CM Finance, Inc.
Earnings Call Third Fiscal Quarter Ended March 31st 2016
Conference Call
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Operator: Welcome to the Earnings Call Third Fiscal Quarter Ended March 31st, 2016 Conference. Your hosts for today's call are Mike Mauer, Jai Agarwal, and Chris Jansen.

Operator assistance is available at any time during this conference by pressing *0. A question-and-answer session will follow the presentation.

I'll now turn the call over to your speakers. Please begin.

Michael Mauer, Chairman and CEO: Thank you, Operator. Thank you all 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 give our standard disclaimer regarding information and forward-looking statements. Jai?

Jai Agarwal, CFO: Thanks, Mike. I would 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, Mike Mauer.

Michael Mauer: Thank you, Jai. I'd like to take this opportunity to thank Jai for his contributions to the firm. As we have announced, Jai will be leaving us shortly to pursue another opportunity. Jai will be returning to the real estate industry where he has significant historical experience.

We have extended an employment offer to Rocco DelGuercio, a highly qualified candidate, to become our next CFO, who comes to us with a wealth of closed-end fund and BDC experience, as outlined in our 8-K filing yesterday. He has accepted, and we look forward to introducing Rocco to all of you on our next call in September, for our June 30th fiscal year-end.

As with our prior calls, I will begin with the discussion of the leveraged finance 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 of the key metrics in our portfolio and fair value marks.

Volatility continues to be the theme in the fixed income markets after a period of increased volatility during the first quarter. While spreads initially widened in the first quarter, on balance, spreads have tightened marginally since the beginning of the year across the broadly syndicated market, the high-yield market, and our focus, the middle market.

Middle market investments have been able to maintain better spreads and terms than the broadly syndicated markets. Very few new issue deals could clear the market in late 2015, and the tightening effect we have seen over the past few weeks is in some ways just simply a return to a functioning market where new issue is an option for borrowers and investors. Overall, volumes have been less than 50 percent over the same period last year.

Supply and demand remain somewhat imbalanced, especially for the more storied credits. We have been and continue to be very selective and cautious, but, broadly speaking, the environment remains investor-friendly with structures and terms favorable to capital providers like us.

I'd now like to turn the call to Chris to discuss investment activity.

Christopher Jansen, Co-CIO, President and Secretary: Thanks, Mike. We did not make any new portfolio investments during the quarter and, during the quarter, we had one investment realization.

Our position in Nexeo Solutions' notes was our only unsecured investment, and we made that investment in April of last year. The yield to maturity on our notes at the time of purchase was over 13 percent. Our realized IRR on this investment was 17 percent. We're very pleased with our returns here.

Since quarter end, we have made one new investment, received one repayment, and have seen news that one additional portfolio investment is likely to repay.

Our new investment is in the first-lien loan of Premiere Global Services, or PGI. PGI is a leading global provider of conferencing and collaboration solutions. Our loan helps back the acquisition of the company by Siris Capital. Our yield on this investment, at cost, is approximately 10.6 percent.

Our investment in RegionalCare's second-lien term loan was repaid at its 101 call premium. Recall that Apollo purchased the company via a change of control amendment with lenders in December. Apollo merged RegionalCare with Capella Healthcare, and refinanced capital structure in April. Our realized IRR on our RegionalCare investment was 14.4 percent.

Remaining on the theme of Apollo and mergers, it was announced that Apollo would be acquiring both AmQuip Crane Rental and Maxim Crane, and merging these two companies. We are invested in the second-lien loan of Maxim Crane and, with its maturity in 2018, we expect to see the new sponsor refinance the capital structure rather than trying to secure change of control amendment as they did with RegionalCare. We do not yet have an expected repayment date for our Maxim position.

Over time, we will seek to increase our number of portfolio companies from the 21 we held at quarter-end; as we do, we will continue to focus on diversifying our portfolio. At March 31st, our largest industry concentration was in gaming at 19.2 percent of the portfolio at fair value; this is up from 18.1 percent last quarter and is a result of loan paydowns and changes in our marks.

