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NEWS - Q1 2016 NewStar Financial Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the NewStar Financial Q1 2016 earnings conference call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to introduce your host for today's conference, Mr. Robert Brown, head of investor relations. You may begin.

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

Thanks, Becky, and welcome to our earnings conference call. We will be discussing NewStar Financial's first-quarter 2016 results. We are pleased that you can 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've 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 this 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 at 1 PM Eastern time today.

Our press release and website provide details on accessing the archives 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 involve risks, uncertainties and contingencies, many of which are beyond NewStar's control and which may cause actual results to differ materially from the anticipated results.

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

More detailed information about these and other risk 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 and as updated by any 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 as 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 May 10, 2016 and urges its shareholders to refer to that document for more complete information concerning the Company's financial results.

Now with that, I would 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. As Rob mentioned, we've posted a slide presentation on our website, and I will refer to a few pages during my remarks. I will focus my comments on highlights from the first-quarter results including the sale of our asset-based lending subsidiary.

Our results in the first quarter reflected a significant financial gain from the strategic sale of our asset-based lending business. That gain was offset by charges taken in anticipation of restructurings and asset sales, elevated credit costs relating to two loans and temporary loss as recognized in the quarter from mark-to-market exposure that we expect to recover in future periods.

We recognized a $22.5 million gain on the sale of our ABL business in the quarter, which added more than $117 million of cash to the balance sheet. I will review this in more detail, but I want to highlight that the additional liquidity and gain on sale allowed us flexibility to accelerate workout strategies and the sale of selected assets.

We also realized a $4.1 million loss on an energy loan and $5 million on $18 million exposure that developed rapidly during the quarter.

As you know, the credit markets have been very difficult for several quarters, and the impact of continued volatility has resulted in approximately $5.7 million of marks that we -- are expected to be temporary and recovered in future periods.

So to recap the key drivers of our results in the quarter, we sold one of our specialized lending businesses where we saw too much competition from banks that generated a large financial gain and added significantly to our liquidity position. In my opinion, it also demonstrated the value of our assets and direct origination platform. In anticipation of the sale, we took some charges related to accelerated workout strategies and potential asset sales intended to de-risk the portfolio. And we absorbed elevated losses on two loans and temporary marks on loans held for sale.

I am pleased with how we were able to achieve multiple objectives in the quarter despite market challenges. Given conditions in the high-yield and loan markets, we throttled back somewhat and decided to be even more selective on new originations. Obviously this slowed our growth but I believe it was prudent given the level of uncertainty in the markets and concerns that problems in the energy sectors would trickle into other areas of the economy, which, by the way, we have seen little or no evidence of.

As a result of our actions in the quarter, we are positioned more conservatively, and we have significant liquidity and financial flexibility. Though we are still operating in difficult markets, I believe we are well-positioned, and we are seeing real signs of improvement that should provide some tailwinds in Q2 and as we head into the second half of the year.

Turning back to the key driver of our results in the quarter, I want to provide some more detailed overview on the sale transaction and how it fits into our strategy.

Highlights of the deal are outlined on slide 4 of the presentation. As previously disclosed, we sold our asset-based lending subsidiary NewStar Business Credit to Sterling National Bank for about 1.3 times book value. The business offers working capital financing options to middle-market companies through revolving credit lines of credit that allow them to borrow against the value of their accounts receivable and inventory. We acquired it in late 2010 from American Capital and expanded it significantly over the past five years.

The purchase price reflected a premium of approximately 6% of gross loans totaling $330 million, and we recognized a gain of approximately $22 million on the transaction in the quarter. The sale of that business represents the continuation of NewStar's transformation from a bank-styled diversified finance Company to a more specialized middle-market direct lender with a focus on managing assets for institutional investors. It also reflects the decision to exit businesses that are increasingly challenged by competition from banks and other lenders with access to lower-cost funding.

As I mentioned, the transaction generated an attractive financial return while demonstrating the value of our direct lending platforms, which we don't believe is fully recognized in our stock price. It also added significantly to our liquidity position, enhancing our ability to pursue other strategic priorities including continued share repurchases. The additional liquidity allows us the flexibility to reinvest in our higher-margin core lending asset management businesses, which we believe are positioned to capitalize on favorable long-term trends including a reduction in banks, levers lending activity and growing interest among institutional investors in middle-market private debt.

