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OHAI - Q3 2017 OHA Investment Corp Earnings Call

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PRESENTATION

Operator

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 expectations as expressed in those forward-looking statements. Those factors are described in more detail in the company's SEC's filings, and I refer you to the company's website or to the SEC 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 afternoon. I would like to welcome all of you to OHA Investment Corporation's 3rd 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 & 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 third quarter ended September 30, 2017. NAV declined $0.42 per share on the third quarter of 2017 to $2.34 from $2.76 at the end of Q2 '17. This decline largely stems from a $7.6 million write-down of our investment in Castex, a legacy energy portfolio investment, which filed for bankruptcy under Chapter 11 on October 16, 2017. 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 $323,000 of Net Investment Income, or $0.02 per share, and declared distributions of $0.02 per share. Cory will provide more detail on the financial results later on in the call.

During the quarter we sold $8.0 million par amount of our $10.1 million investment in TIBCO Software's unsecured notes, which generated a realized capital gain of $1.0 million, or $0.05 per share. Also during the quarter, we made four new portfolio company investments totaling $10.7 million of principal amount.

Subsequent to September 30, 2017, there were three events that I would like to mention. First, as noted earlier, Castex announced that it, together with certain affiliates, had filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code.

Second, last week, we entered into an amendment relating to our credit facility with MidCap Financial. As part of that amendment, we made a voluntary prepayment on the credit facility of $4.5 million, which we made from available cash and amended certain covenants. There is now $36.0 million outstanding under our credit facility.

And finally, last week, we entered into an Incentive Fee Waiver Agreement with our external advisor, OHA, whereby OHA has agreed to waive any incentive fees earned relating to 2017 and 2018. As you will note from our financial statements, a Capital Gains incentive fee of $104,000 was accrued in the third quarter, which under our Investment Advisory Agreement would not have been paid until 2018. With this Waiver agreement now in place, any Capital Gains fee for 2017 that would have otherwise been payable will be waived.

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 third quarter of 2017, as private equity deal count declined 22% and capital invested declined 27% compared to the third quarter of 2016. Year-to-date, through September 30, 2017, both deal count and capital invested have declined 17% year over year.

Performance in the U.S. high-yield market continues to be strong as the broad high-yield index ended the quarter up 2.0%. Year-to-date, through September 30, 2017, the U.S. high-yield market was up 7.0% and high-yield spreads continued to tighten to levels near their post-financial crisis tights. In the past few weeks, however, we have seen some pullback. And through yesterday, the year to date gains stood at 6.6%.

In the leveraged loan market, U.S. institutional new issue activity is at record highs, although a significant amount of this activity has been repricings and refinancings rather than new money deals. Year to date, through September 30, 2017, this market has returned 3.5%.

Activity in the middle market picked up in the third quarter of 2017. Issuance of syndicated middle market loans, those with deals with loan amounts of $350 million or less increased in the third quarter to $10.2 billion from $9.2 billion in the second quarter. Similarly, issuance by companies with EBITDA of $50 million or less increased from $2.3 billion in the second quarter of 2017 to $3.0 billion in the third quarter of 2017. According to LCD, the primary driver of this increased volume in the third quarter of 2017, was attributable to dividend loans, which totaled $1.7 billion in the quarter, up 88% from the second quarter of 2017. In both the broadly syndicated and middle markets, new issue yields have continued to decline.

I will now turn the call over to Cory to discuss the financial results for the 3rd quarter.

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

Thank you, Steven. The financial summary for the 3rd quarter can be found on Page 5. Our investment income for the quarter totaled $2.75 million or $0.14 per share. Base management fees were $440,000 or $0.02 per share, and we accrued $104,000 of capital gains incentive fee in the third quarter. As Steven noted earlier, with the Incentive Fee Waiver Agreement with OHA now in place, any capital gains incentive fee payable for 2017 will be waived.

Our net investment income totaled $323,000 or $0.02 per share. We recorded net realized gain of $1.0 million or $0.05 per share. We recorded net unrealized losses totaling $8.5 million. This excludes the $1.0 million of reversals as a result of realizations or $0.42 per share during the quarter. These unrealized losses related to $8.6 million of write-downs in our legacy investment portfolio. Steven will provide additional commentary on these write-downs and other portfolio activity in a moment.

