Conference Call
CM Finance
May 11, 2017

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

Mike Mauer: Thank you, operator. Thank you all for joining us today. I'm joined today by Chris Jansen, my Co-Chief Investment Officer and Rocco DelGuercio, our CFO. Before we begin, Rocco will give you our customary disclaimer regarding information in forward-looking statements. Rocco?

Rocco DelGuercio: Thanks, Mike. I would like to remind everyone that today's call is being recorded and that this call is the property of CM Finance, Inc. Any unauthorized broadcast of this call in any form is strictly prohibited. Audio replay of this call will be available by using telephone numbers provided in our press release announcing this call. I'd also 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 filing for important factors that may 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 return the call back to our Chairman and CEO, Mike Mauer.

Mike Mauer: Thanks, Rocco. As in past quarters, I will begin today's call with a discussion of the leveraged finance market. Next, Chris will walk you through our investment activity during and after the quarter, and then Rocco will review our financial results. I will conclude with some commentary on our portfolio and our outlook.

While leveraged finance new issue volumes declined slightly in the first quarter from the fourth quarter of 2016, it's worth remembering that the fourth quarter was the most active one since 2014. New issue activity in the broadly syndicated market and the upper end of the middle market continues to be robust and at times frothy. Borrower friendly terms, covenant light deals, and tight spreads abound. LBOs continue to bring new, and in some cases, repeat issuers to the market. That said, refinancing and repricing activity continues not only in the larger transactions but also into the core middle market where it has affected us as well. Many loans which were made in a less aggressive environment for lenders have been refinanced.

2017 is proving to be a challenging time to find opportunities with attractive terms and structures, but our team continues to identify attractive opportunities in the primary and the secondary markets. We continue to be extremely selective in choosing our new investments. Despite the challenges the syndicated market presents, we have a deep pipeline. Club and direct lending opportunities enable us to focus on appropriate structure and covenant protections for our capital. Secondary investments in loans trading at a discount have allowed us to take advantage of the tightening spread environment we find ourselves in, with shorter remaining average maturities and seasoned issuers, who are most likely to refinance. We maintain a focus on first and second lien investments in high quality management teams and companies. We are opportunistic about the opportunities in our pipeline and we expect to redeploy the capital we've received from repayments this quarter.

I'd now like to turn the call over to Chris to discuss our portfolio activities.

Chris Jansen: Thanks, Mike. We made seven investments during the quarter including four investments in three new portfolio companies, and three different investments in existing portfolio companies. We had one realization during the first quarter.

We participated in our new second lien loan from Lionbridge which backed the LBO of the company by H.I.G. Capital. Lionbridge provides translation and globalization services to companies worldwide. Our yield at cost is approximately 11.1%.

Intermedia is a leading provider of cloud-based software solutions for small and medium-sized businesses. We invested in both the first and second lien loans which were placed in connection with the LBO by Madison Dearborn. Our yield at cost is approximately 7.1% in the first lien and 11.2% on the second lien. Our blended yield was approximately 10.5%. I'd like to note that we sold our position in the first lien after quarter-end for a realized IRR of 21.2%, while we continue to hold the second lien loan.

We also invested in Immucor's first lien loan in the secondary market. Immucor develops, manufactures, and sells manual and automated analysis equipment used to test blood for transfusions. TPG is the sponsor. Our yield at cost is approximately 7.2%. We couldn't build as large position as we wanted to, however, so as the market strengthened in the current quarter, we sold our position for a realized IRR of 26.8%.

We made three new investments in existing portfolio companies. These included adding to our position in the first lien loan to Montreign, participating in the new first out revolving credit facility in the out-of-court restructuring of U.S. Well Services, and participating in an incremental second lien loan for PGI.

We fully realized our investment in Land Holdings. This is a club deal, a project-finance loan to build the Scarlet Pearl Casino in Biloxi, Mississippi. This loan was repaid at a premium of 102 for a realized IRR of 14.4%. We had expected Land to pay off at some point during the first half of the year and are very pleased with the return on this investment.

Since quarter end, we've had four realizations and we made two new investments. I mentioned that we sold our positions in the first lien loan of Immucor and the first lien loan of Intermedia. Both of these are small holdings where we felt we couldn't build a meaningful position in a disciplined way, so we took advantage of market liquidity to exit at attractive returns. We also received prepayments on our investments in School Specialty and Telecommunications Management. School Specialty repaid its exit loan at par. Our fully realized IRR was 10.5%. Telecommunications Management repaid its loans this month as CableOne acquired the company. Our fully realized IRR was 9.8%.