The timing of the transaction was also favorable. Given a more challenging environment and continued market volatility, I believe it is a good time to be liquid, and we are. Despite a slow market and relatively weak loan demand, I expect that we will be able to capitalize on attractive opportunities to reinvest the proceeds from the transaction in 2016.

Before I turn it over to John, I also want to provide some perspective on market conditions and how they impact our operating environment in the first quarter.

Volatility in credit markets that began in the second half of last year continued into the first quarter. The combination of economic growth concerns and rising defaults in energy mining commodities continue to drive negative investor sentiment, which resulted in outflows of capital from the credit markets. Sustained outflows beginning in the second half of last year pressured the values of risk assets including noninvestment grade loans, bonds and related securities such as CLO notes. Despite some positive economic (inaudible) and continued relative strength in credit fundamentals, asset values continued to decline in the first quarter.

The decline in liquidity also made credit more uncertain and expensive for issuers, which in turn led to a slowdown in deal activity in the first quarter. Middle-market sponsor lending volume, for example, fell 45% in Q1 to a six-year low.

Excluding the impact of the sale of the asset-based lending business, managed assets held steady at $6.6 billion as runoff also slowed down in the quarter. Although credit costs were elevated in the first quarter, I do not believe it signals broader credit deterioration, and I remain very comfortable with our portfolio. It is defensively positioned in the first lien senior debt and is highly diversified, with little exposure through stress sectors such as energy metals, mining and commodities.

Importantly, the market has stabilized significantly in Q2. We are seeing improvement in secondary pricing levels and M&A activity, which has improved deal flow and will represent opportunities for managers with capital to invest.

After John takes us through the financial results in detail, I will comment on our outlook for 2016. John?

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

Thank you, Tim. My review of our financial results will begin on page 7 of the presentation on the website.

Net income for the quarter was $4 million, or $0.09 per basic and diluted share, compared to $4.2 million, or $0.09 per basic and diluted, in the prior quarter, and $2.5 million, or $0.05 per share in the same period last year. Book value per share decreased by $0.33 to $13.84 in the quarter, reflecting the impact on the share count of options exercise, restricted share grants and temporary unrealized losses on securities reported in comprehensive income, which was partially offset by earnings retention.

Basic shares outstanding as of March 31, 2016 increased by approximately 1.1 million shares, due primarily to the impact of stock options granted several years ago that were exercised by the holders prior to their expiration in 2016. We do not expect to see this level of dilution from option grants in the future given the amounts and the strike price of current outstanding options. Outstanding shares at the end of the first quarter were $47.6 million, and average basic and diluted shares were $46.5 million and $46.5 million, respectively.

If you turn to page 8, it provides a highlight of our financial performance for the first quarter including a summary of our balance sheet, income statement and key ratios for each of the five most recent quarters and the two most recent fiscal years comparison. New investment activity totaled $300 million in the quarter, down from $600 million from the same period last year and $700 million from the prior quarter, due primarily to a slowdown in the overall market activity and selectivity as Tim described earlier.

New investments totaling $43 million were allocated to manage funds with co-investment strategies, and $256 million was retained and held for investment. Investments allocated to managed funds in the quarter were all leveraged finance loans, and the mix and investments retained in the balance sheet included $238 million of leveraged finance loans, $5 million of asset-based loans, which was subsequently sold, and $13 million of equipment loans and leases.

In the first quarter, managed assets decreased by $328 million to $6.6 billion, due primarily to the sale of the asset-based lending subsidiary. Excluding the sale, managed assets were consistent with prior quarters. Compared to the same period last year, managed assets increased by $2.9 billion, due to the acquisition activity in our organic growth. Total assets held by our managed funds were approximately $3 billion at the end of the first quarter.

Total revenue increased by $14 million, or 51%, to $41.7 million for the quarter, due primarily to the impact of a $22.5 million gain on the sale of the asset-based lending business, approximately $6.5 million of asset management and other fee income. That gain was offset by a $1.9 million decrease in net interest income. In addition, the [9.7%] loss was recognized due to the total return swap and loans held for sale marks of $4 million which was due to credit impairment, $5.7 million from marks related to mark-to-market exposure that should be recovered in the future period.

Interest income increased by approximately $1.4 million in the quarter to $62 million, due primarily to higher average loan balances, which is partially offset by a slight decrease in the portfolio yield in last quarter as accelerating amortization and deferred loan fees decreased due to slower runoff in the prior quarters.

