

NewStar Financial, Inc.  
Form 10-Q  
November 07, 2012  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2012

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)

|  |  |
|--|--|
| <b>Delaware</b><br>(State or other jurisdiction of<br>incorporation or organization)                         | <b>54-2157878</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>500 Boylston Street, Suite 1250,</b><br><br><b>Boston, MA</b><br>(Address of principal executive offices) | <b>02116</b><br>(Zip Code)                                   |
| <b>(617) 848-2500</b><br><br>(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.

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

Large accelerated filer

Accelerated filer  x

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  x

As of November 1, 2012, 49,417,138 shares of common stock, par value of \$0.01 per share, were outstanding.

**Table of Contents**

**TABLE OF CONTENTS**

|   | <b>Page</b> |
|---|-------------|
| <b><u>PART I</u></b>  |             |
| <b><u>FINANCIAL INFORMATION</u></b>   |             |
| Item 1. <u>Financial Statements (Unaudited)</u>   | 3           |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011</u>                                       | 3           |
| <u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2012 and 2011</u>            | 4           |
| <u>Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2012 and 2011</u>  | 5           |
| <u>Condensed Consolidated Statements of Changes in Stockholders' Equity for the Nine Months ended September 30, 2012 and 2011</u> | 6           |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2012 and 2011</u>                      | 7           |
| <u>Notes to Condensed Consolidated Financial Statements</u>   | 8           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                              | 33          |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | 48          |
| Item 4. <u>Controls and Procedures</u>  | 50          |
| <b><u>PART II</u></b>   |             |
| <b><u>OTHER INFORMATION</u></b>   |             |
| Item 1. <u>Legal Proceedings</u>  | 50          |
| Item 1A. <u>Risk Factors</u>  | 50          |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 50          |
| Item 6. <u>Exhibits</u>   | 51          |
| <u>SIGNATURES</u>   | 52          |

**Table of Contents**

**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 ability to meet draw requests under commitments to borrowers under certain conditions;
- 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 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:

- acceleration 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;

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

risks and uncertainties relating to the financial markets generally, including disruptions in the global financial markets;

our ability to obtain external financing;

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, 2011.

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.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****NEWSTAR FINANCIAL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | September 30<br>2012<br>(unaudited)                      | December 31,<br>2011 |
|---|--|----------------------|
|   | (\$ in thousands, except share<br>and par value amounts) |                      |
| <b>Assets:</b>  |  |                      |
| Cash and cash equivalents   | \$ 34,176  | \$ 18,468            |
| Restricted cash   | 151,387  | 83,815               |
| Investments in debt securities, available-for-sale  | 20,803   | 17,817               |
| Loans held-for-sale, net  | 48,534   | 38,278               |
| Loans, net  | 1,761,391  | 1,699,187            |
| Deferred financing costs, net   | 12,405   | 11,997               |
| Interest receivable   | 8,917  | 9,857                |
| Property and equipment, net   | 520  | 740                  |
| Deferred income taxes, net  | 46,436   | 47,902               |
| Income tax receivable   | 0  | 293                  |
| Other assets  | 23,907   | 18,029               |
| <b>Total assets</b>   | <b>\$ 2,108,476</b>                                      | <b>\$ 1,946,383</b>  |
| <b>Liabilities:</b>   |  |                      |
| Credit facilities   | \$ 396,318   | \$ 214,711           |
| Term debt   | 1,009,953  | 1,073,105            |
| Repurchase agreements   | 40,778   | 64,868               |
| Accrued interest payable  | 3,177  | 2,853                |
| Accounts payable  | 228  | 430                  |
| Income tax payable  | 2,452  | 0                    |
| Other liabilities   | 68,934   | 26,654               |
| <b>Total liabilities</b>  | <b>1,521,840</b>   | <b>1,382,621</b>     |
| <b>Stockholders equity:</b>   |  |                      |
| Preferred stock, par value \$0.01 per share (5,000,000 shares authorized; no shares outstanding)  | 0  | 0                    |
| Common stock, par value \$0.01 per share:<br>Shares authorized: 145,000,000 in 2012 and 2011;<br>Shares outstanding 49,420,728 in 2012 and 49,345,676 in 2011 | 494  | 494                  |
| Additional paid-in capital  | 641,337  | 635,389              |
| Accumulated deficit   | (26,938)   | (44,703)             |
| Common stock held in treasury, at cost \$0.01 par value; 3,391,354 in 2012 and 3,135,317 in 2011  | (28,056)   | (25,420)             |
| Accumulated other comprehensive loss, net   | (201)  | (1,998)              |
| <b>Total stockholders equity</b>  | <b>586,636</b>   | <b>563,762</b>       |
| <b>Total liabilities and stockholders equity</b>  | <b>\$ 2,108,476</b>                                      | <b>\$ 1,946,383</b>  |

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

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



**Table of Contents****NEWSTAR FINANCIAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****Unaudited**

|   | <b>Three Months Ended<br/>September 30,</b>        |                 | <b>Nine Months Ended<br/>September 30,</b> |                 |
|---|--|-----------------|--|-----------------|
|   | <b>2012</b>  | <b>2011</b>     | <b>2012</b>                                | <b>2011</b>     |
|   | <b>(\$ in thousands, except per share amounts)</b> |                 |  |                 |
| <b>Net interest income:</b>                           |  |                 |  |                 |
| Interest income                                       | \$ 30,812  | \$ 29,500       | \$ 90,945                                  | \$ 84,803       |
| Interest expense                                      | 9,074  | 10,683          | 26,607                                     | 27,582          |
| Net interest income                                   | 21,738   | 18,817          | 64,338                                     | 57,221          |
| Provision for credit losses                           | 3,712  | 4,408           | 6,752                                      | 12,998          |
| Net interest income after provision for credit losses | 18,026   | 14,409          | 57,586                                     | 44,223          |
| <b>Non-interest income:</b>                           |  |                 |  |                 |
| Fee income  | 1,074  | 573             | 3,398                                      | 1,507           |
| Asset management income related party                 | 718  | 697             | 2,188                                      | 1,951           |
| Gain (loss) on derivatives                            | (57)   | 252             | (258)                                      | 277             |
| Gain (loss) on sale of loans                          | 0  | 20              | (418)                                      | 128             |
| Other income (loss)                                   | 1,451  | 1,862           | 2,866                                      | (1,690)         |
| Total non-interest income                             | 3,186  | 3,404           | 7,776                                      | 2,173           |
| <b>Operating expenses:</b>                            |  |                 |  |                 |
| Compensation and benefits                             | 7,832  | 7,706           | 23,101                                     | 22,321          |
| General and administrative expenses                   | 2,843  | 4,190           | 11,627                                     | 10,542          |
| Total operating expenses                              | 10,675   | 11,896          | 34,728                                     | 32,863          |
| <b>Income before income taxes</b>                     | <b>10,537</b>                                      | <b>5,917</b>    | <b>30,634</b>                              | <b>13,533</b>   |
| Income tax expense                                    | 4,471  | 2,508           | 12,869                                     | 5,752           |
| <b>Net income</b>                                     | <b>\$ 6,066</b>                                    | <b>\$ 3,409</b> | <b>\$ 17,765</b>                           | <b>\$ 7,781</b> |
| <b>Basic income per share</b>                         | <b>\$ 0.13</b>                                     | <b>\$ 0.07</b>  | <b>\$ 0.38</b>                             | <b>\$ 0.16</b>  |
| <b>Diluted income per share</b>                       | <b>0.11</b>  | <b>0.06</b>     | <b>0.34</b>                                | <b>0.15</b>     |

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

Table of Contents

## NEWSTAR FINANCIAL, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

## Unaudited

|   | Three Months<br>Ended<br>September 30,      |          | Nine Months Ended<br>September 30, |          |
|---|---|----------|------------------------------------|----------|
|   | 2012  | 2011     | 2012                               | 2011     |
|   | (\$ in thousands, except per share amounts) |          |                                    |          |
| <b>Net income</b>   | \$ 6,066                                    | \$ 3,409 | \$ 17,765                          | \$ 7,781 |
| <b>Other comprehensive income (loss), net of tax:</b>   |   |          |                                    |          |
| Net unrealized securities gains (losses), net of tax expense (benefit) of \$969, \$(784), \$1,136 and \$(1,058), respectively | 1,442                                       | (1,038)  | 1,680                              | (1,443)  |
| Net unrealized derivative gains (losses), net of tax expense (benefit) of \$23, \$125, \$93 and \$(34), respectively          | 35  | (45)     | 117                                | 264      |
| Other comprehensive income (loss)   | 1,477                                       | (1,083)  | 1,797                              | (1,179)  |
| <b>Comprehensive income</b>   | \$ 7,543                                    | \$ 2,326 | \$ 19,562                          | \$ 6,602 |

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

Table of Contents

## NEWSTAR FINANCIAL, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

## Unaudited

|  | NewStar Financial, Inc. Stockholders Equity |                            |                     |                |  |                            |
|--|---|----------------------------|---------------------|----------------|--|----------------------------|
|  | Common Stock                                | Additional Paid-in Capital | Accumulated Deficit | Treasury Stock | Accumulated Other Comprehensive Income (Loss), net | Common Stockholders Equity |
|  | (\$ in thousands)                           |                            |                     |                |  |                            |
| <b>Balance at January 1, 2012</b>                          | \$ 494                                      | \$ 635,389                 | \$ (44,703)         | \$ (25,420)    | \$ (1,998)   | \$ 563,762                 |
| Net income   | 0   | 0                          | 17,765              | 0              | 0  | 17,765                     |
| Other comprehensive income                                 | 0   | 0                          | 0                   | 0              | 1,797  | 1,797                      |
| Issuance of restricted stock                               | 1   | (1)                        | 0                   | 0              | 0  | 0                          |
| Net shares reacquired from employee transactions           | 0   | 0                          | 0                   | (40)           | 0  | (40)                       |
| Tax benefit from vesting of restricted common stock awards | 0   | 98                         | 0                   | 0              | 0  | 98                         |
| Repurchase of common stock                                 | (2)   | 2                          | 0                   | (2,596)        | 0  | (2,596)                    |
| Exercise of common stock options                           | 1   | 663                        | 0                   | 0              | 0  | 664                        |
| Amortization of restricted common stock awards             | 0   | 4,813                      | 0                   | 0              | 0  | 4,813                      |
| Amortization of stock option awards                        | 0   | 373                        | 0                   | 0              | 0  | 373                        |
| <b>Balance at September 30, 2012</b>                       | \$ 494                                      | \$ 641,337                 | \$ (26,938)         | \$ (28,056)    | \$ (201)   | \$ 586,636                 |

|  | NewStar Financial, Inc. Stockholders Equity |                            |                     |                |   |                            |
|--|---|----------------------------|---------------------|----------------|---|----------------------------|
|  | Common Stock                                | Additional Paid-in Capital | Accumulated Deficit | Treasury Stock | Accumulated Other Comprehensive Loss, net | Common Stockholders Equity |
|  | (\$ in thousands)                           |                            |                     |                |   |                            |
| <b>Balance at January 1, 2011</b>                          | \$ 506                                      | \$ 626,177                 | \$ (58,851)         | \$ (13,115)    | \$ (538)                                  | \$ 554,179                 |
| Net income   | 0   | 0                          | 7,781               | 0              | 0   | 7,781                      |
| Other comprehensive loss                                   | 0   | 0                          | 0                   | 0              | (1,179)                                   | (1,179)                    |
| Net shares reacquired from employee transactions           | (1)   | 166                        | 0                   | (988)          | 0   | (823)                      |
| Tax benefit from vesting of restricted common stock awards | 0   | 796                        | 0                   | 0              | 0   | 796                        |
| Repurchase of common stock                                 | (10)  | 10                         | 0                   | (10,031)       | 0   | (10,031)                   |
| Amortization of restricted common stock awards             | 0   | 4,813                      | 0                   | 0              | 0   | 4,813                      |
| Amortization of stock option awards                        | 0   | 1,852                      | 0                   | 0              | 0   | 1,852                      |
| <b>Balance at September 30, 2011</b>                       | \$ 495                                      | \$ 633,814                 | \$ (51,070)         | \$ (24,134)    | \$ (1,717)                                | \$ 557,388                 |

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

**Table of Contents****NEWSTAR FINANCIAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****Unaudited**

|   | Nine Months Ended September 30, |                 |
|---|---------------------------------|-----------------|
|   | 2012                            | 2011            |
|   | (\$ in thousands)               |                 |
| <b>Cash flows from operating activities:</b>                                |                                 |                 |
| Net income  | \$ 17,765                       | \$ 7,781        |
| Adjustments to reconcile net income (loss) to net cash used for operations: |                                 |                 |
| Provision for credit losses   | 6,752                           | 12,998          |
| Depreciation and amortization and accretion                                 | (6,539)                         | (6,356)         |
| Amortization of debt issuance costs   | 3,223                           | 6,965           |
| Equity compensation expense   | 5,186                           | 6,665           |
| (Gains) losses on sale of loans   | 418                             | (128)           |
| Gain on repurchase of debt  | (2,215)                         | (3,627)         |
| Losses from equity method investments                                       | 629                             | 6,861           |
| Losses on other real estate owned   | 324                             | 600             |
| Net change in deferred income taxes   | 1,466                           | 1,072           |
| Loans held-for-sale originated  | (81,979)                        | (31,192)        |
| Proceeds from sale and repayment of loans held-for-sale                     | 71,723                          | 41,386          |
| Net change in interest receivable   | 940                             | (1,905)         |
| Net change in other assets  | (6,328)                         | 4,898           |
| Net change in accrued interest payable                                      | 324                             | (1,974)         |
| Net change in accounts payable and other liabilities                        | 43,216                          | (2,331)         |
| <b>Net cash provided by operating activities</b>                            | <b>54,905</b>                   | <b>41,713</b>   |
| <b>Cash flows from investing activities:</b>                                |                                 |                 |
| Net change in restricted cash   | (67,572)                        | 103,753         |
| Net change in loans   | (62,531)                        | (89,906)        |
| Proceeds from the sale of other real estate owned                           | 0                               | 2,800           |
| Purchase of debt securities available-for-sale                              | 0                               | (14,088)        |
| Proceeds from repayments of debt securities available-for-sale              | 0                               | 4,173           |
| Acquisition of property and equipment                                       | (167)                           | (319)           |
| <b>Net cash provided by (used in) investing activities</b>                  | <b>(130,270)</b>                | <b>6,413</b>    |
| <b>Cash flows from financing activities:</b>                                |                                 |                 |
| Proceeds from exercise of stock options                                     | 663                             | 166             |
| Tax benefit from vesting of restricted stock                                | 98                              | 796             |
| Borrowings on credit facilities   | 410,978                         | 292,356         |
| Repayment of borrowings on credit facilities                                | (229,371)                       | (251,949)       |
| Borrowings on term debt   | 93,400                          | 120,336         |
| Repayment of borrowings on term debt  | (154,337)                       | (289,058)       |
| Borrowings on repurchase agreements   | 0                               | 67,554          |
| Repayment of borrowings on repurchase agreements                            | (24,090)                        | 0               |
| Payment of deferred financing costs   | (3,632)                         | (4,069)         |
| Purchase of treasury stock  | (2,636)                         | (11,019)        |
| <b>Net cash provided by (used in) financing activities</b>                  | <b>91,073</b>                   | <b>(74,887)</b> |

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

|   |           |           |
|---|-----------|-----------|
| <b>Net increase in cash during the period</b>                       | 15,708    | (26,761)  |
| <b>Cash and cash equivalents at beginning of period</b>             | 18,468    | 54,365    |
| <b>Cash and cash equivalents at end of period</b>                   | \$ 34,176 | \$ 27,604 |
| <b>Supplemental cash flows information:</b>                         |           |           |
| Interest paid   | \$ 26,284 | \$ 29,556 |
| Taxes paid  | 10,809    | 6,852     |
| Decrease (increase) in fair value of investments in debt securities | (2,816)   | 2,501     |
| Transfer of asset to OREO   | 14,884    | 0         |
| Transfer of loans, net to loans held-for-sale                       | 14,587    | 0         |
| Transfer of debt from term debt to credit facilities                | 0         | 13,000    |

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

---

**Table of Contents**

**NEWSTAR FINANCIAL, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Unaudited**

**Note 1. Organization**

NewStar Financial, Inc. (the Company), a Delaware corporation, is a specialized commercial finance company focused on meeting the complex financing needs of companies and private investors in the middle market. The Company focuses primarily on the direct origination of bank loans and equipment leases through teams of credit-trained bankers and marketing officers organized around key industry and market segments. The Company's marketing and direct origination efforts target private equity sponsors, mid-sized companies, corporate executives, regional banks, real estate investors and a variety of other referral sources and financial intermediaries to source new customer relationships and lending opportunities. The Company's emphasis on direct origination is an important aspect of its marketing and credit strategy because it provides direct access to customers' management teams and enhances the Company's 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, it has significant input into customers' financial strategies and capital structures. From time to time, the Company also participates in loans as a member of a lending group. 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.

The Company operates as a single segment, and it derives revenues from four specialized lending groups that target market segments in which it believes that it has a competitive advantage:

*Leveraged Finance*, provides senior, secured cash flow loans and, to a lesser extent, second lien, and subordinated debt, and equity or other equity-linked products, which are primarily used to finance acquisitions of mid-sized companies with annual cash flow (EBITDA) typically between \$5 million and \$30 million by private equity investment funds managed by established professional alternative asset managers;

*Real Estate*, provides first mortgage debt and, to a lesser extent, subordinated debt, primarily to finance acquisitions of commercial real estate properties typically valued between \$10 million and \$50 million by professional commercial real estate investors;

*Business Credit*, provides senior, secured asset-based loans primarily to fund working capital needs of mid-sized companies with sales typically totaling between \$25 million and \$500 million; and

*Equipment Finance*, provides leases, loans and lease lines to finance equipment purchases and other capital expenditures typically for companies with annual sales of at least \$25 million.

**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

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

adjustments to certain financial instruments, (iv) valuation of investments and (v) determination of other than temporary impairments and temporary impairments. 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, 2011.

### ***Recently Adopted Accounting Standards***

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. ASU 2011-03 changes the assessment of effective control by focusing on the transferor's contractual rights and obligations and removing the criterion to assess the ability to exercise those rights or honor those obligations. ASU 2011-03 was effective for the interim or annual period beginning on or after December 15, 2011. The adoption of ASU 2011-03 did not have a material effect on the Company's results from operations or financial position.

## **Table of Contents**

In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 2011-04 establishes common fair value measurement and disclosure requirements in GAAP and IFRS. ASU 2011-04 amends topic 820 by clarifying the intent of the application of existing fair value measurement and disclosure requirements. The amendments in this update also change the fair value measurement of financial instruments that are managed within a portfolio subject to market risks and the credit risk of counterparties, the application of premiums and discounts in a fair value measurement, and require additional fair value measurement disclosures. ASU 2011-04 will be applied prospectively and is effective during interim and annual periods beginning after December 15, 2011. The adoption of ASU 2011-04 did not have an impact on the Company's results of operations or financial position as it only impacts required disclosures.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income*. ASU 2011-05 gives two options for presenting other comprehensive income (OCI). An OCI statement can be included with the net income statement, which together will make a statement of total comprehensive income. Alternatively an OCI statement may be presented separately from a net income statement, but the two statements must appear consecutively within a financial report. Currently, ASU 2011-05 is being applied retrospectively and is effective for fiscal years and interim periods within those years, beginning after December 15, 2011. In October 2011, the FASB announced that it is considering deferring certain provisions in ASU 2011-05 related to the presentation and reclassification adjustments from other comprehensive income to net income. The adoption of ASU 2011-05 did not have an impact on the Company's results of operations or financial position as it only impacts required disclosures.

