

Prospect Capital Corporation (NasdaqGS:PSEC) Transcript Details

Detail **Transcript**

Prospect Capital Corporation, Q2 2015 Earnings Call, Feb 05, 2015

Prospect Capital Corporation (NasdaqGS:PSEC) Earnings Call Transcript Thursday, February 05, 2015 10:00 AM

Executives

[Brian H. Oswald](#) - Chief Financial Officer, Principal Accounting Officer, Chief Compliance Officer, Treasurer and Company Secretary
[John Francis Barry](#) - Executive Chairman and Chief Executive Officer
[Michael Grier Eliasek](#) - President, Chief Operating Officer, and Director

Analysts

[Christopher Whitbread Nolan](#) - MLV & Co LLC, Research Division
[Jonathan Gerald Bock](#) - Wells Fargo Securities, LLC, Research Division
[Robert J. Dodd](#) - Raymond James & Associates, Inc., Research Division
[Tengwei Ma](#) - Barclays PLC, Research Division
Unknown Analyst

Presentation

Operator

Good morning, and welcome to the Prospect Capital Corporation's Second Fiscal Quarter Earnings Release Conference Call. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to John Barry, Chairman and CEO of Prospect Capital. John, please go ahead.

John Francis Barry

Thank you, Keith. Good morning, everyone. Joining me on the call today are Grier Eliasek, our President and Chief Operating Officer; and Brian Oswald, our Chief Financial Officer. Brian?

Brian H. Oswald

Thanks, John. This call is the property of Prospect Capital Corporation. Unauthorized use is prohibited.

This call contains forward-looking statements within the meaning of the securities laws that are intended to be subject to Safe Harbor protection. Actual outcomes and results could differ materially from those forecast due to the impact of many factors.

We do not undertake to update our forward-looking statements unless required by law. For additional disclosure, see our earnings press release, our 10-Q and our corporate presentation filed previously and available on the Investor Relations tab on our website, prospectstreet.com.

Now I'll turn the call back over to John.

John Francis Barry

Thanks, Brian. Our net investment income or NII in the December quarter was \$91.3 million or \$0.26 per share. Our net income was \$86 million or \$0.24 per share. A decrease in structuring fees due to lower origination levels and a mix shift toward online loans, which do not have structuring fees, but which are currently delivering an expected levered yield of approximately 19%, drove year-over-year differences.

In December, we suspended our at-the-market equity issuances for the indefinite future due to unattractive share price levels. This reduction in equity and asset growth has resulted in lower origination volumes, compared to prior period. As a tax efficient regulated investment company, our shareholder dividend payout requirement is based on taxable income rather than GAAP net investment income. Taxable income can be coupled meaningfully from such net investment income. In the December quarter, we generated taxable income of \$107.8 million or \$0.30 per share. This is \$0.05 per share more than our recently declared dividends. While regulated investment companies may utilize spill-back dividends in the subsequent tax year to account for prior year distribution requirements, taxable income consistently in excess of dividends enhances the possibility of future special dividends in order to maintain regulated investment company status.

As described in detail in our release, our CLO business generates higher taxable income, which roughly tracks cash income than GAAP income on a recurring basis throughout the life of each CLO. Our CLO business performance has significantly exceeded our underwriting expectations, demonstrating the benefits of our strategy of pursuing majority stakes, working with world-class management teams providing strong collateral underwriting through primary issuance and focusing on the most attractive risk-adjusted opportunities.

As of December 31, we held \$1.12 billion across our fleet of 34 nonrecourse CLO investments. Our underlying CLO portfolio consisted of over 2900 loans and a total asset base of over \$15.9 billion. As of December 31, our CLO portfolio experienced a trailing 12-month default rate of 0.06%, significantly less than the broadly syndicated market default rate of 3.24%. In the same quarter, this portfolio generated an annualized cash yield of 20.6% and a GAAP yield of 14.9%. In the December 2014 quarter, we sold 4 CLOs capturing a weighed average cash realized IRR of 15.3%. We do not expect significant individual CLO sales in the near future given no CLO in our portfolio goes past the 3 investment period until September 2016. Recent drops in loan prices provide attractive opportunities for our CLOs to purchase loans at a discount to par thereby enhancing our potential upside in such investment. We have previously announced monthly cash dividends to shareholders of \$0.0833 per share for February, March and April 2015, with the latter representing our 81st consecutive shareholder distribution in our company's history. We plan on announcing our next series of shareholder distribution in May. We have generated cumulative taxable income in excess of cumulative dividends to shareholders since Prospect's IPO 11 years ago. From the IPO through December 31, 2014, our taxable income is \$39.2 million, in excess of dividends to shareholders in excess of \$0.11 per share. Since our IPO

11 years ago, through our April 2015 distribution at the current share count, we will have paid out \$13.62 per share to initial continuing shareholders and \$1.5 billion in cumulative distributions to all shareholders. Our NAV stood at \$10.35 per share on December 31, down \$0.12 from the prior quarter with most of this difference due to dividends in excess of net investment income demonstrating a relatively stable investment portfolio value in NAV per share over this time period.

We have delivered solid returns while keeping leverage prudent. Net of cash and equivalents, our debt-to-equity ratio was 74.2% in December, up slightly from 72.9% in June.

As of December 31, our asset concentration in the energy industry stood at 4.5%, including our first lien senior secured loans where third parties bear first loss capital risk.

We previously announced a strategy that we've been working on for several months now, to spinoff certain businesses in our portfolio, including our CLO structured credit business, online lending business and real estate business. We believe these dispositions have significant potential to unlock shareholder value through pure-play earnings multiple expansion. Moving strategies into faster-growing non-BDC formats with reduced basket and leverage constraints and freeing up 30% basket can leverage capacity for new originations at Prospect. These investment strategies have grown rapidly for us in recent years. We believe these dispositions will provide expanding capacity to continue that growth. We anticipate these non-BDC companies will have tax-efficient structures. We will likely seek to divest these businesses in conjunction with capital raises for each such business, with the goal of leverage and earnings neutrality for Prospect. The size and likelihood of these dispositions, some of which are expected to be partial rather than complete spinoffs, remain to be determined. We continue to work on structuring these dispositions, including preparation of standalone financial statements and initial registration statements for these businesses that we hope to file in the coming weeks. We expect to file nonregistered investment company offerings with confidential treatment. Our target timing for completion would be in the next several months of calendar year 2015.