We made two new investments, each in portfolio companies that we have followed for some time. Our first new investment is in the second lien secured notes of International Wire Group. International Wire is a manufacturer of copper wire products for a variety of customers in the industrial, automotive, energy, aerospace, medical, appliance, and communications industries. Our yield at cost is 11.3%. We also participated in the incremental second lien loan for TouchTunes, an interactive music and entertainment company. This loan funds the merger of TouchTunes and PlayNetwork. Our yield at cost is 9.4%.

We had 19 portfolio companies as of December 31st and 21 as of March 31st. Today we have 19. As of March 31st, our largest industry concentration was in business services at 19.8% of the portfolio at fair value. Energy was our second largest sector at 14.2% followed by gaming at 14%, telecommunications at 11.4%, and trucking and leasing at 8.6%.

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

Rocco DelGuercio: Thanks, Chris. For the quarter, our net investment income was $6 million or $0.24 per share. As of March 31, the fair value of our portfolio was $268.7 million compared to $245.4 million at December 31. Our net investment activity accounts for a $21 million increase in our portfolio and we had an additional $3.7 million increase from the net changes in our marks, offset by $1.1 million realized loss from the restructure of U.S. Well Services. As of March 31, the weighted average yield of our debt portfolio including amortization was 9.7% compared to 9.8% as of December 31. Our debt portfolio was comprised of 100% floating-rate. All our floating-rate investments have LIBOR scores and our average floor is 1.06%. Our average portfolio company investment was approximately $12.8 million, and our largest portfolio company investment was $29.2 million.

As of March 31, 50.4% of our portfolio was in first lien investments and 49.2% of our portfolio was in second lien investments. We did not hold any unsecured investments. Additional information regarding the composition of our portfolio is included in our Form 10-Q filed yesterday.

We were 0.67 times levered as of March 31 compared to 0.70 times levered as of December 31. With respect to our liquidity, as of March 31 we had $5.5 million in cash, $16.7 million in restricted cash, and $35.7 million of capacity under our $50 million revolving credit facility with Citi.

What that, I will turn the call back over to Mike.

Mike Mauer: Thanks, Rocco. We had a broad-based improvement in our marks this quarter in recognition of the tightening spreads in the leveraged finance market as well as some specifically improving credits. Our investments in energy and oilfield services increased as well, driven by improvements in activity in the D.J. Basin which helped the AAR, and continued excellent financial results for Caelus. U.S. Well completed its out-of-court restructuring and as Chris noted, we participated in the company's new first-out revolver which help address the company's liquidity needs. We are quite positive on the outlook for all of our energy investments. The aggregate increase in our marks on AAR, Caelus, and U.S. Well Services was about $2 million this quarter.

Bird Electric remains a nonaccrual. That represents 2.8% of our portfolio at fair value and we remain in active dialogue with the other stakeholders in the company. We moved the AAR Term B to partial accrual where we accrue interest proportional to the mark on the position. That loan is marked at 50 at quarter end so we are accruing half of its interest rate.

Our portfolio yield decreased to 9.7% from 9.8% last quarter due to the repayment of Land Holdings which had a coupon of 12%. Our new investments in the quarter ended March 31 had an average yield of 10.5%, an improvement over our average yield on new investments of 10.1% last quarter. Our net deployments were $21 million for the quarter. We anticipate additional prepayments may come from our existing portfolio. While nothing has been announced, the current financing environment has been conducive to a variety of expected and unexpected transactions and refinancings for leveraged issuers.

We are committed to paying an attractive and sustainable dividend to our shareholders. Our Board of Directors previously declared a distribution for the quarter ended March 31, 2017 of $0.25 per share which was paid on April 6 to shareholders of record as of March 17. Our Board declared a $0.25 distribution for the quarter ended June 30th payable on July 6 to the shareholders of record as of June 16. We believe that our dividend level 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.

We fully earned our incentive fee in the March quarter but waived a portion of that fee to cover the dividend that was paid on April 6. We expect to earn our incentive fee in the current quarter.

Our realizations year-to-date in 2017 continue to be outstanding, and our realizations have consistently exceeded our average portfolio yield. The average gross IRR on our realizations thus far in 2017 is 16.5%. Realizations help boost our NII and also give us the chance to diversify as we redeploy our capital into new loans.

The value of our portfolio as a whole continues to improve, with net fair value appreciation of $6.4 million over the past two quarters. The team underwrites conservatively focusing on quality management teams, sustainable capital structures, security packages and financial covenants for the protection and preservation of value over the long-term. We focus on protecting against downside risk, but we also think there is additional upside NAV potential to our current portfolio.

