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Q2 2018 OHA Investment Corp Earnings Call

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CORPORATE PARTICIPANTS

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the OHA Investment Corporation Second Quarter Report June 30, 2018 Conference Call. (Operator Instructions)

Before we begin, I would like to remind everyone that today's remarks may include comments which could be considered forward-looking statements and such statements are subject to many factors that can cause actual results to differ materially from our expectations as expressed in those forward-looking statements. Those factors are described in more detail in the company's SEC filings, and I refer you to the company's website or to the SEC's website to review those filings. The Company undertakes no obligation to publicly update or revise any forward-looking statements, which speak only as of today's date.

As a reminder, this conference is being recorded.

I would now like to turn the call over to Steven Wayne, the company's President and Chief Executive Officer. Please begin.

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

Thank you, Norma. Good morning. I would like to welcome all of you to our company's 2nd Quarter 2018 earnings call. I am joined on the call today by Cory Gilbert, our Chief Financial Officer.

The presentation we're about to review was posted to our website earlier this morning under the Events and Presentation headings of the Investor Relations tab. We also refer you to our quarterly report on Form 10-Q that was filed yesterday.

Before I begin today, I want to remind you that OHAI is in the midst of a Strategic Review process that our Board of Directors initiated to provide more scale to OHAI. These options could 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. We are actively working with our financial advisors, KBW, although there is no assurance that the Company will execute on any of these options. As we have said previously, we do not expect to comment further or periodically provide updates to the market with additional information unless and until the Company's Board of Directors has approved a specific transaction or otherwise deems disclosure appropriate or necessary, and I will not be commenting further or answering questions today regarding the strategic review process.

I will now turn to Page 4 and provide a summary of the developments for OHAI for the second quarter ended June 30, 2018.

OHAI's NAV increased for the 3rd consecutive quarter. At the end of the 2nd quarter, NAV was $2.46, a $0.03 per share or 1% increase from March 31, 2018. From a financial standpoint, we finished the quarter with $667,000 of Net Investment Income or $0.03 per share on a GAAP basis and declared distributions of $0.02 per share. Cory will provide more detail on the financial results later on in the presentation.

This quarter, we invested $12.9 million in six new portfolio companies with an aggregate principal amount of $13.1 million. Also during the quarter, we had $6.9 million of realizations, including $6.7 million from our Berlin Packaging 2nd lien term loan, an OHA investment, which was fully realized this quarter upon pay-down.

Two notable developments during the quarter, both relating to legacy investments. First, we extended the maturity on our OCI subordinated notes to August 31, 2019; and second, production restarted on some of the properties underlying our ATP royalty interest, and we received royalty payments during the quarter totaling $153,000. I will provide additional commentary on our portfolio later on in the presentation.

Now turning to the leveraged credit markets. Private equity activity, which generally drives new money financing opportunities in the below-investment-grade credit markets, continued its recent decline in the second quarter of 2018 as private equity deal count declined 30% and capital invested declined 17% compared to levels in the second quarter of 2017. Private equity activity also declined compared to the first quarter of 2018.

After a weak first quarter of 2018, The U.S. high-yield market bounced back in the second quarter, showing a positive return of 1.0% for the quarter. This strength continued into July, which returned 1.1%. High yield spreads have continued to hover at levels near the post-financial crisis tights.

Moving on to the leveraged loan market, the strength we saw in the first quarter continued into the second quarter of 2018. Quarter-over-quarter, new issue volume was up 9% and up 13% from the second quarter of 2017. This increase in volume was driven primarily by M&A activity as May and June were the busiest two-month period for acquisition financing on record, according to LCD. After reaching post-crisis lows earlier in the year, the heavy new supply pushed new issue spreads higher. Average new-issue first lien spreads for single B borrowers rose to LIBOR +374 basis points, up from LIBOR +336 basis points at the end of the first quarter.

After outperforming the high yield market in the first quarter of 2018, the loan index lagged the high yield market in the second quarter of 2018 and was up 0.7%. The recent rise in LIBOR will have a significant impact on both the yields of our floating rate assets and the cost of our borrowing, which is LIBOR based. Although three month LIBOR has gone from 1.33% at the end of the third quarter 2017 to 2.31% today, it has remained relatively stable over the past few months.

Loan issuance in the middle market accelerated both sequentially and year-over-year in the second quarter of 2018. Issuance by companies with EBITDA of $50 million or less increased from $2.3 billion in the second quarter of 2017 and $2.2 billion in the first quarter of 2018 to $2.5 billion in the second quarter of 2018. However, middle market syndicated credits of $350 million or less were down 18% year-over-year in the second quarter of 2018 and down 11% from the prior quarter. There has been a noticeable summer slowdown, with the two-month period ended July being the lowest two-month period of volume issuance in the middle market in the past year.

