Chicago Atlantic Real Estate Finance, Inc. (Q1 2023 Earnings)
May 9, 2023

Corporate Speakers

- Tripp Sullivan; SCR Partners, LLC; President
- John Mazarakis; Chicago Atlantic Real Estate Finance, Inc.; Executive Chairman
- Tony Cappell; Chicago Atlantic Real Estate Finance, Inc.; Chief Executive Officer
- Phil Silverman; Chicago Atlantic Real Estate Finance, Inc.; Interim CFO, Company Secretary

Participants

- Aaron Hecht; JMP Securities LLC; MD & Equity Research Analyst
- Mark Smith; Lake Street Capital Markets, LLC; Senior Research Analyst

PRESENTATION

Operator^ Good day, and thank you for standing by. Welcome to the Chicago and Atlantic Real Estate Finance, Inc. First 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^ Thank you. Good morning. Welcome to the Chicago Atlantic Real Estate Finance conference call to review the company's results for the first 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; 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, May 9, 2023, 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 activity.

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^ Thanks, Tripp. Good morning, everyone. With all that's transpired in the financial sector these past months, I believe we've proven out our original thesis from several years ago. That thesis being, we could bring a direct lending approach to help institutionalize the cannabis credit market and quickly become the leading capital provider in the space.

None of us would have anticipated the shakeout we've seen of late with a large competitor pulling back from the space and other lenders reining in their originations. We've done what you're supposed to do in this type of environment: Create the largest platform that attract borrowers and lenders alike, originate your own loans, so you know the collateral and the borrowers and have the direct relationship, maintain access to accretive sources of capital, make sure your loan portfolio is predominantly floating rate in a rising rate environment, err on the side of being underlevered instead of over levered if rates are rising and the recession is likely, diversify your borrowing base across geography and assets, focus on the best credit operators in limited license states and structure the terms to protect your capital above all else.

Before I turn it over to Tony to provide more of the details, I want to address our 2023 guidance. We noted in our earnings release that we affirmed the outlook that we provided with our Q4 results. We reported better-than-anticipated distributable earnings this quarter due to make whole and prepayment fees from several principal repayments we received during the quarter.

As I noted on our last call, we are intentionally holding back on originations to be even more selective than we've been of late and to take advantage of a large number of refinancings among the largest MSOs over the next 12-plus months.

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

Tony Cappell^ Good morning. At March 31, our loan portfolio had a total loan commitments of $328 million across 24 portfolio companies with a weighted average yield to maturity of 19.4% compared with 19.7% at December 31, and 17.2% a year ago.

New originations during the quarter were $34 million, with all but $800,000 funded to new borrowers. We continue to be very disciplined in deploying the REIT's available capital to focus on strong credit operators and fulfill the growth capital needs of existing borrowers.

During the quarter, we received principal repayments totaling $58.3 million, of which $57.8 million was related to unscheduled early repayments and sales. We received $1 million in prepayment fees and acceleration of original issue discounts from these repayments.

Using those proceeds, we paid down the credit facility by $20.5 million. We currently have approximately $53 million of liquidity in the REIT that we can put to work in the coming months. This credit facility remains the primary means for funding our portfolio growth, and we are in active discussions with additional banks to potentially join the facility.

All loans are performing. Our portfolio is now 88% floating rate based off the prime rate, which is up from 83% floating rate from the last quarter and 63% from March of 2022. The Federal Reserve raised their target rate again last week, which brought the prime rate to 8.25%. We estimate that our weighted average portfolio yield receives 70% to 80% of the benefit from each increase of the prime rate.

Our balance sheet also continues to be under levered at 14% of book equity at quarter end compared with 22% at year-end. Compared with other commercial mortgage REITs with leverage ratios averaging 200% to 300%, our balance sheet is in great shape. I think it's worth noting as well that our credit facility with simple debt service and real estate covenants is different from other mortgage REITs.

Our credit facility is not a repo line, where the collateral is mark-to-market on a much more frequent basis. In our case, we have a debt service coverage ratio on a consolidated basis of 7.6:1 as of quarter end compared with the requirement of 1.35:1.

We understand there is a concern that levered commercial mortgage REITs may lose credit availability due to rising interest rates leading to a decline in real estate collateral value. That's not applicable in our case based on how our credit facility is structured and the nature of our collateral.

Lastly, I'd like to address our pipeline. We have an actionable pipeline of $600 million in opportunities. We are taking advantage of this pipeline throughout the Chicago Atlantic platform, but we are doing so very selectively. While we might be sacrificing a bit on loan portfolio growth in the near term, we believe the next 12-plus months could be one of the better periods in our industry to put capital to work.

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

Phil Silverman^ Thank you, Tony. Net interest income for the quarter was up nearly 1% compared with Q4 due to the recognition of approximately $1 million of nonrecurring income from prepayment fees and acceleration of OID from principal repayments. We also benefited from the impact of the 50 basis point increase in the prime rate in March. These positive impacts were offset by the timing of those early principal repayments.

Total operating expenses for the quarter before CECL provision were down 18%, primarily due to the decrease in net management and incentive fees. Aggregate G&A and professional fees increased sequentially by $220,000 primarily attributable to expense reimbursement to our manager.

Adjusted distributable earnings was $0.62 per diluted share for Q1 compared with $0.57 in Q4. We distributed a dividend of $0.47 for the first quarter, which resulted in a dividend payout ratio of approximately 76%. The Q1 diluted earnings per share was $0.60 compared with $0.41 in Q4. The increase is primarily due to a lower provision for expected credit losses and lower net management and incentive fees.

