P.O. Box 4689
Greenwich, CT 06831
Toll Free: 888-223-9488
International: +1-203-413-2423
transcripts@civi.com

Conference Call
CM Finance
May 8, 2019

Operator: Welcome to the CM Finance Earnings Release Call, Third Quarter ended March 31st 2019. 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.

Mike Mauer: Thank you, operator. Thank you all for dialing in this afternoon. 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 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 the 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.

Michael Mauer: Thanks, Rocco. Last night, we reported our results for our fiscal third quarter ended March 31st. We added more new positions than we have in any prior quarter, and had a net addition of three portfolio companies. We have diversified our portfolio more than ever before with investments in 20 different industries. Oil and gas, which was once by far the largest sector weighting, is now our third largest sector at 10.5% of the portfolio. Very proud of the work our team has done, originating new opportunities, proactively managing the risk, and repositioning us into a more resilient portfolio.

The market in the first calendar quarter of 2019 was surprisingly active. After a tumultuous December, secondary levels snapped back faster than we and probably anyone expected. Volatility, which we saw not only in our market, but across the global equity and fixed income markets, resolved itself quickly and we saw a tightening of spreads beginning to take hold fairly early in the quarter. While new deal economics snapped back to full levels, we are heartened by the fact that new issue deals have not quickly regressed to the borrower and sponsor-friendly terms we saw that especially when considering leverage levels, maintenance covenants, and the ability to pay dividends in the other elements which add risk from a lender’s perspective.

We have a broad perspective on structural terms in the leverage finance market as we invest in direct club loans and secondary opportunities where we see catalysts in strong relative value, and even selectively, in primary syndications. This quarter, we made investments in a DIP loan, in a high-yield bond, in private club transactions, and in the secondary market purchases of loans. Dislocated loan pricing creates secondary opportunities but also echoes in new issue loan terms and pricing. When the secondary market is weak, the primary market is effectively forced to increase coupon and, in many cases, change non-economic terms in the lender’s favor. To state the obvious, this makes for a better environment for us to deploy capital.

For the last several quarters, our bias has strongly favored investments in first liens. Between realizations in second liens, and new first lien investments, we’ve grown our exposure in first lien investments to over 75% of our portfolio. While this may be higher than it will be in the future, it is directionally indicative of where we focus our origination efforts. We continue to invest in short weighted average life assets, where we see opportunity to generate superior returns through early repayment. We are also focused on adding positions in club deals, which will be a step removed from market volatility.

With that, Chris will go through our investment activity during and after the quarter in greater detail, and then Rocco will discuss our financial results. I’ll conclude with the specific detail about our largest marks, both positive and negative. I’ll discuss our write-off of Trident and movement of Fusion to non-accrual. I'll talk about our outlook over the next few months, and then always, we'll end with Q&A. With that, I'll turn it over to Chris.

Chris Jansen: Thanks, Mike. We had a very active quarter, investing in 10 portfolio companies, including five brand new portfolio companies, and one which had previously been a portfolio company which we have previously exited. Of our $65.6 million of new investments, all but $2 million were first lien. We also had four full realizations during the quarter. I'll quickly cover our additions to existing positions first.

We continued adding to our first lien investment in Arcade Bioplan. We began building this position two quarters ago. Our yield at, cost, including this quarter's purchases is approximately 9.6%.

We added to our position in ProFrac, a pressure pumping services provider operating the Permian, DJ, and Haynesville Basins. Our yield, at cost, is now 8.6%.

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 approximately 8.1%.

The next category I'd like to cover are our fundings on revolving and delayed draw positions, which included Sears Holdings' DIP loan, Open Mobile's delayed draw loan, and 1888's revolver. In total, these fundings accounted for approximately $8.9 million of our new investments this quarter.

We had seven other new investments this quarter.

First, we invested in the FILO Exit Loan for Sears. This loan was part of the financing package which allowed the company to exit bankruptcy, and this loan repaid our investment in the Sears' DIP loan. Our yield, at cost, on the FILO loan is 10.6%. Our investment in the DIP loan was paid off concurrently with this transaction.

We invested in FleetPride, which had previously been a portfolio company of ours. This new first lien loan backed the LBO of the company by American Securities. Over the course of our two prior investments, we have had an IRR to date of 15%. While we expect to realize a lower return on this investment, we also have a great deal of confidence in the company. Our yield, at cost, is 7.9%.