Prospect Capital will continue as the only multi-line BDC in the marketplace, with a continued diversified focus on originations that include the businesses being spun out.

We have substantial liquidity to drive future earnings to prudent levels of matchbook funding. We are currently pursuing initiatives to lower our funding costs, including refinancing existing liabilities at lower rates, opportunistically harvest certain controlled investments, optimize our origination strategy mix and rotate our portfolio out of lower yielding assets into higher yielding assets, while maintaining a significant focus on first lien senior secured lending.

Our company is locking a ladder of fixed rate liabilities extending 30 years into the future, while most of our loans float with LIBOR, providing potential upside to shareholders as interest rates rise. Thank you very much. I'll now turn the call over to Grier.

Michael Grier Eliasek

Thanks, John. Our business continues to grow at a solid and prudent pace. Prospect has scaled to over \$7 billion of assets and undrawn credit. Our team has reached approximately 100 professionals, representing one of the largest dedicated middle-market credit groups in the industry. With our scale, longevity, experience and deep bench, we continue to focus on a diversified investment strategy that covers third-party private equity sponsor-related lending, direct nonsponsored lending, Prospect-sponsored operating buyouts, Prospect-sponsored financial buyouts, CLO structured credit, real estate yield investing, online lending, aircraft leasing and syndicated lending.

At December 31, our controlled investments at fair value stood at 26.4% of our portfolio. This diversity allows us to source a broad range and high volume of opportunity, then select in a disciplined bottoms-up manner the opportunities we deem to be the most attractive on a risk-adjusted basis. Our team typically evaluates thousands of opportunities annually and invests in a disciplined manner in a low single-digit percentage of such opportunities. Prospect's originations in recent months have been well-diversified across our 9 origination strategies. Prospect originated nearly \$3.2 billion of closed investments during the 2014 calendar year.

Our non-bank structure gives us the flexibility to invest in multiple levels of the corporate capital stack, with a preference for secured lending and senior loans. At December 31, our portfolio at fair value consisted of 55% first lien, 20.2% second lien, 17.2% CLO structured credit with underlying first lien assets, 0.4% small business whole loan, 1.4% unsecured debt and 5.8% equity investments, resulting in 92.4% of our investments being assets with underlying secured debt benefiting from borrower-pledged collateral.

Prospect's approach is one that generates attractive risk-adjusted yields. And our debt investments were generating an annualized yield of 12.3% as of December 31, an increase of 0.4% from the prior quarter. We also hold equity positions and many transactions that can act as yield enhancers or capital gains contributors, as such positions generate distributions. While the market has experienced some yield compression in the past year, we've continued to prioritize first lien senior and secured debt with our originations to protect against downside risk while still achieving above-market yields through credit selection discipline and a differentiated origination approach. We believe such yield compression may have stabilized recently due to trading valuation discounts for peer company. Originations in the December quarter were \$523 million across 5 new and several follow-on investments. We also experienced \$224 million of repayments from 7 investments as a validation of our capital preservation objective.

During the December quarter, our originations consisted of 60% third-party sponsor deals, 19% CLO structured credit, 19% online lending, 1% real estate and 1% operating buyouts. As of December 31, we held 134 portfolio companies with a fair value of \$6.524 billion, demonstrating both the long-term increase in diversity as well as a migration toward larger position and larger portfolio companies.

Our number of companies is up 3%, and portfolio size is up 34% year-over-year. We also continue to invest in a diversified fashion across many different portfolio company industries with no significant industry concentrations. The largest is about 10%.

Our financial services controlled investments and CLO structured credit investments are performing well with typical annualized cash yield ranging from 15% to 30%. Because of declining unemployment rates and declining gasoline prices, we believe the outlook for consumer credit is positive as we enter 2015, boding well for our financial services and online lending companies. To date, we've made multiple investments in the real estate arena with our private REITs, largely focused on multi-family stabilized yield acquisitions with attractive 10-year financing. We hope to increase that activity with more transactions in the months to come.

In the June 2014 fiscal year, we made 3 investments in noncontrolled third-party-sponsor-backed companies that brought our total investment in each such company to more than 100 million. In the last 2 quarters, we made another 3 such investments, demonstrating the competitive differentiation of our scale balance sheet to close one-stop financing opportunities. We've also made multiple controlled investments that each individually aggregate more than 100 million in size.

We may look to harvest certain controlled investments in 2015, at a hoped for significant gain over our initial costs. Over the past year, we've also entered and expanded in the online lending industry with a focus on prime, near-prime and subprime consumer and small

business borrowers. We intend on growing this investment strategy, which stands at approximately \$248 million today, across multiple third-party and captive origination and underwriting platforms.

Our online business, which includes attractive advanced rate, bank lender financing for certain assets is currently delivering an expected levered yield of approximately 19%. We hope to expand that through securitization in the months to come. The majority of our portfolio consists of agented and self-originated middle-market loans. In general, we foresee the risk-adjusted reward in the current environment to be superior for agented and self-originated opportunities compared to the syndicated market, causing us to prioritize our proactive sourcing efforts.

Our differentiated call center initiative continues to drive proprietary deal flow for our business. As a yield enhancement for our business, earlier this year, we launched an initiative to divest lower yielding loans from our balance sheet, thereby allowing us to rotate into higher yielding asset, and to expand our ability to close scale one-stop investment opportunities with efficient pricing. We expect to close our first par value sale of a lower yielding asset shortly and expect significant such sales this quarter, as a potential earnings catalyst for the future. Our credit quality continues to be strong. Non-accruals as a percentage of total assets stood at less than 0.1% at December 31. Our weighted average portfolio net leverage stood at 4.1x EBITDA, and our weighted average EBITDA per portfolio of company stood at \$20.2 million. We have booked \$40.1 million in originations so far in the current March quarter. Our advanced investment pipeline aggregates nearly \$200 million in potential opportunities, with additions expected boding well for the coming months. Thank you. I'll now turn the call over to Brian.

