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OHAI - Q2 2017 OHA Investment Corp Earnings Call

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CORPORATE PARTICIPANTS

Cory E. Gilbert *OHA Investment Corporation - CFO*

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

PRESENTATION

Operator

(technical difficulty)

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.

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

Thank you, operator. Good morning. I would like to welcome all of you to our company's second 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 second quarter ended June 30, 2017. NAV declined $0.26 per share in the second quarter of 2017 to $2.76 from $3.02 at the end of Q1 2017. This decline largely stems from a $4.7 million write-down of our investment in Castex, a legacy energy portfolio investment, which we placed on non-accrual at the beginning of the year. 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 $145,000 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 later on in the presentation.

During this quarter, we added $1.4 million principal amount to our existing $5.5 million second lien term loan in PAE Holdings, an existing OHAI portfolio investment. Additionally, we had realizations of $1.4 million, which included a partial pay-down in our investment in Talos Production senior unsecured notes of $0.5 million at par and almost a $1 million remittance from our investment in Gramercy, most of which was applied to basis. As you may recall from previous quarters, Gramercy is our CLO equity investment that was called back in December and continues to liquidate its underlying collateral. We ended the quarter with $12 million in cash.

As a brief backdrop of the market environment in which we operate, private equity activity, which generally drives new money financing opportunities in the below-investment-grade credit markets, continued its recent decline in the second quarter of 2017, as deal count declined 39% and capital invested declined 29% compared to levels in the second quarter of 2016.

Performance in the U.S. high-yield market continues to be strong, as the broad high-yield index ended the quarter up 2.1% and the first half up 4.9%. High-yield spreads have continued to tighten to levels near their post-financial crisis tights.

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 transactions. Year-to-date, this market has returned 2.7%.

Activity in the middle market remains somewhat muted and mixed. While issuance of syndicated middle-market loans, loans with loan amounts of $350 million or less, did increase in the second quarter to $9.2 billion from $8.1 billion in the first quarter, issuance by companies with EBITDA of $50 million or less declined 30.7% from the first quarter of 2017 and 7.8% compared to the second quarter of 2016. In both the broadly syndicated and middle markets, new issue yields have continued to decline, making for a challenging environment to find new attractive investments.

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

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

Thank you, Steven. The financial summary for the second quarter can be found on page 5. Our investment income for the quarter totaled $2.5 million or $0.12 per share. Base management fees were $496,000 or $0.02 per share, and there were no incentive fees incurred for the second quarter.

Our net investment income totaled $145,000 or $0.01 per share. We recorded net realized and unrealized losses totaling $5 million or $0.25 per share during the quarter, primarily related to a $4.7 million or $0.23 per share write-down of our investment in Castex. Steven will provide additional commentary on this write-down and other portfolio activity in a moment.

All together, we reported a net decrease in net assets from operations of $0.24 per share. After our $0.02 per share distribution declared in June and paid in early July, our net asset value declined to $2.76 per share, a 9% decline from the first 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 99% of our Level 3 assets with any fair value.

On Page 6, this shows the net investment income section of our income statement for the second quarter of 2017, compared to our results for the first quarter of 2017 and for the second quarter of the prior year. Investment income for the second quarter of 2017 was $2.5 million, unchanged from the first quarter and decreased by $1.9 million or 43% compared to the second quarter of 2016. The decrease from the same quarter prior year is primarily a result of placing our investment in Castex on non-accrual status in the first quarter of 2017, and no income recognized from our limited-term royalty investment in ATP/Bennu in 2017.

As mentioned in our last earnings call, we placed our investment in Castex on non-accrual status based on our March 31, 2017 valuation, which reflected a determination that estimated future payments received from this investment will no longer be sufficient to cover all the contractual, principal and dividend amounts on this investment. Therefore, we continued to not recognize any dividend income from our investment in Castex during the second quarter of 2017.

Interest expense for the quarter was $984,000 or $0.05 per share compared to $974,000 or $0.05 per share in the first quarter of 2017 and $975,000 or $0.05 per share in the same quarter of the prior year. Quarter-over-quarter, interest expense was flat, as the average amount borrowed on our credit facility remained unchanged at $40.5 million.

Management and incentive fees to our advisor were $74,000 lower in the second quarter of 2017 compared to the prior quarter as a result of lower base management fees. Compared to the same quarter prior year, base management fees were lower by $271,000. There were no incentive fees incurred in 2017 or in the second quarter of prior year.

Other G&A expenses for the quarter were $840,000 or $0.04 per share compared to $714,000 or $0.04 per share in the first quarter of 2017 and $1.3 million or $0.06 per share in the same quarter prior year. Quarter-over-quarter, G&A expenses were higher due to higher legal costs, partially offset by lower 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 second quarter of 2017 totaled $145,000 or $0.01 per share compared to $193,000 or $0.01 per share in the prior quarter. In comparison, net investment income for the second quarter of 2016 totaled $1.3 million or $0.06 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 second quarter, our investment in Shoreline, a legacy energy-related portfolio company, was deemed worthless from a tax perspective. Therefore, the loss on our investment was reclassified from unrealized to realized in the second quarter and had no effect on the company's NAV in 2017. Our investment in Shoreline was completely written down to $0 in 2016 from a GAAP perspective.

