CM Finance Third Quarter Earnings Release Conference Call
Conference Call
May 9, 2018

Operator: Welcome to the CM Finance Earnings Release or the Third Quarter Earnings Conference Call. Your speakers for today's call are Mike Mauer, Chris Jansen, and Rocco DelGuercio. Operator assistance is available anytime during this conference by pressing * 0. A question-and-answer session will follow the presentation. I would now turn the call over to your speakers. Please begin.

Mike Mauer: Thank you, operator. And thank you, all, for dialing in today. Joining me are Chris Jansen, my co-chief investment officer; and Rocco DelGuercio, our CFO. Before we begin, Rocco will give you our customary disclaimer regarding information and forward-looking statements. Rocco?

Rocco DelGuercio: Thanks, Mike. I would like to remind everyone that today's call is being recorded and that this call is the property of CM Finance Inc. Any unauthorized broadcast of this call in any form is strictly prohibited. Audio replay of the call will be available by visiting our Investor Relations page on our website at www.cmsn-inc.com. I would also like to call your attention to the Safe Harbor disclosure on our press release regarding forward-looking information and remind everyone that today's call may include forward-looking statements and projections. We ask that you refer to our most recent 10-Q filing for important factors that may cause actual results to different materially from these projections. We will not update forward-looking statements unless required by law. To obtain copies of our latest SEC filings, please visit our Investor Relations page on our website.

At this time, I'd like to return the call back over to our chairman and CEO, Michael Mauer.

Michael Mauer: Thank you, Rocco. Last night, we reported strong results for our fiscal third quarter ended March 31. We had net deployments of $7 million, improved our average yield by 87 basis points, of which 53 basis points is due from an increase in LIBOR, and continued to maintain a majority of our investments in first lien loans. Our net investment income was $0.27 per share more than fully covering our dividend.

Market conditions continue to be challenging both within the broader syndicated leverage finance market and in competitive situations within our core middle market focus. Covenant lite transactions, weaker lender protections, and increasingly aggressive economic turns are a common theme as arrangers and lenders compete for deals. As always, we are conservative underwriters who focus on secured lending for quality companies and management teams. In a frothy market, that means being disciplined in passing on the vast majority of opportunities that we see.

Since our last conference call in February, our originations have been a mix of directly sourced loans and syndicated transactions to borrowers we know well and have historical comfort with. We made a unitranche investment and joined a club deal. Our new investments in the quarter were all first lien including a last-out, first lien unitranche and our one new investment after quarter end was also first lien.

Our pipeline contains a mix of directly sourced opportunities, club transactions, and secondary opportunities. When we analyze secondary opportunities, our investment team focuses on loan structure, including covenants, repayment provisions, and documentation. Generally speaking, we look for shorter-weighed average life assets where we're comfortable holding the position to maturity. Direct lending opportunities tend to have significant structural protection for our capital and often carry higher yield than larger deals in the syndicated markets.

I now like to turn the call over to Chris to discuss our portfolio activity.

Chris Jansen: Thanks, Mike. We made four investments during the quarter. One of which was to a new portfolio company and three of which were to existing portfolio companies. We also had three realizations during the quarter.

We invested in a last out first lien loan as part of the unitranche loan for GEE group, a staffing company focused on IT services and finance and accounting positions. We have followed the company for over a year, and had the opportunity to invest in a seasoned issuer with a world-class management team. Our yield on cost was approximately 17%.

We also added $5.4 million to our position in the term loan of US Well Services. The company has been performing well and we are very comfortable with the structure and the terms of the loan. Our yield at cost on this new purchase is approximately 11.4%.

Subsequent to quarter-end, we sold all of our Class A shares of US Well Services which represented the majority of our equity for approximately $4.5 million. This position was marked at approximately $4.2 million at March 31st. We still hold the Class B shares which are marked at approximately $313,000. I'd also note that we had a partial repayment from Liberty Oilfield Services of $3.5 million, further reducing our oil and gas-related exposure.

Our first realization in the quarter was also a new investment in an existing portfolio company. We participated in the refinancing of the first lien loan of AP Gaming. The company successfully completed an IPO in the quarter although Apollo remains the largest shareholder. Our realized IRR on this term loan was approximately 7.5%. Our realized IRR on all of our investments in AP Gaming, from our initial investment in 2013 through our realization in the quarter was 10.2%. The yield on the new loan to AP Gaming at cost is approximately 6.3%.

