# Q1 2018 Callidus Capital Corp Earnings Call

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TEXT version of Transcript

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Corporate Participants

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* Dan Nohdomi

Callidus Capital Corporation - VP & CFO

* David M. Reese

Callidus Capital Corporation - President & COO

* James A. Riley

Callidus Capital Corporation - Secretary & Director

* Newton Glassman

Callidus Capital Corporation - Executive Chairman & CEO

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Conference Call Participants

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* Jaeme Gloyn

National Bank Financial, Inc., Research Division - Analyst

* Jerome Hass

Lightwater Partners Ltd. - Portfolio Manager

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Presentation

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Operator [1]

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Good morning. My name is Matthew. I am your conference operator today. Welcome, everyone, to the Callidus Capital Corporation First Quarter 2018 Results Conference Call. (Operator Instructions)

Listeners are reminded that portions of today's call and today's discussions, including direct responses to questions posted in today's call constitute forward-looking statements that are subject to risks and uncertainties related to the company's future financial or business performance and conditions. Actual results could differ materially from those anticipated in these forward-looking statements.

Risk factors that may affect results are detailed in the company's filings with the Canadian securities regulatory authorities, which can be accessed at sedar.com. Please note that the company is under no obligation to update any forward-looking statements discussed today, except as required by applicable law. And investors are cautioned not to place undue reliance on these statements.

On the call with us today from Callidus are Newton Glassman, Executive Chairman and Chief Executive Officer; David Reese, President and Chief Operating Officer; Dan Nohdomi, Chief Financial Officer; and Jim Riley, Secretary.

At this time, I'd like to turn the call over to Mr. Glassman. Please go ahead.

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [2]

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Thanks, Matthew. Good morning, everyone, and thank you for joining us for our first quarter 2018 results call.

During the call, I'll be referring to information provided in the financial statements and the MD&A and the associated news release for the quarter. All of such are available on our website and on SEDAR.

And we appreciate your feedback on our materials, so please feel free to communicate directly with any member of the Callidus management team mentioned earlier by the operator.

For our call today, Dave and Dan will provide you with some insight into the details of the operating and financial results for the quarter. Before they do, I'll start off with some brief comments on events since we last spoke approximately 6 weeks ago.

I'd first like to reiterate our 6 strategies for restoring and building shareholder value.

First, currently growing the loan portfolio. And with 4 signed back term sheets totaling approximately $316 million, we are carefully and perhaps too slowly advancing a rate on this objective.

Second, actively managing the loan portfolio to minimize realized losses and with the goal of maximizing recovery of the noncash loan loss provisions recorded today. Given the low end of cash or new provisions -- given the low level of noncash or new provisions in this period as well as the progress to date on the rehabilitation of a number of consolidated entities, we hope we are making progress here as well.

Third, maximizing the cash flow and value of businesses consolidated.

Fourth, prudently increasing leverage including seeking external sources of possible financing at the subsidiary level. In this fourth area, we continue to hold discussions with potential lenders including with the -- including the objective of recapitalizing some of our wholly owned subsidiaries. There is substantial work to be done in this area.

Fifth, enhancing the management team as appropriate. And sixth, considering other transactions that can support and/or benefit the corporation.

As you know, in December of 2017, we completed a normal course issuer bid and had purchased approximately 2.5 million common shares or 100% of the total shares eligible at a weighted average price of $13.03 per common share for approximately $32.5 million. Subsequent to the first quarter -- subsequent to the end of the first quarter of 2018, the TSX accepted our notice of intention to undertake a further NCIB. Under the terms, Callidus may acquire up to 2,648,529 of its common shares representing 5% of the 52,970,597 common shares issued and outstanding as of April 2018. The NCIB will end the earlier of April 17, 2019 or on the date the maximum number of common shares have been purchased.

We will continue to use normal course issuer bids as a means to enhance value per shareholders as long as the company is public and we believe the market price does not reflect the underlying value of the common shares.

Finally, while we continue to work hard to pursue a privatization, we have no material facts or changes to report at this time.

We will update the market when developments occur.

