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Q2 2023 Chicago Atlantic Real Estate Finance Inc Earnings Call

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CORPORATE PARTICIPANTS

Andreas A. Bodmeier *Chicago Atlantic Real Estate Finance, Inc. - Co-President, CIO & Director of Chicago Atlantic REIT Manager, LLC*
Anthony Cappell *Chicago Atlantic Real Estate Finance, Inc. - CEO & Director of Chicago Atlantic REIT Manager, LLC*
John Mazarakis *Chicago Atlantic Real Estate Finance, Inc. - Executive Chairman of the Board of Chicago Atlantic REIT Manager, LLC*
Peter S. Sack *Chicago Atlantic Real Estate Finance, Inc. - Co-President & Director of Chicago Atlantic REIT Manager, LLC*
Phillip Silverman *Chicago Atlantic Real Estate Finance, Inc. - Interim CFO, Company Secretary & Controller*

CONFERENCE CALL PARTICIPANTS

Mark Eric Smith *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*
Mitchel Stuart Penn *Oppenheimer & Co. Inc., Research Division - Research Analyst*
Tripp Sullivan *SCR Partners, LLC - President*

PRESENTATION

Operator

Thank you for standing by, and welcome to the Chicago Atlantic Real Estate Finance, Inc. Second Quarter 2023 Earnings Conference Call. (Operator Instructions) As a reminder, today's program is being recorded. And now I'd like to introduce your host for today's program, Tripp Sullivan.

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 second 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 in 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, August 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 risks 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. After another quarter of volatility in the broader financial sector and cannabis in particular, we can now add the fact that small cap equity risk premiums are at the lowest level in a couple of decades. Seems like, yield will soon be king again. If you add in worries about a recession or not, that's a lot of ways to get distracted. I want to address some of these topics to stress how we've approached the creation, management and execution of our platform at Chicago Atlantic. Over the past 25-plus years, I've been through 3 recessions and several economic cycles. I've seen cycles where there's catastrophic collapse or cycles where competition is fierce. Our job as a fund manager is to smooth out the peaks and throughs evident within the strategy that we're managing.

No deal does that better than the partnership we've created with the State of New York that Peter will discuss in a moment. With the largest platform, our own origination team, experience in direct lending, a well-capitalized and conservative balance sheet and a diversified loan portfolio, I believe we can make a stronger case than ever before that we're the leading capital provider in this space. The pipeline remains robust with actionable deals in excess of $400 million. There are a lot of good things happening in states, such as Maryland and Missouri. And we are starting to see more transaction activity within the industry with the new states coming online that's leading to improved optimism among the investors in different forms of capital allocation.

There's also a growing recognition that the high rate environment isn't going away quickly, which is leading to decisions about whether to grow or not to grow as well as increased M&A funded by debt financing. We're in front of several trends in limited-license states that are moving from medical to adult use in states that have seen the greatest price compression show improvements in wholesale pricing. We have been cautious for some time now, but it could be time to change that to cautiously optimistic. We're picking our spots and remaining incredibly disciplined in the pursuit of new opportunities. Our partnership with New York is a great example of taking the right opportunity backed by strong credit and an appropriate return that could potentially lead to other partnerships. I will now turn it over to Peter.

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

Thank you, John. On June 30, Governor Hochul announced our partnership with New York and the New York State Cannabis Social Equity Investment Fund. The Chicago Atlantic platform has committed $150 million to this partnership with the REIT accounting for up to $50 million of that total commitment. Our investment is subject to the identification and due diligence of dispensary locations. We have a highly skilled real estate team that has lent our expertise to picking and building the right locations. And they have been working on these sites for several months. Last week, we advanced our first capital, nearly $19 million to fund the opening of 17 dispensaries, at least 15 of which should be operational in the fall.

This partnership with New York is a whole new ball game and perhaps the largest commitment to social equity initiatives in the history of the industry. We are fortunate to be the capital provider in the cannabis industry that has the operational, financial, legal and underwriting expertise, not to mention the capital to come alongside the state of New York and make this happen. If this works the way we all envision, there could be future opportunities to replicate this partnership in other states. Tony, why don't you take it from here?

