Third Avenue Focused Credit Fund Transcript

June 20, 2016 | Edited for Clarity

BETTY LIN BLABEY: Good afternoon. My name is Betty Lin Blabey, Director of Marketing & Communications at Third Avenue and I'd like to welcome you to the quarterly update call for the Third Avenue Focused Credit Fund. We appreciate you taking the time to listen.

We're joined today by Lead Portfolio Manager, Tom Lapointe, who will provide an update on the Fund and its current positioning.

The information disclosed on this call is intended for Focused Credit Fund shareholders and their advisors and is not for attribution or for distribution to third parties. If there are members of the press on the call, please exit at this time.

A transcript and replay of this call will be available shortly on our website thirdave.com If you have any questions, you can email creditupdates@thirdave.com or call our client services desk at 212.906.1160.

Thank you for your attention. And I'm happy to turn the call over to Tom Lapointe.

TOM LAPOINTE: Thank you for taking the time today. We will try to make this call succinct and keep it to 20-30 minutes. The agenda is as follows:

- Review the recent cash distribution and future distributions
- Current portfolio statistics
- Portfolio activity
- Review Market conditions
- Portfolio Commentary
- Updates on some large holdings.
- Update on the liquidation process and attempts to maximize value
- We will not be taking live questions, Instead we will answer questions we have received recently

We would like to reiterate our commitment to maximizing the value of the remaining positions in the Third Avenue Focused Credit Fund and returning capital to you in as timely a manner as feasible. We are working to return cash in amounts consistent with being able to continue complying with different regulatory, legal and tax requirements. Last week we made about a 10% cash distribution to shareholders. This cash was accumulated through security sales, coupons received and tenders/redemptions of portfolio securities. We distributed about $64 mm. Post this distribution we expect the fund to continue to receive cash coupons and we will opportunistically sell securities when appropriate. We are working towards strategic transactions that will realize value for certain holdings.

As this cash comes in, we plan on making a further distribution in the 3rd quarter of this year. It is important to note that this cash distribution was a return of capital for tax purposes and should not be classified as income. We have heard some intermediary entities may have reported this to shareholders pursuant to their default option – namely, that the distribution would be income to you. However, this is not accurate. Also, because the NAV drops when we pay out cash, some of these entities do not add it back when calculating returns, so the performance data may be incorrect. Check with your providers or call your TAM representative and we can try to help. Accurate tax information is available on our website.

Portfolio Statistics
Last week along with making the 10% cash distribution, we released May 31 portfolio fact sheet. If you do not have it, please go to our website and down load it. As many of you remember, we switched to monthly data reporting vs quarterly in an attempt to provide more regular transparency into the portfolio.

I will just touch on a few of the larger changes vs the beginning of the quarter.

Portfolio assets were $661 mm at May 31; at January 31 they were $619 mm so this is a market appreciation of securities. The number of holdings is 20 as of May 31, that's down from 36—obviously we are selling things. And the market has improved during that time period so the yield to worst and other data would move accordingly as you would expect. Cash at the end of May 31 was almost 25% and that's up from 16% (note this is prior to the distribution paid out June 15). The ratings of the holdings are also listed if you are interested. Most of the holdings are CCC or unrated.

Portfolio Activity
The Fund realized approximately $40 mm in sales during the quarter. The largest sales were:

- Vertellus Specialties; $13 mm
- Reichhold Chemcical; $8.4 mm
- New Enterprise Stone & Lime; $8.5 mm

Market Conditions
The quarter started much like last year ended. High volatility, lower prices and a lack of liquidity. In mid February- Oil prices started their upward move and the whole market started to feel better.
YTW in the HY index peaked about 11% and is now at about 8%.

The percentage of the High Yield market trading below 70 cents (one metric of distress) spiked from about 5-6% of the market in September 2015 to about 19% of the market in January/ February. It has since recovered and is now back at about 6% of the market.

Defaults have continued to increase, but this is always a lagging indicator and has been driven by commodities. The LTM default rate currently stands at 3.8%--this is up from 1.6% a year ago. Year to date – 35 companies have defaulted with $42BB of debt. 85 % of the defaults have been in the Oil and Gas and Mining names. Excluding Oil/Gas and Metals/Mining defaults, the LTM default rate is only 0.4% that is a very low number vs the 30 yr average closer to 4%

YTD new issuance in HY totaled $150BB vs 182BB last year (-17%) and Bank Loan new issuance is $135BB vs $180BB last year (-25%) CLO issuance is making a comeback but still way below last year, with 75 new CLOs YTD for a total of $31BB vs. 142 deals and $70BB last year down over 50%.

The February bottom in oil coincides with peak in HY spreads and the low in HY bond prices. There seems to be ample liquidity in higher quality credits, but there is limited liquidity in lower quality credits, reorg equities and distressed names. Trading in these names seems to be most active around the releasing of credit results and news related to each specific credit.

