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Street Capital Group Inc.

Fourth Quarter and Full Year 2016 Financial Results Conference Call

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PRESENTATION

Operator

Hi, everyone. Welcome to Street Capital Group's fourth quarter and full year 2016 financial results conference call.

As a reminder, this call is being recorded on Wednesday, March 8, 2017.

At this time, all participants are in a 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 up for questions.

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

I will now 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, Street Capital Group Inc.

Thanks, Kelly (phon). Good morning, everyone, and thanks for joining us today. I'm joined on the call today by Ed Gettings, Chief Executive Officer of Street Capital; Lazaro DaRocha, President; and Marissa Lauder, Chief Financial Officer.

Street Capital Group's fourth quarter and full year 2016 financial results were released today. The press release, financial statements, and MD&A are available on SEDAR, as well as on our website at 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, 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. These statements 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, and employment conditions that may impact the Company, its mortgage origination volumes, 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.

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 Ed Gettings, Chief Executive Officer of Street Capital Group.

Ed Gettings — Chief Executive Officer, Street Capital Group Inc.

Thanks, Jon. Good morning, everyone, and thank you for participating on today's call.

I am pleased to report that we have accomplished the three primary objectives that we set for ourselves in 2016. Our first objective was to advance our Schedule I bank application through to completion. We received approval December 13th of 2016 and began operating as Street Capital Bank Canada on February the 1st, 2017. The receipt of our Schedule I bank license concludes a four-year process for our company and represents a significant milestone in our long-term strategy.

Our second objective was to grow mortgages under administration and hold our market share in the mortgage broker channel. We ended Q3 2016 in the number three position. For your information, we're just receiving the current—the Q4 market share, and we'll have some commentary on that once we've been able to open that up.

We successfully grew mortgages under administration by 12 percent to $27.7 billion from $24.75 billion at the end of 2015.

Our third objective for 2016 was to continue to generate renewal volumes of roughly 75 to 80 percent of loans eligible for renewal. In 2016, we renewed $1.43 billion of mortgages, which is close to 75 percent of those available for renewal.

In 2017, we will set the stage for significant sustainable revenue and earnings growth as we begin to build our bank product suite and benefit from significant growth in renewals.

In 2017, we have five key objectives. Our first priority is to launch our uninsured mortgage product. We expect to make our first loan in early spring.

Second, we will seek to maintain a number three or number four market share position for insured mortgages in the mortgage broker channel.

Our third goal is to maintain renewal levels at 75 to 80 percent as a percentage of the mortgages available for renewal.

Our fourth objective in 2017 will be on building our credit card capability in preparation for a 2018 launch.

And finally, as always, we will maintain our focus on strong underwriting practices in order to sustain our leading credit quality.

We have built a substantial brand in the industry with over 130,000 customers and key broker relationships as a base. We are ready to leverage our leading brand into a multiproduct, multichannel opportunity.

I would like to thank all of our long-term shareholders for their continued support. We expect Street Capital Bank will drive significant value for shareholders in the coming years.

And now I'll turn the call over to Marissa for some additional commentary.

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

Thanks, Ed, and good morning, everyone. I'm pleased to present our 2016 fourth quarter and year-end financial results. I'll first provide highlights of the fourth quarter, then provide a review of the full year results, and end with a discussion of what we're currently seeing moving into 2017, 2018, and into 2019.

So beginning with Q4 results, adjusted diluted earnings per share in Q4 was $0.02 compared to $0.04 last year.

We sold 2.5 billion of mortgages in Q4 compared to 2.14 billion in the same period last year. Of the Q4 2006 (sic) [2016] total, 360 million were renewals, and as expected this was lower than the 590 million we renewed last year.

Net gain after acquisition costs on the sale of mortgages in the quarter were 14.06 million compared to 16.42 million in Q4 of last year. The decrease in gains on sales, despite higher mortgage sales, is mostly due to the expected lower relative proportion of renewals this year of

14.6 percent of total sales compared to 27.5 in Q4 last year. As we have mentioned before, renewals have lower acquisition costs than new mortgages, and therefore earn higher profits.