Now, let's look at the net unrealized losses on the lower half of the page. There, the significant driver of the unrealized loss is from Castex, a legacy energy-related 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 $3.02 per share. Net investment income was $0.01 per share. This was offset by the second quarter distribution of $0.02 per share, and the net negative adjustments in the value of our investment portfolio totaling $0.25 per share, with a $0.23 of that related to our write-down in Castex. These all combined to reduce our net asset value per share to $2.76 for a quarter-over-quarter decrease of $0.26 per share or 9%.

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

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 $128.8 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 $119.5 million of investments, including $81 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 2016, we have made investments in two new non-energy portfolio companies totaling $16.9 million of par value. As I mentioned earlier on the call, this quarter, we added $1.4 million of second lien term loan in PAE at a price of $99.0%, increasing our total position to $6.9 million. We initially purchased $5.5 million of this term loan at a price of 97.0%, and this asset earns interest at a rate of LIBOR plus 9.50% with a 1% LIBOR floor.

We ended the quarter with $12.0 million in cash on our balance sheet, most of which is available for new investments, and $16.0 million available to draw on our Credit Facility.

At the end of the second quarter, the fair value of our Portfolio Investments totaled $84.5 million, excluding our uninvested cash- and as noted on the bottom of the page, they are split 68%, 32% between floating rate and fixed rate investments. Also, 58% of our Portfolio Investments based on fair value, were classified as level 2.

Turning to Page 11. Despite investing just over $130 million over the past 11 quarters (which includes $1.7 million of additional investments in legacy assets) the size of our portfolio by fair value has decreased 51% since September 2014, driven by $108.8 million in net negative valuation changes and $119.5 million of realizations.

Let's now go to Page 12. In response to questions we often get, we have added this page this quarter to better illustrate and explain the significant decline in NAV that OHAI has experienced since September 30, 2014, when OHA became the investment manager of OHAI. As shown here, on that date, the portfolio consisted of $171 million of investment assets in 10 portfolio companies, concentrated heavily in the energy industry. The price of West Texas Intermediate crude oil, or WTI, was over $90 a barrel, but almost immediately started dropping, falling to around $50 a barrel at the end of 2014. In early 2016, WTI was under $30 a barrel and today, it has recovered to the high $40s.

This commodity price movement, in conjunction with similar movement in the price of Natural Gas, took its toll on these legacy energy assets. And over the past 11 quarters, we have had to write down over $103 million of the original $171 million of investment assets, or 61% of the fair value. Most of that, $101 million has come from the 7 legacy energy assets that totaled $127 million of the $171 million of investment assets. As noted below, the amounts written off shown here do not take into account any additional investment, paid-in-kind interest/dividends, or discount accretion subsequent to September 30, 2014.

Now to turn to Page 13. While the portfolio may be smaller, this chart does show a material difference in the composition and diversification of today's portfolio. Although our energy exposure is now under 20%, as I just discussed, too much of this reduction in energy exposure has come from the write down of legacy energy investments. Away from the energy positions, we have substantially diversified our portfolio into a wide range of industries.

Turning to Page 14 for a more detailed look at the company's portfolio changes during the recent quarter. I will focus my comments today 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'd 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 June 30, 2017 Schedule of Investments in our recently filed 10Q, 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, 2016.

As a result, 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's 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 last quarter. Based on their recent production and updated commodity curves, we once again lowered our valuation, now down to $7.6 million at June 30, 2017.

As noted in our 10Q, 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, as mentioned last quarter, 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.

On Talos, a legacy energy asset, last quarter, we discussed in detail that it entered into an exchange agreement with certain holders of the Senior Unsecured Notes. We now hold $11.5 million following the repayment that we received at par on $0.5 million of our Senior Unsecured Notes during this second quarter. The price of the Talos bonds moved from 66% of par at March 31, 2017, to 63.5% of par at June 30, 2017. As a level 2 asset, we rely on pricing services or broker quotes at the balance sheet date to determine fair value of this investment.

During the quarter, we received $980,000 from our liquidating investment in Gramercy, of which we applied $946,000 to our basis.

Although not a significant driver of value change during the first quarter, I would like to point out that we again 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 $19.0 million of principal amount of subordinated notes in OCI.

OCI, a home health provider of pediatric therapy services to Medicaid patients in Texas, has been negatively impacted by Medicaid reimbursement rate reductions, which were proposed in June of 2015 and were officially 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 continued to suffer.

On May 31st, 2017, the Texas Legislature agreed to the 2018, 2019 biennium budget. The new budget, which goes into effect on September 1st, 2017, restores approximately 25% of the original rate cut subject to a number of specific provisions relating to pediatric therapy reimbursement. OCI management continues to address its cost base and pursue operating initiatives to best position itself for success in the new Medicaid rate reimbursement environment that will apply for the next two years.

Also subsequent to quarter-end, we executed a ninth amendment to our note purchase and security agreement with OCI that allows the company to continue its -- to PIK its LIBOR plus 12% cash interest through August 31, 2017.

