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In-Depth Interview
CMFinance
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Operator: Good afternoon, ladies and gentlemen, and welcome to CM Finance's Second 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 zero. A question and answer session will follow the presentation. I'll now turn the call over to the speakers. Please begin.

Michael Mauer: Thank you, operator. Thank you all for dialing in today. I am joined 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 and forward looking statements. Rocco?

Rocco DelGuercio: Thanks, Mike. I would like to remind everyone that today's call is being recorded and that since it is the property of CM Finance Inc., any unauthorized broadcast of this call in any form is strictly prohibited. Audio replay of the call will be available by visiting our investor relations page on our website at www.cmfn-inc.com. I would 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 forward looking statements unless required by law. To obtain copies of our latest SEC filing, please visit our investor relations page on our website. At this time, I would like to turn the call back over to our chairman and CEO, Michael Mauer.

Michael Mauer: Thanks, Rocco. I'll begin today's call with some commentary on the state of the markets. Chris will walk through our investment activity during and after the quarter, and then Rocco will discuss our financial results. I'll conclude with specific detail about our largest marks both positive and negative, our outlook, and thoughts on our progress repositioning the portfolio. As always, we'll end with Q&A.

Last quarter was the tale of two entirely different markets. September and October saw robust new issue volume with relatively stable secondary pricing and activity. Secondary pricing moved steadily lower through November and the loan market saw some spike in volatility in December, that we all observed across markets globally. Although the broadly syndicated loan market is not our primary focus, it influences us in several ways. Most directly, volatility in the broadly syndicated market can create opportunistic investments for us. Pricing, whether spreads and OID in the primary market or dollar prices in the secondary, are the first levers to move. This also affects the value of the existing portfolio. Clearly, secondary market pricing backed up through November and vary significantly in December. This gave us a chance to make several investments at attractive levels.

To highlight this tale of two quarters, in the first half of the quarter, our investments had an average yield of 9%. In the second half, this was 13.2%.

Structural changes in the market flow through more slowly. Using the example of an underwritten loan, leverage security, the size of the equity check, and often the presence of or lack of covenants are agreed to by an underwriter, weeks or even months before a broadly syndicated loan comes to market. Pricing is all that can move. Over the course of weeks and months, both price and terms shift. Deals become less borrower friendly and more lender friendly. In the syndicated markets, this is a slow process even in a fast moving volatile market. As we observed when we spoke last, throughout 2018, most broader market syndications were covenant light, long-dated, and had terms which favored the equity investor's interest.

In the middle market, we believe loan terms start in a better place and are not underwritten as far in advance. Covenants, shorter maturity, amortization, access to management, and lower leverage are the norm. Terms shift more quickly in the lenders' favor, as well, we aren't beholden to a multi-month lead time on structuring a big syndicated transaction. We can adapt the terms we offer more quickly. We continue to invest opportunistically in short weighted average life assets where we see the opportunity to generate returns through secured investments in seasoned issuers, often with the catalyst for early repayment. In the current environment, our bias has strongly favored first liens. Our core vision remains unchanged. We target direct investments in core middle market, either in a bilateral transaction or as part of a club of lenders who we know and trust.

Over the course of 2018, our team has worked tirelessly to reposition and diversify the portfolio. I'd like to put some numbers around that. We entered the year with 24 portfolio companies with an aggregate fair value of $286.5 million. Our average size was just under $12 million. Fifty percent of our investments were first lien and 45% were second lien. As of December 31st, our portfolio looks much different. We increased the number of investments approximately 20% to 29 portfolio companies with an aggregate fair value of $283.3 million. Our average position size decreased by 20% or $2.2 million lower than last year, to $9.8 million. Our investments were at 63.7% first lien and 31.7% second lien. I'd also like to mention that last year, we had approximately 20% exposure to oil and gas. Our largest position at 12/31, Caelus, was repaid after quarter end which reduces our energy exposure significantly.

