Conference Call
CM Finance Fourth Quarter Earnings Release
August 31, 2016 at 2:30 PM ET

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 star zero. A question-and-answer session will follow the presentation. I'll now turn the call over your speakers. You may begin.

Mike Mauer: Thank you, operator. Thank you all for joining us today. With me today are Chris Jansen, my co-chief investment officer, and Rocco DelGuercio, our CFO. Before we begin, Rocco will first 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 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 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-K 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 filing, 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: Thank you, Rocco. As we discussed on our conference call back in May, Rocco DelGuercio has joined us as our new CFO and, effective tomorrow, our Chief Compliance Officer. Rocco joins us from Credit Suisse with over 30 years' experience focused on both registered investment companies and compliance. I'm going to begin today's call with a discussion of the leverage finance market. I'll then turn the call over to Chris to walk through our portfolio activity in the quarter, and Rocco will speak about our financial results. I will conclude with a discussion of our portfolio.

Leveraged finance new issue volumes increased in the second quarter. As we often see, this coincided with tightening spreads and more borrower-friendly terms for debt documentation. Opportunistic refinancing activity, loan repricings and dividend recaps have returned. The average leverage multiple of new loans continues to increase with some notable high multiple outliers leveraged well beyond what we were seeing even six months ago. Supply and demand for debt is rarely in balance, and the market tends to overshoot in both directions.

In the broadly syndicated market, over two-thirds of the issuance is covenant-lite, and what LCD terms “opportunistic transactions,” represented 46% of total issuance for the quarter. As middle market investors, we are somewhat insulated from some of the activity observed in the larger leveraged finance market. But over time, middle market does see the effect of the trends in the broadly syndicated loans. We are extremely selective in making our new investments, passing on a number of deals due to structural considerations.

The middle market continues to present an enormous set of opportunities for investors. While everyone’s definition of middle market is a bit different, we all agree it’s a broad and essential part of the business landscape in America. According to National Center on Middle Market, there are nearly 200,000 companies in the middle market. These companies need capital for growth, to finance working capital, to buy assets, and to be acquired by sponsors. Non-bank lenders like us have the flexibility to lend unconstrained by the OCC and FDIC, and can structure deals that make sense for all parties involved. We’re excited by opportunities we see in the primary and the secondary markets, and as such, we have discipline to be patient and wait for the right borrower, structure, and terms before we deploy our capital. I’d now like to turn the call over to Chris to discuss our investment activity.

Chris Jansen: Thanks, Mike. We made three new investments during the quarter, although you will note two of these in our 10-K. I’ll explain that momentarily. We also had two investment realizations which included one of our three new investments. First, I will go through our new portfolio investments.

As I mentioned on our last conference call, we invested in the first lien loan of Premier Global Services or PGI. PGI is a leading global provider of conferencing and collaboration solutions. This loan backed the LBO of the company by Siris Capital.

We also invested into School Specialty's first lien loan. School Specialty is the leading distributor of supplies and products to the K-12 school marketplace in the United States. Our yielded cost on this investment is approximately 10.7%.

Our final new investment in the quarter was in the second lien loan for MW Industries. MWI designs and manufactures springs and fasteners. We got a small allocation in the process and we evaluated our ability to grow the position to a meaningful hold size. Ultimately, we decided to sell the position at our cost, making MWI one of our two realizations during the quarter. As we sold before the loan funded, there were no cash flows, and as such, there's no IRR to report.

Our other investment realization in the quarter was RegionalCare which I spoke about on our conference call. Our second lien loan was repaid at its 101 call premium in connection with Apollo's decision to merge RegionalCare with Capella Healthcare. Our realized IRR was 14.4%.

Since quarter-end we've had additional investment activity. 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 was 10.3%. The newly merged company, which combined Maxim and AmQuip, was renamed Cloud Crane. We invested in Cloud's second lien secured notes as part of the primary syndication.

Much like MWI, we received a very small allocation. We opted to sell the position at its small gain rather than purchasing more at a premium to the new issue price. Because of the short tenure of our ownership, there's no IRR to report, and since the investment was both made and sold intra-quarter, it will not appear in our holdings on our next 10-Q.

Finally, we made a new portfolio company investment recently. FleetPride is the largest independent distributor of aftermarket, heavy-duty truck and trailer parts in North America. We made an investment in the first lien loan. Our yield at cost on the investment is approximately 10.6%.