We invested in ACPI, a manufacturer of kitchen and bathroom cabinets. Our first lien loan supported the company's acquisition of ELKAY. Our yield, at cost, is 9.8%.

We made an investment in the first lien loan of KIK Custom Products. KIK is a diversified manufacturer of consumer package goods. In particular, personal care products, anti-freeze, and pool chemicals. This a shorter dated loan, maturing four years from now. Our yield, at cost, is 8.4%.

We have a small investment in the first lien notes for Nexeo Plastics. These notes were part of the financing package for the carve out of the plastics distribution business from Univar. The sponsor is One Rock. Nexeo Plastics is a portion of Nexeo Solutions, a former portfolio company of ours. Our yield, at cost, is 10.5%.

We invested in a club deal with both a first lien loan and second lien loan to Carlton Group. The company manages rewards programs for corporate customers. These loans were originally placed as an acquisition financing. Our first lien yields 9.9% at cost, and our second lien yields 14.8%.

Finally, we invested in the first lien loan to Empire Office. Empire is the nation's largest Steelcase dealer, and is the largest commercial furniture dealer more broadly. The yield, at cost, of this investment was 10.5%.

We had four fully realized investments this quarter as well. The first of these, the DIP loan for Sears Holdings I mentioned a few moments ago. By its nature, the DIP was a short-term financing and this obviously has a meaningful effect on the IRR. Our yield was 18.2% and our fully realized IRR on this investment was 59.1%.

We were repaid on Caelus Energy, which has been one of our largest positions since early 2014. Caelus was approximately 8% of the portfolio, and its par repayment is one of the major drivers of the reduction and our exposure to oil and gas. Our realized IRR was 12.4%.

Our first lien loan to Zinc Borrower was repaid. The company's performance has been excellent, and we continue to hold an equity co-invest position in the company. Our fully realized IRR on the loan was approximately 14.4%.

Finally, we have now fully realized our position in US Well Services. Like Caelus, US Well was a debt investment we made in the oil and gas sector in 2014. US Well reorganized in 2017 and our first lien loan was structured into a new term loan, as well as class A and class B LLC units. At the time of the restructuring, we also participated in a new revolving credit facility for the company. We sold our LLC units in the second quarter of 2018, fully realizing that portion of our exposure. In the fourth quarter of 2018, US Well was acquired by a SPAC. Our revolver exposure was repaid and we fully realized that portion of our exposure then. In conjunction with the SPAC transaction, 92% of the first lien loan was repaid with cash and the remaining 8% of the loan received shares in the newly public company. The cash was a substantial portion of the first lien realization but this quarter, we sold our USWS shares. With the USWS shares sold, we have now fully realized our investment in US Well. Our IRR, from our first investment in the first lien loan in May of 2014, to our final sale of shares in March this year, was 15.1%.

Our portfolio company count was 32 at March 31st versus 29 as of December 31st and stands at 33 today. We have not had any full realizations since quarter end, but we did make a new investment in the first lien loan of Limbach Holdings, a contractor focused on HVAC, plumbing, electrical, and mechanical services for commercial construction. Our yield, at cost, on Limbach was 10.8%. Using the GICS Standard as of March 31st, our largest industry concentration was Professional Services at 14%, followed by Media at 10.7%, Energy Equipment and Services at 10.5%, Commercial Services and Supplies at 8.9%, and Construction and Engineering at 7.1%. I'd now like to turn the call over to Rocco to discuss our financial results.

Rocco DelGuercio: Thanks, Chris. For the quarter ended March 31, 2019, our net investment income was $3.4 million or $0.25 per share. The fair value of our portfolio was $299.1 million compare to $283.3 million at December 31. Our investment activity accounted for a $21 million increase in our portfolio, including $4.8 million of net realized and unrealized losses.

Our new investments during the quarter had an average yield of 10.63%. The weighted average yield of our debt portfolio was 10.44%, a decrease of 64 basis points from 11.08% on December 31. The major drivers of this decrease were the decline in LIBOR, the repayment of Sears' DIP, which had an extremely high yield, and the movement of our investment in Fusion Connect to non-accrual.

As of March 31, our portfolio consisted of 32 portfolio companies; 75.9% were in first lien investments an increase from 63.7% last quarter, mainly driven by the repayment of $24.3 million of Caelus second lien, and $63.6 million of new first lien investment in this quarter. As of March 31, 19.9% of the portfolio is in second lien, 3.8% is in unitranche investments, and approximately 0.3% is in equity, warrants and other positions. 94.5% of our debt portfolio was invested in floating rate loans and 5.1% in fixed rate positions. Our average portfolio company investment was approximately $9.3 million, and our largest portfolio company investment was PGI at $18.7 million. We were 0.91 times levered as of March 31 versus 0.86 times levered as of December 31.

