

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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from _____ to _____

Commission File Number 001-33211

NewStar Financial, Inc.

(Exact name of registrant as specified in its charter)

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

500 Boylston Street, Suite 1250,

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

(617) 848-2500

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

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

TABLE OF CONTENTS

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

Note Regarding Forward Looking Statements

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

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

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

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

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

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

Unaudited

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

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

no shares outstanding)

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

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

4

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

Unaudited

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

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

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Unaudited

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

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

6

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Unaudited

NewStar Financial, Inc. Stockholders' Equity

For the Nine Months Ended September 30, 2016

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

NewStar Financial, Inc. Stockholders' Equity

For the Nine Months Ended September 30, 2015

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

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

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

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

7

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Unaudited

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

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

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

8

NEWSTAR FINANCIAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, continued

Unaudited

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

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

NEWSTAR FINANCIAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Unaudited

Note 1. Organization

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

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

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

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

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

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

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

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

Prior Period Reclassification

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

Segment Reporting

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

Recently Adopted Accounting Standards

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

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

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

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

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

Recently Issued Accounting Standards

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

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

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

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

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

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

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

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

Note 3. Acquisition and Disposition Activities

Acquisition

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

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

Sale of NewStar Business Credit LLC

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

Assets and Liabilities Held for Sale

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

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

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

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

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

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

13

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A summary of impaired loans is as follows:

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

	Recorded Investment with a Related Allowance for Credit Losses	Recorded Investment, net, without a Related Allowance for Credit Losses	Recorded Investment without a Related Allowance for Credit Losses	Recorded Investment, net, without a Related Allowance for Credit Losses
	(\$ in thousands)			
September 30, 2016				
Leveraged Finance	\$ 105,099	\$ 100,461	\$ 44,598	\$ 44,469
Real Estate	—	—	7,160	7,160
Total	\$ 105,099	\$ 100,461	\$ 51,758	\$ 51,629
December 31, 2015				
Leveraged Finance	\$ 113,397	\$ 106,762	\$ 44,049	\$ 43,930
Business Credit	—	—	—	—
Real Estate	7,705	7,705	27,236	27,210
Equipment Finance	—	—	772	709
Total	\$ 121,102	\$ 114,467	\$ 72,057	\$ 71,849

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

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

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

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

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

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

December 31, 2015	Leveraged Finance		Business Credit		Real Estate		Equipment Finance	
	Investment	Allowance	Investment	Allowance	Investment	Allowance	Investment	Allowance
(\$ in thousands)								
Collectively evaluated								
(1)	\$2,469,868	\$ 27,874	\$342,281	\$ 1,991	\$65,791	\$ 350	\$172,481	\$ 1,291
Individually evaluated								
(3)	157,446	26,447	—	—	34,941	306	772	—
Total	\$2,627,314	\$ 54,321	\$342,281	\$ 1,991	\$100,732	\$ 656	\$173,253	\$ 1,291

(1) Represents loans and leases collectively evaluated for impairment in accordance with ASC 450-20, Loss Contingencies, and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans and leases. These loans had a weighted average risk rating of 5.1 at September 30, 2016, based on the Company's internally developed 12 point scale for the Leveraged Finance and Real Estate loans. These loans and leases had a weighted average risk rating of 5.1 at December 31, 2015, based on the Company's internally developed 12 point scale for the Leveraged Finance, Real Estate and Equipment Finance loans and leases. Business Credit Loans had a weighted average risk rating of 5.0 at December 31, 2015 based on the Company's internally developed 10 point scale for Business Credit loans.

(2) Excludes \$389.3 million Leveraged Finance loans which the Company elected to record at fair value.

(3) Represents loans individually evaluated for impairment in accordance with ASU 310-10, Receivables, and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

Below is a summary of the Company's investment in nonaccrual loans.

Recorded Investment in	September 30,	
	2016	December 31, 2015
(\$ in thousands)		
Leveraged Finance	\$87,291	\$ 103,563
Business Credit	—	—
Real Estate	—	7,705
Equipment Finance	—	—
Total	\$87,291	\$ 111,268

Loans being restructured have typically developed adverse performance trends as a result of various factors, the result of which is an inability to comply with the terms of the applicable credit agreement governing the borrowers' obligations to the Company. In order to mitigate default risk and/or liquidation, assuming that liquidation proceeds are not viewed as a more favorable outcome to the Company and other lenders, the Company will enter into negotiations with the borrower and its shareholders on the terms of a restructuring. When restructuring a loan, the Company undertakes an extensive diligence process which typically includes (i) development of a financial model with a forecast horizon that matches the term of the proposed restructuring, (ii) meetings with management of the borrower, (iii) engagement of third party consultants and (iv) other internal analyses. Once a restructuring proposal is developed, it is subject to approval by both the Company's Underwriting and Investment Committee. Loans are only removed from TDR classification after a period of performance following the refinancing of outstanding obligations on terms which are determined to be "market" in all material respects. The Company may modify loans that are not determined to be a TDR. Where a loan is modified or restructured but loan terms are considered market and no concessions were given on the loan terms, including price, principal amortization or obligation, or other restrictive covenants, a loan will not be classified as a TDR.

The Company has made the following types of concessions in the context of a TDR:

Group I:

- extension of principal repayment term
- principal holidays
- interest rate adjustments

Group II:

- partial forgiveness
- conversion of debt to equity

17

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

A summary of the types of concessions that the Company made with respect to TDRs at September 30, 2016 and December 31, 2015 is provided below:

	Group I	Group II
	(\$ in thousands)	
September 30, 2016	\$137,614	\$115,491
December 31, 2015	\$183,573	\$162,986

Note: A loan may be included in both restructuring groups, but not repeated within each group.

For the three months ended September 30, 2016, the Company had no charge-offs, and for the nine months ended September 30, 2016 had \$7.5 million, of partial charge-offs related to loans previously classified as TDR. As of September 30, 2016, the Company had not removed the TDR classification from any loan previously identified as such, but had charged-off, sold and received repayments of outstanding TDRs.

The Company measures TDRs similarly to how it measures all loans for impairment. The Company performs a discounted cash flow analysis on cash flow dependent loans and we assess the underlying collateral value less reasonable costs of sale for collateral dependent loans. Management analyzes the projected performance of the borrower to determine if it has the ability to service principal and interest payments based on the terms of the restructuring. Loans will typically not be returned to accrual status until at least six months of contractual payments have been made in a timely manner or the borrower shows significant ability to maintain servicing of the restructured debt. Additionally, at the time of a restructuring and quarterly thereafter, an impairment analysis is undertaken to determine the measurement of specific reserve, if any, on each impaired loan.

Below is a summary of the Company's loans which were newly classified as TDR and existing TDR loans which subsequently defaulted, in each during the periods presented.

	Pre-Modification	Post-Modification	Investment
	Outstanding		in TDR
Three Months Ended	Recorded	Recorded	Subsequently
September 30, 2016	Investment	Investment	Defaulted
	(\$ in thousands)		
Leveraged Finance	\$8,372	\$ 8,473	\$ —
Real Estate	—	—	—
Total	\$8,372	\$ 8,473	\$ —

	Pre-Modification	Post-Modification	Investment
	Outstanding		in TDR
Nine Months Ended	Recorded	Recorded	Subsequently
September 30, 2016	Recorded	Recorded	Subsequently

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Investment (\$ in thousands)	Investment	Defaulted
Leveraged Finance	\$10,147	\$ 9,781	\$ —
Real Estate (1)	—		4,483
Total	\$10,147	\$ 9,781	\$ 4,483

(1) Amount reflects charge-off on an impaired Real Estate TDR that was taken prior to transfer to held-for-sale.

	Pre-Modification Outstanding	Post-Modification Outstanding	Investment in TDR Subsequently Defaulted
Three Months Ended September 30, 2015	Recorded	Recorded	
Leveraged Finance	\$13,650	\$ 13,650	\$ 14,391
Business Credit	—	—	—
Real Estate	—	—	—
Equipment Finance	—	—	—
Total	\$13,650	\$ 13,650	\$ 14,391

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Pre-Modification	Post-Modification	Investment
	Outstanding	Outstanding	in TDR
Nine Months Ended	Recorded	Recorded	Subsequently
September 30, 2015	Investment	Investment	Defaulted
	(\$ in thousands)		
Leveraged Finance	\$13,650	\$ 13,650	\$ 22,333
Business Credit	—	—	—
Real Estate	—	—	—
Equipment Finance	922	922	—
Total	\$14,572	\$ 14,572	\$ 22,333

The following sets forth a breakdown of troubled debt restructurings at September 30, 2016 and December 31, 2015:

As of September 30, 2016 (\$ in thousands)	Accrual Status		Impaired	Specific	For the nine months Charged-off
	Accruing	Nonaccrual			
Loan Type	Balance	Balance	Balance	Allowance	Charged-off
Leveraged Finance	\$51,978	\$ 78,476	\$130,454	\$ 32,680	\$ 3,003
Real Estate	7,160	—	7,160	—	4,483
Total	\$59,138	\$ 78,476	\$137,614	\$ 32,680	\$ 7,486

As of December 31, 2015 (\$ in thousands)	Accrual Status		Impaired	Specific	For the year Charged-off
	Accruing	Nonaccrual			
Loan Type	Balance	Balance	Balance	Allowance	Charged-off
Leveraged Finance	\$53,883	\$ 93,977	\$147,860	\$ 24,958	\$ 4,000
Business Credit	—	—	—	—	—
Real Estate	27,236	7,705	34,941	—	—
Equipment Finance	772	—	772	—	—
Total	\$81,891	\$ 101,682	\$183,573	\$ 24,958	\$ 4,000

The Company classifies a loan as delinquent when it is over 60 days past due. An age analysis of the Company's delinquent receivables is as follows:

60-89 Days Greater than Past Due	Total Past Due	Total Current	Total Loans and Leases	Investment in > 60 Days & Accruing
--	----------------------	------------------	------------------------------	--

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

(\$ in thousands)					
September 30, 2016					
	60-89 Days Greater than Past Due90 Days	Total Past Due	Current	Total Loans and Leases	Investment in > 60 Days & Accruing
(\$ in thousands)					
December 31, 2015					
Leveraged Finance	\$—\$ 16,317	\$16,317	\$3,247,668	\$3,263,985	\$ —
Real Estate	— —	—	17,742	17,742	—
Total	\$—\$ 16,317	\$16,317	\$3,265,410	\$3,281,727	\$ —
December 31, 2015					
Leveraged Finance	\$—\$ 27,165	\$27,165	\$2,600,149	\$2,627,314	\$ 8,530
Business Credit	— —	—	342,281	342,281	—
Real Estate	— —	—	100,732	100,732	—
Equipment Finance	— —	—	173,253	173,253	—
Total	\$—\$ 27,165	\$27,165	\$3,216,415	\$3,243,580	\$ 8,530

A general allowance is provided for loans and leases that are not impaired. The Company employs a variety of internally developed and third-party modeling and estimation tools for measuring credit risk, which are used in developing an allowance for loan and lease losses on outstanding loans and leases. The Company's allowance framework addresses economic conditions, capital market liquidity and industry circumstances from both a top-down and bottom-up perspective. The Company considers and evaluates a number of factors, including but not limited to, changes in economic conditions, credit availability, industry, loss emergence period, and multiple obligor concentrations in assessing both probabilities of default and loss severities as part of the general component of the allowance for loan and lease losses.

On at least a quarterly basis, loans are internally risk-rated based on individual credit criteria, including loan type, loan structures (including balloon and bullet structures common in the Company's Leveraged Finance and Real Estate cash flow loans), borrower industry, payment capacity, location and quality of collateral if any (including the Company's Real Estate loans). Borrowers provide the Company with financial information on either a monthly or quarterly basis. Ratings, corresponding assumed default rates and assumed loss severities are dynamically updated to reflect any changes in borrower condition and/or profile.

For Leveraged Finance loans and Equipment Finance loans and leases (prior to the latter's transfer to held-for-sale), the data set used to construct probabilities of default in its allowance for loan losses model, Moody's CRD Private Firm Database, primarily contains middle market loans that share attributes similar to the Company's loans. The Company also considers the quality of the loan terms and lender protections in determining a loan loss in the event of default.

Prior to the sale of Business Credit, the Company utilized a proprietary model to risk rate the asset based loans on a monthly basis. This model captured the impact of changes in industry and economic conditions as well as changes in the quality of the borrower's collateral and financial performance to assign a final risk rating. The Company also evaluated historical net loss trends by risk rating from a comprehensive industry database covering more than twenty-five years of experience of the majority of the asset based lenders operating in the United States. Based upon the monthly risk rating from the model, the reserve was adjusted to reflect the historical average for expected loss from the industry database.

For Real Estate loans, the Company employs two mechanisms to capture the impact of industry and economic conditions. First, a loan's risk rating, and thereby its assumed default likelihood, can be adjusted to account for overall commercial real estate market conditions. Second, to the extent that economic or industry trends adversely affect a substandard rated borrower's loan-to-value ratio enough to impact its repayment ability, the Company applies a stress multiplier to the loan's probability of default. The multiplier is designed to account for default characteristics that are difficult to quantify when market conditions cause commercial real estate prices to decline.

The Company periodically reviews its allowance for credit loss methodology to assess any necessary adjustments based upon changing economic and capital market conditions. If the Company determines that changes in its allowance for credit losses methodology are advisable, as a result of changes in the economic environment or otherwise, the revised allowance methodology may result in higher or lower levels of allowance. At December 31, 2015, the Company enhanced its approach for determining the expected exposure at default to more precisely reflect loan and lease exposures. Given uncertain market conditions, actual losses under the Company's current or any revised allowance methodology may differ materially from the Company's estimate.

Additionally, when determining the amount of the general allowance, the Company supplements the base amount with an environmental reserve amount which is governed by a score card system comprised of seven risk factors. The risk factors are designed based on those outlined in the Comptrollers of the Currency's Allowance for Loan and Lease Losses Handbook. In the fourth quarter of 2015, the scoring system of the environmental reserve risk factors was recalibrated to align with the enhancement made to the approach for determining the exposure at default. The Company also performs a ratio analysis of comparable money center banks, regional banks and finance companies. While the Company does not rely on this peer group comparison to set the level of allowance for credit losses, use of the peer group does assist management in identifying market trends and serves as an overall reasonableness check on the allowance for credit losses computation.

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

A summary of the activity in the allowance for credit losses is as follows:

	Three Months Ended September 30, 2016			
	Leveraged		Equipment	
	Finance	Real Estate	Finance	Total
	(\$ in thousands)			
Balance, beginning of period	\$62,645	\$91	\$ 1,307	\$64,043
Provision for credit losses—general	349	1	(14)	336
Provision for credit losses—specific	3,234	—	—	3,234
Reclass of Equipment Finance to Assets held-for-sale	—	—	(1,293)	(1,293)
Loans charged off, net of recoveries	46	—	—	46
Balance, end of period	\$66,274	\$92	\$ —	\$66,366
Balance, end of period—specific	\$36,160	\$—	\$ —	\$36,160
Balance, end of period—general	\$30,114	\$92	\$ —	\$30,206
Average balance of impaired loans	\$154,695	\$21,942	\$ —	\$176,637
Average net book value of impaired leases	\$—	\$—	\$ 623	\$623
Interest recognized from impaired loans and leases	\$1,627	\$296	\$ —	\$1,923
Loans and leases (1)				
Loans individually evaluated with specific allowance	\$105,099	\$—	\$ —	\$105,099
Loans individually evaluated with no specific allowance	44,598	7,160	—	51,758
Loans and leases collectively evaluated without specific allowance	2,725,028	10,582	—	2,735,610
Total loans and leases	\$2,874,725	\$17,742	\$ —	\$2,892,467

(1)Excludes \$389.3 million of Leveraged Finance loans which the Company elected to record at fair value.

	Nine Months Ended September 30, 2016				
	Leveraged Business		Equipment		Total
	Finance	Credit	Real Estate	Finance	
	(\$ in thousands)				
Balance, beginning of period	\$54,788	\$1,991	\$656	\$ 1,291	\$58,726
Provision for credit losses—general	1,774	(172)	1,010	2	2,614
Provision for credit losses—specific	18,115	—	4,177	—	22,292
Reclass due to sale of Business Credit and transfer of Equipment Finance to Assets held-for-sale	—	(1,819)	—	(1,293)	(3,112)
Loans charged off, net of recoveries	(8,403)	—	(5,751)	—	(14,154)
Balance, end of period	\$66,274	\$—	\$92	\$ —	\$66,366
Balance, end of period—specific	\$36,160	\$—	\$—	\$ —	\$36,160
Balance, end of period—general	\$30,114	\$—	\$92	\$ —	\$30,206
Average balance of impaired loans	\$169,690	\$—	\$30,699	\$ —	\$200,389
Average net book value of impaired leases	\$—	\$—	\$—	\$ 698	\$698
Interest recognized from impaired loans and leases	\$6,606	\$—	\$1,128	\$ 12	\$7,746

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Three Months Ended September 30, 2015				
	Leveraged	Business	Equipment		Total
	Finance	Credit	Real		
			Estate	Finance	
(\$ in thousands)					
Balance, beginning of period	\$47,698	\$1,097	\$323	\$ 829	\$49,947
Provision for credit losses—general	2,443	168	42	272	2,925
Provision for credit losses—specific	1,550	—	59	—	1,609
Loans charged off, net of recoveries	—	—	—	—	—
Balance, end of period	\$51,691	\$1,265	\$424	\$ 1,101	\$54,481
Balance, end of period—specific	\$23,724	\$—	\$74	\$—	\$23,798
Balance, end of period—general	\$27,967	\$1,265	\$350	\$ 1,101	\$30,683
Average balance of impaired loans	\$170,933	\$—	\$35,218	\$—	\$206,151
Average net book value of impaired leases	\$—	\$—	\$—	\$ 884	\$884
Interest recognized from impaired loans	\$2,672	\$—	\$400	\$ 15	\$3,087
Loans and leases					
Loans individually evaluated with specific allowance	\$103,588	\$—	\$27,704	\$—	\$131,292
Loans individually evaluated with no specific allowance	61,836	—	7,260	847	69,943
Loans and leases collectively evaluated without specific allowance	2,374,451	274,617	65,626	174,361	2,889,055
Total loans and leases	\$2,539,875	\$274,617	\$100,590	\$ 175,208	\$3,090,290

	Nine Months Ended September 30, 2015				
	Leveraged	Business	Equipment		Total
	Finance	Credit	Real		
			Estate	Finance	
(\$ in thousands)					
Balance, beginning of period	\$41,480	\$ 1,334	\$257	\$ 622	\$43,693
Provision for credit losses—general	7,143	(69)	93	479	7,646
Provision for credit losses—specific	7,000	—	74	—	7,074
Loans charged off, net of recoveries	(3,932)	—	—	—	(3,932)
Balance, end of period	\$51,691	\$ 1,265	\$424	\$ 1,101	\$54,481
Balance, end of period—specific	\$23,724	\$—	\$74	\$—	\$23,798
Balance, end of period—general	\$27,967	\$ 1,265	\$350	\$ 1,101	\$30,683
Average balance of impaired loans	\$175,518	\$—	\$36,488	\$—	\$212,006
Average net book value of impaired leases	\$—	\$—	\$—	\$ 909	\$909
Interest recognized from impaired loans	\$8,326	\$—	\$1,183	\$ 30	\$9,539

Included in the allowance for credit losses at each of September 30, 2016 and December 31, 2015 is an allowance for unfunded commitments of \$0.5 million, which is recorded as a component of other liabilities on the Company's consolidated balance sheet with changes recorded in the provision for credit losses on the Company's consolidated statement of operations. The methodology for determining the allowance for unfunded commitments is consistent with the methodology for determining the allowance for loan and lease losses.

During the nine months ended September 30, 2016, the Company recorded a total provision for credit losses of \$24.9 million. The Company increased its allowance for credit losses to \$66.4 million as of September 30, 2016 from \$58.7 million at December 31, 2015 as a result of an increase in the specific allowance for credit losses primarily related to

the deterioration of four credits. In addition, the Company transferred four commercial real estate loans to loans held-for-sale which resulted in an additional \$1.1 million of provision expense. The general allowance for credit losses covers probable incurred losses in the Company's loan and lease portfolio with respect to loans and leases for which no specific impairment has been identified. When a loan is classified as impaired, the loan is evaluated for a specific allowance and a specific provision may be recorded, thereby removing it from consideration under the general component of the allowance analysis. Loans that are deemed to be uncollectible are charged off and deducted from the allowance, and recoveries on loans previously charged off are netted against loans charged off. A specific provision for credit losses is recorded with respect to impaired loans for which it is probable that the Company will be unable to collect all amounts due in accordance with the contractual terms of the loan agreement for which there is impairment recognized. The outstanding balance of impaired loans, which include all of the outstanding balances of the Company's delinquent loans and its troubled debt restructurings, as a percentage of "Loans and leases, net" was 5 % as of September 30, 2016 and 6% as of December 31, 2015.

22

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

The Company closely monitors the credit quality of its loans which is partly reflected in its credit metrics such as loan delinquencies, non-accruals and charge-offs. Changes in these credit metrics are largely due to changes in economic conditions and seasoning of the loan and lease portfolio.

The Company continually evaluates the appropriateness of its allowance for credit losses methodology. Based on the Company's evaluation process to determine the level of the allowance for loan and lease losses, management believes the allowance to be adequate as of September 30, 2016 in light of the estimated known and inherent risks identified through its analysis.

Note 5. Restricted Cash

Restricted cash as of September 30, 2016 and December 31, 2015 was as follows:

	September 30, 2016	December 31, 2015
	(\$ in thousands)	
Collections on loans pledged to credit facilities	\$95,278	\$ 67,892
Principal and interest collections on loans held in trust and		
prefunding amounts	274,991	85,823
Customer escrow accounts	218	277
Total	\$370,487	\$ 153,992

As of September 30, 2016, the Company had the ability to use \$232.1 million of restricted cash to fund new or existing loans.