Portfolio Commentary

The average size of the investments in the Fund's top 10 is about 7% of the Fund, with the largest at 15% and the smallest at 3%.

In the top 10 holdings, seven are post-reorganization companies that we took through a balance sheet restructuring over the past several years and we own equity in each reorganized entity and often some debt as well. In all of these companies, we owned the debt that was the fulcrum security and converted all or partially into new equity.

We are on the Board or have Board observer rights at several of these companies. Our equity ownership ranges from 4-5% on some smaller investments to 25-40% on our larger ones.

In each of these restructured companies, debt levels have been reduced and, in many cases, new capital has been added to help them grow. Despite significant debt reduction, each company still has material debt on the balance sheet.

In many cases, the remaining debt on these companies still trades at stressed or distressed levels, and the equity valuation is small as a percentage of the total capitalization. They remain leveraged companies, just less so.

The ultimate returns for these investments will depend on:

- Financial performance, including whether revenues and EBITDA are stable or can grow
- Valuations in the market place for similar companies
- Capital markets; access at reasonable costs
- Timing of our realization
- Private equity and strategic buyers' willingness and ability to buy and finance M&A activity

The other three names in the top ten are New Enterprise Stone and Lime and iHeart Communications which have not restructured, along with Freddie Mac / Fannie Mae (which is in a unique position that might be considered a "restructuring").

We are generally happy with the recent business results of our top 10 holdings, although there is always room for improvement.

These positions had median revenue that was unchanged from 2014 to 2015 and EBITDA that was up approximately 4%. In 2016, we estimate median revenues will be up approximately 2% and EBITDA will be up approximately 9%.

Clearly, some companies will be better and some worse. Debt levels has come down significantly over the last 2 years. As a result of balance sheet restructurings and EBITDA growth, leverage is down 3 turns on average over the last 2 years. Free cash flows are also improved. All of the debt we own in the top 10 holdings is current, meaning they are paying their coupons (cash or payment-in-kind). We have owned these positions for some time and discussed them over the years.

It's also important to remember that this portfolio has always been different and event driven and as we have sold things and returned capital it has gotten more concentrated. As a result, you should expect returns to be lumpy and uncorrelated. We believe we have a valuable portfolio of mostly post reorg companies and are working to maximize its value.

Company Updates

Corporate Risk Holdings (formerly Altegrity)
Corporate Risk Holdings is a global, diversified risk and information services company serving commercial customers and government entities. The company includes three major business segments: Kroll (corporate background checks & advisory), Ontrack (information security, e-discovery) HireRight (technology-enabled employment background screening, drug and health screening, and employment eligibility). As of April 29, Corporate Risk represented a 14.92% position in the Fund.

We are currently the largest shareholder and own about 30% of the equity and second lien notes. Third Avenue has a designated board seat, and our investment team is actively involved in helping the business succeed.

Only six months after emerging from bankruptcy we have already seen significant progress. Senior management is doing a terrific job: Kroll, Ontrack and HireRight all had the cleanest earnings since we've invested and comparables are up by 5-10% across the businesses. Customers are taking note, and rewarding the company with positive feedback in business in a way many senior people at the company have not seen in years. The company's five-member board is a hands-on group with relevant CEO experiences, and we believe the Board is doing an exceptional job working with management -- a welcome resource for each of the business heads. Finally there has been strategic interest in all of the assets, which is frankly not surprising, and was one of the original reasons for the investment. Management and the board are taking this into consideration as we map out what the best outcomes for shareholders could be.

Corporate Risk remains levered, but is performing in line with expectations, and in some parts, ahead of expectations. We are confident that our shareholders will realize value from the work that is being done at the company and look forward to providing material updates.

Freddie Mac/Fannie Mae
Freddie and Fannie provide funding to the US housing market. As of April 29, Fannie/Freddie represented a 4.45% position in the Fund.

The Fund has owned preferred stock of Freddie Mac and Fannie Mae for years. We have written about it over the years and feel as strongly today as ever about the merits of the investment. We have long viewed this investment as needing a political solution, and while we believe the facts are on our side, we view the ongoing litigations as mostly a wedge to uncover facts from the government and force that solution. This quarter, there was the first release of documents the government has been trying to keep under seal. In several cases, the government is claiming Presidential Privilege to stop the documents from being uncovered. There are rumored to be 10,000-11,000 of these documents under seal and seven of them were released last month. We will continue to monitor the developments with this investment and will liquidate at what we believe to be an opportune time. Prices are up about 50% since the release of the limited documents, but they still only trade at about 18% of what could be the ultimate recovery. This remains a political process, but the facts are starting to come out, and they look good for people who believe these companies have value.

iHeartMedia
iHeartMedia is largest radio broadcaster in the United States and one of the largest outdoor billboard companies in the world. As of April 29, iHeart represented a 4.80% position in the Fund.

