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FSC - Q1 2017 Fifth Street Finance Corp Earnings Call

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CORPORATE PARTICIPANTS

Robyn Friedman *Fifth Street Finance Corporation - Head of IR*

Patrick Dalton *Fifth Street Finance Corporation - CEO*

Steven Noreika *Fifth Street Finance Corporation - CFO*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Fifth Street Finance Corporation's first-quarter 2017 earnings conference call.

(Operator Instructions)

As a reminder, today's call is being recorded. I would now like to turn the conference over to Robyn Friedman, Head of Investor Relations. Ma'am, you may begin.

Robyn Friedman - *Fifth Street Finance Corporation - Head of IR*

Thank you, Shannon. Good morning, and welcome to Fifth Street Finance Corporation's first-quarter 2017 earnings call. I am joined this morning by Patrick Dalton, Chief Executive Officer; and Steven Noreika, Chief Financial Officer. Replay information for this call is included in our February 9, 2017 press release and is posted on the investor relations section of Fifth Street Finance Corporation's website, which can be found at FSC.FifthStreetFinance.com.

Please note that this call is the property of Fifth Street Finance Corporation Any unauthorized rebroadcast of this call in any form is strictly prohibited. Today's conference call may include forward-looking statements and projections that reflect the Company's current views with respect to, among other things, future events and financial performance. Forward-looking statements may include statements as to the future operating results, dividends, and business prospects of Fifth Street Finance Corporation

Words such as believe, expect, seeks, plans, should, will, estimate, project, anticipates, intend, and future, or similar expressions, are intended to identify forward-looking statements although not all forward-looking statements include these words. These forward-looking statements are subject to the inherent risks and uncertainties in predicting future results and conditions. Certain factors could cause actual results to differ materially from those projected or implied in these forward-looking statements.

New risks and uncertainties arise over time, and it is not possible for the Company to predict those events or how they may affect it. Therefore, you should not place undue reliance on these forward-looking statements. We ask that you refer to our most recent filings with the SEC for important factors that could cause actual results to differ materially from these forward-looking statements and productions. To obtain copies of our latest SEC filings, please visit our website or call investor relations at 203-681-3720.

FSC undertakes no obligation to update or revise any forward-looking statements whether as a result of new information, future events, or otherwise except as required by law. The format for today's call is as follows. Patrick will provide an overview of our results and outlook, and Steve will summarize the financials. I will now turn the call over to Patrick.

Patrick Dalton - *Fifth Street Finance Corporation - CEO*

Thank you, Robyn. Welcome to FSC's first quarter of 2017 earnings conference call. Before diving into the quarter, let me begin by saying that I am pleased to be here for my first earnings call as CEO after officially joining in the beginning of January and assuming responsibility for all aspects of FSC's investment and operating strategies.

As you may know, in mid-September, I was engaged as an advisor to the FSAM Board of Directors based upon the recommendation of an independent member of FSAM's Board. In that role, I was tasked with evaluating and making recommendations across three key areas: the people, the investment process, and the investment portfolio. While I have been familiar with Fifth Street for many years, conducting this comprehensive analysis provided me with a more in-depth understanding of the business and the team as well as its many strengths and areas for improvement.

Additionally, since joining, I've had the privilege of speaking with many of our external constituents including shareholders and lenders and other business partners. These conversations have provided me with valuable feedback on the business and helped me formulate our priorities for the future.

Now as CEO, I intend to leverage those insights and get right to work leading the team and the business operations with the focus on our strategic plan to turn around performance and create long-term value for our shareholders and other constituents, including our bank lenders, bondholders, and employees. As for some of my initial impressions, first and foremost, I believe the Fifth Street platform is resilient, remains well positioned within the middle-market lending community, and benefits from having a solid core team in place.

Our focus is on enhancing operating and investment performance, generating NAV stability, optimizing our borrowing facilities, and reducing leverage to inside our target range. During this call, I will discuss the current state of our portfolio, our future investment strategy, the rationale for the proposed changes to our fee structure and realignment of our dividend, and the necessary steps we are taking to further strengthen our infrastructure. Although I believe we have identified most of the key areas for improvement and have a clear plan to achieve our objectives, our efforts to improve performance and reposition the portfolio will take time.