Note 6. Investments in Debt Securities, Available-for-Sale

Amortized cost of investments in debt securities as of September 30, 2016 and December 31, 2015 was as follows:

	September 30, 2016	December 31, 2015
	(\$ in thousands)	
Investments in debt securities—gross	\$105,020	\$ 111,020
Unamortized discount	(6,117)	(6,765)
Investments in debt securities—amortized cost	\$98,903	\$ 104,255

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

The amortized cost, gross unrealized holding gains, gross unrealized holding losses, and fair value of available-for-sale securities at September 30, 2016 and December 31, 2015 were as follows:

		Gross	Gross	
	Amortized	unrealized	unrealized	Fair
	cost	holding	holding	value
	(\$ in thousands)	gains	losses	
September 30, 2016				
Collateralized loan obligations	\$98,903	\$ 1	\$ (8,090)	\$90,814
	\$98,903	\$ 1	\$ (8,090)	\$90,814
	Amortized	unrealized	unrealized	Fair
	cost	holding	holding	value
	(\$ in thousands)	gains	losses	
December 31, 2015				
Collateralized loan obligations	\$104,255	\$ —	\$ (10,078)	\$94,177
	\$104,255	\$ —	\$ (10,078)	\$94,177

During the nine month period ended September 30, 2016, the Company did not purchase any debt securities and a \$6.0 million investment in debt securities was redeemed at par. During the nine months ended September 30, 2015, the Company purchased \$85.0 million of debt securities and \$33.0 million investment in securities were redeemed at par. The Company did not sell any debt securities during the nine months ended September 30, 2016 or 2015.

The Company did not record any net "Other-Than-Temporary Impairment" charges during the nine months ended September 30, 2016.

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

The following is an analysis of the continuous periods during which the Company has held investment positions which were carried at an unrealized loss as of September 30, 2016 and December 31, 2015:

	September 30, 2016		
	Greater than		
	Less than	or Equal to	
	12 Months	12 Months	Total
	(\$ in thousands)		
Number of positions	2	19	21
Fair value	\$8,143	\$81,434	\$89,577
Amortized cost	8,461	89,206	97,667
Unrealized loss	\$(318)	\$(7,772)	\$(8,090)

	December 31, 2015		
	Greater than		
	Less than	or Equal to	
	12 Months	12 Months	Total
	(\$ in thousands)		
Number of positions	20	3	23
Fair value	\$86,245	\$7,932	\$94,177
Amortized cost	95,624	8,631	104,255
Unrealized loss	\$(9,379)	\$(699)	\$(10,078)

As a result of the Company's evaluation of the securities, management concluded that the unrealized losses at September 30, 2016 and December 31, 2015 were caused by changes in market prices driven by interest rates and credit spreads. The Company's evaluation of impairment include quotes from third party pricing services, adjustments to prepayment speeds, delinquency, an analysis of expected cash flows, interest rates, market discount rates, other contract terms, and the timing and level of losses on the loans and leases within the underlying trusts. At September 30, 2016, the Company has determined that it is not more likely than not that it will be required to sell the securities before the Company recovers its amortized cost basis in the security. The Company has also determined that there has not been an adverse change in the cash flows expected to be collected. Based upon the Company's impairment review process, and the Company's ability and intent to hold these securities until maturity or a recovery of fair value, the decline in the value of these investments is not considered to be "Other Than Temporary."

Maturities of debt securities classified as available-for-sale were as follows at September 30, 2016 and December 31, 2015:

	September 30, 2016		December 31, 2015	
	Amortized cost	Fair value	Amortized cost	Fair value
(\$ in thousands)				
Available-for-sale:				
Due one year or less	\$—	\$—	\$—	\$—
Due after one year through five years	—	—	—	—
Due after five years through ten years	37,960	32,959	34,017	30,470
Due after ten years through fifteen years	60,943	57,855	70,238	63,707
Total	\$98,903	\$90,814	\$104,255	\$94,177

Actual maturities of debt securities may differ from those presented above since certain obligations amortize and provide the issuer of the individual debt securities the right to call or prepay the obligation prior to the scheduled final stated maturity without penalty.

Note 7. Borrowings

Credit Facilities

As of September 30, 2016 the Company had two credit facilities through certain of its wholly owned subsidiaries: (i) a \$615.0 million credit facility with syndicated lenders agented by Wells Fargo Bank, National Association (“Wells Fargo”) to fund leveraged finance loans, and (ii) a \$250.0 million credit facility with Citibank, N.A. (“Citibank”) to fund leveraged finance loans.

The Company must comply with various covenants under these facilities. The breach of certain of these covenants could result in a termination event and the exercise of remedies if not cured. At September 30, 2016, the Company was in compliance with all such covenants. These covenants are customary and include, but are not limited to, failure to service debt obligations, failure to meet liquidity covenants and tangible net worth covenants, and failure to remain within prescribed facility portfolio delinquency, charge-off

levels, and overcollateralization tests.

The Company has a \$615.0 million credit facility with syndicated lenders agented by Wells Fargo to fund leveraged finance loans. The credit facility had an outstanding balance of \$293.9 million and unamortized deferred financing fees of \$6.8 million as of September 30, 2016. In February 2016 and June 2016, the Company upsized this facility, which increased the commitment amount from \$475.0 million to \$615.0 million. Interest on this facility accrues at a variable rate per annum. The facility matures on August 10, 2020. The facility provides for a revolving reinvestment period which ends on August 10, 2018, with a two-year amortization period.

The Company has a \$250.0 million credit facility with Citibank to fund leveraged finance loans. The credit facility had an outstanding balance of \$208.3 million and unamortized deferred financing fees of \$2.6 million as of September 30, 2016. Interest on this facility accrues at a variable rate per annum. The facility matures on May 5, 2020. It provides for a revolving reinvestment period which ends on May 5, 2018, with a two-year amortization period.

As a result of the ongoing process to sell its leasing business, NewStar Equipment Finance, the note purchase agreement with Wells Fargo under the terms of which Wells Fargo agreed to provide a \$75.0 million credit facility to fund equipment leases and loans was reclassified to liabilities held-for-sale. The credit facility has an outstanding balance of \$16.9 million and unamortized deferred financing fees of \$0.2 million as of September 30, 2016.

On September 15, 2016, the Company repaid the \$350.0 million note purchase agreement with Credit Suisse that provided the financing to fund the purchase of broadly syndicated bank loans during the warehouse phase of the Arch Street CLO. The supplemental junior note commitment by NewStar Capital was also repaid in full. The notes were repaid from proceeds of the Arch Street CLO bond issuance.

On March 31, 2016, the Company sold its membership interest in NewStar Business Credit LLC (“Business Credit”). In connection with the sale, the Company repaid all outstanding indebtedness of Business Credit, including amounts outstanding under the \$175 million credit facility with a syndicate of lenders agented by DZ Bank AG Deutsche Zentral-Genossenschaftsbank Frankfurt (“DZ Bank”) with an outstanding balance of \$102.0 million and the \$165.0 million credit facility with a syndicate of lenders agented by Wells Fargo with an outstanding balance of \$135.4 million, each of which was terminated. The Company accelerated and recognized deferred financing fees of \$1.1 million and \$0.7 million, respectively, related to the warehouse facilities during the first quarter of 2016.

Senior notes

On April 22, 2015, the Company issued \$300.0 million in aggregate principal amount of 7.25% Senior Notes due 2020 (the “2020 Notes”). On November 9, 2015, the Company issued an additional \$80.0 million in aggregate principal amount of 2020 Notes. The 2020 Notes issued on November 9, 2015, were issued at a debt discount of \$0.8 million which will amortize over the life of the 2020 Notes. The Company used a portion of the net proceeds from the April notes offering to repay in full its corporate credit facility with Fortress Credit Corp. The 2020 Notes mature on May 1, 2020, and bear interest at a rate of 7.25% per annum, which is payable semi-annually on May 1 and November 1 of each year. At any time prior to May 1, 2017, the Company may redeem up to 35% of the aggregate principal amount of the 2020 Notes with the net cash proceeds of certain public equity offerings at a price equal to 107.25% of the aggregate principal amount so redeemed, plus accrued and unpaid interest thereon provided that immediately following the redemption, at least 65% of the 2020 Notes that were originally issued remain outstanding. Additionally, at any time prior to May 1, 2017, the Company may redeem some or all of the 2020 Notes at a price equal to 100% of the aggregate principal amount, plus accrued and unpaid interest thereon and a make-whole premium. On or after May 1, 2017, the Company may redeem the 2020 Notes, in whole or in part, at redemption prices specified in the 2020 Notes plus accrued and unpaid interest thereon. In addition, if the Company undergoes a change of control, the Company will be required to make an offer to purchase each holder’s 2020 Notes at a price equal to 101% of the principal amount of the 2020 Notes, plus accrued and unpaid interest. As of September 30, 2016, unamortized

deferred financing fees were \$5.9 million.

25

Subordinated notes

On December 4, 2014, the Company completed the initial closing of an investment of long-term capital from funds sponsored by Franklin Square Capital Partners ("Franklin Square") and sub-advised by GSO Capital Partners at which the Franklin Square funds purchased \$200.0 million of 10-year subordinated notes (the "Subordinated Notes"), which rank junior to the Company's existing and future senior debt. During 2015, the Company drew an additional \$75 million of these Subordinated Notes. The Company drew the remaining \$25 million in January 2016. The Subordinated Notes were recorded at par less the initial relative fair value of the warrants issued in connection with the investment in December 2014 and January 2015, which was \$55.4 million as of September 30, 2016 and \$60.0 million as of December 31, 2015. The debt discount will amortize over the life of the notes and will be recorded as non-cash interest expense as the Subordinated Notes accrete to par value. As of September 30, 2016, unamortized deferred financing fees were \$5.1 million. The Subordinated Notes bear interest at 8.25% and include a Payment-in-Kind ("PIK Toggle") feature that allows the Company, at its option, to elect to have interest accrued at a rate of 8.75% added to the principal of the Subordinated Notes instead of paying it in cash. The Subordinated Notes have a ten-year term and mature on December 4, 2024. They are callable during the first three years with payment of a make-whole premium. The prepayment premium decreases to 103% and 101% after the third and fourth anniversaries of the closing, respectively. They are callable at par after December 4, 2019. Beginning on December 5, 2019, the Company is required to make a cash payment of principal plus accrued interest in an amount required to prevent the Subordinated Notes from being treated as an "Applicable High Yield Discount Obligation" within the meaning of Section 163(i)(1) of the Internal Revenue Code of 1986, as amended. Events of default under the Subordinated Notes include failure to pay interest or principal when due subject to applicable grace periods, material uncured breaches of the terms of the Subordinated Notes, and bankruptcy/insolvency events.

Term Debt Securitizations

2007-1 CLO. In June 2007, the Company completed a term debt securitization transaction. In conjunction with this transaction the Company established a separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Trust 2007-1 (the "2007-1 CLO Trust") and sold and contributed \$600.0 million in loans and investments (including unfunded commitments), or portions thereof, to the 2007-1 CLO Trust. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2007-1 CLO Trust issued \$546.0 million of notes to institutional investors. The Company retained \$54.0 million, comprising 100% of the 2007-1 CLO Trust's trust certificates. At September 30, 2016, the \$97.4 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$151.6 million. The 2007-1 CLO Trust permitted reinvestment of collateral principal repayments for a six-year period which ended in May 2013. During 2012, the Company purchased \$0.2 million of the 2007-1 CLO Trust's Class C notes. During 2010, the Company purchased \$5.0 million of the 2007-1 CLO Trust's Class D notes. During 2009, the Company purchased \$1.0 million of the 2007-1 CLO Trust's Class D notes.

During 2009, Moody's downgraded all of the notes of the 2007-1 CLO Trust. As a result of the downgrade, amortization of the 2007-1 CLO Trust changed from pro rata to sequential, resulting in scheduled principal payments thereafter made in order of the notes' seniority until all available funds are exhausted for each payment.

The Company receives a loan collateral management fee and excess interest spread. The Company also receives payments with respect to the classes of notes it owns in accordance with the transaction documents. The Company expects to receive a principal distribution as owner of the trust certificates when the term debt is retired. If loan collateral in the 2007-1 CLO Trust is in default under the terms of the indenture, the excess interest spread from the 2007-1 CLO Trust would not be distributed until the undistributed cash plus recoveries equals the outstanding balance of the defaulted loan or if the Company elected to remove the defaulted collateral.

The following table sets forth selected information with respect to the 2007-1 CLO Trust:

	Notes	Outstanding balance	Interest	Legal final
	originally issued	September 30, 2016	rate	maturity
	(\$ in thousands)			
2007-1 CLO Trust				
Class A-1	\$ 336,500	\$ —	Libor+0.24%	September 30, 2022
Class A-2	100,000	—	Libor+0.26%	September 30, 2022
Class B	24,000	18,113	Libor+0.55%	September 30, 2022
Class C	58,500	58,293	Libor+1.30%	September 30, 2022
Class D	27,000	21,000	Libor+2.30%	September 30, 2022
	\$ 546,000	\$ 97,406		

2012-2 CLO. On December 18, 2012, the Company completed a term debt securitization transaction. In conjunction with this transaction the Company established a separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2012-2 LLC (the “2012-2 CLO”) and sold and contributed \$325.9 million in loans and investments (including unfunded commitments), or portions thereof, to the 2012-2 CLO. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2012-2 CLO issued \$263.3 million of notes to institutional investors. The Company retained \$62.6 million, comprising 100% of the 2012-2 CLO’s membership interests, Class E notes, Class F notes, and subordinated notes. On June 12, 2015, the Company sold 100% of the 2012-2 CLO’s Class E Notes totaling \$16.3 million to institutional investors. At September 30, 2016, the \$260.2 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$306.5 million. At September 30, 2016, unamortized deferred financing fees were \$0.9 million. The 2012-2 CLO permitted reinvestment of collateral principal repayments for a three-year period which ended in January 2016.

The Company receives a loan collateral management fee and excess interest spread. The Company also receives payments with respect to the classes of notes it owns in accordance with the transaction documents. The Company expects to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2012-2 CLO is in default under the terms of the indenture, the excess interest spread from the 2012-2 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, are not satisfied.

The following table sets forth selected information with respect to the 2012-2 CLO:

Notes	Outstanding			Legal final maturity
	originally issued	balance September 30, 2016	Interest rate	
2012-2 CLO				
Class A	\$ 190,700	\$ 171,320	Libor+1.90%	January 20, 2023
Class B	26,000	26,000	Libor+3.25%	January 20, 2023
Class C	35,200	35,200	Libor+4.25%	January 20, 2023
Class D	11,400	11,400	Libor+6.25%	January 20, 2023
Class E	16,300	16,300	Libor+6.75%	January 20, 2023
	\$ 279,600	\$ 260,220		

2013-1 CLO. On September 11, 2013, the Company completed a term debt securitization transaction through its separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2013-1 LLC (the “2013-1 CLO”) and sold and contributed \$247.6 million in loans and investments (including unfunded commitments), or portions thereof, to the 2013-1 CLO. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2013-1 CLO issued \$338.6 million of notes to institutional investors. The Company retained \$61.4 million, comprising 100% of the 2013-1 CLO’s membership interests, Class F notes, Class G notes, and subordinated notes. At September 30, 2016, the \$338.6 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$400.0 million. At September 30, 2016, unamortized deferred financing fees were \$2.8 million. The 2013-1 CLO permitted reinvestment of collateral principal repayments for a three-year period which ended in September 2016.

The Company receives a loan collateral management fee and excess interest spread. The Company also receives payments with respect to the classes of notes it owns in accordance with the transaction documents. The Company expects to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2013-1 CLO is in default under the terms of the indenture, the excess interest spread from the 2013-1 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, are not satisfied.

27

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

The following table sets forth selected information with respect to the 2013-1 CLO:

	Notes originally issued (\$ in thousands)	Outstanding balance September 30, 2016	Interest rate	Legal final maturity
2013-1 CLO				
Class A-T	\$202,600	\$ 202,600	Libor+1.65%	September 20, 2023
Class A-R	35,000	35,000	(1)	September 20, 2023
Class B	38,000	38,000	Libor+2.30%	September 20, 2023
Class C	36,000	36,000	Libor+3.80%	September 20, 2023
Class D	21,000	21,000	Libor+4.55%	September 20, 2023
Class E	6,000	6,000	Libor+5.30%	September 20, 2023
	\$338,600	\$ 338,600		

(1) Class A-R Notes accrue interest at the Class A-R CP Rate so long as they are held by a CP Conduit, and otherwise will accrue interest at the Class A-R LIBOR Rate or, in certain circumstances, the Class A-R Base Rate, but in no event shall the interest rate payable pari passu with the Class A-T Notes exceed the Class A-R Waterfall Rate Cap. 2014-1 CLO. On April 17, 2014, the Company completed a term debt securitization transaction through its separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2014-1 LLC (the "2014-1 CLO") and sold and contributed \$249.6 million in loans and investments (including unfunded commitments), or portions thereof, to the 2014-1 CLO. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2014-1 CLO issued \$289.5 million of notes to institutional investors. The Company retained \$58.9 million, comprising 100% of the 2014-1 CLO's membership interests, Class E notes, Class F notes, and subordinated notes. At September 30, 2016, the \$289.5 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$348.4 million. At September 30, 2016, unamortized deferred financing fees were \$2.1 million. The 2014-1 CLO permits reinvestment of collateral principal repayments for a four-year period ending in April 2018. Should the Company determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

The Company receives a loan collateral management fee and excess interest spread. The Company also receives payments with respect to the classes of notes it owns in accordance with the transaction documents. The Company expects to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2014-1 CLO is in default under the terms of the indenture, the excess interest spread from the 2014-1 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, are not satisfied.

The following table sets forth selected information with respect to the 2014-1 CLO:

Notes originally	Outstanding balance	Interest rate	Legal final maturity
---------------------	------------------------	------------------	-------------------------

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	issued	September 30, 2016		
	(\$ in thousands)			
2014-1 CLO				
Class A	\$ 202,500	\$ 202,500	Libor+1.80%	April 20, 2025
Class B-1	20,000	20,000	Libor+2.60%	April 20, 2025
Class B-2	13,250	13,250	(1)	April 20, 2025
Class C	30,250	30,250	Libor+3.60%	April 20, 2025
Class D	23,500	23,500	Libor+4.75%	April 20, 2025
	\$ 289,500	\$ 289,500		

(1)Class B-2 Notes accrue interest at a fixed rate of 4.902%.

2015-1 CLO. On March 20, 2015, the Company completed a term debt securitization transaction through its separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2015-1 LLC (the “2015-1 CLO”) and sold and contributed \$336.3 million in loans and investments (including unfunded commitments), or portions thereof, to the 2015-1 CLO. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2015-1 CLO issued \$410.3 million of notes to institutional investors. The Company retained \$85.8 million, comprising 100% of the 2015-1 CLO’s membership

interests and subordinated notes. At September 30, 2016, the \$410.3 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$496.1 million. At September 30, 2016, unamortized deferred financing fees were \$3.4 million. The 2015-1 CLO permits reinvestment of collateral principal repayments for a four-year period ending in April 2019. Should the Company determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

The Company receives a loan collateral management fee and excess interest spread. The Company also receives payments with respect to the classes of notes it owns in accordance with the transaction documents. The Company expects to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2015-1 CLO is in default under the terms of the indenture, the excess interest spread from the 2015-1 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, are not satisfied.

The following table sets forth selected information with respect to the 2015-1 CLO:

Notes	Outstanding			Legal final
	originally issued	balance September 30, 2016	Interest rate	
2015-1 CLO				
Class A-1	\$253,500	\$253,500	Libor+1.80%	January 20, 2027
Class A-2	35,000	35,000	(1)	January 20, 2027
Class B	50,000	50,000	Libor+2.80%	January 20, 2027
Class C	38,500	38,500	Libor+3.85%	January 20, 2027
Class D	33,250	33,250	Libor+5.50%	January 20, 2027
	\$410,250	\$410,250		

(1)Class A-2 Notes accrue interest at a spread over Libor of 1.65% from the closing date to, but excluding March 20, 2017, and 2.00% thereafter.

2015-2 CLO. On September 15, 2015, the Company completed a term debt securitization transaction through its separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2015-2 LLC (the “2015-2 CLO”) and sold and contributed \$298.4 million in loans and investments (including unfunded commitments), or portions thereof, to the 2015-2 CLO. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2015-2 CLO issued \$327.8 million of notes to institutional investors. The Company retained \$70.1 million, comprising 100% of the 2015-2 CLO’s membership interests and a portion of the Class E notes. At September 30, 2016, the \$327.8 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$397.8 million. At September 30, 2016, unamortized deferred financing fees were \$3.1 million. The 2015-2 CLO permits reinvestment of collateral principal repayments for a four-year period ending in August 2019. Should the Company determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

The Company receives a loan collateral management fee and excess interest spread. The Company also receives payments with respect to the classes of notes it owns in accordance with the transaction documents. The Company

expects to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2015-2 CLO is in default under the terms of the indenture, the excess interest spread from the 2015-2 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, are not satisfied.

29

The following table sets forth selected information with respect to the 2015-2 CLO:

	Notes	Outstanding balance	Interest	Legal final
	originally	September	rate	maturity
	issued	30, 2016		
	(\$ in thousands)			
2015-2 CLO				
Class A-1	\$ 205,000	\$ 205,000	Libor+2.00%	August 25, 2027
Class A-2	23,000	23,000	(1)	August 25, 2027
Class B	40,000	40,000	Libor+2.90%	August 25, 2027
Class C	26,250	26,250	Libor+3.95%	August 25, 2027
Class D	28,500	28,500	Libor+5.25%	August 25, 2027
Class E	5,000	5,000	Libor+7.50%	August 25, 2027
	\$327,750	\$ 327,750		

(1) Class A-2 Notes accrue interest at a fixed rate of 3.461%.

2016-1 CLO. On March 2, 2016, the Company completed a term debt securitization transaction through its separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2016-1 LLC (the "2016-1 CLO") and sold and contributed \$247.3 million in loans and investments (including unfunded commitments), or portions thereof, to the 2016-1 CLO. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2016-1 CLO issued \$255.8 million of notes to institutional investors. The Company retained \$92.2 million, comprising 100% of the 2016-1 CLO's membership interests, and the Class D and Class E notes. At September 30, 2016, the \$255.8 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$348.0 million. At September 30, 2016, unamortized deferred financing fees were \$2.6 million. The 2016-1 CLO permits reinvestment of collateral principal repayments for a four-year period ending in February 2020. Should the Company determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

The following table sets forth selected information with respect to the 2016-1 CLO:

	Notes	Outstanding balance	Interest	Legal final
	originally	September	rate	maturity
	issued	30, 2016		
	(\$ in thousands)			
2016-1 CLO				
Class A-1	\$ 176,500	\$ 176,500	Libor+2.30%	February 25, 2028
Class A-2	20,000	20,000	(1)	February 25, 2028
Class B	36,750	36,750	Libor+3.75%	February 25, 2028
Class C	22,500	22,500	Libor+5.40%	February 25, 2028

\$255,750 \$ 255,750

(1) Class A-2 Notes accrue interest at a fixed rate of 3.44%.

