

NewStar Financial, Inc.
Form 10-Q
November 05, 2008
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

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)

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| | |
|--|--|
| Delaware (State or other jurisdiction of incorporation or organization) | 54-2157878 (I.R.S. Employer Identification No.) |
| 500 Boylston Street, Suite 1600, Boston, MA (Address of principal executive offices) | 02116 (Zip Code) |
| (617) 848-2500 (Registrant's telephone number, including area code) | |
| N/A (Former name, former address and former fiscal year, if changed since last report) | |

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

As of November 3, 2008, 48,522,500 shares of common stock, par value of \$0.01 per share, were outstanding.

Table of Contents

TABLE OF CONTENTS

| | Page |
|---|-------------|
| <u>PART I</u> | |
| <u>FINANCIAL INFORMATION</u> | |
| Item 1. <u>Financial Statements (Unaudited).</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2008 and December 31, 2007</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2008 and 2007</u> | 4 |
| <u>Condensed Consolidated Statements of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2008 and 2007</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and 2007</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 7 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations.</u> | 22 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk.</u> | 33 |
| Item 4. <u>Controls and Procedures.</u> | 34 |
| <u>PART II</u> | |
| <u>OTHER INFORMATION</u> | |
| Item 1. <u>Legal Proceedings.</u> | 34 |
| Item 1A. <u>Risk Factors.</u> | 34 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds.</u> | 36 |
| Item 6. <u>Exhibits.</u> | 36 |
| <u>SIGNATURES</u> | 37 |

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;

expected results of operation;

growth and market opportunities;

future development of our products and markets;

ability to compete; and

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:

risks and uncertainties relating to the financial markets generally;

risks and uncertainties relating to our limited operating history;

our ability to minimize losses and achieve profitability;

our ability to effectively manage our growth;

the competitive nature of the commercial lending industry and our ability to effectively compete;

the regulation of the commercial lending industry by federal, state and local governments;

the existence of delinquencies or non-accruals in our loans that would force us to take charge-offs exceeding our allowance for credit losses;

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impairments to our debt products that could adversely impact our net income and assets and harm our results of operations;

volatility due to the relatively small number of loans and other debt products in our loan portfolio; and

our ability to obtain external financing.

For a further description of these and other risks and uncertainties, we encourage you to carefully read section Item 1A. Risk Factors to our Annual Report on Form 10-K for the year ended December 31, 2007.

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****Unaudited**

| | September 30, 2008 | December 31, 2007 |
|--|--|----------------------|
| | (\$ in thousands, except share and par value amounts) | |
| Assets: | | |
| Cash and cash equivalents | \$ 132,853 | \$ 76,155 |
| Restricted cash | 105,231 | 115,807 |
| Residual interest in securitization | | 631 |
| Investments in debt securities, available-for-sale | 4,166 | 35,498 |
| Loans held-for-sale | 18,562 | 112,944 |
| Loans, net | 2,342,186 | 2,201,442 |
| Deferred financing costs, net | 19,181 | 18,399 |
| Interest receivable | 11,629 | 14,120 |
| Property and equipment, net | 1,261 | 1,593 |
| Deferred income taxes, net | 29,374 | 13,355 |
| Income tax receivable | | 4,635 |
| Other assets | 31,078 | 28,186 |
| Total assets | \$ 2,695,521 | \$ 2,622,765 |
| Liabilities: | | |
| Repurchase agreements | \$ | \$ 63 |
| Credit facilities | 540,030 | 677,739 |
| Term debt | 1,532,425 | 1,364,725 |
| Accrued interest payable | 10,168 | 17,537 |
| Income tax payable | 1,261 | |
| Accounts payable | 176 | 197 |
| Other liabilities | 33,712 | 59,814 |
| Total liabilities | 2,117,772 | 2,120,075 |
| Stockholders equity: | | |
| Preferred stock, par value \$0.01 per share (5,000,000 shares authorized; no shares outstanding) | | |
| Common stock, par value \$0.01 per share: | | |
| Shares authorized: 145,000,000 in 2008 and 2007; | | |
| Shares outstanding 48,522,500 in 2008 and 43,355,713 in 2007 | 486 | 434 |
| Additional paid-in capital | 606,725 | 551,704 |
| Retained deficit | (27,577) | (47,221) |
| Common stock held in treasury, at cost \$0.01 par value; 111,343 in 2008 and 85,207 in 2007 | (909) | (763) |
| Accumulated other comprehensive loss, net | (976) | (1,464) |

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| | | |
|--|---------------------|---------------------|
| Total stockholders equity | 577,749 | 502,690 |
| Total liabilities and stockholders equity | \$ 2,695,521 | \$ 2,622,765 |

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**

| | Three Months Ended September 30, 2008 | | Nine Months Ended September 30, 2008 | |
|---|--|--------------------|---|-------------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (\$ in thousands, except per share amounts) | | | |
| Net interest income: | | | | |
| Interest income | \$ 44,903 | \$ 52,626 | \$ 142,925 | \$ 148,689 |
| Interest expense | 19,864 | 28,071 | 64,771 | 78,877 |
| Net interest income | 25,039 | 24,555 | 78,154 | 69,812 |
| Provision for credit losses | 11,960 | 6,553 | 20,294 | 11,355 |
| Net interest income after provision for credit losses | 13,079 | 18,002 | 57,860 | 58,457 |
| Non-interest income: | | | | |
| Fee income | 725 | 3,334 | 3,652 | 10,177 |
| Asset management income related party | 1,699 | 1,471 | 4,826 | 3,686 |
| Gain on derivatives | 746 | 134 | 791 | 488 |
| Gain (loss) on sale of loans and debt securities | 1,022 | 11 | 283 | (4,256) |
| Loss on investments in debt securities | (6) | (1,979) | (931) | (18,327) |
| Loss on residual interest in securitization | | (28,136) | (631) | (28,136) |
| Other income | 1,350 | 3,317 | 2,295 | 4,235 |
| Total non-interest income | 5,536 | (21,848) | 10,285 | (32,133) |
| Operating expenses: | | | | |
| Compensation and benefits | 5,161 | 11,169 | 26,241 | 34,195 |
| Occupancy and equipment | 795 | 781 | 2,568 | 1,883 |
| General and administrative expenses | 2,500 | 2,309 | 8,036 | 6,745 |
| Total operating expenses | 8,456 | 14,259 | 36,845 | 42,823 |
| Income (loss) before income taxes | 10,159 | (18,105) | 31,300 | (16,499) |
| Income tax expense (benefit) | 2,580 | (7,260) | 11,656 | (6,626) |
| Net income (loss) | \$ 7,579 | \$ (10,845) | \$ 19,644 | \$ (9,873) |
| Basic income (loss) per share | \$ 0.16 | \$ (0.30) | \$ 0.41 | \$ (0.27) |
| Diluted income (loss) per share | 0.16 | (0.30) | 0.41 | (0.27) |

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

| | Common Stock | Additional Paid-in Capital | Retained Deficit | Treasury Stock | Net Unrealized Gain (Loss) on Investments | Accumulated Other Comprehensive Loss, net Net Unrealized Gain (Loss) on Derivatives | Total Stockholders Equity |
|--|-------------------|----------------------------------|---------------------|-------------------|---|---|---------------------------------|
| | (\$ in thousands) | | | | | | |
| Balance at January 1, 2008 | \$ 434 | \$ 551,704 | \$ (47,221) | \$ (763) | \$ (624) | \$ (840) | \$ 502,690 |
| Net income | | | 19,644 | | | | 19,644 |
| Other comprehensive income: | | | | | | | |
| Net unrealized securities gains, net of tax expense of \$154 | | | | | 369 | | 369 |
| Net unrealized derivatives gains, net of tax benefit of \$47 | | | | | | 119 | 119 |
| Total comprehensive income | | | | | | | 20,132 |
| Net proceeds from issuance of common stock | 52 | 48,839 | | | | | 48,891 |
| Shares reacquired from employee transactions | | | | (146) | | | (146) |
| Amortization of restricted common stock awards | | 4,468 | | | | | 4,468 |
| Amortization of stock option awards | | 1,714 | | | | | 1,714 |
| Balance at September 30, 2008 | \$ 486 | \$ 606,725 | \$ (27,577) | \$ (909) | \$ (255) | \$ (721) | \$ 577,749 |

| | Common Stock | Additional Paid-in Capital | Retained Deficit | Treasury Stock | Net Unrealized Loss on Investments | Accumulated Other Comprehensive Loss, net Net Unrealized Loss on Derivatives | Total Stockholders Equity |
|--|-------------------|----------------------------------|---------------------|-------------------|--|--|---------------------------------|
| | (\$ in thousands) | | | | | | |
| Balance at January 1, 2007 | \$ 363 | \$ 463,925 | \$ (38,582) | \$ | \$ (1,977) | \$ (314) | \$ 423,415 |
| Net loss | | | (9,873) | | | | (9,873) |
| Other comprehensive income: | | | | | | | |
| Net unrealized securities losses, net of tax benefit of \$5,706 | | | | | (8,540) | | (8,540) |
| Recognition of net unrealized losses for securities sold net of tax benefit of \$6,391 | | | | | 9,600 | | 9,600 |
| Net unrealized derivatives losses, net of tax expense of \$97 | | | | | | (140) | (140) |
| Total comprehensive loss | | | | | | | (8,953) |
| Shares reacquired from employee transactions | | | | (109) | | | (109) |
| Amortization of restricted common stock awards | | 9,982 | | | | | 9,982 |
| Amortization of stock option awards | | 2,759 | | | | | 2,759 |
| Balance at September 30, 2007 | \$ 363 | \$ 476,666 | \$ (48,455) | \$ (109) | \$ (917) | \$ (454) | \$ 427,094 |

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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, | |
|--|--|------------------|
| | 2008 | 2007 |
| | (\$ in thousands) | |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 19,644 | \$ (9,873) |
| Adjustments to reconcile net income to net cash used for operations: | | |
| Provision for credit losses | 20,294 | 11,355 |
| Depreciation and amortization and accretion | (6,769) | (8,735) |
| Amortization of debt issuance costs | 3,552 | 2,277 |
| Equity compensation expense | 6,182 | 12,741 |
| Net loss on investments in debt securities | 931 | 18,327 |
| Net loss on residual interest in securitization | 631 | 28,136 |
| Net (gain) loss on sale of loans and debt securities | (283) | 4,256 |
| Initial deposit to securitization trust | | (37,031) |
| Gain on repurchase of debt | 2,321 | |
| Net change in deferred income taxes | (16,220) | 2,696 |
| Net change in loans held-for-sale | 69,057 | (54,908) |
| Net change in interest receivable | 2,491 | 5,348 |
| Net change in other assets | 1,742 | (1,806) |
| Net change in accrued interest payable | (7,369) | 3,323 |
| Net change in accounts payable and other liabilities | (23,986) | (6,930) |
| Net cash provided by (used in) operating activities | 72,218 | (30,824) |
| Cash flows from investing activities: | | |
| Net change in restricted cash | 10,576 | (79,398) |
| Net change in loans | (129,063) | (508,436) |
| Purchase of debt securities available-for-sale | | (31,685) |
| Proceeds from repayments of debt securities available-for-sale | 1,253 | 21,368 |
| Proceeds from sales of debt securities available-for-sale | 29,737 | 157,007 |
| Proceeds from sale of loans | | 12,704 |
| Acquisition of property and equipment | (43) | (1,052) |
| Net cash used in investing activities | (87,540) | (429,492) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock, net | 48,891 | |
| Repayments under repurchase agreements, net | (63) | (33,884) |
| Borrowings on credit facilities | 581,898 | 1,077,174 |
| Repayment of borrowings on credit facilities | (719,607) | (997,683) |
| Issuance of term debt | | 446,000 |
| Borrowings on term debt | 402,000 | 83,500 |
| Repayment of borrowings on term debt | (236,620) | (138,000) |
| Payment of deferred financing costs | (4,333) | (6,531) |
| Purchase of treasury stock | (146) | (109) |
| Net cash provided by financing activities | 72,020 | 430,467 |

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| | | |
|---|------------|-----------|
| Net increase (decrease) in cash during the period | 56,698 | (29,849) |
| Cash and cash equivalents at beginning of period | 76,155 | 103,269 |
| Cash and cash equivalents at end of period | \$ 132,853 | \$ 73,420 |
| Supplemental cash flows information: | | |
| Interest paid | \$ 72,141 | \$ 75,533 |
| Taxes paid | 22,703 | 7,200 |
| Decrease (increase) in fair value of investments in debt securities | (523) | 14,246 |
| Transfers of loans held-for-sale to loans, net | 25,325 | |

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 commercial finance company that provides customized debt financing solutions to middle market businesses and commercial real estate borrowers. The Company principally focuses on the direct origination of loans that meet its risk and return parameters. The Company's direct origination efforts target private equity sponsors, corporate executives, regional banks, real estate investors and a variety of other financial intermediaries to source transaction opportunities. Direct origination provides direct access to customers' management, enhances due diligence, and allows significant input into customers' capital structure and direct negotiation of transaction pricing and terms.