With that, I will now ask David to walk us through the operating results for Q1, 2018.

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David M. Reese, Callidus Capital Corporation - President & COO [3]

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Thank you, Newton. As in the past, I will focus my comments on the loan book and provisioning.

We recorded a provision for loan losses, the vast majority or 82% of which was noncash, in the first quarter of 2018 of $15 million, compared with $19.4 million recorded in the prior year quarter.

As for the loan portfolio itself, at March 31, 2018, gross loans receivables were $1.1 billion, up 6% from year-end 2017 and 9% from the first quarter a year ago.

Our average loan size was approximately $58 million, about $2 million higher than a year earlier. We have 19 loans in our current portfolio, up 1 from the end of Q1 2017.

We currently have 4 term sheets totaling $316 million, which have been signed back by prospective borrowers.

Approximately $7.6 million of the provision is noncash and related to unrealized foreign exchange movements while the remainder is primarily attributable to a noncash $4.7 million provision we recorded as a result of a delay in future expected cash flows on 1 specific loan concentrated in the energy sector. We discussed this loan in some detail last quarter. The borrower has substantial commercial interest in a South American country that is experiencing significant political and economic turmoil. No other factors have materially changed since then regarding this loan.

During the first quarter, we recognized a recovery of $29.8 million under the Catalyst guarantee.

In January, we foreclosed on collateral resulting in the acquisition and control of a borrower, Midwest Asphalt Corporation, a paving and maintenance company. And this loan was removed from loans receivable and consolidated in our financial statements. We now have 6 loans removed from loans receivable consolidated in the financial statements in order to protect collateral on those loans.

We continue to work with all companies where we have fully taken control of our collateral to implement strategic decisions and execute new business plans as part of their turnarounds so as to maximize our recoveries. In most cases, we are pleased with the progress we have achieved to date in rehabilitating them.

Our net loans receivable of $245 million at quarter-end decreased very slightly from the end of the first -- fourth quarter of 2017 as increased funding for existing borrowers was offset by higher provisions for loan losses and the consolidation of Midwest Asphalt.

As we have mentioned in prior conference calls, as an asset-based lender, we only extend loans based on the collateral available to support the loan. From time to time in order to protect our collateral positions, we end up owning a business that we acquire as part of a restructuring process. Our objective is to rehabilitate these businesses and ultimately sell them to maximize the recovery of our loan and investment in the business. While the independent and often new management teams are rehabilitating the business, accounting standards require us to fully consolidate those businesses.

And now I'll ask Dan to discuss a few of the financial highlights for the quarter. Dan?

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Dan Nohdomi, Callidus Capital Corporation - VP & CFO [4]

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Thanks, David. Before I review the key financial highlights, let me again remind you of a change in our financial presentation that we implemented in the second quarter of 2017.

The additional business we acquired during the first quarter of 2018 brings a total to 6 that we currently are required under IFRS to consolidate in our financials, and, as active businesses, they affect both our balance sheet and income statement.

Our income statement therefore, includes the revenue and costs generated by these businesses, however, since they are not our core business, we have separated their impact on Callidus revenue and cost of sales. We hope that this additional disclosure will assist readers of our financial statements to compare current reporting periods to historical periods and equally identify the impact of these businesses and their current inclusion in our results.

While it means a more complicated, longer and more detailed income statement, expanded notes and MD&A disclosure, we hope it will assist in separating the impact of these businesses from our fundamental strategy and performance as a specialty asset-based lender.

As the consolidated entities are eventually sold, these businesses will be removed from our books.

Our Q1 2018 leverage ratio increased to 38.2% from 37.3% at year-end, down from 39.9% at the end of the first quarter last year.

This is significantly underlevered and it continues to negatively impact some key metrics such as interest margin.

With respect to our capacity to fund growth with our cash, various undrawn facilities, potential participation by Catalyst Fund V and some changes to existing senior debt and subdebt facilities, we are able to support in excess of $400 million of new loans, up from approximately $300 million at year-end.