We are continuing our work to diversify the portfolio. We held investments in 21 portfolio companies as of March 31st, and 22 portfolio companies as of June 30th. As of June 30th, our largest industry concentration was in gaming at 19.5% of the portfolio at fair value. This is up from 19.2% last quarter, and is the result of portfolio activity outside the sector, as well as changes to our marks. Our second largest sector was energy at 11.7%, followed by telecommunications at 11%. Industrials and automotive each represent just under 8% of our portfolio as of the end of June. 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 $4.4 million or $0.32 per share. As of June 30th, the fair value of our portfolio was $272.1 million compared to $276.5 million at March 31. Our investment activity accounts for a $4.6 million decline in our portfolio offset by a positive $200,000 increase in our net change in our marks.

In our earnings release, you will note that we have reported our portfolio yield two ways. Historically, we have not included the effect of scheduled amortization payments in our yield calculation. However, scheduled par repayments are of increasing importance to us on how we think about yield, especially as we have made several first lien investments at a discount to par in recent months. We believe that calculating our portfolio yield, with amortization included, fairly represents how we think about yield in the context in our investment process. Going forward, this will be the yield that we will be reporting in our earnings release.

As of June 30th, weighted average yield of our debt portfolio at amortized cost without amortization was 9.57% compared to 9.71% at March 31, and 10.91% at June 30, 2015. Weighted average yield of our debt portfolio, including amortization, was 9.8% at June 30, 2016 compared to 9.9% at March 31, 2016.

Our debt portfolio was comprised of 88% floating rate and 12% fixed rate investments. Our average portfolio company investment was approximately 12.4 million, and our largest portfolio company investment was 29 million. 57.7% of our portfolio is in first lien investments and 42.2% of our investments are 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-K filed yesterday.

With respect to our liquidity, we had 18.4 million in cash, 18 million in restricted cash, and 19.5 million of capacity under our 50 million revolving credit facility as of June 30th. We were 0.81 times levered as of June 30th, compared to 0.83 times levered at March 31. With that, I'll turn the call back over to Mike.

Mike Mauer: Thanks, Rocco. While our net fair value change this quarter was small, we had five investments whose fair values changed by over $500,000 and two of these changed by over $1 million. I'd like to go through each of these briefly.

AM General, JAC Holdings, and YRC all increased in value this quarter. AM General manufactures the iconic Humvee for military applications, and is also a contract manufacturer for the R-Class Mercedes Benz. JAC manufactures OEM roof rack systems for cars and light trucks. Both companies benefitted from robust consumer demand. YRC Worldwide is a large less-than-truckload carrier; both YRC and AM General also benefitted from tightening spreads in the broad syndicated market. As these two loans are more liquid than most of our holdings, market moves are a more significant input to fair values for these loans than for some of our other investments.

Trident and Endemol were marked down in the quarter. Both of these loans are performing, both are second lien loans. Trident is a healthcare company providing outsourced imaging and lab services. Leverage has increased since the time of our investment, and Trident's results have been behind budget, although their revenue and EBITDA have been stable over that time. Endemol is a company I spoke about before. Our investment is the second lien and is listed in the scheduled investments under the name AP NMT Acquisition BV. It is a large independent TV programming company, owned by Fox and Apollo, that produces both scripted and reality TV content. Like Trident, leverage is higher than our average portfolio company, and results have been modestly behind budget, and our mark reflects that.

Our marks on our positions in the energy space did not change materially in the quarter. The price of oil has improved from the lows seen earlier in the year. We feel much more confident in the future prospects of our investments in the space when oil is between \$45 and \$50 a barrel rather than in the 30s. Another significant source of comfort is the basins our portfolio companies operate in.

The North Slope of Alaska, the Permian Basin, and the DJ Basin are all geographies with prolific wells and lower breakevens. Caelus operating on the North Slope had excellent well results and has hedged over half its production this year at over \$80 a barrel, and has hedged a significant portion of the expected production in 2017 and out into 2018.

Bird and AAR, our two non-accruals, are services companies. As such, drilling and work over activity are the major drivers in their results. The DJ Basin, where AAR operates, and the Permian Basin, where Bird is located, are some of the first basins to see the benefit of renewed activity as oil prices have recovered.

