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OHAI - Q1 2017 OHA Investment Corp Earnings Call

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## CORPORATE PARTICIPANTS

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**Steven T. Wayne** *OHA Investment Corporation - CEO and President*

## CONFERENCE CALL PARTICIPANTS

**Charles Von Kapff Carlson** *Corbyn Investment Management, Inc. - President, Co-CIO, MD, and Portfolio Manager*

**Richard Siracusa**

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the OHA Investment Corporation first quarter report, March 31, 2017. (Operator Instructions)

Before we begin, I would like to remind everyone that today's remarks may include comments which could be considered forward-looking statements and such statements are subject to many factors that can cause actual results to differ materially from our expectations as expressed in those forward-looking statements. Those factors are described in more detail in the company's SEC filings, and I refer you to the company's website or to the SEC's website to review those filings.

The company undertakes no obligation to publicly update or revise any forward-looking statements, which speak only as of today's date.

As a reminder, this conference call is being recorded.

I will now turn the call over to Steven Wayne, the company's President and CEO. Sir, you may begin.

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

Thank you, Charice. Good afternoon. I'd like to welcome all of you to our company's first quarter 2017 earnings call. I am joined on the call today by Cory Gilbert, our Chief Financial Officer.

The presentation we are about to review was posted to our website earlier today under the Events and Presentations heading of the Investor Relations tab. We also refer you to our quarterly report on Form 10-Q that was filed yesterday.

I'll now turn to Page 4 and provide a summary of the developments for OHAI for the quarter ended March 31, 2017. NAV declined $0.97 per share in the first quarter of 2017 to $3.02 from $3.99 at the end of 2016. This decline largely stems from a $21.2 million write-down of our investment in Castex, a legacy energy portfolio investment, which we placed on non-accrual during the quarter. This write-down was partially offset by $1.4 million of net positive changes in value in our OHA investments. I will cover the Castex write-down and other portfolio investment developments later in the presentation.

From a financial standpoint, we finished the quarter with $193,000 of net investment income or $0.01 per share and declared distributions of $0.02 per share. Cory will provide more detail on the financial results in a few minutes.

During the quarter, we added $7 million of principal amount of second-lien term loan in Equinox Holdings, a leading operator of upscale fitness clubs. Additionally, we had realizations of $8.5 million, which included the subsequent sale of $3 million of Equinox second-lien term loan we initially purchased $10 million of principal amount; a partial pay-down in our investment in Royal Holdings of $4.5 million; a sale of $0.5 million of our investment in Berlin second-lien term loan; and $0.5 million remittance from our investment in Gramercy that was applied to basis. As you may recall from last quarter, Gramercy is our CLO equity investment that was called back in December and continues to liquidate its underlying collateral. Subsequent to March 31, 2017, we received an additional $900,000 remittance from Gramercy, further reducing our basis.

Although the 2016 U.S. high-yield rally continued into the first quarter of 2017, it showed some modest fatigue late in the quarter. The post-election rally that further propelled the high-yield market late last year continued in 2017 as high-yield spreads tightened to within 20 basis points of their post financial crisis tights amid speculation that lower taxes, regulatory rollbacks and increased infrastructure spending would serve as drivers for economic growth. However, slower progress in Washington, a pull-back in equities, and decline in oil prices stalled the high-yield rally late in the quarter. Overall, with a backdrop of modest new issue activity, the broad high-yield index ended the quarter up 2.7% with the lower-rated segments of the market outperforming. Through last Friday, high-yield spreads continued to tighten and the index was up just over 4% for the year.

In the leveraged loan market, U.S. institutional new issue activity is at record highs, although a significant amount of this activity has been repricings and refinancings rather than new money deals. Year-to-date, this market is up 1.8%. The slower activities we have been seeing in the middle market, however, continues. In the syndicated middle market, yields with loan amounts of $350 million or less, total U.S. issuance in the first quarter was down 3% quarter-over-quarter to $8.1 billion, and new issue yields have declined. Adjusted for refinancing during each of the quarters, middle-market issuance for new money deals was down approximately 11% quarter-over-quarter.