Similar to the broadly syndicated market, middle market spreads widened in the second quarter, driven by heightened M&A activity and increased volume. According to LCD, institutional spreads on loans issued by companies with EBITDA of $50 million or less increased from LIBOR +445 basis points in the first quarter of 2018 to LIBOR +453 basis points in the second quarter. Despite this recent rise, over the past year, spreads have come in considerably as the average spread in the fourth quarter of 2016 was 581 basis points.

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

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

Thank you, Steven. The financial summary for the 2nd quarter can be found on page 5.

Our investment income for the 2nd quarter totaled $2.6 million or $0.13 per share, a 15% increase from the prior quarter. Base management fees were $384,000 or $0.02 per share, and there was a reversal of a $1,000 capital gains incentive fee in the second quarter. We finished the quarter with net investment income of $667,000 or $0.03 per share. We recorded net realized and unrealized gains totaling $341,000 or $0.02 per share during the quarter.

All together, we reported a net increase in net assets from operations of $0.05 per share. After our $0.02 per share distribution declared in May and paid in early July, our net asset value increased $0.03 per share to $2.46 per share, a 1% increase from the end of the 1st quarter of this year.

We continued our practice to seek positive assurance from a third-party valuation firm on all Level 3 assets with fair values in excess of $10 million on a quarterly basis. We will also seek positive assurance on other Level 3 assets with any meaningful fair value on an annual basis. This quarter, we sought and received third-party positive assurance on 94% of our Level 3 assets with any fair value.

Page 6 shows the net investment income section of our income statement for the second quarter of 2018 compared to our results for the first quarter of 2018 and for the second quarter of the prior year.

Investment income increased by approximately $344,000 and $152,000 from the first quarter of this year and the second quarter prior year, respectively. The increase quarter-over-quarter is primarily driven by the recognition of $244,000 of unamortized discount associated with the Berlin pay-down that occurred in the second quarter of 2018.

Interest expense for the quarter was $801,000 or $0.04 per share compared to $823,000 or $0.04 per share in the 1st quarter of this year and $984,000 or $0.05 per share in the same quarter prior year. Quarter-over-quarter, the decrease in interest expense is due to lower amortization expense related to our debt issuance costs, partially offset by an increase in one-month Libor. Compared to the same quarter prior year, the decrease is primarily attributable to lower amount outstanding on our credit facility.

Management and incentive fees to our advisor were $18,000 lower in the second quarter this year compared to the 1st quarter and $113,000 lower compared to the same quarter prior year. Our base management fees continue to decrease as a result of the lower average asset balance subject to the base management fee calculation.

Other G&A expenses for the quarter were $743,000 or $0.04 per share compared to $1.1 million or $0.06 per share in the first quarter this year and $840,000 or $0.04 per share in the same quarter prior year. Quarter-over-quarter, Other G&A expenses were $406,000 lower, primarily due to lower legal fees incurred in connection with the Castex bankruptcy and the Strategic Review costs incurred in the first quarter. G&A expenses were $97,000 lower compared to the same quarter prior year, primarily due to lower legal fees.

As a result, our net investment income for the second quarter of 2018 totaled $667,000 or $0.03 per share compared to a net investment loss of ($95,000) or ($0.01) per share for the first quarter of 2018. In comparison, net investment income for the second quarter of 2017 totaled $145,000 or $0.01 per share.

Turning to page 7, you can see the summary of the realized and unrealized gains and losses in the portfolio for the relevant quarters. During the 2nd quarter, we wrote off our investment in Castex, a legacy energy-related portfolio company, from our Schedule of Investments. Therefore, the loss on our investment was reclassified from unrealized to realized in the 2nd quarter and had no effect on the Company's NAV in 2018.

Now, let's look at the net realized -- unrealized and -- gains and losses on the lower half of the page. For the 2nd quarter of 2018, excluding the reversal due to Castex realization, the total net unrealized loss was $9,000. Meaningful valuation changes in the quarter were related to write-downs in our investments in OCI, a legacy non-energy investment, which were offset by a write-up in our ATP royalty interests, a legacy energy investment. Steven will provide further 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 $2.43 per share. Net investment income was $0.03 per share. Net asset value was reduced by the $0.02 -- by the second quarter distribution of $0.02 per share and the net positive adjustments in the value of our investment portfolio totaling $0.02 per share. These all combined to increase our net asset value per share to $2.46 for a quarter-over-quarter increase of $0.03 per share or 1%.

Now to discuss recent portfolio activity, let me hand the call back over to Steven.