Our second-largest sector was healthcare at 13.7 percent, followed by energy at 11.6 percent and telecommunications at 10.9 percent. With the repayment of RegionalCare, our concentration in healthcare declines to 7.8 percent of the portfolio while our other weightings increase slightly.

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

Michael Mauer: Thanks, Chris. As of March 31st, we were 0.83 times levered, essentially unchanged from our leverage at 12/31. We continue to maintain a balance of first- and second-lien investments with 51.4 percent of the portfolio in first-lien investments and 48.6 in second-lien. We do not currently have any unsecured investments.

The weighted average yield on our debt investments, at cost, decreased to 9.73 percent from 10.31 as of December 31st. While Nexeo's coupon was 8 $^{3}/_{8}$ (8.375), our yield, at cost, was approximately 13 percent, and our exit from that investment was a major driver of the decrease in our average yield across the portfolio of this quarter.

The other significant driver was the decision to move AAR from partial non-accrual to full non-accrual. As of March 31st, the fair value of the portfolio was $276.5 million. At

December 31st, the fair value of the portfolio was $293 million. Our investment activity -- including sales, paydowns, and repayments -- accounts for $14.3 million of the fair-value decrease. The remainder is due to net changes in our marks.

With one exception, credit in our portfolio was not a major factor in changes in our fair value this quarter. I have spoken at length about AAR in prior calls. We continue to work through the restructuring process, both on their balance sheet as well as operationally. We received a partial repayment, at par, about 7 percent of our principal, during this quarter. We moved to the remaining position to full non-accrual, and we reduced our fair-value mark on the balance of the position from 65 to 55.

Our other non-accrual loan is Bird Electric. Bird remains in default, and we continue to work closely with other lenders, the company, and the sponsor.

These two loans represent 6.1 percent of our portfolio at fair value and approximately 10 percent at our amortized cost. These two investments continue to be developing situations, and we are having constructive dialogue with all the stakeholders involved. Both continue to be very well-positioned providers within their respective basins, with their key customers, but, obviously, the oil-price environment continues to be a challenge.

Regarding our other investments in the energy space, Caelus and U.S. Well Services continue to perform well. Caelus's commodity hedges in 2016 and 2017 are substantial, and were struck at a much higher oil price than the current spot. We think they are a best-in-class management team, and we're comfortable with the leveraged profile and our collateral coverage.

We have been pleased with U.S. Well's results of operations through a very difficult pricing environment. They have great customer relationships, and we think their Clean Fleet technology is a real competitive differentiator. Our mark was unchanged on both these positions this quarter.

As you know, we agreed to waive our incentive fee through 2016 to the extent necessary for NII to cover the dividend. We also have a three-year high-water mark. The high-water mark was triggered during our prior quarter. We did not earn any incentive fee in this quarter due to the high-water mark, and we do not expect to earn incentive fees in the current quarter ending June.

On April 28th, our Board of Directors declared a distribution for the quarter ended June 30th, 2016 of 35.16 cents per share, payable on [June 7th] to shareholders of record on June 17th. This dividend level represents a $9^3/_8$ (9.375) yield on our IPO price of $15 and a 16.2-percent yield based upon yesterday's closing price of $8.65.

And I'd like to just correct one thing I said. The dividend is payable on July 7th, just to correct what I had said.

After receiving comments on our SBIC License application with the SBA, we will not be proceeding with that process at this time. While disappointed, this outcome does not have an effect on our operations or plans for the future.

With that, I would like to turn the call back to Jai to review our results for the quarter.

Jai Agarwal: Thank you, Mike. Our net investment income for the quarter was $4.3 million, or 31 cents per share. Our aggregate net realized and unrealized losses were $2.4 million, 17 cents per share. The weighted average yield, at cost, on our debt portfolio was 9.73 percent.

Our debt portfolio was comprised of 88-percent floating rate and 12-percent fixed-rate investments. Our average portfolio company investment was approximately $13 million, and our largest portfolio company investment was $29 million. Further 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 $40 million outstanding at quarter-end, and $31 million as of today.