Operator, 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 state a question, please press star (*) 1 on your phone now and you'll be placed into the queue in the order received. 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 star (*) 1 now. Our first question comes from Ryan Lynch from KBW. Please state your question.

Ryan Lynch: Good afternoon, guys. First question is you guys waived a little bit of the incentive fee this quarter which was completely voluntary. Can you just give your thoughts behind the incentive fee waiver and what you guys are thinking about? Is that a policy that you guys are going to potentially keep in place going forward depending on what earnings do relative to the dividend?

Mike Mauer: Ryan, thank you. Appreciate the question and thanks for being on the call today. As far as the waiver, it is something that we look at each quarter. It was a decision made that we would waive a little to make sure that we - although it's a rounding error of less than $50,000, it was something we thought from a shareholder's perspective made sense. To the extent that we are in a similar situation this quarter and right now as of today, it looks like we will fully earn the incentive fee, we might have even a smaller waive than the current one if the numbers play out the way we'd expect, or we may earn it all, but for the current quarter, I'd expect if we're in a similar situation we would do the similar thing. It is not our policy that we've adopted and we will review on a quarter-to-quarter basis. That's kind of the way we've agreed to do it.

Ryan Lynch: Okay. Fair enough. As I look at kind of the outlook for capital deployment, I mean, in your prepared remarks you talked about heavy competition, increasing repricings and refinancings and should increase you guy's prepayments and repayments, and then if I look at your guides results so far in the calendar second quarter about basically $10 million of net repayment so far. Given what's already happened quarter-to-date as well as your outlook, should we expect the portfolio to shrink a little bit over the next couple of quarters and maybe delever the balance sheet a little bit or are you guys hoping to maintain this leverage around 0.7 times going forward?

Mike Mauer: We are targeting to maintain this leverage. We've got a strong pipeline of opportunities that we're going through. I want to caution that opportunities are not delivered and invested deals, but we would expect to continue to deploy capital and not to see continued shrinkage in the portfolio.

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

Mike Mauer: I appreciate it. Thank you very much.

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

Owen Lau: Yes. Good afternoon. Thank you for taking my question. Can you please talk about Lionbridge Technology? It looks like a relatively large new investment with a reasonable coupon rate. How did their language and operational capabilities stand out compared to the competitors to attract investment?

Chris Jansen: Yeah. Owen, this is Chris Jansen. Thanks for the call and the question. Lionbridge is the largest language services provider in the world. It's a very fragmented industry. The top 10 providers hold less than 10% of the market. Realistically, there are only a small handful of competitors that can provide the translation and localization services to multinational corporations. Lionbridge has the scale that's required to help its customers release their products globally, and they've seen a lot of that with their largest customers have actually increased their usage, and also, they work in a number of different languages as their customers' products become increasingly more globalized. Long-standing relationships and deepening relationships with Microsoft and Google kind of bear that out for us. It's a pretty large position for us. We had a detailed one-on-one with management. It's got strong sponsorship with like a 40% equity check, and in our view, it's reasonably low leveraged, so it goes in an interesting situation for us to get involved with in a comfortable way.

Owen Lau: Okay. Thanks.

Mike Mauer: It does have a maintenance covenant in it also.

Chris Jansen: Yes.

Owen Lau: Okay. Got it. Thank you. I have like another modeling question and I want to ask it slightly differently. Land Holdings said that 12% fixed rate got paid down. My math is about $1.3 million in interest income annually and in some new investments and Intermedia Holdings and Lionbridge and which had LIBOR plus 375 to 975, and you received $25 million repayment so far. I'm just wondering your outlook for the interest income in this second quarter. How should we think about that? Thank you.

Mike Mauer: Let me try to give you some guidance. As we look at pipeline of things coming in, these numbers will be affected just mathematically but - at December 31, our average yield at cost was about 9.79. That drop as a result of the things you just talked about, 9.72, very, very small adjustment net. As of today, with the investments we've made, that 9.72 is 9.77. We're basically back to where we were in December from a yield perspective on the portfolio. Going back to one of your earlier questions, our objective is to continue to invest on the low side 8% plus or minus on first liens and some other things, on the high side 12%, 13%, targeting something around 10% on an average yield while continuing to maintain about a 0.7, 0.65 to 0.75 leverage across the portfolio. To date, we have been able to do that. We are not going to continue to stretch for yield just to have a 10% average yield on the portfolio. To the extent, you've seen it over the last year-and-a-half, our yields have been as high as close to 11% on the portfolio and have come down under 10. We think that the risk/return is the most important thing. Some of the lower coupons that you've seen in our portfolio and things like Immucor were short-dated and had discounts associated with them. We will continue to look at lower short-dated coupons to deploy capital and invest cash, but our target continues to be in the neighborhood of where we are currently operating.