Arch Street CLO. On September 15, 2016, NewStar Capital LLC completed a \$409.8 million broadly syndicated loan securitization. The notes offered in the collateralized loan obligation (“Arch Street CLO”) were issued by Arch Street CLO, Ltd., an exempted company incorporated under the laws of the Cayman Islands, and (with the exception of the Class E and F notes) by Arch Street CLO, LLC, a Delaware limited liability company (each a subsidiary of NewStar Capital and collectively, “Arch Street”). The Arch Street CLO notes are backed by a diversified portfolio of broadly syndicated loans purchased and serviced by the Company. Investors purchased approximately \$370.3 million of the Arch Street CLO notes, representing approximately 90.4% of the total capitalization of Arch Street. The Company retained all of the Class F notes and subordinated notes which together totaled approximately \$39.5 million, representing approximately 9.6% of the total capitalization of Arch Street. At September 30, 2016, the outstanding note balance was \$370.3 million and unamortized deferred financing fees were \$4.3 million. The reinvestment period is expected to end in October 2020 and scheduled to mature in October 2028.

The Company receives a loan collateral management fee and excess interest spread. The Company also receives payments with respect to the classes of notes it owns in accordance with the transaction documents. The Company expects to receive a principal

30

distribution as owner of the membership interests when the term debt is retired. If loan collateral in the Arch Street CLO is in default under the terms of the indenture, the excess interest spread from the Arch Street CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, are not satisfied.

Notes	Outstanding		Interest	Legal final
	originally	balance		
issued	September	September	rate	maturity
	30, 2016	30, 2016		
(\$ in thousands)				
Arch Street CLO				
Class X	\$2,500	\$ 2,500	Libor+1.25%	October 20, 2028
Class A	256,000	256,000	Libor+1.65%	October 20, 2028
Class B	48,000	48,000	Libor+2.24%	October 20, 2028
Class C	20,000	20,000	Libor+3.00%	October 20, 2028
Class D	22,750	22,750	Libor+4.20%	October 20, 2028
Class E	21,000	21,000	Libor+8.60%	October 20, 2028
	\$370,250	\$ 370,250		

2015-1 ABS. As a result of the ongoing process to sell its leasing business, NewStar Equipment Finance, the static asset-backed securitization NewStar Commercial Lease Funding 2015-1 LLC (the "2015-1 ABS") that was completed on September 1, 2015 was reclassified to liabilities held-for-sale. As of September 30, 2016, the 2015-1 ABS Class A notes have a balance of \$9.7 million and unamortized deferred financing fees of \$1.1 million.

Note 8. Repurchase Agreements

	At	At
	September	December
	30,	31,
	2016	2015
	(\$ in thousands)	
Outstanding at end of period	\$52,591	\$ 96,789
Deferred financing fees and debt discount	\$—	\$ 565
Repurchase agreements, net	\$52,591	\$ 96,224
Weighted average rate at end of period	2.83 %	3.67 %

The Company has entered into a repurchase transaction with Deutsche Bank AG, pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of February 13, 2015 between Deutsche Bank AG and NS

Bond Funding I LLC (the “Deutsche Bank Repurchase Agreement”). Pursuant to the Deutsche Bank Repurchase Agreement, Deutsche Bank AG will purchase securities and simultaneously agree to sell the securities back to the Company at a specified date. Under the terms of the Deutsche Bank Repurchase Agreement, the Company is required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, there was no outstanding balance under the Deutsche Bank Repurchase Agreement. The Company has made certain representations and warranties and is required to comply with various covenants and requirements customary for financing arrangements of this nature.

The Company has entered into a repurchase transaction with Citigroup Global Markets, pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of March 16, 2015 between Citigroup Global Markets and NS Loan Originator LLC (the “Citigroup Repurchase Agreement”). Pursuant to the Citigroup Repurchase Agreement, Citigroup Global Markets will purchase securities and simultaneously agree to sell the securities back to the Company at a specified date. Under the terms of the Citigroup Repurchase Agreement, the Company is required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, the outstanding balance was \$14.8 million. The Company has made certain representations and warranties and is required to comply with various covenants and requirements customary for financing arrangements of this nature.

The Company has entered into a repurchase transaction with JP Morgan Chase Bank pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of April 2, 2015 between JP Morgan Chase Bank and NS Bond Funding II LLC (the “JP Morgan Repurchase Agreement”). Pursuant to the JP Morgan Repurchase Agreement, JP Morgan Chase Bank will purchase securities and simultaneously agree to sell the securities back to the Company at a specified date. Under the terms of the JP Morgan Repurchase Agreement, the Company is required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, the outstanding balance was \$36.0 million. The Company has made

certain representations and warranties and is required to comply with various covenants and requirements customary for financing arrangements of this nature.

The Company has entered into a repurchase transaction with Natixis Securities Americas LLC pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of October 14, 2015 between Natixis Securities Americas LLC and NS Bond Funding III LLC (the “Natixis Repurchase Agreement”). Pursuant to the Natixis Repurchase Agreement, Natixis Securities Americas LLC will purchase securities and simultaneously agree to sell the securities back to the Company at a specified date. Under the terms of the Natixis Repurchase Agreement, the Company is required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, the outstanding balance was \$1.7 million. The Company has made certain representations and warranties and is required to comply with various covenants and requirements customary for financing arrangements of this nature.

On August 29, 2016, the Company redeemed in full the five-year, \$68.0 million financing arrangement with Macquarie Bank Limited with an outstanding balance of \$10.7 million. The Company accelerated and recognized deferred financial fees of \$0.3 million related to repurchase facility during the three months ended September 30, 2016.

Note 9. Stockholders’ Equity

Stockholders’ Equity

As of September 30, 2016 and December 31, 2015, the Company’s authorized capital consists of preferred and common stock and the following was authorized and outstanding:

	September 30, 2016		December 31, 2015	
	Shares	Shares	Shares	Shares
	authorized outstanding		authorized outstanding	
	(In thousands)			
Preferred stock	5,000	—	5,000	—
Common stock	145,000	46,706	145,000	46,527

Preferred Stock

The Company’s authorized capital stock includes 5,000,000 shares of preferred stock with a par value of \$0.01 per share, all of which remain undesignated.

Common Stock

On October 7, 2015, our Board of Directors authorized the repurchase of up to \$5.0 million of the Company’s common stock from time to time on the open market or in privately negotiated transactions. On February 10, 2016, our Board of Directors authorized an increase to this stock repurchase program to authorize the repurchase of up to an aggregate of \$30.0 million of the Company’s common stock (inclusive of approximately \$4.9 million remaining under the

existing program). The timing and amount of any shares purchased under the repurchase program will be determined by our management based on its evaluation of market conditions and other factors. The repurchase program, as amended, will expire on December 31, 2016 unless extended by the Board and may be suspended or discontinued at any time without notice. As of September 30, 2016, the Company had repurchased 1,241,999 shares of common stock under this program at a weighted average price per share of \$7.18, of which 1,000,000 shares were repurchased in a privately negotiated transaction with an unaffiliated third party for an aggregate purchase price of \$7.0 million.

On March 24, 2015, the Company repurchased 1,000,000 shares of its common stock in a privately negotiated transaction with an unaffiliated third party for an aggregate purchase price of \$10.3 million.

Warrants

On January 23, 2015, the Company completed its December 4, 2014 issuance of warrants as part of the strategic relationship with Franklin Square Capital Partners (“Franklin Square”). The Company issued the second tranche of warrants to purchase 2,500,000 shares of its common stock subject to the same terms as the warrants that were issued on December 4, 2014, bringing the total warrants to purchase shares of common stock to 12,000,000.

Restricted Stock

During the nine months ended September 30, 2016, the Company issued 523,903 shares of restricted stock to certain employees of the Company pursuant to the Company’s 2006 Incentive Plan, as amended and 74,020 shares of restricted stock to certain members

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

of its Board of Directors. The fair value of the shares of restricted stock is equal to the closing price of the Company's stock on the date of issuance. The shares of restricted stock issued to employees of the Company vest in three equal installments on each of the first three anniversaries of the date of grant.

Restricted stock activity for the nine months ended September 30, 2016 was as follows:

	Shares	Grant-date fair value (\$ in thousands)
Non-vested as of December 31, 2015	496,704	\$ 5,629
Granted	597,923	3,835
Vested	(250,846)	(2,876)
Forfeited	(555)	(9)
Non-vested as of September 30, 2016	843,226	\$ 6,579

The Company's compensation expense related to restricted stock was \$1.0 million and \$2.8 million, respectively, for the three and nine months ended September 30, 2016 and \$0.8 million and \$2.5 million, respectively, for the three and nine months ended September 30, 2015. The unrecognized compensation cost of \$3.2 million at September 30, 2016 is expected to be recognized over the next three years.

Stock Options

Under the Company's 2006 Incentive Plan, the Company's compensation committee may grant options to purchase shares of common stock. Stock options may either be incentive stock options ("ISOs") or non-qualified stock options. ISOs may only be granted to officers and employees. The compensation committee will, with regard to each stock option, determine the number of shares subject to the stock option, the manner and time of exercise, vesting, and the exercise price, which will not be less than 100% of the fair market value of the common stock on the date of the grant. The shares of common stock issuable upon exercise of options or other awards or upon grant of any other award may be either previously authorized but unissued shares or treasury shares.

Stock option activity for the nine months ended September 30, 2016 was as follows:

	Options
Outstanding as of December 31, 2015	2,513,532
Granted	—
Exercised	(1,749,187)
Forfeited	(22,500)
Outstanding as of September 30, 2016	741,845
Vested and exercisable as of September 30, 2016	741,845

As of September 30, 2016 and December 31, 2015, the Company has recognized all compensation costs related to options granted.

Note 10. Earnings Per Share

The Company utilizes the two-class method to calculate earnings per share. The two-class method allocates net income to each class of common stock and participating security. Unvested share-based payment awards granted to certain employees and board members entitle holders to same rights as outstanding and vested common stock. These securities are considered to be participating securities and are included in the allocation for computing earnings per share under this method. Income is allocated to common shareholders and participating securities under the two-class method based upon the proportion of each to the total weighted average shares available.

33

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

The computations of basic and diluted income per share for the three and nine months ended September 30, 2016 and 2015 are as follows:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
(In thousands)				
Numerator:				
Net income to common shareholders	\$8,644	\$5,142	\$17,894	\$12,681
Net income allocated to participating securities - basic and diluted	157	57	302	137
Net income allocated to common shareholders - basic and diluted	8,487	5,085	17,592	12,544
Denominator:				
Denominator for basic earnings per common share	45,812	45,745	46,216	46,139
Denominator for diluted earnings per common share:				
Denominator for basic earnings per common share	45,812	45,745	46,216	46,139
Potentially dilutive securities - options	—	2,494	—	2,566
Potentially dilutive securities – restricted stock	—	—	—	—
Potentially dilutive securities - warrants	—	—	—	—
Total weighted average diluted shares	45,812	48,239	46,216	48,705
Earnings per common share				
Basic	\$0.19	\$0.11	\$0.38	\$0.27
Diluted	\$0.19	\$0.11	\$0.38	\$0.26

Warrants to purchase common stock totaling 12,000,000 were not included in the computation of earnings per share for the three and nine months ended September 30, 2016 and 2015 due to the fact that the effect would be anti-dilutive. Stock options totaling 741,845 were not included in the computation of earnings per share for the three and nine months ended September 30, 2016 due to the fact that the effect would be anti-dilutive.

Note 11. Variable Interest Entities

On October 1, 2015, the Company adopted ASU 2015-2, Consolidation – Amendments to the Consolidation Analysis which revised the existing consolidation guidance and required the Company to re-evaluate its consolidation conclusions under the new model. The new consolidation model revised the conditions required for consolidation, the criteria to be considered a variable interest entity and the determination of the primary beneficiary. The Company's involvement in VIE's includes term debt securitizations and sponsored funds.

The Company sponsors the formation of various entities that are considered to be VIEs. The majority of these VIEs were formed to issue term debt securitizations. The assets of the VIEs are primarily comprised of senior secured loans and the liabilities are primarily comprised of debt. The Company's determination of whether it is the primary beneficiary of the VIE is based in part on an assessment of whether or not the Company is exposed to the majority of the risks and rewards of the entity. In instances where the Company retains a significant portion of the equity and remains the servicer of the loans, it was determined that the Company has the power to direct the activities that most significantly impact the economic performance of these VIEs. Additionally, the Company determined that the

potential fees that we could receive directly or indirectly from these VIEs represent rights to returns that could potentially be significant to the VIEs. As a result, the Company was deemed the primary beneficiary and therefore has consolidated these entities. Consolidated VIEs are disclosed in Note 7.

Unconsolidated VIEs

In January 2015, NewStar closed a new managed credit fund, NewStar Clarendon Fund CLO LLC (the “Clarendon Fund”), a \$400.0 million term debt securitization. The Clarendon Fund is the third credit fund established by the Company to co-invest in directly originated middle market commercial loans. To comply with European Union (“EU”) risk retention rules, the Company holds 5% of each class of notes in the securitization (vertical strip), totaling \$20.4 million. The Clarendon Fund employs an independent investment professional who is responsible for reviewing and approving investment recommendations made to the Clarendon Fund by the Company. The Company has determined that it is not the primary beneficiary of the Clarendon Fund and will not consolidate the Clarendon Fund’s operating results or statements of financial position; however, the Company has determined that it has a variable interest in the Clarendon Fund as it holds notes of the securitization.

The following table sets forth the information with respect to the unconsolidated VIEs for which the Company holds a variable interest in as of September 30, 2016 and December 31, 2015:

	September 30, 2016	December 31, 2015
	(\$ in thousands)	
Unconsolidated VIE assets	\$408,553	\$ 483,581
Unconsolidated VIE liabilities	359,693	362,383
Equity interest included on the Consolidated Balance Sheet	23,734	23,910
Maximum risk of loss (1)	24,152	24,327

(1) Includes equity investment the Company has made, or is required to make, and any earned but uncollected management and incentive fees. The Company does not record performance and incentive allocations until the respective measurement period has ended.

In October 2015, NewStar acquired FOC Partners, which now operates as NewStar Capital. At acquisition, NewStar Capital was the investment manager for six collateralized loan obligations and two sponsored funds and provided discretionary services to a series of separately managed accounts. The Company determined that it was not the primary beneficiary of any of acquired CLOs, sponsored funds or separately managed accounts; however, the Company determined that it had a variable interest in the Secured Value sponsored fund as it holds approximately one percent of the interest of the fund.

Note 12. Financial Instruments with Off-Balance Sheet Risk

The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its borrowers. These financial instruments include unfunded commitments and standby letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement we have in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Unused lines of credit are commitments to lend to a borrower if certain conditions have been met. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because certain commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each borrower's creditworthiness on a case-by-case basis. The amount of collateral required is based on factors that include management's credit evaluation of the borrower and the borrower's compliance with financial covenants. Due to their fluctuating nature, the Company cannot know with certainty the aggregate amounts that will be required to fund its unfunded commitments. The aggregate amount of these unfunded commitments currently exceeds the Company's available funds and will likely continue to exceed its available funds in the future.

The credit risk involved in issuing letters of credit is essentially the same as that involved in extending credit to our borrowers. Standby letters of credit are conditional commitments issued by us to guarantee the performance by a

borrower to a third party.

Financial instruments with off-balance sheet risk are summarized as follows:

	September 30, 2016	December 31, 2015
	(\$ in thousands)	
Unused lines of credit	\$287,172	\$ 601,805
Standby letters of credit	8,754	8,696

Note 13. Total Return Swap

The Company was a participant in a Total Return Swap (“TRS”), which matured on March 31, 2016. We acted as the manager of the TRS and selected the specific loans to be subject to the TRS. The TRS did not qualify for hedge accounting treatment as it did not offset the risks of another investment position.

The underlying referenced loan portfolio of the TRS was primarily large, liquid, broadly syndicated senior secure floating rate loans with Citibank, N.A. as the counterparty. The TRS effectively added leverage to the Company's portfolio by providing economic benefits of the loans subject to the TRS, despite the fact that such loans were not directly owned the Company, in return for an interest-type payment to Citibank.

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

On December 4, 2014, NewStar TRS I LLC, a newly-formed wholly owned subsidiary of the Company, entered into the TRS. The initial maximum market value (determined at the time such loan becomes subject to the TRS) of the portfolio of loans subject to the TRS was \$75.0 million. On December 15, 2014, we entered into an amendment to the TRS that increased the maximum value to \$125.0 million, on March 2, 2015, we entered into an amendment that increased the maximum value to \$150.0 million, and on July 14, 2015, we entered into an additional amendment to the TRS that increased the maximum value to \$175.0 million.

Upon maturity of the TRS, the Company purchased \$138.9 million of the loans in the referenced portfolio. The majority of these loans were purchased to fund future CLOs of the Company and its wholly owned subsidiary NewStar Capital. The Company recorded these loans at fair value which was determined by using the midpoint of the bid-ask spread provided by an independent third-party pricing service.

The Company recorded interest income from the TRS portfolio of \$2.2 million, interest expense from the TRS portfolio of \$0.8 million, and a realized loss on the TRS of \$6.1 million in the consolidated statement of operations for the nine months ended September 30, 2016.

At December 31, 2015, the receivable and realized loss on the total return swap on the consolidated balance sheet and consolidated statements of operations consisted of the following:

	Net Receivable	Net Realized Gains/(Losses)
	(\$ in thousands)	
Interest income from TRS portfolio	\$—	\$ 8,667
TRS interest expense	—	(2,652)
Realized loss on TRS	(5,816)	(4,822)
TRS receivable	1,377	—

The fair value of the TRS was reflected as an unrealized gain or loss on the total return swap on the consolidated balance sheet, within other assets or liabilities. The change in value of the TRS was reflected in the consolidated statements of operations as loss (gain) on total return swap.

As of December 31, 2015, the fair value of the underlying referenced portfolio was \$155.6 million.

The Company's obligations under the TRS were non-recourse to it, and its exposure was limited to the value of the cash collateral which fluctuated from time to time depending on the market value of the underlying loans. The Company was required to cash collateralize a specified percentage of each loan included under the TRS in accordance with margin requirements. As of September 30, 2016 and December 31, 2015, the Company had cash collateral on deposit with Citibank of \$0 and \$56.5 million, respectively.

The Company paid interest to Citibank for each loan at a rate equal to one-month LIBOR plus 1.60% per annum. Upon the termination or repayment of any loan under the TRS Agreement, the Company would deduct the appreciation of such loan's value from any interest owed to Citibank or pay the depreciation amount to Citibank in addition to remaining interest payments.

Note 14. Fair Value

ASC 820, Fair Value Measurements (“ASC 820”) establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or

liability as of the measurement date. The three levels are defined as follows:

Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Items Recorded at Fair Value on a Recurring Basis

Investments in debt securities, available-for-sale

Investments in debt securities available-for-sale are recorded at fair value on a recurring basis. The fair value measurement of investments in debt securities is based on third party pricing services or by using internally developed financial models. For securities in less liquid markets where there is limited activity and little transparency around broker quotes used to value such securities, the Company classifies securities valued using broker quotes as Level 3. If quoted prices are not available, then fair value is estimated by using internally developed financial models. These securities are not actively traded and require a private sale, and the valuation involves application of significant management judgment. Inputs into the model-based valuations can include changes in market indexes, selling prices of similar securities, management's assumptions related to the credit rating of the security, prepayment assumptions and other factors such as credit loss assumptions and management's assessment of the current market conditions. Such securities are classified as Level 3, as the valuation models are based on significant inputs that are unobservable in the market.

Loans

Loans designated to Credit Funds managed by NewStar Capital are recorded at fair value on a recurring basis. The Company has elected to apply the fair value option accounting to these loans which is consistent with the manner in which the Credit Funds are managed. The fair value of these loans are based on third party pricing services. These loans are classified as Level 2. During the nine months ended September 30, 2016, the Company recorded a \$3.7 million gain from the change in fair value which was recorded in other miscellaneous income, net.

Total return swap

The fair value of the total return swap was based on third party pricing services who collect prices through a variety of methods including dealer runs, indicative sheets and online posts. The Company recorded the total return swap with Citibank as Level 2. At September 30, 2016, the Company no longer participated in the TRS. At December 31, 2015, the TRS was included within Other liabilities on the consolidated balance sheet. The TRS had a maximum notional amount of \$175.0 million and was carried at an estimated fair value of \$(4.4) million, comprised of \$1.4 million of interest receivable and an unrealized loss of \$5.8 million on the underlying loan portfolio.

Items Measured at Fair Value on a Nonrecurring Basis

Collateral dependent impaired loans

Collateral dependent loans that are deemed to be impaired are valued based upon the fair value of the underlying collateral. For collateral dependent loans for which repayment is dependent on the sale of the collateral, management adjusts the fair value for estimated costs to sell. For collateral dependent loans for which repayment is dependent on the operation of the collateral, management may also adjust values to reflect estimated market value declines or apply other discounts to appraised values. Collateral dependent impaired loans are categorized as Level 3. During the nine months ended September 30, 2016, the Company recorded \$4.2 million of specific allowance for credit losses related to "Collateral dependent impaired loans" measured at fair value at September 30, 2016, which was subsequently charged off when the impaired loans were transferred to the held-for-sale portfolio. During 2015, the Company recorded \$0.3 million of specific allowance for credit losses related to "Collateral dependent impaired loans" measured at fair value.

Loans held-for-sale

Loans held-for-sale are carried at the lower of cost or fair value. Loans held-for-sale measured at fair value consist of loans that have had credit downgrades and/or have remained in the loans held-for-sale portfolio for a significant

period of time. When fair value is determined to be the carrying value, the fair values of these loans are obtained through a third party pricing service or by using internally developed financial models. Inputs into the model-based valuations can include changes in market indexes, selling prices of similar loans, management's assumption related to the credit rating of the loan, prepayment assumptions and other factors, such as credit loss assumptions. Where quoted market prices are obtained through dealer quotes, broker indicative prices or online posts, loans held-for-sale are classified as Level 2. Loans held-for-sale are classified as Level 3 in instances where valuation models are based on significant inputs that are unobservable in the market. During the nine months ended September 30, 2016, the Company recorded a \$5.3 million loss related to "Loans, held-for-sale" measured at fair value. During 2015, the Company recorded a \$2.6 million loss related to "Loans, held-for-sale" measured at fair value.

