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EQB.TO - Q2 2016 Equitable Group Inc Earnings Call

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CORPORATE PARTICIPANTS

Andrew Moor *Equitable Group Inc - President & CEO*

Tim Wilson *Equitable Group Inc - CFO*

CONFERENCE CALL PARTICIPANTS

Geoff Kwan *RBC Capital Markets - Analyst*

Graham Ryding *TD Securities - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. I'd like to welcome shareholders and analysts to Equitable's second-quarter 2016 conference call. We would like to remind you that certain forward-looking statements may be made on this call, including statements regarding possible future business and growth prospects. You are cautioned that forward-looking statements involve risks and uncertainties detailed in the Company's periodic filings with the Canadian regulatory authorities.

Many factors could cause actual results or performance to be different from those expressed by such forward-looking statements. Equitable does not take to update any forward-looking statements made by itself or on its behalf, except in accordance with applicable securities laws.

This call is being recorded for replay purposes. Is now my pleasure turn the call over to Andrew Moor, President and CEO of Equitable Bank. Please go ahead, Mr. Moor.

Andrew Moor - *Equitable Group Inc - President & CEO*

Thank you, Michelle, and good morning, everyone. Joining me is Tim Wilson, Chief Financial Officer of Equitable. Our MD&A and the slide deck at EQBank.ca, the Company's remarks, contain all the details of our Q2 results. To give deep insight into our strategies for building our franchise, and with that, shareholder value, we are planning an Analyst Day for Wednesday, November 16.

The second quarter was Equitable's best on record for franchise growth, as gains in market share and successful geographic and business plan expansions grow total mortgage originations past the CAD2 billion mark, 45% about last year's levels. Growth was achieved across the board.

Single-family alternative led the way, with originations of CAD953 million, up 49% year over year. As this portfolio is the most critical driver of shareholder value at Equitable, continuous growth that has brought single-family alternative mortgage principal well above the CAD7 billion, is important. A pleasant surprise were our commercial lending originations, which grew by 62% to CAD323 million, the best performance of this line of businesses in 17 quarters. We are working hard to make growth a consistent feature of our CAD2.4 billion commercial portfolio, and believe our prospects are very positive.

And on a 32% year-over-year increase in prime mortgage originations, which reached CAD500 million, securitization financing mortgages under management stood at a record CAD9.1 billion at June 30. These results reflect the tremendous work our teams are doing in executing on our long-standing approach of delivering exceptional customer service while maintaining high underwriting standards and operating efficiency. My sense is our entire business is focused on doing the right things to build a better Bank. Taking the Corporate level view, we continue to believe that how we allocate capital and price loans, as well as the efficiency of our branches' banking models, are critical elements in building shareholder value.

Second-quarter earnings amounted to CAD2.05 per share, a strong showing that fell just CAD0.01 short of the quarterly record set last year, when results included a per-share gain of CAD0.10 related to a securities transaction. Also of note when making year-over-year comparisons is the fact that Equitable spent more in this more recent period on strategic initiatives, CAD2.8 million more than in Q2 of 2015, or a cost to EPS of CAD0.13. These initiatives, including the launch of EQ Bank, place us in a fantastic spot, as the banking landscape evolves around us.

EPS grew 20% in comparison to the first quarter, when we incurred CAD2.6 million, or CAD0.12 of cost to support the successful launch of EQ Bank. This earnings increase reflected profitable asset growth, low losses, and sequentially lower levels of EQ Bank-related spending. All of this is good news.

As a result of strong earnings, the Bank produced a second-quarter ROE of 17.1%, which was broadly in line with our long-term ROE track record, in spite of higher costs to support strategic initiatives, and was well above the average of the big banks for the period.

Return on shareholders' capital is the financial metric that Management considers to be of central importance in creating shareholder value. I would point you back to the shareholders' letter in this year's Annual Report that puts that in a broader context. The quarter's results show we're on track with our longer term goals.

On stronger earnings and a positive outlook, our Board declared a quarterly common share dividend of CAD0.21 to holders of record on September 15, payable on October 3. This is an 11% increase over the dividend declared at this time last year. While growing our dividend, Equitable has continued to keep our earnings retention rate high and above the rates of the other banks, and our CET1 ratio is strong. We believe retaining capital is the right decision for our shareholders, while we still have good asset growth opportunities ahead of us.

This quarter, we also executed a transaction that transferred the risks and reward of our securitized prepayable mortgages to third parties, and allowed us to derecognize CAD253 million of assets from our balance sheet. This transaction helped the Bank to maintain its leverage ratio above the target levels.

