CM Finance Inc.
Third Fiscal Quarter Earnings Release Conference
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Operator: Welcome to the CM Finance Third Fiscal Quarter Earnings Release Conference. Your hosts for today's call are Mike Mauer and Jai Agarwal. Operator assistance is available anytime during this conference by pressing *0. A question and answer session will follow the presentation. I will now turn the call over to your speakers. Please begin

Mike Mauer: Thank you, Operator. Good afternoon, everyone, and thank you for joining us. With me today are Chris Jansen, my co-chief investment officer, and Jai Agarwal, our CFO. Before we begin, Jai will first discuss some general information and comment on forward-looking statements. Jai?

Jai Agarwal: I'd like to remind everyone that today's call is being recorded. Please note that this call is the property of CM Finance Inc. and that 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 also like to call your attention to the customary Safe Harbor disclosure in our press release regarding forward-looking information. Today's conference call may also include forward-looking statements and projections and we ask that you refer to our most recent filing with SEC for important factors that could 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'd like to turn the call back to our chairman and CEO, Mike Mauer.

Mike Mauer: Thank you, Jai. I'm going to discuss current market conditions, developments in our portfolio, and our outlook before turning the call back to Jai to review our financial results. We'll conclude today's call with a Q&A session.

We celebrated our first anniversary as a public company in February. The first calendar quarter of 2015 certainly felt much different from the first calendar quarter last year. We were concerned by increasing leverage multiples, weakening structural protections and tightening yields, all of this driven by substantial capital inflows into the leveraged finance market last year. A different set of challenges presented itself this year. The total volume of financing for companies raising $350 million or less is off 45% versus the first quarter last year. We've seen very few new LBOs. Many of our peers have noticed a similar phenomenon in that there haven't been as many good deals for us to invest in in the first quarter this year compared to last year.

Origination of quality transactions is always a challenge of course. That said, because there isn't as much a sense of chasing deals, we've seen a premium for the middle market debt over large broadly syndicated deals widen to 135 basis points. Leverage hasn't changed much year over year, and there's still a preponderance of covenant-lite loans among the broadly syndicated deals. So as with last year, we remain very selective with our investments. We've invested in two deals that entered our pipeline during the quarter while deciding not to proceed with over 25 transactions. That 7% hit rate is an overstatement, a number that doesn't really capture how selective we've been. Several dozen deals that we've looked at this quarter do not even include merit in our official pipeline.

We continue to be active managers of our exposure to oil and gas sector. Looking back to this September, our investments in exploration and production, midstream and oil field services represented approximately 25% of our portfolio at fair value. In December, that percentage was 20.5%. As of March 31, our exposure was 19.2% at fair value. A portion of that decline is attributable to the portfolio growth away from the oil and gas sector, a portion of that reduction is a result in changes in our marks, and a small portion is due to our active management of our positions. We had the opportunity to swap out of our loan in Bennu in favor of increasing our exposure to Caelus. I want to walk you through our investment thesis there.

Bennu Oil & Gas is an offshore exploration and production company in the Gulf of Mexico. Its assets were formerly owned by ATP and were acquired out as part of the bankruptcy estate. The company is owned by a group of former lenders to ATP. Bennu's production is a mix of oil and gas with limited hedges over the next 12 months.

Caelus is another exploration and production company which operates on the north slope of Alaska. It was formed in April 2014 to purchase the Alaskan assets of Pioneer Natural Resources. Apollo is the sponsor. Caelus's production is almost exclusively liquids. When we compare the two companies, we take comfort in Caelus's strong hedging profile over the next couple of years – and I'd emphasize, over a couple of years - its more substantial proved developed producing reserves, and its lower cost to develop the proved and probable reserves. Its cost per well is significantly lower which we believe reduce the risk of its capital expenditures. Caelus has less debt and lower leverage when compared with Bennu, despite the fact that these two loans had the same coupon when issued. Finally, Caelus enjoys the continued support and commitment from Apollo, a premiere sponsor with a stated strategy in energy.

As part of our active management of the portfolio, we sold our second lien position in Bennu and purchased additional second lien loans in Caelus at a net cost of approximately 30 basis points across the entire position.

During the quarter, we made five investments including two new investments in portfolio companies and three additional investments in existing portfolio companies that included Caelus. We had one realization, Bennu. One of those new portfolio company investments is the DIP loan to LightSquared, which I spoke about on our last quarterly call. We expect the milestones required to extend the DIP's maturity to be reached, which would extend the maturity from June 1st to December 31st. We think the DIP loan will remain outstanding at least until the third quarter of this year.

