Conference Call
Earnings Release Call First Fiscal Quarter
Ended September 30th 2015
CMFinance
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Operator: Welcome to the Earnings Release call of Fiscal Quarter ended September 30th, 2015 Conference. Your hosts for today's call are Mike Mauer and Jai Agarwal, and Chris Jansen. Operator's assistance is available anytime during this conference by pressing star (*) and 0. A question-answer session will follow the presentation. I'll now turnover the call over to your speaker. Please begin.

Mike Mauer: Thank you, operator. Hello, everyone, and thank you for joining us today. With me today are Chris Jansen, my co-chief investment officer and Jai Agarwal, our CFO. Before we begin, Jai will first discuss some general information and comment on 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 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 in our press release regarding forward-looking information. Today's conference call may 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, Michael Mauer.

Mike Mauer: Thank you, Jai. On our last call in September, I mentioned that we believe the markets have become very aggressive. Between weakening documentation, which governs structural protections for lenders, and increasing leverage multiples, which speak broadly to the risk lenders were willing to take, we believe this environment is a very difficult one to navigate successfully. While we've seen some stabilization in the broader market, terms in most syndicated loans remain unattractive in our view.

Within the universe of middle market borrowers we see more opportunity. The capital market's process for smaller borrowers is fundamentally different, and the more highly-negotiated, slower-moving process generally works to our advantage. We have walked away from several transactions after full due diligence where we felt that yield or structure were insufficient. That said, because we found the club deals have better terms for investors, we remained very encouraged by our pipeline, and very pleased with our investments during the quarter and after quarter end.

With that background, we have looked at 67 deals that we had passed on since June 30th. We have invested in four new portfolio companies during that same period of time. For most of calendar 2015, we have been focused on portfolio rotation taking advantage of liquidity and repayments to fund the purchase of new investments. We take a lot of pride in our disciplined approach, and we're very pleased with our portfolio company investments today.

During the quarter ended September 30th, we added one syndicated second lien loan LanguageLine Solutions and one club deal, a first lien loan to Land Holdings. During the same period, we exited our investments in Nathan's and Crestwood and received repayments from BBG, Telular and New Standard. As of September 30th, we had 23 portfolio companies.

I'd like to turn the call over to Chris to discuss our investments and our exits as well as our activity since last quarter end.

Chris Jansen: Thanks, Mike. As we discussed on our conference call in September we had several full repayments during our fiscal first quarter. Our loan to BBG repaid in July at a premium of 105 and our realized IRR was approximately 22.5%. Our second lien loan to Telular also repaid in early July at a premium of 101. Our realized IRR in

Telular was 12.4%. New Standard Energy also repaid our first lien loan at par. Our realized IRR including our royalty was approximately 15.8%.

We also sold two of our positions in July. The first was Crestwood, a pipeline company. Our realized IRR was 5.1%. Subsequent to our sale, secondary market levels for Crestwood have declined significantly so we're very pleased about the timing of our sale. We also sold Nathan's Famous, which was our smallest investment at that time. We sold at 106 ¾ for realized IRR of 31.3%. Including our additional investments in existing portfolio companies, our average yield at cost on new investments during the quarter was 11.6%. Our sales, paydowns and repayments were at an average yield of 10.6%.

We made two new portfolio company investments during the quarter. The first is LanguageLine Solutions second lien term loan. LanguageLine is the largest provider of over-the-phone language interpretation services, a business which is driven by legal requirements to provide services to non-English speakers. When compared with other syndicated loans we have seen over the last few months, LanguageLine has relatively lower leverage, stronger covenants and better documentation as well as better return. Our invested yield approximately 11% at cost.

Our second new portfolio company investment is Land Holdings. This is a project finance loan to build the Scarlet Pearl Casino in Biloxi, Mississippi, and it is slated to open this year. The construction risk to the project was reduced significantly by the time we made our purchase. Total debt represents less than 40% of the total cost of the project. Our investment is a first lien loan that yields 12% at our cost.

Since September 30th, we made one new investment and exited one of our existing investments. We sold our second lien loan to Physiotherapy Associates. At $5 million, this was the smallest position in our portfolio at that time, and it yielded a little less than 10%, which is below our average yield for second lien investments. Our realized IRR was 9.5%.