Brian H. Oswald

Thanks, Grier. We believe our prudent leverage, diversified access to matchbook funding, substantial maturity of unencumbered assets and weighting toward unsecured fixed-rate debt demonstrate both balance sheet strength as well as substantial liquidity to capitalize on attractive opportunities. Our company has locked in a ladder of fixed-rate liabilities extending 30 years into the future, while most of our loans float with LIBOR, providing potential upside to shareholders as interest rates rise.

We are a leader and innovator in our marketplace. We were the first company in the industry to issue a convertible bond, conduct an ATM program, develop a notes program, issue an institutional bond and acquire a competitor, as we did with Patriot Capital. Shareholders and unsecured creditors alike should appreciate the thoughtful approach differentiated in our industry, which we have taken toward construction of the right-hand side of our balance sheet.

As of December 2014, we held more than \$4.9 billion of our assets as unencumbered assets representing approximately 75% of our portfolio. The remaining assets are pledged to Prospect Capital Funding LLC, which has a AA rated \$885 million revolver with 22 banks and with a \$1.5 billion total size accordion feature at our option. The revolver is priced at LIBOR plus 225 basis points, a 50-basis-point reduction from the previous rate, and revolves until March 2019 followed by 1 year of amortization with interest distributions continuing to be allowed to us.

Outside of our revolver and benefiting from our unencumbered assets, we've issued at Prospect multiple types of investment-grade unsecured debt, including convertible bonds, a baby bond, institutional bonds and program notes. All of these types of unsecured debt have no financial covenants, no asset restrictions and no cross defaults with our revolver. We enjoy a BBB rating from S&P and a BBB+ rating from Kroll.

We've now tapped the unsecured term debt market to extend our liability duration up to 30 years. We have no debt maturities until December 2015, with debt maturities extending through 2043. With so many banks and debt investors across so many debt tranches, we substantially reduced our counter-party risk over the years.

As of today, we have issued 6 tranches of convertible bonds with staggered maturities that aggregate approximately \$1.25 billion, have interest rates ranging from 4.75% to 6.25% and have conversion prices ranging from \$11.23 to \$12.61 per share. In January, we repurchased \$8 million of such convertible bonds at a significantly accretive discount to par. We have issued a \$100 million 6.95% baby bond due in 2022 and traded on the New York Stock Exchange under the ticker PRY.

On March 15, 2013, we issued \$250 million of 5-7/8% senior secured notes due in March 2023. This was the first institutional bond issued in our sector in the last 7 years. On April 7, 2014, we issued an additional \$300 million of 5% [indiscernible] unsecured notes due July 2019.

We currently have \$785 million of program notes outstanding with staggered maturities between 2016 and 2014 and a weighted average interest rate of 4.88%. With the closing of the facility, one condition precedent to borrowing required an increased level of equity for us to fully utilize the \$885 million of commitment. Our board believes that was in the best interest of shareholders to raise the modest amount of additional equity at a discount in net asset value to enhance liquidity and maximize access to low-cost facility financing. We raised approximately \$147 million of equity capital from September 11 through December 3 at an average price of \$9.89 per share.

No issuance has occurred below a price of \$9.50 per share. We currently have drawn \$201 million under our revolver, assuming sufficient assets are pledged to the revolver and that we are in compliance with all revolver terms and taking into account our cash balances on hand, we now have over \$530 million of new facility-based investment capacity.

Now I'll turn the call back over to John.

John Francis Barry

Thank you, Brian. Lets see what questions we have.

Question and Answer

Operator

[Operator Instructions] And the first question comes from Ryan Lynn [ph] [indiscernible]

Unknown Analyst

Given that you guys are bumping up at the upper end of your leverage at about 0.75 debt-to-equity, and you guys have only deployed about \$40 million of capital quarter-to-date, how should we think about capital deployment going forward? And how do you anticipate funding those deployments?

Michael Grier Eliasek

Sure. Thank you for your question, Ryan. And by the way, in our prepared remarks, the quarter average EBITDA per portfolio can be at \$29 -- actually \$49 million. We are -- we have several levers to pull related to your question, Ryan. We do have debt capacity that we can

utilize for originations. But we also are in the process of harvesting certain investments that would fall into at least a couple of categories. One is our lower yielding assets. We've got about \$0.75 billion, give or take, in lower yielding assets that are yielding in the range of 5.5% to 6.5% typically on a gross basis, which obviously drags down the overall weighted average yield of 12.3%. And if we can divest those assets, that's obviously a significant amount of dry powder that we can redeploy that doesn't impact our leveraged ratio in any fashion. The -- another storehouse of liquidity is through the sale of one or more control deals. We've got some companies in our portfolio that we're quite pleased about in terms of performance. I'm not going to go into specifics on sell-side processes for obvious reasons, but we've got some that we're cautiously optimistic about that we can potentially monetize and of course redeploy. So following those 3 drivers of existing dry powder with our debt capacity and we have over \$500 million that we can utilize in our revolver today, number one. Number two, lower-yielding asset sales; and number three, sale of controlled companies. Those are important drivers. And actually a fourth category on top of that would be through potential capital raises associated with the 3 spinoffs that we've been hard at work on since we announced that initiatives in November.

Unknown Analyst

Then in December quarter, you guys raised a little bit of capital below book value and have since stopped, based on what the current share price is. Are you guys planning on waiting until share price rises above book value before raising any additional shares? And if not, what kind of price levels would you be comfortable issuing shares below book value and why?

Michael Grier Eliasek

We have no plans to raise equity capital. When you aggregate the 4 different drivers that I just mentioned, that's a substantial amount of dry powder and liquidity.

Unknown Analyst

And then focusing on the spinoffs for a minute, you stated you expected spinoffs could maybe be partial spinoffs rather than complete spinoffs. Is there a minimal -- minimum percentage that you would need to spinoff in order to complete these transactions? Or could you guys spin-off as little as 20% or 30%?

Michael Grier Eliasek

I think the minimum size for any spinoff is going to be a function of making sure as on the other end you've got a business with enough initial scale. I think you can appropriately amortize any fixed cost associated with that newly spun company. You want a business with minimum scale to attract follow-on investor interest in that business, with certain market capitalization, access to shelf funding for the future. So there's going to be some obvious pieces there, but no hard and fast specifics. The reason we say your partial spend is take our CLO book, for example. That's a \$1.1 billion, \$1.2 billion of assets. We'd be pretty unlikely to spin that entire book en masse all at once. And in a partial kind of pro rata sliced across those 30-plus deals is much more likely. In the case of real estate, where we have a couple of pure-play REITs that have about \$200 million give or take of our invested capital, that becomes more likely a complete potential transfer. And the same thing with the online business that has about \$250 million of assets, give or take in it. That would at least be the objective subject to, as always, regulatory and mark-based feedback.

