Safeguard Scientifics, Inc.
Second Quarter 2023 Earnings Conference Call
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Presenters
Matt Barnard, General Counsel
Eric Salzman, Chief Executive Officer
Mark Herndon, Chief Executive Officer

Q&A Participants
Jason Stankowski - Clayton

Operator
Ladies and gentlemen, greetings and welcome to the Safeguard Scientifics, Inc. Second Quarter 2023 Earnings Conference Call. At this time, all participants are in a listen only mode. A brief question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star and zero on your telephone keypad. As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Matt Barnard, General Counsel at Safeguard Scientifics. Please go ahead.

Matt Barnard
Good afternoon and thank you for joining us for this presentation of Safeguard Scientifics' second quarter 2023 financial results. Joining me on today's call webcast, Eric Salzman, Safeguard's chief executive officer, and Mark Herndon, Safeguard's chief financial officer. Following our prepared remarks, we will open up the call to your questions.

As always, today's presentation includes forward-looking statements. Reliance on forward-looking statements involves certain risks and uncertainties, including but not limited to the uncertainty of the outcomes of corporate strategic transactions, if any, the uncertainty of the future performance of our companies, our ability to make good decisions about the monetization of our companies, the ongoing support of our companies, our inability to control our companies, fluctuations in the market prices of any of our companies that are publicly traded, and the effective regulatory and economic conditions generally and other uncertainties found in our filings with the SEC.

Many of these factors are beyond our ability to predict or control. As a result of these other factors, our past financial performance should not be relied on as indication of future performance. During the course of today's call were to just expect, anticipate, believe and intend will be used in our discussion of goals or events in the future. Management cannot provide any assurance that future results will be as described in our for looking statements. We encourage you to Safeguard's filings with the SEC including our Form 10-Q which describe in detail the risks and uncertainties associated with managing our business. The company does not assume any obligation to update any forward-looking statements made today. With that, I would now like to introduce Eric.

Eric Salzman

Thanks Matt. Thanks for joining us this afternoon for our Q2 2023 earnings call. Today we will review the following topics. We'll discuss today's announcement regarding our strategic process, our plan to return excess cash to shareholders, and our efforts to materially reduce our ongoing operating expenses. We'll review the portfolio and exit activities of our companies. Next, Mark will run us through the financials. And then we'll open up the call for questions.

I'll start with the strategic process. As we announced in our press release, Safeguard is no longer in discussions with a single counterparty on a potential strategic transaction. After spending considerable time and effort, we could not reach an agreement on deal terms due in part to valuation, tax and structural elements that were critical for us to do the deal. We also explored alternative structures with this counterparty, but were unable to reach agreement on a deal. While other strategic transactions could still be considered, we are now working diligently on a plan to return excess cash to our shareholders, materially reduce our operating costs and exit the assets over the next two years.

First, we intend to return excess cash to shareholders in Q4 2023. We define excess cash as cash on hand, less amounts needed to be retained to support the operations of the company, satisfy liabilities and pay one time costs incurred as a result of pursuing the strategy. Based on our current estimates, which are being further refined and assuming a substantial reduction in our operating costs, which I will discuss in a couple of minutes, we estimate that approximately half of our Q4 2023 balance sheet cash could be returned to shareholders in a dividend.

Second, to substantially reduce our ongoing operating costs, Safeguard is exploring delisting from NASDAQ and becoming a non-reporting bulletin board company. To do this, we would file a proxy and seek a shareholder vote. Over the past few years, we have worked diligently to reduce our corporate expenses. These have come down from $7.1 million in 2019 to our current $3 million corporate expense run rate. However, at this time we do not believe there is room to cut this much further. By delisting from NASDAQ and becoming a non-reporting company, we expect we can reduce our annual cash corporate expenses by up to 50 percent or $1.5 million. Assuming it takes the next two years to exit the remaining portfolio companies, this would amount to $3 million in total savings, which represents a sizable benefit to Safeguard shareholders.

Third, we estimate the exit values from the remaining portfolio companies assuming normal conditions and ordinary course exits would range from $25 million to $45 million over the next two years. We expect the vast majority of these proceeds to come from companies that we categorize as Bucket 1, a concept we introduced last quarter and which I will expand upon a little later in my remarks. We are excited about this path as it reflects our commitment to maximizing value for shareholders and returning cash in a timely manner.

I'll next talk about the portfolio. Last quarter, we divided the portfolio companies into two categories, Bucket 1 and Bucket 2. We would like to further refine this categorization and provide greater detail to help you better understand how we are thinking about the companies and their expected exit values.

We define Bucket 1 companies as those that are well capitalized, executing on their business plans while navigating their share of risks and opportunities, which is typical of VC backed companies at this size and stage. We believe that the vast majority of exit proceeds from Safeguard's portfolio positions will come from Bucket 1 companies. Bucket 1 companies consist of Moxe and meQuilibrium, Prognos and Clutch, the same companies we described last quarter.

