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

Mauer: Thank you, operator. Thank you all for joining us today. I'm joined today by Chris Jansen, my co-chief investment officer, and Rocco DelGuercio, our CFO. Before we start, Rocco will give you our customary disclaimer regarding information and forward-looking statements. Rocco…?

Del Guercio: Thanks, Mike. I would like to remind everyone that today's call is being recorded, and that this call is a 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 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 our forward-looking statements unless required by law. To obtain copies of our latest SEC filings, please visit our website at www.cmfn-inc.com. At this time, I would like to turn the call back over to our chairman and CEO, Michael Mauer.

Mauer: Thanks, Rocco. As is our custom, I will begin today's call with a discussion of the leveraged finance market. I'll turn the call over to Chris to walk through our investment activity during and after the quarter, and then Rocco will speak about our financial results. I will conclude with some commentary on our portfolio. Leveraged finance new issue volumes during the quarter were the highest since 2014. New issue activity in the broadly syndicated market and the upper end of the middle market continued to include borrower-friendly terms, tightening spreads with the vast majority of deals being covenant-lite. Refinancing activity including re-pricings, incremental first lien loans to repay second lien loans, and drive-by high yield issuance has resulted in the repayment of a number of loans which were made in a less aggressive environment for lenders. 2015 was a challenging time to find opportunities with attractive terms and structures. We were extremely selected in choosing our new investments, and we passed the numerous deals due to pricing, aggressive capital structures, or weak protections for the lenders. A very attractive capital market environment also has benefitted us.

We received two unplanned repayments during the quarter, both of which included call premiums. This helped boost our NII during the quarter and gives us the opportunity to redeploy our capital as we enter 2017. We made investments in three new portfolio companies since quarter-end and we have one commitment outstanding that we expect to close during the quarter. Our current pipeline is very active with several potential investments we would assign a high probability to. We are maintaining our focus on first and second lien lending, to high quality management teams and companies with structural protections for us as lenders. Despite the challenges of the syndicated markets, our team continues to originate a lot of exciting deals in the middle market, and where we are optimistic about the direct and club lending opportunities in our pipeline. I'd now like to turn the call over to Chris to discuss our investment activity.

Jansen: Thanks, Mike. We made four investments during the quarter including two investments in new portfolio companies and two different investments in an existing portfolio company. We had four realizations, two of which came with prepayment premiums. As we discussed on our call in November, we invested in the first lien loan of Dayton Superior. Dayton is the leading manufacturer and supplier of concrete construction products in North America supported by engineering and other value-added services. The yield at cost was approximately 10.2%.

Our second new portfolio company investment is Montreign Resort Casino, a development project in Sullivan County, New York. This first lien loan helps fund the construction of the new casino and hotel which would be operated by Empire Resorts which is controlled by the Genting Group. Montreign is granted one of the four new gaming licenses in New York State and is scheduled to open in 2018. Our yield at cost was approximately 10%.

We also made two investments in PGI, one of our existing portfolio companies, during the quarter. We participated in the new second lien loan for PGI. Our yield at cost on this investment was 11.5%. We also added to our position in the first lien loan.

We had four investment realizations during the quarter. First, we realized our investment in NWN Corporation both in its first new loan and our equity co-investment. We made this investment in the fall of 2015. Our fully realized IRR including our loan and equity investments was 11.8%. Our investment in JAC Holdings was called at its make/hold premium in November at a price of approximately 115. The company's sponsor, Wynnchurch, sold the company to Argonaut and our debt was repaid in connection with that transaction. Our realized IRR on this investment was 18.3%.

We also received two repayments in December. Our loan to ASV was repaid with a premium of 101. Our fully realized IRR there was 13.9%. Our loan to AM General was also repaid late in the quarter. We had held this loan since prior to our IPO and our fully realized IRR on this investment was 10.9%. Since quarter-end we've been quite busy. We have made additional investments in two of our portfolio companies, US Well Services and Montreign, and have also added three new portfolio companies. Intermedia is a leading provider of cloud-based software solutions for small and medium size businesses. We hold a small position in both the first and second lien loans which were placed the connection with the LBO Company by Madison Dearborn. Our yielded cost is approximately 7.1% on the first lien, and 11.2% on the second lien. The blended yield is approximately 10.5%.