Operator

And the next question comes from Christopher Nolan with MLV & Co.

Christopher Whitbread Nolan

What's the driver for the decline in the spillover income in the quarter?

Brian H. Oswald

Primarily, the dividends in excess of earnings for the quarter.

Christopher Whitbread Nolan

Great. And then, John, when you're commenting on the harvesting of controlled investments, are you talking about spinning off -- or excuse me, harvesting some of the operating buyouts or some of the CLO book? Would this be a function of the issues with the SEC that Prospect had last year?

John Francis Barry

Well, number one, it's not -- none of the strategies we've articulated today or any other strategies I'm aware of are a function of -- are disagreed [ph] with the SEC, which we now see as behind us, unfortunately. I was focusing more on the control operating companies in our book, and I believe that one or more may in fact be attractive companies for sale. I think people who followed us for years have seen us sell Gas Solutions, NRG and other companies for attractive purchase prices. So we look across our portfolio and we have some hope and ideas for some of the controlled operating companies there. Nothing definite yet, of course, but we do see promise there.

Operator

And the next question comes from Terry Ma with Barclays.

Tengwei Ma

Looks like you guys had a significant amount of impairments this quarter, which were then offset by some write-ups of investments. So can you maybe just talk about what drove the write-up of some of your equity investments like Echelon, First Tower, Harbortouch and also talk about Ajax?

Michael Grier Eliasek

Okay, sure. Let me try to take some of those in turn, Terry. For our aircraft leasing book, what you're seeing with these midlife aircraft, which comprises the bulk of what we're invested in to-date is a significant uptick in valuations, due to the significant decline in crude oil that's good for our business, because carriers tend to keep older, less fuel-efficient planes around for a longer time horizon, and defer new aircraft purchases. So it elongates the useful life of these aircraft. It elongates the cash flows and increases the value. For, I believe you asked about First Tower as well. As I said in my prepared remarks, consumer credit has a significant tailwind behind it. You are entering 2015. Everything is not completely perfect in the economy, of course, but consumers are overall doing better, more money in their wallet as jobs tick up modestly and especially as there's been a nice gasoline dividend in peoples' pocket. We have seen a pretty significant decrease in delinquencies and charge-offs in Tower as well as our other consumer financing-oriented companies. And I will expand that and saying in our consumer online lending business, we're seeing businesses that are, loans trend at significantly lower actual losses compared to expectations. I think you also asked about Ajax. We sold Ajax last quarter.

Tengwei Ma

Okay. So you guys have roughly 5% energy exposure in your portfolio. Can you maybe just give us the sense of what your total exposure to energy is when you consider the loans in your CLO book or the energy loans in your CLO book?

Michael Grier Eliasek

Sure. I don't have a specific percentage right now. Maybe I can get that from our team here while we are proceeding with the call. But I'm told that our energy percentage is in the low single digit for energy within our CLO book, and that energy as a percentage of -- energy in our book as a percentage of total compared to the overall CLO market is less than average. So we are underweight in our business. And overall, our observation is, what's happened -- this is important to understand the CLO business, when you have exposure to the junior-most tranche, and this is counterintuitive to how some people think about structured credit. Volatility is actually your friend, and dips in loan prices are great news, because you can go out and acquire assets at discount to par. Of course, all of that discount accretes to you as the equity holder in the tranche. We have that dynamic going on right now over the last 30, 60 days. You've had to sell-off in the loan market for nonenergy names, completely unrelated energy, and in some cases businesses that are benefiting, and not just neutral to the change in commodity price. So our fleet is out there, scooping up those loans at attractive price. We have got many years to run in terms of reinvestments. That's a good thing. So it's important to understand, it's a non-linear relationship. It's not like loan prices dipped, so therefore you multiply that by the leverage of the equity and then that dips as well. That's incorrect math. The correct viewpoint is more option math saying you've got many years to run, and you can utilize that time horizon to buy on the cheap, and your financing cost is locked in. So that's how we're looking at energy today. And we are also scouring the universe on the direct lending side, and [indiscernible] for potential opportunities. We think it's a wonderful time to be looking at new deals. Capital has retreated substantially from the marketplace. We are valued-based investors. We made a lot of money in value and distressed over the years. Look at the Patriot deal, which was a distress purchase we made in 2009, give or take \$0.50 from the dollar. And we reaped over 40% RRs from that, and you're seeing a dislocation in energy that has analogs to what you saw in -- from '07 to '09 systemwide.

Brian H. Oswald

Let me just add to that. I was looking at -- I pulled up the iShares' energy ETF and I pulled up the stock chart. You can -- everyone knows how to do this on Yahoo! or StockCharts.com, and I compared it to PSEC, and it looked -- each one was right on top of the other over the last 3 months, especially. So looking at that, I realized that this concern about energy is causing, I think, a flight from the high-yield market to also from BDCs perhaps, and also impacting our stock price. And if that's true, I'm happy to send that to anyone you would like me to show you this little bit of investigation I did yesterday. If that's true, we think that we may have some 2 things going for us. One, as the panic over energy recedes, we should benefit; number 2, completely independently, as people look into our portfolio and realize that at 4.5%, which is the lowest I think Brian it has ever been in the history of our company and lower than the average BDC. I think there's some below us, but I think we're lower than the average BDC, that people who are worried about energy will realize our portfolio is pretty much insulated from that.

Operator

And the next question comes from Brent [ph] Dodd with Raymond James.

Robert J. Dodd

First on some of the legacy stuff. As you say, you exited Ajax and then essentially Boxercraft and some of your old legacy investments this quarter. Can you give us a rundown on why you decided to do that now? Obviously, you have been hanging around for a while in many cases. And just any color on the decision to do that in this quarter.