We increased our quarterly CECL reserve by $96,000 as of March 31. The CECL determination for the quarter considered reserve reversals attributable to the principal repayments received during the quarter. On a relative size basis, we increased the total reserve to approximately 1.3% of outstanding principal as of Q1 as compared to 1.2% as of December 31.

Approximately 85% of the portfolio based on outstanding principal is fully secured by real estate with 15% having limited or no real estate collateral. Our portfolio on a weighted average basis had real estate collateral coverage of 1.6x as of March 31, 2023. Our book value as of March 31, increased to $15.04 per common share compared with $14.86 as of December 31.

Operator, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) Our first question comes from Aaron Hecht from JMP Securities.

Aaron Hecht^ John, how would you describe the business environment for your borrowers today? Obviously, there's been pockets of challenges for the industry over the last year or so. But I'm just wondering, is profitability getting incrementally better or worse in general? And then I guess, on that note, it sounds like Congress is trying to drum up support for safe banking again. Any thoughts on if you think it will pass.

John Mazarakis^ Aaron, I couldn't agree with you more. There are pockets out there. And I would say there isn't an incremental improvement, but what we've noticed is that there is a plateau. I think prices are stabilizing. CapEx has been very scarce in the space. And we expect them to start ticking upwards. I mean some of the really competitive states out West that we don't invest in have seen meaningful increases in wholesale price in the order of 30% in some cases.

So nothing to write home about when you're going from $700 to $900, it's nothing great. But still, I think the fact that California is kind of seeing a major exodus from existing cultivators in Colorado, Oregon and Washington is practically staved when it comes to capital. I think it's going to provide an environment for rising prices. Out East, we've seen a plateau and we're expecting prices to begin to rise. I mean -- and I'm excluding Maryland, which is a certainty, obviously.

With respect to the SAFE Act, we're not holding our breath. But as we've said before, for Chicago Atlantic, that's a positive event because we have built a very large platform, and we will be the beneficiaries of much-needed leverage in this space.

Aaron Hecht^ Right. Appreciate that. I was looking at Page 9 of the supplement, and it looks like 44% of your loans are allocated to construction projects. And just wanted to get some color on how you underwrite construction versus providing mortgages on assets that are already in place. And do a lot of the borrowers that are doing construction loans, do they run a negative corporate level cash flows for a period of time? Or do you mandate that they need to have corporate coverage before they can start construction?

John Mazarakis^ So we haven't really funded a construction loan in over 14 months. And what -- we obviously have a construction department, led by our expert, Michael Eizenga, who has built millions of square feet of retail and industrial space in the Midwest.

We currently don't have any borrowers that have purely construction projects other than expansions of existing operations. And to answer your question directly, we don't have any pre-revenue loans, and we haven't funded any loans for over 14 months.

Operator^ Our next question comes from Mark Smith from Lake Street.

Mark Smith^ First question for me. I just want to clarify and make sure I understand things right. What do you guys talk about kind of reining in originations here and kind of your thought process and why? It sounds like it's not as much kind of the risk profile today or capital preservation, but it's more so that you see some more opportunities coming out up over the next 12 months? And am I thinking about that right? Or walk us through kind of why you would reign in a little bit right now.

John Mazarakis^ I didn't hear you clearly on the first part of the question. But I think yes, the second part, we definitely are focused on the top 10 MSOs and we think opportunities will be coming in the next 12 months or so. With respect to the pipeline, I think the pipeline is robust, but we won't blink. We'll kill a loan if we have to. We're not in desperate need to deploy capital. So we've been extremely selective and we've killed a couple deals as they were maturing in the process but before funding. So that's the update.

Mark Smith^ Okay. And then any thoughts around shifting back to some fixed rate loans if the Fed is done, do you guys have any appetite for that today?

John Mazarakis^ We -- I think the best case scenario for us is to remain floating, but actually increase our interest floors. All our loans have a floor. So we've been increasing those floors.

Mark Smith^ Okay. Perfect. And I think the last one for me. Any update on kind of your outlook on prepayments or anything that's coming up here over the next few months?

Phil Silverman^ Thanks, Mark. No, I think with the prepayments that occurred in Q1, there was really no consistent theme across what was paid down, paid off, sold during the quarter and as we've discussed a little bit, we haven't seen a change in the availability of sources of capital, institutional capital for operators with kind of the no movement imminently on SAFE. But with the early repayments being able to occur for a variety of reasons, we don't have any guidance toward that for the remainder of the year.

Mark Smith^ Okay. Okay. Maybe I'll sneak in one more, just big picture thoughts here. Can you walk us through if we were to see SAFE Act passed, how that would change your outlook and how you guys operate the business? Would you get more aggressive? Walk us through any changes that would make on your business?

John Mazarakis^ Yes, we would probably be a little more aggressive. I think we would be the beneficiaries of cheaper capital, primarily coming from the debt side of the equation. And being the largest, I think we'll have access to those deals. Now the capital, I think, will be cheaper. But I think also the rates are going to be somewhat more in line with mainstream industries that kind of reflects the positioning of cannabis and the broader U.S. economy.

So not the cheapest, but still, there will be like a cannabis premium due to the fact that this would be still a taboo industry. I think the net-net benefit to investors will be somewhere along the lines of where it is today because of those 2 counteracting sort of forces.

Operator^ I would now like to turn it back to John Mazarakis for closing remarks.

John Mazarakis^ Thank you all for joining us this morning. We're available for follow-up questions if anyone needs to ask any other questions. Thank you.

Operator^ Thank you for your participation in today's conference. This does conclude the program. You may now disconnect.