The Company operates as a single segment and derives its revenues from two specialized lending groups:

Middle Market Corporate, which originates, structures and underwrites senior debt and, to a lesser extent, second lien, mezzanine and subordinated debt, and equity and other equity-linked products for companies with annual EBITDA typically between \$5 million and \$50 million; and

Commercial Real Estate, which originates, structures and underwrites first mortgage debt and, to a lesser extent, subordinated debt, primarily to finance acquisitions of real estate properties typically valued between \$10 million and \$50 million. Subsequent to December 31, 2007, the Company discontinued the origination of structured products. The Company manages its remaining structured products portfolio within its Middle Market Corporate lending group. As of September 30, 2008, this portfolio had an outstanding balance of \$76.4 million.

During the three months ended September 30, 2008, we did not originate any new commercial real estate loans.

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) valuation of investments, (iii) valuation of residual interest, (iv) determination of other than temporary and temporary impairments and (v) recorded amounts of deferred income taxes. 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, 2007.

Recently Adopted Accounting Standards

On January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 revises the definition of fair value, provides guidance on the methods used to measure fair value and expands disclosure concerning fair value measurements. SFAS 157 establishes a fair value hierarchy that distinguishes between assumptions based on market data obtained from independent sources (observable inputs) and a reporting entity's internally developed assumptions based on the best information available when there is little or no market activity for the asset or liability at the measurement date (unobservable inputs). The fair value hierarchy in SFAS 157 assigns highest priority to quoted prices in active markets (level 1) followed by observable inputs other than quoted prices (level 2) and unobservable inputs have the lowest priority (level

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3). Implementation of the standard did not have a material effect on the Company's results from operations or financial position. The Company did not elect to early adopt FAS 157 for nonrecurring measurements of nonfinancial assets or liabilities as allowed under FSP FAS 157-2.

On January 1, 2008, the Company adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of SFAS No. 115* (SFAS 159). SFAS 159 permits entities to measure many financial instruments and certain other items at fair value. An entity shall report unrealized gains and losses on items for which the fair

Table of Contents

value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument (with a few exceptions), is irrevocable and is applied only to entire instruments and not to portions of instruments. Implementation of the standard did not have a material effect on the Company's results from operations or financial position. As of January 1, 2008, the Company did not elect to record any of its assets or liabilities at fair value, other than those covered under prior accounting guidance. Accordingly, the Company did not record an adjustment related to the adoption of SFAS 159 during the nine months ended September 30, 2008.

Recently Issued Accounting Standards

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)). This statement retains the underlying concepts of SFAS No. 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting. SFAS 141(R) established principles and requirements for financial reporting concerning business combinations. SFAS 141(R) will require that: (1) for all business combinations, the acquirer records all assets and liabilities of the acquired business, including goodwill, generally at their fair values; (2) certain contingent assets and liabilities acquired be recognized at their fair values on the acquisition date; (3) contingent consideration be recognized at its fair value on the acquisition date and, for certain arrangements, changes in fair value will be recognized in earnings until settled; (4) acquisition-related transaction and restructuring costs be expensed rather than treated as part of the cost of the acquisition and included in the amount recorded for assets acquired; (5) in step acquisitions, previous equity interests in an acquiree held prior to obtaining control be re-measured to their acquisition-date fair values, with any gain or loss recognized in earnings; and (6) when making adjustments to finalize initial accounting, companies revise any previously issued post-acquisition financial information in future financial statements to reflect any adjustments as if they had been recorded on the acquisition date. SFAS 141(R) is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008, with the exception of the accounting for valuation allowances on deferred taxes and acquired tax contingencies. SFAS 141(R) amends SFAS No. 109 such that adjustments made to valuation allowances on deferred taxes and acquired tax contingencies associated with acquisitions that closed prior to the effective date of this statement should also apply the provisions of SFAS 141(R). The Company does not expect implementation of the standard to have a material effect on its results from operations or financial position.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an Amendment of ARB No. 51* (SFAS 160). This statement amends ARB No. 51 to establish new standards that will govern the accounting and reporting of noncontrolling interests in partially owned consolidated subsidiaries and the loss of control of subsidiaries. Also, SFAS 160 requires that: (1) noncontrolling interest, previously referred to as minority interest, be reported as part of equity in the consolidated financial statements; (2) losses be allocated to the noncontrolling interest even when such allocation might result in a deficit balance, reducing the losses attributed to the controlling interest; (3) changes in ownership interests be treated as equity transactions if control is maintained; and, (4) upon a loss of control, any gain or loss on the interest sold be recognized in earnings. SFAS 160 is effective for financial statements issued for fiscal years, beginning on or after December 15, 2008, except for the presentation and disclosure requirements, which will be applied retrospectively. The Company does not expect implementation of the standard to have a material effect on its results from operations or financial position.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities, and is effective for financial statements issued for fiscal years beginning after November 15, 2008, with early application encouraged. Since SFAS 161 only requires additional disclosures concerning derivatives and hedging activities, adoption of the standard will not affect on the Company's results from operations or financial position.

Reclassification

Certain amounts in the consolidated financial statements of prior years have been reclassified to conform to the current year presentation.

Table of Contents

Note 3. Fair Value

SFAS 157 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.

The following is a description of the valuation methodologies used for instruments measured at fair value, including the general classification of such instruments pursuant to the valuation hierarchy.

Cash and cash equivalents, including restricted cash

Cash and cash equivalents are recorded at fair value on a recurring basis and include cash balances and money market funds classified as level 1.

Residual interest in securitization

The residual interest in securitization is recorded at fair value on a recurring basis and fair value is based on the present value of expected future cash flows calculated by using independent pricing models or other model-based valuation techniques and management's best estimates of key assumptions. The valuation of residual interest in securitization is classified as level 3 as it relies significantly on unobservable inputs.

Investments in debt securities, available-for-sale

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

Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. If it is probable that payment of interest and principal on a loan will not be made in accordance with the contractual terms of the loan agreement, then it is considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral equals or exceeds the recorded investments in such loans. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When fair value of the collateral is based

Table of Contents

on an observable market price or a current appraised value, the Company records the impaired loan as level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as level 3.

Loans held-for-sale

Loans held-for-sale are not recorded at fair value on a recurring basis and are carried at the lower of cost or market value. Fair values for loans held-for-sale are based on quoted prices, where available, or are determined by discounting estimated cash flows using model-based valuation techniques. Inputs into the model-based valuations can include changes in market indexes, selling prices of similar loans, management's assumption related to credit rating of the loan, prepayment assumptions and other factors such as credit loss assumptions. Where quoted prices are available in an active market, loans held-for-sale are classified as level 1. Level 1 loans include instruments where the fair value is based on a contracted selling price. Loans are classified as level 3 in instances where valuation models are based on significant inputs that are unobservable in the market.

Fair value of derivative instruments

Derivatives are recorded at fair value on a recurring basis. Substantially all derivative instruments held or issued by the Company for risk management or customer-initiated activities are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using broker quotes or financial models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with the counterparty credit risk. The Company classifies derivative instruments held or issued for risk management or customer-initiated activities as level 2. Examples of level 2 derivatives are interest rate swaps and interest rate cap contracts.

The Company also holds a portfolio of warrants for generally non-marketable equity securities. These warrants are primarily from non-public companies obtained as part of the loan origination process. Warrants which contain a net exercise provision are required to be accounted for as derivatives and recorded at fair value. The fair value of the derivative warrant portfolio is reviewed quarterly and adjustments to the fair value are recorded in current earnings. Fair value is determined using internally developed valuation models. Where sufficient data exists, a market approach method is utilized to estimate the current value of the underlying company. The estimated fair value of the underlying securities for warrants requiring valuation at fair value were adjusted for discounts related to lack of liquidity. The Company classifies warrants accounted for as derivatives as level 3.

The following table presents recorded amounts of assets and liabilities measured at fair value on a recurring and nonrecurring basis as of September 30, 2008, by caption in the consolidated balance sheet and by SFAS 157 valuation hierarchy (as described above).

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total carrying value in consolidated balance sheet |
|---|---|---|--|--|
| | (\$ in thousands) | | | |
| Recurring Basis: | | | | |
| Cash and cash equivalents | \$ 132,853 | \$ | \$ | \$ 132,853 |
| Restricted cash | 105,231 | | | 105,231 |
| Residual interest in securitization | | | | |
| Investments in debt securities, available-for-sale | | | 4,166 | 4,166 |
| Warrants | | | 2,621 | 2,621 |
| Other assets | | 7,476 | | 7,476 |
| Total assets recorded at fair value on a recurring basis | \$ 238,084 | \$ 7,476 | \$ 6,787 | \$ 252,347 |
| Other liabilities | \$ | \$ 8,499 | \$ | \$ 8,499 |

Nonrecurring Basis:

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| | | | | |
|---|-----------|----------|----------|-----------|
| Loans held-for-sale | \$ 11,174 | \$ | \$ 7,388 | \$ 18,562 |
| Other assets | | 7,056 | | 7,056 |
| Total assets recorded at fair value on a nonrecurring basis | \$ 11,174 | \$ 7,056 | \$ 7,388 | \$ 25,618 |

Table of Contents*Changes in level 3 recurring fair value measurements*

The table below illustrates the change in balance sheet amounts for the three and nine months ended September 30, 2008 (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.

For the three months ended September 30, 2008:

| | Residual interest in securitization | Investments in debt securities, available-for-sale (\$ in thousands) | Warrants |
|---|--|---|----------|
| Balance as of June 30, 2008 | \$ | \$ 4,619 | \$ 3,309 |
| Total gains or losses (realized/unrealized) | | | |
| Included in earnings | | (6) | (688) |
| Included in other comprehensive income | | (423) | |
| Purchases, issuances or settlements | | (24) | |
| Balance as of September 30, 2008 | \$ | \$ 4,166 | \$ 2,621 |

For the nine months ended September 30, 2008:

| | Residual interest in securitization | Investments in debt securities, available-for-sale (\$ in thousands) | Warrants |
|---|--|---|----------|
| Balance as of December 31, 2007 | \$ 631 | \$ 35,498 | \$ 4,326 |
| Total gains or losses (realized/unrealized) | | | |
| Included in earnings | (631) | (931) | (1,705) |
| Included in other comprehensive income | | 523 | |
| Purchases, issuances or settlements | | (30,924) | |
| Balance as of September 30, 2008 | \$ | \$ 4,166 | \$ 2,621 |

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

Loans classified as held-for-sale consist of loans originated by the Company, intended to be sold or syndicated to third parties. These loans are carried at the lower of aggregate cost, net of any deferred origination costs or fees, or market value.

At September 30, 2008 and December 31, 2007, outstanding balances of loans held-for-sale were as follows:

| | September 30, 2008 | December 31, 2007 |
|-------------------------|-----------------------|----------------------|
| | (\$ in thousands) | |
| Middle Market Corporate | \$ 19,012 | \$ 101,632 |

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| | | |
|----------------------------------|------------------|-------------------|
| Commercial Real Estate | | 13,423 |
| Gross loans held-for-sale | 19,012 | 115,055 |
| Deferred loan fees, net | (450) | (2,111) |
| Total loans held-for-sale | \$ 18,562 | \$ 112,944 |

During the three months ended September 30, 2008, the Company recorded a loss of \$0.1 million on loans held-for-sale at period end. During the nine months ended September 30, 2008, the Company recognized losses of \$0.8 million resulting from a decline in fair value of loans held-for-sale.

During the three months ended September 30, 2008, the Company sold one loan for a gain of \$1.0 million. During the nine months ended September 30, 2008, the Company sold six loans for an aggregate gain of \$1.1 million and transferred loans with an aggregate outstanding balance of \$25.3 million from loans held-for-sale to loans held-for- investment.

Table of Contents

During the nine months ended September 30, 2007, the Company sold three loans for a gain of \$0.1 million.

