FINAL TRANSCRIPT

Street Capital Group Inc.

Second Quarter 2018 Financial Results Conference Call

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PRESENTATION

Operator

Hi, everyone. Welcome to the Street Capital Group Second Quarter 2018 Financial Results Conference Call.

As a reminder, this call is being recorded on Thursday, August 9, 2018.

At this time, all participants are in listen-only mode.

Following the presentation we will conduct a question-and-answer session. Instructions will be provided at that time for research analysts to queue for questions.

If anyone has any difficulties hearing the conference, please press *, 0 for Operator assistance at any time.

I would now like to turn the call over to Jonathan Ross, Head of Investor Relations for Street Capital Group. Please go ahead, Mr. Ross.

Jonathan Ross — Head of Investor Relations, LodeRock Advisors Inc.

Thanks, Jessica. Good morning, everyone, and thanks for joining us this morning. I'm joined on the call today by Duncan Hannay, Chief Executive Officer of Street Capital; and Marissa Lauder, Chief Financial Officer.

Street Capital Group's second quarter 2018 financial results were released earlier this morning. The press release, financial statements, and MD&A are available on SEDAR, as well as on our website, streetcapitalgroup.ca.

Before passing the call over to management, we would like to remind listeners that portions of today's discussion contain forward-looking statements that are based on management's exercise of business judgment, as well as assumptions made by, and information currently available to management. When used in this conference call, the words may, plan, will, anticipate, believe, estimate, expect, intent, and words of similar import, are intended to identify any forward-looking statements. You should not place undue reliance on these forward-looking statements. They reflect our current view of future events, and are subject to certain risks and uncertainties as outlined in the Company's Annual Information Form, and other filings made with securities regulators, which are available on SEDAR.

These factors include, without limitation, expansion opportunities; technological changes; regulatory changes and requirements, including mortgage insurance rules; and changes to the business and economic environment including, but not limited to, Canadian housing market conditions and activity, interest rates, mortgage-backed securities market, and employment conditions that may impact the Company, its mortgage origination volumes, its gain on sale rates and interest margin earned; the launch of new products at planned times; investments in capital expenditures; and competitive factors that may impact revenue and operating costs.

Any of these factors, amongst others, could cause actual results to vary materially from current results, or from the Company's currently anticipated future results and financial condition.

Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, our actual results could differ materially from those anticipated.

We undertake no obligation and do not intend to update, revise, or otherwise publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof, or to reflect the occurrence of any unanticipated events. Although we believe that our expectations are based on reasonable assumptions, we can give no assurance that our expectations will materialize.

I'll now pass the call over to Duncan Hannay, Chief Executive Officer of Street Capital Group.

Duncan Hannay — Chief Executive Officer, Street Capital Group Inc.

Thanks, Jon. Good morning, everyone. We appreciate you taking the time to join the call today.

Despite market-related challenges that persisted in the quarter, Street Capital continued to make progress against its strategic priorities in Q2. First, we continue to build momentum in new addressable markets. For example, we had Street Solution balances of nearly 400 million at the end of Q2 and year-to-date net gains on sale of $800,000 against our 10-year CMB allocation.

Second, renewals were a strong contributor to our financial results in Q2. We have put initiatives in place to ensure we are maximizing the contribution of this profitable stream.

Our efforts drove a 41 percent increase in revenue contribution in Q2, compared to Q2 2017. Year-over-year renewal revenue is up 48 percent. Total revenue grew marginally year over year despite challenges on the prime new origination side of the business because Street Solutions' NIM performance and strong renewal contribution are starting to make a larger impact on our business with each new quarter. This demonstrates the power of our emerging business model and the predictability of our legacy mortgage origination engine.

Third, we worked to finalize critical technology partnerships, supporting the implementation of a modern, cloud-based, digital banking solution. We expect this solution to be ready in the second half of 2019, which will enable us to further diversify our offerings over time, and accelerate our deposit gathering capabilities. These partnerships, and our open banking architecture, will give us a unique competitive position in the Canadian banking landscape, and enable us to deliver a world-class client experience.

During Q2, we also took proactive steps to continue to evolve our risk and control framework at the bank. As a regulated financial institution, and a prudent lender, this is something we are committed to on a consistent basis. Importantly, in the current environment where significant regulatory change is impacting affordability for many buyers, and interest rates are moving higher, management and the Board of Directors see additional risk in the short term and have taken proactive measures to strengthen the Company's internal controls, processes, and technology capabilities to proactively defend against potential issues that may arise. And while these measures can come at the expense of near-term volume growth and market share, they serve to protect the Company's historically strong underwriting and credit performance.

