VIAVID
communications simplified.

ArrowMark Financial Corp.

Q2 2022 Conference Call Financial Results

August 4, 2022

CORPORATE PARTICIPANTS

Julie Muraco, *Investor Relations*

Sanjai Bhonsle, *Chief Executive Officer*

Dana Staggs, *President*

Patrick Farrell, *Chief Financial Officer*

PRESENTATION

Operator

Welcome to the ArrowMark Financial Corp. Q2 2022 Investor Call.

As a reminder, this call is being recorded.

Now, I would like to hand the call over to Julie Muraco, Investor Relations at ArrowMark Financial Corp.

Julie Muraco

Before we begin this conference call, I would like to remind everyone that certain statements made during the call may be considered forward-looking statements, which are based on current Management expectations that involved substantial risks and uncertainties. Actual results may differ materially from the results stated in or implied by these forward-looking statements. ArrowMark Financial has based the forward-looking statements included in this presentation on information available to us today as of June 30, 2022, unless otherwise noted. The Company undertakes no duty to update any forward-looking statements made herein.

In today's call, the Management of ArrowMark Financial will be providing prepared remarks. Investors will have the opportunity to address their questions directly to Management by calling Investor Relations at 212-468-5441 or emailing Jmuraco@arrowmarkpartners.com.

Now, I will turn the call over to Sanjai Bhonsle, Chief Executive Officer of ArrowMark Financial.

Sanjai Bhonsle

Thank you, Julie. Good afternoon and welcome to ArrowMark Financial's Investor Call for Second Quarter 2022. Along with Julie, here with me today are Dana Staggs, President, and Pat Farrell, our CFO.

In the next few minutes, I will briefly comment on the market environment, including factors affecting the credit markets. Then, I will provide ArrowMark Financial's quarterly results and portfolio review. Dana will provide details on the origination pipeline, and Pat will provide you with greater detail on our financial results.

Before I begin, I want to recognize the appointment of Dana Staggs as President of ArrowMark Financial Corp., effective June 9, 2022. Dana has over 27 years of experience leading organizations. He has been with ArrowMark Partners for five years, helping lead the private debt and equity investment strategy at the firm. Dana is focused on the origination, diligence, and management of the investment portfolio. I'm pleased to have Dana as an officer of the company.

Now, on to the markets. During the second quarter, the equity and credit markets continued to experience volatility, with the equity 500 down 15% for the second quarter and down nearly 20% in the first six months of 2022. Likewise, the bond markets also declined with the Bloomberg Berkley's U.S. Aggregate Bond Index, a proxy for investment grade bonds, was down nearly 5% for the quarter and down 10% in the first six months of 2022.

Heightened fears of a recession driven by high inflation, tightening Central Bank monetary policy, supply chain disruptions, and geopolitical risks from the war in Ukraine contributed to the volatility in the equity and credit markets.

Last week, the Federal Reserve announced that it raised the Fed Funds Rate by 75 basis points, the second time the Fed made a 75-basis point hike in the past two months. Many believe the Fed has not finished hiking rates. Additional increases are expected in the second half of the year in order to tame inflation in accordance with a 2% inflation target. We expect that monetary policy will continue to weigh heavily on the markets for the remainder of the year.

With a long-term view in mind, I want to put the macro factors affecting the markets into perspective when it comes to ArrowMark Financial and our underlying investments. ArrowMark Financial's portfolio is made up of securities, primarily issued by money center banks and U.S. community banks. We believe that our investment portfolio is well-positioned despite these macro factors affecting our current economy. Moreover, we believe we have a defensive approach based on capital preservation, income generation, and maximizing total risk-adjusted returns.

Our beliefs are based on the following. First, our investments are structured in a way that mitigates risk. As previously mentioned, our regulatory capital relief investments are primarily issued by money center banks classified as GSIS that are well-capitalized. We also deploy capital in community banks where we invest in term loans, trust preferred, and preferred securities, all priority ranking securities issued by these banks. We believe that money center banks and community banks have been conservative in taking reserves ahead of a possible economic downturn. They are also poised to benefit from increases in lending rates, as well as growth in their loan book. Given strong tier-1 capital ratios and conservative balance sheets for our portfolio banks, we expect the banking sector to be resilient in general during any economic downturn.

