Conference Call
Earnings Call Fiscal Second Quarter
Ending December 31st 2015
CMFinance
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Operator: Welcome to the Earnings Call Fiscal 2nd Quarter ending December 31st, 2015 conference. Your hosts for today's call are Mike Mauer, Jai Agarwal, and Chris Jansen. Operator assistance is available any time during this conference by pressing star zero. A question and answer session will follow the presentation. I'll now turn the call over to your speakers. Gentlemen, you may begin.

Mike Mauer: Thank you operator. Thank you all for joining us today. With me are Chris Jansen, my co-chief investment officer, and Jai Agarwal, our CFO. Before we begin Jai will first give our standard disclaimer regarding information and forward-looking statements. Jai?

Jai Agarwal: Thanks, Mike. I'd like to remind everyone that today's call is being recorded. Please note that this call is the property of CM Finance Inc and that any unauthorized broadcast of this call in any form is strictly prohibited. Audio recording of the call will be available by using the telephone numbers provided in our press release announcing this call. I'd also like to call your attention to the customary Safe Harbor Disclosure in our press release regarding forward-looking information. For this conference call, we also include forward-looking statements and projections and we ask that you refer to our most recent filing with the SEC for important factors that could cause actual results to differ materially from these projections. We will not update our forward-looking statements unless required by law. To obtain copies of our latest SEC filings, please visit our website at www.cmfn-inc.com. At this time, I'd like to turn the call back to our chairman and CEO, Mike Mauer.

Mike Mauer: Thank you, Jai. I'm going to begin our call with a discussion of the market. I'll then turn the call over to Chris to walk through our portfolio activity in the quarter, and then I'll speak a bit about some key metrics and fair-value marks. The fixed-income markets continued to experience weakness last quarter and were exceptionally volatile. Spreads have widened across fixed income especially within the broadly syndicated loan market, the high-yield market and our focus, the middle market.

We are starting to see a better balance to supply and demand since the start of this quarter although volatility continues to create a great deal of uncertainty. Of course, volatility also creates opportunity. Over the past few months, supply has clearly outstripped demand pushing secondary prices lower. The lack of demand has also led directly to a slower pace of originations in our market. This environment remains investor-friendly with structures and terms favorable to capital providers. I now would like to turn the call over to Chris to discuss our investment activities.

Chris Jansen: Thanks, Mike. Our portfolio activity during the quarter was light. As we discussed on our last conference call, we made one new investment in NWN Corporation. This is a small club deal backing the acquisition of the company via a sponsor, New State Capital Partners. Our investment was a $10 million first lien loan at a price of 98 as well as a small equity co-investment of approximately $150,000.00 alongside our lending partners and the sponsor.

During the quarter, we also had two investment realizations. We sold our second lien loan to Physiotherapy Associates. This was a $5 million position with a yield of less than 10%. We evaluated our ability to grow the position to a more meaningful size for us or to exit, and we opted to exit. Our realized IRR was 9.8%.

Our investment in LightSquared was also repaid in December. This repayment was expected as this was a DIP loan and LightSquared exited bankruptcy. Our realized IRR was 9.4%. Our expectation is that over time we will continue to increase our number of portfolio companies from 22 today. As we do, we will continue to focus on diversifying our portfolio.

By industry, our largest concentration is in gaming at 18.1% of the portfolio at fair value. This is up from 16.5% last quarter and is the result of changes in our marks. Our second largest sector was healthcare at 12.9%, followed by energy at 11.9%. Telecommunications follows as our 4th largest sector at 10.6%. I'd now like to turn the call back over to Mike.

Mike Mauer: Thanks, Chris. As of December 31st we were 0.84 times levered versus 0.75 times as of September 30th and 0.71 times at June 30th. We maintain a balance of first and second lien investments with 50.7% of portfolio in first lien, 46.1 in second lien, and we have 3% of the portfolio in an unsecured investment with the remainder in equity and warrants. The weighted average yield on our debt and income-producing securities at cost decreased to 10.31% from 11.02% as of September 30th. While our investment in NWN and realizations of LightSquared and Physiotherapy improved our average yield, the effect was more than offset by our nonaccruals.

