Street Capital Group Inc.

Fourth Quarter and Year-End 2018 Results Conference Call

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PRESENTATION

Operator

Hi, everyone. Welcome to Street Capital Group Fourth Quarter and Year-End 2018 Results Conference Call.

As a reminder, this call is being recorded on Wednesday, March 6, 2019.

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

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

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

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

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

Thanks, Brittney (phon). 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 fourth quarter and fiscal 2018 financial results were released 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'd 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, intend, 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 markets; timing and execution of anticipated transactions and employment conditions that may impact the Company; its mortgage origination volumes; it's gain on sale rates and net interest margin earned; launch of new products at planned times; investments and 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 in these forward-looking statements.

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 except as required by applicable securities laws. Although we believe that our expectations are based on reasonable assumptions, we can give no assurance that our expectations will materialize.

I will 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.

While 2018 was a challenging year, driven by disruptive regulatory and competitive forces in the mortgage market, I am very proud of our team for producing several key wins against the five opportunity spaces we outlined at the beginning of 2018.

The first opportunity space was the diversification of our funding sources. Our team worked for the better part of a year to introduce an off-balance sheet funding solution that would enable us to satisfy strong customer demand for our Street Solutions nonprime mortgage product.

In late December, we announced that we had closed an initial sale of funded Street Solutions mortgage loans to an international third-party institutional investor. We plan to further develop this capability in 2019, as this key funding partnership has the potential to help us better manage balance sheet growth and ensure a consistent product offering in the market.

During the year, we also sourced off-balance sheet funding for prime uninsurable mortgages and sold 56.6 million in the year. While small and evolving, this funding has helped to close a key gap in our product offering, and we're seeing good momentum in 2019.

Lastly, we continue to make steady progress adding third-party deposit brokers during the year, which drove meaningful deposit growth in our GIC product offering.

The second focus area was to build momentum in new addressable markets. Our team more than doubled Street Solutions' originations year over year to 421.4 million with a corresponding lift to recurring net interest income. During the year, we also opportunistically expanded into multiunit residential lending through the CMB program and securitized and sold 264.5 million in mortgages in 2018.

Multiunit residential is a highly attractive, adjacent space where Street Capital Bank has not historically been a player.

Third, we set out to drive strong revenue contribution from prime mortgage renewal volume, and we succeeded. At $2.44 billion, 2018 renewals performed at the top end of our target range, and our efforts during the year drove a $28.3 million in renewal contribution. Part of this success can be attributed to our fourth area of focus, which was to transform and modernize the organization. To this end, we continue to drive a cultural shift towards agile project delivery and digital transformation with the specific objective of improving the customer and broker experience through several initiatives, including specific middle-office improvements. We continue to work on middle-office transformation moving into 2019, where we see additional opportunity to create efficiency and improve the end-to-end customer experience.

Our fifth area of focus was centred on enhancing our risk and governance framework. We further evolved our mortgage underwriting capabilities, or guidelines, during the year and completed a project to enhance our second and third-line oversight capabilities. As part of this, we embedded dedicated risk and compliance resources on the frontlines of the business to ensure we maintain our quality standards and compliance in a changing marketplace.

I would also like to take this opportunity to welcome Lea Ray as Chair of the Company’s Board of Directors and to thank Allan Silber for his service over a distinguished, almost 40-year career with the Company. Lea is an experienced financial executive and board member who has been an invaluable resource since she joined the board as an independent director in 2015.

All this said, Street Capital met several challenges during 2018, and as a management team and Board of Directors we are facing them head-on. Consistent with 2017, these headwinds were primarily in the prime mortgage segment of our business where heightened competitive activity in a smaller prime insured market segment and limited funding in what is now a large prime uninsured segment continue to impact both originations and gain on sale rates. Pressure on prime economics, in turn, limited our ability to generate internal capital and accelerate Street Solutions' originations in line with the strong demand that we're experiencing.

In response to these business challenges, late last year, we announced a strategic realignment, and I've already made several difficult but necessary decisions aligned with our commitment to support responsible growth and sustain the performance. This strategic realignment also calls for us to improve the Bank's capital levels during 2019, and we are actively exploring the various options available to us.

We made the decision to suspend the implementation of a digital banking platform pending the outcome of these efforts. We also completed a workforce reduction in early January. This strategic alignment is ongoing, and we appreciate the support of our dedicated staff and loyal shareholders, as we continue to execute.