In addition, as consolidated businesses are rehabilitated, recapitalized or sold, we will generate additional further capital that we expect to either deploy in opportunities that generate superior returns or help in the recapitalization by replacing existing debt with cheaper debt, et cetera.

Given the size of the loan pipeline, approximately $2.9 billion on a gross basis and the capacity to fund new loans through our current facilities, we continue to target growth in our loan portfolio that will increase leverage in the coming quarters.

I'd like to conclude by highlighting an additional key metric.

Our gross yield in the first quarter of 2018 was 6.3%, a decrease from 10.8% at December 31, 2017, and 20.2% for the first quarter of 2017. The decline from year-end was due primarily to lower interest rates charged on certain loans while the decline from Q1 2017 was due primarily to the elimination for accounting purposes of interest revenue on the consolidation of 3 companies during 2017, and lower interest rates charged and earned on net loans receivable.

To be clear, once consolidated as an operating subsidiary, Callidus cannot and does not charge interest to such an entity and thereby, obviously, negatively impacting comparative period interest margin.

We continue to expect gross yield to remain lower than our normal 18% to 20% as long as businesses acquired from loans remain a significant portion of our loan book.

With that, I'll turn it over to Jim Riley.

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James A. Riley, Callidus Capital Corporation - Secretary & Director [5]

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The press has written on an action commenced by Mr. Kevin Baumann on behalf of Alken Basin, a former borrower. There is no basis for this claim. All claims and other assets of Alken Basin that form the basis of that claim were transferred to a new company pursuant through a court-supervised and approved transaction. Mr. Baumann, reported to act as a director of Alken Basin, is removed from any capacity with Alken Basin and a Callidus nominee has replaced him. The council that brought the action has been terminated.

We will take appropriate steps to also have the action terminated.

Both the timing and misleading information fed to the press in an apparent market manipulation fit a pattern we and others have repeatedly seen in the past and is a victimization of shareholders. We've provided the details of Mr. Baumann's actions to the appropriate authorities. We have named Mr. Baumann in our current action and we'll add this to our mounting evidence in that action.

Now I'll turn it over to Newton.

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [6]

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Thanks, Dan, David and Jim.

Before we take your questions, let me close with a comment on our optimism for the future.

We remain focused on and confident in the 6 key strategies I mentioned at the outset of today's call.

Although we would have liked to make faster or better progress in one or more of these strategies to date, we are committed to restoring and building value for our shareholders and we believe that with these initiatives, we are on the right track and well underway.

Some, but not all, of the delays or issues encountered in one or more of these initiatives and/or the progress of the privatization process have been negatively impacted by factors beyond our control including the recent noise in the market such as that commented on by Jim Riley.

We believe this to be intentional, which unfortunately is somewhat effective to date by certain parties to hurt our shareholders.

We will continue to work with the authorities to try to best bring this noise to an end, but we have no idea or control over when or how such may occur.

Now, Matthew, we would be pleased to take questions.

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Questions and Answers

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Operator [1]

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(Operator Instructions) Our first question comes from the line of Jaeme Gloyn with National Bank.

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Jaeme Gloyn, National Bank Financial, Inc., Research Division - Analyst [2]

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First question is related to the energy loans with about $88.7 million in worth for net loans receivable. Only a $4.7 million provision related to that loan today -- I'm just wondering what are some of the circumstances and factors that might drive a larger provision in future quarters or even a recovery? What are some of the factors that you're looking at?

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [3]

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Jimmy, it's Newton. David, let me start and then if I miss something maybe you can add it. Under the accounting rules, there are mathematical models and factors that drive it. The key factors were disclosed and are what was disclosed in, I think, the year-end MD&A, they are the weighted average cost of capital, probability of execution on the contract and probably of additional contracts going forward. The noncash impairment related to that loan is the result of plugging into that math, the delay of another quarter of executing on that contract. So every quarter that we or the company choose to wait because of the instability in the country has a noncash charge that is kicked out through that formula and it spits out a number, the number was roughly the number that we put in the statements. David, do you have anything to add?