Other real estate owned or repossessed assets

The Company does not record other real estate owned or repossessed assets at fair value on a recurring basis. The fair value is estimated using one of several methods, including collateral value, market value of similar properties, liquidation value and discounted cash flows. Management may adjust the fair value for estimated costs to sell or adjust values to reflect estimated market value declines or apply other discounts to values. The Company records the other real estate owned and repossessed assets as Level 3. During the

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

nine months ended September 30 2016, the Company recorded a \$0.2 million expense to write down other real estate owned to fair value.

The following table presents recorded amounts of assets and liabilities measured at fair value on a recurring and nonrecurring basis as of September 30, 2016, by caption in the consolidated balance sheet and by ASC 820 valuation hierarchy (as described above).

	Quoted Prices in Active Markets for Identifiable Assets (Level 1) (\$ in thousands)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value in Consolidated Balance Sheet
Recurring Basis:				
Assets:				
Investments in debt securities, available-for-sale	\$—	\$ —	\$ 90,814	\$ 90,814
Loans	—	389,260	—	\$ 389,260
Total assets recorded at fair value on a recurring basis	\$—	\$ 389,260	\$ 90,814	\$ 480,074
Nonrecurring Basis:				
Assets:				
Loans, held-for-sale	—	149,089	53,514	\$ 202,603
Other real estate owned/repossessed assets	—	—	15,600	\$ 15,600
Total assets recorded at fair value on a				
nonrecurring basis	\$—	\$ 149,089	\$ 69,114	\$ 218,203

The following table presents recorded amounts of assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2015, by caption in the consolidated balance sheet and by ASC 820 valuation hierarchy (as described above).

Quoted Prices in Active Markets for Identifiable Assets (Level 1) (\$ in thousands)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value in Consolidated
---	---	--	---

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

Market Level 2) Balance Sheet
for

Identical Assets

(Level
1)
(\$ in thousands)

Recurring Basis:				
Assets:				
Investments in debt securities, available-for-sale	\$—	\$ —	\$ 94,177	\$ 94,177
Total assets recorded at fair value on a recurring basis	\$—	\$ —	\$ 94,177	\$ 94,177
Liabilities:				
TRS	—	4,439	—	4,439
Total liabilities recorded at fair value on a recurring basis	\$—	\$ 4,439	\$ —	\$ 4,439
Nonrecurring Basis:				
Collateral dependent impaired loans	—	—	27,473	27,473
Loans, held-for-sale	—	140,151	—	140,151
Other real estate owned/repossessed assets	—	—	250	250
Total assets recorded at fair value on a				
nonrecurring basis	\$—	\$ 140,151	\$ 27,723	\$ 167,874

38

The following table presents a summary of significant unobservable inputs and valuation techniques of the Company's Level 3 fair value measurements at September 30, 2016.

	Fair value	Valuation Techniques	Unobservable Input	Range
	(\$ in thousands)			
Financial assets:				
Investments in debt securities, available-for-sale	\$90,814	Third-party pricing	Pricing assumptions such as prepayment rates, interest rates, loss assumptions, cash flow projections, and comparisons to similar financial instruments	
Loans, held-for-sale	53,514	Discounted cash flow		5% -10%
Other real estate/repossessed assets	15,600	Appraisal	Cost to sell	3%- 7%
Total:	\$159,928			

The following table presents a summary of significant unobservable inputs and valuation techniques of the Company's Level 3 fair value measurements at December 31, 2015.

	Fair value	Valuation Techniques	Unobservable Input	Range
	(\$ in thousands)			
Financial assets:				
Investments in debt securities, available-for-sale	\$94,177	Third-party pricing	Pricing assumptions such as prepayment rates, interest rates, loss assumptions, cash flow projections, and comparisons to similar financial instruments	
Loans and leases, net	27,473	Market comparables	Cost to sell, Marketability discount	3% - 7%
		Valuation model		5%-30%
Other real estate owned/repossessed assets	250	Appraisal	Cost to sell	3% - 7%
Total:	\$121,900			

Changes in level 3 recurring fair value measurements

The table below illustrates the change in balance sheet amounts during the three and nine months ended September 30, 2016 and 2015 (including the change in fair value), for financial instruments measured on a recurring basis and classified by the Company as level 3 in the valuation hierarchy. When a determination is made to classify a financial

instrument as level 3, the determination is based upon the significance of the unobservable parameters to the overall fair value measurement. However, level 3 financial instruments typically include, in addition to the unobservable or level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources); accordingly, the gains and losses in the table below include changes in fair value due in part to observable factors that are part of the valuation methodology. The Company did not transfer any financial instruments in or out of level 1, 2, or 3 during the three and nine months ended September 30, 2016 and 2015.

39

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

For the three months ended September 30, 2016:

	Investments in Debt Securities, Available-for-sale (\$ in thousands)
Balance as of June 30, 2016	\$ 91,400
Total gains or losses (realized/unrealized)	
Included in earnings	342
Included in other comprehensive income (loss)	5,072
Purchases	—
Issuances	—
Settlements	(6,000)
Balance as of September 30, 2016	\$ 90,814

For the three months ended September 30, 2015:

	Investments in Debt Securities, Available-for-sale (\$ in thousands)
Balance as of June 30, 2015	\$ 108,454
Total gains or losses (realized/unrealized)	
Included in earnings	376
Included in other comprehensive income (loss)	(4,365)
Purchases	22,863
Issuances	—
Settlements	(33,000)
Balance as of September 30, 2015	\$ 94,328

For the nine months ended September 30, 2016:

	Investments in Debt Securities, Available-for-sale (\$ in thousands)
Balance as of December 31, 2015	\$ 94,177
Total gains or losses (realized/unrealized)	
Included in earnings	655

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

Included in other comprehensive income (loss)	1,982
Purchases	—
Issuances	—
Settlements	(6,000)
Balance as of September 30, 2016	\$ 90,814

40

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

For the nine months ended September 30, 2015:

	Investments in Debt Securities, Available-for-sale (\$ in thousands)
Balance as of December 31, 2014	\$ 46,881
Total gains or losses (realized/unrealized)	
Included in earnings	620
Included in other comprehensive income (loss)	(5,193)
Purchases	85,020
Issuances	—
Settlements	(33,000)
Balance as of September 30, 2015	\$ 94,328

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments at September 30, 2016 and December 31, 2015. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties.

	September 30, 2016		December 31, 2015	
	Carrying		Carrying	
	amount	Fair value	amount	Fair value
	(\$ in thousands)			
Financial assets:				
Cash and cash equivalents	\$36,266	\$36,266	\$35,933	\$35,933
Restricted cash	370,487	370,487	153,992	153,992
Cash collateral on deposit with custodians	7,564	7,564	61,081	61,081
Investments in debt securities available-for-sale	90,814	90,814	94,177	94,177
Loans held-for-sale, net	429,718	437,153	478,785	483,781
Loans and leases, net	3,186,998	3,183,847	3,134,072	3,147,117
Other assets	17,214	17,214	14,255	14,255
Assets held-for-sale	162,801	171,111	—	—
Financial liabilities:				
Credit facilities, net	\$492,758	\$492,758	\$832,686	\$843,896
Term debt, net	2,327,717	2,353,947	1,821,519	1,819,344
Senior notes, net	373,462	375,250	372,153	368,600
Subordinated notes, net	239,543	302,090	209,509	266,857
Repurchase agreements, net	52,591	52,591	96,224	101,433
Other liabilities	—	—	4,439	4,439
Liabilities held-for-sale	44,158	44,158	—	—

The carrying amounts shown in the table are included in the consolidated balance sheets under the indicated captions.

41

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

The following table presents the carrying amounts, estimated fair values, and placement in the fair value hierarchy of the Company's financial instruments at September 30, 2016 and December 31, 2015. The table excludes financial instruments for which the carrying amount approximates fair value such as cash and cash equivalents, restricted cash, cash collateral on deposit with custodian, investments in debt securities available-for-sale, and financial information disclosed above.

September 30, 2016	Carrying		Fair Value Measurements		
	amount	Fair value	Level 1	Level 2	Level 3
	(\$ in thousands)				
Financial assets:					
Loans and leases, net	\$3,186,998	\$3,183,847	\$—	\$—	\$3,183,847
Loans held-for-sale, net	429,718	437,153	—	252,649	184,504
Other assets	17,214	17,214	—	—	17,214
Assets held-for-sale	162,801	171,111	—	171,111	—
Financial liabilities:					
Credit facilities, net	492,758	492,758	—	492,758	—
Term debt securitizations, net	2,327,717	2,353,947	—	2,353,947	—
Repurchase agreements, net	52,591	52,591	—	52,591	—
Senior notes, net	373,462	375,250	—	375,250	—
Subordinated notes, net	239,543	302,090	—	—	302,090
Liabilities held-for-sale	44,158	44,158	—	44,158	—

December 31, 2015	Carrying		Fair Value Measurements		
	amount	Fair value	Level 1	Level 2	Level 3
	(\$ in thousands)				
Financial assets:					
Loans and leases, net	\$3,134,072	\$3,147,117	\$—	\$—	\$3,147,117
Loans held-for-sale, net	478,785	483,781	—	483,781	—
Other assets	14,255	14,255	—	—	14,255
Financial liabilities:					
Credit facilities, net	832,686	843,896	—	843,896	—
Term debt securitizations, net	1,821,519	1,819,344	—	1,819,344	—
Repurchase agreements, net	96,224	101,433	—	101,433	—
Senior notes, net	372,153	368,600	—	368,600	—
Subordinated notes, net	209,509	266,857	—	—	266,857
Other liabilities	4,439	4,439	—	4,439	—

Valuation of Other Financial Instruments

The methodologies for estimating the fair value of financial instruments that are measured at fair value on a recurring or nonrecurring basis are discussed above. The methodologies for other financial instruments are discussed below.

Cash and cash equivalents, restricted cash and cash collateral on deposit with custodians: The carrying amounts approximate fair value because of the short maturity of these instruments.

Assets held-for-sale: The fair value is determined through the evaluation of the expected sale proceeds.

Credit facilities: Due to the adjustable rate nature of the borrowings, the fair values of the credit facilities are estimated to approximate their carrying values. Rates currently are comparable to those offered to the Company for similar debt instruments of comparable maturities by the Company's lenders.

Term debt securitizations: The fair value was determined by applying prevailing term debt securitization market interest rates to the Company's current term debt securitization structure.

Repurchase agreements: The fair value was determined by applying prevailing repurchase agreement market interest rates to the Company's current repurchase agreement structure.

Senior notes: The fair value was based on available quoted market prices.

Subordinated notes: The fair value was estimated as the present value of expected future cash flows discounted at market interest rates on similar debt instruments, issued by companies with comparable credit ratings.

Liabilities held-for-sale: The carrying amounts approximate fair value.

Other assets/other liabilities: Comprised of non-public investments and, through March 31, 2016, the total return swap. The non-public investments are carried within other assets at \$17.2 million and \$14.3 million, as of September 30, 2016 and December 31, 2015, respectively. These investments are in the form of equity or warrants and are obtained as part of the loan origination process. The investments are initially recorded at cost and reviewed quarterly. If the fair value is less than cost then the investment is written down to fair value with the necessary adjustment recorded through current earnings. Fair value is determined using internally developed valuation models. Where sufficient data exists, a market approach method is utilized to estimate the current value of the underlying company. The estimated fair value of the underlying securities for warrants requiring valuation at fair value is adjusted for discounts related to lack of liquidity. The Company classifies equity and warrants as Level 3. The total return swap, which was included in other liabilities as of December 31, 2015, was based on third party pricing services who collect prices through a variety of methods including dealer runs, indicative sheets and online posts. The Company classified the total return swap as Level 2.

Note 15. Segment Reporting

Beginning in 2016, the Company has two reportable segments, Commercial Lending and Asset Management. Segment information is derived from the internal reporting system utilized by management. Revenues and expenses for segments reflect those revenue and expenses which can be specifically identified and have been assigned based on internally developed allocation methods. Results may be restated, when necessary, to reflect changes in organizational structure or allocation methodology. Any changes in allocations that may affect the reported results of any business segment will not affect the consolidated financial position or results of operations of the Company as a whole.

Commercial Lending

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

Asset Management

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

The following tables presents the statement of operations and total assets for the Company's reportable segments:

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Three Months Ended September 30, 2016		
	Commercial Lending	Asset Management	Consolidated Total
Net interest income:	\$24,135	\$ 1,123	\$ 25,258
Provision for loan losses	3,570	—	3,570
Net interest income after provision	20,565	1,123	21,688
Noninterest income:			
Management fees	—	2,888	2,888
Performance fees	—	465	465
Other lending fees	2,871	75	2,946
Gain/(loss) on sale of loans and equipment	83	69	152
Other noninterest income (1)	1,059	3,456	4,515
Total noninterest income:	4,013	6,953	10,966
Non-interest expense	14,833	3,236	18,069
Income before income taxes	\$9,745	\$ 4,840	\$ 14,585
Income tax expense			5,941
Net income			\$ 8,644

(1) Includes fair value adjustments on Loans held-for-sale and fair value portfolio.

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Nine Months Ended September 30, 2016		
	Commercial Lending	Asset Management	Consolidated Total
Net interest income:	\$65,752	\$ 2,931	\$ 68,683
Provision for loan losses	24,906	—	24,906
Net interest income after provision	40,846	2,931	43,777
Noninterest income:			
Management fees	—	9,031	9,031
Performance fees	—	1,306	1,306
Other lending fees	5,729	107	5,836
Gain/(loss) on sale of loans and equipment	545	220	765
Other noninterest income (1)	13,819	3,720	17,539
Total noninterest income:	20,093	14,384	34,477
Non-interest expense	40,027	7,950	47,977
Income before income taxes	\$20,912	\$ 9,365	\$ 30,277
Income tax expense			12,383
Net income			\$ 17,894

(1) Includes fair value adjustments on Loans held-for-sale and fair value portfolio.

	Three months ended September 30, 2015		
	Commercial Lending	Asset Management	Consolidated Total
	(\$ in thousands)		
Net interest income	\$22,900	\$ 329	\$ 23,229
Provision for loan losses	4,534	—	4,534
Net interest income after provision	18,366	329	18,695
Noninterest income:			
Management fees	—	1,019	1,019
Performance fees	—	—	—
Other lending fees	4,573	—	4,573
Gain/(loss) on sale of loans and equipment	692	—	692
Other noninterest income (1)	(2,792)	—	(2,792)
Total Noninterest income:	2,473	1,019	3,492
Non-interest expense	13,076	304	13,380
Income before income taxes	\$7,763	\$ 1,044	\$ 8,807
Income tax expense			3,665
Net income			\$ 5,142

(1) Includes fair value adjustment on Loans held-for-sale.

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Nine months ended September 30, 2015		
	Commercial Lending	Asset Management	Consolidated Total
	(\$ in thousands)		
Net interest income	\$56,400	\$ 30	\$ 56,430
Provision for loan losses	14,720	—	14,720
Net interest income after provision	41,680	30	41,710
Noninterest income:			
Management fees	—	2,954	2,954
Performance fees	—	—	—
Other lending fees	10,508	—	10,508
Gain/(loss) on sale of loans and equipment	825	—	825
Other noninterest income (1)	760	—	760
Total Noninterest income:	12,093	2,954	15,047
Non-interest expense	33,980	1,076	35,056
Income before income taxes	\$19,793	\$ 1,908	\$ 21,701
Income tax expense			9,020
Net income			\$ 12,681

(1) Includes fair value adjustment on Loans held-for-sale.

September 30, 2016	Commercial Lending	Asset Management	Total
	(\$ in thousands)		
Loans and leases, gross (including loans at fair value of \$389,260)	\$2,892,467	\$ 389,260	\$3,281,727
Loans held-for-sale, gross	435,351	—	435,351
Investments in debt securities, available-for-sale	—	90,814	90,814
Other	372,472	222,996	595,468
Total Balance Sheet Assets	3,700,290	703,070	4,403,360
Illiquid Credit funds *	—	806,535	806,535
Liquid/Tradeable Credit *	—	1,873,646	1,873,646
Total Assets	3,700,290	3,383,251	7,083,541
Less: Non Managed assets (1)	214,183	216,879	431,062
Total Managed Assets	\$3,486,107	\$ 3,166,372	\$ 6,652,479

*Assets managed by the Company for the Illiquid Credit and Liquid/Tradeable Credit Funds are not assets of the Company and are not included in the Consolidated Total Assets as reflected in the Condensed Consolidated Balance Sheet.

(1) Other less unamortized discount on investment in debt securities, available-for-sale.

December 31, 2015	Commercial Lending	Asset Management	Total
	(\$ in thousands)		
Loans and leases, gross	\$3,243,580	\$ —	\$3,243,580
Loans held-for-sale, gross	485,874	—	485,874
Investments in debt securities, available-for-sale	—	94,177	94,177
Other	205,256	22,496	227,752
Total Balance Sheet Assets	3,934,710	116,673	4,051,383
Illiquid Credit funds *	—	824,573	824,573

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

Liquid/Tradeable Credit *	—	2,294,497	2,294,497
Total Assets	3,934,710	3,235,743	7,170,453
Less: Non Managed assets (1)	205,256	15,731	220,987
Total Managed Assets	\$3,729,454	\$ 3,220,012	\$6,949,466

*Assets managed by the Company for the Illiquid Credit and Liquid/Tradeable Credit Funds are not assets of the Company and are not included in the Consolidated Total Assets as reflected in the Condensed Consolidated Balance Sheet.

(1) Other less unamortized discount on investment in debt securities, available-for-sale.

Note 16. Related-Party Transactions

On January 15, 2015, the Company announced the closing of the NewStar Clarendon Fund CLO LLC (the “Clarendon Fund”), a \$400.0 million term debt securitization. The Clarendon Fund is the third credit fund established by the Company to co-invest in directly originated middle market commercial loans. To comply with EU risk retention rules, the Company holds 5% of each class of note in the securitization, totaling \$20.4 million. The Clarendon Fund employs an independent investment professional who is responsible for reviewing and approving investment recommendations made to the Clarendon Fund by the Company. The Company has determined that it is not the primary beneficiary of the Clarendon Fund and will not consolidate the Clarendon Fund’s operating results or statements of financial position. Pursuant to a Collateral Management Agreement dated January 15, 2015, the Company serves as collateral manager of the Clarendon Fund. The Company is entitled to receive a fee, which will accrue quarterly based on the fee basis amount in arrears payable on each payment date. For the three and nine months ended September 30, 2016, the Clarendon Fund’s collateral management fee was \$0.5 million and \$1.5 million, respectively, and for the three and nine months ended September 30, 2015, the Clarendon Fund’s collateral management fee was \$0.5 million and \$1.5 million, respectively.

Pursuant to a Collateral Management Agreement dated June 26, 2014, the Company serves as collateral manager of the Arlington Program. The Company is entitled to receive a fee, which will accrue quarterly based on the fee basis amount in arrears payable on each payment date. For the three and nine months ended September 30, 2016, the Arlington Program’s collateral management fee was \$0.5 million and \$1.5 million, respectively, and for the three and nine months ended September 30, 2015, the Arlington Program’s collateral management fee was \$0.5 million and \$1.5 million, respectively.

Pursuant to an Investment Management Agreement dated August 3, 2005, the Company serves as investment manager of the NewStar Credit Opportunities Fund, Ltd. (the “Fund”), a Cayman Islands exempted company limited by shares incorporated under the provisions of The Companies Law of the Cayman Islands. The Fund pays the Company a fee when cash is distributed to its investors. For the three and nine months ended September 30, 2016, the Fund paid the Company zero and \$0.1 million, respectively, and for the three and nine months ended September 30, 2015, the Fund paid the Company \$0.1 million and \$0.1 million, respectively.

Note 17. Subsequent Events

Term Debt Securitization Redemption

On October 17, 2016, the remaining 2015-1 ABS Class A and Class B notes (all of which NewStar retained) with an outstanding balance of \$9.7 million and \$12.8 million, respectively, were repaid in full. The Company accelerated and recognized deferred financing fees of \$1.1 million related to the repayment of the 2015-1 ABS.

Share Repurchase

On October 21, 2016, the Company’s Board of Directors authorized the repurchase of 2.5 million shares of the Company’s common stock in privately negotiated transactions outside of the Company’s previously announced stock repurchase program.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion contains forward-looking statements. Important factors that may cause actual results and circumstances to differ materially from those described in such statements are described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015, as well as throughout this Item 2. You are cautioned not to place undue reliance on the forward-looking statements contained in this document. These statements speak only as of the date of this document, and we undertake no obligation to update or revise these statements, except as may be required by law.

Overview

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

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

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

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

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

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

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

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

Market Conditions

Market conditions in segments of the loan market we target were mixed in the third quarter as middle market loan volume decreased slightly compared to last quarter while pricing increased. According to Thomson Reuters, overall

middle market loan volume in the third quarter was \$28 billion versus \$33 billion last quarter and versus \$32 billion in the same period last year. The volume represented by new middle market transactions, as opposed to refinancing transactions, was flat in the third quarter at \$14, relative to both the previous quarter and the same quarter last year. Refinancing volume decreased in the third quarter to \$14 billion from \$19 billion in the prior quarter and decreased from \$18 billion in the same period last year. As a percentage of total middle market volume, new transactions increased to 50% versus 43% last quarter and versus 43% in the same period last year.

The pricing environment in our primary target market improved slightly in the third quarter of this year as middle market loan yields were up to 6.7% from 6.3% last quarter and up from 6.2% in the same quarter last year. Middle market loan yields continue to exhibit a premium versus large corporate loans. Loan yields in the large corporate market were down to 5.2% in the third quarter from 5.5% last quarter but were up from 5.1% in the same quarter last year.

Our direct lending platforms provide us with certain flexibility to allocate capital and redirect our origination focus to market segments with the most favorable conditions in terms of demand and relative value. We believe that the yields on our new loan origination will continue to reflect a combination of these broad market trends and shifts in the mix of loans we originate.

Conditions in our core funding markets continued to improve in the third quarter since the beginning of the year when broader market uncertainty, soft CLO equity demand and regulatory constraints weighed on CLO pricing and volume. Conditions have improved in the third quarter, however, and we believe conditions will continue to improve throughout 2016 and into 2017 as industry-specific concerns and regulatory constraints are addressed and investors continue to favor high-yielding, shorter duration floating rate bank loans and CLO bonds over fixed rate debt.