While the market environment remains difficult, the early results from the execution of our strategic alignment, along with a renewed go-to-market strategy, are producing positive initial results as we enter 2019. We are also focused on executing against three related key priorities this year.

The first is prime new mortgage originations. We have placed renewed focus on new broker onboarding, deepening share of wallet, and improving the end-to-end customer experience to drive new prime origination volume growth across both the insured and uninsured segments.

The second priority is prime mortgage renewals. Our team is moving into 2019 with strengthened processes and an enhanced capability to target offers to renewing customers. The goal here is to maximize customer retention and the overall profitability in contribution of mortgage renewals.

And the third is loan origination systems and processes. We have assembled an agile team that is focused on middle-office transformation and digital delivery to improve throughput, customer experience, and the overall efficiency of the Company's mortgage origination platform with the objective of solidifying our competitive advantage in growing overall market share.

In all, this is a long-term transformation journey. The management team and Board of Directors of Street Capital are both aligned and committed to seeing it through for the benefit of our stakeholders.

With that, I will pass it over to Marissa to walk you through our financial results.

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

Thanks, Duncan, and good morning, everyone. Echoing Duncan's comments, 2018 was a challenging year for the Company. Reported EPS for 2018 was a loss of $0.37 per share compared to income of $0.02 last year. Reported EPS was negatively impacted by a few noncash, nonrecurring items at the parent company level.

First, based on the results of our impairment testing, we recorded a noncash write-down of 23.5 million, representing all of the goodwill and the remaining 3.1 million of intangible assets at the parent company level. These assets were part of the parent company's acquisition of the predecessor to Street Capital Bank in 2011.

At the same time, we also reversed 12.5 million of the deferred tax assets, also at the parent company level. Although the majority of the tax loss carryforwards underlying these assets remain available for use, their use is not sufficiently probable to permit recognition as an asset for accounting purposes. None of these noncash write-downs impact our level of regulatory capital at the Bank.

Additionally, as Duncan mentioned, in Q4 and consistent with our strategic realignment, we decided to suspend the implementation of our core banking system. This led to a onetime restructuring charge of 7.4 million in Q4. Despite the termination of the project, the internal development and design work has been retained, and the Bank will reevaluate the implementation of the core banking system towards the end of 2019.

Excluding the nonrecurring items I discussed, adjusted diluted EPS was flat in 2018 compared to $0.06 in 2017. In Q4, adjusted diluted loss per share was $0.01 compared to income of $0.01 last year.

New originations for prime insurable mortgages were 3.74 billion for the year. This is down about 30 percent from 5.37 billion last year. When combined with lower gain on sale rates of 63 basis points in 2018 compared to 81 basis points last year, revenue from prime originations was down 39 percent from 2017. The lower gain on sale rates were driven by increased competition, market spread compression, and also because 2017 included a specific product promotion with an investor for the banker entire premium.

Prime insurable originations were 0.88 billion in Q4, down from 1.14 billion in Q4 2017 and down seasonally from 0.98 billion in Q3. Net gain on sales were 51 basis points in the quarter compared to 75 basis points in Q4 of 2017 and 62 basis points in Q3.

Renewals were strong at 2.44 billion and were up significantly year over year as projected, based on the underlying maturity profile of the mortgages under administration. Renewals drove revenue contribution of 28.3 million in 2018. Our renewal rate for 2018 was strong at 73 percent. And while we continue to target a renewal rate in the mid to high 70 percent range, we are principally focused on maximizing the profit contribution on this segment.

We originated 421.4 million in Street Solutions in 2018 and 121.6 in Q4. We sold 26.2 million of these mortgages to third-party institutional investors in Q4. Our outstanding mortgages under administration for Solutions was 565 million at the end of the year. And for those on balance sheet, we had a weighted average yield of 5.27 percent in 2018. On this, we generated 9.5 million in net interest income.

Our net interest margin was 1.99 percent in 2018, and this is up from 0.82 percent in 2017. This improvement reflects an ongoing expansion of the balance sheet. In Q4, the net interest margin was 2.09 percent compared to 2.6 percent last quarter.

We continue to manage our funding and liquidity conservatively. At December 31st, our deposit base was 638.7 million, up from 558 million in Q3 and up from 481 million in Q2. We continue to add meaningfully to our deposit broker base, and an expansion of these relationships remains a key focus for the bank.

Street Capital Banks CET1 ratio at the end of 2018 was 19.84 percent, and its leverage ratio was 10.07 percent. Both are above our internal targets.

