Chicago Atlantic Real Estate Finance, Inc. (Q3 2022 Earnings)
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Corporate Speakers

- Tripp Sullivan; SCR Partners, LLC; President
- John Mazarakis; Chicago Atlantic Real Estate Finance, Inc.; Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC
- Tony Cappell; Chicago Atlantic Real Estate Finance, Inc.; CEO & Director of Chicago Atlantic REIT Manager, LLC
- Andreas Bodmeier; Chicago Atlantic Real Estate Finance, Inc.; Co-President, CIO & Director of Chicago Atlantic REIT Manager, LLC
- Phil Silverman; Chicago Atlantic Real Estate Finance, Inc.; Interim CFO, Company Secretary & Controller

Participants

- Aaron Hecht; JMP Securities LLC; MD & Equity Research Analyst
- Gaurav Mehta; EF Hutton; Analyst
- Mark Smith; Lake Street Capital Markets, LLC; Analyst

PRESENTATION

Operator^ Good day, ladies and gentlemen, and thank you for standing by. Welcome to the Chicago Atlantic Real Estate Finance, Inc. Third Quarter 2022 Earnings Conference Call. (Operator Instructions)

At this time, I would like to turn the conference over to Mr. Tripp Sullivan of SCR Partners. Mr. Sullivan, you may begin.

Tripp Sullivan^ 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 2022. 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 the 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 9, 2022, will not be updated subsequent to this call. During this call, certain comments and statements we make may be to 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 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 will also 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, and thank you for joining us today. Throughout this year, we have stressed the importance of maintaining discipline in underwriting, loan documentation and loan monitoring. We have also continued to assess asset values in every state as state markets evolve monthly. Given the continued disruption in the capital markets, it is critical that we continue to rely on these aspects of our strategy that have made us successful so far being methodical, analytical and pragmatic. I want to remind again everyone the investment potential of this industry.

Let's compare the performance of the cannabis market in the last 3 years to beer, wine, tobacco and pharmaceuticals. The revenue growth of these other industries from 2019 to '21 was in the low single digits, along with high single digits to low double-digit profit growth at best. The cannabis market, on the other hand, generated annual revenue growth in the mid-30% to low 50% range, along with mid-30% to 50% annual profit growth in the same period.

Cannabis is an industry that has only just begun to grow and will continue to need significant growth capital. I would also highlight that U.S. retail sales estimates from fact book project cannabis sales to increase from $30 billion in 2022 to $53 billion by 2026 with Rhode Island approving a dollhouse cannabis in May and its first retail store opening in early December and with Maryland being expected to move to adult use with the referendum this month, these estimates may, in fact, be conservative.

I don't think we've seen the full impact of New Jersey or New York in those sales estimates either. I also think it is worth mentioning the Safe Banking Act here briefly. There has been an increasing amount of speculation that something could get done before next January.

While this piece of legislation may ultimately pass, we believe that there is still a lot of work in compromise on both sides of the aisle for that to happen. Overall, we believe that this legislation will be a net positive for Chicago Atlantic. Several local banks are already providing smaller loans to smaller operators.

If the Safe Banking Act results in larger regional banks entering the space, we believe that they will want to put sizable capital to work quickly with platforms such as Chicago Atlantic rather than to build out the expertise with their own underwriting and lending groups. Ultimately, this legislation is expected to help us increase our leverage and to result in an overall lower cost of capital for the REIT.

I noted last quarter that it was our #1 goal to increase our syndicated credit facility because of how accretive this lower cost of capital is for our investors. And I'm pleased to announce that we have successfully done so. We increased our facility by $27.5 million to a total of $92.5 million, and we added 4 new banks to our lending group. We're actively working to close another $7.5 million to get us to $100 million in total.

We're also working to ultimately increase the overall size of our revolver as the credit facility will remain the most accretive source of capital for us in the foreseeable future. As we disclosed in our earnings release, we increased our outlook for the full year. We are now expecting adjusted distributable earnings to be in the range of $2.01 to $2.05 per share.