Despite increasing momentum in the second and third quarters of 2016, U.S. CLO year-to-date issuance of \$46 billion remains behind last year's \$76 billion pace through the same period. Volume of \$20 billion in the third quarter represented a 9% increase versus the same quarter last year, as well as an increase versus the \$18 billion issued last quarter. Total U.S. CLO issuance in 2015, 2014 and 2013 was approximately \$99 billion, \$124 billion and \$81 billion, respectively. Due to interest rate uncertainty, remaining industry-specific loan concerns and regulatory constraints, CLO credit spreads widened through the second half of 2015 and beginning of 2016 but have since reversed and continue to improve through the third quarter of 2016 as investors gain comfort with these issues. We believe marginal funding costs will be somewhat range bound at current levels until investors reset rate/return expectations and resolve regulatory issues. Despite the trend in the pricing environment, we believe that market conditions remain supportive for experienced managers such as NewStar to issue new CLOs. We also believe the availability and cost of warehouse financing among banks remains accommodative as more banks have begun to provide this type of financing and existing providers expand their lending activity. As a result, we believe that the terms and conditions for financings available to established firms like NewStar will continue to be supportive.

Loan demand in the middle market is strongly influenced by the level of refinancing, acquisition activity and private investment, which is driven largely by changes in the perceived risk environment, prevailing borrowing rates and private investment activity. Despite these factors being generally less favorable than past quarters, we originated \$193 million of new loans and leases at attractive yields and purchased \$234 million of loans in the third quarter, slightly down from \$476 million last quarter. With attractive pricing, leverage below the broader loan market, and equity contributions increasing, conditions in our primary target markets continued to remain favorable relative to the broader loan market. We anticipate that demand for loans and leases offered by the Company and conditions in our lending markets will remain supportive through 2016 and continue to provide opportunities for us to increase our origination volume.

Recent Developments

Assets and Liabilities Held for Sale

In September 2016, the Company commenced a process to sell the leasing line of business, Equipment Finance. As of that date the assets and liabilities associated with Equipment Finance met the held-for-sale criteria and were transferred to held-for-sale on the consolidated balance sheet.

Liquidity

On October 17, 2016, the remaining 2015-1 ABS Class A and Class B notes (all of which we retained) with an outstanding balance of \$9.7 million and \$12.8 million, respectively, were repaid in full. The Company accelerated and recognized deferred financing fees of \$1.1 million related to the repayment of the 2015-1 ABS.

On September 15, 2016, NewStar Capital completed an \$409.8 million broadly syndicated loan securitization and issued \$370.3 million of notes backed by cash, specific loans and investments. Arch Street CLO permits reinvestment of collateral principal repayments for a four-year period ending in October 2020. The Notes are expected to mature in October 2028.

On September 15, 2016, we repaid the \$350.0 million note purchase agreement with Credit Suisse that provided the financing to fund the purchase of broadly syndicated bank loans during the warehouse phase of the Arch Street CLO.

The supplemental junior note commitment by NewStar Capital, was also repaid in full. The notes were repaid from proceeds of the Arch Street CLO bond issuance.

On August 29, 2016, we redeemed in full the five-year, \$68.0 million financing arrangement with Macquarie Bank Limited with an outstanding balance of \$10.7 million.

Stock Repurchase

On October 21, 2016, the Company's Board of Directors authorized the repurchase of 2.5 million shares of the Company's common stock in privately negotiated transactions outside of the Company's previously announced stock repurchase program.

RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2016 AND 2015

NewStar's basic and diluted income per share for the three months ended September 30, 2016 was \$0.19, on net income of \$8.6 million. Our basic and diluted income per share was \$0.38 for the nine months ended September 30, 2016 on net income of \$17.9 million. This compares to basic and diluted income per share for the three months ended September 30, 2015 of \$0.11, on net income of \$5.1 million and basic and diluted income per share for the nine months ended September 30, 2015 of \$0.27 and \$0.26, respectively, on net income of \$12.7 million. Our managed portfolio was \$6.7 billion at September 30, 2016 compared to \$6.9 billion at December 31, 2015.

Loan portfolio yield

Loan portfolio yield, which is interest income on our loans and leases divided by the average balances outstanding of our loans and leases, was 6.77% and 6.38% for the three and nine months ended September 30, 2016 and 6.32% and 6.19% for the three and nine months ended September 30, 2015, respectively. The increase in loan portfolio yield was primarily driven by an increase in our average yield on interest earning assets from new loan and lease origination and re-pricings subsequent to September 30, 2015. In addition during the quarter ended September 30, 2016 we had a nonperforming loan pay off at par on which we recognized \$3.2 million of interest income.

Net interest margin

Net interest margin, which is net interest income divided by average interest earning assets, was 2.50% and 2.25% for the three and nine months ended September 30, 2016 and 2.57% and 2.35% for the three and nine months ended September 30, 2015, respectively. The primary factors impacting net interest margin for both the three and nine months ended September 30, 2016 were an increase in our average yield on interest earning assets due to the recognition of interest income on a nonperforming loan that was paid off at par, and the acceleration of amortization of deferred fees from loans paid off during the quarter, which were offset by higher interest expense associated with our Subordinated Notes and Senior Notes. The primary factors impacting net interest margin for the three months ended September 30, 2015 were higher income from debt securities, normalization of interest expense after prior quarter acceleration of deferred financing costs and a mix of CLO liabilities. The primary factors impacting net interest margin for the nine months ended September 30, 2015 were the acceleration of amortization of \$3.6 million of deferred financing fees related to the payoff of the corporate credit facility with Fortress Credit Corp. using a portion of the proceeds from the issuance of Senior Notes, the composition of interest earning assets, non-accrual loans, changes in three-month LIBOR, credit spreads and cost of borrowings. Excluding the \$3.6 million of accelerated amortization of deferred financing fees, the net interest margin for the nine months ended September 30, 2015 would have been 2.49%.

Operating expenses as a percentage of average total assets

Operating expenses as a percentage of average total assets was 1.76% and 1.58% for the three and nine months ended September 30, 2016 and 1.45% and 1.43% for the three and nine months ended September 30, 2015, respectively. The increase for the three months ended September 30, 2016 as compared to the three months ended September 30, 2015 was primarily due to an increase in compensation expense of \$3.6 million. During the three months ended September 30, 2016, we recognized \$4.2 million related to severance expense in connection with cost saving initiatives. The increase for the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015 was primarily related to an increase in compensation expense of \$8.6 million primarily related to \$4.2 million in severance costs, a \$2.2 million increase in incentive and equity compensation and an increase in health care costs. General and administrative expense also increased \$4.3 million, primarily associated with strategic initiative costs related to the sale of Business Credit, the potential sale of Equipment Finance and other short term projects.

Operating expenses as a percentage of average assets under management

Operating expenses as a percentage of average assets under management was 1.09% and 0.95% for the three and nine months ended September 30, 2016 and 1.21% and 1.19% for the three and nine months ended September 30, 2015, respectively. The decrease for the three and nine months ended September 30, 2016 as compared to the three and nine months ended September 30, 2015 was primarily due to a combination of acquisition activity and organic growth in assets under management.

Efficiency ratio

Our efficiency ratio, which is total operating expenses divided by net interest income before provision for credit losses plus total non-interest income, was 49.88% and 46.51% for the three and nine months ended September 30, 2016 and 50.07% and 49.05% for the three and nine months ended September 30, 2015, respectively. The decrease in our efficiency ratio for the three months ended September 30, 2016 as compared to the three months ended September 30, 2015 was primarily related to non-interest income activity. During the three months ended September 30, 2016, we recorded a positive mark-to-market adjustment on the loans carried at fair

value and an increase in asset management fee income. Our efficiency ratio was further impacted by an increase in operating expense of \$4.7 million, primarily related to \$4.2 million in severance related expenses and an increase in professional services. The decrease in our efficiency ratio for the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015 was also primarily related to non-interest income activity. During the first quarter of 2016, we sold Business Credit which resulted in a gain of \$22.5 million, and asset management income increased \$7.4 million from the same period in the previous year as a result of the acquisition of NewStar Capital. This was offset by \$4.8 million of losses related to fair value adjustments to loans-held-for sale and an additional loss of \$8.1 million on the TRS portfolio. Our efficiency ratio was further impacted by an increase in operating expenses of \$12.9 million, comprised primarily of \$4.2 million of severance related costs, a \$2.2 million increase in incentive and equity compensation costs and strategic initiative costs of \$2.8 million.

Allowance for credit losses ratio

Allowance for credit losses ratio, which is allowance for credit losses divided by outstanding gross loans and leases excluding loans held-for-sale and fair value portfolios, was 2.29% at September 30, 2016 and 1.81% as of December 31, 2015. The increase in the allowance for credit losses ratio from December 31, 2015 is primarily due to an increase in the specific allowance related to the deterioration of four credits during the first quarter of the year. Each situation reflected a unique set of facts and circumstances that drove the timing and amount of losses recognized in the quarter. During the three months ended September 30, 2016, we recorded \$3.2 million of specific provision for credit losses bringing the year to date specific provision for credit losses on impaired loans to \$22.3 million. During the three months ended September 30, 2016 we had a small recovery of \$0.05 million bringing the year to date charge-offs to \$14.2 million. At September 30, 2016, the specific allowance for credit losses was \$36.2 million, and the general allowance for credit losses was \$30.2 million. At December 31, 2015, the specific allowance for credit losses was \$26.8 million, and the general allowance for credit losses was \$31.9 million. We continually evaluate our allowance for credit losses methodology. If we determine that a change in our allowance for credit losses methodology is advisable, as a result of the changes in the economic environment or otherwise, the revised allowance methodology may result in higher or lower levels of allowance.

Delinquent loan rate

Delinquent loan rate, which is total delinquent loans net of charge offs with outstanding cash receivables that are 60 days or more past due, divided by outstanding gross loans and leases, was 0.50% as of September 30, 2016 as compared to 0.84% as of December 31, 2015. We had delinquent loans with an outstanding balance of \$16.3 million and \$27.2 million as of September 30, 2016 and December 31, 2015, respectively. The decrease is the result of the final resolution of a legacy loan. We expect the delinquent loan rate to correlate to current economic conditions. During times of economic expansion we expect the rate to decline, and during times of economic contraction, we expect the rate to increase, although actual results may vary.

Delinquent loan rate for accruing loans 60 days or more past due

Delinquent loan rate for accruing loans 60 days or more past due is defined as, total delinquent accruing loans net of charge offs with outstanding cash receivables that are 60 days or more past due and less than 90 days past due, divided by outstanding gross loans and leases. At September 30, 2016, we did not have any delinquent accruing loans. At December 31, 2015, we had one loan in this category past its stated maturity that was in the process of being amended, with a balance of \$8.5 million.

Non-accrual loan rate

Non-accrual loan rate is defined as total balances outstanding of loans on non-accrual status divided by the total outstanding balance of our loans and leases held for investment. Loans are put on non-accrual status if they are 90 days or more past due or if management believes it is probable that the Company will be unable to collect contractual

principal and interest in the normal course of business. The non-accrual loan rate was 2.66% as of September 30, 2016 and 3.43% as of December 31, 2015. As of September 30, 2016 and December 31, 2015, the aggregate outstanding balance of non-accrual loans was \$87.3 million and \$111.3 million, respectively and total outstanding loans and leases held for investment was \$3.3 billion at September 30, 2016 and \$3.2 billion at December 31, 2015.

Non-performing asset rate

Non-performing asset rate is defined as the sum of total balances outstanding of loans on non-accrual status, other real estate owned ("OREO") and other repossessed assets, divided by the sum of the total outstanding balance of our loans and leases held for investment and other real estate owned. The non-performing asset rate was 3.12% as of September 30, 2016 and 3.44% as of December 31, 2015. As of September 30, 2016 and December 31, 2015, the sum of the aggregate outstanding balance of non-performing assets was \$102.9 million and \$111.5 million, respectively. During the three months ended September 30, 2016, we transferred \$15.8 million of the impaired real estate loan that was previously held-for-sale into OREO.

50

Net charge off rate (end of period loans and leases)

Net charge off rate as a percentage of end of period loan and lease portfolio is defined as annualized charge-offs net of recoveries divided by the total outstanding balance of our loans and leases held for investment. A charge-off occurs when management believes that all or part of the principal of a particular loan is no longer recoverable and will not be repaid. Typically a charge-off occurs in a period after a loan has been identified as impaired and a specific allowance has been established. The net charge-off rate was (0.01%) and 0.58% for the three and nine months ended September 30, 2016 and zero and 0.17% for the three and nine months ended September 30, 2015, respectively. During the three and nine months ended September 30, 2016, we had a small recovery and net charge offs of \$14.2 million, respectively. During the three months ended September 30, 2015, we did not record any charge-offs or recoveries, and during the nine months ended September 30, 2015 we recorded net partial charge-offs of \$3.9 million.

Net charge off rate (average period loans and leases)

Net charge off rate as a percentage of average period loan and lease portfolio is defined as annualized charge-offs net of recoveries divided by the average total outstanding balance of our loans and leases held for investment for the period. The net charge-off rate was zero and 0.50% for the three and nine months ended September 30, 2016 and zero and 0.18% for the three and nine months ended September 30 2015, respectively.

Return on average assets

Return on average assets, which is net income divided by average total assets, was 0.84% and 0.59% for the three and nine months ended September 30, 2016 and 0.56% and 0.52% for the three and nine months ended September 30, 2015, respectively.

Return on average equity

Return on average equity, which is net income divided by average equity, was 5.16% and 3.61% for the three and nine months ended September 30, 2016 and 3.10% and 2.58% for the three and nine months ended September 30, 2015, respectively.

Review of Consolidated Results

A summary of our consolidated financial results for the three and nine months ended September 30, 2016 and 2015 follows:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(\$ in thousands)			
Net interest income:				
Interest income	\$65,155	\$54,574	\$186,499	\$141,194
Interest expense	39,897	31,345	117,816	84,764
Net interest income	25,258	23,229	68,683	56,430
Provision for credit losses	3,570	4,534	24,906	14,720
Net interest income after provision for credit losses	21,688	18,695	43,777	41,710
Non-interest income (loss):				
Asset management income	3,353	1,019	10,337	2,954

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

Fee income	2,946	4,573	5,836	10,508
Realized loss on derivatives	(13)	(5)	(31)	(24)
Realized (loss) gain on sale of loans, net	(19)	360	36	314
Other miscellaneous income, net	4,231	665	7,195	2,772
Loss on total return swap	—	(3,035)	(6,062)	(971)
Gain (loss) on loans held-for-sale, net	468	(85)	(5,345)	(506)
Gain on sale of Business Credit, net	—	—	22,511	—
Total non-interest income	10,966	3,492	34,477	15,047
Operating expenses:				
Compensation and benefits	13,175	9,561	32,640	24,004
General and administrative expenses	4,894	3,819	15,337	11,052
Total operating expenses	18,069	13,380	47,977	35,056
Income before income taxes	14,585	8,807	30,277	21,701
Income tax expense	5,941	3,665	12,383	9,020
Net income	\$8,644	\$5,142	\$17,894	\$12,681

51

Comparison of the Three Months Ended September 30, 2016 and 2015

Interest income. Interest income increased \$10.6 million, to \$65.2 million for the three months ended September 30, 2016 from \$54.6 million for the three months ended September 30, 2015. The increase was primarily due to an increase in the average balance of our interest earning assets to \$4.0 billion from \$3.6 billion primarily due to new loan originations and an increase in the yield on average interest earning assets to 6.45% from 6.05%. In addition, during the quarter ended September 30, 2016 we had a nonperforming loan pay off at par on which we recognized \$3.2 million of interest income previously not recognized.

Interest expense. Interest expense increased \$8.6 million, to \$39.9 million for the three months ended September 30, 2016 from \$31.1 million for the three months ended September 30, 2015. The increase is primarily due to an increase in leverage and higher cost of funds. The average balance of our interest bearing liabilities increased to \$3.4 billion from \$2.9 billion. The average cost of funds increased to 4.67% from 4.31%.

Net interest margin. Net interest margin decreased to 2.50% for the three months ended September 30, 2016 from 2.57% for the three months ended September 30, 2015. The primary factors impacting net interest margin was higher interest expense associated with our Subordinated Notes and Senior Notes, the composition of interest earning assets, non-accrual loans and credit spreads.

The following table summarizes the yield and cost of interest earning assets and interest bearing liabilities for the three months ended September 30, 2016 and 2015:

	Three Months Ended September 30, 2016			Three Months Ended September 30, 2015		
	(\$ in thousands)					
	Interest	Average		Interest	Average	
	Average	Income/	Yield/	Average	Income/	Yield/
	Balance	Expense	Cost	Balance	Expense	Cost
Total interest earning assets	\$4,019,721	\$65,155	6.45 %	\$3,579,431	\$54,574	6.05 %
Total interest bearing liabilities	3,399,977	39,897	4.67 %	2,882,669	31,345	4.31 %
Net interest spread		\$25,258	1.78 %		\$23,229	1.74 %
Net interest margin			2.50 %			2.57 %

Provision for credit losses. The provision for credit losses decreased \$0.9 million to \$3.6 million for the three months ended September 30, 2016 from \$4.5 million for the three months ended September 30, 2015. During the three months ended September 30, 2016, we recorded net specific provisions for impaired loans of \$3.2 million compared to \$1.6 million for the three months ended September 30, 2015. During the three months ended September 30, 2016, we recorded a general provision of \$336 thousand compared to \$2.9 million for the three months ended September 30, 2015. Our general allowance for credit losses covers estimated incurred losses in our loan and lease portfolio with respect to loans and leases that are not impaired and for which no specific impairment has been identified. A specific provision for credit losses is recorded with respect to loans for which it is probable that we will be unable to collect all amounts due in accordance with the contractual terms of the loan agreement for which there is impairment recognized.

The Company employs a variety of internally developed and third-party modeling and estimation tools for measuring credit risk, which are used in developing an allowance for loan and lease losses on outstanding loans and leases. The Company's allowance framework addresses economic conditions, capital market liquidity and industry circumstances from both a top-down and bottom-up perspective. The Company considers and evaluates a number of factors, including but not limited to, changes in economic conditions, credit availability, industry, loss emergence period, and multiple obligor concentrations in assessing both probabilities of default and loss severities as part of the general component of the allowance for loan and lease losses.

On at least a quarterly basis, loans and leases are internally risk-rated based on individual credit criteria, including loan and lease type, loan and lease structures (including balloon and bullet structures common in the Company's Leveraged Finance and Real Estate loans), borrower industry, payment capacity, location and quality of collateral if any (including the Company's Real Estate loans). Borrowers provide the Company with financial information on either a monthly or quarterly basis. Ratings, corresponding assumed default rates and assumed loss severities are dynamically updated to reflect any changes in borrower condition or profile.

For Leveraged Finance loans and Equipment Finance products (prior to transfer to held-for-sale), the data set used to construct probabilities of default in the Company's allowance for loan losses model, Moody's CRD Private Firm Database, primarily contains middle market loans that share attributes similar to the Company's loans. The Company also considers the quality of the loan or lease terms and lender protections in determining a loan loss in the event of default.

Prior to the sale of Business Credit, the Company utilized a proprietary model to risk rate the asset based loans on a monthly basis. This model captured the impact of changes in industry and economic conditions as well as changes in the quality of the

borrower's collateral and financial performance to assign a final risk rating. The Company also evaluated historical loss trends by risk rating from a comprehensive industry database that covered more than twenty-five years of experience of the majority of the asset based lenders operating in the United States. Based upon the monthly risk rating from the model, the reserve was adjusted to reflect the historical average for expected loss from the industry database.

For Real Estate loans, the Company employs two mechanisms to capture the impact of industry and economic conditions. First, a loan's risk rating, and thereby its assumed default likelihood, can be adjusted to account for overall commercial real estate market conditions. Second, to the extent that economic or industry trends adversely affect a substandard rated borrower's loan-to-value ratio enough to impact its repayment ability, the Company applies a stress multiplier to the loan's probability of default. The multiplier is designed to account for default characteristics that are difficult to quantify when market conditions cause commercial real estate prices to decline.

The Company periodically reviews its allowance for credit loss methodology to assess any necessary adjustments based upon changing economic and capital market conditions. If the Company determines that changes in its allowance for credit losses methodology are advisable, as a result of changes in the economic environment or otherwise, the revised allowance methodology may result in higher or lower levels of allowance. At December 31, 2015 the Company enhanced its approach for determining the expected exposure at default to more precisely reflect loan and lease exposures. Actual losses under the Company's current or any revised allowance methodology may differ materially from the Company's estimate.

Additionally, when determining the amount of the general allowance, the Company supplements the base amount with an environmental reserve amount which is governed by a score card system comprised of seven risk factors. The risk factors are designed based on those outlined in the Comptrollers of the Currency's Allowance for Loan and Lease Losses Handbook. In 2015, the scoring system of the environmental reserve risk factors was recalibrated to align with the enhancement made to the approach for determining the exposure at default. The Company also performs a ratio analysis of comparable money center banks, regional banks and finance companies. While the Company does not rely on this peer group comparison to set the level of allowance for credit losses, use of the peer group does assist management in identifying market trends and serves as an overall reasonableness check on the allowance for credit losses computation.

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

Impaired loans at September 30, 2016 were in Leveraged Finance and Real Estate over a range of industries impacted by the then current economic environment including the following: Media and Communications, Industrial, Commercial Real Estate, Other Business Services, Consumer/Retail, and Building Materials. For impaired Leveraged Finance loans, the Company measured impairment based on expected cash flows utilizing relevant information provided by the borrower and consideration of other market conditions or specific factors impacting recoverability. Such amounts are discounted based on original loan terms. For impaired Real Estate loans, the Company determined that the loans were collateral dependent and measured impairment based on the fair value of the related collateral utilizing recent appraisals from third-party appraisers, as well as internal estimates of market value. As of September 30, 2016, we had impaired loans and leases with an aggregate outstanding balance of \$156.9 million.

Impaired loans with an aggregate outstanding balance of \$137.6 million have been restructured and classified as TDRs. At September 30, 2016, the Company had a \$36.2 million specific allowance for impaired loans with an aggregate outstanding balance of \$105.1 million. As of September 30, 2016, we had one restructured impaired loan which had an outstanding balance greater than \$20 million in addition to one restructured impaired loan which had an outstanding balance greater than \$30 million. In each of these cases, we added to our position to maximize our potential recovery of the outstanding principal.