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David M. Reese, Callidus Capital Corporation - President & COO [4]

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That's correct, Newton. I think the number we had disclosed was $4.7 million and that's probably a relatively good proxy for pushing the contract start date out about a quarter as Newton mentioned.

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Jaeme Gloyn, National Bank Financial, Inc., Research Division - Analyst [5]

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Okay. And within that loan, or that borrower, can you just talk about, I guess how that borrower assumed another loan? And why is it today that it's receiving a guarantee under the coverage and that wasn't previously disclosed or known prior to Q1 '18?

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David M. Reese, Callidus Capital Corporation - President & COO [6]

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Sure. The -- as we disclosed that company purchased through realization an asset and -- that we had loaned money to. So a company that we had loaned money to they acquired at face and that company had been on -- the acquired company had been on our watch list. And so the guarantee followed the acquisition and what we clarified in effective in Q1 of this year was the guarantee amount was treated the same way that all the guarantees are and that it was not just the guarantee amount as of the date of transfer. So that was the clarification that's what resulted in the booking of that event in Q1.

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Jaeme Gloyn, National Bank Financial, Inc., Research Division - Analyst [7]

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Yes. So the guarantee applies to the original loan, not the transfer that was done in Q1? Is that fair to understand?

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David M. Reese, Callidus Capital Corporation - President & COO [8]

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Almost. The guarantee was to the original loan that was transferred, I believe, in March of 2016 into the larger entity that we are talking about but the clarification as to whether the guarantee covered just the dollar amount at the date of transfer or if it was similar to the other guarantees, that was clarified in Q1 and that's what resulted in the recovery tied to that.

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Jaeme Gloyn, National Bank Financial, Inc., Research Division - Analyst [9]

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Okay. Shifting then -- the next question is related to the Catalyst guarantee recovery of, of close to $29 million. The -- it looks to me like that the loan that are covered by the guarantee is significantly lower than that $30 million recovery. What is driving that delta? And should we expect to see other recoveries under the Catalyst guarantee of this nature in the future quarters running through P&L?

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [10]

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Jimmy, it's Newton. In fact, there is a significant amount of bill that is guaranteed. If you go through, I think that the year-end financials, you'll see that the full amount of the guarantees is disclosed and the amount available, I think it's also in this quarter also. The $30 million you're talking about is actually not in excess of what's available. There's still a very large amount that's available under the guarantees. The process is that when Callidus believes it has a permanent impairment, it delivers a notice to Catalyst and when it's proven to be correct, Catalyst immediately honors the guarantee. To the extent that those other loans and other amounts prove to be definitive then I expect that Callidus would deliver a notice to Catalyst. Then Catalyst would continue to honor it immediately. There have been times with when an advance against the guarantee has been made. That's done when it's less than 100% certain but very likely that the guarantee will be called upon. In the event that Callidus is wrong and catalyst is given it the benefit of the doubt that when it's realized upon, it will be repaid but there is a small amount -- medium amount of that. David, you want to add anything? We can offline walk you through where the numbers are and stuff, Jaeme, rather than spend the time on the phone with everybody.

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David M. Reese, Callidus Capital Corporation - President & COO [11]

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No, I mean that's very -- it's just, as Newton said, see provision and go through our income statement that is covered by the guarantee, we have the offsetting recovery that shows as a receivable.

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [12]

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With guarantees still in place.

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David M. Reese, Callidus Capital Corporation - President & COO [13]

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Correct.

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Jaeme Gloyn, National Bank Financial, Inc., Research Division - Analyst [14]

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Okay. And last one for me is then just on the subordinated bridge facility, I see it's been amended to defer interest in -- and principal payments or capitalize those payments on the bridge facility. Why was this done? I guess -- and what were the amendments and waivers agreed to related to the bridge facility?

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [15]

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David, why don't you take that?

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David M. Reese, Callidus Capital Corporation - President & COO [16]

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Thanks, Newton. It was done, as you saw our ability to do new loans is in excess of $400 million now. And the increase in liquidity as a result of the deferral by the Catalyst Funds regarding interest and fees on the subordinated loan adds to our liquidity and it's just a further demonstration of Catalyst Funds, very strong support of Callidus and their desire to be the Callidus loan book grow and their support therein.