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

Good morning. At June 30, our loan portfolio had total loan commitments of $329 million across 25 portfolio companies with a weighted average yield to maturity of 19.2% compared with 19.4% at March 31 and 17.7% a year ago. As expected, we kept new originations limited with total gross originations of only $1.9 million to existing borrowers. That was offset by $6.9 million of principal repayments, $5 million of which was related to unscheduled early repayments. Our portfolio remains 88% floating rate based off the prime rate consistent with last quarter and up from 60% from June of 2022. With the Federal Reserve raising their target rate again last week and the increase in the prime rate to 8.5%, we continue to see a positive impact on portfolio yield. I'll now turn it over to Andreas.

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

For the first time in our life as a platform, we experienced a default this quarter and moved Loan #9 to nonaccrual. The decision to place this loan on nonaccrual is borrower specific and not representative of the performance across the rest of the portfolio. The borrower did not make contractual payments due under our loan since May. As a result, we accelerated the obligations due under the loan and are in the process of exercising our rights and remedies in pursuit of full repayment of outstanding obligations. Due to our stringent underwriting, we are confident that we will be made whole on this loan.

The current outstanding principal balance is approximately $16.1 million, and no past due interest has been accrued or recognized to income. On the capital structure side, we were able to increase our revolving credit facility to $100 million within the quarter with the addition of another bank to the syndicate. With that upsize in the revolver, we are comfortable where we are with that size. As of quarter end, we had $43 million outstanding on the line. With the advance on the $18.8 million New Year loan subsequent to quarter end that Peter mentioned earlier, we drew an additional $15 million on the revolver and have $58 million outstanding on the line as of today, which provides the company with a total of $46 million in liquidity.

Our balance sheet is still under levered at 16% of book equity at quarter end compared with 22% at year-end. Our debt service coverage ratio on a consolidated basis was 11.5:1 as of quarter end compared with the requirement of 1.35:1. Given that leverage among other mortgage REITs remains elevated, we believe we offer a very compelling dividend yield backed by strong portfolio yields and coverage without the level of risk that these other REITs have taken on. In addition, we also benefit from strong underwriting and collateral coverage that extends well beyond the real estate. I'll now turn it over to Phil to review our financial results.

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

Thank you, Andreas. Net interest income for the quarter decreased $1.2 million or 8.4% from Q1. In Q2, we recognized approximately $0.6 million in nonrecurring interest income from early principal repayments as compared to $1 million during the first quarter. The decrease was further driven by the impact of one loan placed on nonaccrual status in May, which accounted for $0.6 million of the sequential decline as well as a decrease in the average principal outstanding of $332 million during Q1 as compared to $319 million in Q2. These decreases were partially offset by lower average borrowings on our revolving credit facility and the positive impact of the 25 basis point increase in the prime rate in May.

Total operating expenses for the quarter before our CECL provision were down 5.8%, primarily due to a decrease in net management and incentive fees. Adjusted distributable earnings was $0.55 per weighted average diluted share for Q2 compared with $0.62 during Q1. We distributed a dividend of $0.47 during the second quarter, which resulted in a dividend payout ratio of approximately 85%. Year-to-date, we have distributed approximately 80% of taxable income. The Q2 diluted earnings per weighted average common share was $0.47 compared to $0.60 in Q1. The decrease is primarily due to a higher provision for expected credit losses and stock-based compensation, partially offset by the lower management and incentive fees. We increased our quarterly CECL reserve by $1.1 million as of June 30.

The CECL determination for the quarter considered reserve reversals attributable to the principal repayments during Q2 as well as the downgrade of one loan with an outstanding principal balance of $11 million to a risk rating of 4. Our reserve estimate further contemplates benchmark third-party loan loss data, which during Q2 reflected an increase in expected loss and probability of default rates as compared to Q1. The increase in these benchmark loss rates are the result of the continued rising rate environment and other macro environmental factors and contributed to the overall increase in the provision during Q2.

