

NewStar Financial, Inc.
Form 10-Q
November 03, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 001-33211

NewStar Financial, Inc.

(Exact name of registrant as specified in its charter)

Delaware 54-2157878
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

500 Boylston Street, Suite 1250,

Boston, MA 02116
(Address of principal executive offices) (Zip Code)

(617) 848-2500

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of November 1, 2016, 44,207,504 shares of common stock, par value of \$0.01 per share, were outstanding.

TABLE OF CONTENTS

	Page
PART I	
FINANCIAL INFORMATION	
Item 1. <u>Financial Statements (Unaudited)</u>	4
<u>Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015</u>	4
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2016 and 2015</u>	5
<u>Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2016 and 2015</u>	6
<u>Condensed Consolidated Statements of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2016 and 2015</u>	7
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2016 and 2015</u>	8
<u>Notes to Condensed Consolidated Financial Statements</u>	10
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	46
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	70
Item 4. <u>Controls and Procedures</u>	71
PART II	
OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	71
Item 1A. <u>Risk Factors</u>	71
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	72
Item 6. <u>Exhibits</u>	73
<u>SIGNATURES</u>	75

Note Regarding Forward Looking Statements

This Quarterly Report on Form 10-Q of NewStar Financial, Inc., contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These are statements that relate to future periods and include statements about:

- our anticipated financial condition, including estimated loan losses;
- our expected results of operation;
- our growth and market opportunities;
- trends and conditions in the financial markets in which we operate;
- our future funding needs and sources and availability of funding;
- our involvement in capital-raising transactions;
- our ability to meet draw requests under commitments to borrowers under certain conditions;
- our competitors;
- our provision for credit losses;
- our future development of our products and markets;
- our ability to compete; and
- our stock price.

Generally, the words “anticipates,” “believes,” “expects,” “intends,” “estimates,” “projects,” “plans” and similar expressions identify forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance, achievements or industry results to differ materially from any future results, performance or achievements expressed or implied by these forward-looking statements. These risks, uncertainties and other important factors include, among others:

- risk of deterioration in credit quality that could result in levels of delinquent or non-accrual loans that would force us to realize credit losses exceeding our allowance for credit losses and deplete our cash position;
- risks and uncertainties relating to the financial markets generally, including disruptions in the global financial markets;
- uncertainties relating to the market price of our common stock prevailing from time to time;
 - risk and uncertainties related to our ability to obtain external financing;
- risk and uncertainties relating to the regulation of the commercial lending industry by federal, state and local governments;
- risks and uncertainties relating to our limited operating history;
- our ability to minimize losses, achieve profitability, and realize our deferred tax asset; and
 - the competitive nature of the commercial lending industry and our ability to effectively compete.

For a further description of these and other risks and uncertainties, we encourage you to carefully read section Item 1A. “Risk Factors” of our Annual Report on Form 10-K, for the year ended December 31, 2015.

The forward-looking statements contained in this Quarterly Report on Form 10-Q speak only as of the date of this report. We expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement contained in this Quarterly Report to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any forward-looking statement is based, except as may be required by law.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

Unaudited

	September 30, 2016	December 31, 2015
	(\$ in thousands, except per share and par value amounts)	
Assets:		
Cash and cash equivalents	\$36,266	\$ 35,933
Restricted cash	370,487	153,992
Cash collateral on deposit with custodians	7,564	61,081
Investments in debt securities, available-for-sale	90,814	94,177
Loans held-for-sale, net	429,718	478,785
Loans and leases, net (including loans at fair value of \$389,260 and \$0, respectively)	3,186,998	3,134,072
Interest receivable	14,829	13,932
Property and equipment, net	296	638
Deferred income taxes, net	29,881	33,133
Income tax receivable	1,381	5,342
Goodwill	17,884	17,884
Identified intangible asset, net	655	910
Other assets	53,786	21,504
Assets held-for-sale	162,801	—
Total assets	\$4,403,360	\$ 4,051,383
Liabilities:		
Credit facilities, net	\$492,758	\$ 832,686
Term debt securitizations, net	2,327,717	1,821,519
Senior notes, net	373,462	372,153
Subordinated notes, net	239,543	209,509
Repurchase agreements, net	52,591	96,224
Accrued interest payable	31,021	18,073
Other liabilities	170,380	41,741
Liabilities held-for-sale	44,158	—
Total liabilities	3,731,630	3,391,905
Stockholders' equity:		
Preferred stock, par value \$0.01 per share (5,000,000 shares authorized);	—	—

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no shares outstanding)

Common stock, par value \$0.01 per share:		
Shares authorized: 145,000,000 in 2016 and 2015;		
Shares outstanding 46,706,004 in 2016 and 46,527,288 in 2015	467	465
Additional paid-in capital	745,443	742,970
Retained earnings	49,247	31,353
Common stock held in treasury, at cost; 10,454,359 in 2016 and 9,154,548 in 2015	(118,552)	(109,245)
Accumulated other comprehensive loss, net	(4,875)	(6,065)
Total stockholders' equity	671,730	659,478
Total liabilities and stockholders' equity	\$4,403,360	\$ 4,051,383

The accompanying notes are an integral part of these condensed consolidated financial statements.