On a related note, U.S. middle-market Private Equity M&A activity remained sluggish in the first quarter of 2017, with the lowest numbers of deals closing since the second quarter of 2013.

I will now turn the call over to Cory to discuss the financial results for the first quarter.

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**Cory E. Gilbert** - *OHA Investment Corporation - CFO*

Thank you, Steven. The financial summary for the first quarter can be found on Page 5.

Our investment income for the quarter totaled $2.5 million or $0.12 per share, a 39% decrease from the previous quarter. Base management fees were $570,000 and there were no incentive fees for the first quarter. Our net investment income totaled $193,000 or $0.01 a share. We recorded net realized and unrealized losses totaling $19.3 million or $0.96 per share during the quarter, primarily related to a $21.2 million or $1.05 per share write-down of our investment in Castex. Steven will provide additional commentary on this write-down and other significant valuation changes in our investment portfolio in a moment.

All together, we reported a net decrease in net assets from operations of $0.95 per share. After our $0.02 per share distribution declared in March and paid in early April, our net asset value declined to $3.02 per share, a 24% decline from the fourth quarter.

We continued our practice to seek positive assurance from a third-party valuation firm on all Level 3 assets with fair values in excess of $10 million on a quarterly basis. We will also seek positive assurance on other Level 3 assets with any fair value below $10 million at least annually. This quarter, we sought and received third-party positive assurance on 96% of our Level 3 asset with any fair value.

Page 6 shows the net investment income section of our income statement for the first quarter of 2017, compared to our results for the fourth quarter of 2016 and for the first quarter of the prior year. Investment income decreased by approximately $1.6 million or 39% from the fourth quarter of 2016 primarily as a result of placing our investment in Castex on non-accrual status in the first quarter, and no income recognized from our limited term royalty investment in ATP/Bennu. During the first quarter of 2017, we placed our investment in Castex on non-accrual status based on our March 31, 2017, valuation, which reflects a determination that estimated future payments received from this investment will no longer be sufficient to cover all of the contractual principal and dividend amounts on this investment. Therefore, we did not recognize any dividend income from our investment in Castex this quarter. Compared to the same quarter in the prior year, investment income decreased $2.7 million or 52% primarily as a result of a decrease in our average portfolio investment balance and Castex and ATP/Bennu placed on non-accrual status.

Interest expense for the quarter was $974,000 or $0.05 per share compared to $988,000 or $0.05 per share in the fourth quarter of 2016 and $1.1 million or $0.05 per share in the same quarter of the prior year. Quarter-over-quarter, interest expense is flat as our amount borrowed on our Credit Facility remained unchanged at $40.5 million.

Management and incentive fees to our advisor were $65,000 lower in the first quarter of 2017 compared to prior quarter as the result of lower base management fees. No incentive fees were incurred in the first quarter of 2017 or the prior quarter. Compared to the same quarter prior year, base management fees were lower by $260,000 and incentive fees were lower by $100,000.

Other G&A expenses for the quarter were $714,000 or $0.04 per share compared to $812,000 or $0.04 per share in the fourth quarter of 2016 and $1.3 million or $0.06 per share in the same quarter prior year. Quarter-over-quarter, the G&A expenses were lower due to lower legal costs partially offset by higher employee-related expenses. Compared to the same quarter prior year, Other G&A expenses were lower due to lower legal costs and lower employee-related expenses.

As a result, our net investment income for the first quarter of 2017 totaled $193,000 or $0.01 per share compared to $1.6 million or $0.08 per share in the prior quarter. In comparison, net investment income for the first quarter of 2016 totaled $1.8 million or $0.09 per share.

Turning to Page 7, you can see the summary of realized and unrealized gains and losses in the portfolio for the relevant quarters. During the first quarter, we recorded small realized gains related to the sale of a portion of our investments in Equinox and Berlin.

Now, let's look at the net unrealized losses on the lower half of the page. There, the significant driver of the net unrealized loss is from our investment in Castex, a legacy energy-related investment. This unrealized loss was partially offset by unrealized gains in OHA portfolio investments and Talos, a legacy energy investment. Steven will provide more commentary on the portfolio valuation changes in a moment.