As I mentioned at the outset, alternative single-family lending originations were up 49% year over year. While data on the size of this market is hard to nail down with precision, we believe that approximately one-half of this growth was related to the growth in the overall market, while the other half came from market-share gains. We're exercising discipline in our pricing and credit approaches to make sure we build a prosperous business.

Our single-family alternative business is continuing to see strong demand in the third quarter, which will continue to support continuing asset expansion, but with much of the recent single-family asset growth coming towards the end of Q2, disposed wealth and net interest income.

Sharing the limelight this quarter is our commercial mortgage lending business, which recently went through a rebranding effort and refined its approach to market with a goal of deepening and broadening distribution partnerships. The results are very promising, as I discussed at the beginning of my remarks. There isn't as much data available on market share in commercial, so it is harder to have a complete confidence in the market dynamics that are causing us to have success in building our book. I'm sure of one thing, however, that our teams are doing a great job of delivering the service our customers want and expect. This is certainly an important factor in our success.

The other significant driver of asset growth was securitization financing, where mortgages under management were up 34% year over year to CAD9.1 billion. Once again, performance was pushed higher by the ongoing development of our prime single-family mortgage business. During the quarter, we funded CAD0.5 billion of prime loans, 32% more than at this time last year. As a result, prime single-family mortgages under management stood at CAD2.9 billion at quarter-end, double the amount of a year ago.

Internally sourced prime originations in the quarter were CAD192 million, with the balance sourced through third parties. As expected, the growth of our internal business is taking time, but we are patient and progress to date suggests we're on the right track.

Active management of our credit risk profile and our workout efforts meant that Equitable's second-quarter credit performance is once again is best-in-class amongst Canada's Schedule I banks. Our provision for credit losses were less than 1 basis point of mortgage principal outstanding, down 3 basis points from the second quarter of last year.

At an aggregate level, net impaired mortgages increased CAD7.8 million year over year. That largely reflected one commercial loan of CAD7.3 million that is now resolved. Given current economic forecasts, we expect to raise rates and credit loss provisions to remain low for the rest of 2016.

In terms of our credit performance in Alberta and Saskatchewan, the MD&A sets out more details of our book in these provinces. We actually saw reductions in both early-stage delinquencies and impaired loans in these provinces compared to the end of Q1. Clearly, this is encouraging data, but we continue to be cautious in these regions that will continue to see rising unemployment and economic stress caused by low energy prices.

I'll return with closing comments in a few minutes, but first Tim will provide his report on our margins and expenses.

Tim Wilson - *Equitable Group Inc - CFO*

Thanks, Andrew. Second quarter unfolded as we expected, with strong growth in assets and net interest income. Net interest income was a record CAD67 million, up 10% from a year ago on an increase in our average asset balances in both core lending and securitization financing. NII grew at a double-digit rate, despite our net interest margin declining 17 basis points over the past year.

Even though margins within our alternative single family and commercial businesses have been relatively stable over the past year, overall NIM declines because of the continued shift in our asset mix towards our lower margin securitization financing business. I want to stress this important point. Marginal spreads in the businesses that generate the vast majority of our earnings have been more or less consistent.

Outside of the impact of the asset mix shift, NIM was affected to a lesser degree by other factors detailed in our MD&A, including a growth in high-rate EQ Bank deposits, low margins on prime single-family assets originated at certain points in the past year, and a decrease in prepayment [take-out]. Sequentially, net interest income was up by 5%, an increase that mirrored the 5% growth in our average mortgage assets.

NIM slightly exceeded our expectations, as prepayment income in core lending moved up quite substantially and NIM was only down by 1 basis point relative to Q1. Of note, the NIM in our securitization business was down by about 8 basis points in the quarter. This result surprised us a bit, and as we dug into the issue, realized that the NIMs were being influenced downward by some nuances in our calculation methodology.

Specifically, we use period-beginning and end-amounts to calculate average asset and liability balances. Those simple averages might not be reflective of the daily average balances, the ones that drive our reported income and expenses. This disconnect is particularly notable with a portfolio like securitization that involves a number of lumpy intra-period transactions, and as a result, our calculated NIM have exhibited some surprising volatility. The spreads on the underlying assets were much more stable quarter to quarter than the calculated NIM using our current methodology would lead you to believe. We will refine our NIM methodology going forward in order to present a more accurate picture of the portfolio's true economics.

