Rate this transcript (CTRL + click):
poor 1 2 3 4 5 excellent

Conference Call
CM Finance
September 7, 2017

Operator: Welcome to the CM Finance Fourth 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 (*) 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 calling in today. I'm joined by Chris Jansen, my Co-Chief Investment Officer, and Rocco DelGuercio, our CFO. Before we begin, Rocco will 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 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 visiting our Investor Relations page on our website at www.cmfn-inc.com. 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-K filing for important factors that may cause actual results to differ materially from these projections. We will not update our forward-looking statement unless required by law. To obtain copies of our latest SEC filings, please visit our Investor Relations page on our website. At this time, I'd like to turn the call back over to our chairman and CEO, Michael Mauer.

Mike Mauer: Thanks, Rocco. As has become our tradition, I will begin with a discussion of the leveraged finance market. Next, Chris will review our investment activity during the quarter, and Rocco will discuss our financial results. I will conclude with some commentary on our outlook for the portfolio.

Lending conditions remain borrower friendly, in both the syndicated loan market and in the upper middle market. Covenant light deals are the norm and structures are aggressive. Refinancing and repricing activity appears to have slowed somewhat since quarter end. However, according to LCD, almost half the loans to middle market issuers were covenant light in the calendar second quarter. We pride ourselves on our attention to documentation and the weak structures, which are current market standards, are a concern to us. Our diverse, multi-channel origination is not dependent on sponsor finance. Our team also maintains longstanding trading relationships which helps us find opportunities in the secondary market that many of our BDC peers do not focus on. Through our relationships with Cyrus Capital and with Stifel, we see diverse opportunities which are not generally visible to other lenders.

As a reminder, Stifel is a full-service retail and institutional broker, and an investment banking firm. As of June 2017, Stifel covered approximately 12,000 US and 290 European equities, and has over 2,000 financial advisers. In addition, the investment banking group consisting over 400 professionals and support associates focused on middle market companies as well as large companies in targeted industries for Stifel.

Also, Cyrus Capital Partners, founded by Steve Freidheim in 1999, is a registered investment adviser with offices in New York and London, managing several billion dollars. Cyrus invests on a global basis in securities and loans, issued by corporates and sovereigns, and invests across the entire capital structure of companies, taking positions in debt, equity, and derivatives. It also directly structures capital solutions for companies and leads capital raises. Cyrus is an active investor that is deep value focused and experienced in legal and process oriented opportunities. The Cyrus team is comprised of professionals with skillsets including bankruptcy and restructuring, industry expertise, legal, private equity, capital structure, derivatives, trading, and capital markets.

Through these strategic relationships and the proprietary networks of our investment team, we are well positioned to call on high quality industry, product, and situational expertise as well as leveraging our origination capacity. Today, our pipeline is focused largely on direct lending opportunities, supplemented by secondary investments and add-ons to existing issuers. All of these channels allow us to bifurcate our analysis into fundamental credit analysis, and analysis of available structural and covenant protection for our shareholders' capital. We're always focused on first and second lien lending to high quality management teams and companies. We are optimistic about the opportunities in our current pipeline and we expect to continue to be able to deploy the capital we've gotten back from pre-payments into new investments.

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

Chris Jansen: Thanks, Mike. We made seven investments during the quarter, including six new portfolio companies and one investment in an existing portfolio company. We also have six realizations during the quarter, and I'll cover the realizations first.

We sold our positions in the first lien of Immucor and the first lien of Intermedia. Both of these were small holdings where we couldn't build a meaningful position, so we used market liquidity to exit both positions at attractive returns. Our realized IRRs for these short holding periods were 24.1% and 20.2% respectively.

Our investment in School Specialty repaid its exit loan at par, as the company's exit loan was refinanced at lower rates. Our fully realized IRR was 14.0%.

Additionally, Telecommunications Management repaid its loans in connection with Cable ONE's acquisition of the company. Our fully realized IRR was 9.6%. We also fully realized our position in North American Lifting Holdings, also known as TNT Crane. The company's leverage increased substantially during our holding period and we remain concerned about liquidity and the company and market exposure. We sold our second lien position, realizing the capital loss but a positive IRR of 7.5% on this investment during our holding period.