Our second realization was, like AP Gaming, also a new investment. FleetPride refinanced its credit facilities extending their maturity by three years. Our fully realized IRR on the old loan was approximately 13.5%. Our yield at cost on the loan is approximately 7.8%.

Our third realization was Medical Solutions. This was a small position for us at just $4 million. Our fully realized IRR was approximately 6.6%.

After quarter end, we made one new investment and had two significant realizations. Our new investment was an outstanding loan in a club deal in the first lien loan to Hostway Corporation. Hostway provides cloud, managed and dedicated server hosting services to developers, startups, small and medium-sized businesses, and large enterprises. Our yield at cost is approximately 9.9%.

As I previously mentioned, we sold our A shares of US Well Services. We exited this position above our mark and made the decision to sell in the context of managing our total exposure to both the borrower and the oil and gas space. The restructuring took place in the first quarter of 2017. We continue to hold the position in the term loan the B shares as mentioned earlier. Our IRR on this equity position was approximately 71.6% inclusive of the loss we booked during the restructuring in 2017.

Finally, we had a partial realization of our position in PR Wireless. We continue to hold a small position in the delayed draw term loan and in warrants, but have sold our entire funded term loan position, which was approximately [14.4%]. Our realized IRR on the term loan was 8.7%. When we fully realize our Open Mobile position including our remaining delayed draw term loan commitment and warrants, we expect the IRR to be higher. Our IRR to-date on all PR Wireless or Open Mobile investments – same company - using March 31 marks for remaining positions is 10.8%.

Our portfolio company count was 24 as of March 31st and is 25 today thanks to our investment in Hostway. We've taken the step of changing our industry categorization to Global Industry Classification Standard or GICS. We think this makes our portfolio composition easier to understand as well as bringing us into alignment with the best practices of other managers. Using GICS, as of March 31st, our largest industry concentration was Professional Services at 12.7%, followed by Energy Equipment and Services at 12%, Hotels, Restaurants, and Leisure at 11.3%, Commercial Services and Supplies at 10.6%, and Diversified Telecommunications Services at 8.5%.

I'd now like to turn the call back to Rocco to discuss our financial results.

Rocco DelGuercio: Thank you, Chris. For the quarter, our net investment income was $3.7 million or $0.27 per share. As of March 31, the fair value of our portfolio was $297.2 million compared to $286.5 million at December 31. Our investment activity accounts for a $7.5 million increase in our portfolio. We also had $595,000 of unrealized appreciation from investments in the quarter.

As of March 31, the weighted average yield of our debt portfolio including amortization was 11.12% versus 10.25% at December 31. The major driver of the increase in our average yield was the increase in LIBOR during the quarter. We also had a positive differential in yield between investments made and realized during the quarter. Our new investments had an average yield of 9.7% versus 8.9% average yield on our realized investments. Our debt portfolio was comprised of 97.4% floating and 2.6% fixed rate investments. Both one and three-month LIBOR are in excess of the applicable floors on all our loans.

Our average portfolio company investment was $12.4 million. Our largest portfolio company, PGI, was $25.3 million and our second largest portfolio company, Caelus, was $23.4 million. As of March 31, 52.5% of our portfolio was in first lien investments including a last-out first lien unitranche investment. 42.4% of the portfolio was in second lien investments, .3% was in unsecured debt, and the remaining 4.8% was in equity and warrant positions. Additional information regarding the composition of our portfolio is included in our Form 10-Q which was filed yesterday.

We were .71 times levered as of March 31 compared to .69 times levered as of December 31. With respect to our liquidity, as of March 31, we had $6.9 million in cash, $2.4 million in restricted cash, and $26.6 million of capacity under our revolving credit facility with UBS.

With that, I'd like to turn back over to Mike.

