FINAL TRANSCRIPT

Street Capital Group Inc.

Second Quarter Results

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PRESENTATION

Operator

Hello, everyone, and welcome to the Street Capital Group's 2015 Second Quarter Financial Results Conference Call. As a reminder, this conference call is being recorded on Wednesday, August 12, 2015. 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 star, followed by zero 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, Chris. Good morning, everyone, and thanks for joining us today. Street Capital Group's 2015 second quarter 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 I pass the call over, we would like to remind listeners that portions of today's discussion contain forward-looking statements that reflect current views with respect to future events, such as Street Capital Group's outlook for future performance. Any such statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected in these forward-looking statements. Undue reliance should not be placed on such statements. Certain material factors or assumptions are implied in making these statements and actual results may differ materially from those expressed or implied in such statements.

Factors that could cause actual results or events to differ materially from current expectations, among other things, include risks related to market factors, no assurance that Street Capital will receive regulatory and shareholder approvals to operate as a Schedule 1 bank, and other factors discussed in materials filed with applicable securities regulatory authorities from time to time, including matters discussed under Risk Factors in the Company's Annual Information Form for the year ended December 31, 2014. Street Capital Group does not undertake to update any forward-looking statements, except as required.

I will now the pass the call over to Alan Silver, Chairman of Street Capital.

Alan Silver – Chairman, Street Capital Group Inc.

Thanks, John. Good morning, everyone, and thank you for participating on today's call. I'm joined on the call today by Ed Gettings, CEO of Street Capital, and Lazaro DaRocha, President.

Just before Ed and Lazaro take you through our formal remarks, I wanted to thank shareholders for their support in bringing us to this point in time. Street Capital stands out for its strong performance and low-risk profile amongst its peers, it always has, and it is thanks to Ed, Lazaro and their team.

I would like to point out that we have added some additional disclosure this quarter versus what was provided in the past, in a consistent effort to be more transparent.

The exemplary leadership of Ed and Lazaro has brought Street Capital so far and I look forward to the months and years ahead, as they focus on turning Street into a sustainable, diversified financial institution.

With that, I will hand the call over to Ed to discuss our performance this quarter.

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

Thanks, Alan, and good morning, everybody. Revenue grew by 71 percent in Q2 2015 to $26.2 million from Q2 2014. For the first six months of this year, revenue was $40.5 million, up 58 percent from last year.

Adjusted diluted earnings per share in Q2 2015 was $0.09, compared to $0.04 in Q2 2014. For the first six months of 2015, adjusted diluted EPS was $0.12, compared to $0.08 in the same period last year.

Adjusted return on equity was strong, at 30.6 percent in Q2 2015 and 21.5 percent for the first six months of this year. This is significantly above last year’s level, primarily driven by strong revenue growth this year due to higher loan volumes, both new funded and renewals, as well as a slight uptick on gain on sale rates.

I’d also note we generated strong bottom line profitability and return on equity, even though we are carrying roughly $800,000 in additional operating expenses every quarter related to the bank platform that we have built out. Street Capital maintained its number three position in the broker channel in Q2, as well, with a market share of 10.3 percent during the quarter.

We also sold $3 billion of mortgages during the second quarter, compared to $1.9 billion in Q2 2014, a 54 percent increase. Our gain on sale as a percentage of mortgages sold in Q2 2015 was 190 basis points, which is higher than the margin realized in Q2 2014 of 184 basis points. The modest increase in gain of sale percentage is due to wider spreads in Q2 of this year, compared to last year.

Acquisition expenses totaled $30.5 million in Q2 2015, an increase of 52 percent over the $20.1 million incurred in the same period one year ago. As of June 30, 2015, our mortgages under administration were $23.4 billion, an increase of approximately $4 billion from a year ago.

We are also focused on generating renewal rates to achieve our 80 percent target. Mortgage renewals provide incremental profitability, because the acquisition costs on renewals are minimal. Renewals accounted for roughly 16 percent of loan sales in the current quarter versus approximately 11 percent in Q2 2014.