As of September 30, 2008 and December 31, 2007, loans consisted of the following:

| | September 30, 2008 | December 31, 2007 |
|---------------------------|-----------------------|----------------------|
| | (\$ in thousands) | |
| Middle Market Corporate | \$ 2,019,046 | \$ 1,881,140 |
| Commercial Real Estate | 387,474 | 367,340 |
| Gross loans | 2,406,520 | 2,248,480 |
| Deferred loan fees, net | (20,791) | (13,651) |
| Allowance for loan losses | (43,543) | (33,387) |
| Total loans, net | \$ 2,342,186 | \$ 2,201,442 |

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

As of September 30, 2008, the Company had seven impaired loans with an aggregate outstanding balance of \$67.9 million. All of these loans have been restructured and classified as troubled debt restructurings (TDR) as defined by SFAS No. 15, *Accounting for Debtors and Creditors for Troubled Debt Restructurings* (SFAS 15). Three of these loans with an aggregate outstanding balance of \$26.4 million were also on non-accrual status. For impaired loans on non-accrual status, the Company reverses the accrued interest previously recognized as interest income subsequent to the last cash receipt. The recognition of interest income on the loan will resume when factors indicating doubtful collection no longer exist, and the non-accrual loan has been brought current. During 2008, the Company recorded \$17.7 million of specific provisions for impaired loans. At September 30, 2008, the Company had a \$11.4 million specific reserve on impaired loans with an aggregate outstanding balance of \$40.7 million. As of September 30, 2008, the Company did not have any loans that were greater than 31 days past due and classified as delinquent by the Company.

As of September 30, 2008, the Company had one \$7.1 million asset which was other real estate owned as a result of a foreclosure on an impaired loan. During the nine months ended September 30, 2008, the Company recorded a \$0.8 million specific reserve related to this loan to reflect its fair value. The outstanding loan balance has been reclassified from Loans, net to Other Assets in the Company's balance sheet.

As of December 31, 2007, the Company had three impaired loans with an aggregate outstanding balance of \$25.7 million. Two of these impaired loans with an aggregate outstanding balance of \$11.2 million were classified as TDR as defined by SFAS 15. Two of these impaired loans with an aggregate outstanding balance of \$21.9 million were on non-accrual status. During 2007, the Company recorded \$9.0 million of specific provisions for impaired loans and at December 31, 2007 had a \$4.6 million specific reserve on its impaired loans.

The aggregate average balance of impaired loans during the three and nine months ended September 30, 2008 was \$57.1 million and \$46.7 million, respectively. The total amount of interest income that would have been recognized during the three and nine months ended September 30, 2008, if impaired and non-accrual loans had performed according to their original terms was \$1.2 million and \$4.5 million, respectively. The amount of cash basis interest income that was recognized for the three and nine months ended September 30, 2008 was \$0.9 million and \$3.1 million, respectively.

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

| | Nine Months Ended September 30, | |
|----------------------------|---------------------------------|-----------|
| | 2008 | 2007 |
| | (\$ in thousands) | |
| Balance, beginning of year | \$ 35,487 | \$ 20,570 |

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| | | |
|--|------------------|------------------|
| Provision for credit losses - general | 2,643 | 6,955 |
| Provision for credit losses - specific | 17,651 | 4,400 |
| Loans charged off, net of recoveries | (10,848) | |
| Balance, end of period | \$ 44,933 | \$ 31,925 |

As the Company's loan portfolio continues to season, it expects to experience additional delinquencies, losses, specific reserves and charge offs as part of its normal course of business. The Company is closely monitoring the credit quality of its loans and expects loan delinquencies, non-accruals and charge offs to increase due to current economic conditions.

Included in the allowance for credit losses at September 30, 2008 and 2007 is an allowance for unfunded commitments of \$1.4 million and \$1.6 million, respectively, which is recorded as a component of other liabilities on the Company's

Table of Contents

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 losses.

Loans that are deemed to be uncollectible are charged off and deducted from the allowance. The provision for credit losses and recoveries on loans previously charged off are added to the allowance.

Based on the Company's evaluation process to determine the level of the allowance for loan losses, management believes the allowance to be adequate as of September 30, 2008 in light of the estimated known and inherent risks identified through its analysis.

Note 5. Restricted Cash

Restricted cash as of September 30, 2008 and December 31, 2007 was as follows:

| | September 30, 2008 | December 31, 2007 |
|--|-----------------------|----------------------|
| | (\$ in thousands) | |
| Collections on loans pledged to credit facilities | \$ 71,371 | \$ 52,831 |
| Principal and interest collections on loans held in trust and prefunding amounts | 29,197 | 59,263 |
| Customer escrow accounts | 4,663 | 3,713 |
| Total | \$ 105,231 | \$ 115,807 |

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

Amortized cost of investments in debt securities as of September 30, 2008 and December 31, 2007 was as follows:

| | September 30, 2008 | December 31, 2007 |
|---|-----------------------|----------------------|
| | (\$ in thousands) | |
| Investments in debt securities - gross | \$ 6,887 | \$ 38,787 |
| Unamortized discount | (2,298) | (2,343) |
| Investments in debt securities - amortized cost | \$ 4,589 | \$ 36,444 |

The amortized cost, gross unrealized holding gains, gross unrealized holding losses, and fair value of available-for-sale securities at September 30, 2008 and December 31, 2007 were as follows:

| | Amortized cost | Gross unrealized holding gains | Gross unrealized holding losses | Fair value |
|---------------------|-------------------|--------------------------------------|---------------------------------------|------------|
| | (\$ in thousands) | | | |
| September 30, 2008: | | | | |
| Debt securities | \$ 4,589 | \$ | \$ (423) | \$ 4,166 |
| | \$ 4,589 | \$ | \$ (423) | \$ 4,166 |

Fair value

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| | Amortized cost | Gross unrealized holding gains | Gross unrealized holding losses | |
|--------------------|-------------------|--------------------------------------|---------------------------------------|-----------|
| (\$ in thousands) | | | | |
| December 31, 2007: | | | | |
| Debt securities | \$ 36,444 | \$ | \$ (946) | \$ 35,498 |
| | \$ 36,444 | \$ | \$ (946) | \$ 35,498 |

During the nine months ended September 30, 2008, the Company sold one debt security at a realized loss of \$0.1 million.

During the nine months ended September 30, 2008, the Company recorded a net other than temporary impairment charge in non-interest income of \$0.9 million relating to two debt securities.

During the nine months ended September 30, 2007, the Company deemed eleven debt securities in its residential mortgage-backed securities (RMBS) portfolio to be other-than-temporarily impaired. The Company recorded an \$18.3 million impairment loss in non-interest income related to these debt securities. Nine of the RMBS securities were sold as part of the securities portfolio sale on June 29, 2007 (see Note 7).

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, 2008 and December 31, 2007:

| | September 30, 2008 | | Total |
|---------------------|------------------------|---|----------|
| | Less than 12 Months | Greater than or Equal to 12 Months (\$ in thousands) | |
| Number of positions | 1 | | 1 |
| Fair value | \$ 4,165 | \$ | \$ 4,165 |
| Amortized cost | 4,588 | | 4,588 |
| Unrealized loss | \$ 423 | \$ | \$ 423 |

| | December 31, 2007 | | Total |
|---------------------|------------------------|---|-----------|
| | Less than 12 Months | Greater than or Equal to 12 Months (\$ in thousands) | |
| Number of positions | 2 | 1 | 3 |
| Fair value | \$ 18,372 | \$ 21 | \$ 18,393 |
| Amortized cost | 19,310 | 29 | 19,339 |
| Unrealized loss | \$ 938 | \$ 8 | \$ 946 |

As a result of the Company's evaluation of each of these securities, management concluded that the unrealized losses at September 30, 2008 and December 31, 2007 were caused by changes in interest rates and credit spreads. The Company's evaluation of impairment included adjustments to prepayment speeds, delinquency and the timing and level of losses on the loans within the underlying trusts. Based upon the Company's impairment review process, and the Company's ability and intent to hold these securities until a recovery of fair value, the decline in the value of these investments was not considered to be other than temporary.

Maturities of debt securities classified as available-for-sale were as follows at September 30, 2008 and December 31, 2007 (maturities of asset-backed and mortgage-backed securities have been allocated based upon estimated cash flows, assuming no change in the current interest rate environment):

| | September 30, 2008 | | December 31, 2007 | |
|--|--------------------|---------------------------------|-------------------|------------|
| | Amortized cost | Fair value (\$ in thousands) | Amortized cost | Fair value |
| Available-for-sale: | | | | |
| Due one year or less | \$ | \$ | \$ 10,456 | \$ 10,456 |
| Due after one year through five years | | | 19,310 | 18,372 |
| Due after five years through ten years | 4,589 | 4,166 | 6,678 | 6,670 |
| Total | \$ 4,589 | \$ 4,166 | \$ 36,444 | \$ 35,498 |

Note 7. Residual Interest

On June 29, 2007, the Company completed the sale of securities and loans with an aggregate amortized cost of \$187.9 million to a third party and reported a \$4.4 million loss on the transaction. The residual interest in the assets sold had a fair value of \$0 at September 30, 2008 and \$0.6

million at December 31, 2007.

The loss on the sale of securities and loans was based on the previous carrying amount of the financial assets allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer. Quoted market prices are generally not available for retained interests, so the Company estimated the fair value of its residual interest based on the present value of expected future cash flows calculated using management's best estimates of key assumptions—credit losses, prepayment speed, forward yield curves and discount rates commensurate with the risks involved. The Company retained servicing responsibilities in addition to its residual interest and no servicing asset or liability was recorded. The Company's residual interest is subordinate to debt holder rights to cash flows. The Company retained the rights to future cash flows arising after the investors in the securitization trust have received the return for which they contracted. The investors and the securitization trust have no recourse to the Company's other assets for failure of debtor to pay when due or in relation

Table of Contents

to achievement of any minimum return. The sale was completed through a newly formed subsidiary and an existing non-recourse financing arrangement was amended to facilitate the transaction. The sale was comprised of \$113.9 million of RMBS securities, \$61.3 million of other debt products and \$12.7 million of loans. The change in the fair value of the residual interest was recorded in the consolidated statement of operations. During the nine months ended September 30, 2008, the Company recorded a \$0.6 million loss on the residual interest. The loss was driven by further deterioration in the performance of the underlying RMBS collateral assets impacting the anticipated cash flows.

Note 8. Derivative Financial Instrument Hedging Activities

During 2006, the Company entered into interest rate swap agreements which were designated and qualified as cash flow hedges of the risk of changes in the Company's interest payments on LIBOR indexed debt. At September 30, 2008, the interest rate swap agreements have a combined notional value of \$32.3 million and have scheduled maturities ranging from April 11, 2010 to October 20, 2013. The Company records the contracted interest rate swap net amounts exchanged in interest expense in the accompanying consolidated statements of operations. During the nine months ended September 30, 2007, the Company recorded hedge ineffectiveness of approximately \$54,000, which is included in gain on derivatives in the Company's consolidated statements of operations.

Note 9. Repurchase Agreements

| Securities sold under agreements to repurchase | Nine Months Ended | |
|--|-----------------------|---------------------------------|
| | September 30, 2008 | Year Ended December 31, 2007 |
| | (\$ in thousands) | |
| Outstanding at end of period | \$ | \$ 63 |
| Maximum outstanding at any month end | 61 | 32,035 |
| Average balance for the period | 7 | 12,309 |
| Weighted average rate at end of period | N/A | 5.97% |

In the past, the Company entered into sales of securities under agreements to repurchase with clients and brokers. These agreements were treated as collateralized financings, and the obligations to repurchase securities sold were reflected as a liability in the Company's consolidated balance sheet. At December 31, 2007, the maturities of these agreements ranged from one to three months. The securities underlying the agreements remained under the Company's control. Investment securities with a market value of \$0.8 million were pledged as collateral for the securities sold under agreements to repurchase at December 31, 2007. The Company no longer utilizes repurchase agreements.

Note 10. Borrowings*Credit Facilities*

At December 31, 2004, the Company had a \$450 million joint loan sale and servicing agreement with Wachovia Capital Markets, LLC (Wachovia), and CDC Commercial Products, Inc. Interest on the credit facility accrued at the commercial paper rate, as defined by the lender. During 2005 the Company amended this facility to reduce it to a \$300 million facility with Wachovia and established a \$300 million credit facility with Citigroup Global Markets Realty Corp. as the note purchaser, and a \$50 million facility with NATIXIS Financial Products Inc. (NATIXIS) as the administrative agent discussed below.