Chris Jansen: Thank you, Rocco. As Chris noted, we have been actively managing our exposure in the energy sector. During and after the March quarter, we shifted a portion of our exposure out of non-income-producing equity into first lien yielding assets. Liberty had a very successful IPO and we were partially repaid with the IPO proceeds at a premium. Inclusive of paydowns, our share of US Well's A shares, and changes to our marks, the fair value of our positions in oil and gas and energy equipment services was reduced by about $850,000.00 from December 31st to today. This includes realized and unrealized appreciation of approximately $1 million year-to-date. I note that we've improved the mix by adding first lien secured exposure as a replacement for equity risk and the fair value of all our energy-related positions were either stable or improved during the period.

Our marks this quarter increased by an aggregate of $1.7 million offset by $319,000.00 in accretion. We had four positions that moved by half a million dollars or more. These were Bird, Caelus, Endemol, and Trident.

Bird Electric continued to benefit from improving fundamentals as well as continued significant work associated with 2017's hurricanes. We increased the mark on our preferred equity position by approximately $500,000 this quarter. Caelus has had excellent fundamental results and is benefiting from the rising price of oil. Oil prices have a double benefit, both increasing the value of the company's reserves and generating additional revenue. We increased the mark from 88 to 90 this quarter. Our mark on Endemol improved from 95 to 99 this quarter. Endemol's results continue to improve and we have marked up the position over the last several quarters.

Finally, our position in Trident Health was marked down in the quarter. Alongside other second lien lenders, we hold a position in the Tranche A second lien loan, Tranche B second lien loan, and a preferred position at the holding company. When comparing our position at December 31st to March 31st, the aggregate value of our marks on Trident Health decreased from 52 to 47. We have the loan on partial accrual given its mark and the fact that interest during the quarter was in the form of PIK. As of April 1st, the interest will be in the form of cash and PIK. We continue to work constructively with other stakeholders toward a longer-term solution for the company's debt structure.

We fully earned our incentive fee in the March quarter and we expect to earn our incentive fee in the current quarter as well. Our distribution for the quarter ended March 31, 2018 was $0.25 per share and was paid on April 5th. We believe our dividend level is consistent with our ability to generate NII without reducing our investment quality or changing or focus from secured lending opportunities. We are committed to paying a sustainable dividend to our shareholders. We earned in excess of our dividend in the March quarter and we believe that our run-rate portfolio yield and portfolio size position us to continue to cover our current dividend rate.

Our leverage, at .71 times as of March 31st is within our target range of plus or minus .75 times. We are comfortable at our current leverage level. That said, our Board of Directors approved decreasing our asset coverage ratio from 200% to 150%

as provided under the Small Business Credit Availability Act. This will become effective in May of 2019.

Our Board also authorized a share buyback program. Over the next 12 months, we may repurchase up to $5 million of our common stock in the open market. Given the significant disconnect between our NAV and our trading levels, we and our Board feel a buyback program is prudent. We are in the process of immediately implementing the buyback program.

With that, operator, please open the lines for Q&A.

Operator: Ladies and gentlemen, at this time, we will conduct the question-and-answer session. If you would like to state a question, please press * 1 on your phone now and you will be placed into the queue in order received. Once again, if you would like to ask a question, please press * 1 on your phone now.

Our first question comes from Allison Taylor Rudary from Oppenheimer. Please state your question.

Allison Rudary: Hi, good afternoon, guys. Can you hear me okay?

Mike Mauer: Yes, perfect.

Allison Rudary: Good. I really appreciate all the color to the portfolio investment this quarter and Mike, I might have missed something so I just wanted to touch on it again. I noticed that there was a pretty substantial uptick in PIK interest income this quarter and I think that you had touched on it when you had spoken about the 1888 Industrial Services loan. Were you talking about that? Does that go by another name that I might've missed? So can we discuss maybe a little bit about kind of that set PIK toggle?

Mike Mauer: Yes, it's two things. The 1888 did not change so that would not have been the uptick in PIK during the quarter, but the previous name to that is AAR. It changed a little while back, but AAR Oilfield Services and 1888 are the same. The difference in the PIK was the change in Trident. December quarter was cash and the March quarter was 100% PIK and starting April 1 is a mix of cash and PIK.

Allison Rudary: Okay. So you think that will go down, we'll see that number tick down again?