Non-interest income. Non-interest income increased \$7.5 million, to \$11.0 million for the three months ended September 30, 2016 from \$3.5 million for the three months ended September 30, 2015. The increase in non-interest income was primarily a result of an increase of \$2.3 million in asset management fees and a \$3.4 million positive mark-to-market adjustment on loans held at fair value, no loss recognized on the total return swap compared to a \$3.0 million loss on the total return swap for the three months ended September 30, 2015 offset by a decrease of \$1.6 million in fee income.

As a result of certain of our troubled debt restructurings, we have received equity interests in several of our impaired borrowers. The equity interests in certain impaired borrowers is initially recorded at fair value when the debt is restructured and is subsequently analyzed at the end of each quarter. In situations where we determine the fair value has declined from the initial fair value recorded, we write-down the value of the equity interest in non-interest income. These equity interests may give rise to potential capital gains or

losses, for tax purposes. This could impact future period tax rates depending on our ability to recognize capital losses to the extent of any capital gains.

Operating expenses. Operating expenses increased \$4.7 million, to \$18.1 million for the three months ended September 30, 2016 from \$13.4 million for the three months ended September 30, 2015. Compensation and benefits expense increased \$3.6 million primarily due to severance costs associated with a reduction in staffing levels to streamline operations. General and administrative expenses increased \$1.1 million primarily related to an increase in professional fees.

Income taxes. For the three months ended September 30, 2016 and 2015, we provided for income taxes based on an effective tax rate of 41% in each period.

As of September 30, 2016 and December 31, 2015, we had net deferred tax assets of \$29.9 million and \$33.1 million, respectively. In assessing if we will be able to realize our deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. We considered all available evidence, both positive and negative, in determining the realizability of deferred tax assets at September 30, 2016. We considered carryback availability, the scheduled reversals of deferred tax liabilities, projected future taxable income during the reversal periods, and tax planning strategies in making this assessment. We also considered our recent history of taxable income, trends in our earnings and tax rate, positive financial ratios, and the current economic environment (including the impact of credit on allowance and provision for loan losses, and the impact on funding levels). Based upon our assessment, we believe that a valuation allowance was not necessary as of September 30, 2016. As of September 30, 2016, our deferred tax asset was primarily comprised of \$31.9 million related to our allowance for credit losses and \$11.7 million related to equity compensation, which was partially offset by deferred tax liabilities of \$14.1 million related to our Equipment Finance portfolio.

Comparison of the Nine Months Ended September 30, 2016 and 2015

Interest income. Interest income increased \$45.3 million, to \$186.5 million for the nine months ended September 30, 2016 from \$141.2 million on a consolidated basis for the nine months ended September 30, 2015. The increase was primarily due to an increase in the average balance of our interest earning assets to \$4.1 billion from \$3.2 billion primarily due to new loan originations subsequent to September 30, 2015 and an increase in the yield on average interest earning assets to 6.10% from 5.87%. In addition, during the quarter ended September 30, 2016 we had a nonperforming loan pay off at par on which we recognized \$3.2 million of interest income previously not recognized.

Interest expense. Interest expense increased \$33.0 million, to \$117.8 million for the nine months ended September 30, 2016 from \$84.8 million on a consolidated basis for the nine months ended September 30, 2015. The increase is primarily due to an increase in leverage and higher costs of funds. The average balance of our interest bearing liabilities increased to \$3.4 billion from \$2.6 billion, and an increase in the average cost of funds to 4.62% from 4.35%, primarily due to increased borrowings under the Subordinated Notes and Senior Notes. This was offset by the acceleration of amortization of \$3.6 million of deferred financing fees related to the payoff of the corporate credit facility with Fortress Credit Corp. during the nine months ended September 30, 2015.

Net interest margin. Net interest margin decreased to 2.25% for the nine months ended September 30, 2016 from 2.35% for the nine months ended September 30, 2015. The decrease in net interest margin was primarily due to the shift in the mix of debt and the issuance of higher cost long-term debt during the first quarter of 2016. The net interest spread, the difference between gross yield on our interest earning assets and the total cost of our interest bearing liabilities, decreased to 1.48% from 1.52%.

The following table summarizes the yield and cost of interest earning assets and interest bearing liabilities for the nine months ended September 30, 2016 and 2015:

	Nine Months Ended September 30, 2016 (\$ in thousands)			Nine Months Ended September 30, 2015		
	Interest Average	Income/ Expense	Yield/ Cost	Interest Average	Income/ Expense	Yield/ Cost
Total interest earning assets	\$4,082,501	\$186,499	6.10 %	\$3,214,755	\$141,241	5.87 %
Total interest bearing liabilities	3,405,781	117,816	4.62 %	2,602,713	84,764	4.35 %
Net interest spread		\$68,683	1.48 %		\$56,477	1.52 %
Net interest margin			2.25 %			2.35 %

Provision for credit losses. The provision for credit losses increased \$10.2 million to \$24.9 million for the nine months ended September 30, 2016 from \$14.7 million for the nine months ended September 30, 2015. The increase in the provision was primarily

due to an increase in specific provisions recorded during the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015, partially offset by a decrease in general provisions. During the nine months ended September 30, 2016, we recorded net specific provisions for impaired loans of \$22.3 million compared to \$7.1 million recorded during the nine months ended September 30, 2015. The net specific component of the provision for credit losses was primarily due to the deterioration of four credits during the first quarter of 2016.

Non-interest income. Non-interest income increased \$19.5 million, to \$34.5 million for the nine months ended September 30, 2016 from \$15.0 million on a consolidated basis for the nine months ended September 30, 2015. The increase in non-interest income was primarily due to a \$22.5 million gain on the sale of Business Credit that occurred during the first quarter of 2016, an increase of \$7.4 million in asset management fees, a \$3.4 million positive mark-to-market adjustment on the loans held at fair value offset by a \$5.1 million increase in loss on the TRS portfolio, a \$4.8 million increase in loss recognized on loans held-for-sale and a \$4.7 million decline in capital market fee income from the same period in the previous year.

As a result of certain of our troubled debt restructurings, we have received equity interests in several of our impaired borrowers. The equity interests in certain impaired borrowers is initially recorded at fair value when the debt is restructured and is subsequently analyzed at the end of each quarter. The equity interests in certain impaired borrowers is initially recorded at fair value when the debt is restructured and is subsequently analyzed at the end of each quarter. In situations where we determine the fair value has declined from the initial fair value recorded, we write-down the value of the equity interest in non-interest income. These equity interests may give rise to potential capital gains or losses, for tax purposes. This could impact future period tax rates depending on our ability to recognize capital losses to the extent of any capital gains.

Operating expenses. Operating expenses increased \$12.9 million, to \$48.0 million for the nine months ended September 30, 2016 from \$35.1 million on a consolidated basis for the nine months ended September 30, 2015. Compensation and benefits expense increased \$8.6 million, primarily the result of the acquisition of NewStar Capital and severance costs associated with a reduction in staffing levels to streamline operations. The remaining increase was the result of an increase in incentive, salaries and equity compensation from the nine months ended September 30, 2015. General and administrative expenses increased \$4.3 million, primarily the result of strategic initiative costs associated with the sale of Business Credit, the potential sale of Equipment Finance and other short term projects.

Income taxes. For the nine months ended September 30, 2016 and 2015, we provided for income taxes based on an effective tax rate of approximately 41% in each period.

Segment Reporting

NewStar manages its operations through two business segments, Commercial Lending and Asset Management.

Commercial Lending

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

The following table sets forth selected information with respect to assets within the Commercial Lending segment.

	September 30,	December 31,
	2016	2015
	(\$ in thousands)	
Loans and leases, gross	\$2,892,467	\$ 3,243,580
Loans held-for-sale, gross	435,351	485,874
Leases held-for-sale, gross (within Assets held-for-sale)	158,289	—
Total Commercial Lending Assets	\$3,486,107	\$ 3,729,454

The following table sets forth selected information with respect to the results of financial operations for the Commercial Lending segment.

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net interest income:	\$24,135	\$22,900	\$65,752	\$56,400
Provision for loan losses	3,570	4,534	24,906	14,720
Net interest income after provision	20,565	18,366	40,846	41,680
Noninterest income:				
Other lending fees	2,871	4,573	5,729	10,508
Gain/(loss) on sale of loans and equipment	83	692	545	825
Other noninterest income (loss)	1,059	(2,792)	13,819	760
Total noninterest income:	4,013	2,473	20,093	12,093
Non-interest expense	14,833	13,076	40,027	33,980
Income before income taxes	\$9,745	\$7,763	\$20,912	\$19,793

Comparison of the Three Months Ended September 30, 2016 and 2015

The Commercial Lending segment reported income before taxes of \$9.7 million for the three months ended September 30, 2016, compared to \$7.8 million for the same period in 2015. Net interest income increased \$1.2 million for the three months ended September 30, 2016 compared to the three months ended September 30, 2015, primarily as a result of an increase in average interest earning assets due to originations subsequent to September 30, 2015. The provision for loan loss amounted to \$3.6 million for the three months ended September 30, 2016 compared to \$4.5 million for the three months ended September 30, 2015. Noninterest income derived from the Commercial Lending segment totaled \$4.0 million for the three months ended September 30, 2016, up from \$2.5 million from the three months ended September 30, 2015. The increase in noninterest income was due to a loss of \$3.0 million recognized on the total return swap for the three months ended September 30, 2015 and a decrease in lending fees of \$1.7 million from the same period in 2015. Commercial Lending noninterest expenses for the three months ended September 30, 2016 increased by \$1.8 million from the same period in 2015.

Comparison of the Nine Months Ended September 30, 2016 and 2015

Net interest income for the segment increased \$9.4 million for the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015, primarily as a result of an increase in average interest earning assets as of result of loan originations subsequent to September 30, 2015.

We had a provision for loan losses of \$24.9 million for the nine months ended September 30, 2016, compared to a provision of \$14.7 million for the comparable period in 2015. The increase in the provision for loan losses was primarily driven by specific provisions of \$22.3 million recorded during the nine months ended September 30, 2016 as compared to \$7.1 million recorded the nine months ended September 30, 2015, partially offset by a decrease of \$5.0 million of general provisions.

Noninterest income for the segment increased by \$8.0 million for the nine months ended September 30, 2016 primarily as the result of the sale of Business Credit during the first quarter of 2016. The gain on sale was offset by of a loss of \$5.3 million recognized on loans held for sale and a \$6.1 million loss on the total return swap.

Noninterest expense for the segment increased by \$6.0 million for the nine months ended September 30, 2016 primarily due to an increase in transaction costs related to the sale of Business Credit, the potential sale of Equipment Fiance and an increase in compensation costs due to severance costs associated with a reduction in staffing levels to streamline operations.

Asset Management

The Asset Management segment includes credit funds managed by the Company and NewStar Capital. These credit funds focus on middle market loans, liquid tradeable credit and liquid loan strategies.

The following table sets forth selected information with respect to assets within the Asset Management segment.

56

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	September 30, 2016	December 31, 2015
	(\$ in thousands)	
Loans and leases, gross (at fair value)	\$389,260	\$ —
Investments in debt securities, available-for-sale, net of mark (1)	96,931	100,942
Illiquid Credit *	806,535	824,573
Liquid/Tradeable Credit *	1,873,646	2,294,497
Total Asset Management Assets	\$3,166,372	\$ 3,220,012

(1) Investment in debt securities gross of amortization of deferred fees, net of fair value adjustment.

*Assets managed by the Company for the Illiquid Credit and Liquid/Tradeable Credit Funds are not assets of the Company and are not included in the Consolidated Total Assets as reflected in the Condensed Consolidated Balance Sheet.

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(\$ in thousands)		(\$ in thousands)	
Net interest income	\$1,123	\$329	\$2,931	\$30
Provision for loan losses	—	—	—	—
Net interest income after provision	1,123	329	2,931	30
Noninterest income:				—
Management fees	2,888	1,019	9,031	2,954
Performance fees	465	—	1,306	—
Other lending fees	75	—	107	—
Gain/(loss) on sale of loans and equipment	69	—	220	—
Other noninterest income (1)	3,456	—	3,720	—
Total Noninterest income:	6,953	1,019	14,384	2,954
Non-interest expense	3,236	304	7,950	1,076
Income before income taxes	\$4,840	\$1,044	\$9,365	\$1,908

(1) Includes mark to mark adjustment on fair value portfolio.

Comparison of the Three Months Ended September 30, 2016 and 2015

The Asset Management segment reported income before taxes of \$4.8 million for the three months ended September 30, 2016, compared to \$1.0 million for the same period in 2015. Noninterest income was primarily the result of asset management and performance fee income of \$3.4 million for the three months ended September 30, 2016, up by \$2.3 million, compared to the same period in 2015. This increase is the result of our continued expansion of our asset management activities through new fund formation and the acquisition of NewStar Capital during the fourth quarter of 2015. Average AUM increased 51% from the same period in 2015.

Comparison of the Nine Months Ended September 30, 2016 and 2015

Noninterest income derived from the Asset Management segment was \$14.4 million for the nine months ended September 30, 2016, up by \$11.4 million, compared to the same period in 2015. This increase is the result of our continued expansion of our asset management activities through new fund formation and the acquisition of NewStar Capital during the fourth quarter of 2015. Noninterest expense increased by \$6.9 million for the nine months ended September 30, 2016 primarily as the result of the acquisition of NewStar Capital.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity consist of cash flow from operations, credit facilities, term debt securitizations and proceeds from equity and debt offerings. We believe that these sources will be sufficient to fund our current operations, lending activities and other short-term liquidity needs. In addition, we had \$429.7 million in net loans held-for-sale on our balance sheet at September 30, 2016, which we have the ability to sell to generate additional liquidity. Subject to market conditions, we continue to explore opportunities for the Company to increase its leverage, including through the issuance of high yield debt securities, convertible debt securities, share repurchases, secured or unsecured senior debt or revolving credit facilities, to support loan portfolio growth and/or strategic acquisitions, which may be material to us. In addition to opportunistic funding related to potential growth initiatives, our future liquidity needs will be determined primarily based on prevailing market and economic conditions, the credit performance of our

57

loan portfolio and loan origination volume. We may need to raise additional capital in the future based on various factors including, but not limited to: faster than expected increases in the level of non-accrual loans; lower than anticipated recoveries or cash flow from operations; and unexpected limitations on our ability to fund certain loans with credit facilities. We may not be able to raise debt or equity capital on acceptable terms or at all. The incurrence of additional debt will increase our leverage and interest expense, and the issuance of any equity or securities exercisable, convertible or exchangeable into Company common stock may be dilutive for existing shareholders.

During the third quarter, the U.S. economy continued to exhibit slow-to-moderate growth, and with uncertainty surrounding a number of economic issues, the third quarter saw varied results from leading economic indicators. Weak signals were seen in business equipment investment, housing and manufacturing, stable signals in labor and consumer spending, and positive signals in consumer confidence, exports, inflation and equities. We expect stable trends and slow-to-moderate growth in the U.S. to continue and monetary policy to remain conducive to gradual growth in the near term. We expect Treasury and investment grade bond rates to remain relatively low and investors to continue to focus on allocating capital to riskier, higher yielding, fixed and floating rate asset classes in order to generate additional yield from their investments. While the securitization market for loans (the CLO market) faces some lingering regulatory uncertainty, the market is improving and remains supportive for experienced CLO issuers such as NewStar. We believe that the CLO market, which the Company partially relies upon for funding, will stabilize in 2016 and improve into 2017. In addition, we believe the Company has substantially greater financial flexibility and increased financing options due to our market experience and improvement in our financial performance.

We believe that our ability to access the capital markets, secure new credit facilities, and renew and/or amend our existing credit facilities continues to demonstrate an overall improvement in the market conditions for funding and indicates progress in our ability to obtain financings on improved terms in the future. Despite these signs of improving market conditions and relative stability in recent years, we cannot assure these conditions will continue, and it is possible that the financial markets could experience stress, volatility, and/or illiquidity. If they do, we could face materially higher financing costs and reductions in leverage, which would affect our operating strategy and could materially and adversely affect our financial condition.

Cash and Cash Equivalents

As of September 30, 2016 and December 31, 2015, we had \$36.3 million and \$35.9 million, respectively, in cash and cash equivalents. We may invest a portion of cash on hand in short-term liquid investments. From time to time, we may use a portion of our unrestricted cash to pay down our credit facilities creating undrawn capacity which may be redrawn to meet liquidity needs in the future.

Restricted Cash

Separately, we had \$370.5 million and \$154.0 million of restricted cash as of September 30, 2016 and December 31, 2015, respectively. The restricted cash represents the balance of the principal and interest collections accounts and pre-funding amounts in our credit facilities, our term debt securitizations and customer holdbacks and escrows. The use of the principal collection accounts' cash is limited to funding the growth of our loan portfolio within the facilities or paying down related credit facilities or term debt securitizations. As of September 30, 2016, we could use \$232.1 million of restricted cash to fund new or existing loans. The interest collection account cash is limited to the payment of interest, servicing fees and other expenses of our credit facilities and term debt securitizations and, if either a ratings downgrade or failure to receive ratings confirmation occurs on the rated notes in a term debt securitization at the end of the funding period or if coverage ratios are not met, paying down principal with respect thereto. Cash to fund the growth of our loan portfolio and to pay interest on our term debt securitizations represented a large portion of our restricted cash balance at September 30, 2016. The increase in the restricted cash balance is primarily related to the new Arch Street CLO.

Cash Collateral on Deposit with Custodians

We had \$7.6 million and \$61.1 million of cash collateral posted with custodians at September 30, 2016 and December 31, 2015, respectively. These amounts represent cash posted as collateral to enhance the credit quality of the underlying referenced portfolio of loans in our total return swap (prior to the March 31, 2016 maturity) and repurchase agreements. At September 30, 2016, we had \$7.1 million posted against our JP Morgan Chase Bank repurchase agreement, \$0.3 million posted against our Citibank Global Markets repurchase agreement and \$0.2 million posted against our Natixis repurchase agreement. At December 31, 2015, \$56.5 million cash collateral was posted against our TRS with Citibank and \$4.6 million was posted against our JP Morgan Chase Bank repurchase agreement. The amount of cash posted as collateral under these credit agreements will vary from time to time as the market value of the underlying assets fluctuates with the changes in the market.

58

Investment in Debt Securities, Available- for- Sale

The fair value of investment in debt securities, available for sale is based on prices received from third parties and reviewed by our pricing and valuation committee. Our investment in debt securities, available for sale is considered Level 3. During the nine months ended September 30, 2016 and 2015, we did not purchase or sell any investment in debt securities available-for-sale. During the three months ended September 30, 2016, a \$6.0 million investment in debt securities was redeemed at par.

At September 30, 2016, the fair value of investment in debt securities, available for sale was \$90.8 million with a net unrealized loss of \$8.1 million, compared to a fair value of \$94.2 million and an unrealized loss of \$10.1 million at December 31, 2015.

As a result of our evaluation of the securities, we concluded that the unrealized losses at September 30, 2016 and December 31, 2015 were caused by changes in market prices driven by interest rates and credit spreads. Our evaluation of impairment include quotes from third parties, adjustments to prepayment speeds, delinquency, an analysis of expected cash flows, interest rates, market discount rates, other contract terms, and the timing and level of losses on the loans and leases within the underlying trusts. At September 30, 2016, we determined that it is not more likely than not that we will be required to sell the securities before we recover the amortized cost basis in the security. We have also determined that there has not been an adverse change in the cash flows expected to be collected. Based upon our impairment review process, and our ability and intent to hold these securities until maturity or a recovery of fair value, the decline in the value of these investments is not considered to be “Other Than Temporary.”

Loans-Held-for-Sale

Loans classified as held-for-sale consist of loans originated by us and intended to be sold to third parties (including credit funds managed by the Company).

These loans are carried at the lower of aggregate cost, net of any deferred origination costs or fees, or market value.

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

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

At September 30, 2016, loans held-for-sale include loans with an aggregate outstanding balance of \$433.3 million that were intended to be sold to credit funds managed by the Company. During the three months ended September 30, 2016, the Company foreclosed on the previously held-for-sale impaired real estate loan, simultaneous with the foreclosure, the Company sold a portion of the property for \$8.5 million and applied the proceeds to the principal loan balance. The remaining \$15.8 million was transferred to Other Real Estate Owned (“OREO”).

Asset Quality and Allowance for Loan and Lease Losses

If a loan is 90 days or more past due, or if management believes it is probable we will be unable to collect contractual principal and interest in the normal course of business, it is our policy to place the loan on non-accrual status. If a loan financed by a term debt securitization is placed on non-accrual status, the loan may remain in the term debt securitization and excess interest spread cash distributions to us will cease until cash accumulated in the term debt securitization equals the outstanding balance of the non-accrual loan, or if an overcollateralization test is present and the overcollateralization ratio is (or was previously) out of compliance with the target, excess interest spread cash is diverted, and used to de-lever the securitization to bring the ratio back into compliance. When a loan is on non-accrual status, accrued interest previously recognized as interest income subsequent to the last cash receipt in the current year will be reversed, and the recognition of interest income on that loan will stop until factors indicating doubtful collection no longer exist and the loan has been brought current. We may make exceptions to this policy if the loan is well secured and is in the process of collection. As of September 30, 2016, we had impaired loans with a balance of \$156.8 million. Impaired loans with an aggregate outstanding balance of \$137.6 million have been restructured and classified as troubled debt restructurings. Impaired loans with an aggregate outstanding balance of \$87.3 million were on non-accrual status. During the nine months ended September 30, 2016, we had net charge-offs totaling \$14.2 million of impaired loans. Impaired loans of \$16.3 million were greater than 60 days past due and classified as delinquent. During the nine months ended September 30, 2016, we recorded \$22.3 million of net specific provisions for impaired loans. Included in our specific allowance for impaired loans was \$4.4 million related to delinquent loans.

We closely monitor the credit quality of our loans and leases which are partly reflected in our credit metrics such as loan delinquencies, non-accruals, and charge-offs. Changes to these credit metrics are largely due to changes in economic conditions and seasoning of the loan and lease portfolio.

We have provided an allowance for loan and lease losses to provide for probable losses inherent in our loan and lease portfolio. Our allowance for loan and lease losses as of September 30, 2016 and December 31, 2015 was \$65.9 million and \$58.3 million, respectively, or 2.28% and 1.80% of loans and leases, gross, respectively. As of September 30, 2016 and December 31, 2015, we also had a \$0.5 million allowance for unfunded commitments, resulting in an allowance for credit losses of 2.29% of loans and leases, gross compared to 1.81% at December 31, 2015.

