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Q3 2023 Chicago Atlantic Real Estate Finance Inc Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Chicago Atlantic Real Estate Finance, Inc. Third Quarter 2023 Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Tripp Sullivan. Please go ahead.

Tripp Sullivan ***SCR Partners, LLC - President***

Thank you. Good morning. Welcome to the Chicago Atlantic Real Estate Finance conference call to review the company's results for the third quarter of 2023.

On the call today will be John Mazarakis. Executive Chairman; Tony Cappell, Chief Executive Officer; Andreas Bodmeier, Co-President and Chief Investment Officer; Peter Sack, Co-President; and Phil Silverman, Interim Chief Financial Officer.

Our results were released this morning in our earnings press release, which can be found on the Investor Relations section of our website, along with our supplemental filed with the SEC.

A live audio webcast of this call is being made available today. For those who listen to the replay of this webcast, we remind you that the remarks made herein are as of today, November 8, 2023, and will not be updated subsequent to this call.

During this call, certain comments and statements we make may be deemed forward-looking statements within the meaning prescribed by the securities laws, including statements related to the future performance of our portfolio, our pipeline of potential loans and other investments, future dividends and financing activities. All forward-looking statements represent Chicago Atlantic's judgment as of the date of this conference call and are subject to risks and uncertainties that can cause actual results to differ materially from our current expectations.

Investors are urged to carefully review various disclosures made by the company, including the risk and other information disclosed in the company's filings with the SEC.

We also will discuss certain non-GAAP measures, including, but not limited to, distributable earnings and adjusted distributable earnings. Definitions of these non-GAAP measures and reconciliations to the most comparable GAAP measures are included in our filings with the SEC.

I'll now turn the call over to John Mazarakis. Please go ahead.

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

Thanks, Tripp. Good morning, everyone. I said last quarter that it might be time to be cautiously optimistic, and we continue to stand by that same outlook. In addition to the positive developments in a number of states in the last 90 days, we've seen HHS come out with a recommendation to reschedule cannabis from a Schedule I to Schedule III, a positive development towards the elimination of the punitive tax burden of operators resulting from 280E as well as SAFE Banking taking a different form as SAFER.

While we remain skeptical about the near-term prospects of SAFER passing Congress anytime soon and the all-important rule implementation to take even longer, the new perception is that changes at the federal level are more possible. That change in perception is positively affecting the reality for equity capital among investors and operators. That reality has had a clear impact on the credit of our borrowers in absolute dollars.

Now that there has been some movement at the federal level, we've been asked if we think that there will be a new supply of capital entering the industry, particularly among the larger banks. We continue to believe that the cannabis industry will remain capital-constrained for some time with demand accelerating and overall credit quality improving. If larger banks get involved in the industry as the federal regulations settle, we still think the first and best option will be to provide capital to proven lenders such as Chicago Atlantic. The learning curve and need to wait for final rule implementations will be a tough initial hurdle for the larger and more highly regulated financial institutions.

We have remained fully committed to this industry from day 1, and we're big believers in the space. There isn't an operator we've worked with and/or lent to or investor in the industry who have doubted our commitment or ability to deliver on their capital needs. With the largest platform, our own originations team, experience in direct lending, a well-capitalized and conservative balance sheet and a diversified loan portfolio, we make the strongest case as the leading capital provider in the space.

Another indication of how the environment has improved is that our pipeline of actionable deals has increased to over $600 million from $400 million last quarter. The originations team has been active in states such as Maryland, Missouri and Ohio, where transaction activity has picked up because of the adult-use transitions.

The maturities that we and other capital providers have talked about for some time still present a tangible and sizable opportunity. There are large operators that still need to refinance their bond and/or debt facilities in the next 12 to 18 months. When you add that to the growth in new states, the outcome is an upward lift to our pipeline.

We have always tried to be prudent and realistic when evaluating the cannabis space. I want to close with a point that drives everything we do here in Chicago Atlantic: each investment decision we make must provide our investors with an attractive yield and protection of principal. We've proven to be good stewards of our investors' capital, and you can expect more of that stewardship as we navigate these opportunities ahead of us.

I will now turn it over to Peter.

Peter Sack ***Chicago Atlantic Real Estate Finance, Inc. - Co-President & Director of Chicago Atlantic REIT Manager, LLC***

Thank you, John. I'd like to first provide a quick update on our partnership with New York and New York's Cannabis Social Equity Investment Fund.

During the quarter, we funded approximately $19 million of the REIT's $50 million commitment to the Social Equity Investment Fund. While there is ongoing litigation in New York surrounding licensing that has slowed deployment of the fund, we remain committed to supporting this initiative and CAURD licensees across the state, and we're highly confident in the credit profile of our fundings to date.