We also invested in Immucor's first lien loan in the secondary market. Immucor develops, manufactures, and sells manual and automated analysis equipment which is used to test blood prior to transfusions. TPG is a sponsor of the company. Our yield at cost is approximately 7.2%.

Finally, we participated in a new second lien loan for Lionbridge which backed the LBO of the company by HIG. Lionbridge provides translation and globalization services to companies worldwide. Our yield at cost on this investment is approximately 11.1%.

We had 22 portfolio companies as of September 30th, and we had 19 as of December 31st. Today, we have 22 portfolio companies. As of December 31st, our largest industry concentration was in gaming at 19.6% of the portfolio at fair value. This is up from 15.5% last quarter and the increase was largely attributable to our investment in Montreign. Our second largest sector was energy at 14.4%, followed by telecommunications at 12%, business services at 10.5%, and trucking & leasing at 9.3%. I'd now like to turn the call over to Rocco to discuss our financial results.

Del Guercio: Thanks, Chris. To the quarter, our net investment income was $4.9 million or $0.36 per share. As of December 31st, the fair value of our portfolio was $245.4 million compared to $264.2 million at September 30th. Our investment activity accounts for a $23.4 million decline in our portfolio offset by a $3.6 million increase from our net changes in our marks. As of December 31, the weighted average yield of our debt portfolio including amortization was 9.8% compared to 10% at September 30th, 2016. Our debt portfolio was comprised of 95.4% floating rate, 4.6% fixed rate investments. All of our floating rate investments have LIBOR floors and our average floor was 1.06%. The average portfolio company investment was approximately 12.9 million and our largest portfolio company was 28.8 million.

As of December 31, 57.2% of our portfolio was in first lien, and 42.8% of the portfolio was in second lien investments. We did not hold any unsecured investments. Additional information regarding the composition of our portfolio is included in our form 10-Q filed yesterday. We were 0.7 times levered as of December 31 compared to 0.72 times as of September 30th. With respect to our liquidity, as of December 31, we had 26.8 million in cash, 27.8 million in restricted cash, and 35.7 million capacity under our 50 million revolving credit facility with Citi. With that, I'll turn the call back over to Mike.

Mauer: Thank you, Rocco. The aggregate mark on our positions in energy and oil field services increased significantly this quarter, driven by improvements in oil prices as well as improvements in the operations of our portfolio companies. Caelus continues to exhibit outstanding fundamental results and we think its management team has done an outstanding job conserving capital and resources, to manage liquidity and capital expenditures through a couple of challenging years. Our mark improves from 70 to 78 this quarter.

AAR concluded it's restructuring in our September quarter. Now that the balance sheet restructure is complete, management has refocused on building its business as activity in the D-J Basin has picked up. Our mark on the term loan B which is a junior term loan in the capital structure, improved by approximately five and a half points this quarter.

Finally, our mark on US Well Services first lien loan improved slightly. The pricing environment of pressure pumping services remains challenging, and we have seen that reflected in weakness in the company's results. We reduced our mark to 75 last quarter as discussions about balance sheet restructuring was underway, and we increased that mark to 77.6 as of December 31st. After quarter-end, US Well completed an out-of-court restructuring to address issues of leverage and liquidity. The first lien loan was partially equitized, and the first lien lenders now own the majority of the equity of the company. Our $6.7 million loan, as shown in December 31st financials, is now a 3.8 million loan. We also have a pro-rata share of the equity which is approximately 2% of the total. We and other first lien lenders also provided a new revolving credit facility to the company. Our commitment to the revolver is approximately $1 million. The net result of this restructuring is that US Well is more conservatively levered, we retained a secured position, and we have upside to our current fair value due to our position in the equity. We think there's a great opportunity here of the near and medium term.