Make no mistake though, we are operating with a renewed sense of urgency and focus. The plan that we have developed touches upon five key areas of our business. First, we plan to reposition our portfolio, which will include reducing concentration risks to certain sectors and individual credits. Second, we will seek to reduce investments on nonaccrual and on our watchlist with the goal of reinvesting these proceeds into safer, interest-generating loans.

Third, we plan to increase the utilization of our existing joint venture with the Kemper Corporation and our SBIC subsidiaries while also looking to create new joint ventures in the future. Fourth, we will propose change to our fee structure to increase alignment with our shareholders and realign our dividend to allow us to pursue lower risk, more stable investments. Lastly, we will look to enhance the existing team with some key hires to bolster our infrastructure.

One of my top priorities is to enhance the underwriting risk management processes with the goal of stabilizing NAV and core earnings. To that end, we embarked on a comprehensive review of FSC's portfolio, which included a detailed evaluation of the overall composition with a particular focus on individual investments that have and continue to cause NAV volatility. As a result of this evaluation, we identified that we mainly experience credit losses in investments with large single name exposures and industry concentrations.

Given the current market environment, the present construction of our portfolio and our continued focus on deleveraging, we believe that now is a prudent time to focus on repositioning the portfolio and enhancing operating flexibility to drive shareholder value. Going forward, we will seek to further diversify our portfolio into additional industries, size investments more appropriately, and focus on investing in companies with strong sustainable free cash flow. As a result, we've worked to reduce industry concentrations to the healthcare and technology sectors.

Further, we will aim to avoid outsized single name exposures and reduce direct crossover investments between FSC and our other BDC, Fifth Street Senior Floating Rate Corp. To expedite the portfolio repositioning, we may proactively seek ways to rotate out of a portion of our portfolio. Additionally, we plan on investing 85% to 90% of our portfolio in traditional senior secured loans and 10% to 15% in a diversified set of opportunistic and/or special situations where we have a core competency and believe our platform provides us with an investing advantage.

Importantly, we believe this opportunistic bucket should offset expected losses in the core portfolio that may occur over a credit cycle. We believe that this strategy will enable us to be even more selective in generating more consistent results for our investors. While our financial statements represent the fair value of our portfolio at December 31, looking ahead, we may experience further volatility in investments on nonaccrual and on our watchlist.

We will continue to work diligently with the private equity sponsors and management teams at our stressed investments as we seek ways to exit, restructure, or improve underlying business performance to maximize recovery for our shareholders. We believe that resolving the assets on nonaccrual in a timely manner and rotating these proceeds into traditional performing senior secured loans is important to our overall portfolio repositioning.

Separately, we believe that there are some key areas of opportunity within the portfolio that should drive incremental value for FSC shareholders. Specifically, we are focused on further ramping with senior secured loan joint venture with Kemper Corporation and believe that we can more efficiently utilize the remaining investment capacity at our SBIC subsidiaries. While not an immediate goal, longer term we have also looked to develop additional joint venture relationships to further diversify the FSC portfolio and drive future earnings.

Turning to our portfolio, we ended the first fiscal quarter with just under $2 billion of investments at fair value, a regulatory debt to equity of 0.84 times. This is above our target range, and we remain steadfast in our focus on reducing leverage to within our target range. Credit weakness in portfolio companies on nonaccrual and on our watchlist drove NAV down to $7.31 per share in December from $7.97 per share at the end of the September quarter.

Additionally, we ended the quarter with 11 investments on nonaccrual representing 7.3% total debt investments at fair value. Our investments in healthcare and for-profit education sectors have experienced issues due to reimbursement for regulatory changes. As these are industries where we have significant exposure, such changes may affect multiple portfolio companies, which is why we are actively working to decrease industry concentrations going forward.

For example, Adventure Interactive, our largest investment on nonaccrual, is a provider of regeneration marketing services to post-secondary education programs. The company has two divisions: marketing services and academic program management. The marketing services division has underperformed due to regulatory pressures in the for-profit education sector, and although a smaller part of the business, the academic program management division has been achieving its plan and is seeking additional funding for growth initiatives.