All together, we reported a net decrease and net assets from operations of $0.42 per share. After our $0.02 per share distribution declared in September and paid in early October, our net asset value declined to $2.34 per share, a 15% decline from the end of the second 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 $10.0 million on a quarterly basis. We will also seek positive assurance on other Level 3 assets with any fair value below $10.0 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.

Turning to Page 6. Page 6 shows the net investment income section of our income statement for the third quarter of 2017 compared to our results for the second quarter of 2017 and for the third quarter of the prior year. Investment income increased by $276,000 from the second quarter of 2017 to $2.75 million, primarily due to the $297,000 of royalty payments received from our investment in ATP/Bennu's limited term royalty interest in the 3rd quarter of 2017. These payments are related to the 2016 fourth quarter production prior to Bennu's bankruptcy filing.

Compared to the same quarter prior year, investment income decreased $1.6 million or 36.0%. 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 this year and lower cash payments received from our limited term royalty investment in ATP/Bennu in 2017. We continued to not recognize any dividend income from our investment in Castex during the 3rd quarter of 2017.

Interest expense for the quarter was $1.0 million or $0.05 per share compared to $984,000 or $0.05 per share in the second quarter of 2017 and $768,000 or $0.04 per share in the same quarter of the prior year. Quarter-over-quarter, interest expense increased $28,000 or 3% as the average amount borrowed on our Credit Facility remained unchanged at $40.5 million, but LIBOR increased quarter over quarter. Compared to the same quarter prior year, interest expense increased $244,000 or 32%, due primarily to the higher borrowing cost under our new credit facility.

Management and incentive fees to our advisor were $48,000 higher in the third quarter of 2017 compared to the prior quarter as the result of the accrual of $104,000 capital gains incentive fee, which were partially offset by lower base management fees. Compared to the same quarter prior year, management and incentive fees were lower by $344,000, driven by lower base management fees and lower investment income incentive fees. Our capital gains incentive fee is determined and payable in arrears as of the end of the each fiscal year but we are required under GAAP to accrue the fee during the period. This is the first quarter we have estimated any capital gains fees since our Investment Advisory Agreement went into effect on September 30, 2014.

As noted earlier, subsequent to quarter end, we entered into an Incentive Fee waiver Agreement with OHA.

Other G&A expenses for the quarter were $865,000 or $0.04 per share compared to $840,000 or $0.04 per share in the second quarter of 2017 and $971,000 or $0.05 per share in the same quarter prior year. Quarter over quarter, G&A expenses increased $25,000. Compared to the same quarter prior year, other G&A expenses were lower by $106,000 or 11% due to lower legal costs.

As a result, our net investment income for the third quarter of 2017 totaled $323,000 or $0.02 per share compared to the $145,000 or $0.01 per share in the prior quarter. In comparison, net investment income for the third quarter of 2016 totaled $1.7 million or $0.08 per share.

Turning to page 7, you can see the summary of realized and unrealized gains and losses in the investment portfolio for the relevant quarters. As Steven mentioned earlier in the presentation, we sold $8.0 million of the senior unsecured notes of TIBCO Software during the 3rd quarter, resulting in a realized capital gain of $1.0 million, or $0.05 per share.

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, and our investments in OCI, a non-energy legacy 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 $2.76 per share. Net investment income was $0.02 per share. This was offset by the third quarter distribution of $0.02 per share and then the net negative adjustments in the value of our investment portfolio totaling $0.42 per share with $0.38 of that related to our write-down in Castex. These all combined to reduce our net asset value per share to $2.34, for a quarter-over-quarter decrease of $0.42 per share or 15%.

Now let me turn 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 $139.4 million in 18 new portfolio companies since September 30, 2014, which we believe demonstrates OHA's origination capability for OHAI.

Since closing the new credit facility just over a year ago, we have made investments in six new non-energy portfolio companies totaling $27.6 million of par value.