In mid-January, as Duncan discussed, we also made a difficult decision to reduce our workforce by about 30 positions, and we expect to incur restructuring charges of up to 2.3 million in Q1 2019. As part of the restructuring and to improve efficiencies and accountability, the Company also reorganized its management team to align its operating model to the new strategic focus.

In our year-end MD&A, we presented certain financial targets that the management team will be working on in 2019. We are expecting an improvement in prime originations and market share in 2019, supported by our renewed go-to-market strategy. I would note that we did observe improving prime originations and market share in the latter part of Q4 2018.

On renewals, we continue to expect them to be in the range of 2.4 billion to 2.6 billion in 2019 and 2.6 billion to 2.8 billion in 2020. We expect renewals to continue at relatively lower net gain on sale rates given the continued expense associated with trailing commissions and continued market competition. And as previously announced, we expect Street Solutions originations to be in the range of 300 million to 450 million with spreads relatively consistent with Q4 2018.

Ultimately, originations for Street Solutions will depend on the success of the Bank's current initiatives to deepen its funding sources, both on and on (sic) balance sheet, and also on the Bank's regulatory capital levels, which we are looking to strengthen, as Duncan mentioned. Additionally, we are also targeting to achieve positive operating leverage in 2019.

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-toned prompt acknowledging your request, and your questions will be answered in the order that 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 Jaeme Gloyn from National Bank. Please go ahead.

Jaeme Gloyn — National Bank.

Yeah. Good morning.

Duncan Hannay

Good morning, Jaeme.

Marissa Lauder

Morning.

Jaeme Gloyn

First question is just around improving the regulatory capital levels. I was hoping you can describe some of the things that you've considered to date or might consider in the future and the timing around that.

Duncan Hannay

Well, as we've said, management is exploring various available options to strengthen the capital base of the Bank. I think we'll keep our comments to that at the current time. But our success relies on improving the capital position of the Bank over the long term. We do intend to make that happen in 2019, and that's our focus. And at the same time, in line with our strategic realignment, we're very focused on improving the sustained performance of the business, such that we can generate capital organically at the same time.

Jaeme Gloyn

Okay. In terms of maybe just a higher-level question, lot of discussion in the newspapers and from real estate boards around mortgage rules and changes there. Have you done any internal analysis? Or can you provide any of your thoughts around changes to the insured mortgage rules, which if loosened, could potentially help you guys out?

Duncan Hannay

Yeah. At this point, we're not building that into any of our go-to-market plans, if you will. I do think there is upside available to us, obviously, if some of the rules, if you will, and/or related stress tests and so forth are loosened. But at this point, we are really solely focused on our go-to-market strategy. We believe there is meaningful opportunity for us to restore market share. We think in and of itself that creates upside for us. And certainly, if there is any loosening of the rules in the current regulatory environment, that would certainly help us.

Jaeme Gloyn

Okay. Fair enough. In terms of the originations within the quarter, Alberta and BC picked up a lot of share after picking up a lot of share even in Q3 relative to Ontario. Can you just speak to some of the dynamics that are at play in the geographic mix of your originations?

Duncan Hannay

Well, for Street Capital, we have put a fairly concerted effort on the western regions and our western sales regions, if you will, given our historic concentration in and around the GTA. We've had success there, and we do expect to continue to build on that. I think that's good in terms of the diversification of our business, and it's just better balancing our portfolio overall geographically. So we'll continue to focus on that. As I said, we've had some success there, and I think that's a healthy thing for the business.

Jaeme Gloyn

So you wouldn't necessarily attribute the decline in Ontario to—as a share, the decline in Ontario as a share—to more intense competition here than in Alberta? Or other factors like that?

Duncan Hannay

Well, I think that, on balance, probably the competition in Ontario has been more intense and that would be a part of the reason, certainly, for the shift. But I think more so it relates to the focus that we've put on our western sales regions as well and strengthening our position there to better diversify the portfolio.

Jaeme Gloyn

Okay. Next question's related to the Stage 2 mortgages. Seeing a pretty big shift in this quarter from Stage 1 to Stage 2. And Stage 2 mortgages represent about 15 percent or 16 percent, I believe, of total mortgages on the Street Solutions side, by the way. That's pretty high compared to some of your other peers that have reported similar stats. I'm just wondering if you could talk to what's driving the increase in Stage 2 mortgages and what kind of risks you're seeing around those.

