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Callidus Capital Corp. (CBL.CA)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, my name is Sharon, and I am your conference operator today. Welcome, everyone, to the Callidus Capital Corporation Second Quarter 2016 Results Conference Call. At this time, all lines are in listen-only mode. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

Listeners are reminded that portions of today's call and of today's discussions, including responses to questions posed 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 condition. 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 Canadian Securities Regulatory Authorities, which can be accessed at www.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 today 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; Jim Riley, Secretary; and Paula Myson, Vice President Investor Relations and Special Projects.

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

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

Thank you, Sharon. Good morning, everyone, and thank you for joining us for our second quarter 2016 results call. During the call, we will be referring to information providing the financial statements and the MD&A and the associated news release for the quarter. All are available on our website as well as SEDAR.

As always, we appreciate your feedback on our materials. So, please feel free to communicate directly with any member of the Callidus team mentioned earlier by Sharon. We will try to keep our comments brief to allow for ample time for Q&A. David and Dan will provide you with some insight into the details of the operating and financial results for the quarter, but to begin, I would like to comment on some significant milestones we have reached in the quarter, as part of the ongoing evolution of Callidus, including positioning the company to restart growth and accelerate the creation of value for all of our shareholders.

It is particularly important to highlight the fact that we have intensely held our loan book constant over the last two quarters, as we undertook a campaign, but first, protect the value of our shares against market opportunists, review the internal processes and staffing to ensure our preparation for the next phase of growth, and solidify our value proposition for all shareholders going forward.

As such, our quarterly result reflects asset management to loan book against the backdrop of initiative to create immediate and long-term value for stakeholders by closing the discounts in our shares from their fundamental value and an enhancement of our capital structure to both reduce future cost of capital and support our projected growth, growth which is clearly not currently reflected in the company's stock price.

The cornerstone in this quarter of our capital markets' activities is a new senior secured investment grade facility created to fund our loan portfolio growth going forward. It is the securitization facility that will have four investment grade debt tranches ranging from AAA to BBB, and represents about 64% of incremental funding in and of itself going forward.

The ratings are important because they indicate that our cost of debt will decline as we move more loans into the securitization program and simultaneously improve the company's liquidity. At the margin, it means that Callidus itself will fund CAD 9 million in cash for every CAD 100 million incremental increase in loan growth, able ultimately to recover 100% of the growth due to the participation agreement with Fund V. We expect the securitization program to represent an ever growing proportion of our capital structure, as it becomes the ultimate source of funding for the incremental growth in our portfolio and further reduces our cost of capital.

I'd like to give you some perspective on how the facilities will be used going forward. The securitization program will augment what we already have in place. Our existing facilities will basically function as a warehousing facilities. We will finance new loans initially in the facilities that already exist, our syndicated senior facility and currently the Catalysts [indiscernible] (04:47) facility.

As loans aggregate to a size that can be effectively securitized, they will be moved into the securitization program. The securitization program will commence with an initial amount of CAD 165 million, of which approximately 64% will receive an investment grade rating. As new loans are added to the total amount in the facility, and therefore the proportionate represents of total debt funding will obviously rise.

Second is the inflection point between the NCIB and SIB programs against the value of deploying capital in the loan portfolio. The return for a participating shareholders has been good, but the trend has shown that there is significant potential for continued future value creation. During this interim period, we have generated cash and have a scalable facilities now to expand liquidity. [ph] And we're going now (05:41) at a point where we must deploy some of that liquidity in order to maintain our increase return to shareholders.

Simply stated, building cash, not used in the SIB or NCIB to this time – at this time, since only about a third has been funded into the SIB, has [ph] hurt (05:58) and cash flow's leverage too low and negatively impacted both net income and return on equity. As a result, we will restart loan growth in the portfolio while we complete the current SIB and consider a follow-on NCIB thereafter.

The Callidus platform is a lot more dynamic use of scale we can achieve and – furthermore, we have always stated that we have and we'll continue to add people ahead of projected growth and strengthen the team in the process. [ph] As first step for such (06:39) is the announcement of the addition of a Chief – the creation of a Chief Credit Officer. Jay Rogers will be Callidus' first Chief Credit Officer. Jay brings with him extensive credit and workout experience most recently as the senior member of Cerberus Capital Management team, and particularly their finance company called Ableco or used to be called Ableco, now called Cerberus Finance – Business Finance.

As Chief Credit Officer, Jay will be responsible for managing the aggregate risk in the loan portfolio, coordinate and manage the work-out of certain credits, and recommend appropriate strategies to the Credit Committee to enhance the operations and overall quality of the loan portfolio. In addition, we will be adding other senior underwriters and senior members of management over the next two quarters to manage, ahead of time, the proposed and projected increase in the loan book.

Last but certainly not least, we are able to update you on the yield enhancements we have spoken off in previous quarters and especially last quarter, which also positively influenced our results in this particular quarter. For the benefit of those who are unfamiliar with yield enhancements, they are required under IFRS accounting rules and are generally no-risk or low-risk financial [ph] instruments (07:57) we receive when we make an accommodation to a borrower.

Yield enhancements are unequivocally and undeniably a fundamental, ongoing, repeating part of the business for a company such as Callidus. It is therefore a key part of normal operations, albeit they can be lumpy.

We deal in a market segment where our clients often go through structural changes. As a result, it is very common for a client to need or desire changes to the original deal with Callidus. When such changes are requested or needed by the client, Callidus may choose to accommodate the borrower, and in exchange, demand or request a change in the economic relationship, resulting in what's known as "yield enhancement". These yield enhancements can take many forms. The most commonly understood would include revenue royalty streams, periodic fee arrangements, warrants and limited equity participations.