We are pleased with the overall performance of our portfolio. Bird Electric, and the term loan B for AAR remain on nonaccrual as we monitor these positions very closely. While the percentage of our fair value increased from 4.5% to 5.1%, that's solely the result of changes in fair value of the portfolio rather than new nonaccruals. Our portfolio yield decreased to 9.8% from 10% last quarter due largely to the repayment of JAC Products and ASV, which had a higher coupon than our average position. Our new investments in the quarter ended December 31st had an average yield of 10.1%, and our investments this quarter end have an average yield of 10.2%. We have deployed $22.3 million of capital and, expect to invest an additional 15 to 30 million this quarter. We anticipate one repayment from our existing portfolio at this point. Cable One has agreed to acquire New Wave Communications where we currently hold a second lien loan. The transaction is stated to close next quarter and we are actively managing our pipeline to prepare for that.

We are committed to paying an attractive, sustainable dividend to our shareholders. Our Board of Directors previously declared a distribution for the quarter ended March 31st, 2017 of $0.25 per share, payable on, April 6, to shareholders of record as of March 17th. Our objective setting our dividend at $0.25 per share is to ensure the 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. The $0.25 per share per quarter represents 10.1% yield as of the close of business yesterday. We fully earned our incentive fee in the December quarter, but we waived a portion of that to cover the 35¢ dividend that was paid on January 5th. We expect to partially earn our incentive fee in the current quarter.

We see exciting opportunities in secured investments in the primary and secondary markets today. Our team continues to identify attractive rich-reward opportunities and is always focused on structural protections for our investments. While the syndicated market remains very challenging for lenders, club and direct lending opportunities are attractive, and we have several high probability deals in our pipeline. Our realizations in calendar 2016 were exceptional with a weighted average gross IRR of 14%, and all of our realizations had a gross IRR of at least 10.9%. These realizations help boost our NII and also give us the chance to redeploy our capital into new loans as we enter the New Year.

The portfolio as a whole continues to show signs of stability and growth with net fair value appreciation of $3.6 million this quarter. Our underwriting will always focus on the quality of management teams, capital structures, our security, and covenants for the protection and preservation of capital over the long term. We are focused on managing to protect against downside risk, but we also think there is real upside [Audio Gap] NAV potential in our current portfolio. With that, operator, please open the line for Q&A.

Operator: Ladies and gentlemen, at this time, we will conduct a question & answer session. If you would like to state your question, please press star one (*1) on your phone now and you'll be place into the queue in order received. Please listen for your name to be announced and be prepared to ask your question when prompted. Once again, to ask a question, press star one (*1) on your phone now. [Pause] Our first question comes from Alison Taylor Rudary from Oppenheimer. Please state your question.

Alison Taylor R: Hi, good afternoon guys. How are you?

Mauer: Good, Alison. Thank you for calling.

Alison Taylor R: Good. So I have two questions for you. The first one is I was just wondering if you could let us know how much of this quarter's gross interest income was a result of your robust repayments versus any accelerated fees that would have received from that versus the – so we can break out the core earnings.

Mauer: Yes, we can walk you through that. What's the second one?

Alison Taylor R: The second one would be we're starting to see a three-month LIBOR around that 1% mark and I know that you have a floating rate portfolio that is benchmarked to LIBOR. I guess, broadly, are your loans based off of three-month LIBOR? Are they starting to reset and hit their floors? How should we think about – with the portfolio's positive leverage to interest rates in '17 and '18?

Mauer: Sure. I'll take the first half and I'll pass the second half over to Chris.

Alison Taylor R: Okay.

Mauer: On the first half, we had $0.62 of income in the way we would break it out – and you guys can dissect it how you like, but core net income from interest was about $0.29. Exit fees that we got whether or not they were prepayment fees or make-wholes were about $0.14, and then we had appreciation in the portfolio of about $0.27. That'll take you up to .69 and then offsetting that was incentive fees that we earned as a result of those earnings of $0.07. That represents the $0.62 in the financials.

Alison Taylor R: Got it.

Mauer: Thanks. Chris, do you want to address the LIBOR?

Jansen: Yes. Our borrowers can either do one or three month LIBOR at their option. The one month, three months spread is about 20, 25 basis points so that right now today is about 78 basis points versus 1.03 for three month.