The strong uptick in revenue for the first three and six months of the year was partly due to above-trend renewal volumes in 2015. Renewals are above trend this year because they reflect both five-year terms originated in 2010, and higher than usual renewals of four- and three-year terms originated in 2011 and 2012, respectively. This is a result of promotions we implemented in those years to meet investor demand for three- and four-year product. Moving into 2016, renewal volumes will revert to normalized trends, being limited to primarily five-year terms originated in 2011. We expect this to translate into approximately 15 percent lower renewals in 2016, compared to 2015. The key message here is that 2016 is a normal year, 2015 is elevated.

Our application to the Ministry of Finance to operate as a Schedule 1 bank is progressing and, as I mentioned last quarter, our next major milestone is the OSFI on-site visit, where OSFI staff will review our control environment and look at how we operate day-to-day. We expect this visit to occur sometime this fall and hope to receive approval to operate as a bank shortly thereafter.

As at the end of the second quarter, the average Beacon score of our portfolio was 742, the average LTV was 82 percent, and the average total debt service was 36 percent.

I'm very pleased with the results we generated in Q2 and I look forward to continuing to advance our core business and the bank application through to completion.

I'll now turn the call over to Lazaro DaRocha.

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

Thanks, Ed. Good morning, everybody. I'm going to step back a little bit and speak about the strategy at Street Capital in broader terms. Ed and I have worked together for a very long time. Together, we've grown Street Capital from its inception in 2007 to $23.4 billion in mortgages under administration at this point in time. We're going to keep growing our current prime insured business. We are just over 10 percent of the broker channel and, based on estimates that the broker channel represents 25 percent of the mortgage originations in total, that represents roughly 2.5 percent of the overall mortgage market, so there is room to grow.

However, I want to touch on our business model, because I don't feel it's necessarily well understood by everyone out there. While we have produced strong growth in insured mortgages since inception and still see opportunity to grow, significant volume growth in insured mortgages is not our focus. The real opportunity for Street Capital that we are focused on is creating a diversified retail lending platform, expanding our product suite to include higher yielding assets, such as uninsured mortgages and credit cards, upon becoming a bank.

As well, I want to point out that at Street Capital growth has always been accomplished hand-in-hand with stringent underwriting practices, one mortgage at a time. Frequently, we are asked if ultimately we own any risk on the loans that we underwrite. Technically, the answer to that is no, given the funding model and the fact that we originate only insured mortgages, but in the same breath I will say that we always underwrite as if we own the loans that we sell to our funders. This is really important and it is where we have a significant competitive advantage. Our funders are third-party regulated financial institutions and we have developed those relationships over many years. We make sure that those funders are getting the best paper available, and the stats prove that out.

At June 30, the serious arrears rate on our portfolio of mortgages was 16 basis points, which is well below the high-20/low-30s reported in CBA stats, which are the default stats within the bank branch business. This is even lower than last year, which was 26 basis points, and that was a very good year in of itself. But serious arrears isn't the only metric where we outperform. CMHC uses an early default rate to assess default within nine months of origination. This is a key measure of underwriting quality and Street Capital's early default rate has consistently been zero for some time now.

Well, how do we accomplish this? First of all, we hire the best underwriters and pay at the top end of the scale to ensure we attract and retain the best. We also staff at levels that allow underwriters to focus on getting the decision right. This certainly costs us more, but it’s worth it. On average, our underwriters do less than six deals per day, which is a fraction of the industry average.

We also invest significantly in quality assurance. QA is another form of audit. Our pre-funding QA department refuse approximately 40 percent of all deals before they even fund. This is far, far above industry standard. What this means is, in effect, 40 percent of our deals are re-underwritten by audit before we even fund them. All new brokers have 100 percent of their files QA’ed on a prefund basis for a significant period of time when they join us. It is only after we are happy with the quality that they get removed from the prefund QA pipe. We also conduct a significant amount of QA post funds. The brokers we work with are continuously monitored throughout their relationship with us and we ensure the integrity of this process by keeping the risk management, sales and underwriting teams completely separate and compensated differently.

In conclusion, I’d like to say that we are very much looking forward to taking our Company to the next level, and we are right on the cusp of that, but one thing that will not change or in the future is the fact that our culture is set up to live and breathe credit quality.

At this point, I’d like to ask the Operator to open the lines for questions. Thank you.

Q & A

Operator

At this time, if you'd like to ask a question, please press star, one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from the line of Jeff Fenwick from Cormark Securities. Your line is open.