As we look forward, our team will continue to work tirelessly to achieve the targets we have outlined for shareholders. However, between our prudent posture on risk management in the current environment, as well as continued pressure on prime new originations and gain on sale rates, these targets are at risk for 2018.

While we carefully manage the business in the near term, our transition from price taker in our legacy business to price maker in our business of the future is ongoing. We remain in the relatively early stages of our transformational journey from being a monoline prime insurable mortgage lender to offering a highly progressive, digitally enabled, open banking platform. And we continue to focus on building durable, quality relationships with brokers and home buyers, prudent risk management, and stable sustainable long-term growth. We have made significant progress over the past year, and we remain squarely focused on executing our mid to long-term strategic vision.

I want to thank our long-term shareholders, the dedicated team at Street Capital Bank of Canada, and the Board of Directors for their ongoing support. Our management team remains excited about the future of this company and confident that the envisioned future can be achieved.

With that, I will pass it over to Marissa.

Marissa Lauder — Chief Financial Officer, Street Capital Group Inc.

Thanks, Duncan, and good morning, everyone.

Echoing Duncan’s comments, in Q2 and the first six months of the year, we saw positive improvements in a range of key focus areas, including Street Solution and prime renewals, which combined to drive marginally higher year-over-year revenue with 17 million in Q2 and 28.6 million year to date.

Adjusted diluted EPS was flat in Q2 at $0.02 per share. Adjusted diluted EPS was $0.01 on a year-to-date basis, which was lower than the same period in 2017 given our weaker performance in Q1 2018.

We continue to see pressure on prime gain non-sale rates, primarily related to competition for prime product and because 2017 included a specific product promotion with an investor where the bank earned higher premiums. The gross gain on sale rate for prime new mortgages was 1.76 in the quarter, down 27 basis points from 2.03 percent in Q2 2017, and relatively flat with 1.75 percent in Q1 2018. The year-to-date gross gain on sale rate was also 1.76 percent, down from 1.94 percent last year.

Renewals were up significantly year over year, as projected, driving revenue contribution of 9.1 million in Q2 on renewal volume of 0.77 billion, up 66 percent from 0.46 billion renewed in Q2 2017. Year to date, prime insured renewals were 1.29 billion, up from 0.77 billion in the same period last year.

The renewal rate remains strong on a year-to-date basis in the vicinity of 73 percent. While we do target 75 to 80 percent renewal rate, we are principally focused on maximizing the profit contribution on this segment of our business.

We originated 107.8 million in Street Solutions product in the second quarter and 206.1 million in the year-to-date period, growing the outstanding balance to just about 395 million. The average spread on Street Solutions was above the average deposit rate, was 2.60 in Q2 2018 compared to 2.71 in Q1 2018, and 2.54 for all of 2017. We generated 2.2 million in net interest income on unsecuritized assets in the quarter and 3.6 million on a year-to-date basis. Net interest margin grew to 2 percent in Q2 2018 and 1.85 percent for the year as our balance sheet continued to gain scale, and our liquidity pool was being sized and managed.

As Duncan mentioned, while we're working very hard to reach our Street Solutions origination target of 600 million to 700 million for the year, and demand remains very strong for the product, there is a risk we will not meet this target in 2018. We are working on several funding solutions for these mortgages, and the ultimate 2018 result will depend on the extent to which we are successful in obtaining additional funding.

As a new Schedule I bank, we are managing our funding and liquidity conservatively. At June 30th, our deposit base was 481 million, up from roughly 383 million last quarter. We continue to add deposit brokers in the quarter, and we were pleased with our progress here. This remains a key area of focus for us over the near, medium, and longer term.

Our CET1 ratio at end of Q2 was 22.24 percent and our leverage ratio was 11.29 percent. As we continue to grow our balance sheet, we expect these ratios to trend into a more optimized range with a corresponding lift to return on equity.

Importantly, we continue to work to hold the line on expenses and remain focused on our target of positive operating leverage in 2018. However, with the pressure on prime new originations, this may be difficult to achieve this year.

Looking further out, we continue to work towards our previously disclosed 2019 and 2020 targets and will provide updates as we gain additional insight in advance through the balance of 2018.

We've made significant progress in the execution of our strategic vision in 2018 and remain confident in our future prospects. We will continue to focus on maximizing financial returns in the product suite that we have right now, but also work to put the pieces together to support long-term product diversity, balance sheet strength, and overall growth.