Gross gains before acquisition costs as a percent of mortgage sold was 166 basis points in the quarter compared to 167 basis points in Q4 2015, and down from 184 basis in Q3 2016. Most of the decline in the ratio from Q3 2016 reflects the narrowing of spreads between market mortgage rates and MBS and CMB rates in Q4.

Our acquisition expense ratio increased to 109 basis points in the quarter compared to 90 basis points last year, primarily due to the lower levels of renewals.

Given our current primary business model of originate to sell, we measure our expense efficiency by the ratio of operating expenses as a percentage of mortgages sold. In Q4, this ratio was 47 basis points, down from 54 basis points last year.

Now turning to a review of the full year results for 2016. For the year, adjusted diluted earnings per share was $0.13, and as expected this is down from $0.21 in 2015.

For the full year, we sold $9.37 billion of mortgages compared to 9.04 billion in 2015. And as we projected at the outset of the year, our 2016 renewals of 1.43 billion were lower than the 1.77 billion we renewed last year.

Net gains after acquisition costs on the sale of mortgages in 2016 were 68.41 million compared to 76.07 million in 2015.

Our gross gain on sale ratio before acquisition costs was 178 basis points for the 12 months compared to 182 basis points in 2015, and within our guided range of 178 to 182 basis points over the 12-month period.

Our acquisition expense ratio was 105 basis points compared to 98 basis points last year. The higher ratio mostly reflects the expected lower proportion of renewals.

Our expense ratio increased to 50 basis points compared to 48 basis points last year, and this is mostly due to a higher cost base associated with our bank-ready activities and the organizational changes made in 2016 that added people costs.

Moving on to some forward-looking information. This quarter we introduced more granular guidance and extended our forecast through to 2019. I would just like to take a minute to remind listeners that forward-looking information I am discussing requires management to make certain estimations and assumptions, and our forward-looking information is subject to change as conditions change or more information becomes available. Please refer to the forward-looking information section in our MD&A, published on our website and available on SEDAR for more information.

As we've been saying for some time, we expect the upward trend in renewals to resume in 2017, with renewal volumes increasing to 1.8 billion to 1.9 billion in 2017 compared to the 1.43 billion we renewed in 2016. We also expect it to continue to grow to 2.4 billion to 2.6 billion in 2018 and to 2.6 billion to 2.7 billion in 2019.

When we launch our uninsured mortgage product this spring, we expect to originate 150 million to 200 million of uninsured mortgages in 2017, rising to 600 million to 700 million in 2018 and to 850 million to 950 million in 2019. This product is expected to earn a net interest margin in the range of 2 to 2.5 percent, and that includes a conservative provision for credit losses. While we expect our expense ratio to increase marginally in 2017, we carefully are managing expenses and expect to achieve positive operating leverage into 2018 and 2019.

Now while there is some uncertainty about the level of prime insured mortgage origination volumes that we expect in 2017, given the mortgage insurance rule changes, right now we continue to believe that a decline of up to 10 percent compared to 2016 is possible. We expect the softness—any softness in new prime insured activity will be offset by a growing level of renewals and the introduction of our uninsured lending product, which could potentially capture some of the previously insurable product.

So when I put all of this together, in 2017 we expect adjusted EPS to be flat to a 5 percent growth over 2016. In 2018, we anticipate a 30 to 35 percent growth over 2017. And finally, in 2019 we expect a 40 to 45 percent growth in EPS over 2018. We have lowered our growth estimations from our last report in Q3 2016 to reflect a more conservative of prime insured mortgage activity.

Before I close, I would also like to draw your attention to our tax loss carryforward balance, which was 333 million at December 31st. This represents real and sustainable advantage for the Company, as we currently are not paying any cash taxes.

With that, I'll pass the call to Lazaro.

Lazaro DaRocha — President, Street Capital Group Inc.