4

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

Unaudited

	Three Months		Nine Months Ended	
	Ended September 30, 2016	2015	September 30, 2016	2015
	(\$ in thousands, except per share amounts)			
Net interest income:				
Interest income	\$65,155	\$54,574	\$186,499	\$141,194
Interest expense	39,897	31,345	117,816	84,764
Net interest income	25,258	23,229	68,683	56,430
Provision for credit losses	3,570	4,534	24,906	14,720
Net interest income after provision for credit losses	21,688	18,695	43,777	41,710
Non-interest income (loss):				
Asset management income	3,353	1,019	10,337	2,954
Fee income	2,946	4,573	5,836	10,508
Realized loss on derivatives	(13)	(5)	(31)	(24)
Realized (loss) gain on sale of loans, net	(19)	360	36	314
Other miscellaneous income, net	4,231	665	7,195	2,772
Loss on total return swap	—	(3,035)	(6,062)	(971)
Gain (loss) on loans held-for-sale, net	468	(85)	(5,345)	(506)
Gain on sale of Business Credit, net	—	—	22,511	—
Total non-interest income	10,966	3,492	34,477	15,047
Operating expenses:				
Compensation and benefits	13,175	9,561	32,640	24,004
General and administrative expenses	4,894	3,819	15,337	11,052
Total operating expenses	18,069	13,380	47,977	35,056
Income before income taxes	14,585	8,807	30,277	21,701
Income tax expense	5,941	3,665	12,383	9,020
Net income	\$8,644	\$5,142	\$17,894	\$12,681
Basic Earnings per share	\$0.19	\$0.11	\$0.38	\$0.27
Diluted Earnings per share	\$0.19	\$0.11	\$0.38	\$0.26

The accompanying notes are an integral part of these condensed consolidated financial statements.

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Unaudited

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(\$ in thousands, except per share amounts)			
Net income	\$8,644	\$5,142	\$17,894	\$12,681
Other comprehensive income gain (loss), net of tax:				
Net unrealized securities (losses) gains, net of tax (benefit) expense of \$2,044, \$(1,782), \$789 and \$(2,120), respectively	3,028	(2,583)	1,193	(3,078)
Net unrealized derivative (losses) gains, net of tax (benefit) expense of \$5, \$(14), \$2 and \$(38), respectively	8	(21)	(3)	(48)
Other comprehensive income (loss)	3,036	(2,604)	1,190	(3,126)
Comprehensive income	\$11,680	\$2,538	\$19,084	\$9,555

The accompanying notes are an integral part of these condensed consolidated financial statements.

6

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Unaudited

NewStar Financial, Inc. Stockholders' Equity

For the Nine Months Ended September 30, 2016

	Additional		Retained Earnings	Treasury Stock	Accumulated	
	Common Stock	Paid-in Capital			Other Comprehensive Loss, net	Common Stockholders' Equity
Balance at January 1, 2016	\$465	\$742,970	\$31,353	\$(109,245)	\$ (6,065)	\$ 659,478
Net income	—	—	17,894	—	—	17,894
Other comprehensive income	—	—	—	—	1,190	1,190
Issuance of restricted stock	6	(6)	—	—	—	—
Shares reacquired from employee transactions	(1)	1	—	(445)	—	(445)
Tax benefit (expense) from vesting of restricted stock	—	(473)	—	—	—	(473)
Repurchase of common stock	(12)	12	—	(8,862)	—	(8,862)
Exercise of common stock options, net	9	(1,108)	—	—	—	(1,099)
Tax benefit from exercise of stock options	—	1,225	—	—	—	1,225
Amortization of restricted common stock awards	—	2,822	—	—	—	2,822
Balance at September 30, 2016	\$467	\$745,443	\$49,247	\$(118,552)	\$ (4,875)	\$ 671,730

NewStar Financial, Inc. Stockholders' Equity

For the Nine Months Ended September 30, 2015

	Additional		Retained Earnings	Treasury Stock	Accumulated	
	Common Stock	Paid-in Capital			Other Comprehensive Income, net	Common Stockholders' Equity
Balance at January 1, 2015	\$466	\$718,825	\$14,463	\$(92,724)	\$ (33)	\$ 640,997
Net income	—	—	12,681	—	—	12,681
Other comprehensive loss	—	—	—	—	(3,126)	(3,126)
Issuance of restricted stock	4	(4)	—	—	—	—
	(1)	1	—	(597)	—	(597)

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Net Shares reacquired from employee transactions						
Tax benefit (expense) from vesting of restricted stock	—	(163)	—	—	—	(163)
Repurchase of common stock	(12)	12	—	(15,854)	—	(15,854)
Issuance of warrants	—	21,766	—	—	—	21,766
Exercise of common stock options	1	1,574	—	—	—	1,575
Tax benefit from exercise of stock options	—	551	—	—	—	551
Amortization of restricted common stock awards	—	2,450	—	—	—	2,450
Balance at September 30, 2015	\$458	\$745,012	\$27,144	\$(109,175)	\$ (3,159)	\$ 660,280

The accompanying notes are an integral part of these condensed consolidated financial statements.