On page 8, you'll find a graphical presentation of the components of the quarterly results and their respective impact on our net asset value per share. Net asset value at the beginning of the quarter was $3.99 per share. Net investment income was $0.01 per share. This was partially offset by the first quarter distribution of $0.02 per share and the net negative adjustment in the valuation of our investment portfolio totaling $0.96 per share with $1.05 of that relating to our write-down in Castex. These all combined to reduce our net asset value per share to $3.02 for a quarter-over-quarter decrease of $0.97 or 24%.

Now, let me hand the call back over to Steven.

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

Thanks, Cory. Let's go to Page 10. As shown here, OHA has been able to invest $127.4 million in 14 new portfolio companies since September 30, 2014, which we believe validates the thesis of OHA's origination capability for OHAI. During that same period, we have realized $118.1 million of investments including $80 million through the full or partial realization of OHA investments. OHA has been able to generate a weighted average unlevered gross IRR of 14.7% on the seven fully-realized OHA investments.

Since closing the new credit facility in early September of last year, we have made investments in two new non-energy portfolio companies totaling $15.5 million of par value. As I mentioned earlier on the call, this quarter we added $7 million of second lien term loan in Equinox Holdings. We initially purchased $10 million of this term loan at a price of $99.25%, and this asset earns interest at a rate of LIBOR plus 7% with a 1% LIBOR floor.

We ended the quarter with $12.9 million in cash and amounts due from unsettled asset sales on our balance sheet, most of which is available for new investments and $16 million available to draw on our Credit Facility.

At the end of the first quarter, the fair value of our Portfolio Investments totaled $88.7 million excluding our uninvested cash - and as noted at the bottom of the page, they are split 63%/37% between floating rate and fixed rate investments. Also, 54% of our portfolio investments, based on fair value were classified as level 2.

Turning to Page 11. Despite investing just over $129 million over the past 10 quarters, which includes $1.7 million of additional investments in legacy assets, the size of our portfolio by fair value has decreased 48%,since September 2014, driven by $103.7 million in negative valuation changes and $118.1 million of realizations.

Let's now go to Page 12. While the portfolio may be smaller, this chart does show a material difference in the composition and diversification of today's portfolio. We unfortunately continue to remain overexposed to energy, but we have substantially diversified the non-energy portion of our portfolio into a wide range of industries.

Turning to Page 13 for a more detailed look at the company's portfolio changes during the recent quarter. I will focus my comments on the meaningful changes in the portfolio during the quarter. During the quarter, we once again wrote-down our investment in the redeemable preferred units of Castex 2005 LP. Originally, a $50 million face investment, we hold an 8% redeemable preferred stock that pays an 8% cash dividend or 10% if paid in kind. Under the terms of the original investment, we are entitled to an additional make whole that would increase our total return at redemption. Per the agreement, since the company PIK's us more than three consecutive quarters, the total return upon redemption previously increased from 12% to 13.5%. Preferred unit holders had a put right starting on July 1, 2016, and we exercised this right on that day. The put right and redemption process is more fully described in footnote eight of the March 31, 2017, Schedule of Investments in our recently filed 10-Q. And as I mentioned in previous earnings calls, we did not receive cash pursuant to the put during the initial 90-day phase, which ended September 29th. As a result of our make whole has further increased from 13.5% to 18% and certain rights have attached.

The valuation methodology for our Preferred stock is driven by a determination of Castex Enterprise Value as of the Balance Sheet date. Based largely on updated oil and gas reserve information Castex management provided, which indicated a much lower reserve base than previously provided, we reduced the value for our Castex preferred units to $12.3 million at March 31, 2017. As Cory mentioned earlier on the call, this updated valuation also resulted in OHAI placing this investment on a non-accrual status during this quarter.

As noted in our 10-Q, the entity through which Castex produces and develops oil and natural gas may undergo a restructuring, bankruptcy, asset sale, or other transaction that could adversely affect the fair value of our investment in Castex and our expected return. I would like to emphasize that there is no guarantee that the outcome of such a transaction would be favorable to us or would enhance the value of our preferred LP interests. Also, we are subject to the risk that Castex or its creditors may make business decisions with which we disagree and that Castex management may take risks or otherwise act in ways that are adverse to our interests.