Now let me provide a few highlights from Q2 on each of these companies. Note that these are not exhaustive, do not reflect all the risks inherent in these venture stage companies. I'll start with Moxe. Moxe posted first half 2023 revenue growth of 20 percent year on year. It signed another contract with a top five electronic medical health record vendor, expanding its network coverage. And its bidirectional convergence product is gaining traction in the market with two leading healthcare providers using it.

meQuilibrium posted first half 2023 revenue growth of over 20 percent year on year. The company exceeded its budgeted revenue and EBITDA targets for the first half and it was operating cash flow positive in Q2.

Clutch posted first half 2023 revenue growth of 35 percent year on year. It closed 10 new logos in the quarter, and it began beta testing embedded AI tools with select customers, allowing the customers the ability to generate content and improve their product and engagement recommendations.

Prognos exceeded its revenue and EBITDA plan for the first half of 2023. The company announced a strategic partnership with GeneDX to help rare disease patients more rapidly gain access to potential treatment options. And the company is adding Travis May, the founder and former CEO of Datavant to Progno’s board.

Bucket 2 companies are those where we expect an outcome that returns a de minimis amount of capital to Safeguard. The expected outcomes for bucket 2 companies are disappointing and results from any number of the following factors: an inability to attract additional equity capital due to business model, financial profile, or risk appetite in the current market, too high a debt load and an inability to refinance the debt in the current market, the company’s path to break even is too distant to attract capital in the current environment.

We have three companies in Bucket 2. While we haven't directly identified them by name, the transactions announced in our earnings release for Ak~~p~~tana and Trice Medical would confirm that they are Bucket 2 companies. For Ak~~p~~tana, we exited our investment in June as part of a senior lender-led restructuring and recapitalization that left investors with a de minimis ownership stake in the company. As part of that transaction, Safeguard was cashed out of its subordinated promissory note for a cash payment of ~~point~~$0.4 million. We have no further economic interest in the company post of this transaction.

For Trice Medical, we exited our position in July as part of a similar senior lender-led restructuring and recapitalization. In the Trice case, Safeguard retained a small subordinated debt position in the recapitalized company, representing the value of our subordinated line of credit that we funded in December '22 and January 2023. In addition, we received a small consent fee payable at maturity and retained a sub two percent ownership stake in the recapped company.

We also have an eighth company which is in an in-between category. This company is in the process of recapitalizing and raising third party capital. Should this transaction come to pass, we expect the company to move to Bucket 1. Should this transaction not be completed then this would move to Bucket 2. We expect resolution of the situation in the next 60 to 90 days.

On an overall portfolio basis, I will note that we do not expect to deploy additional capital to any of our remaining companies' sale processes. We have worked closely with our portfolio companies to pursue M&A, and over the past 18 months, five of our eight companies launched M&A processes with reputable investment banks. Unfortunately, the outcomes of these processes have been disappointing and to date, none of these M&A efforts have resulted in transactions. On our Q1 call, we said that there were two companies in active M&A processes, one for an outright sale and the other for a merger. Neither deal moved forward. A combination of company, business model, balance sheet, and the market environment have led to these outcomes.

On a macro level, the late stage VC market continues to experience headwinds amid a challenging financing and public exit environment. This is driven by a weak IPO market, reduced risk appetite from VCs, higher debt costs, and a pullback in investing by non-traditional investors. Having said that, there are signs of stabilization as evidenced by the fact that median valuations for most VC stage companies ticked up in Q2. And anecdotally, we are seeing some improvement in the overall M&A market.

I will now hand the call over to our CFO Mark Herndon to take you through the numbers in more detail.

Mark Hendon
Thanks Eric. Safeguard's ~~large~~ net loss for the quarter ended June 30th, 2023 was $2.9 million or $0.18 per share as compared to net income for the comparable 2022 second quarter at $0.5 million or three cents a share. The year to date period ended June 30th, 2023 was the net loss of $6.3 million or $0.39 per share as compared to $6.2 million or $0.38 per share for 2022.

Safeguard ended the quarter with $15.1 million of cash, cash equivalents, restricted cash and marketable securities. We continue to have no debt obligations. Our general and administrative expenses were $1.2 million for the second quarter of 2023 versus $1.1 million for 2022 on a rounded basis, helped slightly three and a half percent. Similarly, our general and administrative expenses were $2.4 million for both of the year to date periods. The uptick in expenses is primarily the result of certain professional fees associated with our special project ~~(inaudible)~~.

Corporate expenses for the quarter, which represent general and administrative expenses, excluding stock based compensation, severance expenses and non-recurring and other items were $0.7 million and $0.8 million on a rounded basis for each of the second quarters of 2023 and ‘22, respectively. The year over year decline was 12.2 percent. The corporate expenses for the six months ended June 30th, 2023 were $1.5 million as compared to the $1.7 million for the comparable 2022 period. The declines in corporate expenses were across a variety of expenses, but included lower employee costs, related taxes and professional fees. We expect the quarterly level of corporate expenses have stabilized at this approximate level before we implement any cost structure changes referred to earlier.