7

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Unaudited

	Nine Months Ended September 30,	
	2016	2015
	(\$ in thousands)	
Cash flows from operating activities:		
Net income	\$ 17,894	\$ 12,681
Adjustments to reconcile net income to net cash used for operations:		
Provision for credit losses	24,906	14,720
Depreciation, amortization and accretion	(9,159)	(6,977)
Amortization of debt issuance costs	13,720	14,944
Equity compensation expense	2,822	2,450
Gain on sale of Business Credit	(22,511)	—
(Gain) loss on sale of loans, net	(36)	(314)
Loss (gain) on total return swap	6,062	971
Gain on sale of equipment, net	(724)	(471)
Loss on other real estate owned	—	82
Net change in deferred income taxes	2,466	(5,394)
Loans held-for-sale originated	(217,132)	(490,601)
Proceeds from sale of loans held-for-sale	313,287	263,231
Loss on loans held-for-sale, net	5,345	506
Net change in interest receivable	(2,340)	(2,191)
Net change in other assets	(15,090)	6,587
Net change in accrued interest payable	13,086	21,685
Net change in other liabilities	(11,165)	6,304
Net cash provided by operating activities	121,431	(161,787)
Cash flows from investing activities:		
Net change in restricted cash	(240,397)	(45,443)
Net change in loans	(92,685)	(692,212)
Purchase of equity investments	(4,052)	—
Purchase of debt securities, available-for-sale	—	(85,020)
Proceeds from debt securities, available-for-sale	6,000	33,000
Proceeds from sale of other real estate owned	—	3,211
Acquisition of property and equipment	(9)	(129)
Net cash provided by (used in) investing activities	(331,143)	(786,593)
Cash flows from financing activities:		
Proceeds from exercise of stock options, net	(1,099)	1,575
Tax benefit from exercise of stock options	1,225	551
Tax benefit (expense) from vesting of restricted stock	(473)	(163)
Advances on credit facilities	1,282,522	1,934,949
Repayment of borrowings on credit facilities	(1,602,978)	(1,797,122)
Issuance of term debt	623,197	824,167
Borrowings on term debt	37,600	43,500
Repayment of borrowings on term debt	(142,155)	(170,089)

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Issuance of senior notes	—	300,000
Borrowing on subordinated notes	24,500	50,000
Borrowings on repurchase agreements	3,496	125,012
Repayment of borrowings on repurchase agreements	(47,694)	(44,599)
Repayment of corporate debt	—	(238,500)
Release (posting) of cash collateral	53,517	(14,763)
Payment of deferred financing costs	(10,240)	(25,248)
Purchase of treasury stock	(9,307)	(16,451)
Net cash (used in) provided by financing activities	212,111	972,819
Net increase (decrease) in cash during the period	2,399	24,439
Cash and cash equivalents at beginning of period	35,933	33,033
Less cash of Equipment Finance held-for-sale	(2,066)	—
Cash and cash equivalents at end of period	36,266	57,472

8

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, continued

Unaudited

	Nine Months Ended September 30, 2016 2015 (\$ in thousands)	
Supplemental cash flows information:		
Interest paid	\$ 104,731	\$ 63,079
Taxes paid, net of refund	5,201	7,285
Transfer of loans, net to other real estate owned	15,781	—
Transfer of loans, net to loans-held-for-sale	67,704	—
Transfer of Equipment Finance assets to held-for-sale	160,735	—
Transfer of Equipment Finance liabilities to held-for-sale	44,158	—
Issuance of warrants	—	21,766
Unsettled trades payable	138,639	—

The accompanying notes are an integral part of these condensed consolidated financial statements.

NEWSTAR FINANCIAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Unaudited

Note 1. Organization

NewStar Financial, Inc. (the “Company”) is an internally-managed, commercial finance company with specialized lending platforms focused on meeting the complex financing needs of companies and private investors in the middle market. The Company and its wholly owned investment management subsidiary, NewStar Capital LLC, are registered investment advisers and provide asset management services to institutional investors. The Company manages several private credit funds that co-invest loans originated through its leveraged finance lending platform. Through NewStar Capital, the Company also manages a series of funds structured as CLOs that invest primarily in broadly syndicated loans, as well as other sponsored funds and managed accounts that invest across various asset classes, including broadly syndicated loans and high yield bonds. Through its specialized lending platforms, the Company provides a range of senior secured debt financing options to mid-sized companies to fund working capital, growth strategies, acquisitions and recapitalizations, as well as purchases of equipment and other capital assets.