Our new investment since September 30th is $10 million of the first lien loan of NWN Corporation. Our loan, which is a club deal, backs a sponsor acquisition of the company by New State Capital Partners. We also made a small equity co-investment of approximately of $150,000.00 alongside our lending partners and the sponsor.

Now, I'd like to turn the call back over to Mike.

Mike Mauer: Thank you, Chris. One just correction, it's three new investments since June 30th not four. I just want to clarify that.

Today, we have 23 portfolio companies. We expect to maintain or increase that number. From the sector standpoint, we continue to diversify our portfolio. Gaming is our largest industry at approximately 16.5% of the portfolio. I'd like to note that that is entirely first lien. Our second largest sector weighting was healthcare at a little over 13% followed by telecommunications, which is also just over 13%. Energy represented 12.8% of the portfolio.

All these statistics are as of September 30th. In light of our sale of Physiotherapy after quarter end, healthcare today is our fourth largest sector at about 12%. As of our fiscal year end, June 30th, the fair value of the portfolio was $330 million. As of September 30th, the fair value of our portfolio was $321 million. About half of that decline is attributable to marks for the portfolio and about half is due to our net investment activity during the quarter.

We continue to maintain a balance of first and second lien investments with approximately 48% first lien, 48.5% second lien. We have 3.4% of the portfolio in an unsecured investment with the remainder in equity or warrants. As of June 30th, we were 0.71 times levered. As of September 30th, we were 0.75 times levered. We currently target leverage of 0.7 times, plus or minus 5% to 10% on a net basis.

The weighted average yield of our debt and income-producing securities at cost increased from 10.91% as of June 30th to 11.02% as of September 30th. This improvement was driven largely by our investment in Land Holdings which yields slightly north of 12% at our cost, as well as our sales and repayments which averaged a 10.6% yield at cost. Our exits from Telular, Crestwood and Nathan's all yielded 10% or less.

Since it's been an eventful quarter, I'd like to walk through a bridge of our net asset value from June 30th to September 30th. As of June 30th, our NAV was $14.41. Since that date, we paid a special dividend for $0.43 and our regular dividend for 34.69 cents per share was paid on September 18th. We had net investment income of 35.6 cents during the quarter and finally our marks accounted for 34.4 cents of NAV decline or $4.7 million dollars of net realized and unrealized gains and losses. That takes us to our NAV of 13.65 as of September 30th.

Two of our marks were credit-related due to weaker performance than expected. These were AAR and Bird Electric. AAR is a Colorado-based oil field services company. As drilling activities slowed in the DJ basin where AAR operates, EBITDA began to decline. AAR breached its covenants in the quarter. We and other lenders are in the process of amending both the financial covenants and the amortization schedule for the loan to better align with the current forecast for AAR's financial performance in this environment.

Bird Electric is based in Texas and provides utility services both to the oil and gas and regulated utility industries. Much like AAR, as drilling activity in Texas slowed Bird's results declined; although the decline was more modest. We amended our loan in October, modifying the covenants and increasing the interest rate. In the aggregate, our marks on AAR and Bird accounted for $1.4 million or $0.11 of our NAV decline.

The balance of our marks, $3.2 million or $0.24 per share, were due to the broader market volatility. In particular AM General, Caelus, Endemol, and Trident were marked down by an aggregate of $3.1 million. The balance is attributable to small marks both up and down as well as the effect of sales and repayments versus our marks as of June 30th.

During the September quarter, we earned our full base and incentive management fees for the second consecutive quarter. Based upon our current portfolio, we expect to continue to fully earn our base management fee, and we will earn a significant portion of our incentive fee during our second fiscal quarter, which ends December 31st. We continue to have an active dialogue with the SBA regarding our application for an SBIC license. We have submitted an updated application and are awaiting SBA review and comments.

Finally, on November 3rd, our Board of Directors declared a distribution for the quarter ended December 31st, 2015, of 34.69 cents per share payable on January 5th, 2016, to shareholders of record as of December 18th, 2015.

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 $4.9 million or 35.6 cents per share. Our aggregate net realized and unrealized losses were $4.7 million or 34.4 cents per share. The weighted average yield, at cost, on our debt portfolio was 11.02%. Our debt portfolio was comprised of 82% floating and 18% fixed-rate investments. Our 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 have $49 million borrowed at quarter end and $48 million as of today. We have $2 million available under this facility and over $10 million in cash today. Our investment portfolio today is approximately $326 million with a weighted average yield, at cost, of approximately 11.1%. With that, I'll turn the call back over to Mike.