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [17]

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Just to put a -- some -- a punctuation mark on David's comments, we've seen the signed back term sheet start to grow again, and we want to make sure both the Callidus and Catalyst that to the extent that the funding is required that we'll be able to fund it. So you can see there is an increase from $300 million, $400 million in terms of liquidity available for new loans that's, in significant part -- but not entirely, the result of increased support by Catalyst to Callidus, and we want to make sure that to the extent that the loans meet the credit requirements and the due diligence in process that if as and when we look to close them, Callidus can close them.

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Jaeme Gloyn, National Bank Financial, Inc., Research Division - Analyst [18]

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Right. And in terms of those signed back term sheets and in the past you've generally guided on the date of the press release of the financials as to what will hit in Q2, I guess, based on the fact that there was no disclosures at this point we -- there's nothing funding, there's no new originations expected in Q2 at this time? Is that a fair assumption?

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [19]

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Just to be clear, to the best of my memory, we've never in the past actually said what we expected to close. What we said in the past was that we have had a success rate of 60% to 80% of signed back term sheets being closed. That, in the last couple of quarters, has been slower and below that percentage. There is likely to have been some adverse selection, for lack of a better phrase, in some of the deals that we've been receiving because of the noise in the market. We believe that, that caused and rightly as the company's credit requirements to be much more strict. So that percentage has probably fallen for the last few quarters. We like, based on what we have and the information we have to date and there is no guarantee, we like the credit quality of the stuff that's now signed back much better than we've liked in the past, but our underwriting team and field examiners will have to go through the process and to the extent that they find that the collateral is there and that the deal makes sense from a credit perspective, we will close on that deal. To the extent that they discover as they have in the past, issues that do not meet our requirements, we will maintain the discipline in the business and not close on those deals and we will not be doing growth just for the sake of being able to say that we closed on a deal.

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Jaeme Gloyn, National Bank Financial, Inc., Research Division - Analyst [20]

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Right. Okay. So just last follow-up on that. The signed back term sheets of $316 million this quarter include the same signed back term sheets from Q4 of USD 150 million? Or are these completely new?

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [21]

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It's a mixture of both. So there is 1 or 2 that we're being very, very careful and probably too slow and very cautious, I wouldn't say too slow. We're being slower than we used to be and being incredibly cautious because of obviously missteps over the last year or 2 and we just don't want to make another mistake, if we can help it. And there's also new additional 2 term sheets. So there's a movement of, basically, there is movement in that pile. Jaeme, if you need to call us and we'll walk you through the guarantee stuff.

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Operator [22]

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There are no further questions. I'll turn the call to our presenters. We have a question from Jerome Hass with Lightwater Partners.

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Jerome Hass, Lightwater Partners Ltd. - Portfolio Manager [23]

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Newton, I was wondering if you could give us a little bit of color on the NCIB. And why it hasn't been utilized to date?

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [24]

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I'll hand that over to David but the NCIB is in place. David?

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David M. Reese, Callidus Capital Corporation - President & COO [25]

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Yes. As you know, Jerome, typically with an NCIB, we would set up an automatic share purchase plan with the broker, which we've done in the past. And we can only set the parameters or an ASPP, or an automatic share purchase plan, when we're in a non-blackout period and we have recently been in a blackout period pending release of our results, and also we are continually checking with council, given the progress of our privatization efforts, to see if, in fact, we can -- that keeps us in a blackout. So until the blackout is lifted, we won't be able to set the parameters to start the ASPP. As soon as it is, we will pursue it.

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Operator [26]

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And there are no further questions. I would turn the call to our presenters.

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Newton Glassman, Callidus Capital Corporation - Executive Chairman & CEO [27]

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Great. Thank you, Matthew. I'd like to thank, everyone, for participating. As always, we're happy to chat if you have further questions. We look forward to seeing many of you over the coming weeks. Enjoy your day, and again, thanks for your continued interest and support of Callidus. We truly appreciate it.

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Operator [28]

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This concludes today's conference call. You may now disconnect.