We are exploring social equity initiatives in other states, but it's too early to report anything on that front. We bring an unmatched scale in the industry and expertise across real estate, operational, financial, legal and credit underwriting to make these initiatives actionable.

As we've noted before, we continue to focus our originations in core markets of interest while remaining very disciplined on our underwriting. You can expect that we will continue to take a lead in markets with strong moats and with operators who excel in the fundamentals.

Tony, why don't you take it from here?

Tony Cappell ***Chicago Atlantic Real Estate Finance, Inc. - CEO & Director of Chicago Atlantic REIT Manager, LLC***

Good morning. From a credit perspective, our portfolio has experienced a meaningful improvement in the last 60 to 90 days. With equity values responding positively to the potential rescheduling news, that's a clear positive from a risk premium perspective and improves our position as equity values have increased. If 280E goes away, then the operator profitability and free cash flow should improve materially and multiples will expand, which is the type of event that usually attracts more equity capital.

At September 30, our loan portfolio had total loan commitments of $356 million across 27 portfolio companies with a weighted average yield to maturity of 19.3% compared with 19.2% at June 30 and 18.3% a year ago. Our weighted average loan-to-enterprise value remained attractive at 42.5% compared with 41% at June 30.

Based on the strong start to the quarter, which we disclosed on the last call, total gross originations increased $35 million, approximately $33 million of which was funded to new borrowers. That was partially offset by $11 million of principal repayments, $9 million of which was related to unscheduled early repayments.

Our portfolio is 81% floating rate based off the prime rate, which is down from 88% last quarter and up from approximately 60% in September of 2022. The slight decrease in floating rate loans was due to 3 new loans originated in the quarter, which have fixed coupon, the largest of which was the loan to New York Social Equity Cannabis Investment Fund. Even with these new originations, we continue to see a positive impact on portfolio yield each time the Federal Reserve raises their target rate and the prime rate increases.

I'll now turn it over to Andreas.

Andreas Bodmeier ***Chicago Atlantic Real Estate Finance, Inc. - Co-President, CIO & Director of Chicago Atlantic REIT Manager, LLC***

As disclosed last quarter, we moved Loan #9, which was approximately $16.3 million of principal outstanding to nonaccrual. We noted then that we were in the process of exercising our rights and remedies to pursue full repayment of outstanding obligations and that this course of action was borrower-specific. As of September 30, the loan remains on nonaccrual. However, the administrative agent has foreclosed on the membership interest of the borrower and is in the process of obtaining bids to sell the assets in satisfaction of the loan. We believe those bids will be in excess of our carrying value on the balance sheet.

On the capital structure side, we had $63 million outstanding on the revolving credit facility as of September 30. Subsequent to quarter end, we drew another $11 million on the line. That leaves us a total of $25 million in liquidity, net of estimated liabilities.

As noted in our press release, we are reinitiating discussions with our lending group to extend the line to fund additional investment opportunities. We have the ability to extend the facility up to $125 million via the existing accordion feature and believe this will be a more efficient means of funding growth in the portfolio.

Our balance sheet remains at low leverage of 23% of book equity at quarter end, compared with 22% at year-end. Our debt service coverage ratio on a consolidated basis was 7.2:1 as of quarter-end compared with the requirement of 1.35:1. Ultimately, we would like to approach leverage equal to 100% of our book equity. The near-term realistic target is closer to 50% of book equity. Either target would remain far below that of other mortgage REITs and imply substantial growth in the portfolio over the next few years. We intend to get there in a very measured fashion while also providing a compelling yield to our investors.

I'll now turn it over to Phil to review our financial results. Thank you.

Phil Silverman ***Chicago Atlantic Real Estate Finance, Inc. - Interim CFO, Company Secretary & Controller***

Thank you. Net interest income for the 3 months ended September 30 remained consistent with prior quarter at approximately $13.7 million. Gross interest income increased approximately $0.5 million, driven by the positive impact of the 25 basis point increase in the prime rate in July and the yield generated on new Q3 fundings of nearly $35 million. The portfolio remains well diversified with loans to 27 borrowers as of September 30.

In the third quarter, we recognized approximately $0.7 million in nonrecurring interest income from early principal repayments as compared to $0.6 million during the second quarter. These increases were offset by the incremental interest expense on the $20 million in net borrowings on our revolving credit facility during the quarter.

Total operating expenses before the provision for credit losses were consistent with the second quarter. The $0.2 million decrease in management and incentive fees were offset by a corresponding increase in stock-based compensation expense.

Adjusted distributable earnings was $0.57 per weighted average diluted share for Q3 compared with $0.55 during Q2.

We distributed a dividend of $0.47 for the third quarter, which resulted in a dividend payout ratio of approximately 83%. Year-to-date, we have distributed approximately 80% of taxable income.