These lending activities require specialized skills and transaction experience, as well as a significant investment in personnel and operating infrastructure. Our loans and leases are originated directly by teams of credit-trained bankers and experienced marketing officers organized around key industry and market segments. These teams represent specialized lending groups that are supported by centralized credit management and operating platforms. This structure enables us to leverage common standards and systems, as well as industry and professional expertise across multiple businesses.

The Company targets its marketing and origination efforts at private equity firms, mid-sized companies, corporate executives, banks, and a variety of other referral sources and financial intermediaries to develop new customer relationships and source lending opportunities. The Company's origination network is national in scope and it targets companies with business operations across a broad range of industry sectors. The Company employs highly experienced bankers, marketing officers and credit professionals to identify and structure new lending opportunities and manage customer relationships. The Company believes that the quality of its professionals, the breadth of their relationships and referral networks, and their ability to develop creative solutions for customers position it to be a valued partner and preferred lender for mid-sized companies and private equity funds with middle market investment strategies.

The Company's emphasis on direct origination is an important aspect of its marketing and credit strategy. The Company's national network is designed around specialized origination channels intended to generate a large set of potential lending opportunities. That allows the Company to be highly selective in its credit process and to allocate capital to market segments that we believe represent the most attractive opportunities. The Company's direct origination network also generates proprietary lending opportunities with yield characteristics that we believe would not otherwise be available through intermediaries. In addition, direct origination provides the Company with direct access to management teams and enhances its ability to conduct detailed due diligence and credit analysis of prospective borrowers. It also allows the Company to negotiate transaction terms directly with borrowers and, as a result, advise its customers on financial strategies and capital structures, which it believes benefits its credit performance.

The Company typically provides financing commitments to companies in amounts that range in size from \$10 million to \$50 million. The size of financing commitments depends on various factors, including the type of loan, the credit characteristics of the borrower, the economic characteristics of the loan, and the Company's role in the transaction. The Company also selectively arranges larger transactions that it may retain on its balance sheet or syndicate to other lenders, which may include funds that it manages for third party institutional investors. By syndicating loans to other lenders and the Company's managed funds, it is able to provide larger financing commitments to its customers and generate fee income, while limiting its risk exposure to single borrowers. From time to time, however, the Company's balance sheet exposure to a single borrower exceeds \$35 million.

Beginning in January 2016, the Company's operations were divided into two reportable segments that represent its core businesses, Commercial Lending and Asset Management.

The Commercial Lending segment represents our direct lending activities which are focused on providing a range of flexible senior secured debt options to mid-sized companies with annual cash flow (EBITDA) typically between \$10 million and \$50 million owned by private equity investment funds and managed by established professional alternative asset managers.

The Asset Management segment represents our investment advisory activities which are focused on providing opportunities for qualified investors to invest in a range of credit funds managed by the Company that employ credit-oriented strategies focused on middle market loans and liquid, tradeable credit.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

These interim condensed consolidated financial statements include the accounts of the Company and its subsidiaries (collectively, “NewStar”) and have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). All significant intercompany transactions have been eliminated in consolidation. These interim condensed financial statements include adjustments of a normal and recurring nature considered necessary by management to fairly present NewStar’s financial position, results of operations and cash flows. These interim condensed financial statements may not be indicative of financial results for the full year. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosure of contingent assets and liabilities. Actual results could differ from those estimates. The estimates most susceptible to change in the near-term are the Company’s estimates of its (i) allowance for credit losses, (ii) recorded amounts of deferred income taxes, (iii) fair value measurements used to record fair value adjustments to certain financial instruments, (iv) valuation of investments, (v) determination of other than temporary impairments and temporary impairments and (vi) impairment of goodwill and identified intangible assets. The interim condensed consolidated financial statements and notes thereto should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

Prior Period Reclassification

Prior period amounts are reclassified wherever necessary to confirm with current period presentation.

Segment Reporting

Due to the continued expansion of our asset management activities, through new fund formation and the acquisition of NewStar Capital, the Company reassessed its classification of reporting as a single segment under ASC 280, Segment Reporting. Based on this evaluation, the Company determined that reporting the results of its Commercial Lending and Asset Management as two segments would better reflect how the Company is now managed and how information is internally reviewed. For complete segment information, see Note 15.

Recently Adopted Accounting Standards

In April 2015, the FASB issued ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. ASU 2015-03 is effective for the interim or annual period beginning after December 15, 2015. The Company adopted ASU 2015-03 on January 1, 2016 and applied the standard retrospectively. The balance sheet presented has been adjusted to reflect the period specific effects of the adoption of the guidance. The adoption of ASU 2015-03 had the following impact on the Condensed Consolidated Balance Sheet as of December 31, 2015.