In March, we invested $4 million in a new first lien senior secured notes issued by Nathan's Famous. Nathan's is a licensing company with a franchise system of restaurants as well as wholesale and retail distribution of its famous hotdogs.

We had 26 companies in the portfolio as of March 31st with a total fair value of approximately $311 million. As of today's call, we have investments in 27 companies. We invested in the unsecured debt of Nexeo Solutions in the secondary market in April. Nexeo is the third largest chemical and plastics distributor in North America and the fourth largest in the world. The company is owned by TPG. TPG invested over $500 million in equity to date in the company. Nexeo's notes mature March 2018 and yield over 14% to maturity at the time of our purchase.

We are currently expecting two full realizations this quarter. We have received a payoff notice from BBG, where we own approximately $8.2 million of revolver and first lien term loan, and we have received an indication that CPG, where we own approximately $14.5 million of secured notes will also be repaid this quarter. BBG has scheduled to repay at a premium of 105 late this week or early next week, which will mean a realized IRR in excess of 20%. CPG would repay at a premium as well at 114. If CPG indeed repays our investment this quarter, our realized IRRs would also be an excess of 20%.

As we consider our pipeline, we have two types of deals we are focusing on. First, we have our core, which are senior secured loans to middle market companies. We remain focused on direct origination to allow us to invest in high quality secured loans. The second type of deal we are tracking are secondary market opportunities similar to Nexeo where we think there may be attractive entry points into existing debt. These opportunities are more seasoned and may have higher yields than new origination. Given our investment team's background in stressed/distressed investing and our relationship with Cyrus Capital, we continue to look for good credits in dislocated situations with strong management teams and solid capital structures. We think there may be additional opportunities for us in this calendar year.

We have continued to maintain a balance between first and second lien investments. As of March 31, we held approximately 49% first lien and about 46% second lien with the remainder in warrant and equity positions, the bulk of which is our position in Virgin's equity. Our lockup on the Virgin stock is scheduled to expire May 18th. We do not expect to be long-term holders of the Virgin equity investment. The unrealized gain on our Virgin shares declined from $10.6 million to $4.7 million between December 31st and March 31st. That change in the unrealized gain was the most significant driver of the change in our net asset value of the portfolio this quarter. Based upon Virgin's closing price yesterday, our unrealized gain would be essentially unchanged from quarter end.

As I've stated previously, our target for portfolio leverage is 0.6 to 0.7 times. As of December 31st, we were 0.66 times levered. As of March 31st, we were 0.58 times levered. While we were marginally below our targeted quarter end, we have had net investments of approximately $23 million since March 31st. This additional portfolio activity since quarter end has taken us back squarely into our targeted leverage range. The fair value of our portfolio declined slightly between December and March from 316 to $311 million. The largest driver of the move was Virgin's stock price. Virgin accounted for $5.9 million of the change in our net asset value. The weighted average yield on our debt portfolio and income-producing securities, at cost, increased from 10.97% as of December 31st to 11.2% as of March 31st. This improvement was driven largely by our decision to sell the position in Bennu, which yielded 8.9% at cost, and to increase our position in Caelus where our yield at cost on the purchases during the quarter was 14.24%. As always, we are focused on opportunities to improve the average yield on our portfolio in a prudent and disciplined way as investment opportunities allow.

During the third fiscal quarter, we earned our full base and a portion of our incentive management fee. Based upon our current portfolio in the activity I have mentioned, we expect to continue to earn our full base management fee and our full incentive fee during the quarter end at June 30th, 2015. Additionally, we continue to have an active dialogue with the SBA regarding our application for an SBIC License. Finally on May 6th, our board of directors declared a second calendar quarter dividend of 34.69 cents per share payable on July 5th to shareholders of record as of June 18th. With that, I'd like to turn back to Jai to review our results for the third quarter of the fiscal year. Jai.

Jai Agarwal: Thanks, Mike. Our net investment income for the quarter was $4.7 million or $0.35 per share. Our aggregate net realized and unrealized losses were $6.65 million or $0.49 per share. The weighted average yield at cost on our debt portfolio was 11.2%. Our debt portfolio was comprised of 88% floating rate and 12% fixed-rate investments. Our average portfolio company investment was approximately $11 million and our largest portfolio company investment was $20 million. Additional information regarding the composition of our portfolio is included in our form 10-Q filed yesterday.