The allowance for credit losses is based on a review of the appropriateness of the allowance for credit losses and its two components on a quarterly basis. The estimate of each component is based on observable information and on market and third-party data believed to be reflective of the underlying credit losses being estimated.

It is the Company's policy to record a specific provision for credit losses for all loans for which we have identified impairments during the reporting period. We may charge-off the portion of the loan for which a specific provision was recorded. All of these loans are classified as impaired (if they have not been so classified already as a result of a troubled debt restructuring) and are disclosed in the Allowance for Credit Losses footnote to the financial statements.

Activity in the allowance for loan losses for the nine months ended September 30, 2016 and for the year ended December 31, 2015 was as follows:

	Nine Months Ended September 30, 2016	Year Ended December 31, 2015
	(\$ in thousands)	
Balance as of beginning of period	\$58,259	\$ 42,983
General provision for loan and lease losses	2,580	9,135
Specific provision for loan losses	22,292	9,495
Net charge offs	(14,154)	(3,354)
Reclass due to sale of Business Credit and transfer of Equipment Finance to Assets held-for-sale	(3,112)	—
Balance as of end of period	65,865	58,259
Allowance for losses on unfunded loan commitments	501	467
Allowance for credit losses	\$66,366	\$ 58,726

Borrowings and Liquidity

As of September 30, 2016 and December 31, 2015, we had net outstanding borrowings totaling \$3.5 billion. Borrowings under our various credit facilities and term debt securitizations are used to partially fund our positions in our loan portfolio.

As of September 30, 2016 our funding sources, maximum debt amounts, amounts outstanding and unused debt capacity, subject to certain covenants and conditions, are summarized below:

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

Funding Source	Maximum		Unused	Maturity
	Debt	Amounts	Debt	
	Amount	Outstanding	Capacity	
	(\$ in thousands)			
Credit facilities	\$865,000	\$502,200	\$362,800	2017-2020
Term debt securitizations(1)	2,349,726	2,349,726	—	2022-2028
Repurchase agreements	52,591	52,591	—	2017
Senior notes	380,000	380,000	—	2020
Subordinated notes	300,000	300,000	—	2024
Total	\$3,947,317	\$3,584,517	\$362,800	

(1) Maturities for term debt are based on contractual maturity dates. Actual maturities may occur earlier. We must comply with various covenants in our debt facilities. The breach of certain of these covenants could result in a termination event and the exercise of remedies if not cured. At September 30, 2016, we were in compliance with all such covenants. These covenants are customary and include, but are not limited to, failure to service debt obligations, failure to meet liquidity

covenants and tangible net worth covenants, and failure to remain within prescribed facility portfolio delinquency, charge-off levels, and overcollateralization tests.

Credit Facilities

As of September 30, 2016 we had two credit facilities through certain of our wholly-owned subsidiaries: (i) a \$615.0 million credit facility with syndicated lenders agented by Wells Fargo Bank, National Association (“Wells Fargo”) to fund leveraged finance loans, and (ii) a \$250.0 million credit facility with Citibank, N.A. (“Citibank”) to fund leveraged finance loans.

We have a \$615.0 million credit facility with syndicated lenders agented by Wells Fargo to fund leveraged finance loans. The credit facility had an outstanding balance of \$293.9 million and unamortized deferred financing fees of \$6.8 million as of September 30, 2016. In February 2016 and June 2016, we upsized this facility, which increased the commitment amount from \$475.0 million to \$615.0 million. Interest on this facility accrues at a variable rate per annum. This facility matures on August 10, 2020. The facility provides for a revolving reinvestment period which ends on August 10, 2018, with a two-year amortization period.

We have a \$250.0 million credit facility with Citibank to fund leveraged finance loans. The credit facility had an outstanding balance of \$208.3 million and unamortized deferred financing fees of \$2.6 million as of September 30, 2016. On August 5, 2015, we entered into an amendment to this facility which, among other things, increased the commitment amount to \$250.0 million. Interest on this facility accrues at a variable rate per annum. The facility matures on May 5, 2020. It provides for a revolving reinvestment period which ends on May 5, 2018, with a two-year amortization period.

As a result of the ongoing process to sell its leasing business, NewStar Equipment Finance, the note purchase agreement with Wells Fargo under the terms of which Wells Fargo agreed to provide a \$75.0 million credit facility to fund equipment leases and loans was reclassified to Liabilities held-for-sale. The credit facility had an outstanding balance of \$16.9 million and unamortized deferred financing fees of \$0.2 million as of September 30, 2016.

On September 15, 2016, we repaid the \$350.0 million note purchase agreement with Credit Suisse that provided financing to fund the purchase of broadly syndicated bank loans during the warehouse phase of the Arch Street CLO. The supplemental junior note commitment by NewStar Capital was also repaid in full. The notes were repaid from proceeds of the Arch Street CLO bond issuance.

On March 31, 2016, the Company sold its membership interest in NewStar Business Credit LLC (“Business Credit”). In connection with the sale, all outstanding indebtedness of Business Credit was repaid, including amounts outstanding under a \$175 million credit facility with a syndicate of lenders agented by DZ Bank AG Deutsche Zentral-Genossenschaftsbank Frankfurt (“DZ Bank”) with an outstanding balance of \$102.0 million, and the \$165.0 million credit facility with a syndicate of lenders agented by Wells Fargo with an outstanding balance of \$135.4 million, each of which was terminated. The Company accelerated and recognized deferred financing fees of \$1.1 million and \$0.7 million, respectively, related to the warehouse facilities during the first quarter of 2016.

Senior notes

On April 22, 2015, we issued \$300.0 million in aggregate principal amount of 7.25% Senior Notes due 2020 (the “2020 Notes”). On November 9, 2015, we issued an additional \$80.0 million in aggregate principal amount of 2020 Notes. The 2020 Notes issued on November 9, 2015 were issued at a debt discount of \$0.8 million which will amortize over the life of the 2020 Notes. We used a portion of the net proceeds from the April 2015 notes offering to repay in full our corporate credit facility with Fortress Credit Corp. The 2020 Notes mature on May 1, 2020, and bear interest at a rate of 7.25% per annum, which is payable semi-annually on May 1 and November 1 of each year. At any time prior to May 1, 2017, we may redeem up to 35% of the aggregate principal amount of the 2020 Notes with the net cash

proceeds of certain public equity offerings at a price equal to 107.25% of the aggregate principal amount so redeemed, plus accrued and unpaid interest thereon provided that immediately following the redemption, at least 65% of the 2020 Notes that were originally issued remain outstanding. Additionally, at any time prior to May 1, 2017, we may redeem some or all of the 2020 Notes at a price equal to 100% of the aggregate principal amount, plus accrued and unpaid interest thereon and a make-whole premium. On or after May 1, 2017, we may redeem the 2020 Notes, in whole or in part, at redemption prices specified in the 2020 Notes plus accrued and unpaid interest thereon. In addition, if we undergo a change of control, we will be required to make an offer to purchase each holder's 2020 Notes at a price equal to 101% of the principal amount of the 2020 Notes, plus accrued and unpaid interest. As of September 30, 2016, unamortized deferred financing fees were \$5.9 million.

We must comply with certain covenants and restrictions related to the 2020 Notes. Subject to certain exceptions, the indenture relating to the 2020 Notes restricts our ability to incur additional Non-Funding Indebtedness (as defined in the indenture) but permits the incurrence of indebtedness if on the date of such incurrence and after giving pro forma effect thereto, our Consolidated Non-Funding Debt to Equity Ratio (together with our Restricted Subsidiaries) is not greater than 1.75 to 1.00. Our Consolidated Non-Funding Debt to Equity Ratio is defined as the ratio of our Consolidated Non-Funding Debt (as defined in the indenture) of such person as of such determination date to our Consolidated Stockholders Equity (as defined in the indenture). If we fail to comply with

this and certain other covenants included in the senior notes indenture, it could constitute an event of default that could result in the acceleration of the payment of the aggregate principal amount of 2020 Notes then outstanding and accrued interest. At September 30, 2016 and currently, we were in compliance with all such covenants under the 2020 Notes indenture.

Subordinated notes

On December 4, 2014, we completed the initial closing of an investment of long-term capital from funds sponsored by Franklin Square Capital Partners ("Franklin Square") and sub-advised by GSO Capital Partners at which the Franklin Square funds purchased \$200.0 million of 10-year subordinated notes (the "Subordinated Notes"), which rank junior to our existing and future senior debt. During 2015, we drew an additional \$75 million of Subordinated Notes. We drew the remaining \$25 million in January 2016. The Subordinated Notes were recorded at par less the initial relative fair value of the warrants issued in connection with the investment in December 2014 and January 2015, which was \$55.4 million as of September 30, 2016 and \$60.0 million as of December 31, 2015. The debt discount will amortize over the life of the notes and will be recorded as non-cash interest expense as the Subordinated Notes accrete to par value. As of September 30, 2016, unamortized deferred financing fees were \$5.1 million. The Subordinated Notes bear interest at 8.25% and include a Payment-in-Kind ("PIK Toggle") feature that allows us, at our option, to elect to have interest accrued at a rate of 8.75% added to the principal of the Subordinated Notes instead of paying it in cash. The Subordinated Notes have a ten year term and mature on December 4, 2024. They are callable during the first three years with payment of a make-whole premium. The prepayment premium decreases to 103% and 101% after the third and fourth anniversaries of the closing, respectively. They are callable at par after December 4, 2019. Beginning on December 5, 2019, we are required to make a cash payment of principal plus accrued interest in an amount required to prevent the Subordinated Notes from being treated as an "Applicable High Yield Discount Obligation" within the meaning of Section 163(i)(1) of the Internal Revenue Code of 1986, as amended. Events of default under the Subordinated Notes include failure to pay interest or principal when due subject to applicable grace periods, material uncured breaches of the terms of the Subordinated Notes, and bankruptcy/insolvency events.

We are subject to certain covenants for so long as Franklin Square holds at least \$50 million aggregate principal amount of Subordinated Notes. During this period, (i) the percentage of our gross revenue derived from investment and asset management fees in any fiscal year may not exceed 15% of our gross revenues for such fiscal year and (ii) we may not incur or permit any subsidiary of ours to incur any Indebtedness (as defined in the Investment Agreement related to the Subordinated Notes), if on the date of such incurrence and after giving effect thereto on a pro forma basis, our Total Leverage Ratio would be greater than 5.50 to 1.00. Total Leverage Ratio is defined as the ratio of (i) all of our Indebtedness and the Indebtedness of our consolidated subsidiaries, except for Indebtedness of non-majority owned finance subsidiaries and the Subordinated Notes and other pari passu subordinated debt to (ii) our shareholders' equity plus the Subordinated Notes and such other pari passu subordinated debt.

Term Debt Securitizations

2007-1 CLO Trust. In June 2007, we completed a term debt securitization transaction. In conjunction with this transaction we established a separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Trust 2007-1 (the "2007-1 CLO Trust") and sold and contributed \$600.0 million in loans and investments (including unfunded commitments), or portions thereof, to the 2007-1 CLO Trust. We remain the servicer of the loans. Simultaneously with the initial sale and contribution, the 2007-1 CLO Trust issued \$546.0 million of notes to institutional investors. We retained \$54.0 million, comprising 100% of the 2007-1 CLO Trust's trust certificates. At September 30, 2016, the \$97.4 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$151.6 million. At September 30, 2016, deferred financing fees were expensed in full. The 2007-1 CLO Trust permitted reinvestment of collateral principal repayments for a six-year period which ended in May 2013. During 2012, we purchased \$0.2 million of the 2007-1 CLO Trust's Class C notes. During 2010, we purchased \$5.0 million of the 2007-1 CLO Trust's Class D notes. During 2009, we purchased \$1.0 million of the 2007-1 CLO Trust's Class D notes.

During 2009, Moody's downgraded all of the notes of the 2007-1 CLO Trust. As a result of the downgrade, amortization of the 2007-1 CLO Trust changed from pro rata to sequential, resulting in scheduled principal payments thereafter made in order of the notes' seniority until all available funds are exhausted for each payment.

We receive a loan collateral management fee and excess interest spread. We also receive payments with respect to the classes of notes we own in accordance with the transaction documents. We expect to receive a principal distribution as owner of the trust certificates when the term debt is retired. If loan collateral in the 2007-1 CLO Trust is in default under the terms of the indenture, the excess interest spread from the 2007-1 CLO Trust would not be distributed until the undistributed cash plus recoveries equals the outstanding balance of the defaulted loan or if we elected to remove the defaulted collateral.

The following table sets forth selected information with respect to the 2007-1 CLO Trust:

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	Notes	Outstanding balance originally issued (\$ in thousands)	September 30, 2016	Borrowing spread to LIBOR	
2007-1 CLO Trust					
Class A-1	\$ 336,500	\$ -		0.24	%
Class A-2	100,000	-		0.26	%
Class B	24,000	18,113		0.55	%
Class C	58,500	58,293		1.30	%
Class D	27,000	21,000		2.30	%
Total notes	546,000	97,406			
Class E (trust certificates)	29,100	29,276		N/A	
Class F (trust certificates)	24,900	24,900		N/A	
Total for 2007-1 CLO Trust	\$ 600,000	\$ 151,582			

2012-2 CLO. On December 18, 2012, we completed a term debt securitization transaction. In conjunction with this transaction we established a separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2012-2 LLC (the "2012-2 CLO") and sold and contributed \$325.9 million in loans and investments (including unfunded commitments), or portions thereof, to the 2012-2 CLO. We remain the servicer of the loans. Simultaneously with the initial sale and contribution, the 2012-2 CLO issued \$263.3 million of notes to institutional investors. We retained \$62.6 million, comprising 100% of the 2012-2 CLO's membership interests, Class E notes, Class F notes, and subordinated notes. On June 12, 2015, we sold 100% of the 2012-2 CLO's Class E Notes totaling \$16.3 million to institutional investors. At September 30, 2016, the \$260.2 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$306.5 million. At September 30, 2016, unamortized deferred financing fees were \$0.9 million. The 2012-2 CLO permitted reinvestment of collateral principal repayments for a three-year period which ended in January 2016.

We receive a loan collateral management fee and excess interest spread. We also receive payments with respect to the classes of notes we own in accordance with the transaction documents. We expect to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2012-2 CLO is in default under the terms of the indenture, the excess interest spread from the 2012-2 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, is not satisfied.

The following table sets forth selected information with respect to the 2012-2 CLO:

	Notes	Outstanding balance originally issued (\$ in thousands)	September 30, 2016	Borrowing spread to LIBOR	
2012-2 CLO					
Class A	\$ 190,700	\$ 171,320		1.90	%

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

Class B	26,000	26,000	3.25	%
Class C	35,200	35,200	4.25	%
Class D	11,400	11,400	6.25	%
Class E	16,300	16,300	6.75	%
Total notes	279,600	260,220		
Class F	24,100	24,100	N/A	
Subordinated notes	22,183	22,183	N/A	
Total for 2012-2 CLO	\$325,883	\$ 306,503		

2013-1 CLO. On September 11, 2013, we completed a term debt securitization transaction through our separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2013-1 LLC (the “2013-1 CLO”) and sold and contributed \$247.6 million in loans and investments (including unfunded commitments), or portions thereof, to the 2013-1 CLO. We remain the servicer of the loans. Simultaneously with the initial sale and contribution, the 2013-1 CLO issued \$338.6 million of notes to institutional investors. We retained \$61.4 million, comprising 100% of the 2013-1 CLO’s membership interests, Class F notes, Class G notes, and subordinated notes. At September 30, 2016, the \$338.6 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$400.0 million. At September 30, 2016, unamortized deferred financing fees were \$2.8 million. The 2013-1 CLO permitted reinvestment of collateral principal repayments for a three-year period which ended in September 2016.

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

We receive a loan collateral management fee and excess interest spread. We also receive payments with respect to the classes of notes we own in accordance with the transaction documents. We expect to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2013-1 CLO is in default under the terms of the indenture, the excess interest spread from the 2013-1 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, is not satisfied.

The following table sets forth selected information with respect to the 2013-1 CLO:

Notes	Outstanding balance originally issued (\$ in thousands)	September 30, 2016	Borrowing spread to LIBOR	
2013-1 CLO				
Class A-T	\$202,600	\$ 202,600	1.65	%
Class A-R	35,000	35,000	(1)
Class B	38,000	38,000	2.30	%
Class C	36,000	36,000	3.80	%
Class D	21,000	21,000	4.55	%
Class E	6,000	6,000	5.30	%
Total notes	338,600	338,600		
Class F	17,400	17,400	N/A	
Class G	15,200	15,200	N/A	
Subordinated notes	28,800	28,800	N/A	
Total for 2013-1 CLO	\$400,000	\$ 400,000		

(1) Class A-R Notes accrue interest at the Class A-R CP Rate so long as they are held by a CP Conduit, and otherwise will accrue interest at the Class A-R LIBOR Rate or, in certain circumstances, the Class A-R Base Rate, but in no event shall interest rate payable pari passu with the Class A-T Notes exceed the Class A-R Waterfall Rate Cap.

2014-1 CLO. On April 17, 2014, we completed a term debt securitization transaction through our separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2014-1 LLC (the "2014-1 CLO") and sold and contributed \$249.6 million in loans and investments (including unfunded commitments), or portions thereof, to the 2014-1 CLO. We remain the servicer of the loans. Simultaneously with the initial sale and contribution, the 2014-1 CLO issued \$289.5 million of notes to institutional investors. We retained \$58.9 million, comprising 100% of the 2014-1 CLO's membership interests, Class E notes, Class F notes, and subordinated notes. At September 30, 2016, the \$289.5 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$348.4 million. At September 30, 2016, unamortized deferred financing fees were \$2.1 million. The 2014-1 CLO permits reinvestment of collateral principal repayments for a four-year period ending in April 2018. Should we determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

We receive a loan collateral management fee and excess interest spread. We also receive payments with respect to the classes of notes we own in accordance with the transaction documents. We expect to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2014-1 CLO is in default under the terms of the indenture, the excess interest spread from the 2014-1 CLO may not be distributed if the

overcollateralization ratio, or other collateral quality tests, is not satisfied.

64

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

The following table sets forth selected information with respect to the 2014-1 CLO:

	Notes	Outstanding balance	Borrowing spread to	
	originally issued	September 30, 2016	LIBOR	
(\$ in thousands)				
2014-1 CLO				
Class A	\$202,500	\$ 202,500	1.80	%
Class B-1	20,000	20,000	2.60	%
Class B-2	13,250	13,250	(1)
Class C	30,250	30,250	3.60	%
Class D	23,500	23,500	4.75	%
Total notes	289,500	289,500		
Class E	18,500	18,500	N/A	
Class F	14,000	14,000	N/A	
Subordinated notes	26,375	26,375	N/A	
Total for 2014-1 CLO	\$348,375	\$ 348,375		

(1)Class B-2 Notes accrue interest at a fixed rate of 4.902%.

2015-1 CLO. On March 20, 2015, we completed a term debt securitization transaction through our separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2015-1 LLC (the “2015-1 CLO”) and sold and contributed \$336.3 million in loans and investments (including unfunded commitments), or portions thereof, to the 2015-1 CLO. We remain the servicer of the loans. Simultaneously with the initial sale and contribution, the 2015-1 CLO issued \$410.3 million of notes to institutional investors. We retained \$85.8 million, comprising 100% of the 2015-1 CLO’s membership interests and subordinated notes. At September 30, 2016, the \$410.3 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$496.1 million. At September 30, 2016, unamortized deferred financing fees were \$3.4 million. The 2015-1 CLO permits reinvestment of collateral principal repayments for a four-year period ending in April 2019. Should we determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

We receive a loan collateral management fee and excess interest spread. We also receive payments with respect to the classes of notes it owns in accordance with the transaction documents. We expect to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2015-1 CLO is in default under the terms of the indenture, the excess interest spread from the 2015-1 CLO may not be distributed if the overcollateralization ratio, or if other collateral quality tests, are not satisfied.

The following table sets forth selected information with respect to the 2015-1 CLO:

Notes	Outstanding	Borrowing
originally	balance	spread to

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	issued	September 30, 2016	LIBOR	
	(\$ in thousands)			
2015-1 CLO				
Class A-1	\$253,500	\$ 253,500	1.80	%
Class A-2	35,000	35,000	(1)
Class B	50,000	50,000	2.80	%
Class C	38,500	38,500	3.85	%
Class D	33,250	33,250	5.50	%
Total notes	410,250	410,250		
Subordinated notes	85,815	85,815	N/A	
Total for 2015-1 CLO	\$496,065	\$ 496,065		

(1)Class A-2 Notes accrue interest at a spread over Libor of 1.65% from the closing date to, but excluding March 20, 2017, and 2.00% thereafter.

2015-2 CLO. On September 15, 2015, we completed a term debt securitization transaction through our separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2015-2 LLC (the “2015-2 CLO”) and sold and contributed \$298.4 million in loans and investments (including unfunded commitments), or portions thereof, to the 2015-2 CLO. We remain the servicer

of the loans. Simultaneously with the initial sale and contribution, the 2015-2 CLO issued \$327.8 million of notes to institutional investors. We retained \$70.1 million, comprising 100% of the 2015-2 CLO's membership interests and a portion of the Class E notes. At September 30, 2016, the \$327.8 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$397.8 million. At September 30, 2016, unamortized deferred financing fees were \$3.1 million. The 2015-2 CLO permits reinvestment of collateral principal repayments for a four-year period ending in August 2019. Should we determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

We receive a loan collateral management fee and excess interest spread. We also receive payments with respect to the classes of notes we own in accordance with the transaction documents. We expect to receive a principal distribution as owner of the membership interests when the term debt is retired. If loan collateral in the 2015-2 CLO is in default under the terms of the indenture, the excess interest spread from the 2015-2 CLO may not be distributed if the overcollateralization ratio, or other collateral quality tests, are not satisfied.