(in thousands)	December 31, 2015
As previously reported under GAAP applicable at the time	
Deferred financing costs, net	40,733
Credit facilities	843,896
Term debt securitizations, net	1,837,889
Senior notes, net	379,232

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Subordinated notes, net	215,018
Repurchase agreements	96,789
As currently reported under ASU 2015-03	
Deferred financing costs, net	—
Credit facilities, net	832,686
Term debt securitizations, net	1,821,519
Senior notes, net	372,153
Subordinated notes, net	209,509
Repurchase agreements, net	96,224

In September 2015, the FASB issued ASU 2015-16, Simplifying the Accounting for Measurement-Period Adjustments in Business Combinations (Topic 805). ASU 2015-16 eliminated the requirement to retrospectively adjust the financial statements for measurement-period adjustments that occur in periods after a business combination is consummated. ASU 2015-16 is effective for annual periods and interim periods within that period beginning after December 15, 2015. The Company adopted ASU 2015-16 on January 1, 2016. The adoption of ASU 2015-16 did not have a material impact on our results from operations or financial position.

Recently Issued Accounting Standards

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 provides a framework that replaces existing revenue recognition guidance. ASU 2014-09 is effective for annual periods and interim periods within that reporting period beginning after December 15, 2017. Early adoption is not permitted. The Company is currently evaluating the impact that the adoption of ASU 2014-09 will have on results from operations or financial position.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 825-10). ASU 2016-01 amends existing guidance related to the accounting for certain financial assets and liabilities. These amendments, among other things, require equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income, require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset and eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. ASU 2016-01 is effective for annual periods and interim periods within that reporting period beginning after December 15, 2017, with early adoption permitted. The Company is currently evaluating the impact that the adoption of ASU 2016-01 will have on results from operations and financial position.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). ASU 2016-02 amends existing guidance related to the accounting for leases. These amendments, among other things, require lessees to account for most leases on the balance sheet while recognizing expense on the income statement in a manner similar to existing guidance. For lessors the guidance modifies the classification criteria and the accounting for sales-type and direct finance leases. ASU 2016-02 is effective for annual periods and interim periods within that reporting period beginning after December 15, 2018, with early adoption permitted. The Company is currently evaluating the impact that the adoption of ASU 2016-02 will have on results from operations and financial position.

In March 2016, the FASB issued ASU 2016-07, Simplifying the Transition to the Equity Method of Accounting (Topic 323). ASU 2016-07 eliminates the requirement for an investor to retroactively apply the equity method when its increase in ownership interest (or degree of influence) in an investee triggers equity method accounting. ASU 2016-07 is effective for interim and annual periods in fiscal years beginning after December 15, 2016, with early adoption permitted. The Company is currently evaluating the impact that the adoption of ASU 2016-07 will have on results from operations and financial position.

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting (Topic 718). ASU 2016-09 simplifies several aspects of the accounting for employee share-based payment transactions including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification of related amounts within the statement of cash flows. ASU 2016-09 is effective for annual periods and interim periods within that reporting period beginning after December 15, 2017, with early adoption permitted. The

Company is currently evaluating the impact that the adoption of ASU 2016-09 will have on results from operations and financial position.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments-Credit Losses (Topic 326). ASU 2016-13 sets forth a “current expected credit loss” (CECL) model which requires the Company to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost and applies to some off-balance sheet credit exposures. ASU 2016-13 is effective for annual periods and interim periods within that reporting period beginning after December 15, 2019, with early adoption permitted after annual and interim periods within that reporting period beginning after December 31, 2018. The Company is currently evaluating the impact that the adoption of ASU 2016-13 will have on results from operations or financial position.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230). ASU 2016-15 provides guidance on the classification of certain cash receipts and cash payments for presentation in the statement of cash flows. ASU 2016-15 is effective for annual periods and interim periods within that reporting period beginning after December 15, 2017, with early adoption permitted. The Company is currently evaluating the impact that the adoption of ASU 2016-15 will have on results from operations or financial position.

Note 3. Acquisition and Disposition Activities

Acquisition

As previously disclosed, the Company acquired 100% of the outstanding limited liability company interests of Boston-based Feingold O’Keeffe Capital, LLC (“FOC Partners”), a boutique credit manager, in October 2015. The Company now operates FOC Partners as NewStar Capital, a wholly owned subsidiary of the Company.

During the first quarter of fiscal 2016, the Company completed its purchase price allocations and deemed the difference to be immaterial between the provisional and final purchase price allocations. As the result of facts and circumstances related to the customer contracts and related customer relationships, the Company reassessed the expected economic useful life of these contracts to be approximately 33 months instead of 12 months as originally estimated.