We also received repayment in full of our position in AP Gaming, which had been our largest portfolio company investment. AP Gaming refinanced its loans and we participated in the new first lien loan. Our fully realized IRR was 10.6%, and our yield on our new first lien position at cost is 6.9%.

We also participated in the incremental second lien loan for TouchTunes, an interactive music and entertainment company. This loan funded the merger or TouchTunes and PlayNetwork. Our yield at cost is 9.4%.

As I mentioned on our last call, we purchased second lien secured notes of International Wire group. International Wire is a manufacturer of copper wire products for a variety of their market customers. Our yield at cost is 11.3%. We added to our position in the first lien loan to Montreign, which was our one investment in an existing portfolio company this quarter. We participated in a new first lien loan from Melissa and Doug, which is a maker of a wide variety of children's toys. Our position here is smaller than we like, and we sold it shortly after quarter end, realizing an IRR of 20.0%.

Finally, we invested in Immucor new first lien loan in the primary market. This is a new deal for the same issue where which we held for several months but sold in April. Immucor develops, manufactures, and sells manual and automated analysis equipment used to test blood for transfusions. Our yield at cost is approximately 6.8%.

After quarter end, we had two realizations and one new portfolio company investment. As I just mentioned, we realized our small investment in Melissa and Doug. We also realized our investment of YRC Worldwide, which we had held since CM's IPO in February of 2014. Our realized IRR on YRC was approximately 10.0%. Our new portfolio company investment, made after the quarter, was in the first lien loan to CareerBuilder. This loan back to Apollo's purchase of the company, which is leading online employment website on the internet, which serves both employers and jobseekers. Our yield at cost is 9.0%.

We had 21 portfolio companies as of March 31st, and 23 portfolio companies as of June 30th. Today, we have 22 portfolio companies. As of June 30th, our largest industry concentration was in business services at 16.7% of the portfolio at fair value. Energy, through exposure to both oil and gas, and oil field services industries, was our second largest sector at 15.6%, followed by entertainment and leisure at 15.0%, telecommunications at 12.0%, and healthcare at 11.2%.

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

Rocco DelGuercio: Thank you, Chris. For the quarter, our net investment income was $3.4 million or $0.25 per share. As of June 30th, the fair value of our portfolio was $254.9 million compared to $268.7 million at March 31. Our investment activity accounts for a $13.2 million decrease in our portfolio. We also had $2.7 million in net realized loss associated with our sale of North America Lifting Holdings. This was primarily offset by a $400,000.00 increase in net changes in our marks.

As of June 30th, the weighted average yield of our debt portfolio, including amortization, was 9.73%, up one basis point from our weighted average yield as of March 31. Our debt portfolio was comprised of 95.2% floating rate investments, 4.8% fixed rate investments. All of our floating-rate investments have LIBOR floors, although both one and three-month LIBOR are in excess of the floors on all of our loans. Our average portfolio company investment was approximately $11.1 million, our largest portfolio company investment, PGi, was $25.9 million, and our second largest portfolio company, Caelus, was $22.1 million.

As of June 30th, 49.9% of our portfolio was in first lien investments, and 49.7% of our portfolio was in second lien investments, with the remaining 0.4% in equity investments. We did not hold any unsecured investment as of June 30th. Additional information regarding the composition of our portfolio is included in our Form 10-K filed yesterday. We were 0.6 times levered as of June 30th, compared to 0.67 times levered as of March 31. With respect to our liquidity, as of June 30th, we had $10.6 million in cash, $22.6 million in restricted cash, and $50 million of capacity under our revolving credit line, credit facility with Citi.

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

Mike Mauer: Thank you, Rocco. Our marks this quarter were generally consistent with the prior quarter. In the March quarter, spreads in the leverage finance markets clearly tightened. During the June quarter, we have observed more stability. Also during the quarter, we had two marks which changed more meaningfully. These were AAR and Trident.

Last quarter, we moved the AAR term loan B to partial accrual, where we accrued the interest proportional with the mark on that position. Our mark increase to 65, as of quarter end, so we are now accruing 65% of the stated interest rate. Improvement in activity in the D.J. Basin, as well as some company specific progress led us to increase our mark.