As a reminder, these loans represent 6.2% of our portfolio in a fair value, and approximately 10% at our amortized cost. Both remain on full non-accrual. We continue to work with other lenders and stakeholders and have constructive discussions on both Bird and AAR. Despite the difficulties they have encountered in the energy sector and the reset for the oil in the current price environment, rather than the much higher activity that was at the time of our investment. Their underlying businesses are beginning to see the benefits of the recovery in oil prices versus the earlier part of this year. Both management teams are engaged and focused on operational improvement.

On August 25th, our board of directors declared a distribution for the quarter ending September 30, 2016 of \$0.3516 per share payable on October 6th to shareholders of record as of September 16th, 2016. This dividend level represents a 9 3/8 yield on our IPO price of \$15, and a 14.7% yield based upon yesterday's closing price of \$9.59. As you know, we agreed to waive our incentive fees through calendar '16 to the extent necessary for NII to cover our dividend. We also have a three-year high water mark. The high water mark was triggered in December of '15. We did not earn any incentive fees this quarter due to the high water mark and we do not expect to earn incentive fees through December 31st. We do expect to begin earning our incentive fees during the first calendar quarter of 2017.

We are committed to paying an appropriate dividend level. Our board of directors supports us in this commitment to you, our shareholders. As we move into year-end and into the first quarter of calendar 2017, we are evaluating the portfolio's run rate net investment income. We will work with our board to ensure that our dividend policy going forward is consistent with our ability to generate NII without reaching for yield or changing our focus from secured lending.

Our overall portfolio continues to perform well. The yield on our accruing assets, at cost, is 10.9%. This is in line with our average yield last year on June 30, 2015 before we had non-accruals.

We see opportunity in both primary and secondary markets in first and second lien debt. Our investments in PGI, School Specialty, and FleetPride are all examples of our attention to the full spectrum of opportunities that exist from our direct origination sources and the secondary market. PGI was a larger middle market deal that required market input to adjust the price and structure. School Specialty is a closely held exit loan for a restructured company that we have followed closely since 2013. And FleetPride is one we would characterize as a dislocated credit.

We continue to have a great dialogue with all of our organization channels including our strategic partners, Cyrus and Stifel. We have an ability to look broadly for opportunities to deliver the best risk-adjusted returns in our portfolio. Our underwriting will always focus on the quality of management teams, capital structure, 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. And with that, I'd like to turn it back to the operator to please open the line for Q&A. [Pause]

Operator: Ladies and gentlemen, at this time we will conduct the question-and-answer session. If you would like to ask a question, please press star one on your phones now. Once again, to ask a question, press star one now. Our first question comes from Robert Dodd from Raymond James. Please state your question.

Robert Dodd: Hi, guys. On Bird and AAR for the non-accruals, thank you for the color on those. What needs to happen for those - conceptually, coming back on our call – obviously, a drilling activity, but is the restructuring underway where they could come back to a performing level even without the oil price rising, or is it purely a function of activity in those basins and not being driven by the oil price at this point?

Mike Mauer: Let me answer that, Robert. Thank you for the question and thank you for the attention around these, because I think that we feel better than we have in quite a while about both of these credits, but we also are a bit patient in the way we're approaching those investments. So there are two answers and first is do either of them need restructuring to the capital structure? The answer is – on Bird, I'm not sure that it does. I think that the most critical thing for Bird is to see sustained oil prices in the environment that we're in. I'll call that $45, plus or minus, anywhere in the $40 to $50, and as we break $50, it becomes even better. But it's at $25 to $30 that we saw early this year that is non-constructive and is non-sustainable from the Bird perspective or an AAR perspective. But I think the energy market and the oil level is the most important thing to see for Bird over the medium to longer term.

On AAR, the debt load is a bit higher, so there may be some restructuring there. I don't think it will be significant. There are constructive dialogues that are going on, but again, that gets back to really underpinning long-term is where is the oil piece. And we have seen a pickup in activity for AAR. We've seen a discussion of scheduled standing up of rigs in this $45 plus or minus environment in the DJ Basin. So, from our perspective, it's making sure that we have a capital structure and their current cash flows can support the business while we're not accruing. We will be able to start accruing over the medium term assuming that there is a sustained oil environment around where we are. Hopefully that answers your question.

Robert Dodd: That does answer the question. Thank you. Another one on - not a non-performing asset - a good asset here, Land Holdings. So that's carried above par, I presume a pre-payment penalty. I think, if I remember right, we're into a 102, down from I think above that, before the end of June. All right, so what do you think the probability of that asset repaying? Because obviously, it's a fairly – a pretty good yield, pretty good size and nice prepayment penalty as well if it happens, but what do you think the probability of that staying through, say, the end of the year is?