Looking to the remainder of 2016, our outlook for net interest income is unchanged from the view we expressed on our last quarterly call. That is, we expect that it will increase at low- to mid-teen rates as the Bank continues to grow its assets. Core lending NIM in the second half of the year should remain around Q2 levels, while securitization financing NIM should expand slightly. With the portfolio mix skewing towards securitization financing, due to the growth of our prime business, and creating a negative mix shift, we would expect NIM in aggregate to continue coming down potentially by up to 5 basis points.

Moving on, current growth in the business, as well as investments in support of our key business strategies, led to significant increases in non-interest expenses compared to last year. These increases were planned and we believe create long-term value for our shareholders. Non-interest expenses, excluding the impact of strategic investments, increased 19%, or CAD3.9 million, year over year, and were 6% higher than in the first quarter. FTE was a primary driver of this growth.

We have added about 100 people in the past year and 21 in the last quarter alone. These are increases that are necessary to sustain the high levels of service and the appropriate level of risk management as we grow. Non-interest expenses to support strategic initiatives amounted to CAD3.4 million, 416% above last year's level, but down 40% from the first quarter, when we incurred significant costs to support the launch of EQ Bank.

Looking forward, outside of strategic initiatives, we expect non-interest expenses to continue increasing at year-over-year rates in line with the growth of the Bank for at least the next two quarters. Higher spending will be mainly driven by hiring. With respect to strategic initiatives, costs will likely be CAD0.5 million to CAD1 million higher in Q3 and Q4 as compared with Q2, due to the launch of some new EQ Bank marketing campaigns and continuing hiring. As a result of these investments, we expect our efficiency ratio will remain in the high 30%s for the balance of 2016.

Our capital ratios at quarter end all continued to surpass minimum regulatory standards and most industry comparables. We expect to continue operating above those benchmarks as we grow.

As Andrew mentioned, we entered into a transaction in the second quarter to derecognize CAD253 million of securitized prepayable mortgages. This was done expressly with a view to managing our leverage ratio, although we had the added benefit of booking a small gain on sale. We will continue to execute these transactions to the extent warranted by our asset growth and our leverage ratio position.

Now back to Andrew.

Andrew Moor - *Equitable Group Inc - President & CEO*

Thanks, Tim. 2016 will stand up as a transformative year for Equitable as a result of the launch of EQ Bank, and with it, a brand-new platform to serve Canadians, differentiate our Bank, and diversify our funding sources. Our belief was that there was a market for a born-in-the-mobile world digital bank offering in Canada. We are delighted to say that EQ Bank not only found this niche, it has captured it at a pace that is well beyond our own expectations.

EQ Bank Savings Plus Account deposit balances grew 25% from Q1 and now stand at more than CAD1 billion, even as we had to take steps to improve our service levels in the early going. Our call center is meeting our customers' demands, and we been diligently working on improving the customer experience within the digital platform. While we still have much to do to give our customers the full digital experience that so many are looking for, we are definitely making progress.

To summarize, this was a quarter which continued to demonstrate the value that we built in our franchise with our dedication to customer service, [careful] capital allocation, strong risk management, and the depth of a commitment of our team. The financial results are strong indicators that the assumptions we lay out in our value creation model, most importantly ROE, and the ability to deploy and retain capital are right. Our strategic position as a leader in digital banking should give us all confidence that the Bank is well-positioned for future changes in the industry.

That concludes our prepared remarks. I now would like to invite your questions. Michelle, can you please open the lines to our callers?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Geoff Kwan, RBC Capital Markets.

Geoff Kwan - *RBC Capital Markets - Analyst*

Hello. Good morning.

The first question I had is, in your MD&A, you talk about, and you've had this for at least a couple quarters, about the stress tests in Alberta and Saskatchewan, and in particular, the one where you talk about where there'd be price declines of 30% and a spike of unemployment of about 2 or 3 percentage points. How do you go about applying which of the mortgages wind up defaulting, presumably given a higher unemployment rate?

Andrew Moor - *Equitable Group Inc - President & CEO*

We have models. There's a multi-pack to stress test models, Geoff, that look a whole bunch of things that drive probability of default. They would look at, for example, loan-to-value is actually an indicator of defaults, so the higher the LTV, you've also got the higher probability of default.

And of course, underlying unemployment levels is another important factor in that model. Our portfolio analytics team, who run these stress tests look at those variables -- there's a number of factors in that probability to default calculation. I couldn't precisely define how many of them there are, but we could certainly get back to you with that detail.

Geoff Kwan - *RBC Capital Markets - Analyst*

Okay. Yes. What I'm trying to understand is, when you assume unemployment goes up by X, it's not necessarily -- I don't think there would be a correlation between the LTV and whether or not someone winds up losing their job. Because what I'm getting at --

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Andrew Moor - *Equitable Group Inc - President & CEO*

That is right. That's exactly right. You take it macro review of where unemployment is going, so we say, okay, unemployment goes up by 200 basis points or whatever the assumption in the model is. But it does -- but we also -- when we are looking across the portfolio, we're actually considering the probabilities on a mortgage-by-mortgage level to build up the total picture that we then give you.

