Conference Call
CM Finance
November 10, 2016

Operator: Welcome to the CM Finance first quarter earnings release conference call. Your speakers for today's call are Mike Mauer, Chris Jansen and Rocco DelGuercio. Operator assistance is available at any time during this conference by pressing star zero (*0). A question-and-answer session will follow the presentation. I'll now turn the call over to your speakers. Gentlemen, you may begin.

Mike Mauer: Thank you, operator. Thank you all for joining us this afternoon. With me are Chris Jansen, my co-chief investment officer, and Rocco DelGuercio, our CFO. Before we begin, Rocco will first give 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 is for the property of CM Finance Inc. Any unauthorized broadcast of this call in any form is strictly prohibited. Audio replay of this call will be available by using the telephone numbers provided in our press release announcing this call. I'd like to call your attention to the Safe Harbor Disclosure in 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 filings for important factors that may cause actual results to differ materially from projections. We will not update our forward-looking statements unless strictly required - 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 return the call back to our chairman and CEO, Michael Mauer.

Mike Mauer: Thanks, Rocco. As with our call in August, I'll begin today's call with the discussion of the leveraged finance market. I'll turn the call over to Chris to walk through our portfolio activity in the quarter, and then Rocco will speak about our financial results. I will conclude with the discussion of our portfolio.

Leveraged finance new issue volumes continued to increase in the quarter. The tightening spread and more broadly friendly terms we noted on our last quarter, continue to be seen in the most new issue in the loan market. Almost three quarters of first lien issuance in the primary market is covenant lite. The preponderance of new issues syndicated second in loans today are highly leveraged, covenant lite, long dated, with weak inter-creditor protection. Leveraged multiples in the broadly syndicated market and the upper middle market have continued to creep up and unfortunately, deal terms continue to have an issuer-friendly bias. All in all, it's a very challenging time to find opportunities with terms and structures attractive to us in the leveraged loan market and the middle market. Fortunately, we have the ability to be extremely selective in choosing our new investments and we continue to pass on a number of deals due to pricing, aggressive capital structure, or weak protections for the lenders. I'd now like to turn the call over to Chris to discuss our investment activity.

Chris Jansen: Thanks, Mike. We made five investments during the quarter, including adding to our positions in two existing portfolio companies and three investments in new portfolio companies. We had three realizations which included one of our three new portfolio company investments. While I spoke about a few of our new investments and realizations on the last call in August, I will run through all of our new investment activity for you now.

We added to our position in the first lien loan, a Premier Global Services, or PGi, as well as our position in School Specialty's first lien loan. Our initial investments in both PGi and School Specialty were both made in our fourth fiscal quarter which ended on June 30th. These were our two additions to investments in existing portfolio companies during the quarter.

As I spoke about on our August call, our second lien loan to Maxim Crane was repaid at its 101 call premium. Maxim was acquired by Apollo and merged with AmQuip Crane. Our realized IRR on the Maxim investment was 11.1%. We invested in the merged company, renamed Cloud Crane. We received a very small allocation of the second lien notes and chose to sell the position at a small gain rather than purchasing more at a premium to the new issue price. There was no IRR to report as we held it for a short period of time. Cloud was one of our three new investments and Maxim and Cloud Crane are two of our three realizations in the quarter.

Our third realization was our investment on LanguageLine's second lien loan. The company sponsor, Abry Partners, sold the company to Teleperformance, resulting in the full repayment of our loan in September at its 101 call premium. Our fully realized IRR was 13.3%.

We made a new investment in the first lien loan of FleetPride, the largest independent distributor of after-market heavy-duty truck and trailer parts in North America. FleetPride is owned by TPG. We purchased our position at a discount and our yield at cost on the investment is approximately 10.6%.

Our final new investment in the quarter was in the first lien loan for Redbox. Apollo acquired the former parent company of Redbox in July and financed the company through two separate standalone facilities. Redbox rents DVD and Blu-ray movies and video games through a network of about 40,000 kiosks throughout the United States. Our yield at cost is approximately 10%.

Since quarter end, we have had two invested realizations and have made two new investments. We realized our investment in NWN Corporation, both in its first lien loan and our equity co-investment. We made this investment approximately one year ago. Our fully realized IRR, including our loan and equity investments, was 11.8%.