With respect to our financing facility, we are $26.3 million borrowed under our $50 million facility at quarter end. As of today, we have $8 million available under this facility, $5 million in cash and over $22 million in expected proceeds from the CPG and BBG transactions Mike mentioned earlier. Lastly, I wanted to address our capital gains incentive fee accrual. As of 12/31, we have accrued but not paid capital gain incentive fees on net gains. However, at March 31st primarily due to the decline in the value of our Virgin America stock, we were in a net loss position and therefore reversed the entire accrual. As of today, there's no accrued or paid capital gains incentive fee. Also, capital gains incentive fees are calculated on a tax basis which is based on fair value of assets at the time of our IPO and not on a GAAP basis which reflects our original cost pre-IPO. With that, I'll turn the call back over to Mike.

Mike Mauer: Thanks, Jai. We are proud of the performance of our portfolio. We have no loans on non-accrual, our underwriting is focused on management, capital structure, security, and covenants for the protection and preservation of our shareholders' capital. We will continue to actively manage the portfolio to minimize the risk we take while positioning ourselves to drive returns for our investors. Before we go to Q&A, I'd like to share a few thoughts on GE capital.

GE has been a significant presence in the middle market for many years. While we don't consider them to be a direct competitor, their influence has had an effect on us as it has with everyone else participating in the middle market. GE has been aggressive in holding down pricing at the more conservative, lower leverage portion of the first lien market, which they can do because their cost of capital is much, much lower than BCDs and senior funds. That inures to our benefit sometimes. We partnered with GE on Bird Electric where they were the first lien and we were the second. On one of the deals on our pipeline today, we would also be a beneficiary in partnership with GE where we are looking at a second lien. GE Capital has announced a transition. Their portfolio and platform are for sale. JP Morgan and Citigroup are leading the process, amd we know a number of parties that are bidding on those platforms. To be clear, we see this as a sale of an ongoing business, not a liquidation play. So, while it may be renamed, we think there will be an ongoing lender playing the role that GE currently plays. The existing positions aren't going away and there will continue to be a lender taking significant positions in the first lien middle market debt. Maybe over the short term, GE will be a little less aggressive bidding for new business due to the transition period, but we don't foresee anything significantly changing in the landscape once the process concludes. There will still be a lender anchoring large portions of middle market below the yields where we are targeting to invest our capital. Depending on who the successor to GE is and their cost of capital, we may see a derivative effect to both the first and second lien pricing that widens out and would obviously be a benefit to us. And with that, Operator, we'd like to open up the line to 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. Please listen for your name to be announced. Once again to ask a question, please press *1 now. Our first question comes from Robert Dodd from Raymond James. Please state your question.

Robert Dodd: Hi, guys. Thanks, folks, a lot of details as always. Just looking at the prepayments that you've indicated may occur, BBG including the floor is 13 ½, CPG 14, can you give us a little color on how that obviously can - I mean, is there somewhat above the current going rate and average portfolio yield. Can you give us a color on how you expect the pricing to move going forward and how you expect basically to replace the earnings from those potential assets?

Mike Mauer: Absolutely, Robert, and thank you for the question. Let me put it in a little bit of context here. So, during the quarter ended March 31, the adds were at about an 11.40 average rate. The pay downs were at about 9.5%. The add-ons in the current quarter were a little shy of 11.10. Nexeo Solutions was over 14%. The others were anywhere from YRC, which is a little over 8%, up to 13.5% on the Caelus add-ons. In our pipeline, I would say that we are continuing to focus around an average rate of around 11%. While a year ago I would have said that we saw a lot of opportunities in an average of 11 to 12, I'd say today it's about is more of a 10 to 11 and on both sides of that range. So, there's no doubt that the environment we're in, I mentioned earlier, that we're not seeing aggressiveness on the leverage multiples out there. We are seeing aggressiveness on pushing price down a bit so we are going to continue to be conservative in the way we deploy capital. That having been said as we look at where we're operating in our pipeline, we could continue to be fully deployed even after realizations of those two. The other thing is if you look at our portfolio - and we've said this all along, that we do maintain some liquid names and I'll point out two that are very, very conspicuous, Crestwood andYRC, and those are low yielding assets where we've got over $30 million. So, to an extent, we're redeploying at 10 to 11 and we're taking off 7 ½ to 8 ½. We think that we can continue to maintain around where we are. I would not say that our expectation is we will increase our average yield, which we actually did in the last quarter.

Robert Dodd: Got it. Thank you. Then just an additional clarification on if they pay at – they do pay, BBG, at 105 and CPG at 114, they are currently marked at the end of it that the quarter about at amortized cost. Would those prepayment promise, would that show up in income or as capital gain? I presume it's income, but I just want to clarify.

Mike Mauer: Yes. To the extent that any borrower prepays, it will show up in NII, income.

Robert Dodd: Got it. Thank you.

Operator: Our next question comes from Merrill Ross from Wunderlich Securities. Please state your question.

