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Robert James Dodd *Raymond James & Associates, Inc., Research Division - Research Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and thank you for standing by. At this time, I would like to welcome everyone to Stellus Capital Investment Corporation's Conference Call to report Second Quarter 2018 results. (Operator Instructions) This conference is being recorded today, Wednesday, August 8, 2018.

It is now my pleasure to turn the call over to Mr. Robert Ladd, Chief Executive Officer of Stellus Capital Investment Corporation. Mr. Ladd, you may begin your conference, sir.

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Good morning, everyone, and thank you for joining the call. Welcome to our conference call covering the quarter ended June 30, 2018. Joining me this morning is Todd Huskinson, our Chief Financial Officer, who will cover important information about forward-looking statements as well as an overview of our financial information.

W. Todd Huskinson - *Stellus Capital Investment Corporation - CFO, Chief Compliance Officer, Treasurer and Secretary*

Thank you, Rob. I'd like to remind everyone that today's call is being recorded. Please note that this call is the property of Stellus Capital Investment Corporation 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 number and PIN provided on 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 the 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.stelluscapital.com, under the Stellus Capital Investment Corporation link, or call us at (713) 292-5400.

At this time, I'd like to turn the call back over to our Chief Executive Officer, Rob Ladd.

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Thank you, Todd. As in past quarters, our remarks will cover the following areas. First, portfolio, including asset quality; second, operating results; and lastly, outlook.



We had solid portfolio growth during the second quarter of \$68 million net of repayments. We ended the quarter with an investment portfolio at fair value of approximately \$500 million.

During the quarter, we made \$97 million of investments at par in 5 new and 4 existing portfolio companies. The 5 new investments totaled \$81.8 million at par value and 94% of our first lien and have a weighted average yield of 11.2%. All the loans are at floating rates. We had 5 repayments totaling \$23.1 million and \$7 million of amortization and other repayments.

With respect to asset quality, it's stable at a 2 and our investment rating system are on plan, only 8% of the portfolio is marked at an investment category of 3 or below. In total, we have 3 loans of nonaccrual, which are \$6.3 million combined, representing 1.3% of fair value of the total loan portfolio.

We continue to maintain good diversification with the largest industry sector at 12% of the total, which is software. The average investment for company is approximately \$9.6 million and the largest investment is \$28.9 million both at fair value.

Finally, our portfolio continues to be weighted towards secured lending at floating rates. To this end at June 30, 94% of our loans were secured and 91% were priced at floating rates. Also, 51 of the 52 portfolio companies are backed by a private equity firm.

Now I'll turn the call over to Todd to discuss our operating results.

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Thank you, Rob. We generate \$0.33 per share of core NII during the quarter, which were short of covering the dividend by just a \$175,000. GAAP NII was \$0.30 per share and included a capital gains and incentive fee accrual of \$522,000 or \$0.03 per share. This quarter we adopted a new non-GAAP measure entitled core NII per share, which is GAAP NII, excluding any capital gains incentive fee accrual. This accrual is an above-the-line expense related to below-the-line income. Because unrealized gains are considered in calculating the accrual, but are excluded in determining whether it can be paid. It's uncertain whether this fee will be paid.

It's important to note that continued improvement in asset values both realized and unrealized, is what necessitated the capital gains incentive fee accrual. Life-to-date through June 30, 2018, on a combined basis, we have generated net gains both realized and unrealized of \$2.6 million. We also generated a realized gain of \$1.1 million or \$0.07 per share during the quarter, resulting in realized income on a GAAP basis of \$0.36 per share more than covering the \$0.34 per share dividend for the quarter.

Finally, net asset value increased \$0.14 per share during the quarter for \$13.93 to \$14.07, primarily due to the realized gain and appreciation on our portfolio.

With that, I'll turn it back over to Rob to discuss the outlook.

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Thank you, Todd. For the balance of the third quarter this is what we know. In July, we had a gain of \$2.8 million on the realization on equity investment and also a \$100,000 prepayment fee from a loan that recently paid off.

While actual activity is difficult to predict, we are expecting investments of between \$20 million and \$40 million, and repayments in the same range during the remainder of the quarter, which would imply we'd be relatively flat.

Last quarter, I reported that our investment goal for the year-end was to get to \$500 million of investment portfolio, which we, of course, reached by the end of the second quarter. Given where we are now in the new leverage limits, which I'll discuss next, we are targeting to end the year with the portfolio of between \$520 million and \$540 million. And lastly, I'd like to update you on the steps we've taken related to the recently passed



legislation that allows BDCs to operate with greater leverage, increasing the regulatory cap from 1:1 to 2:1. As you know, on June 28, our shareholders approved an increase to 2:1 leverage and on August 2, our bank facility was amended to decrease the asset coverage covenant to 175%, which is the equivalent of allowing 1.33:1 leverage. In addition, we increased the size of our bank facility to \$180 million from \$140 million.

Our Board, and we as management, believe this increased leverage capacity is very positive for our shareholders as I reported in our last quarter's call. We planned to use the increased leverage moderately, initially it will allow us to operate at 1:1 leverage in stead of the 0.7 to 0.8:1 where we've been operating. This, along with the increased credit facility should allow us to grow our investment portfolio to approximately \$600 million.

With that, we'll open it up for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Christopher Nolan with Ladenburg Thalmann.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Rob, on your comments just now, the 1:1 new leverage ratio target, if I heard you correctly, does that exclude SBA loans?

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Yes, it does.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Great. And Todd, can you give us an operating expense run rate for the second half of the year that might be helpful?