Turning to Page 11. During that same period, we have realized $128.4 million of investments, including $89.8 million through the full or partial realization of OHA investments. $60.2 million of this has come from the full realization of seven investments, which generated a dollar weighted average unlevered gross IRR of 14.6%.

At the end of the third quarter, the fair value of our Portfolio Investments totaled $78.7 million, excluding our uninvested cash and as noted at the bottom of the page, our investment portfolio is split 80%/ 20% between floating rate and fixed rate investments. Also, 65% of our portfolio investments based on fair value were classified as level 2.

We ended the quarter with $16.6 million in cash, although we had $6.4 million due to brokers for unsettled trades, on our balance sheet at September 30, 2017, making $10.2 million of net cash available. Although as previously mentioned, we did pay down $4.5 million of our credit facility last week from available cash.

Moving to Page 12 While we have previously provided return information on a deal-by-deal basis as investments have been realized, we added page 12 this quarter to present the realized and unrealized returns for the 18 portfolio of company investments OHA has made since becoming OHAI's investment advisor. This page further underscores OHA's ability to originate investments for OHAI.

As I mentioned earlier, the seven fully realized investments generated a dollar weighted average IRR of 14.6%. and when you include the $8.0 million of TIBCO that we sold in the quarter, the dollar weighted average IRR increases to 15.1%. The remaining unrealized investments, based on prices as presented in our September 30, 2017, financial statements have a dollar weighted average gross IRR of 13.4%.

I will note that even though these investments are still classified as "Unrealized", as shown in the prior side, several of these investments, Appriss, Royal Adhesives, Berlin and Equinox have had partial realizations to date. The returns shown in this presentation and discussed today are unaudited and provided for informational purposes, and these gross IRRs are presented on an unlevered basis and before any fees or expenses.

Turning to Page 13. Despite investing $141.2 million over the past 3 years which includes $1.7 million of additional investments in legacy portfolio companies the size of our portfolio by fair value has decreased 54% since September 2014, driven by $117.3 million in net negative valuation changes and $128.4 million of realizations.

Let's now go to Page 14, Page 14 is an update to the slide we added our last quarter's presentation, which better illustrates and explains 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 mid $50s. This commodity price movement, in conjunction with similar movement in the price of Natural Gas, took its toll on these legacy energy assets.

Over the past 12 quarters, we have had to write down approximately $111 million of the original $171 million of investment assets or almost 65% of the fair value. Most of that $111 million of write-downs, $108.2 million of it has come from the 7 legacy energy assets that totaled $127 million of the $171 million of investment assets. Put it another way, we had written off over 85% of the legacy energy assets.

As noted below, the amounts written off shown here do not take into account any additional investment, paid-in-kind, interest or dividends or discount accretion subsequent to September 30, 2014.

Let's now go to Page 15. While the portfolio may be smaller, this chart does show material difference in the composition and diversification of today's portfolio. Although our energy exposure is now under 10%, as I just discussed, too much of this reduction in energy exposure has come unfortunately 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. I will note that our legacy position in OCI, shown here as therapy services, does constitute nearly a quarter of our investment portfolio today, which we generally consider to be too large a position in a credit portfolio.

Turning to Page 16 for a more detailed look at the company's portfolio changes during the quarter. I will focus my comments on the meaningful changes in the portfolio during the quarter. The most meaningful change in the portfolio was with regards to Castex in the quarter, we wrote down the remaining $7.6 million of book value we had at the end of the previous quarter. As I mentioned earlier, on October 16, 2017, Castex announced that, together with certain affiliates, had filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. According to the filing, Castex and its affiliates have entered into a restructuring support agreement or an "RSA", with pre-petition lenders holding approximately 86% in principal amount of claims under the pre-petition credit facility. The RSA outlines a plan of reorganization for Castex and its affiliates in bankruptcy. As currently proposed, the RSA does not provide for any recovery to OHAI as a holder of preferred limited partnership units of Castex, even though we previously exercised our put rights with respect to our investment and that liability has not been satisfied. OHAI is not a party to the RSA and is exploring all available options in and out of bankruptcy for recovery on its investment in Castex.