Sale of NewStar Business Credit LLC

On March 31, 2016, the Company sold its asset based lending business, NewStar Business Credit LLC (“Business Credit”) to a third party. The Company opted to sell Business Credit because it was faced with challenges from increasing competition with access to lower cost of funding. The sale resulted in a gain of \$22.5 million, before transaction related costs of \$2.5 million. The net gain is recorded in non-interest income on the accompanying consolidated statement of operations.

Assets and Liabilities Held for Sale

In September 2016, the Company commenced a process to sell the leasing line of business, NewStar Equipment Finance. As of that date certain assets and liabilities associated with Equipment Finance met the held-for-sale criteria. The potential disposal of Equipment Finance did not represent a strategic shift that will have a major effect on the Company’s operations and financial results and is, therefore, not classified as discontinued operations in accordance with ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property and Equipment (Topic 360).

The Company measured the asset and liabilities classified as held-for-sale at the lower of its carrying value or fair value less any costs to sell. Any loss resulting from this measurement is recognized in the period in which the held for sale criteria are met. Conversely, gains are not recognized on the sale of a long-lived asset or disposal group until the date of sale. The Company will reassess the fair value of the assets and liabilities, less estimated costs to sell at each reporting period and until they are no longer classified as held for sale. The Company determined that the approximate fair value less costs to sell exceeded the carrying value of the net assets and no loss was recorded. Equipment Finance is included within our Commercial Lending segment. For the three and nine months ended September 30, 2016, Equipment Finance contributed \$0.8 million and \$2.1 million, respectively, in pretax earnings. For the three and nine months ended September 30, 2015, Equipment Finance contributed \$0.9 million and \$2.3 million, respectively, in pretax earnings.

The following table reconciles the major classes of assets and liabilities classified as held for sale and recorded at the carrying value, less estimated costs to sell as part of continuing operations in the Condensed Consolidated Balance Sheets.

	September 30, 2016 (\$ in thousands)
Assets held-for-sale	
Cash	\$ 2,066
Restricted Cash	23,901

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Loans and leases, net	136,545
Other assets	289
Assets held-for-sale	162,801
Liabilities held-for-sale	
Credit facilities, net	\$ 16,661
Term debt securitization, net	21,480
Accrued interest payable	138
Other liabilities	5,879
Liabilities held-for-sale	44,158

13

Note 4. Loans Held-for-Sale, Loans, Leases and Allowance for Credit Losses

As of September 30, 2016 and December 31, 2015, loans held-for-sale consisted of the following:

	September 30, 2016	December 31, 2015
	(\$ in thousands)	
Leveraged Finance	\$435,351	\$ 485,874
Gross loans held-for-sale	435,351	485,874
Deferred loan fees, net	(5,633)	(7,089)
Total loans held-for-sale, net	\$429,718	\$ 478,785

Loans classified as held-for-sale consist primarily of loans originated or purchased by the Company that are intended to be sold to third parties (including credit funds managed by the Company). During the three months ended September 30, 2016, the Company foreclosed on the previously held-for-sale impaired real estate loan, simultaneous with the foreclosure, the Company sold a portion of the property for \$8.5 million and applied the proceeds to the principal loan balance. The remaining \$15.8 million was transferred to Other Real Estate Owned (“OREO”).

Loans held-for-sale are carried at the lower of either market value or aggregate cost, net of any deferred origination costs or fees.

At September 30, 2016, loans held-for-sale include loans with an aggregate outstanding balance of \$433.3 million that were intended to be sold to credit funds managed by the Company. The Company sold loans with an aggregate outstanding balance of \$105.0 million for a net loss of \$0.04 million to entities other than credit funds managed by the Company during the nine months ended September 30, 2016. The Company sold loans with an outstanding balance of \$37.8 million for a net gain of \$0.3 million to entities other than credit funds managed by the Company during the nine months ended September 30, 2015.

As of September 30, 2016, and December 31, 2015, loans and leases consisted of the following:

	September 30, 2016	December 31, 2015
	(\$ in thousands)	
Leveraged Finance	\$3,263,985	\$ 2,627,314
Business Credit	—	342,281
Real Estate	17,742	100,732
Equipment Finance (1)	—	173,253
Gross loans and leases (2)	3,281,727	3,243,580
Deferred loan fees and discount, net	(28,864)	(51,249)
Allowance for loan and lease losses	(65,865)	(58,259)
Total loans and leases, net	\$3,186,998	\$ 3,134,072

(1) Equipment Finance has been transferred to assets held-for-sale as of September 30, 2016, see note 3.

(2) Includes loans at fair value of \$389.3 million and \$0, respectively.