W. Todd Huskinson - *Stellus Capital Investment Corporation - CFO, Chief Compliance Officer, Treasurer and Secretary*

Sure. Yes, I would say operating expenses we think are going to hold relatively stable for the remainder of the year. If you look at the next 2 quarters, this quarter was a little bit light on say, valuation fees and not a large number, but over the remainder of the year, that will even out over the rest of the year. So when I say operating expenses, I'm also excluding interest expense, which is obviously going to increase to the extent that we increase the portfolio. But that would be my guess, I think they'll be relatively flat over the remainder of the year similar to what they were in the second quarter -- in the first quarter.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Great. Final question, on Abrasive Products & Equipment, which is one of your new nonaccruals, which is roughly \$5 million of cost. Can you give a little update in terms of any resolution you might think about that?



Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Yes. So Chris, we typically don't talk about private companies for reasons of their own privacy and the way they operate in the marketplace. But this is a company that's owned by a substantial private equity firm. And our expectation is that it's should be marked properly and that ultimately, we would expect a positive outcome. And it was placed on nonaccrual because the interest was blocked by the first lien lenders.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Okay. So the interest was blocked by the first lien lenders, if I heard you correctly?

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Correct.

Operator

Our next question comes from Robert Dodd with Raymond James.

Robert James Dodd - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Some kind of housekeeping one first, and then a big one. Just on that Abrasive Products, it's in the Q marked as nonaccrual as of March 29, but if I look at the Q last quarter, it wasn't marked at nonaccrual then at March 31. So what changes there? And was any income from that one, couple of days, reversed out this quarter?

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Yes. So I think it is effective April 1, but because of the loan repricing on March 29, that's the date, and so that would have been a small reversal.

Robert James Dodd - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay, okay, got it. On -- and then on nonaccruals, I can -- I see Grupo Hima, I mean in looking at the footnotes like Grupo Hima is marked nonaccrual, obviously, Abrasive Products is marked as nonaccrual, what's the third one? I can't find it the footnotes.

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Yes, it's a company called Wise Products where we have a solid structure. Yes, I think it's \$500,000 or \$600,000 fair value.

Robert James Dodd - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Got it. Got it. And then last housekeeping one. What's the undistributable -- undistributed taxable income, i.e, the spillover number, not the undistributed NII from the equity schedule, but the taxable spillover?

W. Todd Huskinson - *Stellus Capital Investment Corporation - CFO, Chief Compliance Officer, Treasurer and Secretary*

Yes. So at 12/31 our spillover was \$435,000 I think, something along those lines, so not a lot.



Robert James Dodd - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Got it. Got it. Last question, the big one, obviously. Looking at the Good Source Solutions, I mean, obviously excellent quarter in terms of deployments, that one pretty big loan, \$28.5 million. I mean, can you give us some color -- what's your target hold size because that's one's [paying] your average exposure you give it's much below that concentrated positions just regardless of the quality of the company that you're lending to, do elevate some risk somewhat. So can you give us some color on what -- would we expect more large deals or what's kind of the view on how that's going to be structured, particularly if the leverage goes up?

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Yes. So Bob, very good question. So I think, you expect that our largest hold position has been at where it's been historically, which is in the low 20s. This company, in particular, we had already been involved in the financing and we're involved in its sales and refinancing, if you will. It's a company we knew well, very well capitalized. But I would say that it would be our expectation that we would have position sizes that would be in the low 20s, not in the high 20s. And as an example, you may see that position gets smaller with time. We were to get it close at that time and over time, we'll be sizing positions like that to be smaller.

Operator

Our next question comes from Chris Kotowski with Oppenheimer.

Christoph M. Kotowski - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

I was just wondering, you mentioned the renegotiation of the bank facility. And I was just wondering, are the terms or rate different or was there a give up for the banks accepting the higher level of leverage?

W. Todd Huskinson - *Stellus Capital Investment Corporation - CFO, Chief Compliance Officer, Treasurer and Secretary*

Yes, Chris, so the banks -- our bank group is very supportive. And we actually brought in an additional bank as part of the group and some of the banks outside. So very supportive, there was really no additional cost related to the amendment. The -- we paid a fee for the increased commitment, which is relatively modest. There is one feature of the facility, which I believe we have in the press release, if -- so the interest rate changed or stayed the same at LIBOR plus 250, but if leverage for a quarter -- at the end of the quarter was at 1.1 or higher then the spread would move from 250 to 275 for the following quarter. So no cost for the change, meaningful cost and very supportive group. But, again, the covenant 1.33:1, and so not largely higher. And I think the whole theme here was to allow the company to operate at the 1:1 level.

Christoph M. Kotowski - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. So -- and the trigger is over at 1:1 just on the incremental amount it goes to 275?

W. Todd Huskinson - *Stellus Capital Investment Corporation - CFO, Chief Compliance Officer, Treasurer and Secretary*

No. It's if the leverage in total was 1.1 or higher, not 1.

Christoph M. Kotowski - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

So then it all (inaudible).



W. Todd Huskinson - *Stellus Capital Investment Corporation - CFO , Chief Compliance Officer, Treasurer and Secretary*

Then it would be the entire facility, that's correct.

Operator

At this time, we have no other questioners in the queue. So I will turn it back over to Mr. Ladd for closing comments.

Robert T. Ladd - *Stellus Capital Investment Corporation - Chairman, President & CEO*

Okay, very good. Thank you, David, and thanks, everyone, for your support. We look forward to speaking with you again in November to cover the third quarter.

Operator

Ladies and gentlemen, that concludes today's presentation. You may disconnect your phone lines, and thank you for joining us today.

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