We decreased our mark on Trident Health from 85 to 78. Trident is a healthcare services provider with a focus on diagnostic services into skilled nursing facilities.

Nursing homes have had their share of challenges today, and we think that the customers' weakness is directly affecting Trident's results. We are monitoring the credit closely, especially given the company has a revolver that matures next year.

As of June 30th, Bird Electric was on non-accrual. That represents 2.9% of our portfolio at fair value. On September 1st, the company completed its financial restructuring, which resulted in the elimination of $15 million of second lien principals and the additional of 10 Class C units. The Class C units are a non-voting class of preferred equity with $10 million liquidation preference, that accretes at a 10% rate, until such time as certain EBITDA targets are met. After which, the units are paid at 10% cash dividends. In addition, we retain an option to recover reductions in our claims subject to future performance.

Our portfolio yield was stable at 9.7%. As I mentioned on the outset of the call, we are disciplined in investing new capital. Not overly enamored of the terms generally on offer in the market and cautious in our general outlook. As such, we made a deliberate decision to invest in several lower yielding, liquid, less risky first lien loans during the quarter.

We are committed to paying an attractive, sustainable dividend to our shareholders. Our Board of Directors previously declared the distribution for the quarter end of June 30th, 2017 of $0.25 per share, which was paid on July 6th. Our Board declared a $0.25 distribution for the quarter ending September 30th, payable on October 5th to the shareholders of record as of September 8th. We believe 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 June quarter and expect to earn our incentive fee in the current quarter. Our management of the portfolio has been focused on lowering its risk portfolio, while maintaining net investment income in order to sustain our dividend. As we look back over the last 12 months, we have had net appreciation of $19.7 million. We have decreased our average position size, we have increased our number of portfolio investments, and we have reduced our non-accruals. 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 risks, but we also think additional upside NAV potential remains in our current portfolio.

Operator, please open the line for Q and A.

Operator: Ladies and gentlemen, if you would like to conduct a question, please press (*) 1 on your phone now, and you'll be placed into the queue in the order received. Once again, to ask a question, please press (*) 1 now. Our first question comes from Ryan Lynch from KBW. Please state your question.

Ryan Lynch: Good afternoon, and thank you for taking my questions. First one, you mentioned a lot about the environment today. It's obviously very competitive with a lot of pressure on structures, covenants, even some pressure on yield. When I look at you guys balance sheets today, you guys are running, I would say, under your optimal level of leverage on the balance sheets, you guys do have some capital to deploy. Can you talk about your ability to deploy capital in today's environment, given the competitiveness that we're seeing out there?

Mike Mauer: Yes, it's a great point. I think it's one that everyone across the industry is focused on. First of all, I'd like to highlight that in the environment over the last six months where we've seen a lot of repayments and we've invested over $50 million, we have had stability around our average unlevered yield at 9.7%. I actually believe there is some upside to that, and that longer term at 10% plus or minus, unlevered is the right range for us to be targeting. Specifically, over the next 30 days, plus or minus, we would expect to close on $25 million to $50 million probably in the $30 million to $50 million of new investments. Net of any repayments coming in, it's probably in a $30 million to $40 million because we know of at least one that we expect to repay. The net of all of that should be an increase to our average unlevered yield. That will be, probably, one or two first lien loans and one second lien loan, average among those being around an 11% unlevered yield.

Those are commitments we have, we're finalizing docs and moving towards closing. We have probably another 10 plus live, real opportunities in the pipeline on top of another 20 that are still in gestation. From our perspective, and I think what we're seeing is the investment team has done a fabulous job of working a lot of the traditional sourcings, both sponsored and non-sponsored, and the Stifel banking network has yielded more fruit, I'd say over the last three to six months than it has over the last 12 to 18, and we see more opportunities in that direct lending channel.

Hopefully, that addressed the question.