At this time, we are unable to determine the form and value of a recovery, if any, we expect to receive due in large part to the inherent risks and uncertainty associated with bankruptcy and litigation. Therefore, as we are not yet in a position to determine the form value and likelihood of a recovery, we are estimating a $0 fair market value for our investment in Castex at September 30, 2017, for financial statement purposes.

The only other significant change in portfolio value occurred with OCI, our last non-energy legacy investment. During the quarter, we executed the 10th amendment to our note purchase and security agreement with OCI that allows the company to continue to PIK its LIBOR plus 12% cash interest through December 31, 2017. Although we kept the value of our Subordinated Note investment flat quarter-over-quarter, OCI continues to pay us PIK interest, thus necessitating a $911,000 write-down to maintain a constant fair value. We also took a $93,000 write-down in our OCI equity investment.

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 initially 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 its business and reductions in visit volumes. As a result, operating performance and cash flow have continued to suffer.

In May, the Texas Legislature agreed to the 2018, 2019 biennium budget. The new budget, which went into effect on September 1st, 2017, restored approximately 25% of the rate cuts subject to a number of specific provisions relating to pediatric therapy reimbursement. OCI has started to see the benefit of the rate restoration and management continues to address its cost base and pursue operating initiatives to best position itself for success in the new rate reimbursement environment.

As part of that effort to navigate the challenging rate environment, as posted on its website last month, OCI has entered into an agreement of intent with a nationally recognized Healthcare Maintenance Organization for a unique value-based arrangement, utilizing its clinical resources and extensive independent research experience.

There were no other significant moves in the quarter across the rest of the portfolio but as you see on our schedule of investments, and as I mentioned earlier, we did have one significant divestiture, and we invested $10.7 million par amount in 4 new portfolio company investments during the quarter. DexKo Global, Hayward Industries, MW Industries and Avantor Performance Materials.

As mentioned earlier in the call, in July, OHAI sold $8.0 million (par value) of our $10.1 million investment in TIBCO at an average price of 110.38%. OHAI generated a 19.2% gross unlevered IRR on the realized portion of this investment, which was originally purchased in July of 2015.

Throughout the quarter, beginning in July, OHAI purchased $3.0 million of DexKo Global's second lien term loan at an average price of 99.2%, which pays cash interest of LIBOR +8.25% with a 1% floor and matures in July 2025. At quarter-end, this second lien term loan was marked at 100.5. DexKo is a leading supplier of highly engineered running gear technology, chassis assemblies and related components.

In August, OHAI purchased $1.3 million of Hayward Industries' second lien term loan at a price of 98.25%, which pays cash interest of LIBOR +8.25% and matures in July of 2025. At quarter-end, this second lien term loan was marked at 99.5%. Hayward is a leading manufacturer of residential and commercial pool equipment and accessories.

In September, OHAI purchased $1.4 million of MW Industries' second lien term loan at a price of 99%, which pays cash interest of LIBOR +800 and matures in September 2025. At quarter-end, the second lien term loan was marked at 100.5.

MWI is a leading manufacturer of highly engineered, mission critical springs and fasteners for original equipment manufacturers and after-market applications, serving a wide range of end markets, including medical, heavy equipment, military and automotive.

Also in September, OHAI purchased $5.0 million of Avantor Performance Material's Senior Unsecured Notes at par. The senior unsecured notes mature in October 2025 and pay cash interest at 9.00%. At quarter-end, the Notes were quoted at 102.25%. Avantor is a leading provider of ultra-high purity materials and customized solutions for the biopharmaceutical, biomaterials, research, diagnostics, electronics, aerospace and defense industries.

Lastly, I do want to mention some recent events regarding our limited term royalty interest in certain assets of ATP/Bennu. As in prior quarters, this remains a complex situation and my remarks here are qualified entirely by the detail in the September 30, 2017, 10Q. After Bennu, and its production platform subsidiary Bennu Titan, filed for bankruptcy and production was halted in the fourth quarter of last year, we wrote down the value of this asset to $0. We have maintained that valuation for this quarter as production on these wells has not re-commenced. As we described more fully described in Note 6 to our financial statements in our 10Q, in August, Statoil USA E&P,Inc. acquired the leases to certain wells on which we hold a royalty interest.