### ***Prior Period Reclassifications***

Certain prior period amounts have been reclassified to conform to the current period presentation. Occupancy and equipment are now included in General and administrative expenses.

### **Note 3. Loans Held-for-Sale, Loans and Allowance for Credit Losses**

The Company operates as a single segment, and derives revenues from four specialized lending groups that target market segments in which it believes it has a competitive advantage:

*Leveraged Finance*, provides senior, secured cash flow loans and, to a lesser extent, second lien, and subordinated debt, and equity or other equity-linked products, which are primarily used to finance acquisitions of mid-sized companies by private equity investment funds managed by established professional alternative asset managers;

*Real Estate*, provides first mortgage debt and, to a lesser extent, subordinated debt, primarily to finance acquisitions of commercial real estate properties;

*Business Credit*, provides senior, secured asset-based loans primarily to fund working capital needs of mid-sized companies; and

*Equipment Finance*, provides leases, loans and lease lines to finance equipment purchases and other capital expenditures.

The Company's loan portfolio consists primarily of loans to small and medium-sized, privately-owned companies, most of which do not publicly report their financial condition. Compared to larger, publicly traded firms, loans to these types of companies may carry higher inherent risk. The companies that the Company lends to generally have more limited access to capital and higher funding costs, may be in a weaker financial position, may need more capital to expand or compete, and may be unable to obtain financing from public capital markets or from traditional sources, such as commercial banks.

The Company's borrowers may be particularly susceptible to economic slowdowns or recessions and, as a result, may be unable to make scheduled payments of interest or principal on their borrowings during these periods. Adverse economic conditions also may decrease the estimated value of the collateral, particularly real estate, securing some of the Company's loans.

Loans classified as held-for-sale may consist of loans originated by the Company and intended to be sold or syndicated to third parties (including the NewStar Credit Opportunities Fund, Ltd. (NCOF), a related party) or impaired loans for which a sale of the loan is expected as a result of a



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

workout strategy. At September 30, 2012 loans held-for-sale were \$48.5 million and consisted of leveraged finance loans to nine borrowers which are intended to be sold to the NCOF at an agreed upon price or to entities other than the NCOF. Subsequent to September 30, 2012, the Company sold loans with an aggregate outstanding balance of \$21.4 million to the NCOF as intended.

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

**Table of Contents**

As of September 30, 2012 and December 31, 2011, loans held-for-sale consisted of the following:

|                         | September 30,<br>2012 | December 31,<br>2011 |
|-------------------------|-----------------------|----------------------|
|                         | (\$ in thousands)     |                      |
| Leveraged Finance       | \$ 49,015             | \$ 38,838            |
| Gross loans             | 49,015                | 38,838               |
| Deferred loan fees, net | (481)                 | (560)                |
| Total loans, net        | \$ 48,534             | \$ 38,278            |

The Company sold loans with an aggregate outstanding balance of \$33.1 million for a loss of \$0.4 million to entities other than the NCOF during the nine months ended September 30, 2012. The Company sold loans with an aggregate outstanding balance of \$31.3 million for a gain of \$0.1 million to entities other than the NCOF during the nine months ended September 30, 2011.

As of September 30, 2012 and December 31, 2011, loans and leases consisted of the following:

|                                     | September 30,<br>2012 | December 31,<br>2011 |
|-------------------------------------|-----------------------|----------------------|
|                                     | (\$ in thousands)     |                      |
| Leveraged Finance                   | \$ 1,446,288          | \$ 1,437,040         |
| Real Estate                         | 205,206               | 271,381              |
| Business Credit                     | 196,824               | 111,772              |
| Gross loans and leases              | 1,848,318             | 1,820,193            |
| Deferred loan fees, net             | (28,075)              | (57,306)             |
| Allowance for loan and lease losses | (58,852)              | (63,700)             |
| Total loans and leases, net         | \$ 1,761,391          | \$ 1,699,187         |

As of September 30, 2012 and December 31, 2011, Equipment Finance leases totaled \$14.3 million and \$3.7 million, respectively, and are included in the Business Credit balances above.

The Company grants commercial loans, commercial real estate loans, and leases to customers throughout the United States. Although the Company has a diversified loan and lease portfolio, certain events have occurred, including, but not limited to, adverse economic conditions and adverse events affecting specific clients, industries or markets, that may adversely affect the ability of borrowers to make timely scheduled principal and interest payments on their loans and leases.

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 restructurings ( TDR ).

The Company utilizes a number of analytical tools for the purpose of estimating probability of default and loss given default which vary between its four specialized lending groups. The quantitative models employed by the Company in its Leveraged Finance and Equipment Finance businesses utilize Moody's KMV RiskCalc credit risk model in combination with a proprietary qualitative model, which generates a rating that maps to a probability of default. Real Estate utilizes a proprietary model that has been developed to capture risk characteristics unique to the lending activities in that line of business. The model produces an obligor risk rating which corresponds to a probability of default and also produces a loss given default. In each case, the probability of default and the loss given default are used to calculate an expected loss for those lending groups. Due to the nature of its borrowers and the structure of its loans, Business Credit utilizes a proprietary model that produces a

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

rating that corresponds to an expected loss, without calculating a probability of default and loss given default. 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 below a specified threshold are typically classified as Pass , and loans and leases rated above that threshold are typically classified as Criticized , a characterization that may apply to impaired loans, including TDR. As of September 30, 2012, \$249.3 million of the Company s loans were classified as Criticized , including \$208.3 million of the Company s impaired loans, and \$1.6 billion were classified as Pass . As of December 31, 2011, \$300.9 million of the Company s loans were classified as Criticized , including \$284.9 million of the Company s impaired loans, and \$1.5 billion were classified as Pass .

---

**Table of Contents**

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

A TDR that performs in accordance with the terms of the 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.

As of September 30, 2012, the Company had impaired loans with an aggregate outstanding balance of \$311.6 million. Impaired loans with an aggregate outstanding balance of \$268.6 million have been restructured and classified as TDR. As of September 30, 2012, the aggregate carrying value of equity investments in certain of the Company's borrowers in connection with troubled debt restructurings totaled \$6.6 million. Impaired loans with an aggregate outstanding balance of \$81.9 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 has been brought current. During the three and nine months ended September 30, 2012, the Company charged off \$0 and \$6.2 million, respectively, of outstanding non-accrual loans and recovered \$0.3 and \$1.3 million, respectively, of previously charged-off impaired loan outstanding balances. During the nine months ended September 30, 2012, the Company took previously identified non-accrual loans with an aggregate outstanding balance of \$16.2 million as of December 31, 2011 off non-accrual status and placed loans with an aggregate outstanding balance of \$27.7 million as of September 30, 2012 on non-accrual status. During the three and nine months ended September 30, 2012, the Company recorded \$4.6 million and \$8.8 million, respectively, of specific provisions for impaired loans. At September 30, 2012, the Company had a \$37.7 million specific allowance for impaired loans with an aggregate outstanding balance of \$196.9 million. At September 30, 2012, additional funding commitments for impaired loans totaled \$25.8 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 and the borrowing base availability for asset-based loans, or if the borrower is not in compliance additional funding commitments may be made at the Company's discretion. As of September 30, 2012, \$64.3 million of loans on non-accrual status were greater than 60 days past due and classified as delinquent by the Company. Included in the \$37.7 million specific allowance for impaired loans was \$8.5 million related to delinquent loans.

During the nine months ended September 30, 2012, as part of the resolution of two impaired commercial real estate loans, the Company took control of the underlying commercial real estate properties. The Company recorded a partial charge-off of \$2.7 million and classified the commercial real estate properties as other real estate owned. The commercial real estate properties had an aggregate fair value of \$13.6 million as of September 30, 2012.

As of December 31, 2011, the Company had impaired loans with an aggregate outstanding balance of \$316.3 million. Impaired loans with an aggregate outstanding balance of \$243.5 million have been restructured and classified as TDR. As a result of the adoption of ASU 2011-02, the Company classified loans with an outstanding balance of \$15.5 million as TDR during 2011. As of December 31, 2011, the aggregate carrying value of equity investments in certain of the Company's borrowers in connection with troubled debt restructurings totaled \$7.1 million. Impaired loans with an aggregate outstanding balance of \$102.2 million were also on non-accrual status. During 2011, the Company took previously identified non-accrual loans with an aggregate outstanding balance of \$38.2 million as of December 31, 2010 off non-accrual status, placed loans with an aggregate balance of \$56.4 million as of December 31, 2011 on non-accrual status and charged off \$38.0 million of outstanding non-accrual loans. During 2011, the Company recorded \$18.8 million of specific provisions for impaired loans. At December 31, 2011, the Company had a \$40.7 million specific allowance for impaired loans with an aggregate outstanding balance of \$208.4 million. At December 31, 2011, additional funding commitments for impaired loans totaled \$46.3 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 and the borrowing base availability for asset-based loans, or if the borrower is not in compliance additional funding commitments may be made at the Company's discretion. As of December 31, 2011, \$88.8 million of loans on non-accrual status and an additional \$8.4 million of loans were greater than 60 days past due and classified as delinquent by the Company. Included in the \$40.7 million specific allowance for impaired loans was \$13.8 million related to delinquent loans.

**Table of Contents**

A summary of impaired loans is as follows:

|                           | Investment        | Unpaid Principal  | Recorded Investment with a Related Allowance for Credit Losses<br>(\$ in thousands) | Recorded Investment without a Related Allowance for Credit Losses |
|---------------------------|-------------------|-------------------|---|---|
| <b>September 30, 2012</b> |                   |                   |   |   |
| Leveraged Finance         | \$ 226,927        | \$ 277,140        | \$ 147,352  | \$ 79,575   |
| Real Estate               | 82,897            | 88,701            | 43,503  | 39,394  |
| Business Credit           | 1,822             | 2,584             | 0   | 1,822   |
| <b>Total</b>              | <b>\$ 311,646</b> | <b>\$ 368,425</b> | <b>\$ 190,855</b>   | <b>\$ 120,791</b>   |
| <b>December 31, 2011</b>  |                   |                   |   |   |
| Leveraged Finance         | \$ 237,529        | \$ 327,052        | \$ 153,390  | \$ 84,139   |
| Real Estate               | 75,957            | 93,056            | 55,031  | 20,926  |
| Business credit           | 2,831             | 2,831             | 0   | 2,831   |
| <b>Total</b>              | <b>\$ 316,317</b> | <b>\$ 422,939</b> | <b>\$ 208,421</b>   | <b>\$ 107,896</b>   |

During the three months ended September 30, 2012 the Company recorded recoveries of previously charged-off loans of \$0.3 million. During the nine months ended September 30, 2012 the Company recorded net partial charge-offs of \$11.8 million, and during the three and nine months ended September 30, 2011 the Company recorded net partial charge-offs of \$9.4 million and \$24.7 million, respectively. The Company's general policy is to record a specific allowance for an impaired loan when the Company determines that it is doubtful that it will be able to collect all amounts due according to the contractual terms of the loan. Any partial charge-off of such loan occurring in a subsequent period. 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, and reduces the gross investment in the loan.

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

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

|                            | Leveraged Finance   |                  | Real Estate       |                  | Business Credit   |               |
|----------------------------|---------------------|------------------|-------------------|------------------|-------------------|---------------|
|                            | Investment          | Allowance        | Investment        | Allowance        | Investment        | Allowance     |
| <b>September 30, 2012</b>  |                     |                  |                   |                  |                   |               |
| Collectively evaluated (1) | \$ 1,219,361        | \$ 15,330        | \$ 122,309        | \$ 5,182         | \$ 195,002        | \$ 678        |
| Individually evaluated (2) | 226,927             | 32,382           | 82,897            | 5,280            | 1,822             | 0             |
| <b>Total</b>               | <b>\$ 1,446,288</b> | <b>\$ 47,712</b> | <b>\$ 205,206</b> | <b>\$ 10,462</b> | <b>\$ 196,824</b> | <b>\$ 678</b> |
| <b>December 31, 2011</b>   |                     |                  |                   |                  |                   |               |
| Collectively evaluated (1) | \$ 1,199,511        | \$ 16,062        | \$ 195,424        | \$ 6,586         | \$ 108,941        | \$ 374        |
| Individually evaluated (2) | 237,529             | 28,058           | 75,957            | 12,620           | 2,831             | 0             |

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

|       |              |           |            |           |            |        |
|-------|--------------|-----------|------------|-----------|------------|--------|
| Total | \$ 1,437,040 | \$ 44,120 | \$ 271,381 | \$ 19,206 | \$ 111,772 | \$ 374 |
|-------|--------------|-----------|------------|-----------|------------|--------|

- (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 and leases had a weighted average risk rating of 5.1 and 5.3 based on the Company's internally developed 12 point scale at September 30, 2012 and December 31, 2011.
- (2) 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.

**Table of Contents**

Below is a summary of the Company's investment in non-accrual loans.

| <b>Recorded Investment in Non-<br/>accrual Loans</b> | <b>September 30, 2012</b> | <b>December 31, 2011</b> |
|--|---------------------------|--------------------------|
|  | (\$ in thousands)         |                          |
| Leveraged Finance                                    | \$ 75,585                 | \$ 78,214                |
| Real Estate  | 4,464                     | 21,115                   |
| Business Credit                                      | 1,822                     | 2,831                    |
| <br>Total  | <br>\$ 81,871             | <br>\$ 102,160           |

During the nine months ended September 30, 2012, non-accrual loans with an aggregate outstanding balance of \$27.3 million were resolved as a result of workout processes with the borrowers.

Loans being restructured typically develop adverse performance trends as a result of internal or external factors, the result of which is an inability to comply with the terms of the applicable credit agreement governing their 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) construction of a financial model that runs through the tenor of the restructuring term, (ii) meetings with management of the borrower, (iii) engagement of third party consultants and (iv) internal analysis. Once a restructuring proposal is developed, it is subject to approval by both the Company's Underwriting Committee and the Company's Investment Committee. Loans will only be removed from TDR classification upon the refinancing of outstanding obligations on terms which are determined to be market in all material respects, or upon full payoff of the loan. 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. As of September 30, 12, the Company had one troubled debt restructuring presented net of deferred loan fees against its gross outstanding balance.

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 charge-offs

partial forgiveness

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

conversion of debt to equity

A summary of the types of concessions that the Company made with respect to TDRs at September 30, 2012 and December 31, 2011 is provided below:

|                    | <b>Group I</b>           | <b>Group II</b> |
|--------------------|--------------------------|-----------------|
|                    | <b>(\$ in thousands)</b> |                 |
| September 30, 2012 | \$ 268,567               | \$ 185,699      |
| December 31, 2011  | \$ 243,509               | \$ 195,382      |

Note: A loan may be included in more than one type of restructuring.

For the three and nine months ended September 30, 2012, the Company had partial charge-offs totaling \$0 and \$3.8 million, respectively related to loans previously classified as TDR and received loan repayments of \$13.5 million and \$53.4 million, respectively. As of September 30, 2012, the Company had not removed the TDR classification from any loan previously identified as such.

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 based on the terms of the restructuring. If a charge-off is taken on a restructured loan, interest will typically move to a cash basis where it is taken into income only upon receipt or be placed on non-accrual. Loans will typically not be returned to accrual status until at least six months of contractual payments have been made in a timely manner. Additionally, at the time of a restructuring and quarterly thereafter, an impairment analysis is undertaken to determine the level of impairment on the loan.



**Table of Contents**

Below is a summary of the Company's loans which were classified as TDR.

| For the Three Months Ended | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment<br>(\$ in thousands) | Investment in TDR<br>Subsequently<br>Defaulted |
|----------------------------|---|---|--|
| <b>September 30, 2012</b>  |   |   |  |
| Leveraged Finance          | \$ 0  | \$ 0  | \$ 9,872                                       |
| Real Estate                | 3,800   | 3,800   | 0  |
| Business Credit            | 0   | 0   | 0  |
| <b>Total</b>               | <b>\$ 3,800</b>   | <b>\$ 3,800</b>   | <b>\$ 9,872</b>                                |

| For the Nine Months Ended | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment<br>(\$ in thousands) | Investment in TDR<br>Subsequently<br>Defaulted |
|---------------------------|---|---|--|
| <b>September 30, 2012</b> |   |   |  |
| Leveraged Finance         | \$ 22,190   | \$ 22,190   | \$ 17,665                                      |
| Real Estate               | 47,544  | 47,544  | 0  |
| Business Credit           | 0   | 0   | 0  |
| <b>Total</b>              | <b>\$ 69,734</b>  | <b>\$ 69,734</b>  | <b>\$ 17,665</b>                               |

| For the Year Ended       | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment<br>(\$ in thousands) | Investment in TDR<br>Subsequently<br>Defaulted |
|--------------------------|---|---|--|
| <b>December 31, 2011</b> |   |   |  |
| Leveraged Finance        | \$ 71,470   | \$ 71,470   | \$ 26,154                                      |
| Real Estate              | 0   | 0   | 0  |
| Business Credit          | 0   | 0   | 0  |
| <b>Total</b>             | <b>\$ 71,470</b>  | <b>\$ 71,470</b>  | <b>\$ 26,154</b>                               |

The following sets forth a breakdown of troubled debt restructurings at September 30, 2012 and December 31, 2011:

| As of September 30, 2012 | Accrual Status    |                  |                     |                       | For the<br>nine months |
|--------------------------|-------------------|------------------|---------------------|-----------------------|------------------------|
| (\$ in thousands)        | Accruing          | Non-accrual      | Impaired<br>Balance | Specific<br>Allowance | Charged-<br>off        |
| <b>Loan Type</b>         |                   |                  |                     |                       |                        |
| Leveraged Finance        | \$ 135,462        | \$ 63,360        | \$ 198,822          | \$ 25,701             | \$ 3,814               |
| Real Estate              | 65,297            | 4,448            | 69,745              | 2,218                 | 5,612                  |
| Business Credit          | 0                 | 0                | 0                   | 0                     | 0                      |
| <b>Total</b>             | <b>\$ 200,759</b> | <b>\$ 67,808</b> | <b>\$ 268,567</b>   | <b>\$ 27,919</b>      | <b>\$ 9,426</b>        |

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

As of December 31, 2011

| Loan Type         | Accrual Status |             |                  | Specific Allowance | For the year |
|-------------------|----------------|-------------|------------------|--------------------|--------------|
|                   | Accruing       | Non-accrual | Impaired Balance |                    | Charged-off  |
| Leveraged Finance | \$ 140,271     | \$ 75,492   | \$ 215,763       | \$ 26,266          | \$ 15,740    |
| Real Estate       | 23,277         | 4,469       | 27,746           | 3,836              | 0            |
| Business Credit   | 0              | 0           | 0                | 0                  | 0            |
| Total             | \$ 163,548     | \$ 79,961   | \$ 243,509       | \$ 30,102          | \$ 15,740    |

The Company classifies a loan as past due when it is over 60 days delinquent.