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

Thanks, Cory. Let's go to Page 10. As shown here, OHA has been able to invest $163.2 million in 31 new portfolio companies since September 30, 2014, which we believe demonstrates OHA's origination capability for OHAI.

Turning to Page 11 During that same period, we have realized $163.8 million of investments, including $113.8 million through the full or partial realization of OHA investments. $99.6 million of this has come from the full realization of ten investments.

At the end of the second quarter, the fair value of our Portfolio Investments totaled $72.3 million, excluding the $14.1 million of cash on our balance sheet, which is net of $5.3 million due to broker for unsettled trades. As noted at the bottom of the page, our investment portfolio is now split 88%, 12% between floating rate and fixed rate investments. Also, 63% of our portfolio investments based on fair value were classified as level 2.

Moving to Page 12

This page presents the realized and unrealized returns for the portfolio of company investments OHA has made through June 30, 2018, since becoming OHAI's investment advisor. This page further underscores OHA's ability to originate investments for OHAI. The ten fully realized investments generated a dollar-weighted average gross IRR of 13.4% on an unlevered basis, and when you include the $8.0 million of TIBCO that we sold in the 3rd quarter of 2017, this increases to 13.8%, as shown on the page. The remaining unrealized investments, excluding the recently made investments this quarter, based on prices as presented in our June 30, 2018 financial statements have a dollar-weighted average gross IRR of 12.0% on an unlevered basis.

The returns shown in this presentation and discussed today are unaudited and provided for informational purposes - and these gross IRRs are presented before any fees or expenses. Please note that the explanatory footnotes related to this chart are now found on the following page.

Skipping now down to Page 14. Despite investing $165 million over the past 3.75 years (which includes $1.7 million of additional investments in legacy portfolio companies), the size of our portfolio by fair value has decreased by 58% since September 2014, driven by $115.3 million in net negative valuation changes and $163.8 million of realizations.

Let's now go to Page 15

This page 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 by the end of 2014. In early 2016, WTI was under $30 a barrel, and today, it has recovered to the high $60s.

This commodity price movement, in conjunction with a similar movement in the price of Natural Gas, which still remains under $3, took its toll on these legacy energy assets. Over the past 15 quarters, we have had to write-down or mark down approximately $107.3 million of the original $171 million of investment assets or approximately 63% of the fair value. Most of that $107.3 million of write-downs and mark downs has come from the 7 legacy energy assets that totaled $127 million of the $171 million of investment portfolio.

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

Let's now go to Page 16

While the portfolio may be smaller, this chart does show a material difference in the composition and diversification of today's portfolio. Although our energy exposure has now been reduced to 2% at June 30, 2018, up from 0% last quarter due to the write-up of our ATP royalty interest, too much of this reduction in energy exposure has come unfortunately from the losses in the 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 just over approximately 21% of our investment portfolio plus cash today.

Let's move to Page 17

I will focus my comments on the meaningful changes in the portfolio during the quarter. As mentioned previously in the presentation, our

$6.7 million investment in Berlin second lien term loan, an OHA investment, was fully realized as the result of a pay-down in May, generating an 11.2% gross unlevered IRR.

Also during the quarter, we ascribed $1.4 million of fair value to our ATP royalty interest as production on some of the underlying wells recommenced in April 2018 and production payments resumed in May 2018. This quarter, we received production payments totaling $153,000 and subsequently received an additional $169,000 in July, relating primarily to June production. Previously, these wells ceased production in November 2016 as a result of Bennu's Chapter 7 bankruptcy, which lead OHAI to write down the value of our investment in ATP to $0 that quarter. In 2017, Equinor, formerly known as StatOil, acquired the Titan product platform and certain assets on which we hold royalty interests. Our June 30th valuation of $1.4 million is based on June production volumes assuming they continue over an 18th month period which have been probability-weighted using future commodities pricing curves and discounted back at a 15% rate.

As to the status of the ATP bankruptcy litigation, as in prior quarters, this remains a complex situation and my remarks here are qualified entirely by the detail in the December 31, 2017 10K and our 10Q filed yesterday.

As previously announced, the bankruptcy court ruled in our favor regarding Phase 2 of the ATP litigation, and this favorable ruling was upheld by a District Court in 2017. On April 17, 2018, the U.S. Court of Appeals for the Fifth Circuit affirmed the District Court's opinion, dismissing the claims of the Intervenors. On April 30, 2018, the Intervenors filed a petition with the courts for an En Banc rehearing by all of the Fifth Circuit judges and on June 9, 2018, the Fifth Circuit denied the Petition for a rehearing En Banc. We believe that no valid basis exists for further appellate review. Absent further appellate review, including a petition to the United States Supreme Court, the Fifth Circuits' existing decision will conclude the Adversary Proceeding on a final basis in our favor. The deadline for the Intervenors to file a petition with the United States Supreme Court is September 4, 2018.