Ryan Lynch: Yes, just a follow up to that. You're talking about these new potential originations having approximately 11%, roughly unlevered yield. I look at your investments that you put to work in the calendar second quarter, looks like an 8.2% yield, and given what you said about the competitive environment, pressure on yield, how should investors be comfortable with that sort of yield of the new investments given today's environment, and how do you ensure investors that you guys aren't stretching for yield and then taking on an excess risk to originate those higher yielding loans?

Mike Mauer: Listen, I think, that goes to the heart of our strategy. If you look at that 8.2%, which you're spot on, there are three investments in there that are sub 7%, and those three investments total a little shy of $20 million, or I'll call it 30% to 40% of the new activity. Those were put on because we're not going to stretch for opportunities that don't make sense from a structure or a credit perspective. They're also put on because those are ones where we're very comfortable with the credit risk and liquidity, it's an opportunity for us from a shareholder's standpoint to put 7% money out at with liquidity while we're working with the 9% to 12% opportunities.

Ryan Lynch: Okay, makes sense. Then, when you look at what's going on currently with the hurricane situation with Houston and the potential for Florida with Irma, have you guys looked at your potential exposure? I know you guys have a few oil and gas investments, as well as Bird Electric being a machine operator. Have you guys looked at your exposure and do you guys expect any impacts from Harvey in Houston, or any sort of impact to you guys, portfolio companies from potentially - with the hurricane about to hit Florida?

Mike Mauer: Yes, we've been through the whole portfolio, and specifically there are two companies that we are focused on. One is Open Mobile, which runs cellular service in Puerto Rico. We've had dialogue with them running up into Irma coming into Puerto Rico. They shut down early, they secured facilities. We have not had any update of any significant damage to their equipment, we're waiting for updates and discussions with the company, but there's been nothing negative as of this call that we're aware of. While it was significant, they escaped the eye of the storm.

I'll let Chris comment more on that.

Chris Jansen: Yes, I think the electric is still out in most of Puerto Rico, but keep in mind also that Open Mobile has entered into JV agreement, where they're going to contribute their business and combine it with Sprint's business. They announced that about four months ago, they've been working on it for quite a long time. There's nothing in those documents that we think gets derailed by anything, but that leads us to being even more comfortable with that credit.

Mike Mauer: That timeline is fourth quarter/first quarter expected finalization of the Sprint JV.

Chris Jansen: Yes, and with regard to Bird, Bird as you recall is in the Permian Basin, so they have been unaffected. There has been no negative effect of Harvey on them. In fact, we just met with the sponsor this morning and they are seeing business opportunities for storm damage work, both in Harvey where they have boots on the ground already, and in Irma, this week they will send a couple of crews to help in that. With Florida, as the damage – hopefully it doesn't come in, but as it comes in. That would be a positive to Bird versus a negative. There's been no disruption to the flow of their work in the Permian Basin, that they have seen, and they talk to management daily.

Mike Mauer: They're based in Midland and Eastland, and all their equipment and crews, and everything, were remote from any of Harvey's damage.

Chris Jansen: Yes, it's all West Texas, New Mexico, or predominantly.

Ryan Lynch: Okay. That's great color. Those are all the questions for me, thank you for taking my questions.

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

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

Robert Dodd: Hi, guys. A couple. Just on Bird, real quick, restructured towards the end of the quarter. I'm going to presume right now that that 10%, will that be on the 10% on the $10 million liquidation preference, I presume, would that be on full accrual or is it going to be depending on the mark on the 10 is it going to be partial accrual or…?

Chris Jansen: Yes. Hey, Robert, it's Chris. On non-accrual now, the accrual with kick in at higher levels of profitability, which the company is not yet achieving.

Mike Mauer: We will evaluate that from a non-accrual standpoint at 9/30, but there's nothing today that would lead us to change that. The work on Harvey and Irma and some other progress that they're making could change that over the near term.

Robert Dodd: Okay, thank you. On the point earlier, the number of investments with sub 7% yield, would you – and I think you've effectively said this - but I'll back you into a corner a little bit if I can – would you say that those are temporarily tradable assets where you're parking, for lack of a better term, parking excess cash until such time as other opportunities for high yield, higher return, similar risk - that's the goal at least – investments become available, rather than it being a core piece of the portfolio that we'd expect – 10% of the portfolio, or something like that – to be sub 7% assets going forward?