**Table of Contents**

An age analysis of the Company's past due receivables is as follows:

|                           | 60-89 Days<br>Past Due | Greater than<br>90 Days | Total Past<br>Due | Current             | Total Loans         | Investment in<br>> 60 Days &<br>Accruing |
|---------------------------|------------------------|-------------------------|-------------------|---------------------|---------------------|--|
|                           | (\$ in thousands)      |                         |                   |                     |                     |  |
| <b>September 30, 2012</b> |                        |                         |                   |                     |                     |  |
| Leveraged Finance         | \$ 20,915              | \$ 38,872               | \$ 59,787         | \$ 1,386,501        | \$ 1,446,288        | \$ 21,134                                |
| Real Estate               | 0                      | 4,464                   | 4,464             | 200,742             | 205,206             | 0  |
| Business Credit           | 0                      | 0                       | 0                 | 196,824             | 196,824             | 0  |
| <b>Total</b>              | <b>\$ 20,915</b>       | <b>\$ 43,336</b>        | <b>\$ 64,251</b>  | <b>\$ 1,784,067</b> | <b>\$ 1,848,318</b> | <b>\$ 21,134</b>                         |
| <b>December 31, 2011</b>  |                        |                         |                   |                     |                     |  |
| Leveraged Finance         | \$ 23,940              | \$ 40,951               | \$ 64,891         | \$ 1,372,149        | \$ 1,437,040        | \$ 0                                     |
| Real Estate               | 15,834                 | 13,719                  | 29,553            | 241,828             | 271,381             | 8,438                                    |
| Business Credit           | 0                      | 2,831                   | 2,831             | 108,941             | 111,772             | 0  |
| <b>Total</b>              | <b>\$ 39,774</b>       | <b>\$ 57,501</b>        | <b>\$ 97,275</b>  | <b>\$ 1,722,918</b> | <b>\$ 1,820,193</b> | <b>\$ 8,438</b>                          |

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 changes in economic conditions, credit availability, industry 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 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 or profile.

For Leveraged Finance loans and equipment finance leases, 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 or lease terms in determining a loan loss in the event of default.

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.

For Business Credit loans, the Company utilizes a proprietary model to risk rate the loans on a monthly basis. This model captures 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 has also evaluated historical 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 is adjusted to reflect the historical average for expected loss from the industry database.

If the Company determines that additional 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. Moreover, given uncertain market conditions, actual losses under the Company's current or any revised allowance methodology may differ materially from the Company's estimate.

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

Additionally, when determining the amount of the general allowance, the Company supplements the base amount with a judgmental amount which is governed by a score card system comprised of ten individually weighted 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. 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, it does assist management in identifying market trends and serves as an overall reasonableness check on the allowance for credit losses computation.

**Table of Contents**

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. 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 for all loans for which we have serious doubts as to the ability of the borrowers to comply with the present loan repayment terms.

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

|   | Three Months Ended September 30, 2012 |                    |                    |                     |
|---|---------------------------------------|--------------------|--------------------|---------------------|
|   | Leveraged<br>Finance                  | Real Estate        | Business<br>Credit | Total               |
|   | (\$ in thousands)                     |                    |                    |                     |
| Balance, beginning of period                                | \$ 43,975                             | \$ 10,687          | \$ 672             | \$ 55,334           |
| Provision for credit losses - general                       | (881)                                 | (24)               | 6                  | (899)               |
| Provision for credit losses - specific                      | 4,834                                 | (223)              | 0                  | 4,611               |
| Loans charged off, net of recoveries                        | 305                                   | 0                  | 0                  | 305                 |
| <b>Balance, end of period</b>                               | <b>\$ 48,233</b>                      | <b>\$ 10,440</b>   | <b>\$ 678</b>      | <b>\$ 59,351</b>    |
| Balance, end of period - specific                           | \$ 32,382                             | \$ 5,280           | \$ 0               | \$ 37,662           |
| Balance, end of period - general                            | \$ 15,851                             | \$ 5,160           | \$ 678             | \$ 21,689           |
| Average balance of impaired loans                           | \$ 236,786                            | \$ 75,279          | \$ 2,393           | \$ 314,458          |
| Interest recognized from impaired loans                     | \$ 3,722                              | \$ 1,079           | \$ 0               | \$ 4,801            |
| <b>Loans</b>  |                                       |                    |                    |                     |
| Loans individually evaluated with specific allowance        | \$ 153,370                            | \$ 43,503          | \$ 0               | \$ 196,873          |
| Loans individually evaluated with no specific allowance     | 73,557                                | 39,394             | 0                  | 112,951             |
| Loans previously acquired with deteriorating credit quality | 0                                     | 0                  | 1,822              | 1,822               |
| Loans collectively evaluated without specific allowance     | 1,219,361                             | 122,309            | 195,002            | 1,536,672           |
| <b>Total loans and leases</b>                               | <b>\$ 1,446,288</b>                   | <b>\$ ,205,206</b> | <b>\$ 196,824</b>  | <b>\$ 1,848,318</b> |

|   | Nine Months Ended September 30, 2012 |                  |                    |                  |
|---|--------------------------------------|------------------|--------------------|------------------|
|   | Leveraged<br>Finance                 | Real Estate      | Business<br>Credit | Total            |
|   | (\$ in thousands)                    |                  |                    |                  |
| Balance, beginning of period            | \$ 44,553                            | \$ 19,185        | \$ 374             | \$ 64,112        |
| Provision for credit losses - general   | (950)                                | (1,404)          | 304                | (2,050)          |
| Provision for credit losses - specific  | 7,127                                | 1,675            | 0                  | 8,802            |
| Loans charged off, net of recoveries    | (2,497)                              | (9,016)          | 0                  | (11,513)         |
| <b>Balance, end of period</b>           | <b>\$ 48,233</b>                     | <b>\$ 10,440</b> | <b>\$ 678</b>      | <b>\$ 59,351</b> |
| Average balance of impaired loans       | \$ 237,258                           | \$ 88,377        | \$ 2,620           | \$ 328,255       |
| Interest recognized from impaired loans | \$ 10,914                            | \$ 2,456         | \$ 0               | \$ 13,370        |

**Table of Contents**

|  | Three Months Ended September 30, 2011 |                   |                   |                     |
|--|---------------------------------------|-------------------|-------------------|---------------------|
|  | Leveraged Finance                     | Real Estate       | Business Credit   | Total               |
|  | (\$ in thousands)                     |                   |                   |                     |
| Balance, beginning of period                                       | \$ 62,332                             | \$ 15,558         | \$ 150            | \$ 78,040           |
| Provision for credit losses - general                              | (1,581)                               | (530)             | 189               | (1,922)             |
| Provision for credit losses - specific                             | 5,992                                 | 338               | 0                 | 6,330               |
| Loans charged off, net of recoveries                               | (9,410)                               | 0                 | 0                 | (9,410)             |
| <b>Balance, end of period</b>                                      | <b>\$ 57,333</b>                      | <b>\$ 15,366</b>  | <b>\$ 339</b>     | <b>\$ 73,038</b>    |
| Balance, end of period - specific                                  | \$ 41,888                             | \$ 11,634         | \$ 0              | \$ 53,522           |
| Balance, end of period - general                                   | \$ 15,446                             | \$ 3,732          | \$ 339            | \$ 19,516           |
| Average balance of impaired loans                                  | \$ 268,156                            | \$ 79,124         | \$ 5,201          | \$ 352,481          |
| Interest recognized from impaired loans                            | \$ 4,273                              | \$ 719            | \$ 0              | \$ 4,992            |
| <b>Loans and leases</b>  |                                       |                   |                   |                     |
| Loans individually evaluated with specific allowance               | \$ 174,247                            | \$ 64,244         | \$ 0              | \$ 238,491          |
| Loans individually evaluated with no specific allowance            | 93,441                                | 12,230            | 0                 | 105,671             |
| Loans previously acquired with deteriorating credit quality        | 0                                     | 0                 | 4,903             | 4,903               |
| Loans and leases collectively evaluated without specific allowance | 1,140,740                             | 194,262           | 97,850            | 1,432,852           |
| <b>Total loans and leases</b>                                      | <b>\$ 1,408,428</b>                   | <b>\$ 270,736</b> | <b>\$ 102,753</b> | <b>\$ 1,781,917</b> |

|   | Nine Months Ended September 30, 2011 |                  |                 |                  |
|---|--------------------------------------|------------------|-----------------|------------------|
|   | Leveraged Finance                    | Real Estate      | Business Credit | Total            |
|   | (\$ in thousands)                    |                  |                 |                  |
| Balance, beginning of year              | \$ 58,912                            | \$ 25,869        | \$ 0            | \$ 84,781        |
| Provision for credit losses - general   | (2,115)                              | (3,612)          | 339             | (5,388)          |
| Provision for credit losses - specific  | 15,268                               | 3,118            | 0               | 18,386           |
| Loans charged off, net of recoveries    | (14,732)                             | (10,009)         | 0               | (24,741)         |
| <b>Balance, end of period</b>           | <b>\$ 57,333</b>                     | <b>\$ 15,366</b> | <b>\$ 339</b>   | <b>\$ 73,038</b> |
| Average balance of impaired loans       | \$ 309,734                           | \$ 94,170        | \$ 6,076        | \$ 409,980       |
| Interest recognized from impaired loans | \$ 12,211                            | \$ 2,222         | \$ 176          | \$ 14,609        |

Included in the allowance for credit losses at September 30, 2012 and December 31, 2011 is an allowance for unfunded commitments of \$0.5 million and \$0.4 million, respectively, 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, 2012, the Company recorded a total provision for credit losses of \$6.8 million. The Company maintained its allowance for credit losses at \$59.4 million as of September 30, 2012 and \$64.1 million at December 31, 2011. The Company had \$11.5 million of net charge-offs of impaired loans with a specific allowance and reduced its allowance for credit losses by 31 basis points during the nine months ended September 30, 2012, offset by new specific provisions for credit losses and general provisions for credit losses due to loan growth. The general allowance for credit losses covers probable losses in the Company's loan and lease portfolio with respect to loans and leases 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 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 decreased to 18% as of September 30, 2012 as compared to 19% as of December 31, 2011. 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.

The Company closely monitors the credit quality of its loans and leases 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.

**Table of Contents**

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, 2012 in light of the estimated known and inherent risks identified through its analysis. The Company continually evaluates the appropriateness of its allowance for credit losses methodology.

**Note 4. Restricted Cash**

Restricted cash as of September 30, 2012 and December 31, 2011 was as follows:

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
|  | (\$ in thousands)     |                      |
| Collections on loans pledged to credit facilities                                | \$ 37,822             | \$ 22,137            |
| Principal and interest collections on loans held in trust and prefunding amounts | 111,252               | 57,994               |
| Customer escrow accounts   | 2,313                 | 3,684                |
| Total  | \$ 151,387            | \$ 83,815            |

**Note 5. Investments in Debt Securities, Available-for-Sale**

Amortized cost of investments in debt securities as of September 30, 2012 and December 31, 2011 was as follows:

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
|   | (\$ in thousands)     |                      |
| Investments in debt securities - gross          | \$ 25,298             | \$ 25,298            |
| Unamortized discount                            | (4,378)               | (4,548)              |
| Investments in debt securities - amortized cost | \$ 20,920             | \$ 20,750            |

The amortized cost, gross unrealized holding gains, gross unrealized holding losses, and fair value of available-for-sale securities at September 30, 2012 and December 31, 2011 were as follows:

|                                 | Amortized<br>cost | Gross<br>unrealized<br>holding gains<br>(\$ in thousands) | Gross<br>unrealized<br>holding losses | Fair value |
|---------------------------------|-------------------|---|---------------------------------------|------------|
| <b>September 30, 2012:</b>      |                   |   |                                       |            |
| Collateralized loan obligations | \$ 20,920         | \$ 220  | \$ (337)                              | \$ 20,803  |
|                                 | \$ 20,920         | \$ 220  | \$ (337)                              | \$ 20,803  |
| <b>December 31, 2011:</b>       |                   |   |                                       |            |
|                                 | Amortized<br>cost | Gross<br>unrealized<br>holding gains<br>(\$ in thousands) | Gross<br>unrealized<br>holding losses | Fair value |



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

|                                 |           |      |            |           |
|---------------------------------|-----------|------|------------|-----------|
| Collateralized loan obligations | \$ 20,750 | \$ 0 | \$ (2,933) | \$ 17,817 |
|                                 | \$ 20,750 | \$ 0 | \$ (2,933) | \$ 17,817 |

The Company did not sell any debt securities during the nine months ended September 30, 2012 and 2011.

The Company did not record any net Other-Than-Temporary Impairment charges during the nine months ended September 30, 2012 and 2011.

**Table of Contents**

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, 2012 and December 31, 2011:

|                     | Less than<br>12 Months | September 30, 2012<br>Greater than<br>or Equal to<br>12 Months<br>(\$ in thousands) | Total     |
|---------------------|------------------------|---|-----------|
| Number of positions | 0                      | 4   | 4         |
| Fair value          | \$ 0                   | \$ 18,895   | \$ 18,895 |
| Amortized cost      | 0                      | 19,232  | 19,232    |
| Unrealized loss     | \$ 0                   | \$ 337  | \$ 337    |

|                     | Less than<br>12 Months | December 31, 2011<br>Greater than<br>or Equal<br>to<br>12 Months<br>(\$ in thousands) | Total     |
|---------------------|------------------------|---|-----------|
| Number of positions | 5                      | 0   | 5         |
| Fair value          | \$ 17,817              | \$ 0  | \$ 17,817 |
| Amortized cost      | 20,750                 | 0   | 20,750    |
| Unrealized loss     | \$ 2,933               | \$ 0  | \$ 2,933  |

As a result of the Company's evaluation of the securities, management concluded that the unrealized losses at September 30, 2012 and December 31, 2011 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, 2012, 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, 2012 and December 31, 2011 (maturities of asset-backed and mortgage-backed securities have been allocated based upon estimated maturities, assuming no change in the current interest rate environment):

|  | September 30, 2012 |                                 | December 31, 2011 |            |
|--|--------------------|---------------------------------|-------------------|------------|
|  | Amortized<br>cost  | Fair value<br>(\$ in thousands) | Amortized<br>cost | Fair value |
| Available-for-sale:                    |                    |                                 |                   |            |
| Due one year or less                   | \$ 0               | \$ 0                            | \$ 0              | \$ 0       |
| Due after one year through five years  | 0                  | 0                               | 0                 | 0          |
| Due after five years through ten years | 20,920             | 20,803                          | 20,750            | 17,817     |
| Total                                  | \$ 20,920          | \$ 20,803                       | \$ 20,750         | \$ 17,817  |

**Note 6. Borrowings**

***Credit Facilities***

As of September 30, 2012 the Company had five credit facilities: (i) a \$50.0 million facility with NATIXIS Financial Products, Inc. ( NATIXIS ), (ii) a \$150.0 million revolving credit facility with NATIXIS, (iii) a \$225 million credit facility with DZ Bank AG Deutsche Zentral-Genossenschaftsbank Frankfurt ( DZ Bank ), (iv) a \$75 million credit facility with Wells Fargo Bank, National Association ( Wells Fargo ) to fund new equipment lease origination, and (v) a \$150 million credit facility with Wells Fargo.

The Company has a \$50.0 million credit facility agreement with NATIXIS that had an outstanding balance of \$22.0 million and unamortized deferred financing fees of \$0.1 million as of September 30, 2012. Interest on this facility accrues at a variable rate per annum, which was 3.71% at September 30, 2012. On May 18, 2012, the Company entered into an amendment with NATIXIS that extended the revolving period under the credit facility to December 17, 2012 and amended the final maturity date of the credit facility to December 31, 2012.

**Table of Contents**

The Company also has a \$150.0 million credit facility agreement with NATIXIS that had an outstanding balance of \$104.1 million and unamortized deferred financing fees of \$2.2 million as of September 30, 2012. Interest on this facility accrues at a variable rate per annum, which was 2.55% at September 30, 2012. This credit facility has a reinvestment period ending on August 16, 2013 and is scheduled to mature on February 16, 2019. The Company must comply with various covenants, the breach of which could result in a termination event if not cured. These covenants include, but are not limited to, failure to service debt obligations and failure to meet overcollateralization tests.

The Company has a \$225.0 million credit facility with DZ Bank that had an outstanding balance of \$136.7 million as of September 30, 2012. Interest on this facility accrues at a variable rate per annum. As part of the agreement, there is a minimum interest payment of \$2.8 million per annum required to be made. If the facility is not utilized to cover this minimum requirement, then a make-whole fee is required to be made to satisfy the minimum requirement. The Company is permitted to use the proceeds of borrowings under the credit facility to fund commitments under existing or new asset based loans. This facility is scheduled to mature on April 25, 2013.

On January 25, 2011, the Company entered into a note purchase agreement with Wells Fargo. Under the terms of the note purchase agreement, Wells Fargo agreed to provide a \$75.0 million credit facility to fund new equipment lease originations. The credit facility is scheduled to mature four years after the initial advance under the credit facility. The Company must comply with various covenants, the breach of which could result in a termination event if not cured. These covenants include, but are not limited to, failure to service debt obligations, failure to maintain minimum levels of liquidity, failure to meet tangible net worth covenants and violations of pool default and delinquency tests. As of September 30, 2012, the Company had not drawn any amounts from this credit facility.

The Company also has a \$150.0 million credit facility with Wells Fargo that had an outstanding balance of \$133.5 million and unamortized deferred financing fees of \$1.4 million as of September 30, 2012. The facility provides for a revolving reinvestment period ending in January 2013 with a two-year amortization period. The Company must comply with various covenants, the breach of which could result in a termination event if not cured. These covenants include, but are not limited to, failure to service debt obligations, failure to maintain minimum levels of liquidity, and failure to meet tangible net worth covenants and overcollateralization tests. At September 30, 2012, the Company was in compliance with all such covenants. Interest on this facility accrued at a variable rate per annum, which was 2.71% at September 30, 2012.

***Corporate Credit Facility***

On January 5, 2010, the Company entered into a note agreement with Fortress Credit Corp., which was subsequently amended on August 31, 2010 and January 27, 2012. The credit facility, as amended, consists of a \$25.0 million revolving note and a \$100.0 million term note, which matures on August 31, 2016. The credit facility accrues interest equal to the London Interbank Offered Rate (LIBOR) plus 7.00%.

The Company is permitted to use the proceeds of borrowings under the credit facility for general corporate purposes including, but not limited to, funding loans, working capital, paying down outstanding debt, making certain types of acquisitions and repurchasing capital stock up to \$10 million.

The applicable unused fee rate of the revolving note is 4.0% of the undrawn amount of the revolving note when the total outstanding amount is less than 50% of the commitment amount, 3.0% of the undrawn amount of the revolving note when the total outstanding amount is greater than or equal to 50% but less than 75% of the commitment amount, and 2.0% of the undrawn amount of the revolving note when the total outstanding amount is greater than or equal to 75% of the commitment amount. As of September 30, 2012, the Company had not drawn any amounts from the revolving note. As of September 30, 2012, unamortized deferred financing fees were \$3.0 million.

The revolving note may be cancelled at any time subject to a commitment termination fee. The commitment termination fee will be equal to the product of the aggregate revolving loan commitments as of the date of termination and 1% for any termination made during the period from July 1, 2012 to August 31, 2015, and 0% for any termination made at any time after August 31, 2015.

The term note may be prepaid subject to a commitment termination fee. For any prepayment of term loans made before January 27, 2013, the commitment termination fee will be equal to the product of (x) the amount of the prepayment and (y) 3%. For any prepayment of term loans made during the period from January 28, 2013 to August 31, 2015, the commitment termination fee will be equal to the product of (x) the amount of the prepayment and (y) 1%. For any prepayment made at any time after August 31, 2015 there will not be any fee. As of September 30, 2012, the term note had an outstanding principal balance of \$100.0 million.