Jeff Fenwick – Analyst, Cormark Securities

Hi, good morning, everybody.

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

Good morning, Jeff.

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

Good morning, Jeff.

Jeff Fenwick – Analyst, Cormark Securities

I just wanted to follow on with those comments about your underwriting practices there, with a little more discussion on the broker channel. It's obviously front of mind given what's happened at Home Capital. So, when that news came out, did you go back and do some incremental investigation around that specific issue they'd had, and are you aware of the specific brokers that Home had terminated from their platform and were you dealing with those guys, and if so, what actions have you taken?

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

Well, I can tell you that we're only aware of the individual names to the extent that they're publically available. However, I can tell you that regardless of this Home Trust issue, we have managed the broker sign-up and monitoring process extremely tightly for many, many years now. At the end of the day, it is our QA area and our audit area that manages approval of the process, as well as the individuals that are signed up. They go through an extreme amount of due diligence upon issuing the significant portion of their files, to begin with, and anything that has ever in the past been a problem has been dealt with immediately.

To speak to the individual problem at Home Trust, I don't think is really my place. I can tell you that one of the most significant indicators of whether or not you have frauds in your portfolio is a measure that CMHC has, which is called Early Default. That means a file goes into default within the first nine months of origination. If that happens, there usually was a problem. I can tell you that, for at least two years now, at Street Capital, our early default rate has been zero, and that obviously is extremely good and much better than the industry average.

Again, I don't want to speak directly to anything at Home Trust; however, I can tell you that as far as the issues that have been made publically available, those issues do not, I repeat, do not exist at Street Capital.

Jeff Fenwick – Analyst, Cormark Securities

Okay, and maybe we'll move on to the next subject then. Restructuring costs in the quarter, they came in at $12 million, which was a little surprising to me. You had previously guided towards the end of June to a $7.5 million number there. I'm just wondering why there was such a large discrepancy.

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

That's right, and this is purely a timing issue and not a total quantity issue within the fiscal 2015 period. The original assessment was $7.5 million. That assessment was based solely on the specific severance costs of several executives and employees. However, the termination obligations of those agreements have those executives staying on until the end of the year. Therefore, for accounting purposes, and in talking with our auditors, it became clear that we also needed to accrue for the remainder of their salaries through the rest of the year, as well as what they are entitled to for their bonuses for the fiscal year, but that ended up being roughly an incremental $4 million, and I can tell you that's purely timing. So, instead of absorbing that salary expense and that bonus expense in the remainder of the year, it was just accelerated into Q2.

Jeff Fenwick – Analyst, Cormark Securities

Okay, and I guess to follow on, logically, from there, then, is we can expect a step-down in SG&A of relative magnitude there in Q3, starting in Q3?

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

Well, you should—I don't see at the end of the day—for that direct item, yes; however, perhaps not in total, because we continue to hire as we are right on the cusp of becoming and getting our bank licence. So, in totality, you may see it go up, but it is absolutely offset by that number.

Jeff Fenwick – Analyst, Cormark Securities

Then, one other item I noticed in the quarter, it looks like a new credit facility there that you had secured, so maybe you can give us a little background on that. It looks like it got several uses it can be applied against, including funding conventional mortgages. So, are you going to start to do some non-prime loans ahead of the bank status, I guess is maybe one question there, and any other colour you can offer on the use of the credit facility?

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

Okay, I'll start with the credit facility. So, we arranged through a syndicate of a few banks a credit facility that has three separate tranches, if you will. One is for insured mortgages, the other is for uninsured mortgages and one is just a general operating line. As you know, we became able to issue MBS last year. We've started that program in a small fashion, just to make sure all our processings are working well. So, the use so far has been through insured mortgages' section of that tranche, and we have issued some MBS in the market.

To be clear, that uninsured tranche, it's sort of a misnomer. It doesn't mean it's all to a business. It's prime—what will be eventually insured mortgages. Those are just the low-ratio mortgages that usually take about a month before you apply portfolio insurance on it. We just haven't utilized it because it's been more simple and easy to start MBS through the high-ratio insured stuff.

So, to answer your question, we do conventional mortgages all the time. There's about a 30-day lag of applying portfolio insurance on it, but that's nothing new.