In connection with the \$300 million amended Wachovia credit facility, the Company formed a wholly owned subsidiary, NewStar CP Funding, LLC, a single-purpose bankruptcy-remote entity, to purchase or hold loans and investments. The amount outstanding under the credit facility varies with the balances outstanding of the pledged loans and investments depending on the mix of assets and the rating and diversification of the assets. NewStar must comply with various covenants, the breach of which could result in a termination event. At September 30, 2008, NewStar was in compliance with all such covenants. On February 16, 2007, the Company entered into an amendment to its credit facility with Wachovia to increase the facility from \$300 million to \$400 million. On April 18, 2008, the Company entered into an amendment which, among other things, extended the maturity date to April 15, 2011, completed the annual renewal of the liquidity line that supports the transaction to April 17, 2009, and incorporated an accordion feature, which will allow for potential future expansion of this facility up to \$750.0 million. Interest on this facility accrues at a variable rate per annum, which was 5.93% at September 30, 2008. As of September 30, 2008, the outstanding balance under this credit facility was \$238.1 million. Subsequent to September 30, 2008, Wachovia had agreed to merge with Wells Fargo pursuant to an Agreement and Plan of Merger by and between Wachovia and Wells Fargo dated October 3, 2008. The Company does not currently have a direct lending relationship with Wells Fargo.

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In connection with the \$50.0 million NATIXIS credit facility entered into in August 2005, which was subsequently increased to \$75.0 million in March 2006, the Company formed a wholly owned subsidiary, NewStar Short-Term Funding, LLC, a single-purpose bankruptcy-remote entity, to purchase or hold loans and investments. The amount outstanding under the credit facility varies with the balances outstanding of pledged loans and investments depending on the mix of assets and

Table of Contents

the rating and diversification of the portfolio. On May 29, 2008, the Company entered into an amendment to this credit facility which extended the maturity date to May 22, 2009. NewStar Short-Term Funding, LLC must comply with various covenants, the breach of which could result in a termination event. At September 30, 2008, NewStar Short-Term Funding, LLC was in compliance with all such covenants. Interest on this facility accrues at a variable rate per annum, which was 4.86% at September 30, 2008. As of September 30, 2008, the outstanding balance was \$8.5 million.

In connection with the \$300 million credit facility agreement with Citigroup Global Markets Realty Corp., the Company formed a wholly owned subsidiary, NewStar Warehouse Funding 2005, LLC, a single-purpose bankruptcy-remote entity, to purchase or hold loans and investments. In addition, the Company issued a demand note to the facility for up to \$30 million. NewStar Warehouse Funding 2005, LLC must comply with various covenants, the breach of which could result in a termination event. At September 30, 2008, NewStar Warehouse Funding 2005, LLC was in compliance with all such covenants. On March 29, 2007, the Company entered into an amendment to its credit facility agreement with Citigroup Global Markets Realty Corp. to increase the facility from \$300 million to \$400 million. On November 7, 2007, the Company entered into an amendment to this facility which, among other things, extended the maturity date to November 2010 and reduced the amount outstanding under the facility. In addition, the Company amended the issued demand note to the facility which increased the principal amount to \$40 million. On November 4, 2008, the Company extended the maturity and received commitment for renewal which, among other things, reduced the facility to \$300 million from \$400 million and completed the annual renewal of the liquidity line that supports the transaction to November 2009. Interest on this facility accrues at a variable rate per annum, which was 5.18% at September 30, 2008. As of September 30, 2008, the outstanding balance was \$284.0 million.

On July 29, 2008, the Company entered into a \$15 million credit facility agreement with Union Bank of California, N.A. This credit facility matures on June 22, 2009. Hereford Financial LLC, a subsidiary of the Company and the borrower of the credit facility, must comply with various covenants, the breach of which could result in a termination event. At September 30, 2008, Hereford Financial LLC was in compliance with all such covenants. Interest on this facility accrues at a variable rate per annum, which was 5.21% at September 30, 2008. As of September 30, 2008, the outstanding balance was \$9.5 million.

On March 21, 2006 the Company entered into a \$200 million credit facility agreement with NATIXIS. In connection with this facility, the Company formed a wholly owned subsidiary, NewStar Structured Finance Opportunities LLC (SFO I), a single-purpose bankruptcy-remote entity, to purchase or hold loans and investments. On June 29, 2007, SFO I formed a wholly owned subsidiary, NewStar Structured Finance Opportunities II, LLC (SFO II), a single-purpose bankruptcy-remote entity to purchase or hold loans and investments. In connection with the formation of SFO II, SFO I sold all of its assets with an aggregate carrying value of \$187.9 million to SFO II and SFO II assumed all of SFO I's liabilities associated with this credit facility. In addition, SFO II sold to the investors under this credit facility an undivided interest in each of the assets financed thereunder. The sale of undivided interests was accounted for as a sale of financial assets under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (See Note 7).

On May 1, 2007, the Company formed a wholly-owned subsidiary, NewStar Asset Management LLC, to provide management services to NewStar ArcTurus CLO I Ltd., (ArcTurus I) and acquire loans. The facility was scheduled to mature in May 2008, subject to earlier termination upon the issuance of securities by ArcTurus I. On February 27, 2008, the Company terminated this facility.

Term Debt Facility

On November 8, 2007, the Company entered into a \$300 million term debt financing agreement with Deutsche Bank AG, New York Branch (Deutsche). Interest on this term debt financing agreement accrues at a variable rate per annum, which was 5.31% at September 30, 2008. In connection with the Deutsche term debt financing agreement, the Company formed a wholly owned subsidiary, NewStar DB Term Funding, LLC, a single-purpose bankruptcy-remote entity, to purchase or hold loans and investments. The term debt financing agreement has variable advance rates which are based on the diversification and average rating of the targeted loan collateral. This term debt financing agreement matures on May 7, 2012. On May 6, 2008, the Company entered into an amendment to this term debt financing agreement which, among other things, increased the facility to \$400 million. As of September 30, 2008, the outstanding balance was \$242.0 million. NewStar DB Term Funding, LLC must comply with various covenants, the breach of which could result in a termination event. At September 30, 2008, NewStar DB Term Funding, LLC was in compliance with all such covenants.

Table of Contents*Term Debt*

In August 2005 the Company completed a term debt transaction. In conjunction with this transaction the Company 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. 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%. The \$317.7 million of outstanding notes are collateralized by the specific loans and investments, principal collections account cash and principal payment receivables totaling \$358.1 million at September 30, 2008. The 2005 CLO Trust permits reinvestment of collateral principal repayments for a three-year period ending in October 2008.

| | Notes originally issued | Outstanding balance September 30, 2008 (\$ in thousands) | Interest rate | Original maturity | Ratings (S&P/Moody s/ Fitch)(1) |
|-----------------|-------------------------------|--|------------------|----------------------|---------------------------------------|
| 2005 CLO Trust: | | | | | |
| Class A-1 | \$ 156,000 | \$ 155,982 | Libor + 0.28% | July 25, 2018 | AAA/Aaa/AAA |
| Class A-2 | 80,477 | 63,630 | Libor + 0.30% | July 25, 2018 | AAA/Aaa/AAA |
| Class B | 18,750 | 18,748 | Libor + 0.50% | July 25, 2018 | AA/Aa2/AA |
| Class C | 39,375 | 39,371 | Libor + 0.85% | July 25, 2018 | A/A2/A |
| Class D | 24,375 | 24,372 | Libor + 1.50% | July 25, 2018 | BBB/Baa2/BBB |
| Class E | 24,375 | 15,572 | Libor + 4.75% | July 25, 2018 | BB/Ba2/BB |
| | \$ 343,352 | \$ 317,675 | | | |

(1) These ratings are unaudited and were given in August 2005 and are subject to change from time to time. Fitch affirmed its ratings on December 7, 2007.

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, amounting to 100% of the 2006 Trust s trust certificates. The \$442.3 million of outstanding notes are collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$488.5 million at September 30, 2008. The 2006 CLO Trust permits reinvestment of collateral principal repayments for a five-year period ending in June 2011.

| | Notes originally issued (\$ in thousands) | Outstanding balance September 30, 2008 | Interest rate | Original maturity | Ratings (S&P/Moody s/ Fitch)(1) |
|----------------|--|---|------------------|----------------------|---------------------------------------|
| 2006 CLO Trust | | | | | |
| Class A-1 | \$ 320,000 | \$ 320,000 | Libor +0.27% | March 30, 2022 | AAA/Aaa/AAA |
| Class A-2 | 40,000 | 28,500 | Libor +0.28% | March 30, 2022 | AAA/Aaa/AAA |
| Class B | 22,500 | 22,500 | Libor +0.38% | March 30, 2022 | AA/Aa2/AA |
| Class C | 35,000 | 35,000 | Libor +0.68% | March 30, 2022 | A/A2/A |
| Class D | 25,000 | 25,000 | Libor +1.35% | March 30, 2022 | BBB/Baa2/BBB |
| Class E | 13,750 | 11,250 | Libor +1.75% | March 30, 2022 | BBB-Baa3/BBB- |
| | \$ 456,250 | \$ 442,250 | | | |

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- (1) These ratings are unaudited and were given in June 2006 and are subject to change from time to time. Fitch affirmed its ratings on December 7, 2007.

Table of Contents

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 \$500 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, amounting to 100% of the 2007-1 CLO Trust's trust certificates. The \$530.5 million of outstanding notes are collateralized by the specific loans and investments, principal collection account cash and principal payment receivables totaling \$584.5 million at September 30, 2008. The 2007-1 CLO Trust permits reinvestment of collateral principal repayments for a six-year period ending in May 2013.

| | Notes originally issued (\$ in thousands) | Outstanding balance September 30, 2008 | Interest rate | Original maturity | Ratings (S&P/Moody's/ Fitch)(1) |
|-------------------------|--|---|------------------|----------------------|---------------------------------------|
| 2007-1 CLO Trust | | | | | |
| Class A-1 | \$ 336,500 | \$ 336,500 | Libor +0.24% | September 30, 2022 | AAA/Aaa/AAA |
| Class A-2 | 100,000 | 84,500 | Libor +0.26% | September 30, 2022 | AAA/Aaa/AAA |
| Class B | 24,000 | 24,000 | Libor +0.55% | September 30, 2022 | AA/Aa2/AA |
| Class C | 58,500 | 58,500 | Libor +1.30% | September 30, 2022 | A/A2/A |
| Class D | 27,000 | 27,000 | Libor +2.30% | September 30, 2022 | BBB/Baa1/BBB+ |
| | \$ 546,000 | \$ 530,500 | | | |

(1) These ratings are unaudited and were given in June 2007 and are subject to change from time to time.

Note 11. Stockholders' Equity*Stockholders' Equity*

As of September 30, 2008 and December 31, 2007, the Company's authorized capital consists of preferred and common stock and the following was authorized and outstanding:

| | September 30, 2008 | | December 31, 2007 | |
|-----------------|----------------------|-----------------------|----------------------|-----------------------|
| | Shares authorized | Shares outstanding | Shares authorized | Shares outstanding |
| Preferred stock | 5,000 | | 5,000 | |
| Common stock | 145,000 | 48,523 | 145,000 | 43,356 |

(In thousands)

Preferred Stock

Upon completion of the Company's initial public offering on December 13, 2006, the Company's authorized capital stock included 5,000,000 shares of preferred stock with a par value of \$0.01 per share. As of September 30, 2008, all of the shares remained 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.

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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

Restricted Stock

In connection with the Company's initial public offering, 3,197,482 shares of restricted stock were issued to certain employees of the Company. The shares of restricted stock have a purchase price equal to the pricing of the Company's initial public offering. On May 14, 2008, the Company issued 30,000 shares of restricted stock to certain members of its Board of Directors. The shares of restricted stock had a fair value of \$6.40 per share, which is equal to the closing price of the Company's common stock on the date of issuance. The shares of restricted stock have a graded vesting schedule over a service period of up to five years. Restricted stock activity for the nine months ended September 30, 2008 was as follows:

| | Shares | Weighted average grant-date fair value (\$ in thousands) |
|-------------------------------------|-----------|--|
| Non-vested as of December 31, 2007 | 1,326,840 | \$ 22,515 |
| Granted | 31,400 | 200 |
| Vested | (327,914) | (5,571) |
| Forfeited | (116,532) | (1,962) |
| Non-vested as of September 30, 2008 | 913,794 | \$ 15,182 |

The Company's compensation expense related to its restricted stock was \$1.4 million and \$4.5 million, respectively, for the three and nine months ended September 30, 2008, and \$2.8 million and \$10.0 million, respectively, for the three and nine months ended September 30, 2007. The unrecognized compensation cost of \$8.8 million at September 30, 2008 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 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.