***Term Debt Securitizations***

In August 2005 the Company completed a term debt transaction. In conjunction with this transaction we established a separate single-purpose bankruptcy-remote subsidiary, NewStar Trust 2005-1 (the 2005 CLO Trust ) and contributed \$375 million in loans and investments (including

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

unfunded commitments), or portions thereof, to the 2005 CLO Trust. The Company remains the servicer of the loans and investments. Simultaneously with the initial contributions, the 2005 CLO Trust issued \$343.4 million of notes to institutional investors and issued \$31.6 million of trust certificates of which the Company retained 100%. At September 30, 2012, the

**Table of Contents**

\$130.5 million of outstanding notes were collateralized by the specific loans and investments, principal collections account cash and principal payment receivables totaling \$162.0 million. At September 30, 2012, deferred financing fees were \$0. The 2005 CLO Trust permitted reinvestment of collateral principal repayments for a three-year period which ended in October 2008. During the nine months ended September 30, 2012, the Company repurchased \$9.3 million of the 2005 CLO Trust's Class D notes. During 2011, the Company repurchased \$3.9 million of the 2005 CLO Trust's Class E notes. During 2010, the Company repurchased \$4.6 million of the 2005 CLO Trust's Class D notes. During 2009, the Company repurchased \$1.4 million of the 2005 CLO Trust's Class D notes and \$1.2 million of the Class E notes. During 2008, the Company repurchased \$5.8 million of the 2005 CLO Trust's Class E notes. During 2007, the Company repurchased \$5.0 million of the 2005 CLO Trust's Class E notes. During 2009, Moody's downgraded all of the notes of the 2005 CLO Trust. As a result of the downgrades, amortization of the 2005 CLO Trust changed from pro rata to sequential, resulting in scheduled principal payments made in order of the notes seniority until all available funds are exhausted for each payment. During 2010, Standard and Poor's downgraded all of the notes of the 2005 CLO Trust. During the first quarter of 2012, Moody's upgraded the Class A-1 notes, the Class A-2 notes, the Class B notes, the Class C notes, and the Class D notes, and downgraded the Class E notes of the 2005 CLO Trust. During the third quarter of 2012, Fitch affirmed its ratings of all of the notes of the 2005 CLO Trust.

The Company receives a loan collateral management fee and excess interest spread. The Company may receive a principal distribution when the term debt is retired. The most recent quarterly report of the 2005 CLO Trust dated July 13, 2012 identified \$74.8 million in cumulative charged-off loans in the 2005 CLO Trust as delinquent or charged-off under the terms of the trust indenture. As a result, the excess interest spread from the 2005 CLO Trust will be redirected and combined with recoveries and will be used to repay the outstanding notes until note redemptions equal the underlying non-accrual loan balances or until the Company purchases such loans. As of the July 13, 2012 report, the cumulative amount redirected was \$19.2 million. The Company may have additional defaults in the 2005 CLO Trust in the future. If the Company does not elect to remove any future defaulted loans, it would not expect to receive excess interest spread payments until the undistributed cash plus any recoveries equal the outstanding balances of defaulted loan collateral.

The following table sets forth selected information with respect to the 2005 CLO Trust:

|                   | Notes<br>originally<br>issued | Outstanding<br>balance<br>September 30,<br>2012 | Interest<br>rate | Original<br>maturity | Ratings<br>(S&P/Moody's/<br>Fitch)(1) |
|-------------------|-------------------------------|---|------------------|----------------------|---------------------------------------|
| (\$ in thousands) |                               |   |                  |                      |                                       |
| 2005 CLO Trust:   |                               |   |                  |                      |                                       |
| Class A-1         | \$ 156,000                    | \$ 36,567                                       | Libor + 0.28%    | July 25, 2018        | AA+/Aaa/AAA                           |
| Class A-2         | 80,477                        | 18,667  | Libor + 0.30%    | July 25, 2018        | AA+/Aaa/AAA                           |
| Class B           | 18,750                        | 18,683  | Libor + 0.50%    | July 25, 2018        | A+/Aa1/AA                             |
| Class C           | 39,375                        | 39,233  | Libor + 0.85%    | July 25, 2018        | B+/A2/BB                              |
| Class D           | 24,375                        | 8,922   | Libor + 1.50%    | July 25, 2018        | CCC-/Ba2/CCC                          |
| Class E           | 24,375                        | 8,418   | Libor + 4.75%    | July 25, 2018        | CCC-/Caa3/CC                          |
|                   | \$ 343,352                    | \$ 130,490                                      |                  |                      |                                       |

(1) The ratings were initially given in August 2005, are unaudited and are subject to change from time to time. During the first quarter of 2009, Fitch affirmed its ratings and downgraded the Class D notes and Class E notes. The Fitch downgrade did not have a material impact on the 2005 CLO Trust. During the first quarter of 2009, Moody's downgraded the Class C notes, the Class D notes and the Class E notes. During the third quarter of 2009, Moody's downgraded the Class A-1 notes, the Class A-2 notes and the Class B notes. During the second quarter of 2010, Standard and Poor's downgraded all of the notes to the ratings shown above. During the third quarter of 2010, Fitch downgraded the Class C notes, the Class D notes and the Class E notes to the ratings shown above. During the first quarter of 2012, Moody's upgraded the Class A-1 notes, the Class A-2 notes, the Class B notes, the Class C notes, and the Class D notes, and downgraded the Class E notes to the ratings shown above. Fitch affirmed its ratings during the third quarter of 2012 (source: Bloomberg Finance L.P.). In June 2006 the Company completed a term debt transaction. In conjunction with this transaction the Company established a separate single-purpose bankruptcy remote subsidiary, NewStar Commercial Loan Trust 2006-1 (the 2006 CLO Trust) and contributed \$500 million in loans and investments (including unfunded commitments), or portions thereof, to the 2006 CLO Trust. The Company remains the servicer of the loans. Simultaneously with the initial contributions, the 2006 CLO Trust issued \$456.3 million of notes to institutional investors. The Company retained \$43.8 million, comprising 100% of the 2006 CLO Trust's trust certificates. At September 30, 2012, the \$295.7 million of outstanding

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

drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$339.4 million. At September 30, 2012, deferred financing fees were \$1.0 million. The 2006 CLO Trust permitted reinvestment of collateral principal repayments for a five-year period which ended in June 2011. During 2011, the Company repurchased \$7.0 million of the 2006 CLO Trust's Class C notes,

**Table of Contents**

\$6.0 million of the 2006 CLO Trust's Class D notes and \$2.0 million of the 2006 CLO Trust's Class E notes. During 2010, the Company repurchased \$3.0 million of the 2006 CLO Trust's Class D notes and \$3.0 million of the 2006 CLO Trust's Class E notes. During 2009, the Company repurchased \$6.5 million of the 2006 CLO Trust's Class D notes and \$1.8 million of the 2006 CLO Trust's Class E notes. During 2008, the Company repurchased \$3.3 million of the 2006 CLO Trust's Class D and \$2.5 million of the 2006 CLO Trust's Class E notes, respectively. During 2009, Moody's downgraded all of the notes of the 2006 CLO Trust. As a result of the downgrade, amortization of the 2006 CLO Trust changed from pro rata to sequential, resulting in future scheduled principal payments made in order of the notes seniority until all available funds are exhausted for each payment. During 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes, the Class D notes and the Class E notes of the 2006 CLO Trust. The downgrade did not have any material consequence as the amortization of the 2006 CLO Trust changed from pro rata to sequential after the Moody's downgrade in 2009. During 2011, Moody's upgraded its ratings of all of the notes of the 2006 CLO Trust. During the third quarter of 2012, Fitch affirmed its ratings of all of the notes of the 2006 CLO Trust.

The Company receives a loan collateral management fee and excess interest spread. The Company expects to receive a principal distribution when the term debt is retired. The most recent quarterly report of the 2006 CLO Trust dated September 13, 2012 identified \$21.6 million in cumulative charged-off loans in the 2006 CLO Trust as delinquent or charged-off under the terms of the trust indenture. As a result, the excess interest spread from the 2006 CLO Trust will be redirected and combined with recoveries and will be used to repay the outstanding notes until note redemptions equal the underlying non-accrual loan balances or until the Company purchases such loans. During 2011, the Company elected to purchase \$11.1 million of defaulted collateral from the 2006 CLO Trust to reduce the amount of excess interest spread that otherwise would have been required to be redirected. As of the September 13, 2012 quarterly report, the entire \$21.6 million had been redirected or repurchased. The Company may have additional defaults in the 2006 CLO Trust in the future. If the Company does not elect to remove any future defaulted loans, it would not expect to receive excess interest spread payments until the undistributed cash plus any recoveries equal the outstanding balances of defaulted loan collateral.

The following table sets forth the selected information with respect to the 2006 CLO Trust:

|                   | Notes<br>originally<br>issued | Outstanding<br>balance<br>September 30,<br>2012 | Interest<br>rate | Original<br>maturity | Ratings<br>(S&P/Moody /<br>Fitch)(1) |
|-------------------|-------------------------------|---|------------------|----------------------|--------------------------------------|
| (\$ in thousands) |                               |   |                  |                      |                                      |
| 2006 CLO Trust    |                               |   |                  |                      |                                      |
| Class A-1         | \$ 320,000                    | \$ 206,754                                      | Libor +0.27%     | March 30, 2022       | AA+/Aaa/AAA                          |
| Class A-2         | 40,000                        | 27,670  | Libor +0.28%     | March 30, 2022       | AA+/Aaa/AAA                          |
| Class B           | 22,500                        | 22,500  | Libor +0.38%     | March 30, 2022       | AA/Aa2/AA                            |
| Class C           | 35,000                        | 28,000  | Libor +0.68%     | March 30, 2022       | BBB+/A3/A                            |
| Class D           | 25,000                        | 6,250   | Libor +1.35%     | March 30, 2022       | CCC+/Baa3/BBB                        |
| Class E           | 13,750                        | 4,500   | Libor +1.75%     | March 30, 2022       | CCC-/Ba1/BB                          |
|                   | \$ 456,250                    | \$ 295,674                                      |                  |                      |                                      |

- (1) These ratings were initially given in June 2006, are unaudited and are subject to change from time to time. During the first quarter of 2009, Fitch affirmed its ratings. During the first quarter of 2009, Moody's downgraded the Class C notes, the Class D notes and the Class E notes. During the third quarter of 2009, Moody's downgraded the Class A-1 notes, the Class A-2 notes and the Class B note. During the second quarter of 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes, the Class D notes and the Class E notes to the ratings shown above. During the fourth quarter of 2011, Moody's upgraded all of the notes to the ratings shown above. During the third quarter of 2012, Fitch affirmed its ratings (source: Bloomberg Finance L.P.).

In June 2007 the Company completed a term debt 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 contributed \$600 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 contributions, 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, 2012, the \$483.8 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$537.8 million. At September 30, 2012, deferred financing fees were \$2.4 million. The 2007-1 CLO Trust permits



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

reinvestment of collateral principal repayments for a six-year period ending in May 2013. 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. During the nine months ended September 30, 2012, the Company repurchased \$0.2 million of the 2007-1 CLO Trust's Class C notes. During 2010, the Company repurchased \$5.0 million of the 2007-1 CLO Trust's Class D notes.

**Table of Contents**

During 2009, the Company repurchased \$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 future scheduled principal payments made in order of the notes seniority until all available funds are exhausted for each payment. During 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes and the Class D notes of the 2007-1 CLO Trust. The downgrade did not have any material consequence as the amortization of the 2007-1 CLO Trust changed from pro rata to sequential after the Moody's downgrade in 2009. During the second quarter of 2011, Moody's upgraded the Class C notes, the Class D notes, and the Class E notes. During 2011, Standard and Poor's upgraded the Class D notes. During the fourth quarter of 2011, Moody's upgraded all of the notes of the 2007-1 CLO Trust. During the third quarter of 2012, Fitch affirmed its ratings of all of the notes of the 2007-1 CLO Trust.

The Company receives a loan collateral management fee and excess interest spread. The Company expects to receive a principal distribution 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 could 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 Company may have future defaults in the 2007-1 CLO Trust in the future. If the Company does not elect to remove any future defaulted loans, it would not expect to receive excess interest spread payments until the undistributed cash plus any recoveries equal the outstanding balances of any potential defaulted loan collateral.

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

|                  | Notes<br>originally<br>issued<br>(\$ in thousands) | Outstanding<br>balance<br>September 30,<br>2012 | Interest<br>rate | Original<br>maturity | Ratings<br>(S&P/Moody's/<br>Fitch)(1) |
|------------------|--|---|------------------|----------------------|---------------------------------------|
| 2007-1 CLO Trust |  |   |                  |                      |                                       |
| Class A-1        | \$ 336,500   | \$ 318,105                                      | Libor +0.24%     | September 30, 2022   | AA+/Aaa/AAA                           |
| Class A-2        | 100,000  | 62,390  | Libor +0.26%     | September 30, 2022   | AA+/Aaa/AAA                           |
| Class B          | 24,000   | 24,000  | Libor +0.55%     | September 30, 2022   | AA/Aa3/AA                             |
| Class C          | 58,500   | 58,293  | Libor +1.30%     | September 30, 2022   | BBB+/Baa1/A                           |
| Class D          | 27,000   | 21,000  | Libor +2.30%     | September 30, 2022   | BB-/Ba1/BBB+                          |
|                  | \$ 546,000   | \$ 483,788                                      |                  |                      |                                       |

- (1) These ratings were initially given in June 2007, are unaudited and are subject to change from time to time. Fitch affirmed its ratings on February 24, 2009. During the first quarter of 2009, Moody's downgraded the Class C notes and the Class D notes. During the third quarter of 2009, Moody's downgraded the Class A-1 notes, the Class A-2 notes and the Class B notes. During the second quarter of 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes to the ratings shown above, and also downgraded the Class D notes. During the second quarter of 2011, Moody's upgraded the Class C notes and the Class D notes. During the second quarter of 2011, Standard and Poor's upgraded the Class D notes to the rating shown above. During the fourth quarter of 2011, Moody's upgraded all of the notes to the ratings shown above. During the third quarter of 2012, Fitch affirmed its ratings (source: Bloomberg Finance L.P.).

On January 7, 2010, the Company completed a term debt securitization. In conjunction with this transaction the Company established a separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Trust 2009-1 (the 2009-1 CLO Trust) and contributed \$225 million in loans and investments (including unfunded commitments), or portions thereof, to the 2009-1 CLO Trust at close. The Company had the ability to contribute an additional \$50 million of loan collateral by July 30, 2010 and contributed the full amount during the six months ended June 30, 2010. Simultaneously with the initial contributions, the 2009-1 CLO Trust issued \$190.5 million of notes to institutional investors. The Company retained all of the Class C and subordinated notes, which totaled approximately \$87.9 million, representing 32% of the value of the collateral pool. The 2009-1 CLO Trust was a static pool of loans that did not permit for reinvestment of collateral principal repayments. The 2009-1 CLO Trust was callable without penalty on the distribution date in July 2011 and on each distribution date thereafter. On August 1, 2011, the Company called the 2009-1 CLO Trust and redeemed the notes without penalty and recognized a total of \$3.0 million of interest expense due to the accelerated amortization of deferred financing fees and unamortized discount.

**Table of Contents****Note 7. Repurchase Agreement**

|  | Nine Months<br>Ended<br>September 30,<br>2012 | Period from<br>June 7, 2011 to<br>December 31, 2011 |
|--|---|---|
| <b>Loans sold under agreements to repurchase</b> | (\$ in thousands)                             |   |
| Outstanding at end of period                     | \$ 40,778                                     | \$ 64,868   |
| Maximum outstanding at any month end             | 60,500  | 68,000  |
| Average balance for the period                   | 52,108  | 66,872  |
| Weighted average rate at end of period           | 5.22%   | 5.28%   |

On June 7, 2011, the Company entered into a five-year, \$68.0 million financing arrangement with Macquarie Bank Limited backed primarily by a portfolio of commercial mortgage loans previously originated by the Company. The financing was structured as a master repurchase agreement under which the Company sold the portfolio of commercial mortgage loans to Macquarie for an aggregate purchase price of \$68.0 million. The Company also agreed to repurchase the commercial mortgage loans from time to time (including a minimum quarterly amount), and agreed to repurchase all of the commercial mortgage loans by June 7, 2016. Upon the repurchase of a commercial mortgage loan, the Company is obligated to repay the principal amount related to such mortgage loan plus accrued interest (at a rate based on LIBOR plus a margin) to the date of repurchase. The Company will continue to service the commercial mortgage loans. The facility accrues interest at a variable rate per annum, which was 5.22% as of September 30, 2012. As of September 30, 2012, unamortized deferred financing fees were \$1.2 million and the outstanding balance was \$40.8 million. During the nine months ended September 30, 2012, the Company made principal payments totaling \$24.1 million. As part of the agreement, there is a minimum aggregate interest margin payment of \$8.4 million required to be made over the life of the facility. If the facility is not utilized to cover this minimum requirement, then a make-whole fee is required to be made to satisfy the minimum aggregate interest margin payment.

The proceeds of the Macquarie transaction were used to fully repay the Company's credit facility with Citicorp and refinance all of the commercial mortgage loans previously funded by its warehouse line with Wells Fargo. The transaction generated net proceeds for the Company after retirement of debt and transaction costs of approximately \$20.0 million. The Company did not record any gains or losses. The commercial mortgage loans and related repurchase obligations are consolidated and reflected in the Company's financial statements.

**Note 8. Stockholders' Equity****Stockholders' Equity**

As of September 30, 2012 and December 31, 2011, the Company's authorized capital consists of preferred and common stock and the following was authorized and outstanding:

|                 | September 30, 2012   |                       | December 31, 2011    |                       |
|-----------------|----------------------|-----------------------|----------------------|-----------------------|
|                 | Shares<br>authorized | Shares<br>outstanding | Shares<br>authorized | Shares<br>outstanding |
|                 | (In thousands)       |                       |                      |                       |
| Preferred stock | 5,000                | 0                     | 5,000                | 0                     |
| Common stock    | 145,000              | 49,421                | 145,000              | 49,346                |

**Preferred Stock**

Since the completion of the Company's initial public offering on December 13, 2006, the Company's authorized capital stock has included 5,000,000 shares of preferred stock with a par value of \$0.01 per share, all of which remain undesignated.

**Common Stock**

In connection with the Company's initial public offering on December 13, 2006, the Company issued and sold 12,000,000 shares of its common stock. On December 19, 2006, the underwriters of the initial public offering purchased an additional 1,800,000 shares of the Company's common stock.

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

On November 12, 2007, the Company entered into a definitive agreement with institutional investors to issue 12.5 million shares of the Company's common stock in a private placement at a price per share of \$10.00. The gross proceeds from the offering, which closed in two tranches, were \$125 million. The first tranche of 7.25 million shares closed on November 29, 2007. The second tranche of 5.25 million shares was subject to the Company obtaining stockholder approval, and was approved at a special meeting of stockholders held on January 15, 2008. The second tranche closed on January 18, 2008.

In connection with the private placement, the Company entered into a Registration Rights Agreement with the institutional investors, whereby the Company agreed to register common stock as defined in the agreement. The Company registered the stock on Form S-3 on May 1, 2008, and the SEC deemed the registration effective on May 8, 2008.

**Table of Contents**

On January 25, 2010, the Company announced that its Board of Directors had authorized the repurchase of up to \$10 million of the Company's common stock from time to time on the open market or in privately negotiated transactions. On December 3, 2010, the Company had repurchased the entire \$10 million allotment of its stock. The timing and amount of any shares purchased were determined by management based on its evaluation of market condition and other factors and required use of cash. Upon completion of the stock repurchase program, the Company had repurchased 1,372,300 shares of its common stock under the program at a weighted average price per share of \$7.26.