Second, our portfolio of regulatory capital and community bank investments are diversified across money center banks and community banks.

Third, we further mitigate risks to our portfolio management process as our investment team is in frequent contact with our issuers. Our investment team regularly stress tests the portfolio against various economic scenarios, industry sector credit outlooks, and/or geographic risk.

Finally, the scale and expanse that the ArrowMark Partners platform provides to our advisor offers exceptional benefits, including diverse in-house subject matter expertise and research. The team contributes to improving the Company's efficiencies, which helped to optimize ArrowMark Financial's operating results. Our seasoned team has experience managing investment portfolios through multiple economic cycles and market conditions. This depth of experience is exactly why we remain intently focused on credit quality when underwriting the portfolio.

Now, I would like to say a few words on interest rates and the positive impact on our earnings. We believe a rise in rates should be beneficial to our portfolio due to the floating rate structure of a majority of our investments. Today, approximately 78% of the Company's total investments are in floating rate assets, which provides an inflation hedge to the portfolio. As I mentioned last quarter, we believe that every 25 basis points increase in base rates may translate to as much as an additional half penny to one penny per share per quarter in net income, all things being equal.

The impact to net income from an increase in rate is dependent on a number of variables. These include the mix of floating rate assets and the timing of the reset of the base rates, and the average amount of volumes under our credit facility, for example.

Now, on to ArrowMark Financial's results for the second quarter. We're pleased to report that net investment income for the second quarter of 2022 was approximately $3 million or $0.43 per share, up 2.5% from the prior quarter. Of note, once again, we have over-earned our stated dividend of $0.39 per share per quarter. For the first six months of 2022, net investment income was up approximately 15% as compared to the same period in 2021.

Our net asset value at the end of the quarter was $20.94 per share, down $0.50 per share, or negative 2.3% from the prior quarter end. For the most part, this was due to the volatility of the credit markets. Our NAV has performed well, which compares favorably to the equity and credit market's performance during the quarter. We believe this demonstrates the low volatility characteristics of our investments and their strong underlying credit profile.

Now, let me turn to the portfolio review. During the second quarter, the Company invested a total of $23.8 million in four regulatory capital transactions. The securities were purchased in the primary market and together have an effective weighted average coupon of 10.6%. I want to point out that the yields on this regulatory capital securities will continue to benefit from the rise in interest rates due to the floating rate structure. The $23.8 million of investments was offset by $14.8 million from the full sale of PFF, the full call of first marquee, and other partial pay downs.

The estimated annualized yield of the portfolio investments as of June 30 was 10.11%, up 58 basis points over the last quarter end, partially driven by the sale of low sub- 5% yielding assets and the purchase of much higher yielding regulatory capital assets. I want to highlight that this is the first time the portfolio yield has been above 10% since the second quarter of 2020. At quarter end, total assets of portfolio were reported at approximately $201.6 million, and the investment portfolio was reported at $196.4 million.

Now, I want to introduce Dana Staggs, President of the Company, who will discuss the origination pipeline.

Dana Staggs

Thank you, Sanjai. In Q2, industry-wide regulatory capital origination was robust with an estimated $3 billion to $3.5 billion of issuance, bringing year-to-date 2022 issuance to approximately $4 billion to $5 billion. The new issue market for red cap is expected to meet or exceed 2021 issuance levels. Continued growth of the red cap market supports our efforts to deploy capital into this asset class.

In the community banking space in Q2, subordinated loans issued by community banks were yielding 5% higher versus 3% to 4% for most of 2021. The recent rise in subordinated loan interest rates have been primarily driven by recent increases in the five and 10-year treasury yields. Despite favorable price changes, we still find more attractive opportunities on a risk-adjusted return basis in regulatory capital securities. However, we continue to monitor the community banks' subordinate loans and preferred equity new issue in secondary market. It is our intention to opportunistically invest in those assets when attractive opportunities are available.

