for sale of $446 million, and $98 million of investments and debt securities.

Loans held for sale were primarily comprised of leveraged finance loans with the majority expecting to be sold to our managed credit funds during the next several quarters.

Page 10 provides a visual representation of our capital structure at the end of the quarter. As illustrated, we have approximately $1.4 billion of committed warehouse facilities used to fund new investment activities. In the quarter, we increased the leverage finance warehouse credit facility by $50 million through the addition of a new lender to the syndicate which is agented by Wells Fargo.

Borrowing under warehouse credit facilities increased by $27 million due primarily to advances under the credit facility provided by Credit Suisse used to support the ramp-up effort of the Arch Street fund. This is expected to repaid from the proceeds of a securitization of the Arch Street assets in future periods.

Term debt securitization balances decreased $36 million due primarily to the continued amortization of our 2007-1 CLO and our 2015-1 equipment lease and loan securitization.

[With] significant warehouse capacity, $1.3 billion of long-term capital, we believe that our balance sheet is well-positioned to support our growth plans and provide significant flexibility. With $4 billion of assets and $122 million of liquidity at quarter-end, we have significant operating and financial flexibility which we believe will support our strategic objectives.

If you turn to the next slide in the presentation, I will review the highlights of our credit performance for the quarter. As Tim described earlier, credit costs normalized in the second quarter as provision expense decreased by $14.1 million to $3.6 million. Credit costs in the quarter reflected usual provisioning activity with $1.2 million of general provision and $2.4 million of specifics.

Net charge offs were $6.9 million in the second quarter or 75 basis points of average loans and investments, down from $7.3 million in prior quarters. Charge offs were comprised of $4.5 million applied against a previously-established specific reserve for a real estate loan in connection with the planned disposition of that asset as well as a $1.9 million applied against an existing reserve in connection with the resolution of a long-term workout of a legacy loan that resulted in a $12 million repayment.

As a result, the allowance for credit losses decreased by $3.3 million to $64 million compared to $67.3 million at the end of last quarter. The allowance ratio decreased from 2.19% to 2.09% as charge offs exceeded provision for credit losses in the quarter.

Non-performing assets decreased 16% to $96.2 million or 2.98% of loans, down from 3.63% last quarter due to $12 million of repayment, $6.9 million of charge offs, the re-class of $1.8 million of loans, back to performing status, and a $7.1 million of other loan activity, which is partially offset by two new loans being put on non-accrual for $9.2 million.

As Tim mentioned, our outlook for credit performance continues to be positive reflecting the actions we took last quarter, normalized credit performance this quarter, and our confidence in the quality of the portfolio.

The next slide highlights our credit performance since the Company's inception, which continues to compare favorably to the Moody's benchmark as we incurred nominal defaults and modest losses on loans originated after 2008. Since inception in 2004, we have experienced an average annualized loss of 22 basis points of cumulative leverage finance loans originated.

The next three slides show our detailed balance and income statement, which I have already touched on through the review of key financial highlights. I'll now turn it back to Tim.

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

Thanks, John.

So as you can see on slide 17, our results were generally consistent with our guidance in key areas in the second quarter with the exception of origination volume and margins, which are generally market sensitive. As a result, we have revised our expectations for the balance of the year to reflect a slightly lower outlook for market activity.

As shown, we have reduced our origination targets for the full year to reflect both a reduction in origination related to the sale of our asset based lending business and our expectation for a somewhat slower pace of investment activity for the rest of the year.

Yields on new loans exceeded guidance in Q1 and were in line with expectations in Q2. Although we are now seeing spreads tighten a bit, we believe that yields will hold up through the year as deal flow picks up.

Portfolio runoff from amortization, exits, and prepayments was below expected levels in Q1 due to the slowdown in market activity. Runoff returned to expected levels in Q2. As a result, we have reduced expected growth targets to reflect lower pace of origination, normalized runoff levels, and the impact of the ABL sale.

Net interest margin reflects the sale of the ABL business in Q2. Although we expect the margin to improve as the cash proceeds from the sale are reinvested in middle market loans, we have revised our expectations by 25 basis points.

After exceeding guidance in Q1, non-interest revenue was below expected levels in the second quarter due to temporary marks on loans held for sale and lower than expected capital markets revenue due to market conditions. Going forward, we remain confident in our guidance and maintain our targets for non-interest income.

Credit costs normalized within expected ranges in Q2 and remain comfortable with current guidance. Pre-tax ROE is expected to be between 5% and 7.5% for the year. We do not see any fundamental weakness in [invested] economy as reflected in the performance of the companies in our loan portfolio.

As I have mentioned, we will consider other dispositions of assets outside of our core strategy where we compete more with banks in an effort to improve returns by investing the proceeds in higher margin segments. We have a great track record. We're focused on attractive markets, and we are strategically aligned with world-class partners with complimentary capabilities that are motivated to help us perform and create value for shareholders.

We have an expanded asset management platform that is expected to contribute significantly to fee income, and although we faced some challenges in the first half of the year we remain on track to generate better returns on capital in the second half.

With that, we'll open it up to any questions you might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Steven Kwok, KBW.

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

First question is just on the competitive landscape. What are you seeing there and what gives confidence in terms of the new originations picking up in the back half of the year?

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

Well, the landscape is -- really, Steven, hasn't changed much. There are people looking to get into the middle market, but most of the capital we see -- new capital being invested in the middle market is actually being invested through people like ourselves that have -- already have significant market share there. There are significant barriers to entry in terms of funding and the relationships that we have in the middle market. We've seen a couple of new entrants, but it's really been a relatively small part of the landscape.

In terms of -- and it's still four or five players including ourselves that really dominate the core middle market direct lending business. In terms of volumes, we're seeing it -- I'd say it's based on our conversations with private equity firms, the level of -- or early deal flow we're seeing in pipelines demonstrate a pick-up in M&A activity. The amount of capital that our customers have to put to work we think is beginning to result in some better deal flow, so we expect that'll happen. Summer is typically slow, and despite that we're seeing some more deal flow. We're also -- as I mentioned earlier, I think we're in a position to continue to gain market share because we're making larger commitments to deals and we're working with GSO on a number of transactions that broadens our ability to provide a full range of products to customers. So, I think it's a pick-up in activity and our continuing ability to gain some market share.

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

Good. Thanks for the color. And around the expense management initiatives you have, can you outline what are the plans going forward and what's the run rate we should think about for the expenses by the end of the year?

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

I think it's -- so the expense initiatives -- number one, the strategy as we've mentioned several times is obviously to -- we saw the banks pull out of leverage finance. We saw them compete significantly on pricing in where we play in some of our non-leverage finance business, including asset-based lending and real estate, and so we -- the first part of the expense saves in selling the real estate assets and selling ABL we made some significant cuts on a relative basis to the cost base.

In simplifying the business, we were able to find more efficiencies and reduce some additional expenses, which we've been working on and there'll be some -- you'll see some more of that in the next quarter, and then we have additional strategies to continue to execute along those lines, and we expect to get the expense ratio down within the next year to 1% of assets on the balance sheet. So, if you're looking at a $4 billion balance sheet, expense levels in the closer to $40 million from closer to $60 million looking back a year.

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

[Great]. Thanks for taking my questions.

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

Thanks, Steven. Appreciate it.

Operator

(Operator Instructions) And I am showing no further questions at this time.

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

Thank you.

Unidentified Company Representative

Thank you for joining the call. That'll conclude the earnings call for the quarter. Thanks.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone have a wonderful day.

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