Merrill Ross: Good afternoon. It appears to me that the timing of the onboarded investments in the first quarter was sort of weighted towards the backend, but you talked about having deployed $24 million quarter to date and here in the second quarter. So, can you talk about the timing of investments and pay downs and whether that's a tailwind this quarter?

Mike Mauer: Yes. Absolutely. So, last quarter of approximately $37 million of deployments, less than 50% of that was done prior to March 1st. LightSquared was in for a little bit during the period there and really other than that, there wasn't much deployed until March. Then if you look at this quarter, we've talked about net $23 million gross, there's $24 million deployed quarter to date. And of that $24 million, all but $5 million was deployed in the first 25 days of April. So, that'll be out there for a while. We'd expect that today is the 12th of May so it will be more than half way through the quarter before BBG repays. Our expectation is that the earliest at this point is June 1 for the repayment around CPG. We do have a pretty solid calendar, I'd book-end it at $30 to $50 million of investments that are reasonably probable in our pipeline now.

Merrill Ross: Any comment on the weighted average yield of what you've circled up or in fact invested so far this quarter?

Mike Mauer: I would put it in a 10% plus or minus because they're straddling. There's nothing that's 14 and there's nothing that's 8 in the pipeline.

Merrill Ross: Okay. Thank you.

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

Greg Mason: Great. Thanks, guys. Just a quick follow-up clarification on Robert's question on the repayments. For example, CPG, it's marked at par but your cost basis is still $14.1 million versus the $14.5 million par. In the first quarter, that unamortized OID, will that difference come in to income and then you will have a reversal of unrealized appreciation, or is that unamortized OID just going to be flat appreciation and no impact to the revenue line?

Jai Agarwal: No, that's right. The unamortized OID will go in as interest income.

Mike Mauer: So, the entire amount of OID will come in as interest income and the prepayment penalty will come in as interest income.

Greg Mason: And then you will reverse out the appreciation below the line.

Jai Agarwal: That's right.

Greg Mason: Got it. Perfect. Then one question on the portfolio. It looks like New Standard last quarter was written at 90% at par. It's now down to 84% of par. Any commentary you're willing to give on that credit?

Mike Mauer: Yes, sure. We continued to be, I think, conservative around looking at our energy portfolio. While the market is very, very happy with the run up, I think we're 61, 67 give or take on WTI and Brent today. Number one, we think there's a lag effect before the clients that we lend to benefit from increases in the oil price. Almost, the vast majority of that oil price has been post 3/31 so just a couple data points for you. When we have kind of made underwriting decisions and we have been I think fairly conservative in hair cutting EBITDA on cash flows. That had been a pre-9/30 context. That was a $90 and above environment. At 12/31 we were at $53 - this is WTI price. At 3/31 which is that mark date you're referring to, WTI was at $47 versus the $61 today. From a New Standard standpoint, that is one of the smaller credits. It will continue to be one of the credits that over the long-term needs additional capital and so we will be conservative around how we mark that. They will be more dependent down the road on either partners or raising some additional capital. We continue to feel very good about our secured position and they continue to pay us on a current basis.

Greg Mason: Great comment. Thank you. Then last question, just to the extent that you're willing to talk about it on your Virgin America stock. I know you said you don't want to be holders over the long-term, but how are you viewing that? Obviously, you're going to have some big repayments here from other portions of the portfolio. The stocks come under pressure here, just kind of your appetite for exiting that when the lockup period expires versus holding it for a longer timeframe.

Mike Mauer: Yes, Greg. Thank you and I appreciate you bringing that up because I know it's something that a lot of people are focused on. When we went into this investment, I will tell you my hope was that over the six to 12 month period, we'd be able to realize on top of what we had as great returns on the secured debt, another 25% to 30% return over a 12 month period, which I think for all of our portfolios, people are overjoyed at 25%, 30% returns. When we got to December, we all would have loved to have liquidated at over 100% return in six weeks. Today, that return on an absolute basis, not an annual basis, is just shy of 40%. So, in the context of where we'd like to be on an annualized basis, that's 75%, 80% today. We will look to opportunistically monetize it. Our job is to look to maximize value to shareholders and to be invested in income producing assets. This one right now has a great return of value, long-term it's not an income producing and quite truthfully we don't get paid to be equity investors. We do take views where we've got long-term perspective and this is one that over several years we had a great perspective and, knock on wood, the right perspective as of today.

Greg Mason: That's great commentary. Thank you. I appreciate it, Mike. Appreciate it guys.

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

Mike Mauer: Thank you, Operator. We'd like to thank everyone for joining us today and we look forward to speaking to you again next quarter.

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

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