On May 4, 2011, the Company announced that its Board of Directors had authorized the repurchase of up to \$10 million of the Company's common stock from time to time on the open market or in privately negotiated transactions. On September 16, 2011, the Company had repurchased the entire \$10 million allotment of its stock. The timing and amount of any shares purchased were determined by management based on its evaluation of market condition and other factors and required use of cash. Upon completion of the stock repurchase program, the Company had repurchased 1,042,208 shares of its common stock under the program at a weighted average price per share of \$9.60.

On September 29, 2011, the Company's Board of Directors authorized the repurchase of up to \$10 million of the Company's common stock from time to time on the open market or in privately negotiated transactions. The timing and amount of any shares purchased were determined by management based on its evaluation of market conditions and other factors and required use of cash. The repurchase program expired on September 29, 2012. Upon completion of the stock repurchase program, the Company had repurchased 252,450 shares of its common stock under the program at a weighted average price per share of \$10.26.

***Restricted Stock***

During the nine months ended September 30, 2012, the Company issued 201,367 shares of restricted stock to certain employees of the Company pursuant to the Company's 2006 Incentive Plan, as amended and 48,714 shares of restricted stock to certain members 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 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, 2012 was as follows:

|                                     | Shares    | Grant-date<br>fair value<br>(\$ in thousands) |
|-------------------------------------|-----------|---|
| Non-vested as of December 31, 2011  | 2,951,079 | \$ 19,790                                     |
| Granted                             | 250,081   | 2,693   |
| Vested                              | (70,694)  | (596)   |
| Forfeited                           | (3,334)   | (10)  |
| Non-vested as of September 30, 2012 | 3,127,132 | \$ 21,877                                     |

The Company's compensation expense related to restricted stock was \$1.7 million and \$4.8 million, respectively, for the three and nine months ended September 30, 2012 and \$1.6 million and \$4.8 million, respectively, for the three and nine months ended September 30, 2011. The unrecognized compensation cost of \$5.0 million at September 30, 2012 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, 2012 was as follows:

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

|                                      | <b>Options</b> |
|--------------------------------------|----------------|
| Outstanding as of January 1, 2012    | 5,941,603      |
| Granted                              | 0              |
| Exercised                            | (81,800)       |
| Forfeited                            | (86,667)       |
| Outstanding as of September 30, 2012 | 5,773,136      |
| Vested as of September 30, 2012      | 5,540,506      |
| Exercisable as of September 30, 2012 | 5,540,506      |

**Table of Contents**

As of September 30, 2012, the total unrecognized compensation cost related to nonvested options granted was \$0.2 million. This cost is expected to be recognized over a weighted average period of one year. The Company's compensation expense related to its stock options was \$0 and \$0.4 million, respectively, for the three and nine months ended September 30, 2012, and \$0.5 million and \$1.9 million, respectively, for the three and nine months ended September 30, 2011.

**Note 9. Income Per Share**

The computations of basic and diluted income per share for the three and nine months ended September 30, 2012 and 2011 are as follows:

|  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2012                                | 2011     | 2012                               | 2011     |
|  | (In thousands)                      |          |                                    |          |
| <b>Numerator:</b>                                  |                                     |          |                                    |          |
| Net income   | \$ 6,066                            | \$ 3,409 | \$ 17,765                          | \$ 7,781 |
| <b>Denominator:</b>                                |                                     |          |                                    |          |
| Denominator for basic income per common share      | 47,380                              | 47,943   | 47,358                             | 48,330   |
| <b>Denominator:</b>                                |                                     |          |                                    |          |
| Denominator for diluted income per common share    | 47,380                              | 47,943   | 47,358                             | 48,330   |
| Potentially dilutive securities - options          | 3,390                               | 2,676    | 3,213                              | 2,786    |
| Potentially dilutive securities - restricted stock | 2,000                               | 2,000    | 2,000                              | 2,000    |
| Potentially dilutive securities - warrants         | 152                                 | 0        | 44                                 | 0        |
| Total weighted average diluted shares              | 52,922                              | 52,619   | 52,615                             | 53,116   |

The dilutive effect of warrants to purchase common stock totaling 1,452,656, was not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2011 due to the fact that the results would be anti-dilutive.

**Note 10. 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, standby letters of credit and interest rate mitigation products. The instruments involve, to varying degrees, elements of credit and interest rate 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 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.

At September 30, 2012, the Company had \$256.7 million of unused lines of credit. Of these unused lines of credit, unfunded commitments related to revolving credit facilities were \$209.1 million and unfunded commitments related to delayed draw term loans were \$38.1 million. \$9.5 million of the unused commitments are unavailable to the borrowers, which may be related to the borrowers' inability to meet covenant obligations or other similar events.





**Table of Contents**

Revolving credit facilities allow the Company’s borrowers to draw up to a specified amount, subject to customary borrowing conditions. The unfunded revolving commitments of \$209.1 million are further categorized as either contingent or unrestricted. Contingent commitments limit a borrower’s ability to access the revolver unless it meets an enumerated borrowing base covenant or other restrictions. At September 30, 2012, the Company categorized \$148.6 million of the unfunded commitments related to revolving credit facilities as contingent. Unrestricted commitments represent commitments that are currently accessible, assuming the borrower is in compliance with certain customary loan terms and conditions. At September 30, 2012, the Company had \$60.5 million of unfunded unrestricted revolving commitments.

During the three months ended September 30, 2012, revolver usage averaged approximately 49%, which is in line with the average of 46% over the previous four quarters. Management’s experience indicates that borrowers typically do not seek to exercise their entire available line of credit at any point in time. During the three months ended September 30, 2012, revolving commitments increased \$20.0 million.

Delayed draw credit facilities allow the Company’s borrowers to draw predefined amounts of the approved loan commitment at contractually set times, subject to specific conditions, such as capital expenditures in corporate loans or for tenant improvements in commercial real estate loans. During the three months ended September 30, 2012, delayed draw credit facility commitments decreased \$1.0 million.

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.

Interest rate risk mitigation products are offered to enable customers to meet their financing and risk management objectives. Derivative financial instruments consist predominantly of interest rate swaps, interest rate caps and floors. The interest rate risks to the Company of these customer derivatives is mitigated by entering into similar derivatives having offsetting terms with other counterparties.

These interest rate risk mitigation products do not qualify for hedge accounting treatment. These interest rate swaps and caps contracts are recorded at fair value on the Company’s balance sheet in either Other assets or Other liabilities. Gains and losses on derivatives not designated as cash flow hedges, including any cash payments made or received are reported as gains or losses on derivatives in the consolidated statements of operations. The Company’s outstanding interest rate mitigation products had a fair value of \$0 at September 30, 2012 or at December 31, 2011.

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

|                           | September 30, 2012 | December 31, 2011 |
|---------------------------|--------------------|-------------------|
|                           | (\$ in thousands)  |                   |
| Unused lines of credit    | \$ 256,696         | \$ 252,288        |
| Standby letters of credit | 6,398              | 6,462             |

**Note 11. 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.

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

The following table presents recorded amounts of assets and liabilities measured at fair value on a recurring and nonrecurring basis as of September 30, 2012, by caption in the consolidated balance sheet and by ASC 820 valuation hierarchy (as described above).

**Table of Contents**

|  | Quoted Prices<br>in Active<br>Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Carrying<br>Value in<br>Consolidated<br>Balance Sheet |
|--|---|---|--|--|
|  | (\$ in thousands)   |   |  |  |
| <b>Recurring Basis:</b>  |   |   |  |  |
| Investments in debt securities, available-for-sale                 | \$ 0  | \$ 0  | \$ 20,803  | \$ 20,803  |
| <b>Total assets recorded at fair value on a recurring basis</b>    | <b>\$ 0</b>   | <b>\$ 0</b>   | <b>\$ 20,803</b>                                   | <b>\$ 20,803</b>   |
| <b>Nonrecurring Basis:</b>   |   |   |  |  |
| Loans, net   | \$ 0  | \$ 0  | \$ 85,639  | \$ 85,639  |
| Loans held-for-sale, net   | 28,512  | 0   | 20,022   | 48,534   |
| Other real estate owned  | 0   | 0   | 13,625   | 13,625   |
| <b>Total assets recorded at fair value on a nonrecurring basis</b> | <b>\$ 28,512</b>  | <b>\$ 0</b>   | <b>\$ 119,286</b>                                  | <b>\$ 147,798</b>  |

At September 30, 2012, Investments in debt securities, available-for-sale consisted of collateralized loan obligations. The fair value measurement is obtained through a third party pricing service.

At September 30, 2012, Loans, net measured at fair value on a nonrecurring basis consisted of impaired collateral-dependent commercial real estate loans. The fair values of these loans are based on third party appraisals of the underlying collateral value as well as the Company's internal analysis. During the nine months ended September 30, 2012, the Company recorded a \$3.9 million of specific provision for credit losses related to Loans, net measured at fair value.

At September 30, 2012, Loans held-for-sale, net consisted of leveraged finance loans intended to be sold to the NCOF and to other third parties. The fair values of the loans are based on contractual selling prices.

At September 30, 2012, Other real estate owned consisted of two commercial real estate properties. The fair value of other real estate owned is estimated using one of several methods, including collateral value, market value of similar properties, liquidation value and discounted cash flows.

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, 2012.

|  | Fair value        | Valuation Techniques               | Unobservable Input  | Range                |
|--|-------------------|------------------------------------|---|----------------------|
|  | (\$ in thousands) |                                    |   |                      |
| <b>Financial assets:</b>                           |                   |                                    |   |                      |
| Investments in debt securities, available-for-sale | \$ 20,803         | 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                              | 85,639            | Market comparables Valuation model | Cost to sell Marketability discount   | 3% - 7%<br>5% - 30%  |
| Other real estate owned                            | 13,625            | Market comparables Valuation model | Cost to sell Marketability discount   | 3% - 7%<br>10% - 20% |

|        |            |
|--------|------------|
| Total: | \$ 120,067 |
|--------|------------|

**Table of Contents**

The following table presents recorded amounts of assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2011, by caption in the consolidated balance sheet and by ASC 820 valuation hierarchy (as described above).

|  | Quoted Prices<br>in Active<br>Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Carrying<br>Value in<br>Consolidated<br>Balance Sheet |
|--|---|---|--|--|
|  | (\$ in thousands)   |   |  |  |
| <b>Recurring Basis:</b>  |   |   |  |  |
| Investments in debt securities, available-for-sale                 | \$ 0  | \$ 0  | \$ 17,817  | \$ 17,817  |
| <b>Total assets recorded at fair value on a recurring basis</b>    | <b>\$ 0</b>   | <b>\$ 0</b>   | <b>\$ 17,817</b>                                   | <b>\$ 17,817</b>   |
| <b>Nonrecurring Basis:</b>   |   |   |  |  |
| Loans, net   | \$ 0  | \$ 0  | \$ 64,542  | \$ 64,542  |
| Loans held-for-sale, net   | 38,278  | 0   | 0  | 38,278   |
| <b>Total assets recorded at fair value on a nonrecurring basis</b> | <b>\$ 38,278</b>  | <b>\$ 0</b>   | <b>\$ 64,542</b>                                   | <b>\$ 102,820</b>  |

At December 31, 2011, Loans, net measured at fair value on a nonrecurring basis consisted of impaired collateral-dependent commercial real estate loans. The fair values of these loans are based on third party appraisals of the underlying collateral value as well as the Company's internal analysis. During 2011, the Company recorded a \$4.1 million of specific provision for credit losses related to Loans, net measured at fair value.

At December 31, 2011, Loans held-for-sale, net consisted of leveraged finance loans intended to be sold to the NCOF. The fair values of the loans are based on contractual selling prices.

**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, 2012 and 2011 (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 nine months ended September 30, 2012 and 2011.

For the three months ended September 30, 2012:

|   | Investments in<br>Debt Securities,<br>Available-for-sale<br>(\$ in thousands) |
|---|---|
| Balance as of June 30, 2012                 | \$ 18,335   |
| Total gains or losses (realized/unrealized) |   |
| Included in earnings                        | 57  |
| Included in other comprehensive income      | 2,411   |
| Purchases                                   | 0   |
| Issuances                                   | 0   |

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

|                                  |    |        |
|----------------------------------|----|--------|
| Settlements                      |    | 0      |
| Balance as of September 30, 2012 | \$ | 20,803 |

**Table of Contents**

For the three months ended September 30, 2011:

|   | <b>Investments in<br/>Debt Securities,<br/>Available-for-sale<br/>(\$ in thousands)</b> |
|---|---|
| Balance as of June 30, 2011                 | \$ 17,117   |
| Total gains or losses (realized/unrealized) |   |
| Included in earnings                        | 0   |
| Included in other comprehensive income      | (1,903)   |
| Purchases, issuances or settlements         | (3,783)   |
| Balance as of September 30, 2011            | \$ 11,431   |

For the nine months ended September 30, 2012:

|   | <b>Investments in<br/>Debt Securities,<br/>Available-for-sale<br/>(\$ in thousands)</b> |
|---|---|
| Balance as of December 31, 2011             | \$ 17,817   |
| Total gains or losses (realized/unrealized) |   |
| Included in earnings                        | 170   |
| Included in other comprehensive income      | 2,816   |
| Purchases                                   | 0   |
| Issuances                                   | 0   |
| Settlements                                 | 0   |
| Balance as of September 30, 2012            | \$ 20,803   |

For the nine months ended September 30, 2011:

|   | <b>Investments in<br/>Debt Securities,<br/>Available-for-sale<br/>(\$ in thousands)</b> |
|---|---|
| Balance as of December 31, 2010             | \$ 4,051  |
| Total gains or losses (realized/unrealized) |   |
| Included in earnings                        | 0   |
| Included in other comprehensive income      | (2,582)   |
| Purchases, issuances or settlements         | 9,962   |
| Balance as of September 30, 2011            | \$ 11,431   |

**Table of Contents**

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments at September 30, 2012 and December 31, 2011. 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, 2012 |            | December 31, 2011 |            |
|---|--------------------|------------|-------------------|------------|
|   | Carrying amount    | Fair value | Carrying amount   | Fair value |
|   | (\$ in thousands)  |            |                   |            |
| <b>Financial assets:</b>                          |                    |            |                   |            |
| Cash and cash equivalents                         | \$ 34,176          | \$ 34,176  | \$ 18,468         | \$ 18,468  |
| Restricted cash                                   | 151,387            | 151,387    | 83,815            | 83,815     |
| Loans held-for-sale                               | 48,534             | 48,534     | 38,278            | 38,278     |
| Loans and leases, net                             | 1,761,391          | 1,776,132  | 1,699,187         | 1,660,524  |
| Investments in debt securities available-for-sale | 20,803             | 20,803     | 17,817            | 17,817     |
| Other assets                                      | 0                  | 0          | 7,370             | 7,370      |
| <b>Financial liabilities:</b>                     |                    |            |                   |            |
| Credit facilities                                 | \$ 396,318         | \$ 396,318 | \$ 214,711        | \$ 214,711 |
| Term debt   | 1,009,953          | 956,366    | 1,073,105         | 973,036    |
| Repurchase agreements                             | 40,778             | 40,123     | 64,868            | 63,779     |

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

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, 2012. The table excludes financial instruments for which the carrying amount approximates fair value such as cash and cash equivalents, restricted cash, loans held-for-sale, investments in debt securities available-for-sale, and credit facilities.

|                               | Carrying amount   | Fair value   | Fair Value Measurements |         |              |
|-------------------------------|-------------------|--------------|-------------------------|---------|--------------|
|                               |                   |              | Level 1                 | Level 2 | Level 3      |
|                               | (\$ in thousands) |              |                         |         |              |
| <b>Financial assets:</b>      |                   |              |                         |         |              |
| Loans and leases, net         | \$ 1,675,752      | \$ 1,690,493 | \$ 0                    | \$ 0    | \$ 1,690,493 |
| <b>Financial liabilities:</b> |                   |              |                         |         |              |
| Term debt                     | 1,009,953         | 956,366      | 0                       | 956,366 | 0            |
| Repurchase agreements         | 40,778            | 40,123       | 0                       | 40,123  | 0            |

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

*Loans and leases, net:* The fair value was determined as the present value of expected future cash flows discounted at current market interest rates offered by similar lending institutions for loans with similar terms to companies with comparable credit risk. This method of estimating fair value does not incorporate the exit price concept of fair value and is based on significant unobservable inputs. The amount included in the above table excludes impaired collateral-dependent commercial real estate loans.

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

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

**Note 12. Employee Benefit Plans**



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

The Company maintains a contributory 401(k) plan covering all full-time employees. The Company matches 100% of an employee's voluntary contributions up to a limit of 6% of the employee's base salary, subject to IRS guidelines. Expense for the three and nine months ended September 30, 2012 was \$0.2 million and \$0.5 million, respectively and \$0.2 million and \$0.5 million for the three and nine months ended September 30, 2011, respectively.

### **Note 13. Related-Party Transactions**

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 management fee, payable monthly in arrears, based on the carrying value of the total gross assets attributable to the applicable series of each class of shares at the end of each month. For the three and nine months ended September 30, 2012, the Fund's asset management fees were \$0.7 million and \$2.2 million, respectively, and \$0.7 million and \$2.0 million for the three and nine months ended September 30, 2011, respectively.

**Table of Contents**

During 2006, the Company made a loan based on market terms to a company with a director who is a relative of one of the Company's officers. At September 30, 2012, the loan balance outstanding and amount of committed funds were \$4.8 million and \$6.8 million, respectively.

During 2011, the Company made a loan based on market terms to a company that is 40% owned by a major stockholder of the Company and with respect to which two members of the Company's Board of Directors are affiliated. At September 30, 2012, the loan balance outstanding and amount of committed funds were \$11.9 million and \$13.5 million, respectively.

---

## **Table of Contents**

### **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, 2011, 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***

We are a specialized commercial finance company focused on meeting the complex financing needs of companies and private investors in the middle market. We focus primarily on the direct origination of bank loans and equipment leases through teams of credit-trained bankers and marketing officers organized around key industry and market segments. Our marketing and direct origination efforts target private equity sponsors, mid-sized companies, corporate executives, regional banks, real estate investors and a variety of other referral sources and financial intermediaries to source new customer relationships and lending opportunities. Our emphasis on direct origination is an important aspect of our marketing and credit strategy because it provides us with direct access to our customers' 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, we have significant input into our customers' financial strategies and capital structures. From time to time, we also participate in loans as a member of a lending group. 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.

We operate as a single segment, and we derive revenues from four specialized lending groups that target market segments in which we believe that we have a competitive advantage:

*Leveraged Finance*, provides senior, secured cash flow loans and, to a lesser extent, second lien, and subordinated debt, and equity or other equity-linked products, which are primarily used to finance acquisitions of mid-sized companies with annual cash flow (EBITDA) typically between \$5 million and \$30 million by private equity investment funds managed by established professional alternative asset managers;

*Real Estate*, provides first mortgage debt and, to a lesser extent, subordinated debt, primarily to finance acquisitions of commercial real estate properties typically valued between \$10 million and \$50 million by professional commercial real estate investors;

*Business Credit*, provides senior, secured asset-based loans primarily to fund working capital needs of mid-sized companies with sales typically totaling between \$25 million and \$500 million; and

*Equipment Finance*, provides leases, loans and lease lines to finance equipment purchases and other capital expenditures typically for companies with annual sales of at least \$25 million.

#### ***Market Conditions***

As a specialized commercial finance company, we compete in various segments of the loan market to extend credit to mid-sized companies through our four national specialized lending platforms. We rely primarily on large banks for warehouse lines of credit to partially fund new loan originations and the capital markets for term funding through the issuance of asset-backed notes that are used to refinance bank lines and provide funding with matched duration for our leveraged loan portfolios.