Now, I will return it back to Sanjai.

Sanjai Bhonsle

Thank you, Dana. We firmly believe that during these volatile times, the Company is well-positioned to deliver superior financial results benefitting from the strategic mix of red cap and community bank investments. ArrowMark Financial is the only public company that offers the opportunity to participate in regulatory capital investments. With this strategy and with the stock at an 8.6% yield, we believe that ArrowMark Financial continues to offer exceptional value to investors.

Now, I want to turn the call over to Pat Farrell, Chief Financial Officer of the Company.

Patrick Farrell

Thank you, Sanjai. As I do each quarter, I will present the financial results by going through the components of the Company's quarterly results in detail. The net asset value on June 30 was $20.94 per share, down $0.50 from the prior quarter. The decline in NAV, in part, reflects the volatility of the credit market.

NAV is comprised of four components; net investment income, realized capital gains and losses, the change in value of the portfolio's investments, and lastly, distributions paid during the period.

Let's review these components. Gross income from the quarter was approximately $5 million or $0.71 per share. Total expenses for the quarter were $2 million or $0.28 per share resulting in net investment income for the quarter of $3 million or $0.43 per share. As is the case every quarter, the timing of calls and paydowns impacts the income generation of the Company.

Realized capital gains and losses in the quarter is the second component affecting the change in NAV. The net realized capital gains from investment activities were approximately $2.5 million or $0.36 per share.

The third component, changes in unrealized appreciation or depreciation of the portfolio, relates to how the value of the entire investment portfolio has changed from the previous quarter end to the current quarter end. Through the quarter, the change in net unrealized depreciation on investments and foreign currency transaction was approximately $6.4 million or $0.90 per share. I want to point out that gains and losses from foreign currency hedging activities do not impact our net income.

The fourth component affecting the change in net asset value is distribution. The regular cash distribution for the quarter was $0.39 per share. The distribution of $0.39 per share was paid on June 29.

In summary, we began the quarter with a net asset value of $21.44 per share. During the quarter, we generated the income of $3 million, net realized capital gains of approximately $2.5 million, and the unrealized value of the portfolio and foreign currency transaction decreased by $6.4 million. The sum of these components reduced by a distribution of $0.39 per share resulted in a net asset value of $20.94 per share on June 30, which was down $0.50 from the prior quarter.

We believe this NAV is a true representation of the value of the Company. Although we don't believe we get credit for it in the public markets, the majority of the portfolio is independently marked, meaning we do not put valuations on the majority of investments in our own portfolio, which is a point of differentiation compared to other publicly traded closed-end funds and BDCs.

In the second quarter, approximately 75% of the portfolio prices or marks reflect a minimum of two quotations from broker-dealers or pricing service. These quotations represent an independent third-party assessment of the current value of portfolio.

At quarter end, the Company had total assets $201.6 million, consisting of total investments of $197.1 million and cash interests and dividends receivable in prepaid assets totaling approximately $4.5 million. At quarter end, our dividend yield was approximately 8.1%. As of today, the dividend yield is approximately 8.6%.

Now, let me update you on our credit facility. As disclosed in our 8-K filing on June 3, we amended and extended our credit agreement with Texas Capital Bank, our lender and capital partner since 2014. The interest rate for the facility is now based on the Secured Overnight Financing Rate known as SOFR, and is currently priced at SOFR plus 2.61%. In addition, we upsized the facility to $70 million from $62 million with the option to increase to $90 million. We also extended maturity another three years with an option to extend to a fourth year. We're pleased with the new terms, which will ensure strong and stable access to debt capital over the next four years.

As of June 30, 2022, the Company had $51.5 million drawn from the facility or 26% of total assets. As a registered investment company subject to the Investment Company Act, we only borrow up to 33.3% of our total assets.

Now, I want to turn the call back over to Sanjai.

Sanjai Bhonsle

Thank you, Pat. I would like to thank everyone on the call for listening in today. We appreciate your continued support, and we hope you enjoy the remainder of the summer. Stay safe, and goodnight.

Operator

This concludes today's call. Thank you for attending.