

Rate this transcript (CTRL + click):
poor      excellent

Earnings Call
CM Finance First Quarter Earnings Release
November 11, 2014

Operator: Welcome to the CM Finance Fiscal First Quarter Earnings Release Conference Call. Your host for today's call is Mike Mauer and Jai Agarwal. Operator assistance is available anytime during this conference by pressing *0. A question and answer session will follow the presentation. I will now hand the call over to your speakers. Please begin.

Speaker: Hi, this is Mike Mauer. I'd like to thank everyone for joining. Thank you, Operator. Good afternoon. I'm joined today by Chris Jansen, my co-chief investment officer, and Jai Agarwal, our CFO. Jai will first discuss some general information and forward-looking statements. Jai?

Speaker: I'd like to remind everyone that today's call is being recorded. Please note that this call is a property of CM Finance Inc. and that any authorized broadcast of this call in any form is strictly prohibited. Audio replay 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 and that press release regarding forward-looking informations.

Today's conference call may also include forward-looking statements and projections. We ask that you refer to our most recent filing with the SEC for important factors that could cause actual results for the formality 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 over our chairman and CEO, Mike Mauer.

Speaker: Thank you, Jai. Our structure at CM Finance continues to be proven out with our strategic partnerships with both Cyrus Capital and Stifel, as well as our own proprietary direct origination team. As we began our fiscal 2015 this July, we saw a

continuation of themes which began in the spring. Leverage multiples in the primary market remained high. Issuer-friendly structures remained prevalent and maintenance covenants were rare in the broader syndicated markets. Today, pricing remains tight and we believe opportunities with appropriate reward for the given risk profile to be few and far between, despite our robust M&A activity and significant new issue volumes in the high yield and loan markets generally.

As always, our focus continues to be on originating less liquid middle market investment opportunities where we see better risk return dynamic than is available in a broadly syndicated market. In addition, we continually look for dislocated deals where we have an analytical or structural advantage through our partnerships. During the quarter, 68% of our new investments were first lien, 27% were second lien, the remainder is attributable to warrants which came along with one of our first lien investments.

In the year to date, we have made 20 - in the calendar year to date to be clear, we have 23 investments including 13 new portfolio companies. Four of those investments were in the past quarter, including three new portfolio companies. Two of our new portfolio company investments were first lien and two were second lien. We made three investments after quarter-end including one new portfolio company. We had 25 portfolio companies as of September 30th, with a total fair value of 299 million and 26 companies as of today's call. We grew our portfolio in our targeted range of \$25 million during this past quarter. That's on a net basis despite realizing approximate \$30 million in sales and repayments. I'll briefly go through some of our origination and realizations during the quarter.

In July, our investment in MF Global was repaid at par. This is a loan funding the wind-down of the MF Global bankruptcy. Our investment was originated in conjunction with our strategic relationship with Cyrus. The unlevered realized IRR was 14.2%. In August, our investment in active media services repaid in full. The company's fundamental performance during the period of our investment was excellent. They refinanced into a bank-led financing with BB-type pricing. Our unlevered realized IRR inactive including the pre-payment premium was 16.3%. In September, we took advantage of liquidity in this syndicated loan market to reduce selective exposure on our investments in the oil and gas sector. We sold a portion of our holdings in Bennu. Earlier we had sold a portion of Caelus Energy and we realized gains on both positions.

As we stated in our prior earnings call, we sold our remaining portion in the Endeavor's loans due to risk return profiles as the company continue to consider bankruptcy. We realized an unlevered IRR of 12.3% over the life of that investment. Endeavor did later file bankruptcy, the loans in which we were invested did receive par. We did think that as a prudent measure on capital that the risk return to stay for a very small increment up was not warranted and we are very happy with our decision to exit early and realize unlevered return of 12.3%.

On the originations front, one new investment I'd like to highlight is our loan to All Around Roustabout. I'll refer to it as AAR. AAR is a Colorado-based oilfield services company. This is a great example of a dislocation in an industry that creates opportunity. There are a lot of bad deals out there in oil and gas space generally and a lot of those should never be done. This is in an environment that also causes good deals to struggle.