Our largest gains in the quarter came from TIBCO and Talos, two of our Level 2 assets. On the back of strong and improving earnings, our $10.1 million of TIBCO Notes traded up to 110.750 at March 31st, 2017, from par at year-end, resulting in an unrealized gain of $1.1 million in the quarter. Talos, a legacy energy asset, moved from 59.5% of par at December 31, 2016, to 66% at par at March 31st, 2017, resulting in $800,000 unrealized gain during the quarter on our $12 million principal amount of Senior Unsecured Notes. As Level 2 assets, we rely on pricing services or broker quotes at the balance sheet date to determine fair value of these investments.

Subsequent to quarter end, Talos announced that it entered into an exchange agreement with certain holders of its Senior Unsecured Notes, OHAI is not included. Under the terms of this exchange, these holders swapped $172 million of senior unsecured notes for new operating company's 2nd lien 11% bridge loans that mature in 2022. These holders also extended the maturity on $102 million of Senior Unsecured Notes for 5 years. This leaves approximately $25 million of Senior Unsecured Notes due February 2018 outstanding, of which we hold now $11.5 million following the repayment at par on $0.5 million of Senior Unsecured Notes that we received yesterday.

Although not a significant driver of value change during the first quarter, I would like to point out that we reduced the value of our equity investment in OCI Holdings by $200,000. As a reminder, we have a 20.8% diluted equity ownership in OCI's common equity, and $18.1 million of principal amount of subordinated notes in OCI.

OCI, a home health provider of pediatric therapy services to Medicaid patients in Texas, has negatively been impacted by Medicaid reimbursement rate reductions, which were proposed in June of 2015 and were implemented by the state of Texas effective December 15, 2016. Even prior to the implementation of these reductions, OCI experienced pressures on rates in certain parts of their business and reductions in visit volumes. As a result, recent operating performance and cash flow have declined. Advocacy groups continue to challenge the Medicaid reimbursement rate reductions and are asking the Texas State Legislature to restore funding in its current legislative session. The Texas House of Representatives has included significant Medicaid rate restoration for pediatric therapy service providers in their proposed budget, however, there is no guarantee that the final biannual Texas budget will reflect these restorations. Therefore, the long-term impact to OCI remains uncertain.

Also subject -- subsequent to quarter end, we executed an eighth amendment to our note purchase and security agreement with OCI that allows the company to continue to PIK its LIBOR plus 12% cash interest through June 30, 2017.

So, let's move on to another snapshot of our investment portfolio, the yield comparison on Page 14. This table focuses on the yield in our portfolio both as it relates to cost and fair value. Based on our current yielding investments, which includes any PIK component from performing investments, our portfolio yielded 12.8% and 12.5% based on fair value and cost, respectively, at March 31, 2017. This compares to 12.2% and 9.7%, respectively, at the end of the prior quarter. The increase yields is primarily driven by Castex moving out of the performing portfolio.

As shown on Page 15, we now have 13 active investments, including the $0 value investments in ATP/Bennu and Shoreline, as compared to 10 at September 30, 2014. Eight of these are new investments made by OHA, and they now constitute 57% of the portfolio on a fair value basis.

This ends our formal presentation for today. On Pages 17 and 18, you'll see the current and selected historical price curves for both oil and natural gas. Thanks, again, for your time today and for your continued interest in OHAI. I will now turn the call over to the operator to coordinate the Q&A process.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from Chip Carlson with Corbyn Investment.

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**Charles Von Kapff Carlson** - *Corbyn Investment Management, Inc. - President, Co-CIO, MD, and Portfolio Manager*

With respect to the Castex situation, the fact that it's now on nonaccrual, does that mean that you did not need to include any income from the calculation of net investment income with respect to OIC regulations -- distribution regulations?