As of December 31st, the fair value of our portfolio was 293 million. As of September 30th, the fair value of our portfolio was 321 million. Our investment activity includes sales, pay downs, and repayments and accounts for 7.5 million of the fair value reduction. The remainder is due to declines in our fair value marks.

Portfolio valuations for all BDCs, not just CM Finance, are rightly in focus at the moment. Investors and analysts continue to focus on energy investments in particular. Knowing all of this, I thought it might be helpful to give an update on our most significant changes to our fair value marks this quarter. Six of our positions were marked down by $1 million or more.

AAR, as you will remember, is a Colorado-based oilfield services company. As I mentioned in November, the company's results are significantly dependent on drilling activity in the DJ Basin. With the continued decline in oil prices seen during the second half of 2015, AAR's customers have cut back their operations and pushed service providers like AAR to reduce pricing. AAR is by no means unique within the oilfield service space. This dynamic is playing out across the industry. AAR is in forbearance after violating financial covenants, and we are working with our fellow lenders and the company to amend our loan's terms. In addition, we have moved the interest to PIK and we have AAR on partial nonaccrual. We reduced our mark on AAR from 80 to 65.

Bird Electric Enterprises is based in Texas and provides utility services to both the oil and gas, and regulated utility industries. Bird services the electrical grid performing maintenance and repair as well as doing electrical work on projects in West Texas. We invested in Bird in October of 2014. This is really a story of two business lines. Bird's operations in Texas have been stressed as the activity in the Permian Basin has declined with oil prices. Bird has made some progress expanding the utility portion of its business as well as expanding the operations to outside the oil patch.

The diversification into the utility business into Florida and the Southeast continues, but this has required greater upfront cost to date and is behind schedule. Weakness in Bird's utility business is what surprised us most and was a big input to our mark. We have taken a conservative approach in valuing Bird and we have not assumed any near-term recovery in drilling activity in the Permian. We have also assumed a gradual restoration of profitability to the utilities business. In addition, the company is currently in covenant default under their first lien credit agreement. We've placed Bird on nonaccrual and reduced our mark from 95 to 50.

Caelus is an exploration and production company operating on the north slope of Alaska. Operational performance has been outstanding and we feel the management team is one of the strongest in the industry. Caelus's results have been excellent. The company enjoys a strong hedging profile and has excellent cash flows, and has done an excellent job proactively managing capital and operating expenditures. In 2014, Caelus hedged a majority of their production for 2016 and 2017. That said, the price of oil is a third of what it was at the time of our investment which has an effect on collateral values and investor sentiment. In recognition of the broad re-pricing of risk in the sector, we have reduced our mark from 79 to 65.

Thematically, our marks on TNT Crane and Endemol were reduced for reasons which are quite similar. You'll see TNT Crane listed as North American Lifting Holdings in our financial statements. TNT is an equipment rental company specializing in operated and maintained lifting services, meaning that TNT provides both the operator as well as the equipment. Endemol appears in our financial statements as AP NMT Acquisition BV. The company is one of the largest independent television programming companies producing both scripted and reality TV content. What TNT and Endemol have in common is that they are second lien loans behind relatively illiquid syndicated first lien loans. Both companies enjoy strong sponsorship from First Reserve in the case of TNT, and Fox and Apollo for Endemol. Both capital structures are more levered than our average portfolio company. Finally, both TNT and Endemol's results have been modestly behind their respective budgets.

Neither company is experiencing material financial strain and we don't think either should have an issue servicing their debt. That said, the modest weakness in results, coupled with higher starting leverage with less liquid markets for the loans created a very poor dynamic in the volatile widening-spread environment. Both TNT and Endemol's loans rarely trade. When the loans did trade during the 1st quarter, the first liens gapped down. As a result, the second liens have been marked down as well. We marked TNT down from 92 to 72 and Endemol marked down from 91 to 83.