Chris Jansen: Yes, Robert, we're fully comfortable with holding those long-term but clearly, this is part of our strategy to not force investments just for the sake of keeping a higher return. We're comfortable with the credits long term, but they are highly liquid and should be easily sold to accommodate higher yielding attractive investments as they come in.

Mike Mauer: Not that you'd ever back us in a corner, Robert, but [Laughter] in a word yes. That is, if you would, a redeployment pool that we feel very comfortable about the credit risk, structure risk, sponsors, et cetera.

Robert Dodd: Right, got it. Then, I was scribbling notes, on your comments, post the end, the refinancing wave may have slowed down a little bit, and you gave some color that you still see some more, and obviously you deployed a considerable amount of capital in the quarter but also had a lot of repayments and then chose an exit. Today, would you say that there are any credits on the books that you were maybe not going to get repaid on, but that you consider, for example like TNT Crane, the way you said you've got a good IRR but you had some concerns about it, so you decided to exit it and got a good IRR out of that. Are there any other assets on the books like that, that you would, say, maybe not repayments but that you're considering exiting for credit reasons? I'm not expecting you to name them, because that would be…

Mike Mauer: Yes, there's nothing that we're considering exiting today, so the answer to that is no explicitly. At the same time, where we've got a close eye on it and we're working with other lenders, et cetera, is Trident. We've mentioned that earlier in the speech. We're not focused on exiting, to be clear.

Robert Dodd: Got it. I appreciate it, thank you.

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

Chris Kotowski: Yes, you mentioned in the press release $67 million of repayments and sales, I wonder, was there any significant amount of prepayment income or amortization of OID? Hello?

Chris Jansen: Yes, we're here.

Mike Mauer: There's nothing significant. It was spread across, basically seven – well, I'm sorry - six different - there were two different sales of TNT Crane, so there were seven different exits, but it was broadly spread, there was no big, single lump that made up prepayment or acceleration of deep discount.

Rocco DelGuercio: Unlike last quarter.

Chris Jansen: Yes, where we had a discount, Chris, was in AP Gaming but that's one that we've held for 2.5 plus years, so that had largely been amortized.

Chris Kotowski: Okay. All right, then, looking at your $7.2 million of investment income, all things being equal, that seems like reflective of a reasonable run rate of the current portfolio?

Rocco DelGuercio: Yes, Chris, it does.

Chris Kotowski: Okay. Then, you said that subsequent to quarter end, the net impact of that would be a $30 million to $40 million increase in your…?

Mike Mauer: Including things that are in the pipeline over the next 30 days, it may close by quarter end, it may close slightly after, but yes, those things that we expect to close, exactly.

Chris Kotowski: Okay. They may not have that much of an impact on 3Q revenues but by 4Q, one should see it?

Mike Mauer: That is exactly right.

Chris Kotowski: Okay. Then, I guess I want to come back to Bird one second. It seems that in the restructuring, you're ending up with a smaller claim, less seniority, and a lower rate. Usually, when you have that significant or severe of a restructuring, it seems to me you should end up with talent equity ownership of the company and that seems to be not part of the equation. Am I reading that correctly and can you give any color around that?

Mike Mauer: Sure. A couple of things, number one, is the piece that you did not talk about that I mentioned when I went through it is an option that we continue to have to recover decreases in our claim based upon future performance. There is an upside that has put/call features in it over the next five to 10 years, that as the company performs, we do have the ability to recover in excess of the $10 million. In extreme scenarios in excess of $15 million, but above the $10. There is equity upside, it is not contingent on equity monetization because of put/call provisions in there. The company has an ownership structure that's driven by a minority owner, as well as the founder of the company, Brian Bird, and we did not want to disrupt that equity ownership because of the way a lot of contracts and bidding and everything else goes out, so we opted for this option to realize upside with put/call features in it.

Chris Kotowski: Okay. All right, fair enough. That's it for me, thank you.

Mike Mauer: Yes. Thank you very much, Chris.

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

Mike Mauer: Thank you very much, Operator. I'd like to thank everyone for their questions and their attention today. We look forward to speaking with you in the near future.

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

- End of Recording -