Interest expense increased by $3.2 million as the cost of funds increased to 4.56% from 4.32% in the prior quarter, due primarily to the issuance of higher-cost senior notes totaling $80 million in November and the final drawdown of $25 million of subordinated notes in the first quarter. Noninterest income increased by $15.8 million to $19.2 million for the quarter, due primarily to the $22.5 million gain on the sale of NewStar Business Credit, offset by the marks from the total return swap and loans held for sale.

As I mentioned earlier, we also earned management fees totaling $3.4 million for managed funds during the quarter. New loans and investments originated in the quarter had a weighted average yield of 7.4% compared to 6.8% last quarter, reflecting selectivity and improving pricing environment.

An analysis of the net interest margin follows on the next page. As you can see, the net interest margin -- net new margin narrowed to 2.21% in the quarter, compared to 2.45% last quarter as expected. The margin pressure was due to a combination of factors: higher interest expense, and reduction in amortization of deferred loan fees due to lower prepayments than we typically experience.

We expect to see increasing positive trends in the interest income component of the margin in future quarters as prepayments normalize and the portfolio yield increases due to better pricing and new loan origination. As I mentioned, the cost of funds increased in the first quarter to 4.56% in the -- compared to 4.32% in the fourth quarter due to higher leverage and increasing subordinated note balances.

So going forward, we would expect to see the margin end slightly wider as the portfolio yield continues to improve and future growth is funded by lower-cost CLO and warehouse debt.

The next slide provides a snapshot of the composite of our loan portfolio by industry and vintage as of March 31, 2016. As you can see, the portfolio remains highly diversified by industry, and less than 4% is now comprised of legacy loans originated before the financial crisis. The portfolio is also highly diversified by obligor. The largest single borrower of concentration was 1.2%, and the top 10 obligors represent approximately 9.9% of total portfolio as of March 31, 2016.

Exposure to the energy sector was less than 2.5%. As mentioned previously, managed loans and investments totaled $6.6 billion at the end of March 31, 2016. Approximately $3.7 billion was retained on our balance sheet, and $2.9 billion was managed across 14 funds or accounts.

As of March 31, 2016, our loan and investment portfolio is comprised of loans and leases totaling $3.2 billion, loans held for sale of $475 million, and $96 million of investments in debt securities. Loans held for sale were primarily composed of leveraged finance loans, with the majority expected to be sold to our managed credit funds during the next several quarters.

Page 11 provides a snapshot of our capital structure at the end of the first quarter. As you can see, we have approximately $1.4 billion of committed warehouse credit facilities used to fund new investment activity. In the quarter, we also added $375 million line of credit warehouse to support the launch of a new fund called Arch Street managed on our NewStar Capital platform. Term debt securitization balance has increased by $217 million due to the issuance of $256 million new securitization debt in the first quarter, which was offset somewhat by continued amortization of our 2007b1 CLO and our 2015b1 equipment loan and lease-back securitization.

During the quarter, we issued the final $25 million of subordinated notes under the existing commitment. With significant warehouse capacity and $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 $150 million of unrestricted cash at quarter-end, we have significant operating and financial flexibility which we believe supports growth objectives including share repurchase dividends, acquisitions or divestitures.

If you turn to the next slide, the presentation titled credit performance, I will review the highlights of our credit results for the quarter. As Tim described earlier, credit costs for the quarter exceeded expectation ranges due to several factors. First, we took $9.3 million of credit charges related to two long-term work out of legacy loans in anticipation of restructuring a potential future sale of commercial real estate mortgages. These charges are reflected in provision expense.

Other credit-related costs in the quarter totaled approximately $12.5 million. Of that amount, approximately $3.4 million reflected usual credit provisioning activities, and $9.1 million was related to $4.1 million realized loss on energy loan referenced by the TRS in a rapidly developing credit event during the quarter that led to a $5 million charge-off. Provision expense also included $1.1 million for the general reserve and $16.6 million of net additions to specific reserves, which was up from $2.4 million last quarter. The allowance for credit losses increased by $8.6 million to $67.3 million, compared to $58.7 million at the end of the quarter. The allowance ratio increased from 1.81% to 2.19%, primarily due to higher specific reserves.

Net charge-offs in the quarter were $7.3 million and included the $5 million I referenced earlier, $1 million to charge off the remaining balance of small legacy loan, and $1.3 million to charge off a portion of three commercial real estate loans classified as loans held for sale at March 31 and were subsequently sold.