AAR is a good investment and a good deal where we spent months doing diligence, meeting customers, multiple site visits. We were very focused on the structure on top of the health of the company. Our loan is less than two times levered on a run rate. It has significant amortization and strong maintenance covenants. As part of our investment, we receive warrants in addition to a 15.6% yield on our first lien loan to the company. That's for the 13% coupon. This investment was a result of our strategic relationship with Stifel. Shortly after the loan closed on September 30th, we sold the portion of AAR as we brought in a partner on the deal. This is something we had been planning and working on as we negotiated the deal. The positioning is just a function of the timing around the close in funding. We are positioned to add our targets hold to \$20 million in AAR today. Plus our warrant position on top of that. The \$20 million includes the value to the loan and the warrant, just to be clear.

Another new investment to highlight is Endemol. This is another investment made in conjunction with our other strategic partner, Cyrus. We made the investment in September. As we expected when we made the investment, Endemol subsequently announced a joint venture that merges the company with Core Media and Shine. This creates a 50-50 partnership with 21st Century, Fox, and Apollo. It expands the company's global footprint, operations, and creative content. Fox is expected to

be very active in their 50% partnership for this company. In addition to our primary investment we've purchased additional loans in the secondary after quarter end.

I'd also like to address some broader market issues that have occurred more recently. October was a volatile month for the capital markets. While middle market lending is largely insulated from volatility and equities, treasuries, and commodity markets, it is not immune from broad shifts in sentiment and widespread repricing of this risk. This syndicated loan market saw a notable sell-off particularly attributable to technical factors and partially attributable to broader capital market trends. From a technical standpoint there was substantial supply of broadly syndicated loans while loan mutual funds saw outflows of almost \$4 billion and CLO issuance lagged in September and October. Simply put, supply outpaced demand.

This unbalanced supply trend began in earnest in September. Loan bond and equity markets were correlated, trading down mid-month, although I'd note that the fixed income markets have not rebounded as strong as the equity markets from their lows in mid-October. As long term investors with stable capital base we have the ability to remain patient and disciplined in the phase of this volatility around a very well-invested portfolio. The oil and gas sector has been a particular focus. It remains our most significant industry exposure at approximately 25% of our portfolio, between oil and gas producers and oilfield services. It's also a segment of the fund where we have most aggressively reduced exposure in August and September. Almost two-thirds of the \$30 million proceeds realized during the quarter were sales, active reductions. Of that 20 million over three quarters were in oil and gas specifically E&P companies.

Our E&P exposure declined from 16% of the portfolio as of June 30th to 10% as of September 30th, and we continue to be comfortable with our three investments in that sector. We've done substantial work analyzing breakeven prices for the borrowers. We have examined the borrowers' hedging programs, our asset coverage, and are comfortable despite the headlines that you've seen about WTI. For our oilfield service investments, we are focused on the basins in which they operate, the nature of the services provided, and the structural protections in our loans. We think we have an attractive combination of cash flow sweeps, amortization, maintenance covenants, and appropriate attachment points. All of

our oilfield service companies are levered well below four times. Our oilfield service exposure increased from 3% of the portfolio to 15% during the quarter.

Away from oil and gas, it was announced that New Mountain Capital would be acquiring Healthport, which has been a portfolio company of ours since last October. We currently own 12 million of the second lien term loan. Our expectation is that this loan will be repaid on December 1st. Assuming December 1st, this gives us an expected IRR of 11.8% on HealthPort. One other portfolio company to note, Virgin America has filed their S-1. We own both loans and warrants. In the S-1, Virgin disclosed the debt providers will have the opportunity to receive approximately 20% cash on the face value and may convert their remaining debt and warrant exposure into shares of Virgin America. The IPO price is expected to be a 17% premium to our debt conversion price.

We continue to be pleased with our pipeline. All of these perspective deals have attractive yields and we believe we will have substantial influence over final terms of these investments. On our last call I mentioned three deals we expected to close around our September 30th quarter-end. One of these was AAR, which I spoke about a moment ago. One of these was a \$15 million second lien to Bird Electric Enterprises which closed in October. The other remains in our pipeline with a targeted close this quarter. In addition, we have made additional investments in three existing portfolio companies: JAC Products, New Standard Energy, and Endemol which will you'll see listed in our 10Q as "AP NMT acquisition," not Endemol, if you're trying to connect the dots there. Our portfolio today stands at \$306 million. As our portfolio has grown, we've re-doubled our focus on quality origination and expect to continue to rotate the portfolio out of some more liquid positions as we close on club and bilateral deals. We will focus on more liquid sub and 10% investments which there are several in our portfolio. This process accelerated in our fiscal first quarter, and we expect to continue to actively manage the portfolio, favoring the better loan structures and covenants we see in true middle market lending over the liquidity that often comes with broadly syndicated loans.