Finally, our other significant mark was in YRC Worldwide. The company provides less than truckload transportation services in North America. YRC is our most liquid investment which means it's responsive to changes in the information available to investors. YRC's performance has been generally in line with our expectations and the company was upgraded by S&P in August of 2015. We are a first lien lender, YRC is a public company and has disclosed, that their leverage is 3.2 times as of December 31st. This has de-levered from 4.6 over the past year. However, the macro environment for transportation companies has been challenging, particularly from a volume standpoint. Ultimately, YRC is another market-related mark as other investors clearly view the company less favorably than we do. We reduced our mark from 97.5 to 88.5.

During the December quarter, we earned our full-base management fee. As you know, we agreed to waive our income incentive fee to the extent necessary for NII to cover our dividend. We also have a three-year high water mark. Due to the decline in the fair value of our investment portfolio, the high water mark was triggered. The resulting fee waiver caused an increase in NAV of $1.2 million or $0.09 per share. We did not earn any of the incentive fee in the quarter due to our high water mark, and we expect to fully waive our incentive fees for the next two quarters.

On February 2nd, our Board of Directors declared a distribution for the quarter ending March 31, 2016, of 35.16 cents per share payable on April 7th to shareholders on record as of March 18th. We made a commitment to our shareholders to increase our dividend and this is our second annual increase. Our new dividend level represents a 9 3/8ths yield on our IPO price of $15.00 and a 16% yield based upon yesterday's closing price of 8.75. With that, I'd like to turn the call back to Jai to review our results for the quarter. Jai.

Jai Agarwal: Thanks, Mike. Our net investment income for the quarter was $6.3 million or $0.46 per share. Our aggregate net realized and unrealized losses were 21.8 million or $1.59 per share. The weighted average yield at cost on our debt portfolio was 10.31%. Our debt portfolio was comprised of 80% floating rate and 20% fixed rate investments. The average portfolio company investment was approximately 13 million and our largest portfolio company investment was 29 million. Additional information regarding the composition of our portfolio is included in our Form 10-Q filed yesterday. With respect to our 50 million financing facility, we had $44 million borrowed at quarter end and 41 million as of today. With that I'll turn the call back over to Mike.

Mike Mauer: Thanks, Jai. As I mentioned, we have moved Bird to nonaccrual and AAR to partial nonaccrual. While we are disappointed with the performance of these investments, our overall portfolio is solid. Over 96% of our investments are senior secured. Our underwriting is focused on the quality of management team, capital structure, our security and covenants for the protection and preservation of capital over the long-term. We are in a very difficult investing environment but we believe that being patient and conservative is the right approach. As a BDC we have limited capital available to invest at any given time. The markets continue to be volatile. We continue to have a great dialogue with our origination sources including watching secondary markets closely. We have directly originated investments in our pipeline and we are seeing offerings in several investments that are reasonably attractive. That said, we're going to be patient and we will continue to look for signs of stability before we step in and resume deploying capital. With that, operator, please open the lines for Q&A.

Operator: Ladies and gentlemen, at this time we will conduct a question and answer session. If you would like to state a question, please press star one on your phone now and you'll be placed into the queue in the order received. Once again, to ask a question, please press star one on your phones now. Our first question comes from Robert Dodd. Please state your question.

Robert Dodd: Hi, guys. Looking at, obviously, partial nonaccrual for AAR and working through a process, can you give us any idea about the timeline to come to a conclusion - be that total nonaccrual or return to accrual or however it works out, but I mean, what kind of timeframe are we looking at? Then secondarily is what do you think would be required for it to either come back on to accrual or to go to full nonaccrual?

Mike Mauer: Thank you, Robert. AAR, I think we've talked about it a couple of times. So I think, yes, a very relevant question. We did put a restructuring officer into the company over the last quarter. They went in at the end of the December quarter. They are in working now. I would expect that they are in this quarter and they may go into the next quarter, we're not sure, depending on the product that they are producing. We want to make sure we get all of the information and we get the reporting and everything setup.