Nonperforming assets were $3.6 million of loans, up from $3.4 million last quarter due to three new loans being placed on non-accrual for $10 million, which was partially offset by $6.1 million of charge-offs on non-accruing loans. Although costs were elevated in the first quarter, we have not changed our outlook for the portfolio, which remains very positive.

Next slide highlights our credit performance since they Company's inception. Here, we compare our leverage finance credit performance by vintage to the Moody's data for comparable single B quality loans in the same cohorts. You can see our credit performance is outstanding as we continue to outperform the Moody's benchmark. We incurred minimal defaults and modest losses on loans originated after 2008. Since inception in 2004, we experienced an average annualized loss rate of 23 basis points.

The next three slides show our detailed balance sheet income statements, which I've already touched on through the review of key financial highlights. I will now turn it back to Tim.

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

Thanks, John. As you can see on slide 18, our results varied somewhat from our guidance in key areas in the first quarter. As a result, we have revised our expectations for the balance of the year to reflect our outlook as well as the impact of the sale of our ABL business. As I discussed earlier, the pace of new investment activity was below expected levels in Q1. And loan demand, although it's improving significantly, continues to reflect slower deal activity.

As you can see, we have reduced our origination targets for the full year to reflect both the reduction in origination related to the asset-based lending business as well as our expectation for investment activity.

Yields on new loans exceeded guidance in Q1, and we now believe they are likely to trend slightly higher than expected.

Portfolio runoff was below expected levels in Q1. However, we have reduced expected growth targets to reflect the lower pace of origination and the impact of the ABL business.

The cost of funds and net interest margin continue to reflect the impact of higher costs senior subordinated notes, and the cost of funds exceeded our guidance in Q1. The cost of funds is expected to decline, as John said, however, as we deploy the long-term debt capital and add lower cost CLO debt and fund additional growth.

Noninterest revenue exceeded guidance due to the gain from the sale, but we maintained our targets. Credit costs exceeded targets, but we are expected -- but are expected to normalize within expected ranges for the year. Pretax ROE is forecasted to remain within expected ranges.

We maintain a slower pace of (inaudible) and origination in response to weak demand or poor economic conditions. We would expect to generate additional liquidity, which would be available for opportunities arising from market dislocations as well as other purposes. That said, we do not see fundamental weakness in the economy reflected in the performance of the companies in our loan portfolio and volumes improving.

Another factor we will consider as we allocate capital will be how our stock is trading relative to our book value and to comparable companies. At present, stock is trading at levels that we believe are inconsistent with the intrinsic value of the Company and its assets. They also consider other dispositions of assets outside of our core strategy where we compete more directly with banks.

We have a great track record, we're focused on attractive market segments and we are strategically aligned with world-class partners. We have an expanded asset management platform that is expected to contribute significantly to fee income. And despite some market challenges in the first quarter, we remain on track to generate better returns on capital.

And with that, I would open it up to any questions you have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Steven Kwok, KBW.

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

Just first question just around the credit performance in the quarter. Can you drill down in terms of the legacy loans that you had to establish reserves for along with the three loans that were placed on non-accrual? Can you talk about what categories they were in and the vintage around them? Thanks.

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

Legacy loans were -- was one that we've been in the process of restructuring for. A number of years, industrial manufacturing company. And we -- the vintage on that loan I believe is 2006. I would have to double check that. Just a company where we think there is value, and we worked hard to try to recover the value. Now we believe we have it marked at a level where we are going to be able to resolve it more easily.

The -- and then I think based on the non -- the other legacy loan was a real estate loan that was originated before the crisis. And as we have talked about, as we are liquidating the commercial real estate portfolio, we are actually able to do that at levels that are pretty consistent with where we own those loans. But there's one that we have continued to restructure; we just sold a piece of it. And based on the valuation on that property, we marked the rest of it to a level where we believe we can sell it in the marketplace. So that really was a -- designed to position it for sale as well.

And then the non-accruals are really no specific sectors. One of them was the loan that surprised us. It's a vocational schooling where we created a transaction with three other lenders. Very good sponsor who is -- we have a great track record with. They lost their license with the government that provided tuition assistance and student loan support, surprisingly. And we recovered most of the loan, but the business was shut down pretty abruptly at the end and we lost $5 million on that. So I would say (inaudible) space that was really just surprised that no one anticipated.

The next one that was placed on non-accrual was an energy loan that we've marked down to a very minimal level now. But it's -- it was an energy -- one of our few energy loans, and it just hasn't recovered. And the other is a manufacturing company that is not -- there is no specific issue to it. Those three loans are not legacy loans. They are loans that were actually originated after the crisis. And I think they reflect normal seasoning and what we would expect in the portfolio from time to time, although we were surprised by the one in the educational space.