During our first quarter, our mix of first and second lien investments remained stable. We held 48% first lien, and 51% second lien, with the remainder in warrants. In previous quarters, we categorized our secured bond investments as "senior secured notes." We still have the same investments, CPG and Virgin, but to expand

our public disclosure and provide all of you with better clarity about how we think about those debt positions. We have categorized these debt investments into their first and second lien security positions respectively. I'd like to discuss our portfolio leverage. As I've stated previously, our target is .6 to .7 times leverage overtime. At June 30th, we were .38 times leverage. As of September 30th we are .58 times leverage. We are pleased to announce, as you've seen in the previous 8-K, that we extended in increased our borrowing facilities with UVS.

Our portfolio has grown from \$274 million at the beginning of our fiscal year this July to \$299 million as of September 30th. On an apples-to-apples basis, our weighted average yield on our debt and income producing securities at cost increased from 10.82% as of June 30th to 11.72% as of 11/30. I would note that all of our sales and paydowns during the quarter had yields below the stated portfolio target of 11%. The average yield on our sales and repayments was 9.15%. This was a significant driver in the increased average yield to the portfolio during the quarter. Today, our portfolio is approximately \$306 million and has a weighted average yield of 11.46%. We are pleased with our progress but will strive to improve the yield further in a prudent and disciplined way.

During the quarter, we earned our full base management fee and began earning our incentive fee. This exceeded our expectations on timing and is a testament to the team's effort in originating and executing. Going forward, based upon our current portfolio, we are expecting to fully earn our base management fee and to earn an increased portion of our incentive fees.

Additionally, we continue to work and make progress with our outside counsel, Sutherland, on our application for the SBIC license. It continuous to be a long process but we continue to make progress. Finally, our Board of Directors has declared a fourth calendar quarter dividend of \$.3375 per share payable on January 5th, 2015 to shareholders of record as of December 18th, 2014.

With that I'd like to turn the call back to Jai to review our results for the first three months of the fiscal year. Jai?

Speaker: Thanks, Mike. Our investment portfolio was \$299 million on a fair value basis as of September 30th. That investment income for the quarter was 4.6 million or \$.34 per share. As of September 30th, our portfolio included approximately 48% first lien

debt, 51% second lien debt, and 1% in warrants. The weighted average yield at cost on our debt portfolio was 11.72%. Our debt portfolio was comprised of 89% floating rate and 11% fixed rate investments. Our average portfolio company investment was approximately 12 million and our largest portfolio banking investment was 34 million. Additional information regarding the composition of our portfolio is included in our form 10-Q files last night. With respect to our financing facility, we had \$21.5 million borrowed under our \$50-million facility at quarter end. As of today, we have \$13.5 million outstanding under the facility leaving us with \$36.5 million of availability to fund new investments. With that, I'll turn the call back over to Mike.

Speaker: Thanks, Jai. Now we're approaching our target leverage, we expect our portfolio growth to moderate. We will continue to originate new investments, but we expect to see a mix of repayments and sales offsetting those originations. Now that we've reached our target of an 11% unlevered yield on a cost basis, we intend to further refine the mix of investments in the portfolio, increasing that yield as appropriate on a risk reward dynamic. The prudent underwriting of sound capital structure with protection for our capital and your capital will always be a paramount importance to all of us here at CM Finance. Operator, with that, I'd like you to please open the line for Q&A.

Operator: Ladies and gentlemen, at this time we will conduct a question and answer session. If you would like to say the question please press *1 on your phone now and you will be placed into the queue and order received, or press #1 at any time to remove yourself from the queue. Please listen for your name to be announced and be prepared to ask your question when prompted. Once again to ask a question, please press *1 on your phone now. Our first question comes from Robert Dodd from Raymond James, please state your question.

Male: Hi, guys and congratulations. On the oil and gas fund, can you give us any more color in terms of that mix between oil and gas? I mean obviously gas prices haven't done quite what oil has. In general terms, when it comes to your underwriting to those, what's the kind of downside scenario relative scale in terms of where oil and gas prices can go before it would stress the metrics under which you'd underwritten those loans?