In connection with the Company's initial public offering, stock options exercisable for an aggregate 3,287,365 shares of common stock were issued to certain employees of the Company. Stock options exercisable for an aggregate of 2,613,615 shares of common stock were issued at an exercise price equal to the pricing of the Company's initial public offering and were 60% vested at the IPO with the remaining 40% to vest ratably over a four-year service period. The remaining options for 673,750 shares of common stock were issued at an exercise price equal to the pricing of the Company's initial public offering and vest ratably over a four-year service period.

Stock option activity for the nine months ended September 30, 2008 was as follows:

| | Options |
|--------------------------------------|-----------|
| Outstanding as of January 1, 2008 | 3,306,598 |
| Granted | 1,341,000 |
| Exercised | |
| Forfeited | (383,231) |
| Outstanding as of September 30, 2008 | 4,264,367 |
| Vested as of September 30, 2008 | 2,096,980 |
| Exercisable as of September 30, 2008 | 2,096,980 |

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For the nine months ended September 30, 2008, the weighted average grant date fair value of options granted was \$2.18. As of September 30, 2008, the total unrecognized compensation cost related to nonvested options granted was \$2.7 million. This cost is expected to be recognized over a weighted average period of three years. The Company's compensation expense related to its stock options was \$0.7 million and \$1.7 million, respectively, for the three and nine months ended September 30, 2008, and \$1.0 million and \$2.8 million, respectively, for the three and nine months ended September 30, 2007.

Table of Contents**Note 12. Income Per Share**

The computations of basic and diluted income per share for the three and nine months ended September 30, 2008 and 2007 are as follows:

| | Three Months Ended September 30, 2008 | | Nine Months Ended September 30, 2008 | |
|---|--|---------------|---|---------------|
| | 2007 | 2008 | 2007 | 2008 |
| | (In thousands) | | | |
| Numerator: | | | | |
| Net income (loss) | \$ 7,579 | \$ (10,845) | \$ 19,644 | \$ (9,873) |
| Denominator: | | | | |
| Denominator for basic income per common share | 48,525 | 36,254 | 48,283 | 36,256 |
| Denominator: | | | | |
| Denominator for diluted income per common share | 48,525 | 36,254 | 48,283 | 36,256 |
| Potentially dilutive securities - options | | | | |
| Potentially dilutive securities - warrants | | | | |
| Total weighted average diluted shares | 48,525 | 36,254 | 48,283 | 36,256 |

Weighted average stock options of 4,233,925 and 4,137,054, and 1,452,656 warrants to purchase common stock were not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2008, respectively, due to the fact that the results would be anti-dilutive.

Weighted average stock options of 3,356,955 and 3,322,725, and 1,452,656 warrants to purchase common stock were not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2007, respectively, due to the fact that the results would be anti-dilutive.

Note 13. 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 customers. These financial instruments include unused lines of credit, standby letters of credit and interest rate risk 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 the Company has 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 agreements to lend to a customer, provided that all conditions have been met. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since certain commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower.

Standby letters of credit are conditional commitments issued by the Company 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 loan facilities to 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.

Table of Contents

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

| | September 30, 2008 | December 31, 2007 |
|--|--------------------|-------------------|
| | (\$ in thousands) | |
| Unused lines of credit | \$ 370,704 | \$ 454,837 |
| Standby letters of credit | 32,079 | 20,382 |
| Interest rate mitigation products (notional) | 559,077 | 555,554 |

On June 29, 2007, the Company completed the sale of securities and loans with an aggregate amortized cost of \$187.9 million to a third party and reported a \$4.4 million loss on the transaction. The Company retained a residual interest in the assets sold, which had a fair value of \$0 at September 30, 2008 and \$0.6 million at December 31, 2007 (See Note 7 for additional information).

Note 14. Employee Benefit Plans

The Company maintains a contributory 401(k) plan covering all full-time employees. The Company matches 100% of employee's voluntary contributions up to a limit of 6% of the employee's compensation, subject to IRS guidelines. Expense for the three and nine months ended September 30, 2008 was \$0.1 million and \$0.8 million, respectively, and \$0.1 million and \$0.8 million for the three and nine months ended September 30, 2007, respectively.

Note 15. 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 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, 2008, the Fund's asset management fees were \$1.7 million and \$4.8 million, respectively, and \$1.5 million and \$3.7 million for the three and nine months ended September 30, 2007, respectively.

During 2006, the Company made a loan based on market terms to a company controlled by a relative of one of its officers. At September 30, 2008, the loan balance outstanding and amount of committed funds were \$11.5 million and \$10.6 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, 2007, as supplemented by those factors included in Item 1A of this Quarterly Report on Form 10-Q, 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 commercial finance company that provides customized debt financing solutions to middle market businesses and commercial real estate borrowers. We principally focus on the direct origination of loans that meet our risk and return parameters. Our direct origination efforts target private equity sponsors, corporate executives, regional banks, real estate investors and a variety of other financial intermediaries to source transaction opportunities. Direct origination provides direct access to customers' management, enhances due diligence, and allows significant input into customers' capital structure and direct negotiation of transaction pricing and terms.

We operate as a single segment and derive revenues from two specialized lending groups:

Middle Market Corporate, which originates, structures and underwrites senior debt and, to a lesser extent, second lien, mezzanine and subordinated debt, and equity and equity-linked products for companies with annual EBITDA typically between \$5 million and \$50 million; and

Commercial Real Estate, which originates, structures and underwrites first mortgage debt and, to a lesser extent, subordinated debt, primarily to finance acquisitions of real estate properties typically valued between \$10 million and \$50 million.

Subsequent to December 31, 2007, we discontinued the origination of structured products and continue to manage the remaining portfolio within our Middle Market Corporate lending group. As of September 30, 2008, this portfolio had an outstanding balance of \$76.4 million.

Recent Developments

As of September 30, 2008, we had seven loans with an aggregate outstanding balance of \$67.9 million classified as impaired. Three of these impaired loans with an outstanding balance of \$26.4 million were on non-accrual status as of September 30, 2008. During the three and nine months ended September 30, 2008, we recorded \$11.5 million and \$17.7 million, respectively, of specific provisions for impaired loans.

Market Conditions

There continues to be severe dislocation in the credit markets. Bank loan markets and securitization markets, specifically collateralized debt obligation markets are experiencing significant volatility with continued selling pressure by certain types of investors, many of which are leveraged. This negative environment is further impacted by the overhang of a large inventory of unsold leveraged loan positions that are aging on banks' balance sheets. We expect to continue to experience difficulty in securing term debt financing for our loan portfolio. We anticipate that available debt financing generally will be at higher costs and lower advance rates than the financing that was available earlier in our history. Given current market conditions, we continue to believe executing a traditional term debt securitization could be difficult and, if executed, will be executed as private placements and one-off transactions.

The financings we have renewed and the amendments to existing credit facilities we have obtained in 2008 have been more expensive and provide lower advance rates than similar transactions completed in prior periods. While we expect to be negatively impacted by the trend toward higher cost of borrowing and lower leverage in 2008, we believe that we will also benefit from these market conditions by re-pricing our existing loans when possible, and originating new loans when possible at significantly higher yields and in many cases on more favorable terms.

Slowing economic activity continues to contribute to a decline in overall credit quality. We are closely monitoring the credit quality of our loans. We expect loan delinquencies, non-accruals, and charge offs to increase if the economy continues to weaken.

As a result of the current market and funding conditions, opportunities in the commercial real estate market have slowed. Moreover, refinancing current loans will be difficult. For the second consecutive quarter, we did not originate any new commercial real estate loans.

Table of Contents

RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

NewStar's basic and diluted income per share for the three and nine months ended September 30, 2008 was \$0.16 and \$0.41, respectively, on net income of \$7.6 million and \$19.6 million, respectively. For the three and nine months ended September 30, 2007, NewStar had a net loss per share of \$0.30 and \$0.27, respectively, on a net loss of \$10.8 million and \$9.9 million, respectively. As of September 30, 2008, our managed loan portfolio was \$3.0 billion. During the nine months ended September 30, 2008, loans owned by the NewStar Credit Opportunities Fund, Ltd. (the "NCOF") decreased \$8.7 million to \$569.6 million at September 30, 2008.

Loan portfolio yield

Loan portfolio yield, which is interest income on our loans divided by the average balance outstanding of our loans, was 7.32% and 7.76% for the three and nine months ended September 30, 2008, compared to 9.72% and 9.76% for the three and nine months ended September 30, 2007. The decrease in loan portfolio yield was primarily driven by a decrease in prevailing interest rates over the prior year and, to a lesser extent, changes in product mix and credit spreads in our loan portfolio.

Net interest margin

Net interest margin, which is net interest income divided by average interest earning assets, was 3.90% and 4.09% for the three and nine months ended September 30, 2008, compared to 4.29% and 4.33% for the three and nine months ended September 30, 2007. The primary factors impacting net interest margin are changes in prevailing interest rates, 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 27.66% and 41.66% for the three and nine months ended September 30, 2008, compared to 526.87% and 113.65% for the three and nine months ended September 30, 2007. The decrease in our efficiency ratio during 2008 as compared to 2007 was primarily due to the \$28.1 million loss on the residual interest during 2007 and impairment charges on investments in debt securities during the three and nine months ended September 30, 2007, as well as a decline in operating expenses.

Allowance for credit losses

Allowance for credit losses ratio, which is allowance for credit losses divided by outstanding gross loans excluding loans held-for-sale, was 1.87% as of September 30, 2008 and 1.62% as of September 30, 2007. The allowance for credit losses at September 30, 2008 included specific reserves of \$11.4 million and general reserves of \$33.5 million. During the nine months ended September 30, 2008, we made minor modifications to our general reserve analysis to simplify and more closely align it with our internal credit ratings, which incorporate our ratings migration and loan default experience.

Delinquent loan rate

Delinquent loan rate, which is total delinquent loans that are 31 days or more past due, divided by outstanding gross loans, was 0% as of September 30, 2008 and 0.37% as of September 30, 2007. As of September 30, 2008, we did not have any loans classified as delinquent, but we expect to experience additional delinquencies in the future. Subsequent to September 30, 2008, we modified our delinquent loan rate to include loans which are 60 days or more past due. We believe this is a more appropriate definition and it better aligns our delinquent rate with the calculation of our peers.

Non-accrual loan rate

Non-accrual loan rate is defined as total balances outstanding of loans in non-accrual status divided by our loans held for investment. Loans are put on non-accrual status if they are 90 days or more past due or if management believes that there is reasonable doubt as to collectibility in the normal course of business. The non-accrual loan rate was 1.10% as of September 30, 2008 and 0.37% as of September 30, 2007. Given prevailing economic and market conditions, we expect the non-accrual rate to increase if the economy continues to weaken.

Net charge off rate

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Net charge off rate as a percentage of loan portfolio is defined as annualized charge offs net of recoveries divided by our loans 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. For the three and nine months ended September 30, 2008, the net charge off rate was 0.87% and 0.81%, respectively. We did not charge off any loans during the nine months ended September 30, 2007. We expect the net charge off rate to increase if the economy continues to weaken.

Table of Contents*Return on average assets*

Return on average assets, which is annualized net income divided by average total assets, was 1.15% and 1.00% for the three and nine months ended September 30, 2008. Return on average assets was not meaningful for the three and nine months ended September 30, 2007 as we had net losses.

Return on average equity

Return on average equity, which is annualized net income divided by average equity, was 5.26% and 4.68% for the three and nine months ended September 30, 2008. Return on average equity was not meaningful for the three and nine months ended September 30, 2007 as we had net losses.