Please note that the form of yield enhancements determines the impact that is reported on the profit and loss statements or the balance sheet with essentially no discretion to management under the IFRS rules.

On our last call, we estimated that we would have yield enhancements on seven loans to report in Q2 with three following in Q3. In terms of value, we reported that National Bank had valued the yield enhancements between $0.50 and $1 per share in their valuation prepared in April, in conjunction with the substantial issuer bid. We also stated at that time that we thought that it was unduly conservative and incorrect. As you will see in our MD&A, we have exceeded all of those estimates. We have indicated that there are yield enhancements in place on 13 loans, which is almost 40% of our total portfolio.

These have been internally valued, according to IFRS and with third parties, at CAD 57 million pre-tax with CAD 34.8 million or CAD 0.68 per share on a diluted basis recognized in this quarter alone. Since yield enhancement is an ongoing and critical part of our business, this proves our previous assertions that this has not been properly valued by either the market, including being substantially undervalued by National Bank Financial in their SIB valuation.

The value of the yield enhancements will be reviewed every quarter, and some of those changes as required by IFRS will be put through the income statements and others via the balance sheet. We would expect the yield enhancement not only to add to value, but unfortunately, will also add some volatility of the results going forward.

I will now ask David to walk us through the operating results for the first quarter.

David M. Reese

President and Chief Operating Officer, Callidus Capital Corp.

Thanks, Newton. Once again, we're pleased that the quarter continued our overall long-term trend of consistent improvement with significant gains in the key metrics of gross yield, net income and return on equity. As of yesterday, gross loans receivable before derecognition stood at CAD 1.218 billion, which is what we would expect, given we had held the loan book constant for the past two quarters.

Looking forward and giving you some guidance on growth in the portfolio, the loan pipeline remains very strong at approximately CAD 940 million, and which includes signed back term sheets and the balance of funding for Project Resolve of approximately CAD 150 million. On the repayment side, we received full repayment on two loans during the quarter, totaling just under CAD 60 million. That brings our 2016 year-to-date repayments to six loans, totaling about CAD 165 million.

Looking forward to Q3, we are expecting approximately CAD 75 million in repayments, based on the loan balance as of August. Over the next quarter, we expect the resolution of another CAD 10 million of gross loans receivable, representing four loans in our watch-list accounts.

I want to note that we consider loan repayments to be a critical part of our growth. Successful loan repayments demonstrate how, working with Callidus, our clients benefit from properly sized and designed facilities to support the successful rehabilitation of their companies. This helps future clients gain confidence in our capabilities and the repayments provide us with capital to redeploy.

Now, I'll ask Dan to discuss the financial highlights for the quarter. Dan?

Dan Nohdomi

Chief Financial Officer & Vice President, Callidus Capital Corp.

Thanks, David. Callidus recorded a strong financial performance in the second quarter. I'd like to highlight a few of these key metrics and what were the main drivers in their change from prior periods.

Our earnings for this quarter, for the first time, include the impact of the yield enhancements that Newton has discussed, these are options, and therefore, there will be some variability or volatility in their valuations from quarter-to-quarter. To make it easier for investors to compare our results historically, our reporting, beginning in this quarter and going forward, will present the key financial performance metrics with and without the impact of yield enhancements.

EPS were up CAD 0.39 per share or 115% from last quarter, and CAD 0.37 or 104% from the second quarter of 2015, primarily because of the addition of yield enhancements during the quarter. Revenue after derecognition was down 7% or CAD 3.6 million from the first quarter, and increased CAD 6.6 million or 17% from the prior-year period.

Our consolidated gross yield for the quarter was up at 20%, compared to 19.4% in the first quarter of 2016, and 18.8% in Q2 of 2015. The main driver here is the recognition of additional fees during the period. If we break down the gross yield by our two products, traditional Callidus loans and Callidus Lite, we earned 20.5% on our core Callidus product and 14.4% on our Callidus Lite loans. Both are up from Q2 of 2015, when we earned 19.9% on the Callidus loans and 14.2% on Callidus Lite.

Moving on to one of our most important metrics, ROE, we delivered a record ROE of 29.2% during the second quarter, which compares to 13.9% and 15.2% in the second quarter last year. Net income of CAD 37.5 million increased 119% from CAD 17.1 million last quarter and 103% from the second quarter of 2015.

We have two offsetting unique events that have a substantial impact on net income and ROE, yield enhancements and the Gray Aqua provision. Newton has already discussed the yield enhancements. The Gray Aqua provision was CAD 12 million during the quarter or over 80% of our total loan loss provision for the period. David will be providing some background and commentary on this event in his comments.

Our leverage ratio, which is measured as net debt to gross loans, was 38.5% at quarter-end, consistent with the ratio last quarter, as there was not a material change in the size of our portfolio during the period. Going forward, however, we do expect this increase as we access funding for new loans from our new securitization program.

During the quarter, we've recognized the recovery of CAD 8.5 million under the Catalysts guarantee due to the recognition of specific loan loss provisions. Our liquidity and therefore our capacity to fund new loans has three components. Cash on hand, the undrawn capacity in our debt facilities and further funding we can obtain for loans from Callidus Fund V.

At the end of the quarter, total liquidity would be able to support approximately CAD 480 million of new loans. This leaves us in a very good position and meet the funding requirements that come from our robust pipeline.