And, with that, I'll turn the call back over to Mike.

Michael Mauer: Thank you, Jai. Our overall portfolio continues to perform well. Volatility in the credit markets is always a challenge, but, with that challenge, we see opportunities to invest in dislocated credits, in hung underwriting positions, and, potentially, in companies going through restructuring.

We continue to have a great dialogue with our origination sources. We think that syndicated credit market volatility will continue. And, although there are some signs of stability, there are also significant signs of stress.

We will remain focused on the quality of the management teams, capital structures, our security and covenants for the protection and preservation of capital over the long-term. We continue to believe that being patient and conservative is the right approach, especially in this environment.

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 ask a question, please press *1 on your phone now, and you'll be place into the queue in the order received. 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.

Robert Dodd, Raymond James: Hi, guys. Some housekeeping ones first, if I can. On Regional, you said about the repayment, it repaid at 101 which is 170 in prepaid fee, and then the amortized cost is about 150 below par. So about 150 in accelerated amortization, as well, that we'd expect in the second quarter?

Jai Agarwal: That's right.

Robert Dodd, Raymond James: OK, got it. Just onto Maxim Crane, I mean, maturity 2018, presuming it repays -- which it's not guaranteed, I realize – would there be a prepayment premium associated with that, as well?

Michael Mauer: I do not think there is one, but it depends on timing. But I'll take a look, Robert. I think that one has come down to par.

Robert Dodd, Raymond James: OK, got it. Thank you. On the overall supply-demand dynamic, if I can, I mean, from your opening comments, Mike, I mean, volume's down, you know, roughly speaking, 50 percent from this time last year. There's a lot of capital out there, but then the comment you made that terms were still favorable to capital providers, can you reconcile that a little bit for us? It would seem that, if there's not a supply and there's a ton of demand, the terms would be discontinuing. You know, they deteriorated last year, but they'd be deteriorating, and that doesn't seem to be what you're seeing, so [inaudible at 00:15:47].

Michael Mauer: Yeah, it's a great point, Robert. I'd say I'd bifurcate the markets a bit here. And we're seeing a little bit of a pick-up in the broadly syndicated market around CLO new issuance, so there's a little bit more bid there. And the vast majority of the fall-off has been around sponsored deals, so they tended to be larger deals. And so those are sort of the general statements.

A lot of the deals, we don't even look at. They're LIBOR plus 350 to 500. They may have some second liens that are covenant lites, and we haven't been doing any covenant lites in the last 12 months; we did some before where we thought there was value and everything else, but we thought it got a bit too aggressive.

When we get away from that, we do think that there are a lot of deals that we will not do. Our pipeline has over a dozen things in it today that we talk about and we look at, and, from our perspective, we have some cash. We have that Maxim Crane; let's assume that there is a repayment coming. We have some capital that we do want to deploy, but we are not in a ramp-up period where we've got to deploy $50- to $75 million, and so we can be very selective.

And I think, when you're in a position where you can be very selective, there are opportunities from an investor standpoint to either drive structural terms in pricing or to be able to force pricing around a structure that maybe preexisted. And a very good example of that is PGI. That has evolved and that was a hung position that banks had funded, that they wanted to distribute. Originally, it had about 40-percent equity; that was increased through a PIK Holdco note to be effectively 50-percent equity. It was originally about an 8-percent yield at a slight discount, and the discount was expanded down to be 10 points to effectively get us to a 10.6-percent yield. And that's a perfect example of the types of things that, selectively, we can go after and help drive our target back up into the mid-10 to 11-percent yield on the incremental.

I do think that the opportunities to invest in the 12-to-14 percent are not as attractive and a lot tougher to find than they were 12 and 24 months ago, and that you'll see us more focused in a risk-return in this 9-to-12 range.

Robert Dodd, Raymond James: Got it, got it. Thank you. I mean, one other investment that stands out on kind of the scheduled investments – Land Holdings…

Michael Mauer: Yes.