Review of Consolidated Results

A summary of NewStar's consolidated financial results for the three and nine months ended September 30, 2008 and 2007 follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|-------------|---------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (\$ in thousands) | | | |
| Net interest income: | | | | |
| Interest income | \$ 44,903 | \$ 52,626 | \$ 142,925 | \$ 148,689 |
| Interest expense | 19,864 | 28,071 | 64,771 | 78,877 |
| Net interest income | 25,039 | 24,555 | 78,154 | 69,812 |
| Provision for credit losses | 11,960 | 6,553 | 20,294 | 11,355 |
| Net interest income after provision for credit losses | 13,079 | 18,002 | 57,860 | 58,457 |
| Non-interest income: | | | | |
| Fee income | 725 | 3,334 | 3,652 | 10,177 |
| Asset management income | 1,699 | 1,471 | 4,826 | 3,686 |
| Gain on derivatives | 746 | 134 | 791 | 488 |
| Gain (loss) on sale of loans and debt securities | 1,022 | 11 | 283 | (4,256) |
| Loss on investments in debt securities | (6) | (1,979) | (931) | (18,327) |
| Loss on residual interest in securitization | | (28,136) | (631) | (28,136) |
| Other income | 1,350 | 3,317 | 2,295 | 4,235 |
| Total non-interest income | 5,536 | (21,848) | 10,285 | (32,133) |
| Operating expenses: | | | | |
| Compensation and benefits | 5,161 | 11,169 | 26,241 | 34,195 |
| Occupancy and equipment | 795 | 781 | 2,568 | 1,883 |
| General and administrative expenses | 2,500 | 2,309 | 8,036 | 6,745 |
| Total operating expenses | 8,456 | 14,259 | 36,845 | 42,823 |
| Income (loss) before income taxes | 10,159 | (18,105) | 31,300 | (16,499) |
| Income tax expense (benefit) | 2,580 | (7,260) | 11,656 | (6,626) |
| Net income (loss) | \$ 7,579 | \$ (10,845) | \$ 19,644 | \$ (9,873) |

Comparison of the Three Months Ended September 30, 2008 and 2007

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Interest income. Interest income decreased \$7.7 million, to \$44.9 million for the three months ended September 30, 2008 from \$52.6 million for the three months ended September 30, 2007. The decrease was primarily due to a decrease in the yield on average interest earning assets to 7.00% from 9.19% primarily driven by a decrease in three-month LIBOR, partially offset by growth in average interest earning assets of \$279.3 million. The increase in average interest earning assets was primarily driven by the growth in loans of \$299.3 million since September 30, 2007.

Interest expense. Interest expense decreased \$8.2 million, to \$19.9 million for the three months ended September 30, 2008 from \$28.1 million for the three months ended September 30, 2007. The decrease was primarily due to a decrease in our

Table of Contents

cost of borrowings, partially offset by an increase in average borrowings of \$150.1 million from September 30, 2007 to fund growth in interest earning assets. The decrease in our cost of borrowings, to 4.04% from 6.16%, was primarily attributable to a decrease in three-month LIBOR.

Net interest margin. Net interest margin decreased to 3.90% for the three months ended September 30, 2008 from 4.29% for the three months ended September 30, 2007. The decrease in net interest margin was primarily due to a decrease in our average yield on interest earning assets partially offset by a decrease in our average cost of interest bearing liabilities. The decrease in yield and cost is primarily due to a decrease in three-month LIBOR. The net interest spread, the difference between gross yield on our interest earning assets and the total cost of our interest bearing liabilities, decreased to 2.97% from 3.03% as the decline in three-month LIBOR had a greater impact on the yield on our interest earning assets as yields began to align with the declines in our cost of interest bearing liabilities which re-price more frequently than our interest earning assets.

The following table summarizes the yield and cost of interest earning assets and interest bearing liabilities for the three months ended September 30, 2008 and 2007:

| | Three Months Ended September 30, 2008 | | | Three Months Ended September 30, 2007 | | |
|------------------------------------|---------------------------------------|-------------------------|--------------------|---------------------------------------|-------------------------|--------------------|
| | (\$ in thousands) | | | | | |
| | Average Balance | Interest Income/Expense | Average Yield/Cost | Average Balance | Interest Income/Expense | Average Yield/Cost |
| Total interest earning assets | \$ 2,551,689 | \$ 44,903 | 7.00% | \$ 2,272,435 | \$ 52,626 | 9.19% |
| Total interest bearing liabilities | 1,958,274 | 19,864 | 4.04 | 1,808,174 | 28,071 | 6.16 |
| Net interest spread | | \$ 25,039 | 2.97% | | \$ 24,555 | 3.03% |
| Net interest margin | | | 3.90% | | | 4.29% |

Provision for credit losses. The provision for credit losses increased to \$12.0 million for the three months ended September 30, 2008 from \$6.6 million for the three months ended September 30, 2007. The increase in the provision was primarily due to \$11.5 million of specific provisions recorded for impaired loans.

Non-interest income. Non-interest income increased \$27.4 million, to \$5.5 million for the three months ended September 30, 2008. The increase is primarily due to the \$28.1 million loss on the residual interest in securitization during the three months ended September 30, 2007 and \$2.0 million of impairment charges during the three months ended September 30, 2007 related to our investments in debt securities in our residential mortgage-backed securities (RMBS) portfolio, a \$1.1 million gain recognized in connection with the repurchase of debt and \$1.0 million gain on sale of loans and securities during the three months ended September 30, 2008, partially offset by a \$2.6 million decrease in fee income and a \$0.7 million loss in fair value of an equity position.

Operating expenses. Operating expenses decreased \$5.8 million, to \$8.5 million for the three months ended September 30, 2008 from \$14.3 million for the three months ended September 30, 2007. Employee compensation and benefits decreased \$6.0 million primarily due to a decrease in the non-cash compensation charge related to restricted stock grants made since our inception, including equity awards made in connection with the initial public offering and lower headcount. General and administrative expenses increased \$0.2 million and occupancy and equipment remained consistent with the prior period.

Income taxes. For the three months ended September 30, 2008 and 2007, we provided for income taxes based on an effective tax rate of 25% and 40.1%, respectively. As of September 30, 2008 and December 31, 2007, we had net deferred tax assets of \$29.4 million and \$13.4 million, respectively. Our effective tax rate for the three months ended September 30, 2008 reflects the impact of timing differences related to the recognition of losses on the residual interest in securitization, the impact of nondeductible compensation expenses incurred in connection with our initial public offering and the impact of a related discrete item.

Comparison of the Nine Months Ended September 30, 2008 and 2007

Interest income. Interest income decreased \$5.8 million, to \$142.9 million for the nine months ended September 30, 2008 from \$148.7 million for the nine months ended September 30, 2007. The decrease was primarily due to a decrease in the yield on average interest earning assets to

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7.47% from 9.22% primarily driven by a decrease in three-month LIBOR, partially offset by growth in average interest earning assets of \$397.8 million. The increase in average interest earning assets was primarily driven by the growth in loans of \$299.3 million since September 30, 2007.

Table of Contents

Interest expense. Interest expense decreased \$14.1 million, to \$64.8 million for the nine months ended September 30, 2008 from \$78.9 million for the nine months ended September 30, 2007. The decrease was primarily due to a decrease in our cost of borrowings, partially offset by an increase in average borrowings of \$286.2 million from September 30, 2007 to fund growth in interest earning assets. The decrease in our cost of borrowings, to 4.37% from 6.23%, was primarily attributable to a decrease in three-month LIBOR, negotiated lower borrowing spreads on our credit facilities and increased use of lower cost term debt securitizations.

Net interest margin. Net interest margin decreased to 4.09% for the nine months ended September 30, 2008 from 4.33% for the nine months ended September 30, 2007. The decrease in net interest margin was primarily due to a decrease in our average yield on interest earning assets partially offset by a decrease in our average cost of interest bearing liabilities. The decrease in yield and cost is primarily due to a decrease in three-month LIBOR. 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 3.10% from 2.99% as the decline in three-month LIBOR had a greater impact on the cost of interest bearing liabilities which re-price more frequently than our interest earning assets.

The following table summarizes the yield and cost of interest earning assets and interest bearing liabilities for the nine months ended September 30, 2008 and 2007:

| | Nine Months Ended September 30, 2008 | | | Nine Months Ended September 30, 2007 | | |
|------------------------------------|---|--------------------|-----------------------|---|--------------------|-----------------------|
| | (\$ in thousands) | | | | | |
| | Interest | | Average Yield/Cost | Interest | | Average Yield/Cost |
| | Average Balance | Income/ Expense | | Average Balance | Income/ Expense | |
| Total interest earning assets | \$ 2,554,199 | \$ 142,925 | 7.47% | \$ 2,156,401 | \$ 148,689 | 9.22% |
| Total interest bearing liabilities | 1,978,561 | 64,771 | 4.37 | 1,692,391 | 78,877 | 6.23 |
| Net interest spread | | \$ 78,154 | 3.10% | | \$ 69,812 | 2.99% |
| Net interest margin | | | 4.09% | | | 4.33% |

Provision for credit losses. The provision for credit losses increased to \$20.3 million for the nine months ended September 30, 2008 from \$11.4 million for the nine months ended September 30, 2007. The increase in the provision was primarily due to \$17.7 million of specific provisions recorded for impaired loans and the growth of our loan portfolio.

Non-interest income. Non-interest income increased \$42.4 million, to \$10.3 million for the nine months ended September 30, 2008. The increase is primarily due to the \$28.1 million loss on the residual interest in securitization during the nine months ended September 30, 2007, the \$18.3 million of impairment charges during the nine months ended September 30, 2007 related to our investments in debt securities in our RMBS portfolio, the \$4.3 million loss on sale of loans and securities for the nine months ended September 30, 2007, the \$2.3 million gain recognized in connection with the repurchase of debt during the nine months ended September 30, 2008, an increase of \$1.1 million in management and performance fees related to the NCOF, \$1.1 million gain on sale of loans, partially offset by a \$6.5 million decrease in fee income, the \$2.4 million loss in fair value of our equity positions, and the \$0.9 million loss on investments in debt securities due to net impairments on two of our debt securities and the \$0.6 million loss on the residual interest in securitization.

Operating expenses. Operating expenses decreased \$6.0 million, to \$36.8 million for the nine months ended September 30, 2008 from \$42.8 million for the nine months ended September 30, 2007. Employee compensation and benefits decreased \$8.0 million primarily due to a decrease in the non-cash compensation charge related to restricted stock grants made since our inception, including equity awards made in connection with the initial public offering, partially offset by severance costs of \$2.1 million during the nine months ended September 30, 2008. General and administrative expenses increased \$1.3 million and occupancy and equipment expenses increased \$0.7 million.

Income taxes. For the nine months ended September 30, 2008 and 2007, we provided for income taxes based on an effective tax rate of 37% and 40.2%, respectively. Our effective tax rate for the nine months ended September 30, 2008 reflects the impact of timing differences related to the recognition of losses on the residual interest in securitization, the impact of nondeductible compensation expenses incurred in connection with our initial public offering and the impact of a related discrete item.

Table of Contents

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 offerings. We believe these sources will be sufficient to fund our operations, projected lending activities and other short-term liquidity needs. Our future liquidity needs will be determined primarily based on the growth rate in our loan portfolio. To fund our loan portfolio growth, we anticipate that we will need to incur additional indebtedness, enter into additional term debt securitizations or raise equity capital. We may need to raise additional debt or equity capital based on various factors, including if our loan portfolio grows faster than anticipated, we are unable to fund certain loans with credit facilities or term debt securitizations, or if our cash flow from operations is lower than expected. We may not be able to raise such 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 debt or equity securities may be dilutive for existing shareholders.

We continue to see higher costs of borrowing and lower leverage. Given current market conditions, we believe that executing a traditional term debt securitization could be difficult and, if executed, will be executed as private placements. Moreover the financings we have renewed and the amendments to existing credit facilities in 2008 have been more expensive and provide lower advance rates than similar transactions we completed in prior periods.

Cash and Cash Equivalents

As of September 30, 2008 and December 31, 2007, we had \$132.9 million and \$76.2 million, respectively, in cash and cash equivalents. Cash received from our November 2007 private placement represented a large portion of our cash balance at September 30, 2008. We 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 \$105.2 million and \$115.8 million of restricted cash as of September 30, 2008 and December 31, 2007, respectively. The restricted cash represents the balance of the principal and interest collections accounts and pre-funding amounts in our credit facilities, our term debt securitizations and customer holdbacks and escrows. The use of the principal collection accounts cash is limited to funding the growth of our loan portfolio within the facilities or paying down related credit facilities or term debt securitizations. 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 ramp up 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, 2008.