Before I turn the call over to Chris, I'd also like to take a moment to address the decline in our NAV quarter over quarter. To state the obvious, we are unhappy with our results, and in particular, the markdown that was necessary in Trident Health USA. Trident was the last remaining investment made prior to the IPO in February 2014. We were concerned about the company's performance for the past couple of years, and have been reducing our value accordingly. That said, the speed of Trident's decline surprised us. We wrote down the position in full as of 12/31, which accounts for the loss of $0.67 per share or 73% of the total NAV decline this quarter. After the loss on Trident, we would have had a decline of 2% per share this quarter, essentially attributable to the changes in our marks from the market volatility I discussed earlier.

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

Chris Jansen: Thanks, Mike. We were active in both the primary and secondary markets during the quarter, investing in nine portfolio companies including four new portfolio companies. Of our four new portfolio company investments, three are first lien and our fourth is a junior DIP loan. We added on investments in three first lien loans, and one second lien loan, and added an equity position to an existing portfolio company. We also had six full realizations during the quarter.

As I mentioned on our last call, we invested in the first lien loan of Cook & Boardman in connection with its LBO by Littlejohn, its new private equity sponsor. Cook & Boardman is a specialty distributor of commercial doors and hardware. Our yield, at cost, is approximately 8.7%.

We invested in the first lien loan of Infrastructure and Energy Alternatives, IEA, a construction services firm that focuses on wind, transportation and rail markets. Our yield, at cost, is 10.4%.

We also invested in the first lien secured bonds of Techniplas, a leading manufacturer of complex, lightweight products for the automotive industry. This is a short-dated bond which matures in 2020. Our yield, at cost, is approximately 14.1%.

We also invested in the junior DIP loan for Sears Holdings which is being used to finance the company's operations during the bankruptcy. We expect that this will be repaid shortly as the company is in the market with its bankruptcy exit financing. Given the multi-draw structure of the DIP loan, the yield to maturity across calculation we typically refer to is indicative of our expected return for this loan. We anticipate realizing an IRR in excess of 20% for our investment in Sears.

Turning to the secondary market, we purchased additional first lien loan of Arcade/Bioplan. We began building our position in Arcade last quarter. The company is a leading provider of sampling solutions for the personal care and beauty industry. Our yield at cost including this purchase is approximately 9%.

We added to our position in 4L Technologies first lien loan. This is another short-dated term loan, maturing in 2020. Our yield, at cost, is now 8.1%.

We increased our position in the first lien loan of CareerBuilder. CareerBuilder is a North American leader in human capital solutions and provides a comprehensive and integrated product for employers and job seekers. Our yield, at cost, is now 10.6%.

We also added to our second lien loan position in TouchTunes Interactive Network. TouchTunes is a leading in-venue music and entertainment company, with over 60,000 locations in North America and internationally. Our yield, at cost, is now 11.3%.

As I mentioned, we had five realizations during the quarter. First, we received repayment of our first lien loan to AP Gaming. This was our lowest yielding asset and our fully realized IRR was 6.4%. Over the course of our investments in AP Gaming, dating back to the fourth quarter of 2013, our realized IRR was 9.8%.

We were repaid on our first lien position in FleetPride as TPG sold the company to American Securities. Our realized IRR on this investment was 12.5%. Over the course of our two investments in FleetPride, our realized IRR was 15%.

We were also repaid on our first lien position in Hostway, as the company completed a merger. Our fully realized IRR was 13.2%.

We sold our position in Intermedia's first lien term loan at a gain. We held this position for about four months. Given the opportunity to make investments in shorter dated loans with more price upside, we thought this was a prudent shift for better opportunities. Our fully realized IRR for this short holding period was approximately 16.8% and our realized IRR across all of our investments in Intermedia from the beginning of 2017 through our sale in October 2018 was 14.7%.

We were also repaid on our second lien loan to Montrose Environmental. Montrose was one of our largest positions. Our fully realized IRR on the investment was 15.3%.

Finally, I'd like to explain our partial realization of our position in US Well Services. US Well was acquired by a SPAC and now trades as a public company. In conjunction with this transaction, approximately 92% of our first lien term loan was repaid in cash. We received 77,212 shares of US Well Services, with the ticker USWS, representing the 8% of our loan which was not repaid with cash. The entire lender group received the same pro rata percentage of shares in the debt repayment. Other former lenders also received shares for their LLC interest in the company as well, which you will recall that we sold the shares that we held in the private company in the second quarter of 2018. Additionally, US Wells revolving credit was repaid and our commitment to that facility was terminated. Our realized IRR on the revolver position was approximately 11.7%.