Looking forward, our liquidity will increase again in the third quarter with the finalization and close of our new securitization facility, which should allow us to lever our loan portfolio by an incremental CAD 25 million. So, based on these key metrics, our second quarter financial results extended our overall record of strong and improving performance. David?

David M. Reese

President and Chief Operating Officer, Callidus Capital Corp.

Thanks, Dan. I'd like to expand on one of the items Dan touched on in his comments. Dan mentioned the impact of our provision for loan losses on net income. I want to go into more detail on the provision and what drove that.

The provision for the quarter was CAD 14.4 million, which is a provision rate of 4.9% on an annualized basis. This is running above where we're guiding you last quarter to a range of 2.5% to 3.5% on an annualized basis. While risk is a part of our growing business, the current rate is above where we want it to be.

The largest item including the provision for the second quarter related to the Gray Aqua Group. You'll recall that we have already taken CAD 25.4 million in provisions against this loan to-date. This quarter, we had another CAD 12 million, bringing the total to CAD 37.4 million. This is a loan that was made to a New Brunswick-based salmon farming operation that also has operations in Newfoundland. The collateral on this loan was a combination of fixed assets and working capital.

[ph] In the working capital is inventory. (17:27) The largest inventory of a salmon farming operation is salmon. Like all other inventory, we have third-party appraisals prepared on a periodic basis. We have just received a new appraisal, which indicates the significant downward change in the quantity and quality of the salmon inventory. There are likely several factors contributing to the decline in the value of the fish, most notably, a detrimental change in water temperature and an infestation of marine parasites, sea lice to be exact. As a result, we expect the harvest of this inventory to be much smaller and of less value than originally estimated.

With the final harvest not occurring until March 2017, we will continue to monitor this issue and take any steps to maximize the value of the inventory. We will also begin the process of selling the fixed assets comprised mainly of machinery and equipment. We constantly adjust our underwriting criteria based on what we see in the market and what we experience and learn on individual loans. We have made changes to our practice based on the Grey Aqua experience. Going forward, we will not underwrite loans to businesses where their collateral and cash flow are dependent on biological assets that can unexpectedly and unpredictably deteriorate.

With that, I'll turn it over to Newton for a final comment before we move to questions.

Newton G. Z. Glassman

Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

Thanks, David. We have spent the time to enhance our capital structure and are on track to achieve a lower sustainable cost of capital while funding our future growth for our next phase. It places us in a very strong position to benefit from the favorable conditions in the marketplace, as we restart our loan portfolio growth.

As we enter this new phase, our strong liquidity position allows us to continue to return significant capital to our shareholders through a monthly dividend as well as to those that wish to participate in our existing SIB and future capital markets program. And as our ROE strengthens even further with the growth, since this is a highly scalable business, the ability to increase leverage and our lower cost of capital, long-term shareholders will share in the strong positive future results for Callidus.

As always, I would like to thank our investors for their continued support. And now, operator, we'll be pleased to take questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Jaeme Gloyn from National Bank Financial. Your line is open.

Jaeme Gloyn
Analyst, National Bank Financial, Inc. (Broker)

Q

Yeah. Good morning, guys.

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

Good morning, Jaeme.

Jaeme Gloyn
Analyst, National Bank Financial, Inc. (Broker)

Q

The first question is related to the Gray Aqua provision. Can you just elaborate on the size of that loan? How – what percentage of provisions have you taken to-date as percentage of the loan? And then, a follow-up, the final inventory in March 2017, does that coincide with the maturity of the loan as well?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

So, I'll take the first cutout. And then, David, you can expand on it. I don't believe the size of the loan is public, but the vast majority of the loan has already been written off. Under IFRS rules, we have to value the collateral on an ongoing basis. We're very careful with Gray Aqua. When the value [ph] came in, that there (21:00) is a problem with the inventory. And remember, most of our loans are valued or are [ph] lend against (21:07) inventory receivables and the balance of the [ph] gains fixed (21:11) equipment or machinery and equipment.

We took the provision. The reality is that Gray Aqua was a mistake. We tried something, as I said last quarter and we tried to enter into a new area. We are going to, on occasion, try new areas and new approaches as a growing business. And at times, we'll get it right. And at times, we'll get it wrong. Gray Aqua is a one-off situation in the sense that we [ph] lend against (21:36) inventories that's biologic in nature, and we thought that the operators as well as the third-parties that we had engaged would be able to help us understand the business.

Clearly, the business was more – is more complicated than we thought. We tried it. It didn't work. We'll clean it up to the extent that there is any more left to be written-off. If and when the value of the remaining collateral fall below that value, we'll take a provision on it. But you need to understand that the collateral includes machinery equipment in a number of locations. And at some point, we're obviously going to get very, very close, it's not already there, to the underlying value of the collateral that is not fish related.

So, right now, we're very comfortable with where the provision is. It could go in both directions. It could go up, but it also could go down in the future, meaning the provision will be adjusted relative to the value of the underlying collateral. In terms of the inventory [audio gap] (22:38) all of our loans are technically 364-day loans and have to be renewed. I don't remember the exact date, maybe David does, when that loan is up for renewal. So, we are in the process of dealing with the loan, and we will deal with this in due course and in a timely manner regardless of when the actual technical due date is.

David?

David M. Reese
President and Chief Operating Officer, Callidus Capital Corp.

A

Thanks, Newton. I don't recall the date of the loan offhand. Even if I did, I don't think we would probably disclose it. I don't really have anything to add to your comments, unless Jaeme has a follow-on question on Gray.