To answer your final question, no, we will not be issuing any of our planned uninsured—permanently uninsured mortgage products until after becoming a bank.

Jeff Fenwick – Analyst, Cormark Securities

Okay, thanks for your answers. I'll let someone else take a turn.

Operator

Your next question comes from the line of Shubha Khan from National Bank Financial. Your line is open.

Shubha Khan – Analyst, National Bank Financial

Thanks. Good morning. The first question I had was with respect mortgage production, and I understand there was, I guess, higher than usual three- and four-year terms in 2011 and 2012 that drove stronger renewals this year, but, Ed, did you say that you expect renewal volumes to decline 15 percent year-over-year next year?

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

Yes.

Shubha Khan – Analyst, National Bank Financial

Okay, and is that for the full year?

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

Yes. So, you have to look at it that we pulled forward some renewals, because they were the three-year and four-year terms. We had the normal five-year terms from five years ago, but the three- and the four-year terms are coming through and causing a bit of a cohort bump in 2015, and we would expect that renewals would normalize, but would drop by about 15 percent going into 2016, and then be normal from there on in.

Shuba Khan – Analyst, National Bank Financial

Okay. So, that being the case, what proportion of mortgages sold in the back half of this year will be, I guess, comprised of renewals? Will it be 16 percent, like in Q2, or something higher than that?

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

I think that's—it might be slightly higher, but in that range.

Shuba Khan – Analyst, National Bank Financial

Okay. One other question, and that's on the tax expense. When I adjust the tax expense for the impact of restructuring costs, it seems like the effective tax rate on your core operations was north of 40 percent, and I'm wondering whether I'm missing any sort of significant non-deductible items that impacted the tax in the quarter, and going forward, would it still be appropriate to assume a statutory rate or will there be any discrepancy in the effective tax rate between (inaudible)?

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

Well, I think you must be missing something, because at the Street Capital level the effective tax rate is roughly about 26 percent. So, I will endeavour to reconcile what you're talking about offline and get you an answer.

Shubha Khan – Analyst, National Bank Financial

Okay. That's all my questions.

Operator

Your next question comes from the line of Dylan Stewart from Industrial Alliance Securities. Your line is open.

Dylan Stewart – Analyst, Industrial Alliance Securities

Good morning, guys.

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

Good morning.

Dylan Stewart – Analyst, Industrial Alliance Securities

A quick question just on the market share, obviously a very strong position once again, but just maybe you can give a bit more colour, as certainly we had heard indications that competition was increasing from some of the bigger players, but maybe just give me a little bit of colour on what you guys saw out there this quarter.

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

Yes, well, we're happy with the fact that we went up in market share, obviously. We're consistently playing in the 9 to 10 percent market share range. In terms of competitive activity, in any given quarter you're going to have some players be a little bit more competitive, some players be a little bit less. We felt we had a very good sales focus on the second quarter and are happy with the loan production that we got.

Dylan Stewart – Analyst, Industrial Alliance Securities

All right, perfect. I appreciate the geographic disclosure this quarter, and certainly we see Alberta going down to a lower contribution to originations in the first six months, but I was wondering, on this quarter specifically, if you could give a bit of colour, just is it even a lower contribution than we saw in Q1?

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

It's about the same. To be clear, the drop in Alberta isn't a reflection solely of the Alberta market slowing down. What we did about a year ago, foreseeing problems, was tighten underwriting guidelines specifically within that region. So, you're seeing a very large drop year to date this year to last year, 23 to 15, and I would suggest to you the majority of that came because we tightened up under-writing guidelines in Alberta.

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

Just as another addition, we have an underwriting centre based in Calgary, so we—we have one in Toronto, we have one in Vancouver, but we like the geographic approach for our underwriting centres, because we do believe that it does give us better insights into the differences between the communities in any given region.

Dylan Stewart – Analyst, Industrial Alliance Securities

All right, and maybe just is there any more colour you can give us just on the bank licence application, and are your hopes for a timeline pretty much the same?

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

We are waiting for OSFI just to define the time that they will be in and, as I said in my comments, we expect that they will be in to do the on-site visit soon, and once we are through that, we would hope that we have our licence.