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

So the financials that were presented today and in our 10-K are GAAP financials and presented in accordance with GAAP. We will still have to assess from a tax standpoint what, if any, income we may need to recognize. The standards generally are different between tax and GAAP in terms of the ability or ability to not recognize income, so we won't know that until the end of the year until we go through the process of -- our tax process, but we would expect to certainly be more limited income recognized from a tax standpoint than we have been in future years.

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**Operator**

(Operator Instructions) Our next question comes from [Jack Mayer] with [Wile Trust].

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**Unidentified Analyst**

Could you discuss your ability to repurchase stock in the open market? And how you weigh that investment, which seems to yield much more than anything else versus making new investments and new loans?

**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

Sure. As we have been asked this question on previous calls and as we've disclosed in our public filings, the credit agreement we have in place right now with our lender did not allow us or give us the ability to buy back shares. So in terms of right now, we do not have the ability to repurchase shares.

**Unidentified Analyst**

Does it all -- to what extent does it allow you to distribute anything more than the income that you're required to distribute to shareholders?

**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

We do have limits. We do have a covenant that restricts us from distributing out more than 110% of taxable income without getting their approval.

**Unidentified Analyst**

Has the board or management explored getting a different type of financing that would allow you to repurchase given the enormous disparity between the trading price and NAV?

**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

We certainly have not explored that in the -- recently, as you're probably aware and I'm not sure how long you've been involved with the company. We went through a very lengthy and extensive and frankly difficult process in raising a new credit facility as we approached the maturity of our legacy investment facility, which had been put in place prior to our management. So where we are from a lending standpoint was something that was methodically and difficultly came to bear and that's where we are right now. But to your other question, we have not more recently looked for alternative financing solutions.

**Unidentified Analyst**

And if the board decided to try to put the company into liquidation, would that move be a violation of your credit agreement?

**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

The answer is I'm not really sure. I'm not really going to speculate on what we might or might not do or the board might or might not want to do, but I don't have any answer for that offhand.

**Unidentified Analyst**

I mean, the question is not whether the board is going to do it, the question is whether under the credit agreement, that would be some sort of violation of the credit agreement?

**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

The answer is I don't know. We obviously -- we have standard provisions that require us to repay debt if -- upon certain repayments of sale of assets and things like that. So I don't know whether a decision to wind down or to try and liquidate the company would be a violation. I'd have to look into it more closely.

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**Unidentified Analyst**

Here's one man's view that, that should be looked into very, very seriously given the trading price. And the expense that you incur in running the company, not your fault, but a very small portfolio. This is not a huge company to run as a percentage of assets and it's not about to get cheaper.

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**Operator**

(Operator Instructions) Our next question comes from Richard Siracusa with Merrill Lynch.

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**Richard Siracusa**

I just tuned in, so I probably missed -- I missed everything. But the energy loans that are the crux of the problem, are we close to the end of that hemorrhaging? Or is there still more to come?

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

Well, from a legacy portfolio standpoint, we really -- we only have 3 investments that have any value in our NAV today, 2 of those are energy assets, one of those was one of the few nonlegacy -- sorry, nonenergy legacy assets that we inherited. So there's -- only the Castex investment, which has about $12 million valuation as well as our investment in the Talos notes are the only 2 energy investments that have any positive value right now in our NAV.

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**Richard Siracusa**

Well, how -- what's the dollar amount of the ones that do not have any positive value -- or negative value, if you will?

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

Well, they're not negative, but they have 0 and we're talking about ATP/Bennu and Shoreline, which were written down in prior periods. The answer is 0.

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**Richard Siracusa**

Oh, they were written down?

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

Yes.

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**Richard Siracusa**

So with them, we're done with the write-downs?

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

On those assets, yes.

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**Operator**

Thank you. Speakers, I'm showing no further questions at this time. Mr. Wayne, I'll turn the call back over to you.

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**Steven T. Wayne** - *OHA Investment Corporation - CEO and President*

Thanks, operator. Want to thank everyone for their time today, and I look forward to speaking with you again next quarter.

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**Operator**

Ladies and gentlemen, this concludes today's conference. Thank you for your participation. You may all disconnect, and have a wonderful day.

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