Alison Taylor R: Okay. So have your - your loans, do they have somewhere between a 1% and a 1-1/2% LIBOR floor? So they could - I guess they're choosing one month right now. So we had to get the one month mark up above 1% before we'd start to see some interest pick up?

Jansen: Yes, we have two loans that are above 1% LIBOR floor and it's less than 5% of our portfolio. Everybody else is 1% or lower.

Alison Taylor R: Great, thanks. That's it for me.

Jansen: Thank you.

Operator: Our next question comes from Paul Johnson from KBW, please state your question.

Paul Johnson: Good afternoon, guys. Thanks for taking my question. I had a question about one of the portfolio companies, US Well Services. I know you guys said that you restructured that in the quarter - in the current quarter, first quarter of '17?

Mauer: It was restructured in the first quarter, yes.

Paul Johnson: Okay. Do you guys - are you able to provide kind of an idea of whether or not that, you took the realized gain or loss from doing so?

Mauer: We cannot walk you through that. What I'd say is that we're comfortable that the fair value as of 12/31, if there's upside to that fair value as a result of the restructuring, we have to go through a form of valuation with the Board at the end of every quarter, but we feel that, that restructuring enhanced our position.

Paul Johnson: Okay.

Mauer: Now, there's a second piece to your question, so when we get to next quarter, Rocco, will walk through it because GAAP accounting treats restructurings a little bit different from unrealized gains and losses, transferring to realized, and new positions that are reconstituted from the restructuring coming on and then fair value creating a new unrealized. So I'm just going to caveat that, next quarter you'll see a lot of activity around that.

Paul Johnson: Okay. Fair enough. Then I had another question on North American Lifting, I was wondering maybe if you can give at least a little bit of description around what the company is and maybe where the stress is coming from given that the investment is kind have been marked down slowly here over the past few quarters or so?

Jansen: Yes, hi this is Chris Jansen. North American Lifting is a crane services business mainly located in the southeast gulf coast, owned by First Reserve for the last three plus years. They've been a little bit susceptible to, a little bit on the oil and gas rig business but that's a very, very small percentage of their business now, less than 5%. They've also begun to see a bit of a pick up on the refining business. As you guys are aware, refiners had put off their turn around downtime repairs because crack margins are so high and that's more - and there's been other deferred maintenance by their customers but we're starting to see an upturn in that.

Paul Johnson: Okay. That's good to hear. Then one final question, I don't know if you're able to answer this or not but regarding the casino investment, I was wondering if you can kind of provide at least what's typical for a gaming transaction, what sort of leverage you guys could come in at as a first lien investor in a company like Montreign?

Mauer: Yes, I'll let Chris go into more detail on that but something Montreign you don't really think about as leverage per se because you're in the development stage. The basis is really, equity is in front of you, the loan to value against the property, and then you do look at the leverage once it's gotten up and running but I'll let Chris go through some of the specifics around that.

Paul Johnson: Okay. That makes sense.

Jansen: Yes. It's very hard to speak about Montreign in particular. We don't want to give up any information but particularly we're looking for less than four times total debt to what we feel is a reasonable EBITDA run rate. Again, reiterate Mike's point that this is a 12 more months estimate before it opens, and probably is another 12 months until, in our view until it's more of a run rate. We also look to companies to make sure they have an adequate interest reserve to cover that. So that's one of the key tenets in what we look for in structuring these types of deals.

Paul Johnson: Okay. Yes, that makes sense. That's all I had so thanks for taking my question.

Mauer: Thank you very much. We appreciate it.

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

Robert Dodd: Hi, guys. Actually sticking with the gaming exposure - you mentioned since the end of the quarter you've done a follow-on on Montreign, so your gaming exposure overall now probably north of 20% of the portfolio I would presume. So what's the fear about the exposure to what industry being so high? Obviously the last industry exposure that was very high was oil and gas. That didn't work out too well. So cyclical, very, very cyclical business, completely different dynamics but high exposure, can have some risks that come with that. So what's your feel about the relative diversification on such a big exposure in one industry right now?