Thanks, Marissa. At Street Capital, we are focused on credit quality as our number one priority.

As in the past, our credit quality continues to be strong. At December 31st, the serious arrears rate on our portfolio of mortgages was 11 basis points, well below the CBA performance. This is also below last year, which at 14 basis points was also a very good rate on a well-seasoned portfolio.

At the end of December, at time of origination, the average Beacon score of our portfolio was 746. The average loan to value ratio was 81 percent, and the average total debt service ratio was 36.2 percent.

Now some comments on the recent mortgage insurance rule changes. As previously stated, the most material near-term items are the changes to the qualifying rate and the elimination of the mortgage insurance on most refinance transactions.

While January and February are our seasonally weaker periods for the industry, our volumes so far have been consistent with 2016. However, this is early in the year and before the spring season. It is difficult to predict with any certainty the ultimate effect of these recent changes.

As we have some liquidity options that will mute the impact of reduced insurance availability, as Marissa indicated, we continue to expect the insurance rule changes to have a relatively modest impact on 2017 originations of up to 10 percent decline compared to 2016.

From a net earnings perspective, we have two primary tailwinds that will help mute the impact of the reduced mortgage insurance availability. First, the reduction in the originations will be more than offset by strong growth in renewals, as the profit on renewals is approximately 2 to 2.5 times higher than the profit on new originations. Renewal volume, as Marissa stated, is expected to be between 25 and 33 percent higher in 2017.

Second and most significantly, we launched Street Capital Bank of Canada on February 1st. We have already taken our first deposits, and expect to make our first uninsured loans early this spring, with credit cards to follow in early 2018. We are confident that the bank platform will not only enable Street Capital to diversify its funding sources, but more importantly allow it to raise its own funding for the expansion of products beyond an insured mortgage, thereby diversifying its revenue streams, and allowing it to more dynamically address any future disruptions to market conditions, be they regulatory or otherwise.

I'd also like to highlight that recently the Government of Canada announced a material increase to immigration targets for 2017, focused on economic immigration. In our view, this will continue to stimulate the demand for housing in Canada, as immigration has been a major driver of activity and price over the past several years. The 2017 immigration target has been set at 300,000, which, ignoring the onetime refugee increase in 2016, represents about a 20 percent increase from 2016.

As we have been saying for some time, Street Capital's strategic imperative is not to materially increase its market share of insured mortgages in the broker channel. We will seek to maintain our number three or four position in that channel while focusing our energy and capital on building our banking platform and, in the coming years, expanding into a full suite, retail lending financial institution.

In closing, we feel very excited about the future. Street Capital has embarked on the next phase of its life cycle, a phase that will see it grow from its inception as an unregulated monoline lender to a full suite, retail lending, federally regulated financial institution.

While headwinds will always arise in the market, we enter 2017 confident that we have set Street Capital up to tackle those headwinds straight on from a position of strength.

At this point, I'm going to pass it back to Ed Gettings, who has some comments on recent market share information.

Ed Gettings

Thanks, Lazaro. As I indicated earlier, we were actually in the process of receiving the Q4 lender insights published by Davis + Henderson.

So the first thing I'd like to say is that there has been a reclassification in terms of how they calculate market share. In all prior reports, MCAP and RMG would have been reported as individual brands. They have now classified and combined those two lending brands into one. So that obviously has some implications in terms of priority of market share.

So Street Capital for the quarter of—the last quarter of 2016 achieved a 9.1 percent market share, and that put us in the number four position. And that compares to 9.6 percent for Q3.

On a full year basis, we achieved an 8.8 percent market share, which put us in the number four position for the full year. And that compares versus an 8.7 percent for all of 2015.

So as we said, we are achieving—we are striving to maintain the goal of steady the market share in the channel, and I would say that we were successful in terms of doing that.

On a go-forward position, however, given the reclassification of MCAP and RMG, we will alter our target to maintain the number four position in the market share—in the broker channel.

And with that I would like to turn it back to Jon for final comments.