Finally, with respect to our liquidity, as of March 31, we had $6.8 million in cash, $3.9 million in restricted cash, and $46 million of capacity under our revolving credit facility. Additional information regarding the composition of our portfolio is included in our form 10-Q filed yesterday. With that said, I'd like to turn the call back over the Mike.

Mike Mauer: Thank you, Rocco. We're proud of the progress we've made repositioning the portfolio. Not only have we maintained our focus on secured lending, but the team has done a phenomenal job originating first lien opportunities. We may not always have in excess of three-quarters of the portfolio in first lien investments, but the lower risk profile that we have developed is something that we do intend to maintain over the near to medium term. We do not have a significant portion of portfolio in second lien investments, and we don't see any reason to reach down the capital structure for yield to keep the portfolio in the 10 to 11% context that we think is appropriate in the current market environment.

This quarter, we did write-off Trident as well as two markdowns which I want to discuss with you. Since we believe the probability of any material recovery on Trident is minimal, we have written off the zero value in the current quarter. There is no cash effect of this write-off. It is simply a change from unrealized loss on Trident, to a realized loss. That is why you won't see Trident on the schedule of investments.

We marked down our position in the first and second lien loans on Premiere Global Services by an aggregate of $3.1 million. PGI's fundamental results have been challenged as the company transitions its business to subscription-based models, continues to make operational changes and reduce cost, and faces a capital structure that now has higher leverage than anyone expected when we underwrote the transaction. That said, the sponsor, Siris Capital, continues to be supportive and behaves in a manner that gives us confidence in the business over the long term. We monitor PGi closely and maintain a consistent dialog with fellow lenders and with Siris.

Finally, we reduced our mark on Fusion from 95 to 80. Fusion is a public company trading under the ticker, FSNN. They released an 8K on April 2nd, announcing that they have failed to make a scheduled amortization payment to the first lien lenders, including us. Since then, there have been a series of forbearances signed but the principal of payment has not been made. As such, our expectation is that the company will fail to make interest payments as well and will likely need additional liquidity in the near term. Given our confidentiality obligations, I'm not at liberty to say more, but we are working closely with our fellow lenders and legal and operational advisers.

We remain extremely selective in our new investments. We have added club deals originated through the team's long-standing relationships with other lenders. We have utilized our relationships with investment banks to see opportunities that others have not. We have also found short dated loans in the secondary where we expect to generate about average returns. Our focus is on the quality of management teams, the rigorous evaluation of loan credit, and the security documentation, and on loan-to-value analysis to ensure downside protection. This approach is dedicated to preserving capital and maintaining a stable dividend. Last quarter, I guided that we expected to be over 30 portfolio companies in the near term, and we're very pleased to have crossed that threshold during this quarter, and further grown the company count to 33 today. We have an additional investment that we have committed to that we'll fund in the coming days. Despite the unpredictable nature of unscheduled prepayments, we think that growth of the company count is evidence of our progress and portfolio repositioning that we began several quarters ago. We have targeted opportunistic sales to help fund the purchase of new loans, and we have reinvested the proceeds of larger repayments in multiple new portfolio companies. Our largest single investment is now $15 million versus $26 million a year ago.

We just reached the anniversary of our Board's approval of the modified asset coverage requirements of the Small Business Credit Availability Act. Put in plainer terms, as of May 2nd, we have the ability to increase our leverage from a limit of one times to two times. We have the leverage line capacity to increase beyond one to one today, and are negotiating additional capacity presently. I would guide that our new leverage target will be in a 1.25 to 1.5 times context. This change in the leverage limit is the main reason that our leverage increased quarter-over-quarter as we ramped up with good opportunities as they have become available to us.

Lastly, on this point, the adviser will waive the base management fees in excess of 1% over the next quarter on leverage above one times. We covered the March quarter dividend with NII and fully earned our incentive fee. Although we waived a portion of that incentive fee, we expect to cover the dividend and earn our incentive fee in the June quarter. Our Board of Directors declared a distribution for the quarter ended June 30th 2019 of $0.25 per share, payable on July 5th 2019 to shareholders of record as of June 14th. We have maintained our dividend of $0.25 since March of 2017 and are confident that this is a level that is supported by our ability to generate NII without reducing the quality of our investments or changing our focus from secured lending opportunities.