This outlook assumes the use of our expanded credit facility over the balance of the fourth quarter with leverage by year-end in the range of 25% to 35%. Having declared a $0.47 regular quarterly dividend for Q3 as planned, in December, we expect to declare at least $0.47 for the fourth quarter. We also intend to distribute up to 99% of distributable earnings for 2022. That would imply a special dividend to be declared before year-end to true up our taxable income.

We have combined a very bullish outlook on the cannabis industry with a measured and disciplined approach to underwriting. Our conservative business has been even more evident in our projections, our leverage and our dividend payouts. We believe that these decisions have been the right ones for our shareholders and have led to our outperformance on a relative basis to our peers and our comparable indexes. Tony, why don't you take it from here?

Tony Cappell^ Good morning, everyone. I want to follow up on a point John made earlier about investment potential. As you might expect, we track pricing data and trends in every state in which we're invested, along with those where we are not invested. What we keep seeing in that data is there are a lot of headlines about pricing compression, but not much context beyond the headline. Without the context and analysis, all you might come away with is misguided impression of general operator distress. There have been some well-documented cases in the industry, but for the most part, we are seeing continued growth from our operators.

The way we see it, success is defined differently in every state and not all prices are created equal. Here's a good example. The more competitive states such as Arizona, California, Colorado, Oregon, Washington and Michigan, have seen their average wholesale price per pound decreased from an average of $1,250 per pound in January to roughly $800 per pound in September.

Other states such as Illinois, Maryland, Pennsylvania and Massachusetts have seen declined as well in the same period, but they've all stayed between $22.50 and $37.50 per pound, and the percentage declines haven't been as steep as the Western states. This is where the underwriting discipline and first mover experience in the industry count.

When we look at underwriting cultivation, if an operator can produce at $400 per pound, then they are viable at even a wholesale price of $1,000 per pound. The same goes for a producer whose costs are $1,200 per pound in a market where wholesale pricing is between $2,500 and $3,000 per pound.

For retail operations, we focus on sales per square foot. The current average across our portfolio is $3,000 per square foot. That's comparable to one at Apple Store or other high-end retail stores would produce. An operator with $400 per pound cost structure and $3,000 per square foot in retail sales is viable even in a market like California.

Turning to our origination pipeline. We have remained very active in the second half of the year. As planned, the Chicago Atlantic platform has been able to fulfill demand from new and existing operators until the REIT could increase the size of its credit facility. Just last month, we were pleased to lead and serve as the agent for a new 4-year $350 million facility for our largest multistate operator. The REIT retained its $30 million in that facility. We believe there will be additional opportunities for the REIT to participate in future financing needs with this operator in the not-too-distant future.

While we have stayed active with originations, we have also held the line on our robust structuring upfront intense loan monitoring, strict financial covenants and all asset leans from borrowers that improve our collateral well beyond the 1.9x real estate coverage that we have in our portfolio. In addition, we expect to continue to increase the amount of rate loans to well above 60% of our portfolio.

Loan demand is strong, and with the REIT now having additional capital to put to work and plans to potentially increase the facility again, the REIT can once again reap the benefits of the leading origination platform we have created. Now Andreas will walk us through our investments.

Andreas Bodmeier^ Thanks, Tony. At September 30, our loan portfolio has grown to total loan commitments of $349 million across 22 portfolio companies. It has a weighted average yield to maturity of 18.3%, up from 17.7% at June 30. New originations during the quarter were $5.7 million, comprised of $5 million to a new borrower with a $4 million commitment remaining and $680,000 incremental events to an existing borrower. As discussed on the Q2 earnings call, originations were expected to be low in Q3 due to the REIT's capital constraints.

However, the Chicago Atlantic pipeline remains strong. And with the increase of the credit facility, we expect the REIT to be able to increase its loan originations in Q4. Subsequent to quarter end, we had the origination Tony mentioned earlier, which extended the maturity of a $30 million loan that the REIT holds until 2026. All loans are current and performing.