We would assume -- the model would tell you that the higher LTV mortgages have a higher propensity to default, forfeit. If you just consider changing that single factor, which is obviously logical. If people's equity has been wiped away, they're less likely to be inclined to preserve it and keep paying their mortgage. So high LTV is correlated with higher probability of default -- higher across the entire portfolio, higher unemployment, of course, is correlated with higher propensity to default.

Geoff Kwan - *RBC Capital Markets - Analyst*

I'm assuming the models have built in -- because in Albert, if you have an uninsured mortgage at the time of origination, they have a greater ability, the US-style walk-way as opposed to insured in Alberta where they can't? I'm seeing the models adjust for that.

Andrew Moor - *Equitable Group Inc - President & CEO*

Geographic factors would be one of the variables. Also one of the factors actually is time to resolve, so you have a time to resolve that would be longer in certain geographies because of legal factors. Clearly, the need for -- it would take six months to resolve the mortgages in a western province, but it's clearly shorter in Ontario. The model would factor that in and so the things like the cost of maintaining a property that lost interest, interest foregone, would result in higher losses in those western provinces for an otherwise identical mortgage.

Geoff Kwan - *RBC Capital Markets - Analyst*

The reason I'm asking this question was I was just wondering is if you've ever gone through the exercise of going through probably your worst-case scenario in Alberta, let's say, what spike in employment that you get also happens to the loans that you have that would be the highest loan to values that's set for those price declines -- if you've run a scenario like that and what that does to your losses?

Andrew Moor - *Equitable Group Inc - President & CEO*

We've certainly run it. I wouldn't have the numbers at my fingertips to be able to communicate back to you exactly what that looks like, but certainly if you wanted to come back and ask a little bit more, we could get back to you with a little bit more color on that.

Geoff Kwan - *RBC Capital Markets - Analyst*

Okay. I can check in with Tim after on that.

Andrew Moor - *Equitable Group Inc - President & CEO*

Tim would have that.

Geoff Kwan - *RBC Capital Markets - Analyst*

One other question, if I can. The gain on sale percentage in the quarter seemed a little bit higher than in prior quarters. I know based on mix and whatnot, and where the market is in terms of spreads, can have an impact on that. Just wanted to get a sense from you, as we look through the next two quarters, where you think that might play out?

Tim Wilson - *Equitable Group Inc - CFO*

Geoff, we can talk about it offline, if you want, later. The gain on sale margin came down during the quarter. It was influenced downwards by the larger -- the transaction that we to derecognize mortgages. So our gain on sale of margin would be typically in the 80 to 100 basis point range, and it was 50 this quarter. It was the really the result of the costs of doing that particular transaction.

Geoff Kwan - *RBC Capital Markets - Analyst*

Okay. Okay, yes, we can talk about it offline then. Okay, thank you.

Operator

(Operator Instructions)

Graham Ryding, TD Securities.

Graham Ryding - *TD Securities - Analyst*

Good morning.

Andrew Moor - *Equitable Group Inc - President & CEO*

Good morning.

Graham Ryding - *TD Securities - Analyst*

Just wanted to touch again on the Alberta/Saskatchewan portfolio. Performance is obviously holding in very well, but you did indicate that you prepared for arrears to move higher. Are you seeing any in particular that -- is it seasonality or anything in particular that suggests it should move higher, or are you just being cautious and realistic that the economy and whatnot is under pressure?

Andrew Moor - *Equitable Group Inc - President & CEO*

I would say it's more of the latter, Graham. In fact, I did take a quick look at a the industry lie arrears numbers and they continue to look in great shape. Just talking to our people on the ground, we are not seeing anything that would -- there's nothing in the fact set that would say that arrears is going higher other than the things that you could read a newspaper or whatever about rising unemployment.

So as a Management team, I'm probably more optimistic about the likely outcome in those provinces, having lived in Alberta for a few years and being connected to that market, maybe it just gives me a sunnier optimism about the entrepreneurial spirit that drives that economy. But to be clear to investors we need to be concerned that there's still risk there.

Graham Ryding - *TD Securities - Analyst*

And when you think about your uninsured residential mortgages versus your unissued commercial, do you see any higher risk with one bucket over the other?