This quarter, we were in an extended blackout period and as such, were unable to purchase any additional shares. On May 1st, the Board approved the extension of this $5 million-dollar program through May 1st 2020. We are currently continuing to work with the Board to evaluate the reactivation of the share buy-back program.

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 say a question, please press star one on your phone now and you'll be placed to the queue in the order received. Please just listen for your name to be announced and be prepared to ask the question when prompted. Once again, to ask a question, please press star one on your phone now. [Pause] Our first question comes from Christopher Nolan. Please state your question.

Christopher Nolan: On your new investments, how many turns have you been [Audio Gap]?

Mike Mauer: Chris, I'm sorry. You're breaking up. Could you try it again? Maybe if you're on a speakerphone, pick up, I'm not sure.

Operator: [Pause] Christopher, are you still with us?

Christopher Nolan: Can you hear me?

Operator: We'll go to our - yes. Go ahead.

Christopher Nolan: Can you hear me now?

MikeMauer: Go ahead. Give it a shot. Sorry.

Christopher Nolan: Okay. How many turns of EBITDA for the new debt investments?

Chris Jansen: This is Chris Jansen.

Christopher Nolan: Hey, Chris.

Chris Jansen: The most recent ones we've done are more club deals, which have lower leverage. We don't disclose how much leverage we have on each individual investment. We are focused on the equity cushion, using reasonable multiples of enterprise value to EBITDA, and it's ranged between 40 and 55% for the last three or four deals, the equity cushion.

Christopher Nolan: Okay. And then on the higher leverage limits, Mike, I believe, mentioned that the target level is 1.25 on a regulatory basis. When do you anticipate to reach that, if ever, and also, do you have to get any sort of compliance changes or covenant changes with your debt or bank facility?

Mike Mauer: Yes. So what I mentioned was a range of 1.25 to 1.5. I would expect that within 90 to 120 days, we will be in that range, and no we do not need any amendments or adjustments to our current lending agreements that will allow us to go toward that range, and we have received offers that are actually more attractive on most fronts than our current lending terms to expand up, but we are continuing to have discussions to make sure we maximize returns on that point. Just to clarify, today, we are at just shy of one turn so we have continued to increase post quarter end anticipating that as of this week, we could do above that one time.

Christopher Nolan: Great. Thank you very much.

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

Robert Dodd: Hi, guys. A couple of numbers questions first. Rocco, Can you give us a ballpark, at least, on accelerated fees of one-time fees that occurred in the interest income line this quarter, maybe because of the first Sears DIP or anything else that did repay?

Rocco DelGuercio: Hold on, Robert. Let me look at that. I believe we disclosed it in our financials. Give me a sec.

Robert Dodd: Okay, got it. Obviously, I'm putting some of it at the queue but just another one to go with that while you're looking up, that maybe - the custodian fees this quarter were – custodian and administrative fees were very high – a quarter million bucks, this fee. The nine months last year, it was only slightly higher than that. Is that a new higher run rate going forward, or was there something going on in the quarter that drove those higher and we'd expect them to drop back down to a more historically normal rate going forward? Because obviously, that moves the numbers.

Rocco DelGuercio: So, Robert, on that, basically what happened was we were kind of chewing up the accruals and that's why you're going to see a little bit of uptake, and then next year, for next year, you should be – they should level up back to normal levels.

Robert Dodd: Okay, got it. Got it.

Rocco DelGuercio: Okay. Then on the repayment, two deals. It was Sears and Caelus were basically that had accelerated. We're talking about $600,000 on that.

Robert Dodd: Got it. Thank you. Then, on credit quality, obviously, Premiere and Fusion Connect, you gave some color on them as there's limited amounts you can say, but at the same time, I mean, we saw – not that long ago, a rapid deterioration in Trident, which caught you a bit by surprise – it caught everybody by surprise. What's the risk that we're seeing a repeat of that with Premiere and Fusion? Obviously, they're marked well above where Trident ultimately exited, obviously. What's the embedded risk there given some of these things have had surprising and rapid results in the not so distant past?

Mike Mauer: I'm going to try to answer a little bit of this. Obviously, as you acknowledged in your question, we are bound by confidentiality so I can't go into specifics. What I would state as a – our view a very, very significant difference between the two is that if you look at two things. Number one, most importantly, we're first lien here, we were second lien in Trident. Number two, in that context, public information prior to the surprise, you had an equity cushion. I believe it was between $150 million plus or minus, and you had a junior capital of about $100 million below.