We continue to believe that the company has liquidity runway through the next major maturity in 2018, and that it should be able to remain current on its interest obligations while it attacks its capital structure through bond exchanges and buy backs. The company's structure traded off materially in 2015.

Beginning in November 2015, the company engaged in a series of transactions that we believe are setting the table for a potential value enhancing exchange for junior creditors and overall improvement of the capital structure.

The company made four transactions of note:

1) transfer of 100 million shares of CCO equity (the equity of the outdoor business) to an unrestricted subsidiary, using a "permitted investments" basket;
2) issuance of $225 million of debt of an international entity and subsequent dividend of most proceeds to CCO equity holders;
3) sale of non-strategic CCO assets for approximately $600 million; and
4) repayment of a $300 million intercompany note to CCO and subsequent dividend of $540 million to CCO equity holders, including the $300 million repaid.

The result of these transactions is that company has a substantial amount of cash (approximately $1 billion as of March 31, 2016), of which, we believe, over $300 million is unrestricted and can be used for liability management, as well as an additional amount that can be loaned for similar purposes. This unrestricted liquidity is substantial and could be the key to permanently lowering the company's interest burden and free cash flow burn. The company just won a lawsuit against the 1st lien lenders that should allow the company to proceed with an offer to purchase debt at a discount.

The company also announced 1Q16 numbers that positively surprised the street, showing strong results at the radio/media segment, and good same-store results at the outdoor business. Our bonds appreciated materially since February from around 20% to close to 40%, all the while clipping a current cash coupon of 12%

New Enterprise Stone & Lime
New Enterprise Stone & Lime is one of the largest aggregate producers (crushed stone) and highway construction companies in the United States. As of April 29, New Enterprise represented a 4.71% position in the Fund.

We believe that the company should remain a performing credit and will seek to refinance its capital structure in the coming year. We believe that assets cover the bonds and that ultimately the bonds we own are worth par and pay a cash 11% coupon. The 11% notes currently trade in the 90 context.

While New Enterprise has a substantial amount of leverage, the new management helped guide the company towards more disciplined bidding, and the company has turned away unprofitable business. EBITDA more than doubled from around $50 FY 2014 to the LTM figure of over $100mm Backlog has jumped sharply, from $143mm in February to $270mm in April. This is an improving credit with good upside and a near term catalyst.

Update on the liquidation process and attempts to change structure to maximize value

We have also received requests from many of you to try to provide alternatives that give shareholders more choices. We believe that amongst our shareholders, there is a strong preference for providing different options that allow different shareholders to make an appropriate choice given their individual situation. Generally, the options that have been requested are:

- Provide an immediate cash-out option at some reasonable price – that shareholders could take if they wanted
- Provide a way to maximize value in a non –liquidating vehicle (or at least a vehicle that is not under any requirement to return cash until full value has been realized.
- Provide a way to just stay where you are and receive cash as the portfolio winds down.

We are working with our legal counsel, tax advisers and regulators and others to determine if there are any alternative structures the Fund could utilize that would allow us to create options like these for shareholders, but at present we cannot predict what additional structures, if any, might be available in the future.

Q&A

Q: What is the status of the Sub chapter M issue - and will the fund be in compliance with sub chapter M?

A: The recent cash distribution was sized to allow the Fund to meet Sub Chapter M diversification requirements at its next measurement date on July 31st under reasonable and stress-tested assumptions.

Q: What are the consequences of not meeting sub chapter M of the Tax code – how will returns be effected?

A: At this time, we believe that it is important to Fund shareholders that the Fund remains a pass-through entity for tax purposes. The present portfolio generates a significant amount of interest income, much of with is Payment-in-Kind at this point. Therefore, if the Fund were to be taxed at a Fund level, returns would be materially affected. We will continue to review this issue and are also considering alternative means of maintaining a pass through status without meeting Sub-Chapter M.

Q: When do you think you will be making the next cash distribution and how much will it be?

A: We expect to make a distribution in Q3, but the size of that distribution with depend greatly on where we stand at that time on the tax pass-through issues I have just been discussing. If we must retain cash as a diversifying asset to meet Sub Chapter M requirements, the distribution will be less than all of the cash available, much as in the case of the most recent distribution. Please remember that, as we are not earning any fee for managing the Fund, we have no incentive to keep cash other than to help the fund maintain its pass-through tax statute, which we believe provides a material benefit to shareholders at this time, given the amount of interest generated by the current portfolio.

BETTY LIN BLABEY: Great, thank you. That concludes our quarterly update for the Third Avenue Focused Credit Fund. A transcript and replay of this call will be available shortly on our website thirdave.com If you have any questions, you can email creditupdates@thirdave.com or call our client services desk at 212.906.1160. We thank you for joining and your continued support in Third Avenue Management.