Our portfolio is currently at about 60% floating rate based off of the prime rate. So we have been able to effectively manage the impact of rising rates. Last week's decision by the Federal Reserve to raise the Fed funds rate by another 75 basis points should result in another increase in portfolio yield in Q4. With our leverage expected to increase from 20% to 25% to 35% by year-end, the higher interest on the credit facility could

potentially offset some of that yield in distributable I'll now turn it over to Phil to review our financial results.

Phil Silverman^ Thank you, Andreas. Turning now to our financial results for the third quarter. As expected, net interest income continued to increase sequentially, up $1.5 million or 13.4% from Q2. The increase was primarily due to the 150 basis point increase in the prime rate during Q3, which impacted the 60% of our portfolio, which bears a floating rate. Additionally, the company benefited from a full quarter of interest recognition on our Q2 loan originations.

Total operating expenses for the quarter were consistent with Q2 at approximately $2.9 million, which includes management and incentive fees of $1.3 million, aggregate G&A and professional fees of $1.4 million and stock-based compensation of approximately $100,000. Incentive and management fees were up sequentially in line with higher net interest income, while the other G&A and professional fee expenses were down nearly $100,000 as compared to prior quarter.

We anticipate full year G&A will be approximately $3.5 million, which includes costs associated with our upsized credit facility, which were not capitalizable under GAAP. The incentive fees pick our manager are calculated on a rolling 12-month basis. These incentive fees for the last 12 months as of Q3 less the fees paid and waived in the previous 3 quarters was approximately $519,000 in Q3 compared to approximately $599,000 in Q2.

In Q4 2021, the manager granted an incentive fee waiver of approximately $1.1 million in connection with our IPO. This fee waiver from Q4 2021 will be excluded from the rolling 12-month calculation in Q4 2022. As a result, we expect an increase in the incentive fee for Q4 and a corresponding decrease to distributable earnings for the same period. As of quarter end, we increased our provision for expected credit losses by $300,000 or nearly $0.02 per weighted average diluted common share.

Similar to last quarter, our reserve was increased based on a quarterly reevaluation of overall current macroeconomic conditions, including, for example, the rising rate environment as opposed to any company-specific factors impacting the credit quality of our borrowers. Nearly 96% of the portfolio continues to be fully secured by real estate and 4% is limited or no real estate collateral.

Our portfolio on average had real estate collateral coverage of 1.9x as of September 30, 2022. The CECL reserve was added back to the calculation of distributable earnings consistent with prior quarters. The other adjustments to distributable earnings include stock-based compensation and depreciation and amortization, which amounted to $223,000 in Q3 compared to approximately $291,000 in Q2.

Our adjusted distributable earnings per share was $0.58 per diluted share for Q3, up sequentially from $0.50 in Q2. Our book value as of September 30 was $15.23 per common share compared with $15.13 as of June 30. Operator, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) Our first question and comment comes from the line of Aaron Hecht from JMP Securities.

Aaron Hecht^ Congrats on getting that extra liquidity on the credit facility. I know you've been working on that for a while. When you look at your pipeline today, how is the investment yield changed across the landscape? I mean, obviously, there's been significant capital market volatility, interest rates are up. Are investment yields keeping up with the cost of capital increase that you guys are seeing for you anything on the market?

John Mazarakis^ Thanks for the question. Yes, the answer -- the quick answer is absolutely. We're seeing yields like I don't have any expectation for those to subside anytime soon. Keep in mind that for the broader market, the increase in rates probably highlights the 300% to 400% increase from 0 to 4.25%. In our case, the increase is much smaller relative to the initial rate that the borrowers were paying before. So that is a key metric to kind of define stress in cannabis versus the broader market.

Aaron Hecht^ Okay. And then you guys guided to some higher leverage, I think, in the fourth quarter. Is that simply putting your commitments to work? Or do you have new deals lined up? And are you expecting to work with more operators? Or is this working within your existing operators (inaudible).

Tony Cappell^ Yes. That would be right now earmarked for new deals. Obviously, from a commitment perspective, we have the ability to fund that. But there's no expectations for any of that to be drawn in the near term. So that's really more new operators and kind of at higher returns.