Andrew Moor - *Equitable Group Inc - President & CEO*

They are different kinds of risk, frankly. There's a little more systemic risk in the housing market in the sense that all assets are likely correlated -- house prices --houses, generally would fall in a particular region. I don't think they are correlated, necessarily, across the country.

In the commercial space, it's different. You're thinking more about that asset by asset. Got great covenants behind some of these commercial assets and it tends to be something about the project that's failed as opposed to the value of the underlying real estate that causes losses.

So it's a different kind of risk and it is one of the reasons why we like being in both businesses, frankly. It does diversify our risk. We don't think that just because of a potential correction of the housing market, if it happened, that our commercial book would practically suffer losses as a result.

Graham Ryding - *TD Securities - Analyst*

Got it. Can you remind what sort of loan to values you have on your commercial book, and what are the types of commercial loans that are in that Alberta/Saskatchewan portfolio?

Andrew Moor - *Equitable Group Inc - President & CEO*

The primary loans in Saskatchewan market, I think we have disclose our LTVs, on average there would be in the high 60%s level. Mostly it would be the residential, so multi-family apartment buildings, a little bit industrial and multi-tenant industry. Mostly it's apartment buildings and a little bit of construction. But all looks like good assets. We reviewed the assets one by one and we've got no concerns about any at this point.

Graham Ryding - *TD Securities - Analyst*

Okay, great. Just jumping to the capital side. You're still planning, I think, to shift to this a AIRB model, is there any indication at this point what sort of impact that could have on your overall CET-1 ratio?

Andrew Moor - *Equitable Group Inc - President & CEO*

Too early to say that. Clearly there is a view that the risk weights would come down, but that doesn't necessarily mean that we would run at the same capital levels as we do today. So the broader implications of that, we don't have a really good feel on that. The big picture though is to improve to make more sophisticated the bank continues to grow over the next decade or so our capital allocation process so that will much more closely link what the regulators expect from capital with the true risk of the underlying assets.

What we really believe that AIB will allow us to do is to lend effectively on lower risk assets and get the capital relief that reflects that. The challenge we have today is if we lend to further the develop some apartment building and then it stabilizes it, our risk weightings don't actually change as that asset matures and becomes less risky. As it becomes a great asset, then some of our larger competitors can underbid us and take that loan away. We'd really like to be able to offer a longer-term solution for our customers so that we can provide the term funding as that asset become less risky, and the ARB would allow us to do that by reflecting a lower capital risk weight as the asset becomes less risky.

Graham Ryding - *TD Securities - Analyst*

Okay. Got it. And maybe just quickly on the EQ Bank, how are you feeling about the service levels now relative to where you were last quarter? I'm not sure if you disclosed it, but how many account holders do you have behind those deposits right now?

Andrew Moor - *Equitable Group Inc - President & CEO*

We've got about 23,000 accounts represent the CAD1 billion of liabilities for us, assets for our customers, and I'm feeling fantastic about the service. Give it a try, but what we are hearing is that our call center is really standing up well, the great news about the effectiveness of the app is that people don't have to call because the thing works really well. People are using all of the features of the product, so they're depositing checks through the remote deposit check capture system, they are paying -- this is a very important thing. We are the only bank in the country that allows you to make payments out of the high-interest savings account or the interest-bearing account. And we were the first bank in the country to offer free interac transfers as well. But particularly the fact that they come out of an interest-bearing account continues to be a recurring differentiator for us. We are going to red flag deals and look at what the people are saying in the bloggersphere about EQ Bank, you'll see some really good things being said about the people that really are interested in this how banking is evolving. And I think it's -- I'm excited about where this can go for our institution for sure.

Graham Ryding - *TD Securities - Analyst*

Great, and have you worked through the backlog?

Andrew Moor - *Equitable Group Inc - President & CEO*

Yes. So we did go to a queuing system, which allowed us to then, lest customers came on with more kid gloves rather than trying to deal with the surging business. That queue is now being taken down, so anybody can open accounts as they feel and when they feel like. We are getting about 70 new accounts a day, opening up today.

Graham Ryding - *TD Securities - Analyst*

Great. Thank you.

Andrew Moor - *Equitable Group Inc - President & CEO*

Thanks, Graham.

Operator

(Operator Instructions)

There are no further questions. At this time, I will turn the conference back to Mr. Moor.

Andrew Moor - *Equitable Group Inc - President & CEO*

Thanks, Michelle, and thanks for all of you listening. We look forward to speaking to you in November following our third quarter report. In the meantime, I hope you enjoy the rest of the summer.

Operator

Ladies and gentlemen, this does conclude the conference call for today. You may now disconnect your line and have a great day.