Moving on to our largest decline in fair value for the quarter, OCI, our last non-energy legacy portfolio company investment. Although we kept the overall fair value of our investment in OCI's Subordinated Note flat quarter-over-quarter once again through June 30, 2018, OCI continued to pay us substantially in PIK, which resulted in a $1.1 million unrealized loss during the quarter. We also wrote down the remaining $162K of our equity interest in OCI to $0.

OCI, a home health provider of pediatric therapy services to Medicaid patients in Texas, has been negatively impacted by Medicaid reimbursement rate reductions that 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 rate 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 suffered.

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

As part of the effort to navigate the challenging rate environment, OCI announced on January 30th, 2018, that it had been selected as the preferred provider by Superior HealthPlan, covering approximately 167,000 member lives in the Texas Travis service delivery area and Central Medicaid Rural Service Area, covering 15% of all Texas counties. This preferred provider arrangement commenced on March 1, 2018, and OCI now provides speech, physical and occupational therapy in all practice venues for Superior's pediatric members aged three years and older as well as adults. This value-based care program is the first of its kind in the Texas Medicaid pediatric therapy services market. The program has been rolled out, and initial results have been encouraging. And although the program is still in its infancy, we continue to believe this is a significant positive for the Company and will help mitigate the Medicaid rate reimbursement reduction and other industry issues OCI has faced over the past few years.

There were no other meaningful valuation changes during the quarter across the rest of the portfolio, but as you see on our Schedule of Investments, and as I mentioned earlier, we added $13.1 million par amount in six new portfolio company investments during the quarter: Community Brands, PowerSchool, Ensono, Vertafore, FirstLight and Edelman.

In May, OHAI purchased $1.7 million of second lien term loan in Ensono at 96% of par, which pays cash interest at a rate of Libor +9.25% and matures in April 2026. Ensono is a hybrid IT managed service provider focused on mission-critical workloads for enterprise customers in the United States and Europe.

In June, we made investments in five new portfolio companies. We purchased $6.0 million of second lien term loan in Ministry Brands at 99% of par, which pays cash interest at a rate of Libor +8.0% with a 1% Libor floor and matures in June 2023. Ministry Brands is a provider of member management and financial planning software as well as payment processing technology solutions for associations and member-based organizations, non-profits and private schools (K-12).

We purchased $3.8 million of second lien term loan in PowerSchool at 99% of par, which pays cash interest at a rate of Libor + 6.75% and matures in June 2026. PowerSchool is a provider of software solutions catering to K-12 schools in the United States and Canada.

We purchased $900,000 of second lien term loan in Vertafore at 99% of par, which pays cash interest at a rate of Libor +7.25% and matures in July 2026. Vertafore is a provider of software and services for the property and casualty insurance distribution market.

We purchased $400,000 of second lien term loan in FirstLight Fiber at 99% of par, which pays cash interest at a rate of Libor +7.50% and matures in June 2026. FirstLight is an independent bandwidth infrastructure provider across the state of New York and northern New England.

Finally, we purchased $300,000 of second lien term loan in Edelman Financial at 99.5% of par, which pays cash interest at a rate of Libor +6.75% and matures in June 2026. Edelman is a provider of independent, technology-enabled financial advisory services and investment advice to employer-sponsored defined contribution plans and retail investors.

So, let's move on to another snapshot of our investment portfolio, the yield comparison on Page 18. This table focuses on the yield of our portfolio, both as it relates to fair value and cost. Based on our current yielding investments, which includes any PIK component from performing investments, our portfolio yields 14.3% and 13.6% based on weighted average fair value and cost, respectively, at June 30, 2018. This compares to 14.1% and 13.6%, respectively, at March 31, 2018. Our portfolio yield at June 30, 2018, excluding our investment in OCI, were 9.8% and 10.0% based on weighted average fair value and cost, respectively.

As shown on Page 19, we have 23 active portfolio company investments as of June 30, 2018, as compared to 10 investments at September 30, 2014. Twenty-one of these are new investments made by OHA, and they now constitute 73% of the investment portfolio on a fair value basis.

Before I end today, I would also like to note that we are actively engaged with our lender, Midcap Financial, on extending the maturity of our credit facility, which comes due on September 9, 2018.

This ends our formal presentation for today. I will now turn the call over to the operator to coordinate the Q&A process.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And at this time, I have no callers in the queue. I'd like to turn the call back over to Mr. Steven Wayne for closing remarks.

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

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

Operator

Ladies and gentlemen, thank you for your participation on today's conference. You may disconnect. Have a wonderful day.