Jaeme Gloyn
Analyst, National Bank Financial, Inc. (Broker)

Q

No. But I will follow on just some other loan disclosures, specifically related to oil and gas loans. I noticed that the collateral coverage ratio declined from [ph] 172% to 118% (23:27) from Q1 to Q2. Can you just describe what happened or what drove that decline?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

The decline in – first of all, I don't know about you, but having collateral of 118% makes me pretty happy in something that's been beat up [ph] in a sector, (23:47) I suspect that most lenders, especially the Canadian banks [ph] that blends with the sector, (23:51) would be beyond ecstatic to have 118% coverage on their loan.

That being said, again, both under IFRS and under internal policy, we revalue the collateral on an ongoing basis. When we see the collateral changing, we change the value of the collateral. And at times, if we're worried about it, we will change the requirements under the borrowing base. So, if we saw – as an example, if we saw a loan in oil and gas or anywhere else that didn't have sufficient collateral, we would consider changing the borrowing base and advancing less. If we see any of these loans approaching something that concerns us, we'll either advance less or change the borrowing base, as these are right.

Jaeme Gloyn
Analyst, National Bank Financial, Inc. (Broker)

Q

Okay. Great. Fair enough. Shifting gears to the yield enhancements and the CAD 32 million gain, can you just sort of elaborate on the size of the [ph] potential can, (24:52) the size of the original loan that those warrants are associated with? What's the value of shareholders' equity or percentage that that CAD 32 million would represent of the company? And then, maybe just some commentary on the industry or sector that those warrants are attached to.

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

Some of that, I could answer. Some of it, we're not legally allowed to answer for a bunch of reasons. We will not tell you the size of the original loan. It is a loan that originally was troubled. We helped the company review their operations. They entered an additional and extra line of business, [ph] which makes their credit basically found. (25:46) They came to us and asked us if we would amend and help them with our facility to help them go in that business. It is a huge incremental increase in their business. They seemed to be executing well to extremely well.

We are very supportive of them. They are a poster child of how we can help and why we would want to help a company that first was in trouble and then figures out a way to get out of trouble. Without our help, it would not have been able to go into this additional business, which is, in terms of revenue, billions of dollars for them potentially. At least, the first part of it is a couple of billion dollars or more.

The value is not determined by us. The value is actually determined in conjunction with third-parties outside of the firm and then reviewed with the auditors. The IFRS rules are incredibly specific and esoteric. The form of the yield enhancement itself will determine when it hits your financial statement and where. So, for example, under the IFRS rules, there is zero discretion in dealing with this issue. So, if you are receiving work or options as we did in this particular case, one is required to value those options or warrant and put them through the P&L.

Similarly, when we receive a cash fee, that also must be run through the P&L. If we have [ph] Gray's equity (27:36) being granted to us or other forms of yield enhancements, it actually goes on to the balance sheet and is only recognized on the P&L at the time of the sale. I understand that that's complicated and I understand it's hard to follow. There's no discretion. There is nothing we can do nor is there anything we would do other than abide explicitly and directly with the IFRS rules.

In addition, under the IFRS rules, we are required to recognize whether it's on the P&L or the balance sheet, the yield enhancements in the period in which it becomes obvious that that is available to us or that is the agreement with the party has been entered into. So, this quarter's yield enhancements disclosure actually incorporates in effect some things that have in the past been in our P&L, such as fees or revenue and other things that have not, such as the option in this one situation and some other things that are on the balance sheet which have not in the past been included.

This is a recurring and ongoing part of our business. It is a fundamental part of the business. It's critical to how we run the business. It will contribute. Albeit in a very lumpy way, in every period going forward, they will be revalued as required under IFRS on a quarterly basis. But as the book grows, as you can see, with almost 40% of our loans having some form of yield enhancements, one can easily understand that, as the book grows, so will yield enhancements and it requires valuation by TheStreet.

So, right now, we don't think TheStreet is valuing either the restart of growth or the ongoing contributions of yield enchantments to the earnings stream and the earnings power of the business. One approach, which was suggested to me, which I actually think is, at least, intellectually acceptable, albeit I don't believe it's the right way to do it, is that similar to the way public-private equity firms are valued, where they value the management fee at a higher ongoing multiple that they carry, it would be arguable that the income stream of normal income would be valued in our business at Callidus at a higher multiple than the ongoing value of yield enhancement. But it's very clear to me that a 1 multiple on that value is simply intellectually indefensible.

We've already exceeded essentially the valuation on a 1 multiple basis that National Bank included in their valuation in the SIB and even the most conservative approach, where there would be a lower multiple on yield enhancement to normal earning, would result in a multiple greater than 1. So, clearly, this is something that we're going to have to help TheStreet understand and TheStreet will decide how to value.

Jaeme Gloyn Q
Analyst, National Bank Financial, Inc. (Broker)

Okay. So, just one point to clarify. The unrecognized value of CAD 22.2 million, where is that on the balance sheet right now?

Newton G. Z. Glassman A
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

That's not on the balance sheet.

Jaeme Gloyn
Analyst, National Bank Financial, Inc. (Broker)

Q

Okay. Sorry. But I thought I heard you said it was on the balance sheet. Okay.

Dan Nohdomi
Chief Financial Officer & Vice President, Callidus Capital Corp.

A

No...

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

No, what I said is that IFRS requires specific and explicit treatment sometimes on the P&L, sometimes on the balance sheet and sometimes you don't recognize it until it's earned.