Asset Quality and Allowance for Loan Losses

If a loan is 90 days or more past due or if management believes that there is reasonable doubt as to collectibility in the normal course of business, it is our policy to place the loan on non-accrual status. 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, 2008, we had seven impaired loans with an aggregate outstanding balance of \$67.9 million. All of these loans have been restructured and classified as troubled debt restructurings as defined by SFAS No. 15, *Accounting for Debtors and Creditors for Troubled Debt Restructurings*. Three of these loans with an aggregate outstanding balance of \$26.4 million were also on non-accrual status. We did not have any loans greater than 31 days past due and classified as delinquent. During the three and nine months ended September 30, 2008, we recorded \$11.5 million and \$17.7 million, respectively, of specific provisions for impaired loans. As our loan portfolio continues to season, we expect to experience additional delinquencies, losses, specific reserves, troubled debt restructurings and charge offs as part of our normal course of business. Moreover, the weakening economy has led to a decline in overall credit quality across the market. We are closely monitoring the credit quality of our loans. We expect loan delinquencies, non-accruals and charge offs to increase if the economy continues to weaken.

Despite our limited historical loss experience, we have provided an allowance for loan losses to provide for losses inherent in our loan portfolio. Our allowance for loan losses as of September 30, 2008 and December 31, 2007 was \$43.5 million and \$33.4 million, or 1.81% and 1.48% of loans, gross, respectively. As of September 30, 2008, we also had a \$1.4 million allowance for unfunded commitments resulting in an allowance for credit losses of 1.87% of outstanding loans.

Table of Contents

Activity in the allowance for loan losses for the nine months ended September 30, 2008 and for the year ended December 31, 2007 was as follows:

| | Nine Months Ended September 30, 2008 | Year Ended December 31, 2007 |
|---|--|---------------------------------|
| | (\$ in thousands) | |
| Balance as of beginning of period | \$ 33,387 | \$ 19,395 |
| Provision for loan losses | 3,353 | 9,593 |
| Specific provision for loan losses | 17,651 | 8,992 |
| Net charge offs | (10,848) | (4,593) |
| Balance as of end of period | 43,543 | 33,387 |
| Allowance for losses on unfunded loan commitments | 1,390 | 2,100 |
| Allowance for credit losses | \$ 44,933 | \$ 35,487 |

As of September 30, 2008, we had one \$7.1 million asset which was other real estate owned as a result of a foreclosure on an impaired loan. During the nine months ended September 30, 2008, we recorded a \$0.8 million specific provision related to this loan. The outstanding loan balance has been reclassified from loans, net to other assets on our balance sheet.

Borrowings and Liquidity

As of September 30, 2008 and December 31, 2007, we had outstanding borrowings totaling \$2.1 billion and \$2.0 billion, respectively. Borrowings under our various credit facilities, term debt securitizations and repurchase obligations have supported our loan growth.

As of September 30, 2008, 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 Amount | Amounts Outstanding | Unused Debt Capacity | Maturity | |
|-------------------|------------------------|------------------------|-------------------------|----------|------|
| | | | | | |
| | (\$ in thousands) | | | | |
| Credit facilities | \$ 890,000 | \$ 540,030 | \$ 349,970 | 2009 | 2011 |
| Term debt (1) | 1,745,602 | 1,532,425 | 213,177 | 2012 | 2022 |
| Total | \$ 2,635,602 | \$ 2,072,455 | \$ 563,147 | | |

(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 which could result in a termination event, and at September 30, 2008, 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.

Credit facilities

As of September 30, 2008 the Company had four credit facilities: (i) a \$400.0 million credit facility with Wachovia Capital Markets, LLC (Wachovia), (ii) a \$400.0 million credit facility with Citigroup Global Markets Realty Corp. (Citigroup), (iii) a \$75.0 million facility with NATIXIS Financial Products, Inc. (NATIXIS) and (iv) a \$15.0 million credit facility with Union Bank of California, N.A.

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The Company has a \$400.0 million credit facility agreement with Wachovia that had an outstanding balance of \$238.1 million as of September 30, 2008. Interest on this facility accrues at a variable rate per annum, which was 5.93% at September 30, 2008. This facility was scheduled to mature on August 4, 2010. On April 18, 2008, we entered into an amendment which, among other things, extended the maturity date to April 15, 2011, completed the 2008 annual renewal, and incorporated an accordion feature, which will allow for potential future expansion of this facility up to \$750.0 million. Subsequent to September 30, 2008, Wachovia had agreed to merge with Wells Fargo pursuant to an Agreement and Plan of Merger by and between Wachovia and Wells Fargo dated October 3, 2008. We do not currently have a direct lending relationship with Wells Fargo.

The Company has a \$400.0 million credit facility agreement with Citigroup that had an outstanding balance of \$284.0 million as of September 30, 2008. Interest on this facility accrues at a variable rate per annum, which was 5.18% at September 30, 2008. This facility is scheduled to mature in November 2010. In addition, the Company issued a demand note to the facility for up to \$40.0 million. On November 4, 2008, the Company extended the maturity and received commitment for renewal which among other things, reduced the facility to \$300 million from \$400 million and completed the annual renewal of the liquidity line that supports the transaction to November 2009.

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The Company has a \$75.0 million credit facility agreement with NATIXIS that had an outstanding balance of \$8.5 million as of September 30, 2008. Interest on this facility accrues at a variable rate per annum, which was 4.86% at September 30, 2008. On May 29, 2008, we entered into an amendment which, among other things, extended the maturity date to May 22, 2009.

Table of Contents

On July 29, 2008, the Company entered into a \$15.0 million credit facility agreement with Union Bank of California, N.A. that had an outstanding balance of \$9.5 million as of September 30, 2008. This credit facility matures on June 22, 2009. Interest on this facility accrues at a variable rate per annum which was 5.21% at September 30, 2008.

On May 1, 2007, we formed a wholly-owned subsidiary, NewStar Asset Management LLC, to provide management services to NewStar ArcTurus CLO I Ltd., (ArcTurus I) and acquire loans. The credit facility was scheduled to mature in May 2008, subject to earlier termination upon the issuance of securities by ArcTurus I. On February 27, 2008, we terminated this facility.

Term debt facility

On May 6, 2008, we entered into an amendment to the term debt financing agreement with Deutsche Bank AG, New York Branch which, among other things, increased the facility to \$400.0 million. Interest on this term debt financing agreement accrues at a variable rate per annum, which was 5.31% at September 30, 2008. This term debt matures on May 7, 2012. As of September 30, 2008, the outstanding balance was \$242.0 million.

Term debt securitizations

In August 2005, we completed our first term debt securitization. In conjunction with this transaction, we established a separate single-purpose bankruptcy-remote subsidiary, NewStar Trust 2005-1 (the 2005 CLO Trust). The notes issued by the 2005 CLO Trust are collateralized by the specific assets, principal collection account cash and principal payment receivables totaling \$358.1 million at September 30, 2008. Outstanding drawn notes at September 30, 2008 were \$317.7 million. The stated maturity date of the notes is July 25, 2018. However, we expect them to mature earlier assuming, among other things, certain collateral characteristics, certain repayment rates, no refinancing and the exercise of a clean-up call repurchase option. The 2005 CLO Trust permits reinvestment of collateral principal repayments for a three-year period ending in October 2008.

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

| | Notes and certificates originally issued (\$ in thousands) | Outstanding balance September 30, 2008 (\$ in thousands) | Borrowing spread to LIBOR % | Ratings (S&P/Moody s/ Fitch)(1) |
|------------------------------|---|---|--------------------------------|---------------------------------|
| 2005 CLO Trust: | | | | |
| Class A-1 | \$ 156,000 | \$ 155,982 | 0.28% | AAA/Aaa/AAA |
| Class A-2 | 80,477 | 63,630 | 0.30 | AAA/Aaa/AAA |
| Class B | 18,750 | 18,748 | 0.50 | AA/Aa2/AA |
| Class C | 39,375 | 39,371 | 0.85 | A/A2/A |
| Class D | 24,375 | 24,372 | 1.50 | BBB/Baa2/BBB |
| Class E | 24,375 | 15,572 | 4.75 | BB/Ba2/BB |
| Total notes | 343,352 | 317,675 | | |
| Class F (trust certificates) | 31,648 | 31,648 | N/A | N/A |
| Total for 2005 CLO Trust | \$ 375,000 | \$ 349,323 | | |

(1) These ratings were given in August 2005 and are subject to change from time to time. Fitch affirmed its ratings on December 7, 2007.

Table of Contents

In June 2006, we completed our second term debt securitization. In conjunction with this transaction, we established a separate single-purpose bankruptcy-remote subsidiary, NewStar Commercial Loan Trust 2006-1 (the 2006 CLO Trust). The notes issued by the 2006 CLO Trust are collateralized by the specific assets, principal collection account cash and principal payment receivables totaling \$488.5 million at September 30, 2008. Outstanding drawn notes at September 30, 2008 were \$442.3 million. The stated maturity date of the notes is March 30, 2022. However, we expect them to mature earlier assuming, among other things, certain collateral characteristics, certain prepayment rates, no refinancing and the exercise of a clean-up call repurchase option. The 2006 CLO Trust permits reinvestment of collateral principal repayments for a five-year period ending in June 2011.

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

| | Notes and certificates originally issued (\$ in thousands) | Outstanding balance September 30, 2008 | Borrowing spread to LIBOR % | Ratings (S&P/Moody s/ Fitch)(1) |
|------------------------------|--|---|--------------------------------------|---------------------------------------|
| 2006 CLO Trust: | | | | |
| Class A-1 | \$ 320,000 | \$ 320,000 | 0.27% | AAA/Aaa/AAA |
| Class A-2 | 40,000 | 28,500 | 0.28 | AAA/Aaa/AAA |
| Class B | 22,500 | 22,500 | 0.38 | AA/Aa2/AA |
| Class C | 35,000 | 35,000 | 0.68 | A/A2/A |
| Class D | 25,000 | 25,000 | 1.35 | BBB/Baa2/BBB |
| Class E | 13,750 | 11,250 | 1.75 | BBB-/Baa3/BBB- |
| Total notes | 456,250 | 442,250 | | |
| Class F (trust certificates) | 43,750 | 43,750 | N/A | N/A |
| Total for 2006 CLO Trust | \$ 500,000 | \$ 486,000 | | |

(1) These ratings were given in June 2006 and are subject to change from time to time. Fitch affirmed its ratings on December 7, 2007. In June 2007 we completed our third 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). The notes issued by the 2007-1 CLO Trust are collateralized by specific assets, principal collection account cash and principal payment receivables totaling \$584.5 million at September 30, 2008. Outstanding drawn notes at September 30, 2008 were \$530.5 million. The stated maturity date of the notes is September 30, 2022. However, we expect them to mature earlier assuming, among other things, certain collateral characteristics, certain prepayment rates, no refinancing and the exercise of a clean-up call repurchase option. The 2007-1 CLO Trust permits reinvestment of collateral principal repayments for a six-year period ending in May 2013.

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

| | Notes originally issued (\$ in thousands) | Outstanding balance September 30, 2008 | Borrowing spread to LIBOR | Ratings (S&P/Moody s/ Fitch)(1) |
|------------------|--|---|---------------------------------|---------------------------------------|
| 2007-1 CLO Trust | | | | |
| Class A-1 | \$ 336,500 | \$ 336,500 | 0.24% | AAA/Aaa/AAA |
| Class A-2 | 100,000 | 84,500 | 0.26 | AAA/Aaa/AAA |
| Class B | 24,000 | 24,000 | 0.55 | AA/Aa2/AA |
| Class C | 58,500 | 58,500 | 1.30 | A/A2/A |
| Class D | 27,000 | 27,000 | 2.30 | BBB/Baa1/BBB+ |

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| | | | | |
|------------------------------|------------|------------|-----|-----|
| Total notes | 546,000 | 530,500 | | |
| Class E (trust certificates) | 29,100 | 29,100 | N/A | N/A |
| Class F (trust certificates) | 24,900 | 24,900 | N/A | N/A |
| Total for 2007-1 CLO Trust | \$ 600,000 | \$ 584,500 | | |

(1) These ratings are unaudited and were given in June 2007 and are subject to change from time to time.

Table of Contents

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.

Unfunded commitments are agreements to lend to a borrower, provided that all conditions have been met. 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 management's credit evaluation of the borrower. At September 30, 2008, we had \$370.7 million of unfunded commitments.

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, 2008 we had \$32.1 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, 2008, the notional value of the interest rate mitigation products was \$559.1 million.

On June 29, 2007, we completed the sale of securities and loans totaling \$187.9 million, including \$113.9 million of RMBS holdings to a non-recourse, off-balance sheet financing vehicle and recognized a \$4.4 million loss on the sale. We retained a residual interest in the assets sold, which had a fair value of \$0 at September 30, 2008. Our valuation of the residual involves two basic assumptions (i) a forecast of cash flows from the underlying collateral, and (ii) a discount rate applied to those cash flows. This rate was established by modeling the pool to create CDO tranches of AAA through BBB, which reflected a mix of debt in place against those assets and reflected an estimated market rate at that time. The loss for 2008 was driven by further deterioration in the performance of the underlying RMBS collateral assets impacting the anticipated cash flows. The change in the fair value of the residual interest is recorded in the consolidated statement of operations.