That concludes our prepared remarks this morning, and I'll now pass the call back to the Operator to begin the question-and-answer session.

Q&A

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. Should you have a question, please press the * followed by the 1 on your touch-tone phone. You will hear a three-tone prompt acknowledging your request, and your questions will be polled in the order they are received. Should you wish to decline from the polling process, please press the * followed by the 2. If you're using a speakerphone, please lift the handset before pressing any keys.

Your first question comes from Brenna Phelan of Raymond James. Please go ahead.

Brenna Phelan — Raymond James

Hi, good morning.

Duncan Hannay

Hey, Brenna.

Marissa Lauder

Morning.

Brenna Phelan

So in the MD&A, the discussion referencing inherent risk of misrepresentation in mortgage docs, was this in response to anything specific that your underwriters came across? Were there any relationships with brokers severed in the quarter?

And following onto that, can you comment on the CMHC's request that the CRA take a more direct and formal role in tackling mortgage fraud? Are you engaged in any discussions there?

Duncan Hannay

Thanks for the question, Brenna. I'll get started. I begin by saying we've always taken a very prudent approach to risk management. We see greater risk in the market right now. I wouldn't say it's specific to any single incidents, but it's driven by a combination of regulatory change, rising interest rates, and higher housing prices. And this is really, for us, about maintaining quality over quantity.

Specific to your question on the broker's side, as you know, again, we take a very prudent approach to risk management. We add, monitor, and remove brokers from our platform in the normal course of our business. So that's—I would say there's nothing unusual there particularly. We really strive to build durable long-term relationships. But, again, we won't sacrifice quality over quantity as this is really a key pillar of our propositions to all stakeholders, including funders and insurers and so forth.

As it relates to CMHC specifically, we have ongoing conversations with CMHC. We're certainly supportive of any advancements or help that they can provide and any way that we can further strengthen the controls and processes that we have in place to manage risk within the business.

Brenna Phelan

So is that something that you've seen specifically? The cases of just fraudulent T4s or T4s being printed from the CRA website and then being doctored?

Duncan Hannay

You know, Brenna, I think what I will say is we see more risk in the market right now, and it's driven by a number of factors. I wouldn't point to that specifically. But I'd say given the challenges buyers have from the perspective of affordability, comparatively high home prices, rising interest rates, a number of factors, I'd say the incentives are higher there as it relates to misrepresentation, and we're putting in place additional controls and processes in our business just to make sure that we can protect our business and maintain that high underwriting quality and credit quality that we're known for. This is really the core pillar of our proposition to funders, and we want to be progressive in this area.

Brenna Phelan

Okay. Then moving onto funding and liquidity, the commentary seems to suggest—is this—are you finding the broker deposit market quite competitive? Is—are your initiatives taking foot? Are you expanding your reach? Do you think that there's room for you to continue to grow in that space? Or is it imperative that you, sooner rather than later, get a direct-to-consumer offering?

Duncan Hannay

No, we continue to make progress there. And I wouldn't say it's a function of the competitive set necessarily. From the deposit brokers that we're working with, we're quite happy with the flows that we're receiving, and we've seen good growth, albeit a little bit behind where we'd like to be. The fundamental issue is really just continuing to extend our reach. We've made progress this quarter, but particularly as it relates to some of the larger deposit boards it's just taking a little bit longer for us to get there. But—so that's put us in a position of being a little liquidity constrained in the near term, but we continue to work towards expanding that reach, and we remain confident that we'll get there. It's—we're just experiencing the growing pains of that process.

Brenna Phelan

Okay. And on the asset side, are—what's your view on the competitive landscape right now? Are your competitors being more aggressive on price than you think is prudent?

Duncan Hannay

Well, as you can see, our margins in prime insured in particular, although they stabilized after the first quarter, they continue to be below historic levels, and that is certainly a direct result of the competitive posture in the market right now. So that's a challenge for us, but we're pleased at least that they're stabilizing. We do expect that that will persist for the balance of the year, and the reality is that our competitors are aggressive in what is a smaller addressable market today.

Brenna Phelan

Okay. And last one from me; geographic breakdown of originations in the quarter, a bit of a shift to Alberta. Do you think there's opportunity to keep that relative geographic shift? What's the market like there?

Duncan Hannay

Well, as you know we have a fairly high concentration in the GTA.

Brenna Phelan

Yep.