Mike Mauer: Yes, you will. Not all the way back, but partially back. Now again, I want to clarify two things before we go on. One is I'm going to just clarify one of my partners' comments about the 14.4% on PR Wireless - that was a $14.4 million paydown. And the second thing is that today, subsequent to his comment, the B shares that had a $313,000.00 value for US Well equity that we said we continue to hold, we sold today at slightly above the mark value. So just to assume, it's just a tad above that, but those are just a few clarifications I want to get out there for everyone.

Allison Rudary: Great. That's great color. Then I guess my second question was kind of regarding the AGS or American Gaming Systems that looks like that restructured deal that posed the idea it might be a little bit lower of a yield than you might otherwise necessarily target. Do you see this loan as more of a transitional position or are you guys comfortable holding it for a long period of time? Is it something that you might think of maybe exiting - I assume it's reasonably liquid - if you had the opportunity to deploy into something that was higher yielding?

Mike Mauer: Exactly. You hit the nail on the head.

Allison Rudary: Okay, great. That's it for me. Thanks for your time.

Mike Mauer: Thank you.

Operator: Our next question comes from Paul Johnson from KBW. Please state your question.

Paul Johnson: Hey. Good morning, guys. Thanks for taking my questions. I just wanted to touch on the leverage, the asset coverage. I just was wondering if you guys can talk at all about if you have formed your thoughts around what sort of assets that you'd be looking to invest in or anything that you might be looking to do differently or perhaps the same in pursuing that additional leverage.

Mike Mauer: As you know, the board approved it so it will not be effective until May of 2019. We've had extensive discussions at the board level and at the management level around this exact topic. Given that we are 12 months from implementing, there is going to be a lot more discussions around it so there is not an exact plan to implement because even if there was one, it would be different 12 months from now but the general parameters that we are looking at are using the increased leverage, number one, to increase return for shareholders, that's the most important thing. Coincidental with that at an equal level, is to do that in a way that ideally reduces the risk. So by definition, that would lend us to a higher mix of the low risk, a little bit lower return using more leverage. That doesn't mean we won't still do some of what we're doing now but not in the same ratios. We need to continue to develop that. We've got models. We're looking at different ratios. It will also depend on the financing that's available out there. We started discussions with our current lender, one of our former lenders; we're talking to other people. It's everything from unsecured debt to the UBS facility. We have discussions around, instead of a strict advance rate on our overall portfolio, looking at the underlying assets, highly liquid first lien, less liquid first lien, last out, second out, and all of those having potentially different advance rates but that is all information to come over the next six to nine months, I'd say, as we develop not only our strategy but our leverage providers develop their strategies because the ones we've talked to have not fully thought through it.

Paul Johnson: Then I guess on that for your credit facilities and your term loan that you have, are there 1:1 debt limitations on those, covenants, on those facilities at all?

Mike Mauer: No.

Paul Johnson: Okay. As we think about this from just a high level, I think I've read that the blended yield – and you can correct me if I'm wrong on this – the cost of your debt is around 4.85% and then of course you add in base fees and that's probably roughly around another 4%, and then possibly a little bit more advent cost in looking at the yields that are available on the market today and of course, it could be 12 months away from any sort of implementation, but it starts to squeeze on the margin and like you're saying, it really depends on the cost of debt and what's available when you start to do that. I don't know, I mean the ROE starts to get squeezed out there. I mean if you're targeting lower-yielding safer investments which we do think is the right strategy, the math has to work out for sure…

Mike Mauer: Yes, but I think the important part of that math that you've left out is that if you are going to be lending on lower risk lower return, you're not going to be paying a LIBOR plus 350 to 400. You're going to be paying probably more like LIBOR plus 200 to 250, so the math is very, very different on the borrowing cost of a lower risk lower return than our current portfolio.

Paul Johnson: Okay, that makes sense. I mean I appreciate you for correcting me on that. Other than that, I guess just looking at maybe the share repurchases. I just was curious if you guys had made any repurchases since you announced that back or the board had chosen to do that a couple of weeks ago.

Mike Mauer: No, they didn't choose a couple of weeks ago. Last week was the board meeting and so we are in the process of putting that all in place. I would expect that by the end of next week, everything will be done and in place to begin the buyback program. [Pause]

Paul Johnson: Hello?

Mike Mauer: Yes.

Paul Johnson: Sorry about that, I got cut off. Yes, those are all my questions. Thanks.

Mike Mauer: Yes, I'm sorry. Did I come through or not in the answer to the buyback?