Dylan Stewart – Analyst, Industrial Alliance Securities

Just finally, just to clarify on the increased costs on the bank licence application infrastructure you're building, certainly, would you see a large bump up in costs once you're ready to roll with the bank charter going forward, or is the cost you're implementing today sort of setting you up to really ramp up operations quickly?

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

I think the cost structure—for all intents and purposes, we're somewhat operating like a bank right now, in terms of the compliance department, the risk management, anti-money laundering processes. There might be a slight uptick as we add a few more people, but I would think that our expenses would stay relatively flat, but with a slight uptick.

Dylan Stewart – Analyst, Industrial Alliance Securities

Okay, perfect. That's it for me, guys. Thanks very much.

Operator

Again, if you would like to ask a question, please press star, one. Your next question comes from the line of Stephen Boland from GMP Securities. Your line is open.

Stephen Boland – Analyst, GMP Securities

Morning, just a couple of quick questions. I appreciate the colour on your underwriting procedures, especially for new brokers, where you're seeing 100 percent MUA. Within that bucket—and obviously this is your experience, not Home Capital's—have you seen more incidents of—I won't say fraud, but fraud paperwork or incomplete paperwork …

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

No.

Stephen Boland – Analyst, GMP Securities

… and, really, just what's happening in the industry and the negative sentiment on the broker channel right now?

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

The short answer is, no, we haven't seen anything different through the first six months of this year than in any prior year. The reality of it is in this market there is, and always has been, a certain element of faulty paper flying around. We just believe we've been very good at weeding that out since the beginning.

The one thing that is public information that was stated by Home Trust in a call was that they've started doing income verification on letters. Well, income verification on letters has always been done at Street Capital. There's the rare exception, as you always have exceptions, but the vast majority, there's income verification.

Stephen Boland – Analyst, GMP Securities

Okay, and just a second question. Obviously, or I guess you're implying that you haven't had any fraudulent mortgages that you're aware of on your book. From any conversations you've had with your insurers, is there a demand to do more QA, is there—if there is an incident of fraud, do they have the right to put that mortgage back to you or do they have to wait for a claim? I'm just wondering what is the procedure if it does happen to you.

Lazaro DaRocha – Chief Financial Officer, Street Capital Group Inc.

Well, you have different questions there, so let me address them separately. Another a very different business model between us and the likes of Home Trust is that, as you know, the mortgages that we underwrite, we then to sell third parties—each of those third parties, two of them are large Canadian banks and one of them is a large US bank—and we have the luxury or the pain, depending on how you look at it, of having those funders have permanent audit of Street Capital. There's people here every month auditing us from these funders. All of these audits are always exceptional, and it shows in that our relationship with our funders just continues to grow, which is what allows us to continue to grow our business. Speaking specifically to the insurers, they all provide audits, as well, and our audits are exceptional on that case, too. As I said to you, it doesn't get much better than having an early default rate of zero.

So, have I had an explicit discussion with an insurer about a theoretical/hypothetical question on what would happen if they would find a problem with a file? Well, that is an issue that exists at any time, it's not specific to what has occurred with Home Trust, and the master policy with insurers are clear that, unless they find extreme negligence or complicity in the preparation of a file by an employee, the insurance would not be null and void. That being said, insurers always reserve the right, on a case-by-case basis, to make a final decision. But, we do not get those claim cut-backs at Street Capital, I'm not worried about it, and, to put a final comment on it, while a lot of external people have asked about this, the people that haven't asked about the Home Trust problem at Street Capital are our funders, because they know things are clean here due to their audits.

Stephen Boland – Analyst, GMP Securities

Okay, great, and just a second question. You mentioned the gain on sale had improved year-over-year. Where do you see that trend going maybe in the next quarter or two?

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

I think that we benefited from some wider credit spreads this quarter and I would expect that it's going to normalize to our historical level.

Stephen Boland – Analyst, GMP Securities

Okay, that's great. Thanks, guys.

Operator

There are no further questions in the queue. I will now turn the call back to John Ross for closing remarks.

Jonathan Ross – Head of Investor Relations, Street Capital Group Inc.

So, thanks, everyone, for participating on today's call. Certainly, we're here to help, so if there's anything else you need information on, give us a shout today, and we'll have a transcript of the call later this afternoon. Thanks and have a great day.

Operator

This concludes today's conference call. You may now disconnect.