Mike Mauer: Thanks, Jai. Our underwriting is focused on the quality of the management team, capital structure, our security, and covenants for the protection and preservation of capital. Over 96% of our investments are senior secured. We have no loans that are on nonaccrual. We will continue to actively manage the portfolio to find the best investment opportunities for our shareholders.

We are monitoring a number of companies currently trading in the secondary and our pipeline of transactions to examine remains robust. Now that we have reached our target leverage, our portfolio growth has moderated but we expect to continue to make new investments in directly originated and club deals as we identify those opportunities. With that operator, please open the line for Q and 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 in the queue in the order received or you may press #1 anytime 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, press *1 on your phones now. Our first question comes from Robert Dodd from Raymond James. Please state your question.

Robert Dodd: Hi guys. Just going to AAR, obviously you have a bit of a credit markdown. You underwrote that late last year after the oil prices had taken a pretty substantial step down. Can you give us any color on what changed between the underwriting framework to the environment now that led to it obviously violating a covenant?

Mike Mauer: Yes, thank you Robert. Maybe what I'll do is I'll answer that and then maybe give a little bit more broader discussion around the energy investments. We underwrote that really over the summer and it closed on September 30th I believe, in the last day of the quarter we actually funded that. The underwriting process, we were underwriting in a, I'll say, low to mid 30s EBITDA.

When we actually closed, there was still huge momentum on the positive side from drilling activity and a need for oil field service in the DJ so it ended up significantly north of 34. From a standpoint of momentum, the activity in the basin really did not slow significantly, until late in the year probably an understatement, going into 2015 is where it started to subside.

During the last three to four months, we have worked extensively with the company including bringing in a new CEO. What we've seen over the last four to five months is the deterioration really from March through June, July bottoming out in the July-August timeframe, and then from the September-October and over the last week or so, we've actually seen stability and a little bit of a rebound not only in the activity because you've had fallout from some of the smaller players falling away.

They've given up trying to stay around by undercutting price so we've had a little bit - I wouldn't say it's significant but a little bit of success with the company and seeing an ability to increase their pricing a little. You've seen a mini cycle happening where the [inaudible] and coming off hopefully. They're very stable. They've got great relationships with their largest client which has always been Noble. Anadarko is the one that has been increasing. What I'd like to do is just maybe a little overview of the energy sector off of that backdrop.

We've got three investments in energy sector representing 12.8% of the portfolio as of September 30th. AAR which we just spoke about, U.S. Well and Caelus. U.S Well provides hydraulic tracking services to E&P operators in the Marcellus and Utica Shale during the completion phase of drilling a new well. Specifically U.S. Well's largest customer is Antero Resources.

Antero's commodity hedge is a significant multi-year program of their production. Those hedges have allowed them to be more active than many of their competitors despite the decline in gas prices which has helped the U.S. Well.

U.S. Well's result have been good and we're not concerned about that credit. AAR, I just talked about. I did not mention earlier that the amortization was actually significant during the quarter. About 835,000 amortized down about 4.5% of our loan balance amortized down at par.

AAR's largest customer Noble, we discussed and they have discussed publicly that they are focused on the DJ basin which is the heart of AAR's activity. They've also recently increased their activity with Anadarko. We're disappointed that their performance hasn't lived up to expectations. Given the move in oil prices, we have adjusted our expectations and we've marked down our positions by five points due to the fundamental underperformance.

Caelus Energy is the last of our three energy investments, focused on operations in the North Slope of Alaska. Apollo and Management teamed up to acquire the Alaskan operations of Pioneer Energy in 2014, early 2014. Obviously the price of oil declined significantly from the time of their investment.

Caelus' fundamental performance has been outstanding due both to excellent well results as well as a substantial hedging program that was in place. Caelus' leverage is modest and its most recent reserve report that we received in the last 60 days shows substantial asset coverage. We marked down the position in light of the broader markets where spreads have widened for all E&P companies regardless of their fundamentals.

