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FSC - Q2 2017 Fifth Street Finance Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Fifth Street Finance Corp.'s Second Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to introduce your host for today's conference, Robyn Friedman, Head of Investor Relations.

Robyn E. Friedman - *Fifth Street Finance Corp. - Executive Director and Head of IR*

Thank you, Charlotte. Good morning, and welcome to Fifth Street Finance Corp.'s Second Quarter 2017 Earnings Call.

I am joined this morning by Bernard Berman, Chairman and Chief Executive Officer; Steven Noreika, Chief Financial Officer; and Brian Walter, Head of Institutional Products.

Replay information for this call is included in our May 10, 2017, press release and is posted on the Investor Relations section of Fifth Street Finance Corp.'s website, which can be found at fsc.fifthstreetfinance.com.

Please note that this call is the property of Fifth Street Finance Corp. 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 Corp. Words such as believes, expects, seeks, plans, should, will, estimates, projects, 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 projections. 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: Bernie will provide an overview of our results, and Steve will summarize the financials.

I will now turn the call over to our CEO, Bernie.

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

Thank you, Robyn. Before turning to our quarterly results, I would like to briefly discuss the leadership transition that occurred last month. On April 5, 2017, I was appointed as CEO of FSC following the resignation of Patrick Dalton. As you may know, I have been a partner at Fifth Street's external investment adviser for over 12 years, and have served as Chairman of FSC's Board of Directors since 2014. The leadership transition has been a smooth one, and I'm excited to lead FSC as it continues to execute on its strategy to enhance shareholder value.

We have made progress executing against our stated initiatives. I will go into each of these areas in greater detail. But at a high level, during the quarter, we stabilized credit, reduced leverage to within our targeted range, reduced the number of loans and percentage of the investment portfolio on nonaccrual, and instituted a total return hurdle. All of these actions should enable us to continue to generate more consistent results and deliver enhanced value for our stockholders going forward.

The March quarter was marked by greater credit stability and a decrease in leverage to within our targeted range of 0.6x to 0.8x debt-to-equity. As we continue to work through and resolve our underperforming investments, we believe that NAV has begun to stabilize. We ended the quarter with NAV of $7.23 per share, down $0.08 from the prior quarter. NAV was primarily impacted by 1 unrealized write-down of approximately $0.07 per share related to 1 equity investment. Excluding the unrealized equity investment write-down, our credit portfolio was flat quarter-over-quarter.

As we stated last quarter, 1 of our top priorities was resolving the assets on nonaccrual, and rotating those proceeds into traditional, performing, senior secured loans. During the quarter, we made progress executing on this initiative, as we sold 2 investments that were on nonaccrual and restructured 2 investments that were on nonaccrual. As of March 31, we had 8 investments on nonaccrual, down from 11 investments in the previous quarter.

Our nonaccrual assets at March 31, represented 5.4% of total debt investments at fair value and 11.3% at cost, down from 7.3% of total investments at fair value and 18.2% at cost as of December 31.

Although we are pleased with the initial steps we have taken, we continue to work diligently with the private equity sponsors and management teams at our stressed investments to identify further opportunities to exit, restructure or improve underlying business performance and maximize recoveries for our shareholders.

To expedite the process and take advantage of attractive market dynamics for sellers, we, along with the other lenders in certain instances, have engaged consultants or investment banks to seek opportunities to monetize certain assets with the goal of receiving full or partial repayment of the outstanding debt.

Turning to the middle market. We believe this environment continues to be challenging despite a rebound in volumes from the fourth quarter, mainly driven by refinancings. An increase in demand from new market entrants and private credit funds has led to an increase in refinancings, which has resulted in significant spread tightening. As a result of the current investment environment, we deleveraged our balance sheet and selectively invested in credits with strong risk-adjusted returns, shying away from refinancings that had both increased leverage and tighter pricing.

During the quarter ended March 31, we closed $113 million of investments in 6 new and 1 existing portfolio company.

Another broader theme in the middle market has been the continued increase in LIBOR. With 79% of our portfolio in floating rate debt, we believe our portfolio is well-positioned to benefit in a rising interest rate environment. As of March 31, 83% of the total floating rate debt portfolio had a LIBOR floor of 1% to 2%, with over 90% of those loans having a LIBOR floor of 1%.