Speaker:

Sorry. Thank you, Robert. I appreciate it. Let me just hit that in a couple of ways. Number one is on the oil and gas, when we talk about E&P producers, there are three in there and that's New Standard, Bennu, and Caelus. Those are all oil. New Standard is in the Eagle Ford basin which tends to be one of the most reliable and lowest cost producers. Bennu is in the gulf and not on-shore, it's offshore, has an extremely low extraction cost. Caelus is North Slope Alaska and very favorable conditions. We have gone back and looked at the coverages that we've got from a proved develop producing and proved non-develop producing perspective. We've gone back and done analysis not only against these regions but these regions plus trying to understand and make sure we fully appreciate the Eagle Ford, the Permian basin, the Marcellus, the Bakken, and D-J basin.

Between all of those, we do cover the areas where our oilfield service producers are also. There are hedges on oil at all of these oil and gas at 50% plus of expected and they've been on place for a while. In the oilfield services side, we've got AAR where we spent a lot of time, directly myself and one of the senior members from the team talking to the key client there. They continue to be committed to development and to AAR as a service provider there. There is a lot of room from where oil and gas are today and that is the D-J basin and its oil. Then US Well, we have spent time reviewing that and that's in the Marcellus. That's principally gas. Their principal customer has hedged a huge portion of the gas. I believe it's at \$4.00-plus, not fitted to today's price of gas, it's even higher, but they have put a high hedge on it. As I said earlier, the services are all well below the four times and I think that both of those are today under three and a half times leverage and that continues from our discussions, we've focused a lot around it over the last two weeks. We continue to maintain a lot of the models that we've got tracking those breakevens and I will tell you that from our experience, and we've spent a lot of time around this and we use third party consultants and industry consultants. You won't get a unified view on where the bottom is, where people start curtailing their exploration. There's no doubt that in the mid-70's, there is some reduction to the E&P growth plans. I think the key thing that we have determined in our discussions, in our analysis is that even at that mid-70's the critical thing is it's curtailment to the growth. It's not decreasing the amount; it's decreasing the growth rate. Our credits were not underwritten assuming that you had to have growth rate to make them perform.

We also have gone back and looked at 65 and 55 as far as oil prices. Again, there's no definitive answer on that but from the three that are producing the oil, they should perform fine especially with the hedges. From the two oilfield service providers, again they should perform fine in this environment and we remain very comfortable with them. I'm not sure since you had a couple of questions there if I had all pieces, so if I didn't, please tell me what I missed.

Male: You covered all the bits I needed on that. Thank you. Just one housekeeping one, if I can, on the capital gains incentive fee. Given the net unrealized and realized [\[Unintelligible\]](#) were relatively modest, can you explain - obviously it was waived so it didn't actually affect it on the spot. Can you explain where that came from even the low net realized, unrealized gains?

Speaker: Sure, this is more of a gap concept than a contractual capital gains fee. Contractually we pay capital gains, incentive fee on gains that have been realized, offset by unrealized losses only. From a gap perspective, we get the benefit of unrealized gains and therefore we have to accrue incentive fees on gains including unrealized gains. Therefore, the gap incentive fee is higher but since it's a way of pursuing to our contract, we just had to present it on a growth basis.

Male: [\[Crosstalk\]](#) the unrealized gains were...

Speaker: Robert, let me give you numbers okay, because that may help you.

Male: Okay.

Speaker: The realized gain amount, and this includes from a pre-9/30 quarter of about 85,000 and about 370,000 realized in the 9/30, there's about 450,000 of realized gains. There is unrealized appreciation as of quarter end of approximately 1.7 million and there is unrealized depreciation of about 1.4. The net of all of that is \$690,000.00 between the realized gains, unrealized appreciation and unrealized depreciation. Then the gap treatment requires us to take our 20% incentive fee against that and record it even though we would not get paid that tomorrow. It'd all have to be realized and crystallized as it is on that date for us to see it and not calculating it but there's...

Male: [Laughter] I think I understand now. I hope [\[Unintelligible\]](#). Thanks guys.

Speaker: Okay.