Jaeme Gloyn
Analyst, National Bank Financial, Inc. (Broker)

Q

Right. Okay. The last question just before I turn it over. With respect to the expenses, you'd mentioned that there's been some recent hires within the quarter and you expect to make some hires subsequent to the quarter. How do you see expenses evolving over the coming quarters? I guess, how much of these new hires are reflected in the current quarter and how much would you expect to be reflected going forward?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

I think that's actually a really good question. I think all of these questions have been really good, actually. We've always said that we hire ahead of growth. We've always said that when we are growing. We argued that our expenses were ahead of what we thought the normalized amount would be. I would argue that our expenses currently are a little bit but not a lot, meaning in Q2 and Q1 where they would be. But since we're restarting growth, we would expect that, even with the hires to come more into line and go down over time, it might be lumpy at the frontend and then come down as a percentage.

We think that's the right way to build the business. We think that you actually have to have the people in the business and understanding it ahead of your need for them so that they can actually learn it. Historically, we have said publicly that, roughly, for every CAD 100 million of growth, the operating leverage is such that [ph] by CAD 500,000 (32:52) of expense is lumpy because, this time, you're hiring a more expensive person like a chief credit officer or an underwriter or whatever. And then, next time, you're hiring a field examiner or a collateral clerk.

Typically, we would backfill the office after we've built in the higher and more senior people. We would expect, as a result of the increased leverage and the new securitization facility, that overall and over the next two quarters to four quarters our expense ratio is actually coming down and our cost of capital is coming down, but it will take us a few quarters.

Jaeme Gloyn
Analyst, National Bank Financial, Inc. (Broker)

Q

Okay. I'll turn it over to somebody else for now.

Operator: Your next question comes from Stephen Boland from GMP Securities. Your line is open.

Stephen Boland
Analyst, GMP Securities LP

Q

Good morning. Just two questions. I guess, you've already touched on the provision. Can you talk on the recovery that occurred in the quarter? Is that from one loan or is it just the ongoing adjustment with your collateral values that you're getting that money back from – through the guarantee?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

David, Dan, maybe you guys could answer that.

Dan Nohdomi
Chief Financial Officer & Vice President, Callidus Capital Corp.

A

Sure, Newton. The recovery of CAD 8.5 million is just a normal course for us. It covers some loans that are guaranteed from Callidus and that's really all it is, Stephen.

Stephen Boland
Analyst, GMP Securities LP

Q

Okay. And Gray Aqua is not part of that recovery, right?

Dan Nohdomi
Chief Financial Officer & Vice President, Callidus Capital Corp.

A

We haven't disclosed that. But I think if you look at and see that we took a CAD 12 million provision and that our total recovery was CAD 8.5 million.

Stephen Boland
Analyst, GMP Securities LP

Q

Right. Just confirming. Okay. Maybe the second question is just for you Newton and looking forward over the next four months to your past comments about going private, restarting growth as you said, you're throwing some big EPS up, your SIB [indiscernible] (35:04) essentially nearly done and you're considering then an NCIB.

If the stock is near or at the range of the National Bank, is your rent really the trigger or is it – if January comes or February and the stock is still – if it hits that range but doesn't stay there, what should we look forward to? Is it ongoing battle for you to keep the shareholders in surplus value in all these mechanisms that you're doing? Hopefully, that was clear.

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

I think I understand parts of the question. So, let me try to address as much as it is I can. And if I missed something, you can re-ask or you can clarify the questions, Stephen. First off, I think one of your underlying assumptions about the SIB is not correct. The SIB, unfortunately, for us, has only had about 1/3 of it tendered.

As of the last extension that I think was July 30, [ph] so either 29th or 30th. (36:10) Only about 1.2 million shares out of an offering for CAD 3.7-ish million had been tendered, which is somewhat disappointing to us because, frankly, it's better for the company more shares that are tendered into the SIB. As a result of the SIB, we're sitting on a lot of cash because we have to actually have the cash to settle at a fairly quick basis, sometimes within the days or a couple of days of the shares being tendered. So, we have to actually sit on cash, which in turn has reduced our leverage as you can see from the numbers to about 38.5% – 40-ish percent.

And that in turn has hurt what otherwise would have been net income and ROE. The SIB is a critical part of what we're trying to do for long-term shareholders. We work for the long-term shareholders. It's our job to figure out the best ways for them to get a return. At CAD 16.10, it is our view that, even to the midpoint of the National Bank valuation, that's a 25% return roughly, CAD 4.16, but 25% essentially no change in risk and risk that's a no execution risk. Returns, in our view, is actually a very good use of capital to the investors. What we've noticed is that as a result of holding the book steady, that cash is actually going up. And that will further hurt both ROE and net income if we don't start deploying the cash, which is why we have said that we will restart growth.

Notwithstanding that, we clearly on an operating basis exceeded all of TheStreet's target. And if you include yield enhancements, which we believe and can prove is an ongoing part of the business, we massively exceeded all of TheStreet's targets. So, it's a little surprising for me this morning to read – I read three positive notes about the company exceeding expectations and one with a very short headline that said that we missed the operating expectations, which is just factually not correct.

So, the problem that we're going to deal with going forward is what's the value if there is to be a growing private transaction. And the answer is that we will engage in a process if the stock has not – oh, let me go back. So, you mentioned something about the National Bank valuation. Clearly, the National Bank valuation is too low. They included CAD 0.50 to CAD 1 for yield enhancement, and we've actually basically disclosed CAD 0.50 really more than the pre-tax at about CAD 0.60-odd after tax per share. I think it was about CAD 0.60 odd, CAD 0.62 of share after-tax if my math is correct. And that would assume it was only a 1 multiple, which is just mathematically not correct.