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

Got it. And then just in terms of I guess -- are there any loans that are on your credit watch right now?

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

There are always names on our credit watch. We have -- we look at every name on a regular basis. And so some are above plan, some are on plan, some are behind and some get far enough behind that we pay a lot more attention to them.

So there are, but there certainly is no increase in the number of names that we would consider on credit watch. In fact, I know it's taken a long time and it's tough to still be talking about legacy loans, but we are down to about 4% of the portfolio being legacy loans. And I'd say that over the last couple of years that watch list of names has -- where we are concerned about marks and losses has been reduced and worked out very significantly. And I think this last quarter is getting to the very tail end of what we need to do to fully resolve it.

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

Got it. And then just around competition, given the slowdown you have seen, have there been any changes around the competitive landscape?

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

Well, I think the landscape is -- the big macro trend is that the banks have over the last 18 months have significantly pulled back from our market. BDCs are much less active. They've been obviously much lower as they've been unable to raise new capital, so we've seen less of them in the marketplace.

But I think what happens is it is a relatively small, nichey market. And when there is enough competition that when volume falls off like it has, you do see some pressure on new deals. And so the competition is still really centered in the old GE business which is Antares, Gallup, Madison Capital, and XT, ourselves I would say are the core -- and a couple of banks that still play in that marketplace. There are a lot of other investors that we see in different parts of the capital structure and in our markets, but that's the most consistent competition we see.

And, frankly, we are all a little bit -- struggling with the low volume that you are seeing in the market. The volume to me was -- the low volume was caused by serious disruption and high yield in loan markets. And as that has settled down now, we are starting to see much better flow. And I think you'll hear from us and from others in this business that we expect volumes to steadily pick up between now and the end of the year. So we do think there will be a lot of opportunities.

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

Got it. Great. Thanks for taking my questions.

Operator

Shiloh Bates, AR Capital.

Shiloh Bates - *AR Capital - Analyst*

For the percentage of the portfolio, the 2.5% that is energy, you mentioned that one of those loans had been down substantially. Did the remainder there -- did they survive at oil where it is today?

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

Yes. We have obviously been through this for several quarters now. Been through this portfolio with a fine tooth comb. The one we -- the one that we put on non-accrual and took a big specific on this is actually in the TRS. So we have actually realized the loss this period as we (technical difficulty) the TRS is the worst. And as the most severe mark on it -- the rest of them are -- we believe are marked appropriately. They have all been marked down to some degree. And I think we are -- we feel like they are marked appropriately right now.

Shiloh Bates - *AR Capital - Analyst*

Got it. And then another place in leverage finance where we've seen some stress is the retail industry. Could you just comment on how your portfolio there is looking today?

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

Yes, it's -- we have seen that as well. And certainly if you are looking at new issues in retail, the market response to them is -- has been very, very mixed and there in this pressure on it. We've got about $100 million, I think -- that right, John? $100 million of retail, which is about 3% of the portfolio. It's not a big part of what we do. We are obviously very focused on it, and we have taken some -- increased our general reserves on a couple of names based on just where we are seeing things trade in the marketplace and downgraded in ratings.

But it is diverse. And where we are, we think we are in niches that are less vulnerable to the trends that are hurting the big retailers online and so forth.

So we feel pretty good about it. We haven't done much new stuff at all, and I think we are, again, a sector we are very carefully watching and I think we are appropriately marked in.

Shiloh Bates - *AR Capital - Analyst*

Okay. And then one final question. Just given where you guys are in terms of liquidity and the valuation of the stock as a percent of book, how much buybacks did you do in Q1? And maybe what should we expect over the next quarter or two?

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

We have a $30 million buyback. I don't believe we have disclosed how much we've --

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

We will. In the file of the 10-Q, we will disclose --

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

In the Q, we will disclose how much of that we have used. But it's a $30 million buyback. And I think it's as good or better place we can put our money as anything else we see out there. We've got a lot of cash, and so we are interested in buying back stock at these levels.

Shiloh Bates - *AR Capital - Analyst*

That's great to hear. Hey, thanks for taking my question.

Operator

And I'm showing no further questions at this time. I would now like to turn the call back over to Mr. Robert Brown for closing remarks. Please go ahead.

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

Thanks, Vicki. That will conclude our call for the day. 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 great day.