Operator^ Our next question or comment comes from the line of Gaurav Mehta from EF Hutton.

Gaurav Mehta^ I wanted to ask on some expense items. You talked about G&A expectations of $3.5 million, which is at the higher end of your prior expectation of $2.5 million to $3.5 million as you mentioned, cost of upsized credit facility. But outside of that, are there any other items that brought G&A to the higher end? And then I guess as you think about the run rate of G&A, and how should we think about that?

Phil Silverman^ Gaurav, thanks for the question. Yes, as you correctly pointed out, we increased our G&A guidance slightly to about the $3.5 million. And as you also correctly pointed out, we dedicated substantial internal resources of our manager rather than an investment bank or a third party during Q3 to pursue and source the increase commitments on the upsized credit facility. And so that's really the significant driver of the increase in Q3 and therefore, the run rate for the year. Those presumably are onetime cost, although we continue to pursue further increases to the total commitments on that facility, as we've noted. I think the Q2 expense numbers are indicative of our run rate going forward.

Gaurav Mehta^ Okay. Maybe on your guidance of distributable earnings. I was curious if you could help us understand maybe the variance between the 4Q earnings as implied by the guidance versus 3Q, it seems like 4Q would be lower than 3Q. I know earlier you said higher incentive fee, but I guess outside of that, are there any or items that have been in 4Q earnings lower than 3Q?

Phil Silverman^ No, it's really predominantly the incentive fee. It is a fairly substantial difference in the nature of the way it's calculated. We've explained that in our prepared remarks. That will drive distributable earnings down slightly. We have not forecasted any additional rate hikes from the Fed beyond what's occurred through today. So that is not contemplated in our calculations. We expect expenses and other operations of the company to remain relatively consistent through the fourth quarter.

Operator^ (Operator Instructions) Our next question comment comes from the line of Mark Smith from Lake Street Capital Markets.

Mark Smith^ A couple from me. First, any outlook really into repayments or anything that we should have on our radar that could be coming up that changes portfolio a little bit?

Tony Cappell^ Yes. We just have one deal that is set to mature in Q4. And again, it's not that big. Well, our expectation is we will be able to roll that into a new deal at a higher return. Now if that does pay down, we are very confident that, that can be put to work in short order. Other than that, there are really no expectations of payoffs.

Mark Smith^ Perfect. Then as we look at kind of structuring of new deals, any pushback any issues as you guys look at continued move to floating rates as well as kind of getting the real estate collateral that you look for in need.

John Mazarakis^ So yes, we're trying to pick the best of the best deals. We've been able to increase our floating percentage -- the floating percentage of the portfolio from 60% to the low 70%. So we're very mindful of not committing to any fixed loans. And we're actively pursuing converting any fixed loans to floating loans.

So collateral obviously has become top of mind and creditworthiness in general has been what we've been selling after in the last couple of quarters since the rates started to increase. We have not -- I mean, obviously, borrowers will always push back regardless of the conditions. So nothing new to report on that front.

Mark Smith^ Okay. And then last one for me. You mentioned it a little bit in your comments, but as we look at Missouri and Maryland, looking positive here for legalization. Either of those that you really think maybe change your outlook that are good growth opportunities and then maybe not looking at a full lane duck session here. Does that reduce the risk or reduce the odds maybe of getting safe act or anything else faster over the next few months?

John Mazarakis^ The truth is that we were expecting those 2 states to flip because of the overwhelming support by voters. So we were actively pursuing deals in those states, and

we've actually made -- we're in the process of closing deals in those states. So yes, net-net positive, great story for both states. It's a win-win for everyone.

Operator^ Thank you. There appears to be no additional questions in the queue. I'd like to turn the conference back over to Mr. Mazarakis for any closing remarks.

John Mazarakis^ Well, thank you very much. I wanted to thank everyone. We feel that we put another good quarter up for scrutiny by the group. And we're going to continue to do what we do and hopefully deliver more quarters like this one. Have a wonderful day.

Operator^ Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may now disconnect. Everyone, have a wonderful day.