On a relative size basis, we increased the total reserve to approximately 1.6% of outstanding principal as compared to 1.3% as of March 31. Approximately 74% of the portfolio based on outstanding principal is fully secured by real estate collateral. 24% is partially secured with the remaining 2% having no real estate collateral. Our portfolio on a weighted average basis had real estate collateral coverage of 1.5x as of June 30, 2023. Our book value as of June 30 increased to $15.06 per common share compared with $15.04 as of March 31.

Lastly, I would note that based on our results through the first half of the year, we have affirmed our previously issued 2023 outlook. Operator, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Mark Smith from Lake Street.

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

Just curious if you can give us any additional details on this New York deal kind of potential timing of additional capital put into this rates? Any additional details you can give us would be great.

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

Unfortunately, we will stick to what we published so far. I think it's detailed enough to kind of provide a guidance as to the risk return associated with the transaction. In line with what we've done in the past, we can't discuss our borrowers in detail.

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

That's fair. And then any additional thoughts on new states. I know we talked recently on Minnesota (inaudible) states that maybe have recently gone forward with (inaudible) utilization or any [that you see] in the pipeline that maybe gets you excited?

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

Ohio, it's probably the next state. As you know, they've gathered enough signatures to have the initiative on the ballot in November. That was expected. So we should be looking at Ohio turning rec sometime next year. I would also say that we're a little bit cautiously optimistic with PA, although it's a harder way to get through the legislature. But those 2 states are rather big. And of course, the biggest state that has collected the signatures is the state of Florida. We're not holding our breath, but we have capable operators representing our portfolio in Florida, and we also feel strongly that at some point in the next 24 months, probably Florida will turn rec .

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

Okay. And I assume your outlook on anything changing at the federal level is probably unchanged?

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

Yes. That requires a crystal ball. We're not quite there yet, but we can speculate.

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

The last question for me is just as we look at industry headwinds, others in the industry that have reported pretty tough results and outlook here. Are you seeing anywhere to call out from pockets of continued or maybe worse new weakness geographically?

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

I haven't been seeing weakness, and I'm kind of constantly boots on the ground. What I have seen is a plateau as a result of turning off the CapEx (inaudible). So I suspect -- what we're seeing is prices are kind of leveling off, and in some cases, ticking upwards. So -- this is a Darwinian process, whoever knows what they're doing, they're going to excel, and there's going to be consolidation, which we were prepared for since day 1.

Operator

(Operator Instructions) And our next question comes from the line of Mitchel Penn from Oppenheimer.

Mitchel Stuart Penn ***Oppenheimer & Co. Inc., Research Division - Research Analyst***

Can you provide more details on the nonaccrual?

And give us an idea of the process and the timing in terms of how this is -- this is the first time we've seen a nonaccrual. So more color around that?

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

Mitch, Chicago Atlantic is known for being very efficient. So I'm happy to report that we have a scheduled sale taking place tomorrow. But of course, the borrower has also filed a counterclaim. And we're going to try to go over it today. As of right now, the sale is scheduled for tomorrow, and we have a few buyers in line waiting to purchase the assets. So we're very much ahead of the game.

Mitchel Stuart Penn ***Oppenheimer & Co. Inc., Research Division - Research Analyst***

Terrific. And that $16.2 million on your books?

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

I'm sorry, Mitch, can you repeat that?

Mitchel Stuart Penn ***Oppenheimer & Co. Inc., Research Division - Research Analyst***

The value -- the carrying value, $16.2 million, that loan...

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

Yes, plus [$600,000] (corrected by company after the call) of...

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

That's correct, Mitchel. The carrying value on the balance sheet is $16.2 million. We had about $600,000 of income that would have been recognized on this loan had it not been placed on nonaccrual status. And at this point, we're very comfortable that any reserves on the balance sheet are sufficient if there were to be any losses related to this loan.

Operator

This does conclude the question-and-answer session as well as today's program. Thank you, ladies and gentlemen, for your participation. You may now disconnect. Good day.