Jonathan Ross

That's great. Kelly, we can open the line for questions.

Q&A

Operator

Sure. At this time I would like to remind everyone if you would like to ask a question, please press *, then the number 1 from your telephone keypad.

Your first question comes from the line of Dylan Steuart from Industrial Alliance. Your line is open.

Dylan Steuart — Industrial Alliance Securities

Good morning, everybody.

Marissa Lauder

Good morning.

Ed Gettings

Morning, Dylan.

Dylan Steuart

Just a quick question on the market share. I mean, second straight quarter of pretty strong results and a nice rebound from the beginning half of 2016. I guess are you confident that the improvements to broker customer service have really started to take hold here?

Ed Gettings

Yeah. Again, just to remind everybody, we made operational changes in Q1 of 2016. We honestly did not get the change executed as well as we would like to have. We suffered in Q2. We felt very confident, though, that our service levels have returned in Q3 and Q4, as borne out by the market share. So I'm confident we are back in the good books with our brokers and we're delivering appropriate service levels.

Dylan Steuart

Okay. Perfect. And I just want to clarify, just on the margins, I know you talked about the relative amount of renewals and some market conditions, but just wondering was there any promotions to brokers? Or anything like that weighing on the margins? Just in light of, sort of, the strong originations we saw.

Lazaro DaRocha

No. We didn't have—Dylan, it's Lazaro. We didn't have anything out in the market that wasn't just matching what was in the market, whether it was rate to the consumer or a commission to the broker. So no, we didn't have anything—we weren't buying market share if that's where you're getting at.

Dylan Steuart

Okay. No. That's perfect. And I guess, just finally, just on the refinancings, I know—I believe you guys have introduced a different priced product. Just wondering how—I know it's early days of the new rules, but just wondering how the pickup in your refinancings are going?

Lazaro DaRocha

Well, certainly we've seen a slowdown in refis. As we said on the call, we expect new originations in total to—that they could drop up to 10 percent in 2017. Obviously, the bulk of that would be refinances.

As I said in my part of the statement, so far through January and February of 2017 we're actually flat or a little bit ahead in total new originations compared to the same quarter last year. However, it's very early days.

To your point, yes, we've absolutely seen a significant drop in refis currently. However, it's been made up in other areas, such that our total originations is slightly ahead from last quarter.

Dylan Steuart

Okay. That's great. I'll requeue it. Thanks very much, though.

Operator

Again, if you would like to ask a question, please press *, then the number 1 from your telephone keypad.

Your next question comes from Jaeme Gloyn from National Bank Financial. Your line is open.

Jaeme Gloyn — National Bank Financial

Yeah. Good morning.

Ed Gettings

Good morning, Jaeme.

Jaeme Gloyn

First question—a few questions here. First one related to the renewals and the performance in 2016 and Q4 was that it was close to 75 percent. I was just wondering if there's—if you could sort of describe why it was close to and not in that 75 to 80 percent range? And then have there been any changes or investments made to get that number into the range for 2017?

Lazaro DaRocha

Jaeme, it's Lazaro. So close is absolutely accurate. I would say—I don't have the exact number in my head, but it's pretty darn close. It's a rounding error, I would say, to 75.

Have we made some changes? Yes. In October, we made some material operating changes. As you know, it is our funders who decide which subservicer that they wish us to use. With one of our funders—one of our largest funders, the subservicer that they used up until October did not have facilities in the Ontario GTA area, and where they were subservicing from was showing a very big lag in terms of their renewal performance versus our other primary subservicer. So in October, they—through the summer they were working on setting up the operations in the GTA area. In October, it went live. And since then we've seen some material improvements in performance on that book, and therefore we're comfortable with the target. I believe we have, Marissa, 78—sorry, what is our—75 to 80 percent?

Marissa Lauder

75 to 80, yeah.

Lazaro DaRocha

So we feel comfortable about achieving that target in 2017 as the performance of that one servicer has started to get to those levels.