Overall, conditions in targeted segments of the loan market weakened again in the third quarter of 2012 as M&A activity remained muted through seasonally slow summer months amid continuing concerns about Europe and the strength of the US economy. As a result, overall loan volumes declined and yields fell as lenders competed for fewer deals.

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

In contrast, conditions in our funding markets showed improvement in the third quarter despite concerns about emerging macro economic trends. We believe that 2012 new CLO issuances reached nearly \$32 billion through the third quarter, exceeding 2011's full-year total of \$12.3 billion, with volume forecast to reach \$45 billion for the year. We also expect CLO credit spreads to trend tighter. As a result, we believe that markets conditions remain supportive for us to issue a new CLO.

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. Overall activity remained subdued in the third quarter due to slower leveraged buyout style acquisition activity among private equity firms and weak market sentiment.

Total middle market loan issuance in the third quarter was down from the second quarter and refinancing remained the dominant use of proceeds. Loan demand derived from merger and acquisition activity and private equity deal volume fell again in the second quarter, continuing a modest downward trend.

Despite these headwinds, we originated \$179 million of new loans with attractive credit spreads and yields in the third quarter, which compared favorably to both our historical averages for comparably rated loans and yields on loans originated in the first half of 2012. Pricing and credit parameters in our target markets deteriorated somewhat in the third quarter, but continued to compare favorably to the broader loan market, in which larger corporations typically borrow from syndicates of banks and loans are issued, priced and traded in a bond-style market that is more highly correlated with the high yield debt market.

We continue to believe that demand for new middle market loans and credit products will improve because there is a substantial amount of debt nearing maturity that will need to be refinanced and private equity firms have substantial un-invested capital, which we believe that they will deploy through investment strategies that emphasize investments in mid-sized companies. In the short term, we also expect that loan demand will improve following the US elections to the extent that the direction of fiscal and tax policies becomes clearer, which may result in business owners and executives making investment decisions that have been deferred due to market uncertainty. We also continue to believe that a significant and lasting impact of the credit crisis that began in 2008 has been a reduction in the number and capacity of lenders in the markets in which we compete. As a result of these factors, we anticipate that demand for loans and credit products offered by the Company and conditions in our lending markets will remain favorable for an extended period of time.

**Table of Contents*****Recent Developments******Liquidity***

On November 5, 2012, we entered into an amendment to our \$150.0 million credit facility with Wells Fargo which increased the size of the facility from \$150.0 million to \$175.0 million through the addition of a new lender. The amendment also has an accordion feature that provides for further increase to \$200.0 million, and extends the revolving period under the credit facility to November 2015, and amended the final maturity date to November 2017.

***Stock Repurchase Program***

On September 29, 2011, our Board of Directors authorized the repurchase of up to \$10 million of the Company's common stock from time to time on the open market or in privately negotiated transactions. The timing and amount of any shares purchased were determined by management based on its evaluation of market conditions and other factors and required use of cash. The repurchase program expired on September 29, 2012. Upon completion of the stock repurchase program, we had repurchased 252,450 shares of our common stock under this plan at a weighted average price per share of \$10.26.

**RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011**

NewStar's basic and diluted income per share for the three months ended September 30, 2012 was \$0.13 and \$0.11, respectively, and \$0.38 and \$0.34 for the nine months ended September 30, 2012, respectively, on net income of \$6.1 million and \$17.8 million, respectively, compared to basic and diluted income per share for the three months ended September 30, 2011 of \$0.07 and \$0.06, respectively, and \$0.16 and \$0.15 for the nine months ended September 30, 2011, respectively, on net income of \$3.4 million and \$7.8 million, respectively. Our managed loan portfolio was \$2.4 billion at September 30, 2012 and at December 31, 2011. As of September 30, 2012, loans owned by the NewStar Credit Opportunities Fund ( NCOF ) were \$515.2 million.

***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 6.45% and 6.32% for the three and nine months ended September 30, 2012 and 6.58% and 6.37% for the three and nine months ended September 30, 2011. The decrease from 2011 to 2012 in loan portfolio yield was primarily driven by a decrease in our average yield on interest earning assets from new loan and lease origination and re-pricings subsequent to September 30, 2011. The portfolio yield for accruing loans was 6.80% and 6.74% for the three and nine months ended September 30, 2012.

***Net interest margin***

Net interest margin, which is net interest income divided by average interest earning assets, was 4.22% for each of the three and nine months ended September 30, 2012 and 3.98% and 4.07% for the three and nine months ended September 30, 2011. The primary factors impacting net interest margin for the three and nine months ended September 30, 2012 were non-accrual loans, changes in three-month LIBOR, credit spreads and cost of borrowings. The primary factors impacting net interest margin for the three and nine months ended September 30, 2011 were non-accrual loans, changes in three-month LIBOR, our product mix, debt to equity ratio, credit spreads and cost of borrowings.

***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 42.95% and 48.29% for the three and nine months ended September 30, 2012 and 53.53% and 55.33% for the three and nine months ended September 30, 2011. The decrease in our efficiency ratio during the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 was primarily due to a decrease in operating expenses and an increase in net interest income and non-interest income during 2012. The decrease in our efficiency ratio during the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was primarily due to an increase in non-interest income and net interest income, partially offset by an increase in operating expenses during 2012.

***Allowance for credit losses ratio***

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

Allowance for credit losses ratio, which is allowance for credit losses divided by outstanding gross loans and leases excluding loans held-for-sale, was 3.21% at September 30, 2012 and 3.52% as of December 31, 2011. The decrease in the allowance for credit losses ratio is primarily due to a decrease in the balance of the specific allowance for credit losses, and slowing negative credit

---

**Table of Contents**

migration and improving economic conditions. During the three and nine months ended September 30, 2012, we recorded \$4.6 million and \$8.8 million of specific provision for credit losses on previously identified impaired loans. At September 30, 2012, the specific allowance for credit losses was \$37.7 million, and the general allowance for credit losses was \$21.7 million. At December 31, 2011, the specific allowance for credit losses was \$40.7 million, and the general allowance for credit losses was \$23.4 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 rapidly changing economic environment or otherwise, the revised allowance methodology may result in higher or lower levels of allowance. Moreover, actual losses under our current or any revised methodology may differ materially from our estimate.

***Delinquent loan rate***

Delinquent loan rate, which is total delinquent loans that are 60 days or more past due, divided by outstanding gross loans and leases, was 3.48% as of September 30, 2012 as compared to 5.34% as of December 31, 2011. We expect the delinquent loan rate to fluctuate if economic conditions continue to negatively impact the financial performance of certain borrowers and their ability to meet their obligations on a timely basis.

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

Delinquent loan rate for accruing loans 60 days or more past due, which is total delinquent accruing loans net of charge-offs that are 60 days or more past due and less than 90 days past due, divided by outstanding gross loans and leases, was 1.14% as of September 30, 2012 as compared to 0.46% as of December 31, 2011. We expect the delinquent accruing loan rate to fluctuate if economic conditions continue to negatively impact the financial performance of certain borrowers and their ability to meet their obligations on a timely basis.

***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 4.43% as of September 30, 2012 and 5.61% as of December 31, 2011. As of September 30, 2012 and December 31, 2011, the aggregate outstanding balance of non-accrual loans was \$81.9 million and \$102.2 million, respectively and total outstanding loans and leases held for investment was \$1.8 billion at the end of each period. We expect the non-accrual loan rate to fluctuate if economic conditions continue to impair certain borrowers' ability to fully repay principal and interest under the terms of their loan agreement.

***Non-performing asset rate***

Non-performing asset rate is defined as the sum of total balances outstanding of loans on non-accrual status and other real estate owned, 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 5.13% as of September 30, 2012 and 5.61% as of December 31, 2011. As of September 30, 2012 and December 31, 2011, the sum of the aggregate outstanding balance of non-performing assets was \$95.5 million and \$102.2 million, respectively. We expect the non-performing asset rate to fluctuate if economic conditions continue to impair certain borrowers' ability to fully repay principal and interest under the terms of their loan agreements.

***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. The net charge-off rate was (0.07)% and 0.83% for the three and nine months ended September 30, 2012 and 2.10% and 1.86% for the three and nine months ended September 30, 2011. We expect the net charge-off rate (end of period loans and leases) to fluctuate if economic conditions continue to impair certain borrowers' ability to fully repay principal and interest under the terms of their loan agreement.

***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 (0.06)% and 0.82% for the three and nine months ended September 30, 2012 and 2.12% and 1.87% for the three and nine months ended September 30, 2011. We expect the net charge-off rate (average period loans and leases) to fluctuate if economic conditions continue to impair certain borrowers' ability

to fully repay principal and interest under the terms of their loan agreement.



**Table of Contents****Return on average assets**

Return on average assets, which is net income divided by average total assets, was 1.16% and 1.17% for the three and nine months ended September 30, 2012 and 0.71% and 0.55% for the three and nine months ended September 30, 2011.

**Return on average equity**

Return on average equity, which is net income divided by average equity, was 4.15% and 4.13% for the three and nine months ended September 30, 2012 and 2.41% and 1.86% for the three and nine months ended September 30, 2011.

**Review of Consolidated Results**

A summary of NewStar Financial's consolidated financial results for the three and nine months ended September 30, 2012 and 2011 follows:

|   | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|---|----------------------------------|-----------|---------------------------------|-----------|
|   | 2012                             | 2011      | 2012                            | 2011      |
|   | (\$ in thousands)                |           |                                 |           |
| <b>Net interest income:</b>                           |                                  |           |                                 |           |
| Interest income                                       | \$ 30,812                        | \$ 29,500 | \$ 90,945                       | \$ 84,803 |
| Interest expense                                      | 9,074                            | 10,683    | 26,607                          | 27,582    |
| Net interest income                                   | 21,738                           | 18,817    | 64,338                          | 57,221    |
| Provision for credit losses                           | 3,712                            | 4,408     | 6,752                           | 12,998    |
| Net interest income after provision for credit losses | 18,026                           | 14,409    | 57,586                          | 44,223    |
| <b>Non-interest income:</b>                           |                                  |           |                                 |           |
| Fee income  | 1,074                            | 573       | 3,398                           | 1,507     |
| Asset management income                               | 718                              | 697       | 2,188                           | 1,951     |
| Gain (loss) on derivatives                            | (57)                             | 252       | (258)                           | 277       |
| Gain (loss) on sale of loans                          |                                  | 20        | (418)                           | 128       |
| Other income (loss)                                   | 1,451                            | 1,862     | 2,866                           | (1,690)   |
| Total non-interest income                             | 3,186                            | 3,404     | 7,776                           | 2,173     |
| <b>Operating expenses:</b>                            |                                  |           |                                 |           |
| Compensation and benefits                             | 7,832                            | 7,706     | 23,101                          | 22,321    |
| General and administrative expenses                   | 2,843                            | 4,190     | 11,627                          | 10,542    |
| Total operating expenses                              | 10,675                           | 11,896    | 34,728                          | 32,863    |
| Income before income taxes                            | 10,537                           | 5,917     | 30,634                          | 13,533    |
| Income tax expense                                    | 4,471                            | 2,508     | 12,869                          | 5,752     |
| Net income  | \$ 6,066                         | \$ 3,409  | \$ 17,765                       | \$ 7,781  |

**Comparison of the Three Months Ended September 30, 2012 and 2011**

**Interest income.** Interest income increased \$1.3 million, to \$30.8 million for the three months ended September 30, 2012 from \$29.5 million for the three months ended September 30, 2011. The increase was primarily due to an increase in average balance of our interest earning assets to \$2.1 billion from \$1.9 billion, partially offset by a decrease in the yield on average interest earning assets from 6.23% to 5.98%.

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

*Interest expense.* Interest expense decreased to \$9.1 million for the three months ended September 30, 2012 from \$10.7 million for the three months ended September 30, 2011. The decrease is primarily due to a decrease in the average balance of our interest bearing liabilities.

*Net interest margin.* Net interest margin increased to 4.22% for the three months ended September 30, 2012 from 3.98% for the three months ended September 30, 2011. The increase in net interest margin was primarily due to a decrease in our cost of interest bearing liabilities, partially offset by a decrease in our average yield on interest earning assets. The net interest spread, the difference between gross yield on our interest earning assets and the total cost of our interest bearing liabilities, increased to 3.43% from 2.94%. At September 30, 2012, 71% of our adjustable rate loans included interest rate floors.

**Table of Contents**

The following table summarizes the yield and cost of interest earning assets and interest bearing liabilities for the three months ended September 30, 2012 and 2011:

|                                    | Three Months Ended September 30, 2012 |                                |                           | Three Months Ended September 30, 2011 |                                |                           |
|------------------------------------|---------------------------------------|--------------------------------|---------------------------|---------------------------------------|--------------------------------|---------------------------|
|                                    | (\$ in thousands)                     |                                |                           |                                       |                                |                           |
|                                    | Average<br>Balance                    | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Cost | Average<br>Balance                    | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Cost |
| Total interest earning assets      | \$ 2,051,456                          | \$ 30,812                      | 5.98%                     | \$ 1,877,897                          | \$ 29,500                      | 6.23%                     |
| Total interest bearing liabilities | 1,416,689                             | 9,074                          | 2.55                      | 1,286,503                             | 10,683                         | 3.29                      |
| Net interest spread                |                                       | \$ 21,738                      | 3.43%                     |                                       | \$ 18,817                      | 2.94%                     |
| Net interest margin                |                                       |                                | 4.22%                     |                                       |                                | 3.98%                     |

*Provision for credit losses.* The provision for credit losses decreased to \$3.7 million for the three months ended September 30, 2012 from \$4.4 million for the three months ended September 30, 2011. The decrease in the provision was primarily due to a decrease of \$1.7 million of specific provisions recorded during the three months ended September 30, 2012 as compared to three months ended September 30, 2011. During the three months ended September 30, 2012, we recorded specific provisions of \$4.6 million compared to \$6.3 million recorded during the three months ended September 30, 2011. The decrease in the specific component of the provision for credit losses was primarily due to lower outstanding loan balances since September 30, 2011 of impaired loans with a specific allowance, slowing negative credit migration, and improving economic conditions. Our general allowance for credit losses covers probable losses in our loan and lease portfolio with respect to loans and leases 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. Impaired loans, which include all of our delinquent loans and troubled debt restructurings, as a percentage of Loans, net decreased to 18% as of September 30, 2012 as compared to 21% as of September 30, 2011. 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. Consequently, as the percentage of impaired loans in our loan portfolio decreased as compared to September 30, 2011, the percentage of loans in our loan portfolio being evaluated under our general allowance analysis has increased.

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 changes in economic conditions, credit availability, industry 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 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 or profile.

For Leveraged Finance loans and equipment finance leases, 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 in determining a loan loss in the event of default.

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.

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

During 2010, the Company recognized the need to adjust this methodology to reflect more stable macroeconomic conditions, improvements in capital market liquidity, greater visibility on the economy and underlying asset values, as well as evidence of property price stabilization. The Company refined its approach for commercial real estate loans at this time primarily through three updates to the existing framework. First, it calibrated the stress multipliers across all loan-to-value tiers to reflect increased depth in the financing markets compared to what was available in 2009. Second, the category of credits on which the stress multipliers were applied was changed to credits with a weaker risk profile in addition to loan-to-value ratios in excess of the specified threshold, which remained unchanged. Last, estimates of loss upon a default were amended to reflect the results of an updated internal loss and recovery analysis. The impact of these modifications was a decrease in the commercial real estate allowance for loan losses of

## Table of Contents

approximately 20 basis points. If the Company determines that additional 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. Moreover, given uncertain market conditions, actual losses under the Company's current or any revised allowance methodology may differ materially from the Company's estimate.

For Business Credit loans, the Company utilizes a proprietary model to risk rate the loans on a monthly basis. This model captures 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 has also evaluated historical 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 is adjusted to reflect the historical average for expected loss from the industry database.

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 additional 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. No material modifications have been made to the allowance for credit losses since 2010. Moreover, 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 a judgmental amount which is governed by a score card system comprised of ten individually weighted 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. 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, it 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. 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 for all loans for which we have serious doubts as to the ability of the borrowers to comply with the present loan repayment terms.

Impaired loans at September 30, 2012 were in Real Estate, Leveraged Finance, and Business Credit over a range of industries impacted by the then current economic environment including the following: Buildings and Commercial Real Estate, Broadcast and Entertainment, Nondurable Consumer Products, Energy and Chemical Services, Financial Services, Healthcare, Printing and Publishing, Restaurants, and Industrial and Other Business Services. 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.

*Non-interest income.* Non-interest income decreased \$0.2 million, to \$3.2 million for the three months ended September 30, 2012 from \$3.4 million for the three months ended September 30, 2011. The decrease is primarily due to a decrease of \$0.8 million related to gains on the repurchase of debt and a decrease of \$0.3 million of derivative income, partially offset by a \$0.5 million increase of fee income and a decrease of \$0.3 million of losses on equity interests in certain impaired borrowers.

As a result of certain of our troubled debt restructurings, we have received an equity interest in several of our impaired borrowers. The equity interest 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 are deemed to be under the equity method of accounting, we record our ownership share of the borrowers' results of operations in non-interest income. Additionally, our corresponding share of our borrowers' results of operations may directly impact the remaining net book value of these respective loans. 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 decreased \$1.2 million, to \$10.7 million for the three months ended September 30, 2012 from \$11.9 million for the three months ended September 30, 2011. General and administrative expenses decreased \$1.3 million primarily due to a decrease in professional services expense of \$0.7 million, and a decrease in loan workout costs of \$0.7 million. Employee compensation and benefits was equal period over period. Salaries and incentive compensation increased by \$0.5 million due to an increase in headcount and higher incentive

compensation accruals, which were partially offset by a decrease of \$0.4 million in equity compensation expense.

**Table of Contents**

*Income taxes.* For the three months ended September 30, 2012 and 2011, we provided for income taxes based on an effective tax rate of 42% for each period.

As of September 30, 2012 and December 31, 2011, we had net deferred tax assets of \$46.4 million and \$47.9 million, respectively. In assessing the realizability of 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, 2012. 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 impact of the downturn in the current economic environment (including the impact of credit on allowance and provision for loan losses; and the impact on funding levels) on the Company. Based upon our assessment, we believe that a valuation allowance was not necessary as of September 30, 2012. As of September 30, 2012, our deferred tax asset was primarily comprised of \$23.9 million related to our allowance for credit losses and \$14.5 million related to equity compensation.

**Comparison of the Nine Months Ended September 30, 2012 and 2011**

*Interest income.* Interest income increased \$6.1 million, to \$90.9 million for the nine months ended September 30, 2012 from \$84.8 million for the nine months ended September 30, 2011. The increase was primarily due to an increase in average balance of our interest earning assets to \$2.0 billion from \$1.9 billion, partially offset by a decrease in the yield on average interest earning assets to 5.97% from 6.03%, primarily driven by a decrease in contractual interest rates from new loan origination and re-pricings subsequent to September 30, 2011.

*Interest expense.* Interest expense decreased \$1.0 million to \$26.6 million for the nine months ended September 30, 2012 from \$27.6 million for the nine months ended September 30, 2011. The decrease is primarily due to a decrease in average interest bearing liabilities.

*Net interest margin.* Net interest margin increased to 4.22% for the nine months ended September 30, 2012 from 4.07% for the nine months ended September 30, 2011. The increase in net interest margin was primarily due to a decrease in our average cost of interest bearing liabilities, partially offset by a decrease in our average yield on interest earning assets from new loan origination and re-pricings subsequent to September 30, 2011. The net interest spread, the difference between gross yield on our interest earning assets and the total cost of our interest bearing liabilities, increased to 3.45% from 3.14%.