So, let's move on to another snapshot of our investment portfolio, the yield comparison on Page 15. 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 12.6% and 13.0% based on fair value and cost, respectively, at June 30, 2017. This compares to 12.8% and 12.5%, respectively, at the end of the prior quarter.

As shown on Page 16, we now have 12 active investments, including the $0 value investment in ATP/Bennu, as compared to 10 at September 30, 2014. Eight of these are new investments made by OHA, and are -- and they now constitute 61% of the portfolio on a fair value basis.

This ends our formal presentation for today. On pages 18 and 19, you will see the current and selected historical price curves for both Oil and Natural Gas. Thanks for your time today, for your continued interest in OHAI.

I will now turn the call over to the operator to coordinate the Q&A process.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of [Dan Lippen], private investor.

Unidentified Participant

I came on late, but is there any path towards getting a raise on the ROE on these, on this pretty small fund? Hard to make up for the expenses with $55 million net assets.

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

I'm not really sure what the question is there. But again, obviously, we're trying to redeploy whatever assets we have in new investments, and we're trying to figure out how to get through the rest of this legacy asset portfolio, and we're continuing to monitor our expenses and minimize them to the extent we can. But clearly, at this size, it does make it difficult for us to generate high amounts of investment income. Obviously, to the extent we could raise more capital if we were not trading at such a discount, we would certainly look to do that and try and redeploy that in -- along the lines of the kind of investments that we've been able to invest since we've taken over. So I understand the point and the frustration, and it is hard to generate the kind of returns that investors expect in a vehicle like this, of this size. So we're mindful of that and we continue to try and work on ways to fix that.

Operator

(Operator Instructions) And our next question comes from the line of [George Gaspar], private investor.

Unidentified Participant

Could you just relay it again, you indicate there's 12 active investments, is that correct?

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

Yes, that is correct.

Unidentified Participant

Okay. And how in -- and the valuation of them relative to the investment that you have in, is what? Can you lay that out again, please?

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

I'm not sure I understand the question.

Unidentified Participant

Well, what would be the -- how do you -- the valuation of them relative to what you have invested, is it prospective or...? I'm just trying to measure how valuable these investments are.

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

All of these investments have been valued by our valuation committee and have been reviewed and -- at least, our Level 3 assets, by an outside third party. So I'm not sure if that answers your question or what specifically you're looking for. But we don't value them at cost. The cost of, particularly the legacy investments, were actually obviously much higher. If you look on Page 15 of the investor presentation, it does talk about -- it gives investment by investment the -- both the principal sum, originally our cost, and where our fair valuation is today.

Unidentified Participant

Okay. And I'm not looking at that online. But could you just relate the Talos energy situation again? You -- I think you indicated there's $11.5 million holding at this point in time. Is that correct?

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

That is correct. There's $11.5 million base value that we have left. It was marked this quarter at $7.3 million.

Unidentified Participant

I'm sorry, would you please repeat that?

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

Sure. We have -- we hold $11.5 million of principal amount and our original cost was $11.5 million, and at the fair value, it was marked on our balance sheet at 6/30 at $7.3 million.

Unidentified Participant

Okay, all right. And now was that a further write-down in the quarter then to get it to $7.5 million? Or was that previously done?

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

It was -- it had been previously -- as I talked in my remarks, the price changed slightly during the quarter. It moved from $66 at the end of the third quarter to $63.5 at this quarter. So there was a slight write-down, 2.5 points. But then on the flip side, it also did reduce by about $0.5 million, because we received $0.5 million of payment at par during the quarter.

Unidentified Participant

Right, right. Any level of confidence that you can get out of this situation ultimately for what it stands for on your books at this time?

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

Well, we stand by our marks clearly. That is marked, as I also said, by a pricing service. It's a Level 2 asset. So we don't mark that ourselves in valuation committee. But we are -- we just did receive $0.5 million at par, and we're hopeful, given that the maturity of this asset is in February of next year, so we're less than 6 months from maturity, that we're hopeful we could receive par on that asset.

Unidentified Participant

Right, right. Okay. And then the amount of money available for investments at this time, you indicated there's $12 million in cash and is it a $16 million possible credit draw?

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

It is $16 million, although the $16 million does expire. We lose the ability to invest that in the...

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

Middle of September.

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

Middle of September. That was a 1 year delayed draw facility from when we closed the facility. So if that doesn't get used by the middle of September, it will expire.

Unidentified Participant

Okay. And what are your possibilities of generating a new credit draw to give you some flexibility to make additional investments beyond that $12 million in cash?

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

Beyond that, I would say between now and the middle of September, it's unlikely we would find enough investments to both invest our usable cash, as well as draw the -- as we've said very clearly, we remain disciplined. We're not going to buy assets that we don't feel are good investments. We're not going to -- the expiration of the delayed draw is not going to drive us to make any investment decisions that we otherwise wouldn't want to make.

Operator

(Operator Instructions) This concludes today's Q&A session. I would now like to turn the call back over to Steven Wayne for closing remarks.

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

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