Our investment in JAC Holdings was called at its make-whole premium last week. Make-whole premium was approximately 115. The sponsor, Wynnchurch, recently agreed to sell the company to Argonaut. Our realized IRR was 18.3%.

Our first new investment since quarter end is in a new second lien loan for PGi, Premiere Global Services. This is a club deal at the same issuer as our existing first lien loan. Our yield at cost is 11.5%. Our second new investment after quarter end is in the first lien loan of Dayton Superior. Dayton is the leading manufacturer and supplier of concrete construction products in North America which is supported by engineering and other value-added services. The yield at cost is approximately 10.1%. I'd like to note that of our new investments, in PGi's first and second lien loans, School Specialty, FleetPride, Redbox, and Dayton Superior, only FleetPride is covenant lite.

We have 22 portfolio companies as of June 30th, 22 as of September 30th and we have 21 today. As of September 30th, our largest industry concentration was in gaming at 15.5% of the portfolio at fair value. This is down from 19.5% as of last quarter and the reduction is the result of a partial pay down of our loan to Land Holdings. Our second largest sector was energy at 12.2%, followed by autos and telecommunications, each at 11.4%. Our fifth largest sector exposure was business services at 7.1%.

While unscheduled repayments have been a challenge in our effort to increase our total number of portfolio company investments, we're pleased to have diversified our industry concentration and we've continued to reduce our average position size from 14 million a year ago to 12 million today. I'd now like to turn the call over to Rocco to discuss our financial results.

Rocco DelGuercio: Thanks, Chris. For the quarter, our next investment income was $3.9 million or $0.29 per share. As of September 30th, the fair value of our portfolio was $264.2 million compared to $272.1 million at June 30th. Our investment activity accounts for an $8.9 million decline in our portfolio which was offset by $1 million increase in our net changes in our marks.

At September 30th, the weighted average yield of our debt portfolio including amortization was 10% compared to 9.8 at June 30th, 2016. Our portfolio was comprised of 90.2% floating rate and 9.8% fixed rate investments. Our average portfolio company investment was approximately 12 million and our largest portfolio company was approximately 29 million. 63.1% of the portfolio is in first lien investments and 36.8% of our investments are in second lien and we currently do not hold any unsecured investments. Additional information regarding the composition of our portfolio is included in our Form 10-Q which was filed yesterday.

At September 30th, we were at 0.72 times levered compared to 0.81 times levered as of June 30th. With respect to our liquidity, as of September 30th, we had 12.6 million in cash, 16.1 million in restricted cash and 35.5 million of capacity under our 50 million revolving credit facility with UBS. With that, I'll return the call over to Mike.

Mike Mauer: Thanks, Rocco. I want to provide the details behind the aggregate mark on our positions in energy and oil field services, which increased slightly this quarter. We had significant changes to marks for Caelus and US Well. We also concluded the financial restructuring of our investment in AAR which I will speak about in a moment. Caelus continues to benefit from excellent well results, its hedge profile which extends into 2018, and an improved oil price environment versus earlier this year. We continue to feel very good about the Caelus investment between the solid operating results and the Smith Bay discovery announced in October. Our mark increased from 65 to 70 this quarter. Until this quarter, US Well Services results have frankly exceeded our expectations. However, the pricing environment for pressure pumping services has been challenging and we have begun to see the weakness reflected in the company results. The team and I are working closely with our fellow lenders as this situation develops. We reduced our mark from 89.5 to 75 this quarter.

On a more positive note, after working with the company and our fellow lenders over the past year, we have concluded the financial restructuring of All Around Roustabout, AAR. Historically, CM Finance has held the first lien loan to AAR Intermediate Holdings LLC and warrants at the same entity. Today, our investment has been restructured into a new Term Loan A and Term Loan B, a direct equity investment, and an undrawn revolving commitment of approximately $1 million. The old first lien loan was partially equitized resulting in the lenders taking majority ownership of the company. The remaining loan was restructured into a first out and last out, the Term A and Term B. Our revolver commitment is intended to fund working capital as the company recovers. We have placed the Term A on accrual while the Term B remains a non-accrual. Our old warrants were cancelled. This restructuring reduces debt and in particular, the cash interest burden on the company while preserving our ability to recoup value in the future. The aggregate fair value of our Term A, Term B and equity position is the same as our fair value on the pre-restructured first lien loans as of June 30th.