Owen Lau: Okay. Thanks for the color.

Operator: Once again, if you would like to ask a question, please press star (*) 1 on your phones now. At this time, we have another question from Robert Dodd from Raymond James. Please go ahead, sir.

Robert Dodd: Hi, guys. Just real quick one on AAR. The coupon change from three months - or sorry, from one month to three months if I remember. I mean, was there - just obvious question, was that at their election or was there some incremental change in the structure?

Mike Mauer: No. That's an optional election that they have and great question, but they can elect from time to time whether or not it's one month, three months, and that was the election they took and I guess their view on LIBOR over the near to medium term.

Robert Dodd: Got it. Thank you. Just in general, in terms of the overall competition, you're seeing obviously as you said - I mean spread have tightened, structures in the broadly syndicated market. Can you give us any more color - I mean, where - where is that coming from? Is this the same people you - same lenders you normally see that are just being more aggressive, or are there new operators in the segment you are seeing, maybe moving down, moving up, whatever that are driving this kind of dynamic?

Mike Mauer: You know, Robert, thank you. I appreciate it. I'd say my rule of thumb is 80-20. 80% of the time, it is going to be the same people that we see. There are at the fringes 20% of the time, there may be a new competitor, but more importantly to your point is that the competitors that we've seen that I've been running into for the past 10 years in one form or another have continued to grow. It's not just the BDCs, It's the private funds that they raise that they invest alongside, et cetera. There's been money dedicated to the space and that continues to make it very competitive. From our perspective, we continue to look at the right clubs to participate in, source our deals through, whether or not it is our Cyrus relationship or Stifel relationship, or a lot of the direct sourcing that we've got. We continue to do all of that. On top of which, you've all seen that we've got the team here that has a lot of experience, 10 to 20 years among different members of the team that work with Chris and I, and we've continued to watch a lot of names that we liked but maybe we didn't participate in and we may not have had the capital at the time because we were fully deployed. We may have seen something that said, you know what, it's a little bit of a show me. We'd like to see a little performance before we invest in something and if there is liquidity, a club member who wants to lighten up or something that has a little bit of secondary liquidity, we'll go into it.

International Wire is a perfect example of that. That's an 11% plus, something that we looked at, at the time. We actually liked it at the time but we were basically fully invested and we passed on it, and over the last couple of months we've been watching and there was one investor who decided for whatever reason to lighten up and we had been waiting to see if something became available and were able to invest in it, but each of those is very unique, and it's not just a new issue but watching a lot of the names in club and broader markets that we have liked and we focused on.

Robert Dodd: Okay. Great. Thank you for that, that color. I got one more. I think, Chris, you mentioned - and I didn't get the name. I think there was one of the positions you put on in Q1 you then, it's also one of the exits in Q2 because you didn't get a position as large as you wanted, and I think you've got - your realized IRR was pretty healthy. I don't know if you've got it at a discount originally, but can you give us any color? Would there be accelerated amortization at discount in the top line or realized gain in the second quarter or is there anything more you can tell us about that particular situation?

Rocco DelGuercio: Hi. It's Rocco. Yes. That would be amortization income in the top line.

Robert Dodd: Okay. Got it.

Chris Jansen: The actual investment, Robert, is Immucor. One of our team members here have identified that along the lines of - looked at it for a couple of years. We view that as a short-term 12 to 18-month kind of hold when we bought it, as it would go up to par with market conditions where they are in a secondary and shot up to par right away. There was a low coupon position, so we elected just to sell out versus trying to build the position at too low of a spread. The other was the million dollars of first lien in Intermedia which helped bolster our - we liked the credit. It helped bolster our take on the second lien, increase that, and that traded up close to three points. They're the healthy IRRs. It's just that pop up and that's just annualization of anywhere from the 2 to 2 plus point gain if you will...

Robert Dodd: Got it.

Chris Jansen: Increase in the price. Sorry.

Robert Dodd: Yes. Appreciate that. Thank you.

Chris Jansen: Thank you.

Operator: At this time, we have no further questions.

Mike Mauer: I'd like, operator, to thank you and thank everyone for dialing in. We appreciate the time and look forward to following up. Thank you.

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

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