Paul Johnson: I think the last part was cut off but I pretty much heard the bulk of it which is [Crosstalk]...

Mike Mauer: Okay, so just to restate it if anyone else got cut off, we are putting everything in place, all the accounts, all the processes, et cetera. That should be completed over the next week or so, so by the end of next week, we expect it to be up and running.

Paul Johnson: Okay. Thanks, guys. That's all I have.

Mike Mauer: Thank you.

Operator: Our next question comes from Robert Dodd from Raymond James. Please state your question.

Robert Dodd: Hi, guys. I have several questions. Just going back to Paul's question about leverage and your comment, Mike, that if you can get I guess a lower risk type asset and perhaps more diversified, you could lower the cost, right? I mean your marginal cost of borrowing is only effectively like L+1 because you've got a sizeable non-use fee on the current facility. Do you think you could get that down as well if you change the structure of the facility to better match potentially lower risk assets?

Mike Mauer: It is entirely possible and that's why one of the first calls we made was to our current provider to talk about different ways of thinking about our current facility.

Robert Dodd: Okay, got it. So, same work-wise, obviously. Do you have – and I realize it's a year out before it can happen. There's a lot of discussion that can go on between now and then but can you give any comment about what you think your target leverage ratio could be? Obviously, you've got one right now and I'll call it, yes, 0.8. Do you think 1.5 is in the ballpark? I'll say it out loud. I hope it's not 1.8 [Laughter] or is it lower than that?

Mike Mauer: Well, it's not 1.8 and 1.5 could be in the ballpark. It could be 1.2. It all comes back to, quite truthfully, Robert, I think what people are not talking enough about is what is the availability and what are the types of assets as well as financing that's out there, because those are two critical things. I think the one premise that a lot of people have around this is that it's going to be a more competitive market out there because there is going to be more leverage and so it's going to drive yields tighter on the less risky and the more liquid. That might be true, because if you think about pure math, that should be the direction. The flipside of that is also true that if everybody starts going to the highly liquid lower risk, then the stuff we're doing today for the same risk we've got, we should be able to get wider spreads and better pricing and better structure and maybe we don't have to increase leverage as much to increase ROE, because everybody else is going away from the stuff that we do very, very well today. So it really is going to be market-dependent but the leverage is dependent upon the type of risk we're taking but in any scenario, that should translate into better ROE for the shareholder.

Robert Dodd: Got it. I appreciate that clarification. On that front, lower risk versus your first lien, looking at G or GEEE or however exactly you're supposed say it, L+13.75 for a first lien loan, can you give us any comment on that? When you're talking about how competitive the market is, etcetera when I look across the rest of your first lien type assets, much lower spreads obviously, that one really stands out so why should we have confidence that that's got the same kind of first lien credit quality as the rest of your portfolio?

Chris Jansen: Hey, Robert, it's Chris.

Robert Dodd: Hey, Chris.

Chris Jansen: The company right now is borrowing at L+10.75. We were reviewing the credit about a year and a half ago and really liked the credit; and the lender wanted to take their position down and we are sharing in all the loan repayments and excess cash flow sweep but we're last out principal-wise in a refinancing or a sale or something like that.

Rocco DelGuercio: Hey, [Crosstalk]…

Robert Dodd: Did we clear that? L+13.75, that's after the last out adjustment. That's not the coupon…

Chris Jansen: Yes.

Robert Dodd: Yes, okay.

Mike Mauer: The other important thing is that was not a market deal done today. It was a company that we actually have gotten to know through Stifel, through that channel that we've got fairly proprietary. There was an existing lender. We had followed this company and looked at it and had extensive discussions last year. The other party, quite truthfully was outsized in their loan and wanted to bring some down and they preferred to do it in a first-out position. We said, "Fine." We've now watched this thing continue and how it has performed and done everything they've done last year, and so we were in a position of move quickly and negotiate a one-off deal.

Robert Dodd: Got it, got it. On Trident, just mechanics for the accounting purposes, the biggest piece of Trident, the $20-million piece and marked at about 52. So I would say right now you're accruing the PIK or 50% of the PIK off. That's what you did in the quarter and then is that right? Then next quarter, can you tell us what the mix roughly of cash versus PIK is? Because obviously, it'll move around the recognition rate that you take on the income.