As a result of that information, it will allow us to finalize the process around an amendment with the company. To answer that question, I think it's either late March quarter or some time into the June quarter before we've got an amendment in place. That's the first part.

The second part is around some clarity of accrual going off and back to cash versus playing down and not being recoverable. They continue to have a very, very stable base centered around one principal customer Noble in the DJ Basin, and they continue to have a very preferred basis of operation off the Wells Ranch. It's all very well documented if you research the DJ Basin. Based upon that, we would expect that this will stay on PIK for the foreseeable future until we work our way through a trough. We feel very good about the company but we do not think that it goes back on to a cash basis until you see a recovery in oil. I will tell you I don't think that's in the next six months. I'd be surprised if it is, and anyone who can tell me when it does come, I'd love to talk to him, but I think it's further out than that.

Robert Dodd: Okay. On Bird, on the utility side of the business which usually I'd expect to be - was there a change in terms of a regulatory change or law change in any of the states they operate in that drove that or just something?

Mike Mauer: No, it wasn't a regulatory change. What it was was that they have been operating in Texas and some surrounding states, and they actually, as part of the ramp up of the utility business, have been awarded a fairly significant contract in with Florida Power & Light. As a result of that, 13 crews were relocated to Florida in late October, early November. The cost, redeployment, and timing were all significantly more than originally budgeted for. As of the end of January and into

February that appears to be working the way it's expected, but on a significant delay.

Robert Dodd: Okay, great. Thank you. Then on the capital availability side, just picking a name at random and – we'll use a random or not. I'm not naming anybody, but TNS marked roughly at par on the schedule of investments. Given your relatively constrained capital position right now, have you considered, basically, selling some of your better-performing loans that you've got that haven't been marked down yet to free up some capital to be a bit more opportunistic, given your expertise in some of the more shaky credits that are out there now?

Mike Mauer: Again, I appreciate the question because it is a dialogue that daily, as we sit around and we look at whether or not it's pipeline or secondary opportunities where there's first lien or second lien available at some attractive levels. We are conservative from saying we don't want to step in until we think there is really some stability around some of these. We don't need to bottom tick it to be very profitable. We're focused on making sure that we do have NII to cover the dividend, we more than have that today going forward. So we're comfortable with that. We don't want to rule off a bunch before we see opportunities. Without saying names, we do think that there are 50 to 60 million of relatively liquid positions that we could rotate out of over the short end. Probably 30 to 40% of that over seven to 10 days and the other 50 to 70% of that over several weeks to create liquidity to the extent we see opportunities.

Robert Dodd: Thank you.

Operator: Our next question comes from Greg Mason. Please state your question.

Greg Mason: Great. Good afternoon. Thanks for taking my questions. First, just on the incentive fee waiver due to the high hurdle – high watermark there, if that is the wave for the next two quarters. If these marks come back quicker than expected, is there any clawback to those incentive fees that have been waived this quarter and maybe the next two quarters?

Jai Agarwal: Greg, this is Jai. There is no clawback to those incentive fees even if the marks come back. It is a quarter-by-quarter calculation.

Mike Mauer: So it's a permanent waiver, Greg. Thank you for the question because I think that's very important for investors to recognize.

Greg Mason: Yeah. Okay, great. Then on the leverage currently at 0.88, that's equity, can you remind us again about your target and how do you feel about running above that target for a while? How much capital do you have based on that leverage target? You said you've got $50 million to $60 million of liquid investments but do some of those have to go back to reduce your leverage closer to your target?

Mike Mauer: Yes. So our target which was .7 plus or minus 10%, we are above that and that's driven by the marks obviously. We're very comfortable operating in and around that. From a standpoint of liquidity, and I talked about 50 to 60 million, we have the ability to create liquidity there and reinvest it 100%. If we did elect to do that we would be neutral on our leverage from pre-rotating to post-rotating in and out of an investment. We could elect to partially de-lever if we wanted to in that situation.

Greg Mason: Okay and then just one last question. AAR partial PIK nonaccrual, could you quantify how much is accruing versus how much is not? Is it 50/50 or what percent?