Marissa Lauder

Yeah. It's Marissa. Thanks, Jaeme. Generally speaking, I mean, I'll just point to the size of our portfolio is relatively small, and one of the underlying ways we move things to Stage 2 is, as opposed to on an individual mortgage level, it's on a pooled basis. And so when we look at the probability of default, which can be affected by things like the economic environment or the overall change in the Beacon score for a particular pool of mortgages, the entire pool is moved into Stage 2.

So it creates some volatility, given the size of our portfolio. So there's nothing specific that we're seeing underlying the portfolio that's giving us concern. It's a part of the methodology that we're using that's creating some of that volatility. I will point to a very low Stage 3 and a very low over-90-day rate. And over the last year, we've actually haven't realized any losses in the Street Solutions portfolio. So we're quite comfortable with the credit quality that we're seeing. And so you will see a little bit of volatility, given the size of our portfolio, moving in between Stage 1 and 2.

Jaeme Gloyn

Yeah. Those are fair comments. Just one quick follow-up. When you look at those pools, was there any particular pool like, let's say, the northern part of Toronto or a particular other—

Marissa Lauder

Yeah. They're not pooled geographically.

Jaeme Gloyn

Okay.

Marissa Lauder

They're pooled based on more on credit quality, more on Beacon band ranges. And we do find that lower Beacon bands tend to have more volatility between Stage 1 and 2. I think we'll start to see that smooth out over time as we have more historical experience.

Jaeme Gloyn

Okay. Great. Thanks. And if I could, just a few quick sort of guidance or sort of guidance-type questions. The commentary around the net gain on sale margin for prime mortgages, prime-originated mortgages, came in around 20 basis points here in Q4, and the commentary is around for that pressure to persist into 2019. Is that based off of that Q4 number? Or more based off of the 2018 level, which would have been quite a bit higher than that 20?

Marissa Lauder

Yeah. So I just want to—the 20 would include the amortization of the portfolio insurance. And I do like to talk about this excluding that because the portfolio insurance is not variable with volumes. So I would—in between what we've seen in Q3 and Q4, on a weighted average basis is what I'm looking at as we're moving into most of 2019 at this point.

Jaeme Gloyn

Okay. Great. And with respect to CMB securitizations and sales of IO strips, is this a level that you would consider to be normal at this stage? Or were there some other factors at play in Q4 that drove a higher level of revenue?

Marissa Lauder

We are hoping to maximize our allocation of the 10-year CMB. So with the levels that we see in Q4, we certainly hope that they will continue into the rest of 2019. It will obviously depend on the availability of the mortgages and the allocations. But we are seeing, and we have seen, good traction in Q1 this year, and we're expecting to at least maintain those levels, assuming the market stays the way it is.

On the IO strip, that's really dependent on what we have on our balance sheet that's securitized mortgages. And so you can see the balance there is not very large right now. So we wouldn't intend to necessarily continually sell IO strips unless we were trying to manage the size of our balance sheet.

Jaeme Gloyn

Okay. Great. Thanks very much.

Duncan Hannay

Thanks, Jaeme.

Operator

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

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

Brenna Phelan — Raymond James

Hi. Good morning.

Duncan Hannay

Hi, Brenna.

Marissa Lauder

Hi, Brenna.

Brenna Phelan

So I just wanted to start with the impairment of the goodwill and the intangibles. Can you just walk us through the methodology you undertook there, the sort of cash flow generation assumptions for the units specifically related to the intangibles, which I believe were associated with the renewal stream? Just kind of walk us through your inputs to that modelling.

Marissa Lauder

Okay. So, I mean, when we're looking at the impairment test, we're looking at the cash generating unit, which would be the Bank, and so what our financial forecasts on a very conservative basis would be over the next three years. You can imagine, with the last couple of years of pressure on our earnings, we had to, for purposes of the impairment test, be very conservative in our assumptions around those future cash flows.

Then when we looked at the carrying value compared to the fair value, we had a shortfall. And that shortfall had a fairly large range depending on the discount rate we used. And you can imagine, we used a fairly high discount rate of 15 percent, which was disclosed in our Q3 report. And using a range of discounts, we ended up with that impairment. Now when we looked at partly writing down the goodwill, but the entire amount fell within the range of reasonable outcomes and included, at that time, the intangible assets, not because we thought our renewal stream was necessarily impaired, but the intangibles less the goodwill fell in total within that range.