On November 1, the Bankruptcy court approved the sale of the Titan Production facility to Statoil. We believe that Statoil is seeking easements and regulatory approvals necessary to operate the Titan production facility, and it is possible that Statoil will resume production from one or more of the wells.

In addition, while the bankruptcy court has ruled in our favor, regarding Phase 2 of the ATP litigation, which was upheld by a district court, the matter is still under appeal at the fifth circuit and at this time, no arguments have been scheduled for this appeal.

Before I move on, I would like to note that we now have only two legacy investments left with any fair value. Talos, which has a scheduled maturity in February 2018, and OCI.

So, let's move on to another snapshot of our investment portfolio, the yield comparison on Page 17. 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 12.4% and 13.1% based on weighted average cost and fair value, respectively, at September 30, 2017. This compares to 12.6% and 13.0%, respectively, at the end of the prior quarter.

As shown on Page 18, we now have 16 active investments, including the $0 value investments in ATP/Bennu and Castex 2005 and our minimal residual CLO investment as compared to 10 investments at September 30, 2014. Twelve of these are new investments made by OHA, and they now constitute 67% of the portfolio on a fair value basis.

This ends our formal presentation for today. On pages 20 and 21, you will see the current and selected historical price curves for both Oil and Natural Gas. Given the reduction in our legacy energy asset portfolio, we don't expect to provide these slides in the future.

Thanks for your time today and for your continued interest in OHAI. Before I go to the Q&A, I want to offer some perspective as OHAI has completed its third anniversary under OHA management on September 30, 2017. I also want to share some initiatives we are taking in connection with the company going forward.

As both the investment advisor and a the shareholder of the company, we are surely disappointed by the magnitude of write-downs in the legacy investment portfolio. While we are proud of the meaningful success of new investments made under OHA leadership, these gains have only cushioned the substantial losses. When OHA took over the management of NGP Capital Resources Company, OHAI's predecessor entity, OHA's plan at that time was to bring the capabilities of a large well-established $20 billion-plus asset manager to diversify the investment portfolio away from energy, make new investments leveraging OHA's origination capabilities and over time, raise additional capital to create a leading BDC, consistent with OHA's credit platform, which now exceeds $30 billion.

The downturn in energy prices and other challenges associated with the legacy portfolio have dramatically challenged our ability to achieve this goal, and we fully recognize that the company is not operating at scale, especially given these write-downs.

It has always been OHA's objective to maximize shareholder value, and we are mindful of the expense burden relative to a sub-scale investment portfolio. With the outcomes from the legacy portfolio more in view, OHAI's Board of Directors and management are in a better position to actively pursue options that could provide more scale to OHAI. These options may include, among other things, raising additional capital, a merger or joint venture with another party, the acquisition of existing investment portfolios or other strategic transactions. While we are committed to taking these actions that we believe will maximize shareholder value, there is obviously no guarantee that the company will execute on any of these options.

No timetable or formal process has been set and OHAI does not expect to comment further or update the market with any additional information unless and until its Board of Directors has approved a specific transaction or otherwise deems disclosure appropriate or necessary.

I will now turn it 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 Steven Martin from Slater Capital Management.

Steven L. Martin - *Slater Capital Management, L.L.C. - Manager*

Steven, you mentioned in your prepared remarks that Talos matures on February 1, 2018. Can you give us some qualitative comments or any comments about your expectation of repayment?

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

Yes. Just to be clear, I believe the actual maturity is February 15, 2018. But yes, it matures in a couple of months. Look, it is always hard to handicap, and we have expectations that it's going to repay us at par. There's no reason to believe that otherwise, but obviously it still operates in the energy area and has a highly levered capital structure. But it is our expectation is that we will be repaid.

Operator

(Operator Instructions) And our next question comes from the line of [Jacob Heitkamp], a private investor.

(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*

Thank you, operator. I want to thank everybody for their time today, and I look forward to speaking with you next year. 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.