Robert Dodd, Raymond James: …where your fair value is higher than amortized cost, which typically happens if you think a prepayment is potential there, as well. I mean, can you give us – you know, have you heard anything on that front and that driving the mark there or…

Michael Mauer: I'm going to ask Chris to address that, but a lot of this comes down to construction work risk operating at a loan to value, so…

Christopher Jansen: Hey, Robert, the facility was completed, as we spoke about, and opened in December – December 9th of last year. Right now, it's a 103 call until June 26th, and then it goes down to 102. Just to refresh your memory, because I think we spoke about this last quarter, the deal, the casino itself is being sponsored by an individual who has greater than 65 percent of the cost of the build invested in equity.

Robert Dodd, Raymond James: Right.

Christopher Jansen: The debt here is well under $100 million, which was probably about 60 percent of what they had originally forecast, because the sponsor had purchased back pieces of debt from other lenders…

Michael Mauer: And retired.

Christopher Jansen: …and retired it. We do expect this to either be – you know, there's a whole, a significant possibility that it's refinanced some time after the call goes to 102; if not, we're quite pleased to hold onto it since it's at 12 percent with a very favorable capital structure.

Michael Mauer: I think it's a great example of where we have continued to, as recently as the last 48 hours, have discussions with Management, Management being the principal owner there. They continue to investment more capital, either through buying back some of the debt where he's been able to buy it back between 99 and 101 from other parties. We're not a seller there. We like the loan-to-value. We like the proposition, and we think that the longer it's out there, the better it is for our shareholders given the risk-return on it.

One correction – I just got a note passed to me – Maxim steps down to 101 in the near future, so it's not par but it's a more probable 101 take out.

Robert Dodd, Raymond James: Got it. Thank you. One last one, if I can. Since the end of the quarter, obviously, I mean, loan markets continue to kind of valley, for lack of the better term. I mean, can you give us any color -- and I know you don't want to do this, but I'm going to ask you anyway…

All: [laughter]

Robert Dodd, Raymond James: …on what there has been or will be in terms of fair value mark, since the end of the quarter, just from mark-to-market perspective?

Michael Mauer: Yeah, you're right. We do not go through and remark fair value on a daily basis, so I don't even want to try to answer that. I think we're very comfortable with the value of the portfolio, but I could not quantify the benefit of that market.

Robert Dodd, Raymond James: Got it. Thank you.

Michael Mauer: Yep.

Operator: Our next question comes from Owen Lau from Oppenheimer. Please state your question.

Owen Lau, Oppenheimer: Hi, thank you for taking my question. My question is related to capital deployment. I may ask the question slightly differently. Maybe, could you please add more color about the timing and which sector you see the opportunity to deploy your remaining capital to earn the 35 cents per share? Thank you.

Michael Mauer: Sure. I think there are two pieces to that, if I can. One is what is the timing until our next new investment and deploying more capital, and there is nothing that is imminent, that we have committed to that we expect to fund in the next 14 days.

We are working in several opportunities. As I said, we've got a reasonably strong pipeline of investments to look at. We ended the quarter at 0.83 times leverage, which was basically flat over the prior. We've had one repayment – RegionalCare – since then, and we have made one investment since then, also, so we haven't fully redeployed but we've partially redeployed that repayment.

As far as the second part of the question around fully earning the dividend, we are focused, really, around being cautious in our approach right now. And while we want to fully earn and cover the dividend, and we will continue to waive our fee -- even with a full recovery on mark-to-market, if we didn't have a high-water, we'd still be waiving to make sure that we maintain that dividend through the end of the year, as we had said we would – we want to be cautious in the way we deploy capital in this market because we have seen volatility come and go. And as Robert had just commented, it feels like we've got some more stability. We'd like to see a little bit more time around that stability as we are looking to deploy, and we would rather be a little under-earning in paying the dividend than deploying capital too fast in the prudent deployment for our shareholders.

Owen Lau, Oppenheimer: OK, that's it for me. Thank you very much.

Michael Mauer: Thank you.

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

Michael Mauer: Thank you, Operator. And, at this time, I'd like to thank everyone else who had called in today. Look forward to speaking to you next quarter.

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

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