With respect to our ownership interests, we have an aggregate carrying value at June 30th, 2023 of $13 million as compared to $15.4 million at December 31st, 2020. This quarter's activity was limited to the $3 million deployment to progress that increased our carrying value and the application of the equity method of accounting, which reduced our carrying value based on our share of the losses of our companies. We also recorded a $0.2 million impairment this quarter related to one of our remaining other ownership interests.

Our reported share of the losses of our equity method and ownership interest from the three months ended June 30th, 2023 was $2.8 million as compared to $3.9 million for the comparable period in 2022. This change is largely the result of several companies reaching zero carrying value during late 2022 or even during 2023. At that point, we generally cease recording losses from that entity. I would also like to remind everyone that we report our share of losses for the equity method companies on a one quarter lag, so this quarter share of losses reflect the first quarter of 2023.

Also, with respect to our ownership interest, the third party debt at this group of six remaining companies was approximately $135 million versus $134 million last quarter, essentially unchanged. And I'll just note that the six companies remaining, -- we're referring to are InfoBionic, meQuilibrium, Moxe, Prognos, Syapse, and Clutch. This group excludes Ak~~p~~tana and Trice, who were in this disclosure last ~~year~~ quarter where we no longer have an ownership interest.

Cash at the same group of six companies was unchanged at $51 million. However, you may recall that Prognos raised equity during the quarter. So, after considering their equity raise, there continues to be a decrease in the group's cash primarily related to the quarterly burn at three companies.

In terms of revenue performance, we reported an 11.7 percent increase at this group of six companies for the trailing 12 month period ended March 31st, 2023, due to the one quarter bag. We continue to see consistent strong growth from Moxe and meQuilibrium. In this quarter both Clutch and Syapse also showed improved revenue growth for this trailing 12 month period.

Now it is time for us to turn to the Q&A segment of the call. So I'll ask our operator to open the phone lines for questions.

Operator
Thank you. Ladies and gentlemen, we will now be conducting a question and answer session. If you would like to ask a question, please press star and one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star and two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. Ladies and gentlemen, we will wait for a moment while we poll for questions.

Our first question comes from the line of Jason Stankowski with Clayton. Please go ahead.

Jason Stankowski
Hey, guys. Can you hear me?

Eric Salzman
Yeah, yes, yes we can.

Jason Stankowski
Okay, good. Do you know if the return of capital, at least the first one you potentially in Q4, if it all goes that way, will be a return of capital similar to our dividend a few years ago?

~~Eric Salzman~~Mark Herndon
Yep, and just for those~~, they're~~ that are on the phone, ~~that's~~ a quick recap. In December 2019, the company paid a dollar dividend per share and that was a return of capital, so effectively a non-taxable distribution to shareholders at that time. And that is based on a taxable analysis for the year. And that was the circumstance in 2019. We are similarly -- in a similar situation this year. We expect that we'll be in that position and I'll caveat it that everything can change. If we have a transaction flips us to a -- to use the tax technical term -- in accumulated earnings and profit position --

Jason Stankowski
That'd be a good problem to have right?

~~**Eric Salzman**~~**Mark Herndon**
Yeah, that would be OK. We'll address that if it occurs. But our expectation is that we would be in a similar circumstance.

Jason Stankowski
And then, I don't know when the decision was made or how far along. But can you give us -- assuming you continue to go down the cost reduction path and prepare a proxy -- do you have a thumbnail of what that timeline would look like? Is that a week process or like a three month process, or are you kind of ready to go.

~~**Mark Herndon**~~**Eric Salzman**
Well, I would, I would say we indicated a Q4 return of capital and that would correspond with the delisting process also. So that's the time frame you change the plan for.

Jason Stankowski
Right, they're not -- they're not inextricably linked, right? You could do a dividend if you want, but I guess you're saying they kind of are because you need that reduction in overhead, sort of to plan how much cash you actually want to keep. So you need that approval to figure that out.

~~**Mark Herndon**~~**Eric Salzman**
Exactly. One does not require the other, but input from one will determine what amount of money needs to be retained.

Jason Stankowski
I think that's all I have. Thank you.

Operator
Thank you. Ladies and gentlemen, a reminder, if you wish to ask a question, please press star and one. Ladies and gentlemen, if you are listening via the webcast, you may type your question into “ask a question box.” Matt, there are no questions on the audio bridge. You can take over.

Matt Barnard
We do not have any questions on the webcast either.

Eric Salzman
Well, thank you for joining us on the call today. And as always, please contact us, contact us if you have any follow up questions. Thanks and have a good evening.

Operator
Thank you. The Conference of Safeguard Scientifics, Inc. has now concluded. Thank you for your participation. You may now disconnect your lines.