So, clearly, it's our view that the National Bank valuation itself is too low on the low side. And to be fair to National Bank, they didn't have the same amount of data that we have now because we're further along in a whole bunch of the yield enhancement. And frankly, we have more of them now. We have told people in Q1 that it was 7, and we are working on three more, and now we have 13.

When you combine that with growth, and we know that some proportion of the new loans will end up having yield enhancement, even at a 1 multiple, it's clearly too low in the National Bank valuation. Our job will be to be to run a process if the stocks remain undervalued, whereby the minority shareholders get full value for their stock. It's one of the reasons why we have said in the past, and I'm repeating now, that Catalyst will not be a bidder in the going-private transaction.

Our view is that the market may misinterpret it and see us, at Catalyst, trying to buy the business on the chip. So, we've removed ourselves from any future prospective process to make sure that people understand that our interests are aligned. Since we're not the buyer and we have to mark-to-market, in the funds, we want that sale to be as high as anybody else does. And we will ensure that the process takes care of and maximizes the value for the minority of shareholders.

Legally, as part of any going-private transaction, if the stocks does not recover to where we think it's a fair value, there will be another third-party valuation and opinion provided to the board, and then the board will decide whether it's fair value. Since we're clearly restarting growth and intending to restart growth, if that growth materializes along with the increased value of yield enhancements, it's pretty clear that our view is that the stock is worth a lot more than what the historic National Bank [ph] valuations as it was (41:35) and we'll leave it to the board to evaluate it and to run the process.

Stephen Boland
Analyst, GMP Securities LP

Q

And your time line is still [ph] near end then, right, through that – through that, (41:46) to get to that valuation for that time?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

What I've always said is that – if the value has not been unlocked, we will start the process before yearend. We obviously would never be able to complete a transaction before yearend and the process would take as long as it takes. The first thing you do, generally, is you hire a third-party to run a sale process. You'd to hire another third-party as part of that process, separate, independent from the one running the process to provide evaluation. We will follow the letter of the law and the process that we will do everything we can back to my value. And as I've said in the past, if that means we started in – that means if the stock has got recovered sometime in Q4, we will start the process in Q4.

Stephen Boland
Analyst, GMP Securities LP

Q

Okay. That's great. That's all I have. Thanks.

Operator: Your next question comes from Paul Holden from CIBC. Your line is open.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

So, I want to ask a couple of questions on the yield enhancements. So, one, to get -I just want to make sure I understand the accounting appropriately and I think, Newton, you kind of referred to this already, but I want to make sure I understand it. In terms of mark-to-market gains, those will be broken out separately on the income statement as it was this quarter. And then, in terms of the royalty income and other type of income enhancements, those will be included in revenue, i.e., like the CAD 2.8 million this quarter, is that correct?

A

Yeah. To be clear, we've always included anything that's on the revenue line, where it's been received in cash. We're required under the accounting rules to do so. The accounting rules are incredibly asset [indiscernible] and frankly annoying. Under the IFRS, the deal was discussed. I've argued that there is a lot more form than substance under the rules, and that it could cause people to misunderstand it. We have to follow those rules, we have no choice. We will follow those rules. The rules generally say two things, and David or Dan, you can expand on this.

When I look at it, I think there is two ways. The first is that the form of the agreement determines the accounting treatment and the findings of it is also determined by the form. So, basically when you look at the form of how the yield enhancement is taken, whether if a revenue or fee issue, it leads you down one path or options, it leads you down a similar path, but with potentially different timings and valuation issues, or it's straight out equity or other issues, you don't recognize it until the very end. It's kind of silly because you're recognizing something immediately and you're deferring others, this is proportionally long unit it's actually realized on.

So, I agree that leaders of the statements will not see some of it because under the accounting rules, it's actually not recognized until it's actually crystallized and realized upon. There is nothing we can do about that. All we can do is, do what we did we think fairly well this quarter and we're open to suggestions of people actually have better ideas of breaking it out and showing how much of it was revenue, how much of it is options etcetera, and then fair valuing it so as quarters go by if there is a change in a fair value, you'll see it and you'll see where it is.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

And then what would be dealing with the stress lending portfolio, there may not be a very typical situation, but just on average I mean what is the type of situation that would get you into these yield enhancement instruments.

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

You're right. There is no typically – first of all I want to go back and ask David and Dan. Do you guys have anything to add on these crazy after the IFRS rules related to yield enhancements.

Dan Nohdomi
Chief Financial Officer & Vice President, Callidus Capital Corp.

A

Yeah, just pointing out one thing, Newton, that on page 13, of our MD&A and I'm sure Paul you've looked at this. We would get our chart and this chart will get updated every quarter. To Newton's point there is five different methods of accounting depending on what the instruments are and so we've broken out our portfolio that has yield enhancements into each of those buckets and we show what those through the P&L in the quarter and as Newton said also what is not yet recognized and why it's not recognized. So, you know what is likely to come at some point in the future assuming things pulled up. So, that will be the chart you're going to want to look at every quarter.

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

Okay, that's helpful. And if people have suggestions we're certainly willing to entertain discussion about whether there is a better way to disclose it or whatever else. My worry is that the MD&A now has become an extremely long and in places complicated read. It's a result of the accounting rules. We are required obviously to follow the accounting rules and we're doing so. But I'm getting worried that it's getting too hard to follow. We will continue to provide as much transparency as we can and that means that we have to figure out a way to summarize better at the front end of the MD&A or in the press releases, we'll try to do that. As the team can attest, we spent an enormous amount of time and lots of effort trying to simplify the language and the disclosure, both in the MD&A and the press release. I don't think we're very good at it, and I think we can improve at it.