The following table summarizes the yield and cost of interest earning assets and interest bearing liabilities for the nine months ended September 30, 2012 and 2011:

|                                    | Nine Months Ended September 30, 2012 |                         |                    | Nine Months Ended September 30, 2011 |                         |                    |
|------------------------------------|--------------------------------------|-------------------------|--------------------|--------------------------------------|-------------------------|--------------------|
|                                    | Average Balance                      | Interest Income/Expense | Average Yield/Cost | Average Balance                      | Interest Income/Expense | Average Yield/Cost |
| Total interest earning assets      | \$ 2,034,212                         | \$ 90,945               | 5.97%              | \$ 1,878,825                         | \$ 84,803               | 6.03%              |
| Total interest bearing liabilities | 1,409,637                            | 26,607                  | 2.52               | 1,272,219                            | 27,582                  | 2.90               |
| Net interest spread                |                                      | \$ 64,338               | 3.45%              |                                      | \$ 57,221               | 3.14%              |
| Net interest margin                |                                      |                         | 4.22%              |                                      |                         | 4.07%              |

*Provision for credit losses.* The provision for credit losses decreased to \$6.8 million for the nine months ended September 30, 2012 from \$13.0 million for the nine months ended September 30, 2011. The decrease in the provision was primarily due to a decrease of \$9.6 million of specific provisions recorded during the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011. During the nine months ended September 30, 2012, we recorded specific provisions of \$8.8 million compared to \$18.4 million recorded during the nine months ended September 30, 2011. The decrease in the specific component of the provision for credit losses was primarily due to lower outstanding loan balances since September 30, 2011 of impaired loans with a specific allowance, slowing negative credit migration, and improving economic conditions. Our general allowance for credit losses covers probable losses in our loan and lease portfolio with respect to loans and leases 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. Impaired loans, which include all of our delinquent loans and troubled debt restructurings, as a percentage of

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

Loans, net decreased to 18% as of September 30, 2012 as compared to 21% as of September 30, 2011. 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. Consequently, as the percentage of impaired loans in our loan portfolio decreased as compared to September 30, 2011, the percentage of loans in our loan portfolio being evaluated under our general allowance analysis has increased.



**Table of Contents**

*Non-interest income.* Non-interest income increased \$5.6 million, to \$7.8 million for the nine months ended September 30, 2012 from \$2.2 million for the nine months ended September 30, 2011. The increase is primarily due to a \$5.4 million loss on the value of equity interests in certain impaired borrowers during the nine months ended September 30, 2011, a \$1.8 million net loss on equity method of accounting interests during the nine months ended September 30, 2011, as compared to a \$0.6 million net loss on equity method of accounting interests during the nine months ended September 30, 2012, a \$1.9 million increase of fee income, partially offset by a loss of \$0.4 million on the sale of loans. During the nine months ended September 30, 2012, we also recognized a \$2.2 million gain on the repurchase of debt, as compared to a \$3.6 million gain for the nine months ended September 30, 2011.

*Operating expenses.* Operating expenses increased \$1.8 million, to \$34.7 million for the nine months ended September 30, 2012 from \$32.9 million for the nine months ended September 30, 2011. General and administrative expenses increased \$1.1 million. General and administrative expenses were impacted by a \$3.1 million charge, partially offset by a \$1.0 million insurance recovery related to a settlement of litigation brought by an investor in one of our borrowers. Although we have considered the claims to be without merit, we decided that the settlement of the lawsuit was prudent in order to avoid further expenses to defend the case and to eliminate the risk of exposure as a result of an unfavorable evidentiary ruling that occurred during the three months ended June 30, 2012. Employee compensation and benefits increased \$0.7 million primarily due to an increase in headcount and higher incentive compensation accruals, which were partially offset by lower equity compensation expense.

*Income taxes.* For the nine months ended September 30, 2012 and 2011, we provided for income taxes based on an effective tax rate of 42% and 43%, respectively.

**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. In the first quarter of 2012, we amended our corporate credit facility with Fortress to provide for \$25.0 million in additional borrowing and entered into a new \$150.0 million revolving term credit facility with NATIXIS. In January 2012, we amended our facility with Fortress to increase the size of the facility to \$125 million and extended the maturity date to August 31, 2016. In connection with the amendment, we borrowed \$12.6 million under the term loan facility on January 31, 2012 and the remaining \$37.4 million available for borrowing under the term loan facility on March 20, 2012. In February 2012 we entered into a new \$150.0 million revolving term credit facility with NATIXIS that matures in February 2019. During the second quarter of 2012 we amended our credit facility with NATIXIS, which extended the revolving period to December 17, 2012 and the final maturity date to December 31, 2012.

We believe that these sources will be sufficient to fund our current operations, lending activities and other short-term liquidity needs. We continue to explore, subject to market conditions, 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 a revolving credit facility, to support portfolio growth and 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 economic conditions, the credit performance of our loan portfolio and origination volume. We may need to raise additional capital in the future based on various factors that include: 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 of 2012, the U.S. economy grew modestly despite European financial and sovereign headwinds. This expansion was reflected in the stable performance of U.S. debt and equity capital markets. We expect the broader favorable trends in the U.S. to continue as Treasury and investment grade bond rates set all-time lows and investors focus on allocating capital to riskier higher yielding, fixed and floating rate asset classes in order to achieve yield targets. The larger, more liquid segments of the securitization markets also displayed improved issuance volume and pricing. With the strengthening of the high yield loan markets as well as the broader securitization market, conditions in the securitization market for bank loans (the CLO market) have improved year-to-date. We believe that the CLO market, which the company partially relies upon for funding, has recovered to a point that it will provide a reliable source of capital for companies like NewStar. In addition to these signs of improving market conditions, we believe the Company has substantially greater financial flexibility and increased financing options due to the improvement in our financial performance.

We believe that our ability to access new credit facilities and renew and 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, we cannot assure you that this will continue, and it is possible that market conditions could become uncertain or deteriorate. 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.



---

**Table of Contents**

***Cash and Cash Equivalents***

As of September 30, 2012 and December 31, 2011, we had \$34.2 million and \$18.5 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 non-restricted cash to pay down our credit facilities.

***Restricted Cash***

Separately, we had \$151.4 million and \$83.8 million of restricted cash as of September 30, 2012 and December 31, 2011, 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 and portfolio within the facilities or paying down related credit facilities or term debt securitizations. As of September 30, 2012, we could use \$22.6 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, 2012.

***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. 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, 2012, we had impaired loans with an aggregate outstanding balance of \$311.6 million. Impaired loans with an aggregate outstanding balance of \$268.6 million have been restructured and classified as troubled debt restructurings. Impaired loans with an aggregate outstanding balance of \$81.9 million were on non-accrual status. During the nine months ended September 30, 2012, \$13.1 million of loans were charged-off, and we recovered \$1.6 million of previously charged-off impaired loans outstanding. Impaired loans of \$64.3 million were greater than 60 days past due and classified as delinquent. During the nine months ended September 30, 2012, we recorded \$8.8 million of specific provisions for impaired loans. Included in our specific allowance for impaired loans was \$8.5 million related to delinquent loans.

We closely monitor the credit quality of our loans and leases which is 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, 2012 and December 31, 2011 was \$58.9 million and \$63.7 million, respectively, or 3.18% and 3.50% of loans and leases, gross, respectively. As of September 30, 2012, we also had a \$0.5 million allowance for unfunded commitments, resulting in an allowance for credit losses of 3.21%.

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 that during the reporting period to record a specific provision for credit losses for all loans which we have identified impairments. Subsequently, 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.

**Table of Contents**

Activity in the allowance for loan losses for the nine months ended September 30, 2012 and for the year ended December 31, 2011 was as follows:

|   | Nine Months<br>Ended<br>September 30,<br>2012 | Year<br>Ended<br>December 31,<br>2011 |
|---|---|---------------------------------------|
|   | (\$ in thousands)                             |                                       |
| Balance as of beginning of period                 | \$ 63,700                                     | \$ 84,503                             |
| General provision for loan and lease losses       | (2,137)                                       | (1,604)                               |
| Specific provision for loan losses                | 8,802   | 18,782                                |
| Net charge-offs                                   | (11,513)                                      | (37,981)                              |
| <br>  |   |                                       |
| Balance as of end of period                       | 58,852  | 63,700                                |
| Allowance for losses on unfunded loan commitments | 499   | 412                                   |
| <br>  |   |                                       |
| Allowance for credit losses                       | \$ 59,351                                     | \$ 64,112                             |

During the nine months ended September 30, 2012 we recorded a total provision for credit losses of \$6.8 million. The Company decreased its allowance for credit losses 31 basis points to 3.21% of gross loans at September 30, 2012 from 3.52% at December 31, 2011, due to improving economic conditions and slowing negative credit migration.

**Borrowings and Liquidity**

As of September 30, 2012 and December 31, 2011, we had outstanding borrowings totaling \$1.4 billion at the end of each period. Borrowings under our various credit facilities and term debt securitizations have supported our loan growth.

As of September 30, 2012, our funding sources, maximum debt amounts, amounts outstanding and unused debt capacity, subject to certain covenants and conditions, are summarized below:

| Funding Source       | Maximum Debt<br>Amount | Amounts<br>Outstanding | Unused<br>Debt<br>Capacity | Maturity |      |
|----------------------|------------------------|------------------------|----------------------------|----------|------|
|                      | (\$ in thousands)      |                        |                            |          |      |
| Credit facilities    | \$ 650,000             | \$ 396,326             | \$ 253,674                 | 2012     | 2019 |
| Term debt (1)        | 1,072,562              | 1,009,952              | 62,610                     | 2012     | 2022 |
| Repurchase agreement | 40,778                 | 40,778                 |                            |          | 2016 |
| <br>                 |                        |                        |                            |          |      |
| Total                | \$ 1,763,340           | \$ 1,447,056           | \$ 316,284                 |          |      |

(1) Maturities for term debt are based on contractual maturity dates. Actual maturities may occur earlier.

We must comply with various covenants, the breach of certain of these covenants could result in a termination event if not cured, and at September 30, 2012, we were in compliance with all such covenants. These covenants vary depending on the type of facility and are customary for facilities of this type. These covenants 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 and charge-off levels. In addition, we are required to make termination or make-whole payments in the event that certain of our existing credit facilities are prepaid. These termination or make-whole payments, if triggered, could be material to us individually or in the aggregate and in the case of certain facilities could be caused by factors outside of our control, including as a result of loan prepayment by the borrowers under the loan facilities that collateralize these credit facilities.

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

### *Credit Facilities*

As of September 30, 2012 we had five credit facilities: (i) a \$50 million facility with NATIXIS Financial Products, Inc. ( NATIXIS ), (ii) a \$150 million facility with NATIXIS, (iii) a \$225 million credit facility with DZ Bank AG Deutsche Zentral-Genossenschaftsbank Frankfurt ( DZ Bank ), (iv) a \$75 million credit facility with Wells Fargo Bank, National Association ( Wells Fargo ) to fund new equipment lease origination, and (v) a \$150 million credit facility with Wells Fargo.

We have a \$50.0 million credit facility agreement with NATIXIS that had an outstanding balance of \$22.0 million and unamortized deferred financing fees of \$0.1 million as of September 30, 2012. Interest on this facility accrues at a variable rate per annum, which was 3.71% at September 30, 2012. On May 18, 2012, we entered into an amendment with NATIXIS that extended the revolving period under the credit facility to December 17, 2012 and amended the final maturity date of the credit facility to December 31, 2012.

**Table of Contents**

We also have a \$150.0 million credit facility agreement with NATIXIS that had an outstanding balance of \$104.1 million and unamortized deferred financing fees of \$2.2 million as of September 30, 2012. Interest on this facility accrues at a variable rate per annum, which was 2.55% at September 30, 2012. This credit facility has a reinvestment period ending on August 16, 2013 and is scheduled to mature on February 16, 2019.

We have a \$225.0 million credit facility with DZ Bank that had an outstanding balance of \$136.7 million as of September 30, 2012. Interest on this facility accrues at a variable rate per annum. As part of the agreement, there is a minimum interest payment of \$2.8 million per annum required to be made. If the facility is not utilized to cover this minimum requirement, then a make-whole fee is required to be made to satisfy the minimum requirement. We are permitted to use the proceeds of borrowings under the credit facility to fund commitments under existing or new asset based loans. This facility is scheduled to mature on April 25, 2013.

On January 25, 2011, we entered into a note purchase agreement with Wells Fargo. Under the terms of the note purchase agreement, Wells Fargo agreed to provide a \$75.0 million credit facility to fund new equipment lease originations. The credit facility is scheduled to mature four years after the initial advance under the credit facility. We must comply with various covenants, the breach of which could result in a termination event. These covenants include, but are not limited to, failure to service debt obligations, failure to maintain minimum levels of liquidity, failure to meet tangible net worth covenants and violations of pool default and delinquency tests. As of September 30, 2012, we had not drawn any amounts from this credit facility.

We also have a \$150.0 million credit facility with Wells Fargo that had an outstanding balance of \$133.5 million and unamortized deferred financing fees of \$1.4 million as of September 30, 2012. The facility provides for a revolving reinvestment period ending in January 2013 with a two-year amortization period. We must comply with various covenants, the breach of which could result in a termination event. These covenants include, but are not limited to, failure to service debt obligations, failure to maintain minimum levels of liquidity, and failure to meet tangible net worth covenants and overcollateralization tests. At September 30, 2012, we were in compliance with all such covenants. Interest on this facility accrued at a variable rate per annum, which was 2.71% at September 30, 2012.

*Corporate Credit Facility*

On January 5, 2010, we entered into a note agreement with Fortress Credit Corp., which was subsequently amended on August 31, 2010 and January 27, 2012. The credit facility, as amended, consists of a \$25.0 million revolving note and a \$100.0 million term note, which matures on August 31, 2016. The credit facility accrues interest equal to the London Interbank Offered Rate (LIBOR) plus 7.00%.

We are permitted to use the proceeds of borrowings under the credit facility for general corporate purposes including, but not limited to, funding loans, working capital, paying down outstanding debt, making certain types of acquisitions and repurchasing capital stock up to \$10 million.

The applicable unused fee rate of the revolving note is 4.0% of the undrawn amount of the revolving note when the total outstanding amount is less than 50% of the commitment amount, 3.0% of the undrawn amount of the revolving note when the total outstanding amount is greater than or equal to 50% but less than 75% of the commitment amount, and 2.0% of the undrawn amount of the revolving note when the total outstanding amount is greater than or equal to 75% of the commitment amount. As of September 30, 2012, we had not drawn any amounts from the revolving note. As of September 30, 2012, unamortized deferred financing fees were \$3.0 million.

The revolving note may be cancelled at any time subject to a commitment termination fee. The commitment termination fee will be equal to the product of the aggregate revolving loan commitments as of the date of termination and 1% for any termination made during the period from July 1, 2012 to August 31, 2015, and 0% for any termination made at any time after August 31, 2015.

The term note may be prepaid subject to a commitment termination fee. For any prepayments of term loans made before January 27, 2013, the commitment termination fee will be equal to the product of (x) the amount of the prepayment and (y) 3%. For any prepayment of term loans made during the period from January 28, 2013 to August 31, 2015, the commitment termination fee will be equal to the product of (x) the amount of the prepayment and (y) 1%. For any prepayment made at any time after August 31, 2015 there will not be any fee. As of September 30, 2012, the term note had an outstanding principal balance of \$100.0 million.

*Term Debt Securitizations*

In August 2005 we completed a term debt transaction. In conjunction with this transaction we established a separate single-purpose bankruptcy-remote subsidiary, NewStar Trust 2005-1 (the 2005 CLO Trust ) and contributed \$375 million in loans and investments (including unfunded commitments), or portions thereof, to the 2005 CLO Trust. We remain the servicer of the loans and investments. Simultaneously with the initial contributions, the 2005 CLO Trust issued \$343.4 million of notes to institutional investors and issued \$31.6 million of trust certificates

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

of which we retained 100%. At September 30, 2012, the \$130.5 million of outstanding notes were collateralized by the specific loans and investments, principal collections account cash and principal payment receivables

**Table of Contents**

totaling \$162.0 million. At September 30, 2012, deferred financing fees were \$0. The 2005 CLO Trust permitted reinvestment of collateral principal repayments for a three-year period which ended in October 2008. During the nine months ended September 30, 2012, we repurchased \$9.3 million of the 2005 CLO Trust's Class D notes. During 2011, we repurchased \$3.9 million of the 2005 CLO Trust's Class E notes. During 2010, we repurchased \$4.6 million of the 2005 CLO Trust's Class D notes. During 2009, we repurchased \$1.4 million of the 2005 CLO Trust's Class D notes and \$1.2 million of the Class E notes. During 2008, we repurchased \$5.8 million of the 2005 CLO Trust's Class E notes. During 2007, we repurchased \$5.0 million of the 2005 CLO Trust's Class E notes. During 2009, Moody's downgraded all of the notes of the 2005 CLO Trust. As a result of the downgrades, amortization of the 2005 CLO Trust changed from pro rata to sequential, resulting in scheduled principal payments made in order of the notes seniority until all available funds are exhausted for each payment. During 2010, Standard and Poor's downgraded all of the notes of the 2005 CLO Trust. During the first quarter of 2012, Moody's upgraded the Class A-1 notes, the Class A-2 notes, the Class B notes, the Class C notes, and the Class D notes, and downgraded the Class E notes of the 2005 CLO Trust. During the third quarter of 2012, Fitch affirmed its ratings of all of the notes of the 2005 CLO Trust.

We receive a loan collateral management fee and excess interest spread. We may receive a principal distribution when the term debt is retired. The most recent quarterly report of the 2005 CLO Trust dated July 13, 2012 identified \$74.8 million in cumulative charged-off loans in the 2005 CLO Trust as delinquent or charged-off under the terms of the trust indenture. As a result, the excess interest spread from the 2005 CLO Trust will be redirected and combined with recoveries and will be used to repay the outstanding notes until note redemptions equal the underlying non-accrual loan balances or until we purchase such loans. As of the July 13, 2012 report, the cumulative amount redirected was \$19.2 million. We may have additional defaults in the 2005 CLO Trust in the future. If we do not elect to remove any future defaulted loans, we would not expect to receive excess interest spread payments until the undistributed cash plus any recoveries equal the outstanding balances of defaulted loan collateral.