After quarter end, we made three investments. We finished building our position in the first lien loan of Arcarde/Bioplan. Our yield at cost, across the entire position, increased to 9.6%.

We increased our position in the first lien loan of ProFrac, a pressure pumping services provider operating in the Permian, DJ and Haynesville Basins. Our yield, at cost, is now 8.6%.

Finally, we invested in the first lien loan for FleetPride which I've funded with the underwriters to repay us in December but was marketed to perspective lenders in January. FleetPride is the largest independent distributor of after-market, heavy duty truck and trailer parks in North America. Our yield, at cost, on this new loan is 7.9%.

We had two realizations after quarter end as well. Our first lien loan to Zinc Borrower was repaid. We continue to hold an equity co-invest position in the company. Our fully realized IRR on the loan was approximately 14.5%. Caelus Energy, our largest position as of last quarter, paid off its second lien loan at the end of January. Caelus sold its largest asset to Eni, and repaid all lenders in full. Our realized IRR was approximately 12.3%. I'd also note that this repayment significantly reduces our exposure to oil and gas, as Caelus was approximately 8% of the portfolio.

Our portfolio company count stood at 29 as of December 31st and stands at 29 today due to our investment with FleetPride and the repayment of Caelus just a few days ago. Using the GICS standard as of December 31st, our largest industry concentration was professional services at 15%, followed by Media at 12.8%; Energy, Equipment and Services at 10.6%; Oil, Gas and Consumable fuels at 8.5%, and Diversified Telecommunication Services at 7.7%. I'd now like to turn the call over to Rocco to discuss our financial results.

Rocco DelGuercio: Thanks, Chris. For the quarter ended, December 31, 2018, our net investment income was $3.7 million or $0.27 per share. The fair value of our portfolio was $283.3 million compared to $330.7 million at September 30th. Our investment activity accounted for a $34.4 million decrease in our portfolio including $13.1 million of net realized and unrealized losses. Of these gains and losses, the full write-down of our investment in Trident accounted for $9.2 million of the $13.1 million of the net realized and unrealized losses.

The weighted average yield of our portfolio increased 18 basis points from 10.9% on September 30th to 11.08% on December 31. New investments during the quarter had an average yield of 10.77%. As of December 31, our investment in Trident was on non-accrual.

Our portfolio consisted of 63.7% first lien investments, 4.1% unitranche investments, 31.7% second lien investments, and approximately 0.5% equity warrant and other positions. 94.8% of our debt portfolio was invested in floating rate loans and 5.2% in fixed rate positions. Our average portfolio company investment was approximately $9.8 million, and our largest portfolio company investment was Caelus at $24 million. We were 0.86 times levered as of December 31, and 0.86 times levered as of September 30th.

Finally, with respect to our liquidity, as of December 31, we have $6.2 million in cash, $6 million in restricted cash and $50 million of capacity under our revolving credit facility. Additional information regarding the composition of our portfolio is included in our form 10-Q which was filed yesterday. Investment activity after quarter end through February 5th included purchases of $23.4 million and $29 million of proceeds from repayments of Zinc and Caelus. With that, I'd like to turn the call back over to Mike.

Michael Mauer: Thank you, Rocco. As I mentioned earlier, this quarter was challenging for us and the write-down of Trident was particularly difficult. That said, we have been actively repositioning the portfolio prior to this quarter and we think there are several elements to that process that we don't want to lose sight of. As part of this broader repositioning, we've reduced our average position size and simultaneously increased the number of sectors we're exposed to. Going forward, we would expect to see our average position size to be in the current 10 million context.

We remain extremely selective in our new investments, underwriting conservatively, focusing on the quality of management teams, loan documentation, collateral security, and loan-to-value analysis. We focus on preserving capital and maintaining a stable dividend. We are sensitive to the ebb and flow of repayments and reinvestments and are always disciplined in making investments with appropriate protections for our capital and return for our shareholders.