In terms of the nature and types of the yield enhancements, they range. So, you're right, there is no typical one. What I would say to you is that from a pure specific perspective, we have a sample size and we have a long enough period now, where we have more than a normal distribution, normal distribution being [indiscernible] (48:11). We obviously have had multiple years of running the business. We have CAD 1.2 billion in the portfolio, and we currently have plus or minus 40-ish loan. And over time, [indiscernible] (48:27) specifically valid that some large proportion of our portfolio will eventually have some yield enhancements to us, and that makes intellectual sense if you think about it. These are companies that are going through a restructuring process.

They're going to see opportunities that they didn't think they would see that will result in an opportunity for us where we can help them, like the biggest contributor to yield enhancements on the P&L this quarter. And there will be others that don't execute as well as they think, and they need help from us; and as a result, we have to decide if we're going to help them. And if so, on what terms? That would be something like a company that's been in the public domain in the past, which it's now been the report process called Blueberry. We will get value where we help people, or else we just won't help them and we'll liquidate our collateral.

So, it's really up to us to decide if we're willing to help people and accommodate them; and if so, what the price of that will be. If you look at it, you'll see there is a range. The range is from a small fee for an extension because somebody couldn't finance us out after the term of the loan, to very large where, but for our contribution, the rest of the stakeholders [ph] at (49:51) the borrower would not have any of the upside, and we want and believe that, as a result, we're entitled to a piece of it, and we negotiate it.

One of the problems with yield enhancements is that it's a negotiation. So, we don't get to determine the form in isolation of what that yield enhancement will look like. It requires a conversation and a negotiation with the borrower. We don't control the ultimate outcome, or else we'd have a more formalized approach that we could show to you guys. We have to negotiate it with the borrower.

There are times when the borrower may say, we don't agree to that, we're not going to do it, it's not worth it to us, and we'll get nothing. There'll be other times where they say, we don't agree with that, but we would offer you X, Y or Z. I do think that the right way to handle it is to statistically look at it over time and say, well, when you have a portfolio of X dollars, over time, yield enhancement will contribute Y number of income because it'll be Z number of loan. And I think it will take a number of quarters of our doing it for people to see. I would point out that historically some of it has already been included in revenue and therefore the implied multiple in the market, which is on the revenue side or the fee side because by law, we're required to recognize revenue and we receive it or when it's agreed to.

So, I think, what you were really worried about is trying to disaggregate enhanced yield enhancements, and I think that people are already starting to think about finally, how do you value yield enhancements separate from the ongoing stream of a portfolio of X hundred or billions of dollars, and I don't think it's an easy issue. I think it's hard.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

So, a follow-up question to that. So, to give out the portion of yield enhancements that's currently not included in revenue and hasn't been historically, how do we think about that value being crystallized? Is it when a company saw that, i.e., there is a change in equity ownership? Is it when the lending relationship ends? So, yeah, how do we think about it?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

So, I would say two things. First of all, our average term is somewhere between two and two and a quarter years right now. So, whatever is on that table, I would [indiscernible] (52:34), and I would say that it would be received essentially sometime on average over the duration of that average term, that's number one.

Number two, I wouldn't – this is just me. I don't focus on the specific of this unrecognized or that recognized yield enhancement agreement. I focus on it as a percentage of the total book because that would help me model out how that will grow over time, but that's how I would do it. And then, I would add average term to it. It's clearly not been included in earnings, and it has not been included in valuation. We're happy to help people to think about it, it's not our place to tell them or tell you how to do it, other than to say that a [ph] value that's zero (53:25), which is what the market has been doing, is clearly indefensible intellectually.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

Right. I guess what I'm specifically trying to get at here, say, it's warrants or direct equity ownership, how do you actually crystallize that value of equity?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

Well, it depends on the agreement. So, there may be a [ph] shotgun with (53:49) the company where they have to buy it back from us over a period of time. There may be a [indiscernible] (53:33) call arrangement. If it's an – if its options or warrants or a straight-up equity. If we own 100% of the business, it would be because we're selling the business and it's entirely within our control. This is no different than – I'm not trying to be arrogant when I say this, it's no different than what Catalysts already does incredibly well, which is unlock value from companies that need our help. In these circumstances, this goes very well with the competitive advantages already at Catalysts. And frankly, CBL gets to exploit because of its relationship with Catalysts. So, when it comes to monetizing on this, that's not frankly something I worry about. I care about the value in creating the value. We'll end up getting the value as we have historically and always we'll try to do as best we can. But that's why I said to look at the term, the average term.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

Okay. So, different topic now to review of employees and some of the decisions you're making going forward. So, first off, in terms of the decision to hire new underwriters, how many do you currently have today? And have you seen some turnover over the last year?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

Including junior people, David, we have how many right now?

David M. Reese
President and Chief Operating Officer, Callidus Capital Corp.

A

We would have, with junior people – four, five – nine.

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.

A

So, if you think about it, nine underwriters for our portfolio of 30-odd, 40-ish loans, it's a little bit heavy. Some of that is as a result of junior people being groomed to take on more responsibility, which we're in the process of. Some of that is because we always knew that we would end up restarting growth sooner or later, and it's actually frankly a little bit sooner than I have thought it would be. I think that – and we've said this publicly, I think that we'll probably add two senior or mid-senior underwriters in the next couple of quarters, it's in the – I think it's in the press release and I think I'm pretty sure it's in either the MD&A or my earlier comments.