Jansen: Sure. Good question, Robert. Let me take it name by name. Land Holdings is the Scarlet Pearl Casino which is a new build that opened up recently in Biloxi, Mississippi. It's owned by a very wealthy investor, entrepreneur. Our loan to value there conservatively is under 20% of the cost of the build. The sponsor continues to put money into the company, into the casino for improvements so that is a rock solid investment, again in the Biloxi, Mississippi market. Montreign, owned by Resorts World. Resorts World is owned by eventually the Genting Group out of Malaysia. Widely diversified, multi-billion dollar capital company and family, actually, with a lot of casino experience. They operate Resorts World which is located in Queens. They operate Yonkers Raceway and they have their finger on the pulse of the very important Asian gaming market particularly in New York. They have made a substantial equity investment already in the casino which is almost 50% of the cost of the casino overall. So you have an experienced operator with huge capital underneath us, and again this is more the New York City market, so much different market than Biloxi.

Last but not the least, American Gaming which is our largest exposure - American Gaming provides the games for class II and class III casinos. The company went in May of '15, made a huge acquisition to double the size of the business. That acquisition was performed exceedingly well. I went to the G2E gaming exposition in October for another management meeting. They are rationing their new products which are very, very much in demand to make sure they can deliver. Class II, class III is largely the tribal gaming which is a much different characteristic than either New York City area or Biloxi, and it's a widely diversified nationwide market.

Robert Dodd: Okay. I appreciate it. It’s very, very helpful.

Jansen: No, it's a great question, Robert, but three vastly different market dynamics.

Robert Dodd: Yes, got it. I appreciate it. Last one for me if I can, just going back to the interest rate issue. I don't know Rocco if you have it handy but obviously, presumptively the next move in rates if it goes up 25 basis points brings it up right to the floor in the one month if they take that option. Can you give us ballpark sensitivity, obviously that would increase your interest expense but not your income. Slightly negative if that move happens but not substantial, but beyond that relative sensitivity if rates are up a 100 basis points from here, normally we see this something you see as obviously put the table in the Q but I haven't found it yet for earnings today. If it's in your Q I apologize, but can you give us a sensitivity if it goes up 100, what's the benefit to earnings on that?

Mauer: Rocco, I'm not sure if we've got that table. I apologize, I should know that answer and I don't. I do not have, I know we've talked about it but I don't have the number at the tip of my fingers.

Rocco: I don't have it handy. I do know in our Q we're doing a sensitivity analysis on if the interest rates go up X, how much it is - bear with me one second, let me just see if I can find it.

Robert Dodd: No worries.

Rocco: So assuming that - I'm not sure if this answers your question Robert, but I'm going to give it a shot, okay?

Robert Dodd: Okay.

Rocco: Assuming that the LIBOR goes up 1%, that's going to increase our net investment, our net interest income by about $950,000.00. Assuming it goes up 2% that increases our net interest income by about $2 million.

Robert Dodd: Okay.

Jansen: I'm sorry, this is Chris, Robert. It's on page 40 in item III of the 10-Q as well.

Robert Dodd: Got it, I appreciate that. So I can look it up.

Jansen: Well, I figured I'd do it while Rocco was giving you the answer.

Robert Dodd: There it is. Yes, I see it now. It's in the text instead of in the table. So I got it. Thank you.

Mauer: I think that's great that you bring it up Robert, because that has come up a couple of times. Alison has brought it up also. Basically we are at the inflection point between the 1 and 3 months and depending on what people are selecting right now as far as their borrowing rates. As you can see the 1% is $900,000.00 and 2% is full, an incremental 1.1. So we're basically starting to participate now as you saw the average LIBOR floor is 1.05.

Robert Dodd: Got it. I appreciate it. Thank you.

Operator: Once again if you would like to ask a question, please press star, one on your phone now. Gentlemen, at this time I have no further questions.

Mauer: Thank you, operator. I'd like to thank everyone for calling in and participating. Thank you very much for the questions and the follow-ups. We look forward to talking to you in the future.

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

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