Mike Mauer: Yes, I would tell you. When we first went through this I wanted to make sure I fully understood how we think about this. The key thing is that, basically, given our mark at 65, we are recognizing 65% of the PIK income. What we don't want to do is take fees on a full PIK accrual when our principal is marked at 65. So the partial nonaccrual means that we'll recognize income on a percentage basis proportional with the mark.

Greg Mason: Got it. We've seen that with other firms in the past. All right, thanks, guys. I appreciate all of the comments.

Mike Mauer: Thank you very much, Greg.

Operator: Our next question comes from Merrill Roth. Please state your question.

Merrill Roth: Hi. Good afternoon. Wondering if outside the oilfield services and the energy path are you finding that your companies are hunkering down expecting a recession or a real back up in growth in the current environment or do you really think that a lot of these marks were related to preservations would say or volatility in the market?

Mike Mauer: Merrill, thank you for the question. I absolutely think it's the latter. Overall, the portfolio companies are performing. You could see a modest miss or something here or there but we've seen that over the years and typically you'll see a little miss in one quarter, a little make up in another quarter. But that's more of the exception than the rule and we really think that this is more of a volatility and spread-widening that you're seeing across the fixed income markets all the way from investment-grade down through the middle market.

Merrill Roth: All right, thank you.

Operator: Our next question comes from Chris Kotowski. Please state your question.

Chris Kotowski: Yes, most of mine have been asked and answered but can you describe the sensitivity of Bird Electric? Obviously, they're operating in Texas and I was wondering, what was exactly their exposure to the weakness in the energy market? I was thinking about the other non-energy credits. Are there any that are particularly dependent on an energy-intensive geography or end market in some way ?

Mike Mauer: Yes, I'd say two things. One, on the energy side, the sensitivity is as you would have expected and that is that it really started January of '15. So a little over a year ago you had your large customers come back and say, "We're getting hit so want you to reduce your rate." At the same time there's been some pullback in the volume over that period of time. The second piece to your question around the utilities and first or second derivative risk as we think about it is you've got Texas, and Florida, and some of the surrounding. But for Bird specifically that is maintenance work and that not really we've not seen a significant, if any, fall off. We've actually seen a ramp up related to the contracts awarded in Florida and so that maintenance work is going to get done no matter what. It's a matter of execution and that's where they did stub their toe and trip, in the 4th quarter in Florida.

Chris Kotowski: Okay, and then any other of your portfolio companies that have a stealth exposure - the second derivative?

Mike Mauer: Yes, I do. Actually, there is one or two, I mean – I'll let Chris, because I know he's very close to both of these, answer that question.

Chris Jansen: Yes hi Chris, it's Chris Jansen. TNT, it's a crane company, it does lifting services. So think of aerial lifts or crane work. They're embedded a lot within their customer base. At the time the deal was done in late 2013, there was about 25% geared to oil and gas and E&P. In recent quarters it's down to between 10 and 15%. We've seen the predominant portion of effect against that. We have also seen some weaknesses from delays in their maintenance work which was the deferral of business rather than a cancellation of projects. So this still needs to happen. We're expecting TNT's results to improve in 2016 from that deferral of plant and refinery maintenance.

Chris Kotowski: Okay.

Chris Jansen: As far as other commodities, Nexeo is a stocking distributor of chemicals and plastics. They take inventory risk, and in a rising price environment that inventory can be a big benefit. A declining price environment is a bit of a risk in our judgment, Nexeo's management has done great job working through the volatility and commodity crisis. They've done very well. Nexeo has, since the time of our investment. They de-levered from over six times to about 5.3 times leverage today.

Chris Kotowski: Okay. Thank you.

Operator: As a reminder, if you would like to ask a question, please press star one on your phones now. At this time we have no further questions.

Mike Mauer: Thank you to everyone who joined us today. We look forward to speaking with you again next quarter and, operator, thank you.

Operator: This concludes today's conference call. Thank you for attending.

- End of Recording -