Up 92% YTD: Should You Own This Financial Stock?

Description

Of the 32 financial services companies trading on the TSX, **Callidus Capital Corp.** (TSX:CBL) has the second-best year-to-date return, up 92% through September 19. Sitting less than 3% off its 52-week high but well below its all-time high of $24.01, the mid-market lender's 6.1% yield is awfully enticing.

But should you take the bait? The answer depends on how you view risk.

Callidus lends money to companies who've been turned down by the big banks. Often, these companies have lower credit ratings and are experiencing some form of financial distress.

The average loan is between $5 million and $100 million with interest rates of 14% or higher. Because it's charging more than the traditional bank, its demand loans have very few covenants attached to its borrower agreements. However, it only lends against fully secured assets such as accounts receivable, inventory, machinery and longer-term assets such as real estate, and then it's only a percentage of the appraised liquidation value.

While that might sound like any bank, Callidus is 62% owned by Catalyst Capital Group Inc., a Toronto-based private equity firm (Canada's second largest), which has been in business since 2002 and has over $7 billion in assets under management. Its founder, Newton Gassman, has been in and around distressed debt situations since he graduated from Wharton business school in 1990.

Callidus went public in April 2014 at $14 per share, raising $290 million, of which $125 million was used to repay funds provided by Catalyst for its original loan portfolio, while the remaining funds were used for additional loans. At the time of its IPO it had 19 loans outstanding for $471 million; at the end of the second quarter of 2016 there was $1.2 billion outstanding spread over 33 loans with 58% in Canada and 42% in the U.S. In addition, it has a pipeline of $940 million in potential new loans.

For the six months ended June 30, its gross yield (total revenue divided by average loan portfolio outstanding) was 19.7%, 130 basis points higher than in the same period a year earlier. As a result, its net income grew 59% year over year to $54.5 million–a return on equity of 21.6%, 720 basis points higher than in the first six months of 2015.

Those are all good numbers, yet its shares sit 32% below its all-time high and just 17% above its IPO price. That's despite the company's share-repurchase efforts to keep its stock price propped up. In April, Callidus hired **National Bank** to do a fair value analysis of its stock. The bank estimated it was worth between $18 and $22.

The big sticking point: it's set aside $25 million for loan-loss allowances related to its loan to Gray Aqua Group Ltd., a salmon farming operation in New Brunswick. The company calls it an "isolated atypical event," but the increase in its allowance for loan losses ratio to 6% in Q2 2016 from 3.1% in Q2 2015 has got many analysts concerned that where there's smoke, there's fire.

As a result, Catalyst might be forced to take Callidus private. National Bank analyst Jaeme Gloyn recommended in May that investors hang on to their shares because he feels an $18 go-private deal could happen very soon.

Investors should hope it doesn't because there are only 50 stocks on the TSX yielding 6% or more; Callidus is one of them.

If you want income despite its warts, I believe Callidus is worth more than $18 per share. What's not to like about being paid 6% to find out exactly how much more?

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