Jaeme Gloyn

Okay. Interesting. Appreciate that extra colour. Want to jump to the outlook section related to the uninsured mortgage.

The originations seem to be a little bit higher than what I was expecting, that's number one. I was just wondering if you could give a little bit of guidance around that.

And number two is the estimate of margins, which includes some level of PCLs. Just hoping you can give a little bit of colour as to what you're anticipating with PCLs. I believe you've said before that it's about 25 basis points, but how you're arriving at that 2 to 2.5 percent margin level would be great.

Ed Gettings

Well, on the pricing side, so how we get—to be clear—the 2 to 2.5 percent is the coupon on the mortgage, less our expected cost of funds, less our PCLs. Yeah, you're accurate. We have in the past, and that is our target underwriting criteria is targeted at a PCL of 25 basis points. We have built a very detailed underwriting guideline-pricing matrix using rates are in the market for similar products. We have a very good handle on what our cost of funds is now that we've launched our own GIC products, and those are conservative estimates of the numbers that have fallen out of that mathematical equation of those three items.

Jaeme Gloyn

Okay. So yeah, just to get a little bit more colour then on the GIC rates and on what you're doing with the mortgage rates themselves. If you look at some of the competitors in that space, I mean they're generating NIMS that are above 2.5 percent, generally speaking. So where are you relative to those competitors, let's say the larger competitors, on GIC rates and mortgage rates?

Ed Gettings

Well, again, when we create a plan, we create a plan that we believe we can deliver, and the reality is that we're the new kid on the block on the GIC rates, so we anticipate having GIC rates that are a few basis points higher than our direct competition, which I would not include as the big banks, but the smaller institutions such as Equitable and Home (phon), and we believe that to track the liquidity, we'll need to, at first, while we're building our brand in that product, to be out there with a slightly higher rate. So that's a bit of a drag on our rate compared to others. But that, quite frankly, is quite marginal because you're talking a few basis points.

The reality of it is we want to be very conservative in terms of the credit quality of what we launch. And so while you are accurate about the equivalent spreads of our competitors being higher than we are saying, we anticipate operating closer to the almost prime segment of that Alt A space, at least to begin with, and that comes with a lower consumer rate. We do not—we want to walk before we run. We do not want to launch at the lower end of the curve there, so that is why you're seeing our NIMs being in that 2 to 2.5 percent range.

Marissa Lauder

Jaeme, it's Marissa. Also, you have to consider that if you're looking at some direct competitors who might be in this space, their net interest margin is reflective of a very, a very small PCL right now as we're at a good point in the credit cycle. So the 25 that we're using is probably quite high.

Jaeme Gloyn

Yup. That's fair. Thank you. So next question related to the spreads in the mortgage market, the mortgage spreads. Have you seen those return to more normal levels? And is that the guidance for 175 to 180 versus the 166 in Q4? And how is pricing on previously insurable mortgages been impacted versus let's say Q3, or the rest of 2016?

Marissa Lauder

Jaeme, it's Marissa. On what we're seeing in the spreads right now is we saw a little bit of softness in January, but it has started to return to higher rates through February and the beginning of March.

Lazaro DaRocha

And it's Lazaro. In terms of the mortgage rates on, I guess, in particular, refinance transactions that no longer qualify for insurance, I would say you've seen some separation of pricing now between what I call the monolines and the banks where absolutely the monolines have taken rate, ourselves included, have taken rates up on refis anywhere between 15 and 25 basis points, whereas the banks have not, and that is the cause of what I said earlier. We have seen a significant drop in refis for us, and we would imagine the same is the case for other lenders in the space who have priced themselves what I would call slightly out of the market.

Jaeme Gloyn

Yeah. I guess my question is then now—let's just focus on refis then, since we're on that topic. The premium that you're receiving from your investors, has that been impacted? Or is the spread still the same?

Lazaro DaRocha

No. We're getting the same premium from our investors. Even though the volumes that they would get for those products are down dramatically, we are still getting the same premium. They would obviously earn a bigger spread, given that there is a higher rate on that product. However, the reality of it is that those price increases—the impact of those price increases has made very little impact on P&L, because the volume has dropped dramatically for that product.