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 Note 2 to the consolidated financial statements included in the Company's 2007 Annual Report, as updated in Note 2 to the unaudited consolidated financial statements in this 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 2007 Annual Report, aside from certain refinements to estimates and assumptions related to the January 1, 2008 adoption of SFAS No. 157, *Fair Value Measurements* (SFAS 157), as discussed below and described in greater detail in Note 3 to these consolidated financial statements.

Fair Value

On January 1, 2008, the Company adopted SFAS 157 which defines fair value as the price that would be received to sell the financial asset or paid to transfer the financial liability in an orderly transaction between market participants at the measurement date.

The Company utilizes fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. SFAS 157 differentiates between those assets and liabilities required to be carried at fair value at every reporting period (recurring) and those assets and liabilities that are only required to be adjusted to fair value under certain circumstances (nonrecurring). Cash and cash equivalents, investments in debt securities, available-for-sale, residual interest in securitization and derivatives are financial instruments recorded

at fair value on a recurring basis.

Table of Contents

Additionally, from time to time, the Company may be required to record at fair value other financial assets on a nonrecurring basis, such as loans held-for-sale and loans held-for-investment. These nonrecurring fair value adjustments typically involve application of the lower of cost or market accounting or write-downs of individual assets. Further, the notes to the consolidated financial statements include information about the extent to which fair value is used to measure assets and liabilities and the valuation methodologies used.

SFAS 157 establishes a three-level hierarchy for disclosure of assets and liabilities recorded at fair value. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used for measurement are observable or unobservable. Observable inputs reflect market-derived or market-based information obtained from independent sources, while unobservable inputs reflect management's estimates about market data.

Level 1 - Valuation is based upon quoted prices for identical instruments traded in active markets. Level 1 instruments include securities traded on active exchange markets, such as the New York Stock Exchange, as well as U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets.

Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. Level 2 instruments include securities traded in less active dealer or broker markets.

Level 3 - Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

For assets and liabilities recorded at fair value, it is the Company's policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy in SFAS 157. When available, the Company utilizes quoted market prices to measure fair value. If market prices are not available, fair value measurement is based upon models that use primarily market-based or independently sourced market parameters, including interest rate yield curves, prepayment speeds, option volatilities and other assumptions. However, in certain cases, when market observable inputs for model-based valuation techniques may not be readily available, the Company is required to make judgments about assumptions market participants would use in estimating the fair value of the financial instrument. The models used by the Company to determine fair value adjustments are periodically evaluated by management for relevance under current facts and circumstances.

The degree of management judgment involved in determining the fair value of a financial instrument is dependent upon the availability of quoted market prices or observable market parameters. For financial instruments that trade actively and have quoted market prices or observable market parameters, there is minimal subjectivity involved in measuring fair value. When observable market prices and parameters are not fully available, management judgment is necessary to estimate fair value. In addition, changes in market conditions may reduce the availability of quoted prices or observable data. For example, reduced liquidity in the capital markets or changes in secondary market activities could result in observable market inputs becoming unavailable. Therefore, when market data is not available, the Company would use valuation techniques requiring more management judgment to estimate the appropriate fair value measurement.

Table of Contents

As of September 30, 2008, 0.5% of total assets and 5.1% of the assets we measured at fair value used significant unobservable inputs (level 3 assets). During the three and nine months ended September 30, 2008 we recognized losses of \$0.7 million and \$4.1 million, respectively, in earnings and a recovery of \$0.5 million for the nine months ended September 30, 2008 in other comprehensive income related to changes in fair value of these level 3 assets. The table below sets forth information regarding our level 3 assets as of September 30, 2008:

| Description | Fair Value at September 30, 2008 (\$ in thousands) |
|---|--|
| Commercial loans held-for-sale: | |
| Senior secured cash flow | \$ 7,388 |
| Residual interest in securitization | |
| Investments in debt securities, available-for-sale: | |
| Securities backed by residential real estate mortgages, commercial real estate mortgages and other assets | 1 |
| Securities backed by licenses and easements | 4,165 |
| Warrants | 2,621 |
| Total level 3 assets at fair value | \$ 14,175 |

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, 2008 and December 31, 2007, investments in debt securities available-for-sale totaled \$4.2 million and \$35.5 million, respectively. At September 30, 2008 and December 31, 2007, our net unrealized loss on those debt securities totaled \$0.4 million and \$0.9 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. Our goal is to manage interest rate sensitivity so that movements in interest rates do not adversely affect our net interest income. Interest rate risk is measured as the potential volatility to our net interest income caused by changes in market interest rates. During the normal course of business our lending to clients and our investments in debt securities create some interest rate risk as does the impact of ever-changing market conditions. Our management attempts to mitigate this risk through our Asset Liability Committee (ALCO) process taking into consideration balance sheet dynamics such as loan and investment growth and pricing, changes in funding mix and maturity characteristics. The ALCO group reviews the overall rate risk position and strategy on an ongoing basis. The ALCO group also reviews the impact on net interest income caused by changes in the shape of the yield curve as well as parallel shifts in the yield curve.

We invested the proceeds from our December 2006 initial public offering and our November 2007 private placement in short term instruments to permit us ready access to cash in order to fund our directly originated loan growth. As a result, our sensitivity to interest rate movement has increased. As the cash is redeployed and we continue to grow our loan portfolio, this interest rate sensitivity as a percentage of earnings will decrease over time.

The following table shows the hypothetical estimated change in net interest income for a 12-month period based on changes in the interest rates applied to our portfolio and cash and cash equivalents as of September 30, 2008. Our modeling is based on contractual terms and does not consider prepayment:

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| | Rate Change (Basis Points) | Estimated Change in Net Interest Income Over 12 Months (\$ in thousands) |
|-------------|---------------------------------------|---|
| Decrease of | 100 | \$ (590) |
| Increase of | 100 | 5,768 |

As shown above, we estimate to the best of our ability that a decrease in interest rates of 100 basis points would have resulted in a decrease of \$0.6 million in our annualized net interest income, and an increase in interest rates of 100 basis points would have resulted in an increase in our net interest income of \$5.8 million. The estimated changes in net interest income reflect the potential effect of interest rate floors on loans totaling approximately \$445 million.

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 that occurred during our third quarter of 2008 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.

Our Risk Factors, which contain a detailed discussion of certain risks that could materially and adversely affect our business, operating results or financial condition are discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007. Other than discussed below, there have been no material changes to the Risk Factors previously disclosed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007. The following Risk Factor should be read in conjunction with the Risk Factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2007. The remaining Risk Factors included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007 remain unchanged.

Recent Global Market Disruptions

Global economic conditions, regulatory actions and volatility and other developments in the financial markets affect our business. As a financial services company, factors such as interest rates, the liquidity and volatility of fixed-income, equity, credit, currency, derivative and other financial markets, and investor confidence can significantly affect our business. These factors can also impact the businesses in which our customers and sources of financing are engaged. Such factors have affected, and may further unfavorably affect, both regional and worldwide economic growth, creating adverse effects on many companies, including us, in ways that are not predictable or that we may fail to anticipate.

Since mid-2007, global credit and other financial markets have suffered substantial stress, volatility, illiquidity and disruption. These forces reached unprecedented levels in September and October 2008, resulting in the bankruptcy or acquisition of, or government assistance to, several major domestic and international financial institutions. These events have significantly diminished overall confidence in the financial markets and in financial institutions, generally. This reduced confidence could further exacerbate the overall market disruptions and risks to market participants, including NewStar.

Global economic conditions have led to a severe dislocation in the credit markets in which we operate. Bank loan markets and securitization markets, specifically collateralized debt obligation markets are experiencing significant volatility with continued selling pressure by certain types of investors, many of which are leveraged. This negative environment is further impacted by the overhang of a large inventory of unsold leveraged loan positions that are aging on banks' balance sheets.

The recent market developments and the potential for increased and continuing disruptions present risks to our businesses and operations. The following are the principal risks to our business due to the recent market disruptions, but a continuation or worsening of the economic climate could lead to other unanticipated risks.

Table of Contents

The recent disruptions in the global financial markets may increase the number of charge-offs, impairments and non-accruals in our loan portfolio, which may exceed our allowance for credit losses and could negatively impact our financial results.

Our business, financial condition and results of operations may be adversely affected by the deteriorating economic and business conditions in the markets in which we operate. Delinquencies, non-accruals and credit losses generally increase during economic slowdowns or recessions. Our Middle Market Corporate group primarily consists of loans to small and medium-sized businesses that may be particularly susceptible to economic slowdowns or recessions and may be unable to make scheduled payments of interest or principal on their borrowings during these periods. In our Commercial Real Estate group, economic slowdowns or recessions could increase potential payment defaults on the underlying commercial real estate. Therefore, to the extent that economic and business conditions continue to deteriorate as they have during recent periods, our non-performing assets are likely to increase and the value of our loan portfolio is likely to decrease. Adverse economic conditions also may decrease the value of the collateral, particularly real estate, securing some of our loans or other debt products. Further or prolonged economic slowdowns or recessions could lead to financial losses in our loan portfolio and a decrease in our net interest income, net income and book value.

Slowing economic activity continues to contribute to a decline in overall credit quality. We are closely monitoring the credit quality of our loans, but we expect loan delinquencies, non-accruals, impairments and charge-offs in our loan portfolio to increase if the economy continues to weaken. A prolonged economic downturn could lead to loan delinquencies, non-accruals, impairments and charge-offs in our loan portfolio exceeding our allowance for credit losses, which could negatively impact our financial results.

Unfavorable economic conditions may also make it more difficult for us to maintain both our new origination volume and the credit quality of new business at levels previously attained. These events could negatively impact our results of operations.

The recent disruptions in the global financial markets may continue to negatively impact our ability to raise additional capital.

As a result of the current economic climate and tightness in the capital markets, we expect to continue to experience difficulty and higher cost in securing term debt financing for our loan portfolio. Given current market conditions, we continue to believe executing a traditional term debt securitization could be difficult and, if executed, may not be structured on terms as advantageous to us as we have obtained in previous transactions. Additionally, the financings we have renewed and the amendments to existing credit facilities we have obtained in 2008 have been more expensive and provide lower advance rates than similar transactions completed in prior periods. While we believe that we will benefit from these market conditions by re-pricing our existing loans when possible and originating new loans when possible at significantly higher yields and potentially on more favorable terms, we expect to be negatively impacted by the trend toward higher cost of borrowing and lower leverage in 2008 and in future periods.

Unfavorable economic conditions could also increase our funding costs. The current market disruptions have limited our access to the capital markets and may result in a decision by lenders not to extend credit to us, or renew existing credit facilities which could negatively impact our results of operations.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.
Use of Proceeds from Registered Securities**

On December 13, 2006 the Securities and Exchange Commission declared effective our Registration Statement on Form S-1 (File No. 333-137513) in connection with the initial public offering of our common stock. The managing underwriters for our initial public offering were Goldman, Sachs & Co., Morgan Stanley, Citigroup and Wachovia Securities. On December 19, 2006 we completed the sale of 13,800,000 shares of our common stock (including 1,800,000 shares pursuant to the exercise by the underwriters of their over-allotment option) at a price of \$17.00 per share. We received net proceeds in the initial public offering of approximately \$218,178,000. No expenses were paid or payments made to our directors, officers or affiliates or 10% owners of any class of our equity securities. From December 19, 2006 through September 30, 2008 we used approximately \$50,000,000 to repay short-term indebtedness under our credit facilities, approximately \$38,925,000 to repay and terminate corporate debt, approximately \$1,005,000 to pay accounting fees associated with the initial public offering, approximately \$25,000 to pay miscellaneous expenses associated with the initial public offering and the remaining proceeds to fund loan growth.

Item 6. Exhibits.

| Exhibit Number | Description | Method of Filing |
|---------------------------|---|--|
| 3(a) | Amended and Restated Certificate of Incorporation of the Company. | Previously filed as Exhibit 3(a) to the Company's Annual Report on Form 10-K for the year ended December 31, 2006 (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 (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. |

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 5, 2008

By: */s/ JOHN K. BRAY*
John K. Bray
Chief Financial Officer

37

Table of Contents

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