Brenna Phelan

So it was just assessed on a total basis versus—I guess what I'm trying to get at is—

Marissa Lauder

Yeah. Yeah. I know what you're—

Brenna Phelan

—is the renewal stream, was that assessed to be impaired because—

Marissa Lauder

Mm-hmm.

Brenna Phelan

—the risk of it not being profitable over a longer term is elevated?

Marissa Lauder

No. If you look at the renewal stream in isolation, obviously it's going to be a very big contributor to our revenue on a go-forward basis, just based on the mortgages under administration we have. So this is more about a holistic view of the carrying value of the assets associated with the original purchase.

Brenna Phelan

Okay. And then sticking with the renewals rate, so you made reference to roughly 73 percent are being renewed, but the focus on profitable growth. Is there a—like what's driving your assessment of the profitability threshold that you need to meet? Is that based on gain on sale? And is that consistent with what's in the quarter? Or how do you see that trending over the next two years?

Duncan Hannay

It is, Brenna, effectively based on gain on sale, and we do see—we've made really good progress over the course of the year, as I noted, in terms of it creating greater precision, I would say, in terms of the customer retention as well as renewal based on targeting offers to clients, based on propensity to renew, and so forth. And the focus is on maximizing profitability first, and really customer retention and renewal second. So you may see a little bit, in terms of the actual renewal rate, you may see some fluctuation. So even on balance for the year, I think it went to 72 percent from 75 percent the prior year but, again, that's really based on the focus on maximizing contribution.

Marissa, I don't know whether you have anything to add in terms of looking forward?

Marissa Lauder

Yeah. A pure mathematical view of this would say we wouldn't renew a mortgage that's going to create an economic loss for us. And so we will turn that renewal away if the competition on pricing is too high. And so that might lower our renewal rate, but at the end of the day, increase the economics for the renewal book because we didn't take the loss.

On the other hand, to Duncan's point, we do have some pricing flexibility where we understand enough about our customers, where we can increase our renewal rate by having targeted offers but maybe at a slower lower gain on sale rate, but we're willing to do that as well because we want to increase the volume of renewals.

Brenna Phelan

And then, just anecdotally, as these mortgages are coming up for renewals, is there still a very high level of demand for borrowers for refinances that you then can insure and not still have to turn away? How is that trending?

Duncan Hannay

Well, I think the one bright spot has been some improved traction in the prime uninsurable segment of our business where, as I noted, our funding, or at least our product, has not been particularly competitive. But we've seen both stronger demand and improved—and much more competitive products. So it does put us in a better position to refinance.

Obviously, now, with the equity in homes not rising at quite the same pace as it was, there isn't as much room for consumers in that regard. But I think, on balance, we see the renewal rates on the portfolio being fairly consistent year over year, and we'll have some increased capacity now for refinance now that our prime uninsured product is more competitive.

Brenna Phelan

Okay. And then just a quick follow-up on Jaeme's question on the Stage 2 loans. So specifically, the noise in the quarter, that's related to Beacon band-based pooling versus general economic conditions. Is that fair?

Marissa Lauder

Yeah. Yeah. Yeah. We're not—

Brenna Phelan

Okay. And then—

Marissa Lauder

They're fairly benign go-forward macroeconomic conditions. And we use a consensus view based on the major banks' economic forecasts. And so it's not a call on the economic environment going forward.

Brenna Phelan

Okay. And then just last one for me. The target for positive operating leverage in 2019, can you tell us what the run rate quarterly OpEx assumption, what you're forecasting there in order to obtain that positive operating leverage?

Marissa Lauder

I can't give you the exact number. I will say, Brenna, that we're trying to grow our overall expense base, which would be both FTE costs and general operating expenses, modestly. So taking from 2018 and adding a modest increase to a quarterly run rate would probably be all right. Now that's assuming there are no unforeseen circumstances that require us to spend a certain amount of money.

And then I'll just also remind you that included in our general expenses is servicing costs associated with our deposit book and our Street Solutions book. It's not part of net interest income. So they naturally would go up as the balances on the balance sheet will go up.

Brenna Phelan

So that's this modest growth is expected to offset the decline in the FTE count from the restructuring?

Marissa Lauder

Yeah. The FTE count. So there's servicing and other expenses we have for our strategic initiatives. But overall, trying to be very modest with our expense growth.

Brenna Phelan

Okay. Thank you very much.

Duncan Hannay

Thanks, Brenna.

Operator

Ladies and gentlemen, there are no further questions. This concludes your conference call for today. We thank you for participating and ask that you please disconnect your line.