Mike Mauer: Let me see if I'm answering the question and if not, correct me. The accrual is going to be the cash portion of the interest which is 50% of the total interest will be cash pay, and 50% of the total interest will be PIK. We'll be non-accrual on the PIK portion. So what we get paid in cash, we will recognize what we get paid in kind, we will not recognize and accrue. [Crosstalk] the total position, that's 50% of the interest. I think about it as the total position as opposed to tranche by tranche.

Robert Dodd: So in this quarter that you just reported, you recognized 50% of the interest as well. It was just all PIK, is that right?

Mike Mauer: In this quarter – hold on one second. [Pause] Yes, exactly.

Robert Dodd: Okay, got it.

Mike Mauer: I wanted check to make sure before I [Crosstalk]…

Robert Dodd: Yes, [Laughter] thank you. Thank you. A couple other things in top line. It looked to me like obviously dividend income, there were some PIK same as last quarter. I presume that's related to Bird Electric, right, so that should be ongoing?

Chris Jansen: Yes.

Robert Dodd: Yes, okay.

Mike Mauer: Okay, hold it. That's converted to current because they have passed the milestone where they need to convert to cash so that's no longer PIK.

Rocco DelGuercio: Yes, you won't see that.

Robert Dodd: Okay. Then the other question, just when I look at the top line, obviously a really strong quarter. It looks to me that there was maybe 750 - and you broke down obviously the realizations and things like that. But there's about 750,000 give or take between some accelerated OID accretion and things like that that outsizing the quarter and that's the non-recurring piece that we wouldn't expect next quarter because obviously you had some large repays, etcetera. Is that the outsize number we're looking at or is it a little smaller than that?

Rocco DelGuercio: No, that's about right.

Robert Dodd: Okay, I got it.

Mike Mauer: Yes, that's primarily related to Fleetpride.

Robert Dodd: Yes, got it. Last one, if I can. On the energy front, obviously, you changed in the – obviously oil right now is doing quite well so their assets are appreciating. If you increase the leverage, [laughter] would you change the effective cap? I mean if you go up, the energy, if it stays at 20% of the portfolio just looking at the historic numbers, that becomes larger and larger relative to the equity base and the potential volatility given commodity exposure or would that change the industry limits that you have internally for allocation?

Mike Mauer: Yes. I think you've got to think about it as the notional amount being around where it is. Might the notional amount might be slightly different but the percentage would come down significantly.

Robert Dodd: Right, okay.

Mike Mauer: Okay?

Robert Dodd: Got it, yes. Got it. I appreciate that. Thank you. Okay, that's it for my questions. Thanks a lot.

Mike Mauer: Just for the record for everyone, the energy we would expect to continue to trend down in the mid-teens not be in the high-teens between the two categories. I just note for everyone on the call, I know two years ago, there were a lot of trepidation around this portfolio in energy. The first lien, second lien nature of our portfolio is very different than some other BDCs that had mostly either second lien or subordinated or mezz type exposure and – knock on wood – we still have exposure and we like our exposure but the thesis has proven out in the way that we've approached it.

Operator: Our next question comes from Troy Ward from Ares Management. Please state your question.

Troy Ward: Yes. Hey, guys. Just real quick on your liability side of the balance sheet. As we think about a year from now going from 1:1 debt to 2:1, can you just remind us what the maturity of your liability side and also whether or not there are any restrictions on the 1:1 leverage built into those liabilities?

Rocco DelGuercio: Hey, Troy. On the term loan, it is December of 2020 it matures, and on the revolver, it's December 2019 and there are no restrictions. Mike had noted there are no restrictions to 1:1.

Troy Ward: Great, thanks.

Operator: Once again, if you like to ask a question, please press star (*) and 1 on your phone now. At this time, we have no further questions.

Mike Mauer: Well, I'd like to thank everyone for the time. We're actually pretty excited about where the portfolio is and our pipeline going forward and the dividend levels that we've got and everything else. We think that it's a very good market. It's a competitive market but given our size and our sourcing channels with both Stifel and Cyrus, we're pretty excited about the next three to six months and I think that is the window that I feel comfortable talking about in any market these days is three to six months, so thank you.

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

- End of Recording -