Since 3-month LIBOR is currently at approximately 1.18%, LIBOR floors of 1% have been exceeded. And going forward, FSC should experience improving net interest margins, which should result in a benefit to earnings. This benefit should increase as 3-month LIBOR continues to rise, since approximately 60% of our liabilities are comprised of fixed rate securities.

We ended the March quarter at 0.73x debt-to-equity, within our target range of 0.6x to 0.8x. We are pleased to have reduced leverage back within our target range, as it provides us with operational flexibility to selectively deploy capital into new investments.

Additionally, during the quarter, as we have continued to have cash in our SBIC funds, we repaid approximately $65 million of SBA debentures, which we expect will save FSC $3.3 million of coupon interest on an annual basis.

We continue to evaluate the composition of our liabilities on a regular basis and maintain an active dialogue with our lenders.

Turning to our fee structure, we are pleased that our new investment advisory agreement was overwhelmingly approved by shareholders, following our Special Meeting of Stockholders in late March. As a reminder, we adjusted our Part I incentive fee by introducing a permanent total return hurdle, which may decrease the incentive fee by 25% per quarter after taking into account any realized and unrealized losses. The permanent total return hurdle will have a look-back feature, which expands every quarter, scaling up to a 3-year look-back once fully phased in and became effective retroactive to January 1, 2017.

Additionally, we decreased the quarterly hurdle rate used in calculating the incentive fee from 2% to 1.75%.

As a reminder, on our last call, we laid out a revised dividend policy focused on 2 goals: one, setting the dividend at a level that is aligned with the core run rate earnings power of the portfolio; and two, strengthening our balance sheet. At that time, the Board of Directors declared a $0.02 quarterly dividend for June, and a $0.125 quarterly dividend for the September quarter.

Given our focus on meeting or exceeding our dividend with net investment income over the long term to preserve NAV and create confidence in the shares of FSC, we are pleased that our March earnings of $0.13 would have covered the quarterly dividend of $0.125 per share the Board declared for September. We continue to believe that this change to our dividend policy provides a long-term benefit to our shareholders.

Although we are pleased with the progress made towards executing our strategy during the March quarter, our efforts to stabilize NAV and create long-term value for shareholders continue. I look forward to providing further updates as we make progress on our 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 M. Noreika - *Fifth Street Finance Corp. - CFO*

Thank you, Bernie.

We ended the second quarter of fiscal 2017 with total assets of $1.9 billion, as compared to $2.2 billion at December 31, 2016.

Portfolio investments totaled $1.8 billion at fair value and were spread across 113 companies at March 31, 2017. At the end of the March quarter, we had $92.8 million of cash and cash equivalents, including restricted cash on our balance sheet.

Net asset value per share was $7.23 as of March 31, 2017, as compared to $7.31 in the prior quarter. NAV was primarily impacted by an unrealized write-down of approximately $0.07 per share related to an equity investment. Excluding this equity write-down, NAV would have been flat quarter-over-quarter.

At March 31, 2017, we had 8 investments on nonaccrual, comprising 5.4% of our total debt portfolio at fair value or 11.3% at cost. This compares to 7.3% at fair value or 18.2% at cost as of 12/31/16.

We ended the March quarter within our target regulatory leverage range at 0.73x debt-to-equity, down from 0.84x last quarter.

For the quarter ended March 31, 2017, we generated total investment income of $45.6 million. Net investment income was $18.5 million for the quarter or $0.13 per share.

During the second fiscal quarter, we closed $112.7 million of investments in 6 new and 1 existing portfolio company. Additionally, we received $208.8 million in connection with the full repayments and exits of 11 of our investments. We also received an additional $55.5 million in connection with other paydowns and sales of investments.

As of March 31, 89.1% of the portfolio at fair value consisted of debt investments, 74.6% of the portfolio was invested in senior secured loans and 78.9% of the debt portfolio consisted of floating rate securities.

FSC's senior secured loan joint venture with an affiliate of Kemper Corporation generated $2.6 million of income for FSC during the March quarter. As of March 31, 2017, the joint venture had $338.5 million of assets, including investments in senior secured loans to 31 portfolio companies.

For the March quarter, the weighted average yield on FSC's debt investments, including the JV, was 10.4% with the cash component of the yield making up 9.1%. At March 31, the average size of a portfolio debt investment was $19.4 million and our top 10 portfolio company investments represented 32.4% of our total assets.

I will now turn it back over to Robyn.

Robyn E. Friedman - *Fifth Street Finance Corp. - Executive Director and Head of IR*

Thank you for joining us on today's call.