Jaeme Gloyn

Okay. Great. That's good colour. Last one for me for now. Just on your colour around January and February originations being flat to the previous year. Is that partly because of your weak—I guess it was a little bit of a weak quarter last year? Or are you actually seeing potentially some increased market share? And I'm basing this comment on commentary from one of your other competitors in the prime space suggesting that they're feeling significant headwinds from Vancouver. So just a little bit of colour there?

Lazaro DaRocha

Yeah. It's hard to say where our market share is going in Q1, because I don't have a good handle. I don't think anyone does in terms of what's happened to the market overall in terms of a reduction in volumes. I know absolutely Q1 for the market must be down over the prior year, given what I've spoken to with several other people, but it's really hard to say.

All I can say is our volumes are flat to slightly up in through February, and our anticipation is Q1 will be flat to slightly up. And then if the rest of the market is down, then that'll mean market share increase for us. That's just basic math.

In terms of your statement around Vancouver. We haven't seen the same sort of drag on our book in Vancouver. Now my view—Vancouver—our average mortgage size is $350,000. We were never playing in that segment that was driving such high price appreciations in Vancouver. So all I can tell you right now is our Q1 is looking good compared to last year.

Unknown Speaker

Okay. Great. That's good colour. Appreciate it, guys.

Operator

Again, if you would like to ask a question, please press *, then the number 1 from your telephone keypad.

Your next question comes from the line of Stephen Boland from GMP Securities. Your line is open.

Stephen Boland — GMP Securities

Morning, guys. Two quick questions. Just going into the uninsured origination guidance, what would be the split of 2018–'19, in terms of one-, three-year, five-year paper? What—is that going to be pretty consistent over those three years?

Ed Gettings

Yes. Yeah …

Stephen Boland

Or do you anticipate a change?

Unknown Speaker

No. We haven't built in any difference in anticipation of term split from one year to the next. We believe that roughly 80 percent of the product will be in the one-, two-, and three-year, which is pretty consistent with our peers in that space.

Stephen Boland

Okay. That's good. And secondly, just on—you mentioned you have taken your first deposit, which is great. How many boards or what's the plan in terms of how many boards you're—are you on several right now? And where you see that expanding throughout this year?

Lazaro DaRocha

Well, we—I won't give you an exact number. I will say we just started the process in—come Feb 1. We couldn't sign up, and regardless of who told us they were interested, no one—you couldn't get to a contract with anyone until Feb. 1. So we've got some on already, and obviously our goal is to increase that as much as we can in short order. We have a couple more coming in, in the month of March, one of those being—or sorry—both of those being a pretty decent, big-size name brands in the space that everyone would know.

So our concern around uninsured mortgage volumes is not the ability to raise deposits, because our volume estimates are quite—you know, they're quite conservative and reasonable. If we're going to have any challenge, it's going to be keeping the demand down because we do have to lift to an OSFI limit. And if we have a challenge, it will be we have too much demand as opposed to we can't get enough GICs to fill that demand.

Stephen Boland

Okay. And finally, just to be … For your three years, you're comfortable that you have the infrastructure and the underwriting capabilities in house to do that kind of volume growth going from the 150 to the 850.

Ed Gettings

Steve, it's Ed. We have a separate underwriting team that's set up to do this uninsured product, and, yeah, we are comfortable. We may have to add some bodies as we grow in year two and year three, but it's going to generate revenue for us, so it's going to be positive operating leverage for us.

Stephen Boland

Okay. That's great. Thanks very much, guys.

Operator

And there are no further questions at this time. I turn the call back over to Mr. Ross for closing remarks.

Jonathan Ross

Just wanted to say thanks to everyone for participating on the call today, and obviously if there are any questions throughout the day, feel free to reach out to myself.

Thanks, and enjoy your day.

Operator

And this concludes today's conference call. You may now disconnect

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