We're pleased with the overall performance of our portfolio. Our portfolio yield improved from 9.8% last quarter to 10% this quarter. While at the same time, we increased our exposure to first lien assets from 57.7% to 63.1%. We have also reduced the percentage of our portfolio on non-accrual to 4.5% of fair value.

Looking to the future, I'm pleased to tell you all that we have secured a new credit line with Citibank. This is a multi-year revolving credit facility that will replace our revolving line with UBS. Our term loan with UBS that has over two years to run remains unchanged. Our new Citi revolver has a higher effective rate when drawn but has substantially lower upfront cost. Importantly, it has a two-and-a-half year life.

On November 3rd, our Board of Directors declared a distribution for the quarter ending December 31st, 2016 of $.3516 per share, payable on January 5th to shareholders of record as of December 16th, 2016. This dividend is our final one at this rate and is consistent with both the promise we made at the time of the IPO and our contractual waiver on on incentive fees in order to cover the dividend through calendar 2016.

Due to our three-year high watermark which was triggered in December of 2015, we did not earn any incentive fees during the quarter ended September. We expect to partially earn our incentive fee in the current quarter ending December.

We are committed to paying an attractive, sustainable dividend to our shareholders. Our board of directors supports us in this aim, and we have done an extensive review of our dividend over the past quarter. Our objective in setting the March 31, 2017 dividend is to ensure that our dividend policy going forward is consistent with our ability to generate NII without reducing our investment quality by reaching for yield or changing our focus from secured lending opportunities. With that in mind, we've taken the proactive step of reducing our dividend level for the first calendar quarter of 2017 to $0.25 per share which is an 11% yield as of the close of business yesterday. We are not taking a view on future rate increases and our new dividend level does not assume rate hikes in the near term.

We see opportunities in secured investments in both primary and secondary markets. Quality origination is always challenging but our team continues to identify attractive risk-reward with meaningful structural protections for our investments. In a challenging market for lenders, we have made a conscious decision to focus on moving up the capital structure. Overall, the portfolio is positioned to perform well into the new year. While there continue to be investments experiencing fundamental headwinds, the portfolio as a whole continues to show signs of stability and appreciation. Our underwriting will always focus 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. With that, operator, please open the line for Q&A.

Operator: Ladies and gentlemen, at this time we'll conduct a question-and-answer session. If you would like to state a question, please press star one (*1) on your phone now. Once again, to ask a question, please press star (*1) on your phone now. Our first question comes from Ryan Lynch from KBW. Please state your question.

Ryan Lynch: Hey, good afternoon and thank you for taking my questions. First one, I just had a clarification on JAC Holdings. You said that was called quarter to date and that there was a make-whole premium of about 115%. So if I do the math on that, that's about $2 million. One, is that correct? And number two, is that going to flow through the interest income line or is that going to come through a gain line item?

Chris Jansen: Number one - this is Chris, Ryan. That's correct. It's probably a little less than $2 million but the first part is correct.

Rocco DelGuercio: Yes. It will flow through the other income line. Not as capital gain.

Ryan Lynch: Okay. Then in regards to the dividend, you guys obviously did a lot of work and a lot of math on the dividend. So is it fair to assume that you guys have set the dividend at the level that you guys expect a fully earn or maybe even over-earn going forward, assuming you guys fully earning the incentive fee or at least the incentive fee expense fully turning back on?

Mike Mauer: So let me answer that a couple – there's a couple pieces to your question there. First, we have looked at it and we've been, we think, conservative around making sure that we can cover the dividend over the foreseeable future and that's the $0.25. Around the incentive fee, we have not made any assumptions as far as mark ups and downs in the portfolio, and the three-year look back will continue to apply at least for another year as we had a large write-down in the fourth quarter of 2015. With that having been said, we do expect to partially earn our incentive fee in most, if not all, quarters going forward. Now, I caveat it as partially earned because of the look back.

Ryan Lynch: Okay. Then you guys had net repayments in calendar 3Q. It looks like so far quarter date of calendar Q4, you guys also have net portfolio repayments. So, how much of the net repayments did you guys have had in Q3 and Q4 is you all wanting to delever your balance sheet versus maybe a bit of just the ebbs and flows of lending in an unpredictable market as well as maybe seeing less attractive opportunities given competition?