When we looked at our energy exposure as of June 30th to September 30th, we've reduced our exposure from 18.2% of the portfolio to 12.8%. We sold our position in Crestwood and Chris talked about the timing of that earlier. We actively managed our portfolio, and we worked with New Standard over several quarters, which culminated in the full repayment of our loan in August.

These two realizations are responsible for the bulk of our reduction in energy. Our marks during the quarter on AAR and Caelus were about $2.1 million down. Our realizations plus the AAR amortization were $17.6 million. Hopefully that sheds a little more light on our energy portfolio and the thought process on our investments here and how we've been managing that exposure.

Robert Dodd: It does, very, very helpful comment. One more question. You mentioned you're looking at some more opportunities in the secondary market to buy some discounted positions. Obviously you talked earlier about the - liking to control a structure in the middle market [inaudible] you're buying if you're considering opportunities in the secondary market which probably have weaker covenant packages or docs prepared by somebody else. What's the thought process balance between being willing to take maybe a weaker package but the price that you're willing to do that at?

Mike Mauer: Let me use an actual investment as a little bit of how we think about Nexeo. Nexeo is something we bought earlier in the year and to your point, the structure is set, we don't have influence over it. When we analyze it structurally, you've got, in our view, 24 to 36 months left before it has to be refinanced, 100% vote, it's got maturities coming up on tranches senior to us.

They can't be refinanced without us being refinanced. If for some reason, somebody found a way to do that, that's our two to three year timeframe. You've got a significant equity sponsor, TPG. Their recent comps for the business that shows that equity the TPG has in it is still in the $400 million range junior to us.

When we look at that structural maturity, all set by our ability not to have input into the document, and substantial equity under us, at a 14% investment on the initial investments we went in on, it was very, very compelling.

That was several months ago and the last month, there has been a press release that I don't know where it came from, I can't remember if it was the sponsor or the company, but they have hired bankers to review sale and IPO alternatives for the company. That thesis continues to play out and to the extent that that happens over the next 12 to 18 months, that 14% is going to be a high teens to 20% return.

Robert Dodd: Thank you, really good color.

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

Greg Mason: Great. Good afternoon guys. I appreciate the color you've given on the last couple of questions. I think a lot of your commentary on AAR answers this question but I just want to ask it directly. With reworking the loans, is there any risk of AAR missing a payment here in the foreseeable future?

Mike Mauer: As I said earlier, we are in the throes of negotiating the amendment and restructuring. I would expect that within a week or two, we'll have that done. They will be current on all of their interest. Amortization schedule will be reset on that as a result of the amendment that is not finalized. Our view is that they've got adequate cash liquidity based upon the current environment for the next at least 12 and probably 24 months. From our standpoint, that's the critical time around this sector.

Greg Mason: Great, I appreciate that. Then just one other question as we look at your balance sheet, with the high-end of you targeted leverage range and I think you've already done a lot of the portfolio optimization, of getting rid of some of the low-yielding credits. Just as you look at the business today and going forward, can you talk about your capital management, your needs for additional capital, how you keep the team occupied and active in the market and just other plans that you may have inside our even outside for capital availability for you and your team.

Mike Mauer: That's a great question. I appreciate it Greg. First of all, within the portfolio there continues to be a few names that have some liquidity around the names like YRC. We also have LightSquared which is a lot of public information out there. They expect to be taking that out. It actually matures at the end of the year. We love that loan. It's a great first lien loan but we're pretty sure we're getting 10 million in cash back from that so there's a few places that create some known liquidity to us and there's always unknown repayments that come.

On top of that, we have no intention to go out and issue below NAV, so I just want to state that publicly. We continue to look at what opportunities are out there. We are entertaining some people who have approached us about potentially managing private capital on the side.

With the portfolio in the 300 to 350 range, the team continues to be very active looking at opportunities in the event that we have the LightSquared cash or we want to monetize YRC or something else because it's accretive to shareholders. At the same time, we will consider other ways to increase some capital on your management that would not deter or detract from our attention to the BDC.

Greg Mason: Great guys, appreciate it. Thank you for your commentary.

Mike Mauer: Thank you.

Operator: Once again, if you would like to have a question, please press *1 on your phones now. At this time, we have no further questions.

Mike Mauer: Thank you operator. I'd like to thank everyone again and we look forward to speaking with you in February on our next call.

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

- End of Recording -