We maintained our company count at 29 this quarter despite unplanned prepayments. I expect us to be over 30 portfolio companies over the near term as we experience larger repayments. We target reinvestment into multiple portfolio companies where there used to be a single one.

On the subject of repayments and reinvestments, we had two realizations which I think are very significant for us. During the quarter, we had a substantial realization of our investment in US Well. You may recall that we sold our shares in US Well in May at a gain versus our basis. Those shares were received in US Well's restructuring in January of 17. This quarter, we had another partial realization, our position in the revolver was repaid in full and 92% of the remaining term loan was paid in cash. All term loan lenders took approximately 8% of their loan principal in the form of public shares when US Well was acquired by a SPAC. We have less than $1 million of exposure now, the aforementioned US Well Services shares, and we have a double-digit IRR to date on US Well including all transactions and holdings since our original investment in 2014.

Second, Caelus was repaid last week. Caelus is a great example of what our team does best. We leveraged a direct relationship with management and a sponsor that predated the investment. We added to the position opportunistically at a lower level than our original purchase price, and we had conviction on this thesis through a volatile market. Our marks on Caelus moved higher throughout 2018 as fundamental results were strong and our analysis of Caelus' underlying assets proved to have value well in excess of the loan. Ultimately, the company sold its primary assets to Eni and fully repaid the loan with those proceeds. Caelus was our largest position and its a realization we are very proud of. As Chris mentioned, our fully realized IRR was approximately 12.4%. These two realizations represent about half of our exposure to the energy sector. Energy once represented over 25% of the portfolio. Today, it's close to 10%. We have brought our energy exposure down through profitable sales and repayments, not markdowns. We are comfortable with our energy industry weighting in its current context.

We covered the December quarterly dividend with NII, and fully earned our incentive fee. We expect to cover the dividend and earn an incentive fee in the March quarter.

Our board of directors declared a distribution for the quarter-ended in March 31, 2019 of $0.25 per share payable on April 4, 2019 to shareholders of record as of March 15, 2019. We believe our dividend level is consistent with our ability to generate NII without reducing our investment quality or changing our focus from secured lending opportunities, and further believe our quarterly dividend is both sustainable and attractive to shareholders. For the full year of 2018, we fully covered our annual dividend of $1.00. Our run rate portfolio yield and our current portfolio quality, give us confidence as we enter 2019.

Last calendar year, our board authorized a share buyback program. In the quarter end December 31, we repurchased just approximately 31,000 shares of stock at an average price of $8.25 representing a 28.19% average discount to NAV. Since the inception of the program through today, we have repurchased almost 85,000 shares, increasing our NAV by approximately $0.02. As a reminder, our total capacity for repurchases under this program is 5 million of which we have used $749,000.

Operator, please open the line for Q&A.

Operator: Ladies and gentlemen, at this time, we will conduct the question and answer session. If you would like to state a question, please press * 1 on your phone now and you'll be placed 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, please state your question.

Robert Dodd: Hi guys. On kind of the market environment, and thanks for the color on all that, Mike, with the first half of the quarter yields being at 9 but then by the second 13. I mean obvious question, where do they stand so far as you can tell today as we go into February and then along with that, and obviously you gave us deployments and everything, repayments to date, what does the pipeline look like and maybe yields in that context as well as we head into February and March?

Michael Maurer: Thanks, Robert. A couple of things. From the yield today, the pipeline we've got probably I'd say up to half a dozen real active opportunities, that's probably a couple more than we have capacity for today but we think that there will - we know that there will be some monetizations coming over the next several months and we'll continue to trend towards more names in a $10-million target. That pipeline is anywhere from I'll call it 8 ½ up to 15. It's a wide spectrum. There's only one up in that 15 neighborhood. Most are centered in an 8 ½ to an 11 and I'd say one at 8 ½ and then a couple in the 9 ½ to 11. So with our average yield over the last few quarters on the portfolio being in the I'll call it 10 ½ to 11 ¼, I would say that the average of what we continue to look at is in that 10 ½ plus or minus.