While we cannot be sure of the future, we are working closely with the private equity sponsor and the management team with the goal of ensuring the best possible outcome for FSC shareholders. For the quarter ended December 31, 2016, we generated $0.16 of net investment income per share. Additionally, 15.5% portfolio at fair value consisted of non-interest generating assets, which include nonaccruals and equity investments.

In light of this, we decided to realign our dividend policy with the goal of generating a long-term, sustainable dividend in order to fortify our balance sheet and stabilize NAV. In reassessing our dividend policy, we are focused on two goals. First, staying the dividend at a level that is aligned with our core run rate earnings power of the portfolio, and second, strengthen our balance sheet by using earnings in excess of our June quarterly dividend to de-lever, provide stability to NAV, and reduce our cost to capital.

We believe it is important to meet or exceed our dividend with net investment income over the long term to preserve NAV and create confidence in the shares of FSC. After taking these factors into consideration, we have determined to move to a quarterly dividend of $0.125 per share. However, as I mentioned, to strengthen our balance sheet and to de-lever in the near term, our Board of Directors has declared the following dividends: a $0.02 monthly dividend for March, which equates to a $0.14 dividend for the March quarter; and a $0.02 quarterly dividend for the June quarter.

Additionally, to provide further visibility, the Board of Directors has also declared a $0.125 dividend for the September quarter. At that time, we plan to reevaluate the dividends based on the progress we have made on FSC's stated initiatives. We believe that this change to our dividend policy should provide a long-term solution for our shareholders.

Next, I would like to discuss FSC's fee structure and the changes we are proposing to our shareholders. As a reminder, in January of 2016, FSC's base management fee on total gross assets, excluding cash and cash equivalents, was permanently reduced from 2% to 1.75%. This 25 basis point cut was voluntary and pertained to all fee earning assets without thresholds placing our fee structure at the median for the industry.

At this time, we are proposing to adjust our part one incentive fee and introduce a permanent total return hurdle, which may decrease the incentive fee by 25% per quarter after taking into account any realized and unrealized losses. This permanent total return hurdle will have a look back feature to expand every quarter scaling up to a three-year look back once fully phased in, and will become effective retroactive to January 1, 2017, mirroring my start date.

We believe that implementing a permanent total return hurdle is another step towards increasing the alignment between our manager, FSAM, and the shareholders of FSC while still allowing FSAM to remain competitive and attracting the best talent to manage FSC's shareholders' capital. We also believe this fee structure is among the most competitive of our BDC peers with total assets greater than $2 billion. There's only one other peer that has a permanent total return hurdle.

In conjunction with implementing a total return hurdle, we are seeking to move the accrual rate using in calculating the incentive fee to 7%, which is in line with our peer group. This hurdle rate should allow us to reposition the portfolio into safer lower-yielding assets which should reduce future credit losses and allow us to be more competitive in winning or participating in new deals. We believe that this is a prudent move and over the long term should provide for more stable NAV and attract the return and equity for our shareholders.

We are putting these proposed changes to a vote during a special meeting of our shareholders. We filed a preliminary draft with FSC's special meeting proxy with the SEC this morning, which all shareholders can view at this time. Additionally, we urge all of our shareholders to be on the lookout for the special meeting proxy, which should be mailed out to you in the coming weeks. We look forward to discussing these proposed changes with our investors in the weeks ahead.

Lastly, I would like to discuss our plans to strengthen our infrastructure and further align employee interest with those of our shareholders. As I discussed earlier, I believe we have a solid team in place today, and I am grateful for their contributions and commitment to our long-term plan. We are currently recruiting key hires in a few core areas that will add additional value to FSC.

In the few weeks since I joined, we've already added resources in portfolio management and operations to strengthen those divisions. Additionally, we have identified certain senior roles that we believe are necessary to help us achieve our goals. These include an experienced chief credit officer to help lead our investment process and ensure that our target portfolio is prudently constructed. And a chief accounting officer, who will support our CFO in the accounting team.

We are also looking for candidates to enhance our originations and underwriting teams. Furthermore, we plan to optimize the internal team structure in an effort to operate as efficiently and effectively as possible. The team is united in driving sustainable results for our shareholders. To further align the interest of our employees and investors, we will also tie a greater portion of our employees' compensation directly to the performance of FSC, effective immediately.