Michael Grier Eliasek

Sure. Well, I guess each has its own individual case. Boxercraft was a tiny position that we inherited as part of the Patriot portfolio. We didn't value it very much coming in, and it was occupying significant amount of time. So we really wanted to divest that value maximizing in tax efficient way as a small position. Ajax, as a forging company, has cycled in line with other industrial-related businesses. And we basically got a strategic bid that paid us more of a full cycle replacement cost type value, as opposed to the generic TTM EBITDA multiple financial sponsor viewpoint. And we ran the math on, waiting for recovery versus exiting at this price and deemed as attractive to exit and also did so in a tax-advantaged way. So that was the story on Ajax. So when John and I talked about potential harvesting [ph] in 2013 we were thinking about positions that are larger and we hope would be more significant in the gain and move-the-needle category.

Robert J. Dodd

Just some additional questions on the CLO book. On the 4 that you decided to exit in the quarter, I mean, can you give us -- of those, did you control the core on any of those CLOs? Obviously, you've talked in the past about how that's a big thing you look to do. And frankly, if you did control the call, why did you elect to sell at realized losses versus exercise the core and potentially generate material realized gains given where they were -- where the cost and fair value was versus the power of those investments, particularly if your loss rate is so much lower, you'd expect it to collect a significant portion of that par amount and realize the gain. So what was the decision there? Or is that -- is the core portion of the strategy in controlling that, has that shifted?

Michael Grier Eliasek

Sure. We -- all 4 deals were controlled deals, and we exited at prices exceeding the -- what we would have gotten calling those deals. And it's important for folks to understand the 4 deals that we exited were very late, and their lives were very close to ending their reinvestment period and needed to be monetized. And what we were doing was we were exiting positions, in many cases buying brand new positions the same day with some attractive investment partners, as an elongated option value and that's item number one. Item number two, that we exited those deals at north of 15% IRR cash in, cash out on a total basis. And the other aspect is that we pay very, very close attention to our adjusted leverage ratio, which is an important aspect to maintaining and sustaining our investment-grade rating that we've had now for almost 6 years. And we take that obligation very seriously, and making sure that we have ready access to the debt capital markets for not only refinancing our latter debt maturities as they come due in each of the next several years, beginning at the end of this year, but also have the ability to opportunistically refinance right now some of our existing debt. We've been aggressively doing that. We saw some of our converts as very attractively priced and repurchased those at a huge IRR, just in last few weeks. And we'll opportunistically look to do more of the same if those opportunities present themselves. We have also been refinancing some of our program notes that were issued at higher treasury levels, and we get a significant bottom line benefit from refinancing by issuing in the market today. And we've got some other debt outstanding that we're eyeballing. So all those things had, as a predicate, an attractive rating with an attractive cost of capital debt access that's embedded in that rating. So all those were considerations. And as we put in our prepared remarks, we have no plans currently to divest any further CLOs in the near future. Those plans could change, but right now we have no such plans. And our next deal doesn't go past reinvestment for, I think, the first one is 1.5 years out and the vast bulk of them are years out. So we've got a long runway of positive option value there in our structured credit book.

Robert J. Dodd

Okay, understood. But just sticking with these 4 in particular right now, 3 of those 4 have fair value marked above cost last quarter. In aggregate, they were marked above cost last quarter, as is the overall CLO book. Yet they all took realized losses at about 15, overall, between the 4, about 15% of cost was the realized loss. And the -- as you said, the IRR on those investments is about 15%, which is about where your GAAP yield on your CLO book is in contrast to your cash yield. So I mean, was there something particularly problematic about these that changed rapidly from the end of September to the period when you sold these, in the first case there in October, a month after

the last fair value update? And I mean, is there something we should read into that as to the overall book being marked above par when we've got the 4 most recent cases, all again in aggregate marked above par but then took material losses when a realization event actually occurred?

Michael Grier Eliasek

Sure. I would not read too much into that, Robert. There's a few other dynamics at play here. One is that, in some cases, I think, in many cases we received payments between 9 30, and when there was a monetization and so that's not reflected in the exit number, but would be a significant additional value to make the delta significantly less than the 15 you mentioned. That's item number one. Item number two is, it's a little bit [indiscernible] if you are selling and buying the same day, but you think what you're selling is -- what you're buying is more attractive to what you're selling on a net basis, you're coming out ahead. Number three, we have embedded into many of our deals certain rebates on costs. As a control investor, we can throw our weight around and get a special deal above and beyond buying in at a much more attractive OID level than another investors. The catch is those rebates don't necessarily travel with the deal if we sell to a third party. So it's in general, more attractive for us to hold onto CLOs than to sell them in the market early. We had specific reasons related to elongating the cycle and our leverage ratio that I mentioned that were special to the December quarter only, but we do not expect that to reoccur anytime in the near future. And then related to energy, I've answered to your prior question,

John Francis Barry

[indiscernible] Say, for a second, Robert, I was going to say Brent, did your dad talk you going into research?

Robert J. Dodd

No. Even after you spell out the spelling of your name, sometime it doesn't quite work out.

John Francis Barry

So Robert, the other thing I wanted to mention to you is, you might want to take some time to speak to team CLO, because there is yet another layer to this onion, which I think Grier adverted to and that is that team CLO believes that the opportunity to buy in a dislocated market represented significant economic value in excess of the hit that we would take selling into a dislocated market. So first question we had was well, we can buy now and have -- put on the book some long-lived assets that are going to produce great economic returns, look at the discounts that we can buy. Then your next thought is, should I want to sell now. Well, okay, let's wait now. That -- and we concluded, we're not going to do that. We're going to match buys and sales and the accounting is not as pretty as we would have liked. But if you talk to team CLO, they will be able to give you the chapter and verse on why our shareholders were economically advantaged in dollars and cents, although it will take time to realize that over the life of the [indiscernible] and I think the [indiscernible] and CLOs that we purchased on the same day. So I did want to make sure you understood that portion. Let me put it this way. If they were Robert Dodd Enterprises, all alone, he would have done the exact same trade we did, we believe.