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

Male: Great, thank you. First on the American General loan, last quarter is marked at \$.90 on the dollar. Looks like it got paid down from \$14 million to \$10 million there. Can you talk about that one a little bit since it's marked down a bit would seem to be showing a little bit of stress with the repayment this quarter maybe that improved?

Speaker: There's two things. From a marked perspective - I'm sorry, let me talk to the decrease first. The decrease is because we did actively bring down a piece of that and we sold that at an actual price of 93. The mark today I believe is 92 opposed to the 90 before. It's been in this 92, 93 range. Do I think we could lighten up more? Probably could without a problem. During the last year, I think we've discussed this credit in the past but let me just refresh for any new people on the line. The cost basis for the VDC where the loan came in was at 88. During the year, they continue to perform well around their spare parts and replacement business which was the underpinning basis for the underwriting we did.

We did have in there that we expected some small amount of non-US military sales to happen. They had been curtailed for a while. That's a little bit of background on why we lightened up. It was curtailed probably a little longer than we would have liked. We did see that to begin to ramp up over the summer and has continued to increase production. So on top of the sales business, the Humvee business - for those of you don't know, in general they do make the Humvee which is the military vehicle not the one that you would see driving down the street. The alternate sales are to foreign governments for border patrol, military, and other uses of that kind. They are not for commercial use; this is not a commercial vehicle. So it has continued to perform, it has started to rebound in its production, and the spare parts in logistics which really services about an installed base of 10,000 vehicles for the US military continues to perform. That's a little background on why it came down, where our sale was, and where we've got it marked.

Male: I appreciate that. Then the Healthport deal that should exceed in the fourth quarter, is there going to be any pre-payment penalties associated with that?

Speaker: Yes, that is at 101 I believe - I got to double check it because I did see something from someone else talking about 102 but I think it's a 101.

Male: Okay. On Virgin Atlantic, so you get to convert essentially 75% of your debt into stock and the IPO price is at 17% premium to that. So should we - that math take the 11.4 million of debt, you convert 8.6 million of it into equity and you get a 17% gain as it stands right now, so like a \$1.5 million gain? Is that the math or is there some other [\[Crosstalk\]](#) there?

Speaker: You're directionally right and so because they have not set every last decimal, we said approximately 20%. We worked our math so it's something probably between 75% and 80%. I'd say it's closer to 80 than 75, but it's below 80%, converts at that rate that you just said so it's probably if you're using the 75 to calculate the gain, that gain would be a little bit too high but within a rounding error. The second piece is that the warrants that we've got will convert and I'm going to kind of shorthanded because the \$2.50 warrants will receive their intrinsic value of a dollar. The \$3.50 warrants will be exchanged for \$2.50 warrants and will receive the new intrinsic value of a dollar. The aggregate value of those warrants will be converted at the IPO price, not at a discount to it. We'll receive stock at the IPO price. Our stock position will be subject to, assuming this goes through, a six-month lock up.

Male: All right. Looking at the debt that's essentially held at par, this is not currently in the fair value of your book at it stands at quarter end, correct?

Speaker: It should be in the fair value of our book.

Speaker: It's at par. It's very [\[at par\]](#).

Speaker: Yes, but that's what we had as the fair value as of 9/30 was the par value. I'm not sure if I'm answering the question.

Male: The potential gain from converting the debt though...

Speaker: [\[Crosstalk\]](#) fair value.

Male: Got it, okay.

Speaker: Okay.

Male: One last question on just timing of new deals in the quarter, it sounded like you talked about one or maybe two of them happen late in the quarter. Can you just walk us through the timing and the quarter of when the new investments hit?

Speaker: Sure. You're talking about in the 9/30 quarter, correct?

Male: Correct, AAR, JAC, and Endemol.

Speaker: Okay. So JAC closed on September 26th. Endemol closed on August 14th. The AAR and the TNT Crane add-on which was a small one 1.1 million closed on September 30th. That accounts for all the new adds.

Male: All right, great. So very little income from AAR, JAC, this quarter?

Speaker: Correct, that was all variant last week or last day.

Male: Okay. Great. Thanks, guys. I appreciate it.

Speaker: Thank you.

Speaker: Once again ladies and gentlemen, if you would like to ask a question please press *1 on your phone now. Gentlemen, at this time, I have no further questions.

Speaker: Thank you, Operator, and we'd like to thank everyone for joining us today and we look forward to speaking again next quarter.

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

- End of Recording -