Charlotte, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Chris York from JMP securities.

Christopher John York - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

So I want to begin with trying to understand a little bit more about Patrick's resignation. So what specifically caused him to resign after taking the job in November? And then, serving as an adviser to the Board prior to his accepting of his role as the CEO?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

Chris, we're limited in what we can say about that. We talked about that in the 8-K. It was not a result of any disagreement with the operations, policies or procedures of the company. And that's all we can say about that.

Christopher John York - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. As a follow-up, Bernie, do you want the job as CEO long term? And then, if so, what is your message to employees at FSAM today given the many changes in this position over the last couple of years?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

The message is, we're working to stabilize NAV, rotate out of our nonperforming assets and improve performance. And yes, I'm very happy to be here. I've been here for over 12 years, as I said. So, happy to be here. I'm going to work hard for the shareholders.

Christopher John York - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

And so, do you expect to essentially retain that position? Or is that kind of an interim label with the thought process of potentially finding someone else?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

No, there is no interim label. There is no search on the CEO.

Christopher John York - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. Fair enough. And then the reinvestment of your borrowing facilities that (inaudible) mature here in August and then September. So have you had any discussions with these lenders about amending the facilities? And then, do you expect the maturity of these facilities to extend? And or be forced to make concessions in any terms?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

We have certainly had discussions with our lenders. We continue to have discussions. I can't tell you what the terms are going to be right now, but we are well-aware of the revolving period, dates, and the maturity dates and all the details in those facilities. And we're working hard and when I have something definitive to announce, we will announce it.

Christopher John York - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. And then, I guess, I'll ask 1 more and then hop back in the queue. So The Wall Street Journal reported that FSAM is exploring strategic options. So, in light of that, how should investors think about the management of the portfolio? And then, maybe the deployment of new investments? I mean, you had a decent quarter of new originations, in light of potentially changing incentives for the responsibilities of those that are managing the business?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

Yes, I think, I've already addressed how we are working on the portfolio and you've seen what our originations are. And we're working hard for the shareholders. And as I'm sure you know, we don't comment on rumors, so thank you for the questions.

Operator

Our next question comes from the line of Christopher Testa from National Securities.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Just curious, more of the high-level question. How are you guys dealing with sponsors and deal flow given you've been capital constrained for quite some time and have likely had to pass on a lot of the deals?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

You know, as I said, it's a competitive time in the middle market. And we are looking for the best risk-adjusted returns we can find. We successfully delevered and we do have capacity to do deals if we like them. So if we like the return on the deal, we're going to make it. But we are not constrained right now.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Okay. And just looking at, I guess, the uses of capital. Just curious, where you're looking at allocating between the Kemper JV and doing more kind of senior secured loans on balance sheet and just how you're kind of balancing those 2?

Brian T. Walter - *Fifth Street Asset Management Inc. - MD and Head of Institutional Products*

Sure. It's Brian Walter. We evaluate every investment on an independent basis. The Kemper JV is something that we're very focused on. We recently, at the end of last year, got a rating for the vehicle, which should help that vehicle and may continue to top rate and look for good risk-adjusted investments for that vehicle. Obviously, FSC has its own mandates as well and its own needs, so we evaluate those independently.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Got it. And I know, last quarter you guys had announced that you're changing the strategy of the portfolio and the investments pretty dramatically. Just wondering, just ballpark estimate, how would you characterize the current book? How much of that would you say is something that you would not be originating now under your new kind of strategy?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

I think that's very, very difficult to speculate on.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Okay. And just remind us again on -- if you have a current share repurchase authorization?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

We fully utilized the last share repurchase plan of $50 million. We invested all $50 million last year. So there is right now nothing authorized.

Christopher Robert Testa - *National Securities Corporation, Research Division - Equity Research Analyst*

Okay. Is there an inclination on behalf of the Board to renew that for when your leverage gets a bit lower to utilize that?

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

I don't want to speak for the Board, but I think if the leverage got lower, I imagine that's something they would look at. They've repurchased shares, a lot of shares in the past and then, our leverage was higher and the plan ended. So they may look at that in the future, but I don't want to speculate.

Operator

Thank you. I'm not showing any further questions at this time. I would like to turn the call back over to management for closing remarks.

Bernard D. Berman - *Fifth Street Capital LLC - Co-President*

Thank you, everyone, and we look forward to reporting to you on further progress in the future.

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.