We'd clearly decided to increase the structure and discipline of the business with the hiring of Jay and the creation of a Chief Credit Officer back on purpose. Obviously, we think that managing at CAD 2.5 billion book is fundamentally different than managing a CAD 1.2 billion book, so we're getting ready for that.

We've been fairly privileged and blessed for the last two quarters to able to turn inward. And frankly, in a twisted way, Gray Aqua has been a great [ph] lesson (56:58). So, there are some collaterals and there are some forms of inventory that we'll just never touch ever again. And the experience has taught us that there are just some areas, no matter what we think internally, we will never be able to actually understand some businesses as well as we would like. And I frankly would rather have the experience – a one-off experience in the biologics area, have something like Gray Aqua now in the business when we have a ton of liquidity and no issues while we were taking a pause in growth than when the business is being [ph] fresh (57:38), growing businesses learn while they're growing. There's nothing unusual about that. What is unusual about Gray Aqua is that, A, some of the process that was involved in Gray Aqua was not as robust as we would like. And in the last quarter, we highlighted nine changes, I think it's nine, nine changes internally. Those changes are obviously continuing, as you can see, by the retirement of Craig Boyer and – the pending retirement at the end of the year of Craig Boyer and the hiring of Jay Rogers. We're clearly very focused on tightening and continuing to tighten the business. We think that's normal.

David M. Reese
President and Chief Operating Officer, Callidus Capital Corp.
A

And Paul, to answer your question very specifically about turnover. We've had zero turnover. And as Newton mentioned, other than Craig who will be retiring by year end, we've had no turnover in the underwriting and credit section of our business.

Paul Holden
Analyst, CIBC World Markets, Inc.
Q

Got it. Thanks for that.

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.
A

Well, we had one person who, unfortunately and unfortunately for his family, died but technically wasn't in the underwriting group.

Paul Holden
Analyst, CIBC World Markets, Inc.
Q

One final question from me...

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.
A

And we were not [indiscernible] (58:58).

Paul Holden
Analyst, CIBC World Markets, Inc.
Q

With respect to the SIB, Newton, as you pointed out, only a third or so has been tendered relative to the amount you are willing to buy back. So, if that number does not increase, do you take a [ph] similar to move (59:18) as to what you've done in the past in terms of extending the offer and perhaps increasing the offer price?

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.
A

I'm not going to speculate on what my board may have approved or not approved or decided to do going forward. If you remember, Paul, you were one of the proponents who told me that SIB was going to be oversubscribed and that you thought it would be significantly oversubscribed going into that CAD 14, which I think contributed to your target of CAD 14, CAD 15. My view at the time was I think that that wouldn't be incredibly stupid by the markets, but if they're going to be stupid, we will take advantage of it on behalf of our long-term shareholders, so long as we do it in a legally appropriate and a highly transparent manner, which was the point of the SIB.

Clearly, the market is not stupid. It certainly didn't tender very much from CAD 14 to CAD 15.50, and now CAD 15.10. Very confident in my board, and that the board will evaluate it on an ongoing basis. I'm pretty sure that the entire board is disappointed that only roughly a third has been tendered into the SIB. Under the rules, the SIB can basically be renewed, we're currently doing it on a monthly basis. I will talk with my board in the next few days and we'll decide what's going to happen at the expiry of this extension, which I think is August 30 or something. David, do you remember the exact day?

David M. Reese
President and Chief Operating Officer, Callidus Capital Corp.
A

Yes. That's right, Newton. At the end of August.

Paul Holden
Analyst, CIBC World Markets, Inc.
Q

And so...

Newton G. Z. Glassman
Executive Chairman & Chief Executive Officer, Callidus Capital Corp.
A

I think – my personal view is that banking on the market being stupid overall is a losing strategy in the long run, and I believe that the market will eventually understand both the value of this business restarting growth, the quality of our earnings which clearly has held in very, very well even with Gray Aqua as a fairly atypical issue because we're never going to be in the biologics business, and we will never frankly value inventory that way ever again, even if it's not a biologics business. And we're not going to have inventory technically that is a very quick – not only a quick wasting asset but requires investment to maintain its value.

So, there's a whole bunch of process and procedure issues that we are unique, the Gray Aqua, and in a twisted way, I think it's helped our team. But I also don't think the market is stupid enough to put a zero value on yield enhancement. It's going to put a multiple on it, I don't know if the market will put the same multiple as our normal revenue stream and maybe it'll be that it puts it on the same multiple for the stuff that we recognize as fee or income because that's fairly stable, and a different multiple on the stuff that's either often directly, but I don't think the market is going to put a zero value on it which it currently is.

So, we'll see what the market does. And if the market does disagree with my board's view of the value, then we'll evaluate what we think that value is and we will decide to use capital in the most efficient manner for our long-term shareholders, and if we're making that 20%, 25%, 30% return by buying into the SIB, then we're extending it or increasing the price up, that's what we'll do. And remember, the stock price goes up as you actually materialize on that growth. So, our view of value and the world's view of value will change once growth starts hitting the loan book, it will go up. And if people want liquidity, we're more than happy, we're not quite ecstatic, and encourage them to tender to the SIB.

Paul Holden
Analyst, CIBC World Markets, Inc.
Q

Great. That's all the questions from me.

Operator: [Operator Instructions] We are showing no further questions at this time. I will turn the call over to Mr. Reese.

David M. Reese

President and Chief Operating Officer, Callidus Capital Corp.

Thank you, Sharon. Thank you, all, for your questions. We look forward to seeing many of you over the coming weeks. Enjoy your day, and thanks again for your support of Callidus.

Operator: Ladies and gentlemen, this concludes today's conference call. You may now disconnect your lines.