We are focused on operating with clarity, transparency, and consistency. I believe the strategy that we have described today will provide greater stability, allow us to de-lever in the near future, turn around performance, and drive enhanced value for all of our constituents over time. Repositioning the portfolio to strengthen our infrastructure should enhance value for shareholders but will take some time.

So we ask for and we appreciate your patience. I'm excited for the opportunity to continue meeting with more of our investors and analysts over the coming weeks and months. Additionally, I look forward to providing further updates as we continue to make progress on the stated initiatives over the course of the year.

I will now turn the call over to our CFO, Steve Noreika, to discuss our financial results for the quarter in greater detail.

Steven Noreika - *Fifth Street Finance Corporation - CFO*

Thank you, Patrick. We ended the first quarter of FY17 with total assets of $2.2 billion as compared to $2.3 billion at September 30, 2016. Portfolio investments totaled just under $2 billion at fair value and were spread across 123 companies at December 31, 2016.

At the end of the December quarter, we had $181 million of cash and cash equivalents including restricted cash on our balance sheet. Net asset value per share was $7.31 as of December 31, 2016 as compared to $7.97 in the prior quarter. NAV was primarily impacted this quarter by credit related losses which were partially offset by accretion due to share repurchases and market-driven write-ups as spreads continued to tighten in the December quarter.

Since last quarter, six new investments have been moved to nonaccrual status. At December 31, we had 11 investments on nonaccrual comprising 7.3% of our total debt portfolio at fair value. Despite deleveraging on an absolute dollar basis by $75 million during the quarter, we ended the December quarter above our target regulatory leverage range at 0.84 times debt to equity driven principally by the effect of credit weakness on our NAV.

As Patrick stated earlier, we are extremely focused on bringing leverage back within our target range, which is important to our lenders and rating agencies and will also provide additional operating flexibility. Additionally, we are focused on optimizing our balance sheet, and over the course of this year, we plan to evaluate options regarding our liability structure including debt issuances or refinances.

For the quarter ended December 31, 2016, we generated total investment income of $51.8 million. PIK interest collected in cash was in excess of PIK income accrued for the quarter, and net investment income was $23.3 million for the quarter or $0.16 per share. During the first quarter of FY17, we closed $118.3 million of investments in five new and three existing portfolio companies.

Additionally, we received $187.7 million in connection with the repayments and exits of 10 of our non-controlled investments, all of which were exited at or above par. We also received an additional $37.8 million in connection with other paydowns and sales of investments. As of December 31, 90.7% of the portfolio at fair value consisted of debt investments, 77.6% of the portfolio was invested in senior secured loans, and 81% of the debt portfolio consisted of floating rate securities.

FSC's senior secured loan joint venture with an affiliate of Kemper Corporation generated an 8.8% weighted average annualized return on FSC's investment during the December quarter. As of December 31, 2016, the joint venture had $318.8 million of assets including investments in a range of one-stop and senior secured loans to 34 portfolio companies. During the December quarter, we received a credit rating for the joint venture and we look forward to further utilizing the JV in the coming quarters.

For the December quarter, the weighted average yield on FSC's debt investments, including the JV, was 10.3% with the cash component of the yields making up 9.1%. At December 31, the average size of the portfolio debt investment was $19 million, and our top 10 portfolio company investments represented 28.3% of total assets. During the quarter ended December 31, 2016, we repurchased 2.3 million shares of common stock in the open market at an aggregate cost of $12.5 million.

This brings the total amount repurchased during calendar year 2016 to $50 million, which resulted in NAV accretion of $0.18 per share. I will now turn it back over to Robyn.

Robyn Friedman - *Fifth Street Finance Corporation - Head of IR*

Thank you for joining us on today's call. We appreciate you spending the time to listen as we discussed the comprehensive plan for FSC. Since we have covered a lot of material, we have chosen not to host a live Q&A for this conference call but have reached out to schedule time with all of our analysts, and we encourage investors that have questions to call investor relations at 203-681-3720 or email investor relations at IR@FifthStreetFinance.com. I will now turn the call back over to Shannon.

Operator

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