Q3 earnings per weighted average diluted common share was $0.54 compared to $0.47 in Q2.

Our quarterly CECL reserve remained consistent with prior quarter at approximately $5.2 million as of September 30 and June 30. The reserve determination for the quarter considered reversals attributable to the principal payments received during Q3, which included the full repayment of Loan #15 and was offset by new reserves on third quarter originations.

Credit quality of the portfolio remained stable with 88% of the portfolio risk rated 3 or better as of September 30 compared to 87% as of June 30.

On a relative size basis, our reserve for expected credit losses represents 1.5% of outstanding principal as of September 30 as compared to 1.6% as of June 30. Approximately 74% of the portfolio based on outstanding principal is fully secured by real estate collateral. 23% is partially secured with the remaining 3% having no real estate collateral.

Our portfolio on a weighted average basis had real estate coverage of 1.5x as of September 30, 2023.

Our book value as of September 30 increased to $15.17 per common share compared with $15.06 as of June 30.

Lastly, I would note that based on our results through the first 9 months of the year, we affirm our previously issued 2023 outlook.

Operator, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll take our first question from Crispin Love of Piper Sandler.

Crispin Elliot Love ***Piper Sandler & Co., Research Division - Director & Senior Research Analyst***

First off, so you talked about the credit worthiness of your operations improving just given the potential for changes in scheduling and also regulatory relief.

But with this improvement in credit, do you think that yields with new borrowers could decrease even if there isn't a big pickup in competition over the near term?

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

Thank you for the question, Crispin. This is John. We haven't observed anything that points to compression of interest -- of, basically, yield. So we expect actual yields to remain where they are.

Crispin Elliot Love ***Piper Sandler & Co., Research Division - Director & Senior Research Analyst***

Okay. Great. Helpful. And then just on Loan #9, which is in nonaccrual. It sounded like in your comments that you expect that loan to be resolved with a sale. Do you have any more color there or timing that you would maybe expect a sale for that loan?

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

It's for a workout or for the foreclosure process, I think it's been a pretty fast process given the fact that there is no capability of declaring bankruptcy. We feel that the bids will ultimately be in excess of our carrying value. And that's all I have for now. We're hoping to resolve it very soon.

Crispin Elliot Love ***Piper Sandler & Co., Research Division - Director & Senior Research Analyst***

Great. Good news there. And then just one last one for me. Just on the dividend, it seems like that you're on track to pay a special dividend in the fourth quarter. I'm just curious if that still stands with the target of distributing 90% to 100% of net income through dividends.

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

We expect to distribute above 90%, yes.

Operator

(Operator Instructions) And we'll go to Mark Smith of Lake Street.

Mark Eric Smith ***Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst***

Just curious if you have any updated thoughts on Ohio or other new states and maybe any call-out for states that are moving on pace or well or any other new states that maybe are taking a little longer to get up and running?

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

Yes, I think yesterday was a monumental day because Ohio is a traditionally conservative market. So seeing that 56%, 57% has been very encouraging. We sort of expected it, but it's one thing to expect it and another to actually have it on the ballot so -- and then passing.

I think Florida looks good. We'll see, we'll see what happens. I don't have a crystal ball. So we just have to wait.

Mark Eric Smith ***Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst***

Has there been any significant moves in build-out or need for capital in some of the states that have been -- have more recently moved either rec or medical?

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

Absolutely. Those are the states that we see most of the movement. Like I mentioned, Maryland, Ohio, was sort of expected so there was some movement there. And then Missouri.

Mark Eric Smith ***Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst***

Okay. And then similarly, as you look broadly at the industry, in particular, in states where you are today, are you seeing any regions or areas that are -- have become more troubling? Or do you feel like we've kind of bottomed out across the board?

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

I think we've pretty much bottomed out and you see some positive momentum in actually the Western states surprisingly. Some of those numbers from a price perspective, at least wholesale price perspective, are taking on a year-over-year basis positively.

So yes, definitely, when you strip all capital from an industry, and that industry is very CapEx-intensive, it is not surprising that prices have plateaued from a wholesale perspective. So that's a positive development.

Mark Eric Smith ***Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst***

Okay. And the last one for me, just if you can discuss any more in depth kind of some shift to more fixed rate loans this quarter. Do you see more of that as we move forward? Any additional thoughts would be great.

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

No. I think it was just random. Yes, we saw it as well. I think it was just -- it just happened. We don't expect to move to a fixed rate structure. Having said that, we do have floors. So a fixed rate in an environment where rates may start coming down is not the worst position to be in.

Operator

And there appears to be no additional questions. I'll turn it back to John Mazarakis for any closing remarks.

John Mazarakis ***Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC***

Thank you all for joining us this morning. We're available for follow-up questions. Thanks, again. Thank you.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.