Michael Grier Eliasek

[indiscernible], which we monetized in 2013, Robert, was bought at a dip at its inception for different reasons. There was one, the various European flash crashes that's occurred over the last few years that wasn't energy related. But then we exited that one at a 32% [indiscernible] IRR, can be advantageous to form a new issue CLO, even at a higher AAA cost if you know you are able to buy loan assets at pretty significant discounts. Then I was trying to answer the energy question. Our CLO book has an energy exposure of 3.9% and I'm told by our CLO team that compares to the overall loan market at 4.7%. So we think we're not only underweight energy in our overall PSEC book relative to other BDCs. We are way underweight relative to the high yield market, which I think it approaches 20%. And we are also underweight in CLO. So I'd agree with John that to suggest PSEC is some proxy [ph] for -- in energy fixed income, high-yield index is a big mistake.

Operator

And the next question comes from Jonathan Bock with Wells Fargo.

Jonathan Gerald Bock

Grier, I actually missed one quick stat, but did you happen to give us the current...

Michael Grier Eliasek

Jon, it sounds like we lost you. [Technical Difficulty]

Jonathan Gerald Bock

So just real quick, Grier. There was one stat I missed, what you deployed to date subsequent to quarter end. I think you gave that number. Do you happen to have it handy?

Michael Grier Eliasek

Yes, it's about \$40 million.

Jonathan Gerald Bock

\$40 million. Okay. Just a couple. So regarding the CLOs, I really appreciate that. One question is, as of December 31, the question is could you liquidate that book at that fair value mark?

Michael Grier Eliasek

Well, we would want to liquidate our book at that mark, but we feel very good about the value of the third party process, that looks exactly that question, and has some pretty intense in tax and other related modeling to it. We, as managers, have very limited involvement in that third-party process. It's approved by the independent directors. So that's what -- where the third parties came out.

Jonathan Gerald Bock

I appreciate that, but I do think CLO equity is trading between 6 to 8 points lower, and so to hold that at par at a point when we can pretty easily see that values are down, that's -- it befuddles us. But the only question that we have then is, we agree with you, Grier, there the volatility is attractive for the long run. It's just that you can't keep it at par and still assume that this is going to be a great 17% assets in all markets, right? I mean, that's just a question which we...

Michael Grier Eliasek

We have a controlled premium embedded in our -- you're mentioning certain points, I'm not sure what data you're referring to. The deals we're involved in are more akin to controlled buyouts or your middle-market bespoke deals where you get an inefficiency and controlled premium. There is no trade or mark on the deals that we invest in. It's like we hold between 51% and 90%, and the management team owns a significant part of the balance, and maybe there's a few other small fry, but the deals we're involved in look quite different from distributed fragmented deals. And again, we get outside economics that we benefit from. And that option value to call and the cost rebates,

the other elements I mentioned, have real value to them, John.

Jonathan Gerald Bock

Got it, and appreciate that. So you could, I guess, because of the corporate controlled premium, you could actually liquidate close to the fair value, I guess, if you were to sell it because they are very valuable and different than anything else?

John Francis Barry

Well, yes, Jon. First, in fact, empirically when we look at the pricing on -- this is John Barry, not Grier. We look at the pricing on these smaller pieces, the expected returns are significantly less, as you've observed, as Grier has stated, as I have observed. And it's no surprise that the retail person wanting to buy 500,000 of this or that doesn't have the negotiating leverage, doesn't command control over the terms, doesn't control the call, and as a result, will not earn the returns we've been earning. That's one [indiscernible].

Jonathan Gerald Bock

I appreciate that.

John Francis Barry

Also there's more to it. And haven't you heard about the investment banker who moved from New York to Los Angeles and he hired a broker and bought a house. And broker said, well, you're not going to get anything for \$1 million. And so he finally bought a house, and then he got moved back a month later, and he put the house on the market and the same broker said, there's no way you could get a \$1 million for this. Okay. So it depends on also if you are -- how would I put it? A forced seller, which we were -- in effect were forcing ourselves to sell on a matchbook basis, because we wanted to buy new things. You probably are not going to get the same price that you're going to get if you say I'm going to put this out there, I'm going to give people time to come and bid, and I'm going to tell them I may need to sell, I may not. We made it clear that we wanted to sell on a matchbook basis. So as a result, we left money on the table for those sales, but we believe selling on a matchbook basis is a prudent risk control, because obviously you can get upside down if you don't do that. Now in the future, as Grier said, we don't anticipate making any sales in order to buy new ones, that could change. And therefore we don't see ourselves as being in a situation where we would be under any, how would I put it, time pressure to try to liquidate a position. And that's why I think the sales that you're looking at, as I said to Brent -- really Robert Todd are anomalous.

Jonathan Gerald Bock

Got it, and I appreciate that. And again, look, CLOs are very attractive investments. So we appreciate the candor there. One question, I mean I guess, it gets to a point where you're putting out a portion of your book that will be marked as you spin out portions of your online lending book and your CLO book. You mentioned that it was going to be earnings and leverage-neutral, I was just curious, will it also be NAV-neutral as well?

Michael Grier Eliasek

Well, that's our objective, Jon. And because if you just do a straight spin of assets and leave leverage by the PSEC, you would obviously be goosing the leverage in a way that's not too interesting from a risk and other standpoint. So that's why we messaged that a capital raise would be likely. And the objective would be to take proceeds and redeploy them expeditiously into a similar yielding diversified pool of assets, like what PSEC is already invested in. And we're not talking about each of these spends being several billion in size each. So we should be able to redeploy in an expeditious fashion. So that would be the goal. But as always, the objective has to be measured against what happens from a regulatory and market feedback aspect. We have not filed the registration statements for these 3. We've been hard at work since November working on the accounting. It's a lot of work to get the standalone business accounting right and in some cases, like for example, real estate, REITs are required to have 12 31 fiscal years. So you actually have to do the audit for 2014 and then you can file. So that elongates things a little bit. And once we file and start getting feedback, then we can take it from there, but certainly that's the objective, John.

John Francis Barry

Well, the objective for me in terms of objectives is to have anything we do be NAV positive. And let's take a look at the online lending book. People seem to be willing to pay a lot of money for those online loans. So let's see where that happens. Where that gets done, there are still sticky wickets to get through but we believe that that's a valuable part of our portfolio that we see elsewhere in the marketplace, maybe I should send a iShares online lending thing around too. These sales were in the marketplace that people put a premium on that book.

Jonathan Gerald Bock

Got it.