The following table sets forth selected information with respect to the 2015-2 CLO:

	Notes originally issued (\$ in thousands)	Outstanding balance September 30, 2016	Borrowing spread to LIBOR	
2015-2 CLO				
Class A-1	\$205,000	\$ 205,000	2.00	%
Class A-2	23,000	23,000	(1)
Class B	40,000	40,000	2.90	%
Class C	26,250	26,250	3.95	%
Class D	28,500	28,500	5.25	%
Class E	5,000	5,000	7.50	%
Total notes	327,750	327,750		
Class E (retained)	23,250	23,250	7.50	%
Subordinated notes	46,806	46,806	N/A	
Total for 2015-2 CLO	\$397,806	\$ 397,806		

(1) Class A-2 Notes accrue interest at a fixed rate of 3.461%.

2016-1 CLO. On March 2, 2016, the Company completed a term debt securitization transaction through its separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Funding 2016-1 LLC (the “2016-1 CLO”) and sold and contributed \$247.3 million in loans and investments (including unfunded commitments), or portions thereof, to the 2016-1 CLO. The Company remains the servicer of the loans. Simultaneously with the initial sale and contribution, the 2016-1 CLO issued \$255.8 million of notes to institutional investors. The Company retained \$92.2 million, comprising 100% of the 2016-1 CLO’s membership interests and, the Class D and Class E notes. At September 30, 2016, the \$255.8 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$348.0 million. At September 30, 2016, unamortized deferred financing fees were \$2.6 million. The 2016-1 CLO permits reinvestment of collateral principal repayments for a four-year period ending in February 2020. Should the Company determine that reinvestment of collateral principal repayments are impractical in light of market conditions or if collateral principal repayments are not reinvested within a prescribed timeframe, such funds may be used to repay the outstanding notes.

The following table sets forth selected information with respect to the 2016-1 CLO:

	Notes originally issued (\$ in thousands)	Outstanding balance September 30, 2016	Borrowing spread to LIBOR	
2016-1 CLO				
Class A-1	\$ 176,500	\$ 176,500	2.30	%
Class A-2	20,000	20,000	(1)
Class B	36,750	36,750	3.75	%
Class C	22,500	22,500	5.40	%
Total notes	255,750	255,750		
Class D (retained)	23,750	23,750	5.50	%
Class E (retained)	23,000	23,000	7.50	%
Subordinated notes	45,506	45,506	N/A	
Total for 2016-1 CLO	\$348,006	\$ 348,006		

(1) Class A-2 Notes accrue interest at a fixed rate of 3.44%.

Arch Street CLO. On September 15, 2016, NewStar Capital LLC completed a \$409.8 million broadly syndicated loan securitization. The notes offered in the collateralized loan obligation (“Arch Street CLO”) were issued by Arch Street CLO, Ltd., an exempted company incorporated under the laws of the Cayman Islands, and (with the exception of the Class E and F notes) by Arch Street CLO, LLC, a Delaware limited liability company (each a subsidiary of NewStar Capital and collectively, “Arch Street”). The Arch Street CLO notes are backed by a diversified portfolio of broadly syndicated loans purchased and serviced by the Company. Investors purchased approximately \$370.3 million of the Arch Street CLO notes, representing approximately 90.4% of the total capitalization of Arch Street. The Company retained all of the Class F notes and subordinated notes which together totaled approximately \$39.5 million, representing approximately 9.6% of the total capitalization of Arch Street. At September 30, 2016, the outstanding note balance was \$370.3 million and unamortized deferred financing fees were \$4.3 million. The reinvestment period is expected to end in October 2020 and scheduled to mature in October 2028.

Notes Outstanding Borrowing

Edgar Filing: NewStar Financial, Inc. - Form 10-Q

	originally	balance	spread to	
	issued	September	LIBOR	
		30, 2016		
	(\$ in thousands)			
Arch Street CLO				
Class X	\$2,500	\$ 2,500	1.25	%
Class A	256,000	256,000	1.65	%
Class B	48,000	48,000	2.24	%
Class C	20,000	20,000	3.00	%
Class D	22,750	22,750	4.20	%
Class E	21,000	21,000	6.95	%
Total notes	370,250	370,250		
Class F (retained)	5,500	5,500	8.60	%
Subordinated notes	34,000	34,000	N/A	
Total for Arch Street CLO	\$409,750	\$ 409,750		

2015-1 ABS. As a result of the ongoing process to sell its leasing business, NewStar Equipment Finance, the static asset-backed securitization NewStar Commercial Lease Funding 2015-1 LLC (the "2015-1 ABS") that was completed on September 1, 2015 was

reclassified to liabilities held-for-sale. As of September 30, 2016, the outstanding balance of the 2015-1 ABS Class A notes was \$9.7 million and the outstanding balance of the Class B notes, (all of which we retained) was \$12.8 million. Unamortized deferred financing fees were \$1.1 million.

Repurchase Agreements

We entered into a repurchase transaction with Deutsche Bank AG, pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of February 13, 2015 between Deutsche Bank AG and NS Bond Funding I LLC (the “Deutsche Bank Repurchase Agreement”). Pursuant to the Deutsche Bank Repurchase Agreement, Deutsche Bank AG will purchase securities and simultaneously agree to sell the securities back to us at a specified date. Under the terms of the Deutsche Bank Repurchase Agreement, we are required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, there was no balance under the Deutsche Bank Repurchase Agreement. We have made certain representations and warranties and are required to comply with various covenants and requirements customary for financing arrangements of this nature.

We entered into a repurchase transaction with Citigroup Global Markets, pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of March 16, 2015 between Citigroup Global Markets and NS Loan Originator LLC (the “Citigroup Repurchase Agreement”). Pursuant to the Citigroup Repurchase Agreement, Citigroup Global Markets will purchase securities and simultaneously agree to sell the securities back to us at a specified date. Under the terms of the Citigroup Repurchase Agreement, we are required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, the outstanding balance was \$14.8 million. We have made certain representations and warranties and are required to comply with various covenants and requirements customary for financing arrangements of this nature.

We entered into a repurchase transaction with JP Morgan Chase Bank pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of April 2, 2015 between JP Morgan Chase Bank and NS Bond Funding II LLC (the “JP Morgan Repurchase Agreement”). Pursuant to the JP Morgan Repurchase Agreement, JP Morgan Chase Bank will purchase securities and simultaneously agree to sell the securities back to us at a specified date. Under the terms of the JP Morgan Repurchase Agreement, we are required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, the outstanding balance was \$36.0 million. We have made certain representations and warranties and are required to comply with various covenants and requirements customary for financing arrangements of this nature.

The Company has entered into a repurchase transaction with Natixis Securities Americas LLC pursuant to the terms of a Global Master Repurchase Agreement (2000 version), dated as of October 14, 2015 between Natixis Securities Americas LLC and NS Bond Funding III LLC (the “Natixis Repurchase Agreement”). Pursuant to the Natixis Repurchase Agreement, Natixis Securities Americas LLC will purchase securities and simultaneously agree to sell the securities back to the Company at a specified date. Under the terms of the Natixis Repurchase Agreement, the Company is required at all times to maintain a level of overcollateralization for the obligations, which is maintained through daily margining. As of September 30, 2016, the outstanding balance was \$1.7 million. The Company has made certain representations and warranties and is required to comply with various covenants and requirements customary for financing arrangements of this nature.

On August 29, 2016, we redeemed in full our five-year, \$68.0 million financing arrangement with Macquarie Bank Limited with a balance of \$10.7 million. The financing was structured as a master repurchase agreement under which we sold a portfolio of commercial mortgage loans to Macquarie for an aggregate purchase price of \$68.0 million and agreed to buy them back over a specified period. During the three months ended September 30, 2016, we accelerated and recognized deferred financing fees of \$0.3 million related to the redemption.

Stock Repurchase Program

On October 7, 2015, our Board of Directors authorized the repurchase of up to \$5.0 million of the Company's common stock from time to time on the open market or in privately negotiated transactions. On February 10, 2016, our Board of Directors authorized an increase to this stock repurchase program to authorize the repurchase of up to an aggregate of \$30.0 million of the Company's common stock (inclusive of approximately \$4.9 million remaining under the existing program). The timing and amount of any shares purchased under the repurchase program will be determined by our management based on its evaluation of market conditions and other factors. The repurchase program, as amended, will expire on December 31, 2016 unless extended by the Board and may be suspended or discontinued at any time without notice. As of September 30, 2016, the Company had repurchased 1,241,999 shares of common stock at a weighted average price per share of \$7.18, of which 1,000,000 shares were repurchased in a privately negotiated transaction with an unaffiliated third party for an aggregate purchase price of \$7.0 million.

On March 24, 2015, the Company repurchased 1,000,000 shares of its common stock in a privately negotiated transaction with an unaffiliated third party for an aggregate purchase price of \$10.3 million.

In October 2016, subsequent to the end of the third quarter, we repurchased 2,000,000 shares of our common stock from Capital Z Financial Services Fund II, L.P. and a related fund in a privately negotiated transaction for an aggregate purchase price of \$17,860,000. We also repurchased 500,00 shares of our common stock in a privately negotiated transaction from a former executive officer at an aggregate purchase price of \$4,465,000. The transactions were executive outside of the Company's previously announced stock repurchase program.

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We maintain an overall risk management strategy that may incorporate the use of derivative instruments to minimize significant unplanned fluctuations in earnings caused by interest rate volatility. Our operations are subject to risks resulting from interest rate fluctuations on our interest-earning assets and our interest-bearing liabilities. We seek to provide maximum levels of net interest income, while maintaining acceptable levels of interest rate and liquidity risk. As such, we may enter into interest rate swap and interest rate cap agreements to hedge interest rate exposure to interest rate fluctuations on floating rate funding agreement liabilities that are matched with fixed rate securities. Under the interest rate swap contracts, we agree to exchange, at specified intervals, the difference between fixed and floating interest amounts calculated on an agreed-upon notional principal amount. We record the exchanged amount in net interest income in our statements of operations. Under the interest rate cap contracts, we agree to exchange, at specified intervals, the difference between a specified fixed interest (the cap) and floating interest amounts calculated on an agreed-upon notional principal amount, but only if the floating interest rate exceeds the cap rate. The interest rate caps may not be matched to specific assets or liabilities and would not qualify for hedge accounting.

Gains and losses on derivatives not designated as hedges, including any cash payments made or received, are reported as gain or (loss) on derivatives in our consolidated statements of operations.

OFF BALANCE SHEET ARRANGEMENTS

We are party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our borrowers. These financial instruments include unfunded commitments and standby letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement we have in particular classes of financial instruments.

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments.

Unused lines of credit are commitments to lend to a borrower if certain conditions have been met. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because certain commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each borrower's creditworthiness on a case-by-case basis. The amount of collateral required is based on factors that include management's credit evaluation of the borrower and the borrower's compliance with financial covenants. Due to their nature, we cannot know with certainty the aggregate amounts that will be required to fund our unfunded commitments. The aggregate amount of these unfunded commitments currently exceeds our available funds and will likely continue to exceed our available funds in the future. At September 30,

2016, we had \$287.2 million of unused lines of credit.

Standby letters of credit are conditional commitments issued by us to guarantee the performance by a borrower to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending credit to our borrowers. At September 30, 2016, we had \$8.8 million of standby letters of credit.

On December 4, 2014, we entered into a total return swap ("TRS") for senior floating rate loans with Citibank, N.A. ("Citibank"). The TRS with Citibank enabled us, through a wholly owned financing subsidiary, to obtain the economic benefits of the loans subject to the TRS, despite the fact that such loans would not be directly owned by us, in return for an interest payment to Citibank. The underlying loan portfolio of the TRS was typically large, liquid broadly syndicated loans. We acted as the manager of the TRS and selected the specific loans to be subject to the TRS. The TRS did not qualify for hedge accounting treatment as it did not offset the risks of another investment position. The initial maximum market value (determined at the time such loans became subject to the TRS) of the portfolio of loans subject to the TRS was \$75.0 million. On December 15, 2014, we entered into an amendment to the TRS that increased the maximum value to \$125.0 million. On March 2, 2015, we entered into an amendment that increased the maximum value to \$150.0 million, and on July 14, 2015, we entered into an additional amendment that increased the maximum value to \$175.0 million. Interest accrued at one-month LIBOR+1.60% per annum. We were required to cash collateralize a specified percentage of each loan included under the TRS in accordance with margin requirements. On March 31, 2016, the TRS matured. At

maturity we purchased approximately \$138.9 million of the loans that were referenced by the TRS. The majority of these loans were purchased to fund future CLOs.

CRITICAL ACCOUNTING POLICIES

The Company's consolidated financial statements are prepared based on the application of accounting policies, the most significant of which are described in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 2 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as updated in Note 2 to the unaudited consolidated financial statements in this Quarterly Report. These policies require numerous estimates and assumptions, which may prove inaccurate or subject to variations. Changes in underlying factors, assumptions or estimates could have a material impact on the Company's future financial condition and results of operations. The most critical of these significant accounting policies are the policies for revenue recognition, allowance for credit losses, income taxes, stock compensation, valuation of investments, fair value measurements used to record fair value adjustment to certain financial instruments, determination of other than temporary impairments and temporary impairments, and impairment of goodwill and identified intangible assets. As of the date of this report, the Company does not believe that there has been a material change in the nature or categories of its critical accounting policies or its estimates and assumptions from those discussed in its Annual Report on Form 10-K for the year ended December 31, 2015.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We are exposed to changes in market values of our portfolio of loans for which the fair value option was elected, loans held-for-sale, which are carried at lower of cost or fair value, and our investment in debt securities, available-for-sale and derivatives, which are carried at fair value. Fair value is defined as the market price for those securities for which a market quotation is readily available and for all other investments and derivatives, fair value is determined pursuant to a valuation policy and a consistent valuation process. Where a market quotation is not readily available, we estimate fair value using various valuation methodologies, including cash flow analysis, as well as qualitative factors.

As of September 30, 2016 and December 31, 2015, investments in debt securities available-for-sale totaled \$90.8 million and \$94.2 million, respectively. At September 30, 2016 and December 31, 2015, our net unrealized loss on those debt securities totaled \$8.1 million and \$10.1 million, respectively. Any unrealized gain or loss on these investments is included in Other Comprehensive Income in the equity section of the balance sheet, until realized.

Interest rate risk represents a market risk exposure to us. Interest rate risk is measured as the potential volatility to our net interest income caused by changes in market interest rates.

As of September 30, 2016, approximately 4% of the loans in our portfolio were at fixed rates and approximately 96% were at variable rates. Additionally, for the loans at variable rates, approximately 92% contain an interest rate floor. The majority of our loan have a 100 basis point LIBOR floor. Our credit facilities and term debt securitizations all bear interest at variable rates without interest rate floors.

The presence of interest rate floors in our loan agreements results in assets with hybrid fixed and floating rate loan characteristics. Provided that the contractual interest rate remains at or below the interest rate floor, a performing loan will typically behave as a fixed rate instrument. If contractual interest rates are in excess of the interest rate floor, a performing loan will typically behave as a floating rate instrument. In a low interest rate environment, floors provide a benefit as we are able to earn additional income equal to the difference between the stated rate of the interest rate floor

and the corresponding contractual rate. If interest rates rise, the potential benefit provided by interest rate floors would decrease resulting in lower net interest income. The cost of our variable rate debt would increase, while interest income from loans with interest rate floors would not change until interest rates exceed the stated rate of the interest rate floors or upon the re-pricing or principal repayment of the loans.

70

The following table shows the hypothetical estimated change in net interest income over a 12-month period based on a static, instantaneous parallel shift in interest rates applied to our portfolio and cash and cash equivalents as of September 30, 2016. Our modeling is based on contractual terms and does not consider prepayment or changes in the composition of our portfolio or our current capital structure. It further generalizes that both variable rate assets and liabilities are indexed to a flat 3 month LIBOR yield curve. Although we believe these measurements are representative of our interest rate sensitivity, we can give no assurance that actual results would not differ materially from our modeled outcomes.

		Estimated Change in Net Interest Income Over
Rate Change		12 Months (\$ in thousands)
(Basis Points)		
Decrease of	100	\$ 22,034
Increase of	100	7,233
Increase of	200	20,185
Increase of	300	33,209

The estimated changes in net interest income reflect the potential effect of interest rate floors on loans totaling approximately \$3.4 billion. Due to the presence of these interest rate floors, as interest rates begin to rise from current levels, the cost of our variable rate debt increases. The interest rate on performing loans will remain fixed until the contractual rate exceeds the stated rate on the interest rate floors. Consequently, the result is a negative net interest income impact as interest rates initially increase until they reach an inflection point. Beyond this inflection point, which is typically close to the portfolio's weighted average stated floor rate, the benefit of rising rates begins to accrue to us as the interest rate on performing loans starts to adjust upward.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this Quarterly Report (the "Evaluation Date"). Based on this evaluation, our principal executive officer and principal financial officer concluded that, as of the Evaluation Date, these disclosure controls and procedures are effective.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) identified in connection with the evaluation of our internal control over financial reporting that occurred during the third quarter of 2016 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time we expect to be party to legal proceedings. We are not currently subject to any material legal proceedings.

Item 1A. Risk Factors.

There have been no material changes to the Company's risk factors since our most recently filed Annual Report on Form 10-K.

71

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table sets forth the repurchases we made for the three-month period ending on September 30, 2016:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (4)
	(1)(2)(3)	(1)(2)(3)	(3)(4)	Programs (4)
July 1-31, 2016	\$ 14,958	\$ 8.69	\$ 11,837	\$21,148,985
August 1-31, 2016	2,000	9.00	2,000	21,130,986
September 1-30, 2016	5,514	8.99	5,514	21,081,400
Total: Three months ended September 30, 2016	22,472	\$ 8.79	19,351	21,081,400

- (1) The Company repurchased 19,351 shares during the period pursuant to the share repurchase program that we announced on October 7, 2015 (the "Repurchase Program") and amended on February 10, 2016. Certain of these shares were repurchased on the open market pursuant to a trading plan under Rule 10b5-1 of the Exchange Act.
- (2) Includes an aggregate of 3,121 shares of Common Stock acquired from individuals in order to satisfy tax withholding requirements in connection with the vesting of restricted stock awards under equity compensation plans during the third quarter.
- (3) The Repurchase Program, as amended in February 2016, provides for the repurchase of up to \$30.0 million of the Company's common stock from time to time on the open market or in privately negotiated transactions.

Item 6. Exhibits.

Exhibit

Number	Description	Method of Filing
3(a)	Amended and Restated Certificate of Incorporation of the Company.	Previously filed as Exhibit 3(a) to the Company's Annual Report on Form 10-K for the year ended December 31, 2006, filed on April 2, 2007 (File No. 001-33211) and incorporated herein by reference.
3(b)	Amended and Restated Bylaws of the Company.	Previously filed as Exhibit 3(b) to the Company's Annual Report on Form 10-K for the year ended December 31, 2006, filed on April 2, 2007 (File No. 001-33211) and incorporated herein by reference.
4	Indenture by and between Arch Street CLO, LTD., as Issuer, Arch Street CLO, LLC., as Co-Issuer, and U.S. Bank National Association, as Trustee, dated as of September 15, 2016.	Previously filed as Exhibit 4.1 to the Company's Current Report on Form 8-K filed on September 21, 2016 (File No. 001-33211) and incorporated herein by reference.
10(1)	Termination Agreement and General Release effective as of July 14, 2016 between NewStar Financial, Inc. and Peter A. Schmidt-Fellner.	Filed herewith.
10(2)	Early Retirement Agreement and General Release effective as of September 30, 2016 between NewStar Financial, Inc. and John J. Frishkopf.	Filed herewith
10(3)	Collateral Management Agreement by and between Arch Street CLO, LTD., as Issuer, and NewStar Capital LLC, as Collateral Manager, dated as of September 15, 2016.	Previously filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 21, 2016 (File No. 001-33211) and incorporated herein by reference.
31(a)	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
31(b)	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
32	Certifications pursuant to 18 U.S.C. Section 1350.	Filed herewith.

73

101 The following materials from the Quarterly Report of NewStar Financial, Inc. on Form 10-Q for the quarter ended September 30, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2016 and 2015, (iii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016 and 2015, (iv) Condensed Consolidated Statements of Changes in Stockholders' Equity for the nine months ended September 30, 2016 and 2015, (v) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015, and (vi) Notes to the Condensed Consolidated Financial Statements. Filed herewith.

101.INS XBRL Instance Documents

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Label Linkbase Document

101.PRE XBRL Taxonomy Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NEWSTAR FINANCIAL, INC.

Date: November 3, 2016 By: /S/ JOHN KIRBY BRAY
John Kirby Bray
Chief Financial Officer

EXHIBIT INDEX

Exhibit

Number	Description	Method of Filing
3(a)	Amended and Restated Certificate of Incorporation of the Company.	Previously filed as Exhibit 3(a) to the Company's Annual Report on Form 10-K for the year ended December 31, 2006, filed on April 2, 2007 (File No. 001-33211) and incorporated herein by reference.
3(b)	Amended and Restated Bylaws of the Company.	Previously filed as Exhibit 3(b) to the Company's Annual Report on Form 10-K for the year ended December 31, 2006, filed on April 2, 2007 (File No. 001-33211) and incorporated herein by reference.
4	Indenture by and between Arch Street CLO, LTD., as Issuer, Arch Street CLO, LLC., as Co-Issuer, and U.S. Bank National Association, as Trustee, dated as of September 15, 2016.	Previously filed as Exhibit 4.1 to the Company's Current Report on Form 8-K filed on September 21, 2016 (File No. 001-33211) and incorporated herein by reference
10(1)	Termination Agreement and General Release effective as of July 14, 2016 between NewStar Financial, Inc. and Peter A. Schmidt-Fellner.	Filed herewith.
10(2)	Early Retirement Agreement and General Release effective as of September 30, 2016 between NewStar Financial, Inc. and John J. Frishkopf.	Filed herewith.
10(3)	Collateral Management Agreement by and between Arch Street CLO, LTD., as Issuer, and NewStar Capital LLC, as Collateral Manager, dated as of September 15, 2016.	Previously filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 21, 2016 (File No. 001-33211) and incorporated herein by reference.
31(a)	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
31(b)	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
32	Certifications pursuant to 18 U.S.C. Section 1350.	Filed herewith.
76		

101 The following materials from the Quarterly Report of NewStar Financial, Inc. on Form 10-Q for the quarter ended September 30, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2016 and 2015, (iii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016 and 2015, (iv) Condensed Consolidated Statements of Changes in Stockholders' Equity for the nine months ended September 30, 2016 and 2015, (v) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015, and (vi) Notes to the Condensed Consolidated Financial Statements. Filed herewith.

101.INS XBRL Instance Documents

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Label Linkbase Document

101.PRE XBRL Taxonomy Presentation Linkbase Document