The Company internally risk rates loans based on individual credit criteria on at least a quarterly basis. Borrowers provide the Company with financial information on either a quarterly or monthly basis. Loan ratings as well as identification of impaired loans are dynamically updated to reflect changes in borrower condition or profile. A loan is considered to be impaired when it is probable that the Company will be unable to collect all amounts due to it according to the contractual terms of the loan agreement. Impaired loans include all non-accrual loans, loans with partial charge-offs and loans which are troubled debt restructuring (“TDR”).

The Company utilizes a number of analytical tools for the purpose of estimating probability of default and loss given default for its specialized lending groups. Management considers results from quantitative models in its Leveraged Finance lending group, which utilize Moody’s KMV RiskCalc credit risk model in combination with a proprietary qualitative model. The Real Estate lending group considers results from a proprietary model that we have developed to capture risk characteristics unique to the lending activities in that line of business. The results from models used by each lending group assist management in determining an appropriate obligor risk rating, which corresponds to a probability of default, as well as a loss given default. In each case, the determined probability of default and the loss given default are used to calculate an expected loss for those lending groups. Prior to classifying Equipment Finance as held-for-sale, management used similar models as its Leveraged Finance group. In each case, the expected loss is the primary

component in a formulaic calculation of general reserves attributable to a given loan. Loans and leases which are rated at or better than a specified threshold are typically classified as “Pass”, and loans and leases rated worse than that threshold are typically classified as “Criticized”, a characterization that may apply to impaired loans, including TDR. As of September 30, 2016, \$134.9 million of the Company’s loans were classified as “Criticized,” all of which were impaired loans, and \$3.1 billion were classified as “Pass”. As of December 31, 2015, \$152.1 million of the Company’s loans were classified as “Criticized”, including \$143.6 million of the Company’s impaired loans, and \$3.1 billion were classified as “Pass”.

A TDR that performs in accordance with the terms of its restructuring may improve its risk profile over time. While the concessions in terms of pricing or amortization may not have been reversed and further amended to “market” levels, the financial condition of the borrower may improve over time to the point where the rating improves from the “Criticized” classification that was appropriate immediately prior to, or at, restructuring.

When the Company rates a loan above a certain risk rating threshold and the loan is deemed to be impaired, the Company will establish a specific allowance, if appropriate, and the loan will be analyzed and may be placed on non-accrual. If the asset deteriorates further, the specific allowance may increase, and the asset’s deterioration may ultimately result in a loss and charge-off.

A loan is considered impaired when it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The measurement of impairment of a loan is based upon (i) the present value of expected future cash flows discounted at the loan’s effective interest rate, (ii) the loan’s observable market price, or (iii) the fair value of the collateral if the loan is collateral dependent, depending on the circumstances and our collection strategy. Impaired loans are identified based on the loan-by-loan risk rating process described above. It is the Company’s policy during the reporting period to record a specific provision for credit losses and/or partial or full charge off for all loans for which we have serious doubts as to the ability of the borrowers to comply with the present loan repayment terms.

As of September 30, 2016, the Company had impaired loans with a balance of \$156.9 million. Impaired loans with an aggregate outstanding balance of \$137.6 million have been restructured and classified as TDRs. At September 30, 2016, additional funding commitments for TDRs totaled \$5.1 million. As of September 30, 2016, the aggregate carrying value of equity investments in certain of the Company’s borrowers in connection with troubled debt restructurings totaled \$11.0 million. Impaired loans with an aggregate outstanding balance of \$87.3 million were also on non-accrual status. For impaired loans on non-accrual status, the Company’s policy is to reverse the accrued interest previously recognized as interest income subsequent to the last cash receipt in the current year. The recognition of interest income on the loan only resumes when factors indicating doubtful collection no longer exist and the non-accrual loan payment status has been brought current. During the three and nine months ended September 30, 2016, the Company had a small recovery of \$0.05 million and charged off \$12.9 million, respectively, of non-accruing loan balances. During the three months ended September 30, 2016, the Company placed no loans on non-accrual status. During the nine months ended September 30, 2016, the Company placed loans with an aggregate outstanding balance of \$14.3 million, on non-accrual status. During the three and nine months ended September 30, 2016, the Company recorded \$3.2 million and \$22.3 million, respectively, of net specific provisions for impaired loans. At September 30, 2016, the Company had a \$36.2 million specific allowance for impaired loans with an aggregate outstanding balance of \$105.1 million. At September 30, 2016, additional funding commitments for impaired loans totaled \$9.1 million. The Company’s obligation to fulfill the additional funding commitments on impaired loans is generally contingent on the borrower’s compliance with the terms of the credit agreement, or if the borrower is not in compliance additional funding commitments may be made at the Company’s discretion. As of September 30, 2016, the Company had loans totaling \$16.3 million on non-accrual status which was greater than 60 days past due and classified as delinquent by the Company. Included in the \$36.2 million specific allowance for impaired loans was \$4.4 million related to delinquent loans.