Mike Mauer: Well, let me answer that a couple of ways. As you probably are aware, we normally do not just, in our script, go through any partial pay downs. We wait until we've fully realized. Land Holding is one where we have received a partial pay down in July. The partial pay down was approximately 50% of it, 11.98 million at the premium. The IRR on that piece realized was a little over 15%, and we are in the process of – we've got two or three things that, hopefully, over the next four to six weeks, we will reinvest in. One of those is like a similar yield first lien category. The others are first liens also, but more in line with the investments that Chris talked about in the 10% to 11% range. So, Land Holdings right now, the debt - the total debt, Chris, is 30?

Chris Jansen: Yes. Altogether it's about 50 from the company debt. This is…

Mike Mauer: Including the FF&E of the - and the term debt is 30?

Chris Jansen: Thirty.

Mike Mauer: Which we are first lien against all of the plant and property. The equipment has a separate lien which is on top of that 30 and the cost base is well in excess of 200 million on that 30 million that we have advanced. So, we love that loan and I think, to your point, at some point they will refinance it, but we think that at this point they have not given any signs that it's going to happen soon and that has brought down our gaming exposure a little bit further.

Robert Dodd: Perfect. Thank you for the color and congratulations for the stable quarter.

Mike Mauer: Thank you.

Operator: Our next question comes from Greg Mason from Ares Management. Please state your question.

Greg Mason: Great. Good afternoon, guys. Appreciate you taking my questions. Just had a question on your comments about looking at the dividend related to long-term net investment income, being able to cover that. If we look at this quarter, you had $0.32 of NII versus the $0.35 dividend, and you didn't have any incentive fees. Can you just walk us through just some of your – without giving guidance I guess, but just it seems like those two numbers seem to be far away from each other as you look at having the dividend being covered by NII over the long run?

Mike Mauer: Well, I'll just say, Greg, you're right. Without giving guidance and without – listen, that's why I tried to walk through it the way I did, which is we feel pretty comfortable about the dividend level for the September and December quarters at this point. And we are going to look during December and into the first quarter of 2017 at that level, and that is a board-level discussion. We have started that discussion and education about where the market is, where we are, where our portfolio is. So, that is something that will develop over that time, but beyond that, I would be giving more guidance than I think is appropriate right now.

Greg Mason: Okay and then just as we think about modeling the earnings going forward. If we look at the current dividend on the current book value of 11.90, it's 11.8% return on book equity. Others have written about the math to make that work, and I think you probably have to do 13-plus percent type of yield. You did 10.6% yields this quarter. I think that's been pretty stable over the last few quarters. Just your views as we go into year-end. What you're seeing in terms of yield opportunities, is there an opportunity to do greater than the mid 10% asset yields or is this kind of the appropriate level for the risk you guys are targeting?

Mike Mauer: Our target right now is in that mid-10. I'll call it 10 to 11. There are a couple we're looking at that are in the 8.5 to 9.5 that are secured four or five times by assets that we love, first lien and there is another one that's 12.5/13%, okay? But on average, I think the 10 to 11 is appropriate.

Greg Mason: Okay, great and then one last question. Your comments on the incentive fees coming back in Q1, are they not being paid now because of the three-year look back or because of the target dividend that you gave at the IPO?

Mike Mauer: It is zero today because of the three-year look back. It would be partially earned, not fully earned without that.

Greg Mason: So to that end, give that's a three-year look back and some of the issues happened in 2015, can you help us think about why that kind of kicks back in in Q1 of '17, since that would be kind of two years into the three-year look back?

Mike Mauer: Yes because we had excess capacity in that look back going into December quarter and we – as a result of the write downs, we used some of that excess, plus we dipped in to trigger the look back.

Greg Mason: Got it, okay.

Mike Mauer: Because there is the maximum you can pay out and we weren't paying out the maximum prior to December of last year.

Greg Mason: Got it. Thank you, guys. Appreciate it.

Mike Mauer: Okay. Thank you very much, Greg.

Operator: Once again, if you would like to ask a question, please press star one now. [Pause] There are no further questions at this time.

Mike Mauer: Operator, thank you. And we would like to thank everyone for taking the time and calling in, and as always, we are available. Thank you.

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

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