Mike Mauer: More of the latter than the former. So it's - we're comfortable running in a 0.8 plus, 0.8 minus leverage so that is easy, I think it was 0.82 at the end of last quarter. So we're comfortable with that leverage level. That having been said, we're not rushing to redeploy. We had been redeploying. We've got several things in the pipeline right now. We hope at least one of those closes in the next three, four weeks, no assurances. There's two or three that have I think 80% or better probability of closing over the next eight to 12 weeks. So we are looking to redeploy and to bring that leverage back up from the 0.71 that it is at today. Or at 9/30, let me rephrase.

Ryan Lynch: Sure. Yeah. So then just one last one. Given the competitive environment where there is clearly being some pressure on yields as well as covenants in new loans being issued today as well as your - you all's continued focus on doing more secured lending and obviously not reaching for yield, is it fair to assume that your guys' portfolio yield is going to be ticking down over the next couple of quarters? Assuming that there's no real substantial changes in the environment as we sit here today?

Mike Mauer: In answer to that, I'd say that's probably more of a historical answer than a present one and what I mean by that is, over the last six months, our target yield has trended toward 10% plus or minus. If you asked me that question a year ago to a year-and-a-half ago, we would've been 50 to 100 basis points higher. Two years ago, we were definitely a target yield of 11% plus or minus. So we have trended down over the last three to six months, we've probably stabilized on what our target yield is for new investments, and that's around 10% and we will have some that are over and some that are under and most of those will be first lien under and second lien over but that's the generalization that doesn't always hold.

Ryan Lynch: Okay. Thank you for taking my questions.

Mike Mauer: Yes. The only thing I just - last point on that is, if you look at the net average for the quarter ended 9/30, it was about 10.2, just shy of that, and the net addition post 9/30 is close to the 10.6 and that has - the 10.6 has a second lien in it that we mentioned, PGi, where the 10.2 is all first lien.

Ryan Lynch: Okay. Understood. Thanks, guys.

Mike Mauer: Thank you. We appreciate the question.

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

Robert Dodd: Hi guys. Again, thanks for the color on the dividend framework and the market. Looking at - one of the issues - Land Holding repaid about half during the quarter. Any expectations on the other half, obviously to the context of Land at 12% yield, right? So repaying half tends to lower the yield. Any view on whether that other half is going to come out any time soon?

Chris Jansen: Yes. Hey, Robert. It's Chris. It probably, in the next six months, would come out - but there's nothing imminent there. The call premium steps out again in June so that gives us some good runway to that and we think - we're feel pretty comfortable about it being out for the next three to six months. There has been no - there's been no indication or conversations with the sponsor there who's an individual. It gets pretty granular with conversations with him there but none in the last two, three months.

Robert Dodd: Got it. Honestly, your energy, good up there. Thanks for the update on those. Any other areas in the market that - or on your portfolio - that you're avoiding particular industry rather than just, or any other signs anywhere else you're seeing about kind of what the - the next phase is obviously. Energy, we're now kind of on the upswing a little bit, thankfully. Retail, there are worries. Anything else market-wise not necessarily portfolio-wise where you think issues are starting to come up?

Mike Mauer: Yes. You've mentioned a couple of industries there. One, energy, everyone knows and can see our portfolio, we're not looking to put anything more on. There's lots of opportunities if you want to. The second one is, we did Redbox which is considered a retailer. We look at it as a distribution channel. It is retail but in the retail context, what we are definitely avoiding is specialty retail. I think that's been a consistent theme since the first day of our IPO. We don't like things that are fad-driven and on top of that, if you look at structurally over the last five to 10 years, and I think it's accelerating right now, that retail and specialty retailers are being just intermediated by the online option. So we are continuing not starting, but continuing to avoid that.

Robert Dodd: Got it. To that kind of following up on that point, specialty retail and also more focused on things like that. There seems to be - it's a foot traffic rather than a consumer spending issue. So from that perspective and I don't cover Redbox, etcetera. [Laughter] Do you know - when you're underwriting, you'll see we did. Where they're located - machines are in terms of - obviously if they're mall locations, I'd be worried about the foot traffic. If they're outside a gas station, less so, or a grocery store. Do you know what the breakdown of where they are?