Robert Dodd: Got it. Thank you. Then structurally, obviously you talked about you've grown the number of assets on the portfolio, etcetera and the average size has come down. I realize this is a lot easier to ask this question than it is to actually do it, but is there more you can do on that – because obviously looking at Trident, it was a 7% of the portfolio at cost and a zero on a 7% portfolio position is painful. If that had been a more diversified portfolio or not diversified, smaller positions, if it was a 2% asset, having problems is a lot less painful than a 7% asset having problems to NAV. So can you give us maybe a longer-term view, obviously you'd expect average portfolio of your position size to be 10 million in the near term but long term, where would you like that to be with the caveat that obviously these bigger positions, if something goes wrong and bad credits always happen, it can be very, very painful to shareholders' NAV?

Michael Mauer: Listen, I appreciate your observations. We agree with you 100% and that's why we're working to reposition it. I would say to you that long term, we would look to - and I'll remind everyone that May 2, we have increased leverage coming onboard. We have not set final-final with the board yet. We had our board meeting this week and we will set everything final the next board meeting which will be the one-year anniversary of that approval. But directionally, I'd expect us to be in a 1 ¼ to 1 ½ times leverage. That will put us directionally 350 to 400 million of assets. With that as a backdrop of a total portfolio, be targeting somewhere in a 40 to 50 names. That is the 8 to 10 on average. We will occasionally do 15 million and there will be reasons to do that. One may be that we think that – and it'll be more typically in two scenarios, one where its first lien, we really like it and it may or may not have some liquidity, everyone will recall we got as high as I think 28, 29 million with AP Gaming. It was first lien, performing well, it was very liquid, it was almost a substitute for being long cash at point and ended up being a nice overall return.

The other situation is where it is opportunistic to protect a position and to facilitate a refinancing or something else, maybe at 10 or 12 million or going to 15 but we're not going to be doing those that are not well-secured first liens. We're going to avoid the concentrations that we've had in some of the second liens historically on the larger side. So hopefully I addressed the question.

Robert Dodd: Yes, got that and I have to ask about Trident. Obviously, you said it surprised you much, the speed of the deterioration. The mark's zero now and obviously, so the expected recovery I presume is zero or really close to it. What's the view on the asset value? When we look at something like Caelus which obviously with energy, it raised concerns because of commodity exposure but there was tremendous asset value underpinning that which obviously is manifested by selling one asset and paying everybody off. So on Trident, why isn't the asset value there?

Michael Mauer: Because there's been deterioration of the core business. Beyond that, it's hard for me to answer because as you I'm sure are aware, we've got a lot of confidentiality on the financing and everything else but it is not like a reserve-based loan or an asset base similar to Sears where we had something in bankruptcy and we had assets below it we could quantify whether or not they were stratified in four, five different buckets when they were receivables and inventory. Most companies that we look to have equity value that is justified by the sponsors, this had sponsors, had several sponsors, some very good sponsors involved. I think there were five BDCs involved lending both second lien and first lien. So a lot of it us looked at and came to a similar conclusion around the opportunity and the risk return and we were wrong is the bottom line.

Robert Dodd: Got it. One more if I can. Because you mentioned on the Sears that you have an expected IRR of 20% when it repays and that could be soon or it could shift around a little bit but I presume that there's going to be for lack of a better term, prepayment fee-type income when that repays rather than it being a realized gain kind of event.

Michael Mauer: The answer is yes to that and Robert, I think its public knowledge so I can say this that there's court hearings and everything else. They are trying to get this thing out of bankruptcy in the next days, days not weeks, let's put it that way.

Robert Dodd: Yes, very public now. Thank you, Mike.

Michael Mauer: You are right. It is basically acceleration of OID is the primary contributor to that high IRR.

Robert Dodd: Got it. Thank you.

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

Chris Kotowski: Yes, good afternoon. I was just also curious about the comment you made about the first half and the second half. Just when you said it was 9% in the first half and 13% in the second half, is that the yield on deals you saw in the market or is that just your coupon divided by where your marks were at two respective time points?