As of December 31, 2015, the Company had impaired loans with a balance of \$193.2 million. At that date, impaired loans with an aggregate outstanding balance of \$183.6 million had been restructured and classified as TDR. As of December 31, 2015, the aggregate carrying value of equity investments in certain of the Company's borrowers in connection with troubled debt restructurings totaled \$11.4 million. Impaired loans with an aggregate outstanding balance of \$111.3 million were also on non-accrual status. During 2015, the Company charged off \$4.0 million of outstanding non-accrual loans. During 2015, the Company placed loans with an aggregate outstanding balance of \$38.2 million on non-accrual status and returned loans with an aggregate outstanding balance of \$0.9 million to performing status. During 2015, the Company recorded \$9.5 million of net specific provisions for impaired loans. At December 31, 2015, the Company had a \$26.8 million specific allowance for impaired loans with an aggregate outstanding balance of \$121.1 million. At December 31, 2015, additional funding commitments for impaired loans totaled \$10.9 million. As of December 31, 2015, loans to three borrowers totaling approximately \$18.6 million were on non-accrual status and were greater than 60 days past due and classified as delinquent by the Company. Included in the \$26.8 million specific allowance for impaired loans was \$2.8 million related to delinquent loans.

A summary of impaired loans is as follows:

	Investment, Net		
	Investment, Net of Charge-offs	Unamortized Discount/Premium	Unpaid Principal
	(\$ in thousands)		
September 30, 2016			
Leveraged Finance	\$ 149,697	\$ 144,930	\$ 180,240
Real Estate	7,160	7,160	7,160
Total	\$ 156,857	\$ 152,090	\$ 187,400
December 31, 2015			
Leveraged Finance	\$ 157,446	\$ 150,692	\$ 188,453
Business Credit	—	—	—
Real Estate	34,941	34,915	38,286
Equipment Finance	772	709	772
Total	\$ 193,159	\$ 186,316	\$ 227,511

	Recorded Investment with a Related Allowance for Credit Losses	Recorded Investment without a Related Allowance for Credit Losses	Recorded Investment, net, without a Related Allowance for Credit Losses
	(\$ in thousands)		
September 30, 2016			
Leveraged Finance	\$ 105,099	\$ 100,461	\$ 44,598
Real Estate	—	—	7,160
Total	\$ 105,099	\$ 100,461	\$ 51,758
December 31, 2015			
Leveraged Finance	\$ 113,397	\$ 106,762	\$ 44,049
Business Credit	—	—	—
Real Estate	7,705	7,705	27,236
Equipment Finance	—	—	772
Total	\$ 121,102	\$ 114,467	\$ 72,057

During the three months ended September 30, 2016, the Company recorded a small recovery of \$0.05 million on loans previously charged-off, and during the nine months ended September 30, 2016, the Company recorded net charge-offs of \$14.2 million. During the three months ended September 30, 2015, the Company did not record any charge-offs or recoveries, and during the nine months ended September 30, 2015, the Company recorded net partial charge-offs of \$3.9 million. The Company's policy is to record a specific allowance for an impaired loan to cover the identified impairment of that loan. Based on the Company's experience any potential charge-off of such loan would occur when

any loan loss amount is considered to be confirmed. The Company may record the initial specific allowance related to an impaired loan in the same period as it records a partial charge-off in certain circumstances such as if the terms of a restructured loan are finalized during that period. When a loan is determined to be uncollectible, the specific allowance is charged off, which reduces the gross investment in the loan.

While charge-offs of amounts previously reserved have no net impact on the carrying value of net loans and leases, charge-offs lower the level of the allowance for loan and lease losses; and, as a result, reduce the percentage of allowance for loans and leases to total loans and leases, and the percentage of allowance for loan and lease losses to non-performing loans.

Below is a summary of the Company's evaluation of its amortized cost portfolio and allowance for loan and lease losses by impairment methodology:

September 30, 2016	Leveraged Finance		Real Estate	
	Investment	Allowance	Investment	Allowance
	(\$ in thousands)			
Collectively evaluated (1) (2)	\$2,725,028	\$ 29,614	\$10,582	\$ 91
Individually evaluated (3)	149,697	36,160	7,160	—
Total	\$2,874,725	\$ 65,774	\$17,742	\$ 91

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December 31, 2015	Leveraged Finance		Business Credit		Real Estate		Equipment Finance	
	Investment	Allowance	Investment	Allowance	Investment	Allowance	Investment	Allowance
(\$ in thousands)								
Collectively evaluated								
(1)	\$2,469,868	\$ 27,874	\$342,281	\$ 1,991	\$65,791	\$ 350	\$172,481	\$ 1,291
Individually evaluated								
(3)	157,446	26,447	—	—	34,941	306	772	—
Total	\$2,627,314	\$ 54,321	\$342,281	\$ 1,991	\$100,732	\$		