Michael Grier Eliasek

Let's talk about that because there is a consumer book, maybe it has the most upside industry. We will find out. Put aside the text [ph] infused which some say are more like [indiscernible] disguised companies that traded 40x book. And I don't view that as a disappointment even if they trade now from offering, right? We're here in a [indiscernible] world would be delighted for a fraction of the 40x book. And surely, the analyst on the phone would agree with that. But even if you put aside those and you just talk about traditional bricks and mortar consumer finance businesses, as they tend to trade at 2x to 3x book value, well in excess of anything corporate credit BDCs tend to see in any period, at any cycle. So perhaps investors will see that and bid these up substantially. It's hard to tell. It's premature, but certainly that's our objective.

Jonathan Gerald Bock

Appreciate it on your thoughts and just to make sure I recapped, it's going to be earnings leverage and NAV neutral. So good, glad to hear it. I guess, the one issue you mentioned as it relates to leverage, because you said you wouldn't want to spin these out without a capital raise and that makes total sense and people appreciate that thought. When I think of the reasoning behind actually raising the additional \$90 million of equity capital at a point when the stock was well below book value, you mentioned that it was to, in effect, increase the maximized access to the low-cost facility funding as well as enhance liquidity. By my calculation, you only have \$200 million outstanding on \$885 million of commitments, why do you need new equity to maximize what is apparently, should be outstanding to you right now?

Michael Grier Eliasek

I'm trying to understand your question, Jon. I guess, there's a few different elements here. One is, and no, we don't want to go into all the chapter and verses, as a roadmap for things that we've done in a proprietary fashion, so our competitors can copy us. I said this in November as well, and we want to gin up advantages for our shareholders, not other company's shareholders. But there are certain ways that we would have to do a spin as a 40-Act vehicle, certain hoops we have to jump through. They cause us to go in a certain direction, Jon. That item number one.

Jonathan Gerald Bock

So your lenders required you to raise that additional equity?

Michael Grier Eliasek

I thought you were talking about the spinoffs, I'm sorry. I don't think I understand your question. On the question of utilizing our facility, we are planning on utilizing our facility in a lot of different ways, including refinancing. We've already begun that refinancing some of our higher cost existing debt that can be called. There is other debt coming due here in 2015, we'll be examining that hard. And do our [indiscernible] period start to expire. And so we want -- if we have a certain facility phase right now, it's \$885 million in size. And we want to make sure that we have the sufficient borrowing base in order to utilize that. So we made that determination. And remember, we're making plans there, not just for the next 5 seconds or for a week, but for a multi-year carefully thought-out liquidity plan for our business. And you don't just -- you have a Bullet type maturity come up on a bond or a convert and not know what to do, or wait until 10 seconds beforehand to figure it out. We figured out exactly what to do for all of those, and that's part of the plan.

Jonathan Gerald Bock

Got it. Okay.

John Francis Barry

But also related to that. It's Barry. Yogi Bear said, predictions are very hard, especially about the future. And if there is a sell-off in the loan market where opportunities in the CLO market or other opportunities, we don't want to be the person with his nose pressed against the glass wishing he could participate, but he doesn't have enough money in his pocket, and he can't fully utilize his facility. So you need to plan, hope for the best, plan for the worst, and you need to risk-control this business at all times. And that means making sure we have maximum financial flexibility and are not dependent on outside forces, whatever they might be to "Mother, may I" let us take advantage of great opportunities that crop up in the market or build in risk controls against maybe bad things happening to us, missiles heading our way. And we felt that in light of all of the risks that are out there and the attended opportunities, that what we did made a lot of sense and was good for our shareholders. And being one, I agree.

Jonathan Gerald Bock

Appreciate that. And then I guess in terms of, John, when you talk about being a shareholder, I appreciate your comment. So right now if you maybe fast forward, rewind a couple of quarters, your shareholders were receiving a \$0.33 dividend and had a NAV of \$2 -- \$10.72 and today there are going to receive a \$0.25 dividend with NAV, obviously, lower than that, yet out-performance fees and incentive fees paid to you went up from \$43 million to over \$57 million. Is that fair that shareholders can take less and will now receive less while the manager receives more?

John Francis Barry

Well, Jon, I think we have taken steps to -- first of all, I want to clear the thing, receive less. If you take a dollar and you keep it in the business as opposed to pay out a dividend, you haven't taken away any dollars of value from a shareholder. I mean that's just flat out wrong to assert that. I just clear up the value, that a dollar retained is a dollar that goes into the business, as opposed to out the door. That's item number one. Item number two is we did, as a board, make the decision in December to adjust the distribution payout. We just didn't view the business as getting appropriate credit anywhere close to it at that distribution payout rate. We and other BDCs were trading at a pretty sharp discount around that time. We said, we're just going out the door when it could be utilized in the business for better purposes like acquiring new originations at an attractive -- at attractive price. On -- from a taxable earnings perspective, and as you know taxable income is what drives a [indiscernible] payout requirement. You have to pay out at least 90% in order to be tax efficient, 98% in order to avoid excise taxes, and of course there is spillbacks you can use from a timing standpoint. But over the long-term, those are the numbers that need to be hit. We were within the taxable income of the business and have more than covered dividends out of taxable income since inception for the company. And we could have continued to do that. But we looked at and said, this isn't really receiving a marketplace credit, and there is so much fear of a change, it's better to make a change, retain that capital in the business, but I think what you're seeing from a dynamic, I mean, you referenced adjustments in net asset value. We hope to obviously see that correct itself in the future. Making a change in the distribution policy is one way to correct that. Another way is through some of the harvesting of investments that I mentioned previously we're working on to potentially sell in 2015. I can't say too much more about that because we're in the throes of that right now, but we're cautiously optimistic about that.

Michael Grier Eliasek

Let's -- Jon, let's talk about fairness for a second. And I'm reminded of the senator who said, "Everybody down here in Washington agrees that we should be seeking fairness." The only problem is, no one seems to be able to agree on what it is. Would you agree with me that the statement you made about fairness implying we're doing something unfair would apply to any business development company that increased its asset base, whether by selling stock or issuing debt or borrowing, and had its stock price decline over the last year.