Chris Jansen: Excellent question, Robert. There are grocery store - there's over 40,000 different kiosks so they cover broadly the vast majority of the United States. They have a nationwide agreement with Walgreens. So it hits where people go shopping every day for staples. But at such a low-cost option versus video-on-demand for most of America, it definitely gets into the convenience factor. What really, kind of the cement for us, was that it's very low leverage and there are excellent structural protections for the lenders within the covenants of the first lien term loan.

Mike Mauer: I think one of the key things that Chris touched on in the underwriting process here, Redbox when you examine it, is the installed base of 40,000 kiosks over everything from drugstores, convenience stores, grocery stores and I'm sure there's some in some mall base but it's not a mall-based system that is set up. On top of that, from a lender's structure, this is a business that over the medium term in our underwriting diligence, we really, really like. On the long-term, that's an equity question and I'm not - and our team is not prepared to take a view on that. So from the structure of the loan, it's heavily amortized, cash flow sweep and will be a shorter average life than our other investments.

Robert Dodd: Okay. Thank you for that color. That was my last question. Thank you.

Mike Mauer: Thank you Robert. Appreciate it.

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

Chris Kotowski: Yes, thank you. Looking at your equity investments, they're all carried pretty much at de minimis valuations but - and I know we shouldn't count on anything coming out of that. But can you kind of go through where there is significant potential and I guess what I mean by that is, were all these stakes acquired post a work out? So in a new and a reasonably refreshed capital structure, and where is your ownership a significant portion of the total company?

Mike Mauer: I'll take that and I'll let Chris chime in. So there is a couple. One is, All Around Roustabout. So we believe - and I just talked about Redbox probably being a shorter than average life - I would turn around and tell you that the AAR, due to the cycle we're going through the restructuring, we were just completely will be in a longer than average life investment. We are not expecting a recovery to the level in which we originally underwrote it. That company was doing over $40 million of EBITDA at that point and you can put whatever multiple you'd like to put on it but I think a conservative multiple would've been four to five times. At four to five times, that infers a firm value of $160 million to $200 million. There's debt on it of less than $80 million and we own approximately, just a tad under, 12% of the equity in that. So given that we don't expect a full recovery, we do think there's upside, we do think that EBITDA will go significantly north of $10 and probably north of $20 million. We're not assuming that it goes north of $30 in any of our cases today. We do assume that as you cycle back to an active market and I don't know if that's in the 50s or the 60s but our base case says that oil will be in a $45 to $50 range for quite a while. Then we will fully recover all of our debt and there will be value down the road to the equity. Today, we don't think that value is more than much of an option value and you can see that from where we had it marked. Chris, do you want to comment on PR Wireless?

Chris Jansen: The other equity investment in the form of warrants that we hold is in PR Wireless or Open Mobile. Wireless, probably that's the fourth wireless player in Puerto Rico. That deal was structured, with the lenders receiving basically stapled on to the term loan, altogether about a 20% warrant in the company. Similar to AAR, we would expect at some point to get some value out of that but at this point, the company continues to slightly delever and is performing adequately. So there's no immediate value to those warrants as we expect right now.

Chris Kotowski: The other two are below that, it sounds like.

Chris Jansen: Yes. NWN is one that we sold that was a de minimis 150 some odd thousand of equity that we've lost. We sold it basically for that amount so that one is out. The last one…

Mike Mauer: Now, we've sold it at cost …

Chris Jansen: We sold it cost…

Mike Mauer: That is all factored into the IRR that we talked about on NWN.

Chris Kotowski: Okay.

Chris Jansen: The last which is really kind of a - just a - not an anomaly but it's our out-of-the-money warrants in Endeavour which we value at either zero or one but it's just a line item in our financial statements. We wouldn't expect to get any value for that.

Chris Kotowski: Okay.

Mike Mauer: That one that – there was no cost too. It came as part of a loan that we bought and we may have ascribed some cost to it from a GAAP perspective but again that was not something we bought separate equity.

Chris Kotowski: Okay. Thank you. That's it for me.

Mike Mauer: Chris, sorry. That's similar for PR Wireless. We ascribed some value from the loan purchase to those warrants but we didn't pay anything for them.

Chris Kotowski: Okay. All right, good. Thank you.

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

Mike Mauer: Thank you, operator. We'd like to thank everyone for joining us today and we look forward to speaking with you in February. Thank you.

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

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