The following table sets forth selected information with respect to the 2005 CLO Trust:

|                              | Notes and<br>certificates<br>originally<br>issued<br>(\$ in thousands) | Outstanding<br>balance<br>September 30,<br>2012 | Borrowing<br>spread to<br>LIBOR<br>% | Ratings<br>(S&P/Moody's/<br>Fitch)(1) |
|------------------------------|--|---|--------------------------------------|---------------------------------------|
| <b>2005 CLO Trust:</b>       |  |   |                                      |                                       |
| Class A-1                    | \$ 156,000   | \$ 36,567                                       | 0.28%                                | AA+/Aaa/AAA                           |
| Class A-2                    | 80,477   | 18,667  | 0.30                                 | AA+/Aaa/AAA                           |
| Class B                      | 18,750   | 18,683  | 0.50                                 | A+/Aa1/AA                             |
| Class C                      | 39,375   | 39,233  | 0.85                                 | B+/A2/BB                              |
| Class D                      | 24,375   | 8,922   | 1.50                                 | CCC-/Ba2/CCC                          |
| Class E                      | 24,375   | 8,418   | 4.75                                 | CCC-/Caa3/CC                          |
| Total notes                  | 343,352  | 130,490   |                                      |                                       |
| Class F (trust certificates) | 31,648   | 31,538  | N/A                                  | N/A                                   |
| Total for 2005 CLO Trust     | \$ 375,000   | \$ 162,028                                      |                                      |                                       |

- (1) The ratings were initially given in August 2005, are unaudited and are subject to change from time to time. Fitch affirmed its ratings in February 2009 and downgraded the Class D notes and Class E notes. The Fitch downgrade did not have a material impact on the 2005 CLO Trust. During the first quarter of 2009, Moody's downgraded the Class C notes, the Class D notes and the Class E notes. During the third quarter of 2009, Moody's downgraded the Class A-1 notes, the Class A-2 notes and the Class B notes. During the second quarter of 2010, Standard and Poor's downgraded all of the notes to the ratings shown above. During the third quarter of 2010, Fitch downgraded the Class C notes, the Class D notes and the Class E notes to the ratings shown above. During the first quarter of 2012, Moody's upgraded the Class A-1 notes, the Class A-2 notes, the Class B notes, the Class C notes, and the Class D notes, and downgraded the Class E notes to the ratings shown above. Fitch affirmed its ratings during the third quarter of 2012 (source: Bloomberg Finance L.P.).

In June 2006 we completed a term debt transaction. In conjunction with this transaction we established a separate single-purpose bankruptcy remote subsidiary, NewStar Commercial Loan Trust 2006-1 (the 2006 CLO Trust) and contributed \$500 million in loans and investments (including unfunded commitments), or portions thereof, to the 2006 CLO Trust. We remain the servicer of the loans. Simultaneously with the



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

initial contributions, the 2006 CLO Trust issued \$456.3 million of notes to institutional investors. We retained \$43.8 million, comprising 100% of the 2006 CLO Trust's trust certificates. At September 30, 2012, the \$295.7 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$339.4 million. At September 30, 2012, deferred financing fees were \$1.0 million. The 2006 CLO Trust permitted reinvestment of collateral principal repayments for a five-year period which ended in June 2011. During 2011, we repurchased \$7.0 million of the 2006 CLO Trust's Class C notes, \$6.0 million of the 2006 CLO Trust's Class D notes and \$2.0 million of the 2006 CLO Trust's Class E notes. During 2010, we repurchased \$3.0 million of the 2006 CLO Trust's Class D notes and

**Table of Contents**

\$3.0 million of the 2006 CLO Trust's Class E notes. During 2009, we repurchased \$6.5 million of the 2006 CLO Trust's Class D notes and \$1.8 million of the 2006 CLO Trust's Class E notes. During 2008, we repurchased \$3.3 million of the 2006 CLO Trust's Class D and \$2.5 million of the 2006 CLO Trust's Class E notes, respectively. During 2009, Moody's downgraded all of the notes of the 2006 CLO Trust. As a result of the downgrade, amortization of the 2006 CLO Trust changed from pro rata to sequential, resulting in future scheduled principal payments made in order of the notes seniority until all available funds are exhausted for each payment. During 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes, the Class D notes and the Class E notes of the 2006 CLO Trust. The downgrade did not have any material consequence as the amortization of the 2006 CLO Trust changed from pro rata to sequential after the Moody's downgrade in 2009. During 2011, Moody's upgraded its ratings of all of the notes of the 2006 CLO Trust. During the third quarter of 2012, Fitch affirmed its ratings of all of the notes of the 2006 CLO Trust.

We receive a loan collateral management fee and excess interest spread. We expect to receive a principal distribution when the term debt is retired. The most recent quarterly report of the 2006 CLO Trust dated September 13, 2012 identified \$21.6 million in cumulative charged-off loans in the 2006 CLO Trust as delinquent or charged-off under the terms of the trust indenture. As a result, the excess interest spread from the 2006 CLO Trust will be redirected and combined with recoveries and will be used to repay the outstanding notes until note redemptions equal the underlying non-accrual loan balances or until we purchase such loans. During 2011, the Company elected to purchase \$11.1 million of defaulted collateral from the 2006 CLO Trust to reduce the amount of excess interest spread that otherwise would have been required to be redirected. As of the September 13, 2012 quarterly report, the entire \$21.6 million had been redirected or repurchased. We may have additional defaults in the 2006 CLO Trust in the future. If we do not elect to remove any future defaulted loans, we would not expect to receive excess interest spread payments until the undistributed cash plus any recoveries equal the outstanding balances of defaulted loan collateral.

The following table sets forth the selected information with respect to the 2006 CLO Trust:

|                              | Notes and<br>certificates<br>originally<br>issued<br>(\$ in thousands) | Outstanding<br>balance<br>September 30,<br>2012 | Borrowing<br>spread to<br>LIBOR<br>% | Ratings<br>(S&P/Moody's/<br>Fitch)(1) |
|------------------------------|--|---|--------------------------------------|---------------------------------------|
| <b>2006 CLO Trust:</b>       |  |   |                                      |                                       |
| Class A-1                    | \$ 320,000   | \$ 206,754                                      | 0.27%                                | AA+/Aaa/AAA                           |
| Class A-2                    | 40,000   | 27,670  | 0.28                                 | AA+/Aaa/AAA                           |
| Class B                      | 22,500   | 22,500  | 0.38                                 | AA/Aa2/AA                             |
| Class C                      | 35,000   | 28,000  | 0.68                                 | BBB+/A3/A                             |
| Class D                      | 25,000   | 6,250   | 1.35                                 | CCC+/Baa3/BBB                         |
| Class E                      | 13,750   | 4,500   | 1.75                                 | CCC-/Ba1/BB                           |
| Total notes                  | 456,250  | 295,674   |                                      |                                       |
| Class F (trust certificates) | 43,750   | 43,750  | N/A                                  | N/A                                   |
| Total for 2006 CLO Trust     | \$ 500,000   | \$ 339,424                                      |                                      |                                       |

- (1) These ratings were initially given in June 2006, are unaudited and are subject to change from time to time. During the first quarter of 2009, Fitch affirmed its ratings. During the first quarter of 2009, Moody's downgraded the Class C notes, the Class D notes and the Class E notes. During the third quarter of 2009, Moody's downgraded the Class A-1 notes, the Class A-2 notes and the Class B note. During the second quarter of 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes, the Class D notes and the Class E notes to the ratings shown above. During the fourth quarter of 2011, Moody's upgraded all of the notes to the ratings shown above. During the third quarter of 2012, Fitch affirmed its ratings (source: Bloomberg Finance L.P.).

In June 2007 we completed a term debt 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 contributed \$600 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 contributions, 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, 2012, the \$483.8 million of outstanding drawn notes were collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling

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

\$537.8 million. At September 30, 2012, deferred financing fees were \$2.4 million. The 2007-1 CLO Trust permits reinvestment of collateral principal repayments for a six-year period ending in May 2013. 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. During the nine months ended September 30, 2012 we repurchased \$0.2 million of the 2007-1 CLO Trust's Class C notes. During 2010, we repurchased \$5.0 million of the 2007-1 CLO Trust's Class D notes. During 2009, we repurchased \$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

**Table of Contents**

Trust changed from pro rata to sequential, resulting in future scheduled principal payments made in order of the notes seniority until all available funds are exhausted for each payment. During 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes and the Class D notes of the 2007-1 CLO Trust. The downgrade did not have any material consequence as the amortization of the 2007-1 CLO Trust changed from pro rata to sequential after the Moody's downgrade in 2009. During the second quarter of 2011, Moody's upgraded the Class C notes, the Class D notes, and the Class E notes. During 2011, Standard and Poor's upgraded the Class D notes. During the fourth quarter of 2011, Moody's upgraded all of the notes of the 2007-1 CLO Trust. During 2012, Fitch affirmed its ratings of all of the notes of the 2007-1 CLO Trust.

We receive a loan collateral management fee and excess interest spread. We expect to receive a principal distribution 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 could 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. We may have future defaults in the 2007-1 CLO Trust in the future. If we do not elect to remove any future defaulted loans, we would not expect to receive excess interest spread payments until the undistributed cash plus any recoveries equal the outstanding balances of any potential defaulted loan collateral.

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

|                                   | Notes<br>originally<br>issued | Outstanding<br>balance<br>September 30,<br>2012 | Borrowing<br>spread to<br>LIBOR | Ratings<br>(S&P/Moody's/<br>Fitch)(1) |
|-----------------------------------|-------------------------------|---|---------------------------------|---------------------------------------|
| (\$ in thousands)                 |                               |   |                                 |                                       |
| <b>2007-1 CLO Trust</b>           |                               |   |                                 |                                       |
| Class A-1                         | \$ 336,500                    | \$ 318,105                                      | 0.24%                           | AA+/Aaa/AAA                           |
| Class A-2                         | 100,000                       | 62,390  | 0.26                            | AA+/Aaa/AAA                           |
| Class B                           | 24,000                        | 24,000  | 0.55                            | AA/Aa3/AA                             |
| Class C                           | 58,500                        | 58,293  | 1.30                            | BBB+/Baa1/A                           |
| Class D                           | 27,000                        | 21,000  | 2.30                            | BB-/Ba1/BBB+                          |
| <b>Total notes</b>                | <b>546,000</b>                | <b>483,788</b>                                  |                                 |                                       |
| Class E (trust certificates)      | 29,100                        | 29,100  | N/A                             | N/A                                   |
| Class F (trust certificates)      | 24,900                        | 24,900  | N/A                             | N/A                                   |
| <b>Total for 2007-1 CLO Trust</b> | <b>\$ 600,000</b>             | <b>\$ 537,788</b>                               |                                 |                                       |

- (1) These ratings were initially given in June 2007, are unaudited and are subject to change from time to time. Fitch affirmed its ratings on February 24, 2009. During the first quarter of 2009, Moody's downgraded the Class C notes and the Class D notes. During the third quarter of 2009, Moody's downgraded the Class A-1 notes, the Class A-2 notes and the Class B notes. During the second quarter of 2010, Standard and Poor's downgraded the Class A-1 notes, the Class A-2 notes, the Class C notes to the ratings shown above, and also downgraded the Class D notes. During the second quarter of 2011, Moody's upgraded the Class C notes and the Class D notes. During the second quarter of 2011, Standard and Poor's upgraded the Class D notes to the rating shown above. During the fourth quarter of 2011, Moody's upgraded all of the notes to the ratings shown above. During the third quarter of 2012, Fitch affirmed its ratings (source: Bloomberg Finance L.P.).

On January 7, 2010, we completed a term debt securitization. In conjunction with this transaction we established a separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Trust 2009-1 (the "2009-1 CLO Trust") and contributed \$225 million in loans and investments (including unfunded commitments), or portions thereof, to the 2009-1 CLO Trust at close. We had the ability to contribute an additional \$50 million of loan collateral by July 30, 2010 and contributed the full amount during the six months ended June 30, 2010. Simultaneously with the initial contributions, the 2009-1 CLO Trust issued \$190.5 million of notes to institutional investors. We retained all of the Class C and subordinated notes, which totaled approximately \$87.9 million, representing 32% of the value of the collateral pool. The 2009-1 CLO Trust was a static pool of loans that did not permit for reinvestment of collateral principal repayments. The 2009-1 CLO Trust was callable without penalty on the distribution date in July 2011 and on each distribution date thereafter. On August 1, 2011, we called the 2009-1 CLO Trust and redeemed the notes without penalty and recognized a total of \$3.0 million of interest expense due to the accelerated amortization of deferred financing fees and unamortized discount.

*Repurchase Agreement*

On June 7, 2011, we entered into a five-year, \$68.0 million financing arrangement with Macquarie Bank Limited backed primarily by a portfolio of commercial mortgage loans previously originated by us. The financing was structured as a master repurchase agreement under which we sold the portfolio of commercial mortgage loans to Macquarie for an aggregate purchase price of \$68.0 million. We also agreed to repurchase the commercial mortgage loans from time to time (including a minimum quarterly

---

**Table of Contents**

amount), and agreed to repurchase all of the commercial mortgage loans by June 7, 2016. Upon the repurchase of a commercial mortgage loan, we are obligated to repay the principal amount related to such mortgage loan plus accrued interest (at a rate based on LIBOR plus a margin) to the date of repurchase. We will continue to service the commercial mortgage loans. The facility accrues interest at a variable rate per annum, which was 5.22% as of September 30, 2012. As of September 30, 2012, unamortized deferred financing fees were \$1.2 million and the outstanding balance was \$40.8 million. During the nine months ended September 30, 2012, we made principal payments totaling \$24.1 million. As part of the agreement, there is a minimum aggregate interest margin payment of \$8.4 million required to be made over the life of the facility. If the facility is not utilized to cover this minimum requirement, then a make-whole fee is required to be made to satisfy the minimum aggregate interest margin payment.

The proceeds of the Macquarie transaction were used to fully repay our credit facility with Citicorp and refinance all of the commercial mortgage loans previously funded by our warehouse line with Wells Fargo. The transaction generated net proceeds for us after retirement of debt and transaction costs of approximately \$20.0 million. We did not record any gains or losses. The commercial mortgage loans and related repurchase obligations are consolidated and reflected in our financial statements.

*Stock Repurchase Program*

On September 29, 2011, our Board of Directors authorized the repurchase of up to \$10 million of the Company's common stock from time to time on the open market or in privately negotiated transactions. The timing and amount of any shares purchased will be determined by management based on its evaluation of market conditions and other factors and required use of cash. The repurchase program expired on September 29, 2012. Upon the expiration of the stock repurchase program, the Company had repurchased 252,450 shares of its common stock under this program at a weighted average price per share of \$10.26.

**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, standby letters of credit and interest rate mitigation products. The instruments involve, to varying degrees, elements of credit and interest rate 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, 2012, we had \$256.7 million of unused lines of credit. Of these unused lines of credit, unfunded commitments related to revolving credit facilities were \$209.1 million and unfunded commitments related to delayed draw term loans were \$38.1 million. \$9.5 million of the unused commitments are unavailable to the borrowers, which may be related to the borrowers' inability to meet covenant obligations or other similar events.

Revolving credit facilities allow our borrowers to draw up to a specified amount, subject to customary borrowing conditions. The unfunded revolving commitments of \$209.1 million are further categorized as either contingent or unrestricted. Contingent commitments limit a borrower's ability to access the revolver unless it meets an enumerated borrowing base covenant or other restrictions. At September 30, 2012, we categorized \$148.6 million of the unfunded commitments related to revolving credit facilities as contingent. Unrestricted commitments represent commitments that are currently accessible, assuming the borrower is in compliance with certain customary loan terms and conditions. At September 30, 2012, we had \$60.5 million of unfunded unrestricted revolving commitments.

During the three months ended September 30, 2012, revolver usage averaged approximately 49%, which is line with the average of 46% over the previous four quarters. Management's experience indicates that borrowers typically do not seek to exercise their entire available line of credit at any point in time. During the three months ended September 30, 2012, revolving commitments increased \$20.0 million.

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

Delayed draw credit facilities allow our borrowers to draw predefined amounts of the approved loan commitment at contractually set times, subject to specific conditions, such as capital expenditures in corporate loans or for tenant improvements in commercial real estate loans. During the three months ended September 30, 2012, delayed draw credit facility commitments increased \$1.0 million.

---

## **Table of Contents**

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, 2012 we had \$6.4 million of standby letters of credit.

Interest rate risk mitigation products are offered to enable customers to meet their financing and risk management objectives. Derivative financial instruments consist predominantly of interest rate swaps, interest rate caps and floors. The interest rate risks to the Company of these customer derivatives is mitigated by entering into similar derivatives having offsetting terms with other counterparties. At September 30, 2012 and December 31, 2011, the fair value of the interest rate mitigation products was \$0.

## **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 2011 Annual Report, 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 and valuation methodologies. 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 2011 Annual Report.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

We are exposed to changes in market values of our loans held-for-sale, which are carried at lower of cost or market, 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, 2012 and December 31, 2011, investments in debt securities available-for-sale totaled \$20.8 million and \$17.8 million, respectively. At September 30, 2012 and December 31, 2011, our net unrealized loss on those debt securities totaled \$0.1 million and \$2.9 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, 2012, approximately 1% of the loans in our portfolio were at fixed rates and approximately 99% were at variable rates. Additionally, for the loans at variable rates, approximately 78% contain an interest rate floor. Our credit facilities and term debt securitizations all bear interest at variable rates without interest rate floors, however, our corporate credit facility contains an interest rate floor set at a rate of 1.50%.

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.

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, 2012. Our modeling is based on contractual terms and does not consider prepayment or changes in 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.

**Table of Contents**

|             | <b>Rate Change<br/>(Basis<br/>Points)</b> | <b>Estimated Change in<br/>Net Interest<br/>Income<br/>Over 12 Months<br/>(\$ in thousands)</b> |
|-------------|---|---|
| Decrease of | 100                                       | \$ 8,530  |
| Increase of | 100                                       | (8,000)   |
| Increase of | 200                                       | (6,720)   |
| Increase of | 300                                       | (2,490)   |

The estimated changes in net interest income reflect the potential effect of interest rate floors on loans totaling approximately \$1.5 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 portfolios 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. The inflection point as of September 30, 2012 was estimated to be 1.50%.

**Table of Contents****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 2012 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.

**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, 2012:

| Period                                | Total<br>Number of<br>Shares<br>Purchased (1) | Average<br>Price Paid<br>Per Share (1) | Total Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs<br>(2) | Approximate<br>Dollar Value of<br>Shares that May<br>Yet Be<br>Purchased<br>Under the<br>Plans<br>or Programs<br>(2) |
|---------------------------------------|---|--|--|--|
| July 1-31, 2012                       |   | \$                                     |  | \$ 7,403,438   |
| August 1-31, 2012                     |   |  |  | 7,403,438  |
| September 1-30, 2012                  |   |  |  |  |
| Three months ended September 30, 2012 |   | \$                                     |  | \$   |

(1) We did not repurchase any shares during the period in connection with our share repurchase program that we announced on September 29, 2011.

(2) The repurchase program referenced in footnote (1) provided for the repurchase of up to \$10 million of the Company's common stock from time to time on the open market or in privately negotiated transactions. The repurchase program expired on September 29, 2012.



**Table of Contents****Item 6. Exhibits.**

| <b>Exhibit Number</b> | <b>Description</b>  | <b>Method of Filing</b>  |
|-----------------------|---|--|
| 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. |
| 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.  |
| 101*                  | The following materials from the Quarterly Report of NewStar Financial, Inc. on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2012 and 2011, (iii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 and 2011, (iv) Condensed Consolidated Statements of Changes in Stockholders' Equity for the nine months ended September 30, 2012 and 2011, (v) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and 2011, 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  |  |

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

101.PRE XBRL Taxonomy Presentation Linkbase Document

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**Table of Contents**

**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 7, 2012

By:

/s/ JOHN KIRBY BRAY  
**John Kirby Bray**  
**Chief Financial Officer**

52

**Table of Contents****EXHIBIT INDEX**

| <b>Exhibit Number</b> | <b>Description</b>  | <b>Method of Filing</b>  |
|-----------------------|---|--|
| 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. |
| 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.  |
| 101*                  | The following materials from the Quarterly Report of NewStar Financial, Inc. on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2012 and 2011, (iii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 and 2011, (iv) Condensed Consolidated Statements of Changes in Stockholders' Equity for the nine months ended September 30, 2012 and 2011, (v) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and 2011, 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  |  |



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

101.PRE XBRL Taxonomy Presentation Linkbase Document

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.