Jonathan Gerald Bock

I'll have to think about it. I would probably just suffice to say that, at the end of the day, boiling it all down, if people receive less, yet managers receive more and receive less is not in terms of stock price, but in terms of dividends or NAV reduction, my guess is the board would probably always want to look for ways to rectify that through either lower expenses, or I guess another question is, if business -- if dollars are supposed to go back in the business, there is an excellent way to do that by buying back your own stock?

Michael Grier Eliasek

Okay, well, Jon, I actually don't need to think about it for more than a second. Any BDC external manager that increased assets in the last year, whether by issuing debt or issuing equity and also had its stock price decline made more money while shareholders saw the value of their shares go down. That's true of many BDCs. It only takes -- I'm sure everyone else in this call figured that out in about one second, but if it takes you longer to think it through, that's fine with me.

Brian H. Oswald

That's fair. I think probably people judge us based on the NAV and distribution assumptions. The things we can't control, I know I'd appreciate it Jon, I'll appreciate it clearly.

Jonathan Gerald Bock

I am not done.

Brian H. Oswald

No, no, no. Hold on...

Jonathan Gerald Bock

Okay, fine, you want to talk over me.

Brian H. Oswald

No, I do not.

John Francis Barry

I would like the answer. I also refer you to [indiscernible] any and all the academic research that points out the value of a share in a shareholder's hands is not altered by the payout ratio, okay? And what we've done is we have reduced our dividend to remove any question, whether it will be long-term sustainable. From net investment income, we've been leaving aside taxable income. So that any anxiety anybody has out there, worrying in bed at night, "Oh! they might have to cut the dividend." That's now behind us, and we think that's a good thing. We now think we have a solid foundation of net investment income, even under adverse circumstances, whether or not there are many originations and there are not many structuring fees and we can still out-earn our dividend, as we have done in this quarter. And we think that is delivering shareholder value.

Michael Grier Eliasek

I would also add, Jon, we just had 2 BDCs report that had NAV declines of 4% to 6% with significant exposure strategy, which could get worse before it gets better. And our NAV, taking away the distribution policy adjustment, our portfolio value held up extremely well in the quarter just ended, which is a quarter we're addressing in this call. So to suggest if somehow our NAV is faring worse than our peers is just plain wrong, right. It's the opposite. Our portfolio is holding up extremely well, and you have others who have made unwise credit choices they are paying the consequences for that in real time.

John Francis Barry

But Jon, I want to be clear, I appreciate the questions because they give us an opportunity to respond and explain why we disagree with some of the answers that have been put out there, and we believe that our answers are data-driven and are supported by substantial evidence. You might even look up. I'm going to speculate that your statement about the manager company making more money while shareholders see their share price decline is probably true. I'm going to guess up 20 BDCs, that's going to be my guess.

Jonathan Gerald Bock

I guess that the reference to John. And just to be clear, you can't control your share price, but you can control your return on equity and your NAV by making proper capital allocation and market decisions. And you can also control your dividend distribution. Those are the measures that people choose to attach, in many cases, management fees too, over time, particularly as it relates to NAV through realized loss look backs and unrealized loss look backs. If that's the case, and you delivered significant value, and we can cap it with this.

John Francis Barry

But Jon, you're turning the focus of this call that our NAV is doing worse than the others, that is just wrong. While we just put out in the quarter, and a lot of folks have yet to report, when you line up and have a table of NAV performance, PSEC will end up doing better than the vast majority of folks in my prediction.

Jonathan Gerald Bock

I appreciate that, but we can easily just say, at the end of the day if NAV falls, is there a point where its shareholders are somehow receiving less in the form of NAV and distributions, does the incentive fee still need to increase in light of those 2 facts? That's the question.

John Francis Barry

I have another credit [indiscernible] your question. Our [indiscernible] incentive fees are not increasing real time, okay? So that's just, there's a number of predicacy [ph] on your question, that is incorrect for the audience. First of all, the dividends, dollars retain the business that's somehow destroyed, that's not correct. That PSEC NAV performance is worse than peers, that's false. It's been better than peers when you look at the last quarter. Brian is showing me how the incentive fees went down year-over-year in the last quarter. So you made 3 statements there, Jon, which were just wrong and we have to correct on the record for everybody to hear.

Jonathan Gerald Bock

We appreciate, I think, that the dividend is down, NAV is down and fees are up and on an absolute basis.

John Francis Barry

Fees are not up, they are down, Jon. So that's another wrong statement..

Jonathan Gerald Bock

Not quarter-over-quarter, sir. I'm talking over a period of one year.

Michael Grier Eliasek

Okay, well, we're doing -- this is the earnings call for December, and we're talking about the quarter.

John Francis Barry

And then also...

Brian H. Oswald

As I have said, any BDC could increase its asset base and has a contract identical to ours, of which the vast majority of the industry has, can be tarred with this same brush, but why this is all laser being focused on us. I know, you have a story and you're sticking to it. I get it. But again, we're all entitled to our own opinions, but we're not entitled to our own set of facts. Please look at our financials and when you make statements, please check our financials before you make them. I would appreciate it, okay.

Jonathan Gerald Bock

We will and those facts were correct, and I appreciate your time today to take the questions.

Brian H. Oswald

You don't think they were.

John Francis Barry

They were not correct. Next question please.

Operator

We have a follow-up question from Christopher Nolan with MLB and Company.

Christopher Whitbread Nolan

I appreciate the back and forth, just I want to applaud Jon Bock. I like PSEC. I have a buy-rating on the stock, but the management is also paid at the very highest levels, compared to other BDCs. And I think his point in terms of lower dividends and erosion of book value are well taken. I think the management in PSEC is quality, but at the same time, a dollar retained in this business actually, to a larger percent than other BDCs, actually goes to management. So that's my statement.

Michael Grier Eliasek

Thanks, Chris. Thanks so much for your [indiscernible]. We really appreciate that. And I think you've seen [indiscernible] this company also supports this business with some pretty substantial personal investments as well. But we appreciate your comment. Thank you, Chris.

Operator

And at this time, I would like to turn the call back over to management for any closing comments.

John Francis Barry

Okay. So we don't have any more questions. I appreciated the spirited discussion, and I'm looking forward to the next earnings call. And meanwhile, we're going to get back to work doing the best we can. Thank you, all.

Operator

Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.

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