Robert Dodd: Okay, okay. Understood. Then the only other - Mike, your comment at the beginning, it seems that the market bouncing back in terms of loan bids, and this isn't just a case with you guys but with a number of other BDC's as well. Well, I really haven't seen other than the specific credit issues, we really haven't seen a lot of NAV rebound from just a rebound and kind of the secondary loan pricing as a feed into the fair value mythology. So, is there any color you can give on why we haven't seen a little bit more of a benefit from that pure mark to market?

Mike Mauer: I think that's a great question. We have this debate among ourselves and we also spend a lot of time thinking about fair value. Where something is actively traded and you see a large volume in it, it's pretty easy to figure out what the fair value is, Endemol is something like that where you saw it move up.

Outside of that, where there's not a lot of activity, then what you're doing is you're trying to say what are some of the market dynamics at work, and you can talk about where the market has moved. Number two, where LIBOR had moved – and that moved against us by about 20 basis points give or take during the quarter from a mark perspective. Number three, it is really looking at fundamentals, and you try to take all of those things – the market dynamics, the fundamentals, the activity, and in the fundamental category, this quarter is a unique quarter where majority of – and I'm talking to the market right now, and I would say I don't think we're different than the market. The majority of investments don't report new information because it's year-end. So, you have until after quarter-end where every other quarter, the majority are reporting new numbers mid-quarter because it's a quarter-end, it's not a year-end.

So, I think that you have a little less information when you're going through your analysis from the fundamental side because you don't have new fundamentals. Then you do have the market information, our portfolios tend to be less liquid, less traded, less data points and so, we are, I think, always going to make sure that we're doing the right things from the conservative standpoints, and not quick to write things up, if that helps.

Robert Dodd: Yes, yes. That helps a lot. I really appreciate that comment. Thank you.

Rocco DelGuercio: Hey, Robert. It's Rocco again. While Mike was talking, I was able to look through financials a bit. Acceleration, on page 40, the acceleration was a little over a million dollars.

Robert Dodd: Got it. Thank you.

Operator: Our next question comes from Paul Johnson. Please state your question.

Paul Johnson: Good afternoon, guys. Thanks for taking my question. First, I just want to make sure that I heard you correctly. Did you say that you will be planning to waive fees on assets above the one times leverage level to 1% for base fee?

Mike Mauer: Yes, the base fees for assets above one turn of leverage will be 1%, not one and three quarters.

Paul Johnson: Okay. Is that effective immediately or is that – does that need to be essentially voted on to be effective? How does that work?

Mike Mauer: It's effective immediately, it is. We, as a manager, can do that unilaterally. We can waive it. We don't have to ask permission to reduce the fee.

Paul Johnson: Okay, great. I think that's absolutely the right thing to do. Then, I guess, on that point, because you could maybe - you mentioned your target leverage range earlier. Could you talk to anything on what sort of strategy you would pursue, if anything different from what you pursued today in terms of the asset mix for assets above that one times that the equity leverage levels?

Mike Mauer: Yes. Thank you for the question, because it's one that probably I didn't spend enough time around. If you watched over the last 24 to 36 months, you've watched our mix move from 60% second lien to today, 20-odd percent second lien. So, one was a shift of where we are in the cycle and where terms have been, especially during 2018 and late '17. Consistent with that, we have shifted to more first lien, targeting a 60% first lien, 40% max second lien in the current environment. The opportunities we continued to see as we have increased our leverage have been attractive on the first lien. I think I've said it in my script that while we're at over 75% today, I don't think that we necessarily will stay at that level, but directionally, we will continue to be more weighted toward first lien, than second lien, or more unitranche where we have a first lien claim and more control around situations. So, we will continue to do that as we ramp into the 1 ¼ or 1 ½ times. Market may change. If we end up back in the 2010, 2011 environment, we will communicate will all of you, but that would be a very different environment than today as far as the amount of equity that's in the covenants, the controls, and the return that you get for second lien versus today.

Paul Johnson: Great. Those are all my questions. Thank you for that detail.

Mike Mauer: Thank you very much.

Operator: Once again, if you would like to ask a question, please press star one on your phones now. [Pause] At the time, we have no further questions.

Mike Mauer: Thank you very much. We appreciate everyone's time and we look forward to talking to you, I think, in September because we've got our year-end at June 30th. Thank you very much.

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

- End of Recording -