Duncan Hannay

And we certainly do like major urban centres for a number of reasons, but we do want to see that geographical mix continue to shift a little bit. So I'd say on balance it's positive that we're seeing a bit of shift to the west and the Alberta area, and we do look to continue to diversify our geographies over time.

Brenna Phelan

Okay. Thank you very much.

Duncan Hannay

Thanks, Brenna.

Marissa Lauder

Thanks.

Operator

Now, ladies and gentlemen, as a reminder, should you have a question, please press the *, followed by the 1.

Your next question comes from Dylan Steuart of Industrial Alliance. Please go ahead.

Dylan Steuart — Industrial Alliance

Good morning.

Duncan Hannay

Hi, Dylan.

Marissa Lauder

Good morning.

Dylan Steuart

Just a follow-up on the reduced outlook and the tightening up new originations. I guess, one, is there any geographic regions just based on your risk assessment that you're avoiding? And two, maybe just get into a bit of, I guess, the increased processes that are—is it a fact that it's just slowing down the underwriting process and that's what is behind the expected drop for the balance of 2018?

Duncan Hannay

So, Dylan, I think we're taking a cautious stance in reaction to risks we see in the market, continued softness in prime insured, and prudent growth of our balance sheet as we manage through the early days as a Schedule I bank. Certainly the second half is now expected to be slower than we anticipated. But we continue to see positives in executing our strategic plan, very good strong results on the renewal side, demand for our Street Solutions product, and healthy spreads in NIM starting to make an impact on the business.

To your question on geographies, as you know, we don't originate in Quebec quite deliberately, and we tend to be highly concentrated in urban markets, as I noted, because we like the credit profile and the stability of those areas. So while we will probably diversify out of and away from—not away from, but diversify from our concentration in the GTA to other urban centres, I'd say no major plan geographically to shift the mix beyond where we are today.

Dylan Steuart

Okay. And maybe just on the renewal stream, no change in your outlook there, but with the increased, I guess, the increased underwriting diligence, any chance that we could see a bit of a hit to renewals coming up, if you're looking at those a little bit closer?

Duncan Hannay

No, I think we're still holding the line on where we are from a renewal perspective. We've been very focused in our efforts around, I guess, quality over quantity. So although the renewal rates are just slightly below the range that we've said on a percentile basis, we're really focused on maximizing contribution, and we're underway with a number of key initiatives to make sure that we do just that, and we bespoke price every renewal in such a way that we maximize that contribution.

Dylan Steuart

Okay. Great. And just finally, maybe just an update on, I guess, the progress made within the quarter on the digital banking offering, and just a reminder of, I guess, expected SG&A incremental costs due to the rollout of this over the next year?

Duncan Hannay

Yeah. So as I mentioned, very good progress. We have down selected our technology partners during Q2, and during the quarter continued to work completion of those arrangements and kick off our activities, which would see us launching our digital banking solution in the second half of 2019. So we're quite pleased with that progress. We very much see this vision of a digital, cloud-delivered, open banking platform coming to reality, and we do believe it will be differentiated and quite unique in the North American marketplace. And as such, we've attracted the attention of Tier 1 providers in both core banking and in public cloud delivery. So we're really pleased with that progress.

Marissa Lauder

Dylan, it's Marissa. Just in terms of SG&A, through the development phase over the next six to nine months, you'll start to see an increase in development costs in our balance sheet, but no meaningful change to SG&A in the short term. As we go live later in 2019, there's obviously some servicing as SaaS-based model, so will be some costs that will be generated from running the direct deposit platform. And we'll be able to give you a little bit more colour on that later in 2018, once we've got a little bit more firm on those costs. But I will say that from a cost perspective and the deposits that we're expecting to generate from the platform, and the corresponding mortgages that we put on our balance sheet, it's positive to P&L overall, even with an increase to SG&A related to operating the platform.

Duncan Hannay

I think the other thing to note, Dylan, is that we're using off-the-shelf solutions, so we are not—and deploying sort of a SaaS model. So we're not looking at, we're looking to do this in a way that is asset and capital light and leverages, as I said, sort of Tier 1 capabilities and in an off-the-shelf way. So we're not looking at a particularly complex or custom, if you will, instillation, albeit it will certainly be unique in the form that we deliver it. So that's—and of course because we're a de novo in this category, it's not like we've got the challenges of legacy technologies to deal with in terms of conversion and so forth.

Dylan Steuart

Okay. No, that's very helpful. Thanks very much.

Duncan Hannay

Thanks, Dylan.

Operator

There are no further questions at this time.

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating, and ask that you please disconnect your lines.

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