Michael Mauer: So during the quarter, we put on approximately 12 new investments and some of those were in the same name because we used the secondary opportunity to buy. Anything before November 15 we took and did a weighted average cost yield of what we bought. Not on market, this is what we did. So that was 9%. Then the second half of the quarter, November 15 after, was the 13% of what we did and what we put on.

Chris Kotowski: Okay, so that's the deals you saw in the market.

Michael Mauer: We saw a lot more. Those are the ones we executed on.

Chris Kotowski: Okay. Is it reasonable to assume that with the snapback in the markets in the new year, there's probably much more limited opportunities now and it's – you seem to have confidence you can continue to add new loans but are we looking at adding at 9% or are we looking at adding at 13 or something in between?

Michael Mauer: Yes, that was where I tried to give some guidance. We've got half a dozen things in the pipeline, low being 8 1/2 and high being 15. I center around the 10 to 11 on average of the opportunities we have out there and the little bit of a preamble earlier in the call talking about how the markets move quickly on price and not on structure, we actually, there's one that we're knee deep in and hopefully we'll execute on over the next few days, that because of that disruption in December, pricing did come back some, Chris, so that it would've been let's call it 14, 15% that had to get done in December. But because it grew out, it's probably coming down in the different components between 10 to 12%. However, we're able to get a lot tighter docs on restricted payments, on other debts, on things like that that we know they were talking to people in December and we all said no to that. But we've been able to shift that with some time.

Chris Kotowski: Alright and then the other question on the buybacks, I understand that given your cap and capital you on some level hate to use any capital to buy back stock but on the other hand, I do have to believe that less than 70% of NAV that it's the most compelling where you could possibly deploy capital but your buybacks have been very measured and modest. I mean I guess what do you think are - is there room to be more aggressive on that or are there other options to kind of close the gap between where your stock is trading and NAV?

Michael Mauer: We're looking at all of that and everything is on the table.

Chris Kotowski: OK. Alright. Thank you.

Operator: Our next question comes from Christopher Nolan. Please state your question.

Christopher Nolan: Hi. A follow-up on Chris Kotowski's question on buybacks. If you're going to lever up the balance sheet, why don't you just do a tender?

Michael Mauer: Chris, we keep looking at everything and nothing's off the table.

Christopher Nolan: Alright, it just seems it makes a lot of sense on multiple levels given where we are in the credit cycle and everything else. On your comments in terms of your average portfolio size which was 9.8, am I correct that you're comfortable with that level or should we see the average portfolio investment go down?

Michael Mauer: I think that anything in an 8 to 11 on average we're comfortable with. We're not comfortable with a 12 to 15 on average and I think that trying to get more specific between 9 versus 9.8, I'd be misleading you on trying to be that exact because when we're committing to deals, we're normally committing in a 5, 8, or 10. Those are normal increments if you're a 10 or below. You can't really commit at 9.3 or 9.5 to a deal. So from an average, we think that 8 to 11 across the portfolio will probably be the bookends of what we're targeting.

Christopher Nolan: I guess sort of an objective question would be where do you see the risk, do you see the risk higher this year than it was 12 months ago and how has that affected how you're running things?

Michael Mauer: From a credit risk, we have thought that that's been going up for the last year and a half. So if you look at our portfolio shift, where it was more predominant second lien than first lien because of credit risk and very importantly, because of documentation and structural risk, we had seen that going up. Over the next 12 months, I think that what we're worried about is watching for a cycle, watching for softness in certain industries. There are some industries that because of it are actually going to give us better terms and may become more attractive, things like home building and building materials, housing, etcetera where we think that that is one that could cycle. It's always going to be there but what is the right level of leverage and how much equity do you want below you. So, we want to be conscious of cyclicals and non-cyclicals. I think from a credit risk, we're cautious. We do think that from a structural standpoint, over the short term that is actually moving our way, that is an area that having done this for 25 years now, three to six months from now that could be dramatically different, depending on the environment.

Christopher Nolan: Thank you for taking my questions.

Michael Mauer: Yes, thank you very much.

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

Michael Maurer: Thank you everyone. We appreciate the time and we will talk to you again. Thanks.

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

- End of Recording -