VersaBank

Second Quarter 2022 Financial Results Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to VersaBank's Second Quarter 2022 Financial Results Conference Call.

This morning, VersaBank issued a news release reporting its financial results for the second quarter and year-to-date ended April 30, 2022. That news release, along with the Bank's financial statements and supplemental financial information, are available on the Bank's website in the Investor Relations section, as well as on SEDAR and EDGAR.

Please note that in addition to the telephone dial-in, VersaBank is webcasting the conference call live over the internet. The webcast is listen-only. If you are listening to the webcast but wish to ask a question in the Q&A session following Mr. Taylor's presentation, please dial into the conference line, the details of which are included in this morning's news release and on the Bank's website.

For those participating in today's call by telephone, the accompanying slide presentation is available on the Bank's website.

Also, today's call will be archived for replay, both by telephone and via the internet, beginning approximately one hour following completion of the call. Details on how to access the replays are available in this morning's news release.

I would like to remind our listeners that the statements about future events made on this call are forward-looking in nature and are based on certain assumptions and analysis made by VersaBank management. Actual results could differ materially from our expectations due to various material risks and uncertainties associated with VersaBank's business. Please refer to VersaBank's forward-looking statement advisory in today's presentation.

I would now like to turn the call over to Mr. David Taylor, President and Chief Executive Officer of VersaBank. Please go ahead, Mr. Taylor.

David Taylor — President and Chief Executive Officer, VersaBank

Thank you, Michelle (phon). Good morning, everyone, and thank you for joining us today on this call. With me is Shawn Clarke, our Chief Financial Officer.

Those who have been following VersaBank for a number of quarters or more will note some small, but we think important, adjustments to the way we are describing our business and our quarterly results.

First off, we are more definitively referring to our Digital Banking operations when describing our deposit and lending business, and to DRTC, when describing our Cybersecurity Services, as well as certain Banking and Financial Technology Development.

Further, we have begun breaking out our non-interest expense into its component Digital Banking and DRTC parts to provide a more fulsome view of each operational segment.

We believe this better serves our shareholders and prospective investors, providing a clearer picture of the individual performance of each of our Digital Banking and DRTC operations, and enabling better comparison to our peers in each sector.

Within our Digital Banking operations, we are presenting net interest margin based on total assets, that is, including cash and other assets, as we have done historically and is the convention with publicly traded banks in Canada. However, we are also presenting net interest margin with cash and other assets excluded, as per the practice of US banks.

In addition, we are now reporting our efficiency ratio for only our Digital Banking operations, which excludes the impact of DRTC. Again, we believe these adjustments will enable the investment community to better compare our results to those of our peers, including our US peers.

And finally, a quick reminder here that we report our financial results in Canadian dollars, and all amounts in today's call will be in Canadian dollars unless otherwise stated.

Now onto the results. For the second quarter of 2022, Q2 saw continued momentum across our business and was highlighted by yet another record loan portfolio in our Digital Banking operations, which increased 34 percent year on year and 11 percent sequentially, to just shy of $2.5 billion.

Importantly, this growth was driven to a large degree by our strategic focus on Points-of-Sale Financing portfolio, which grew 51 percent year over year.

Consolidated net income for Q2, however, was dampened by expenses related to a number of investments that we believe will continue to drive portfolio growth in both the short and long terms, most notably, transitory costs associated with the preparation for the launch of the rollout of the Point-of-Sale offering in the United States and preparation for the launch of the Canadian dollar version of our revolutionary Digital Deposit Receipts.

We also saw a dampening effect from the successful execution of our strategy to expand Point-of-Sale portfolio on the net interest margin in our Digital Banking operations. As a reminder, we are in slightly lower margins, on average, from our Point-of-Sale loans than we do our commercial real estate loans. From a sheer growth opportunity, however, the point-of-sale market represents our far greatest opportunity to drive sustained long-term profitability and also a conservative, more efficient use of our capital.

In DRTC, we continue to see strong growth, which delivered year-over-year increases in revenue and gross profit of 41 percent and 57 percent respectively.

Although profitability here was dampened by investments and prep for VCAD launch, including completion of the SOC2 Audit, I'll remind you here that the gross profit amount for DRTC is included in non-interest income in VersaBank's consolidated income statement. Shawn will discuss the financials in more detail in a moment.

A significant highlight of the second quarter was the launch of Point-of-Sale business in United States and the addition of our first US Point-of-Sale customer on March 31st. That customer is a large North American commercial transportation financing business, focused on independent owner-operators, and a great example of the inherent value of our offering, addressing an unmet need in a market by providing a highly flexible and economically superior, technology-based alternative.

We're off to a great start. Discussions with our other potential partners are very encouraging, confirming our belief that our offering is unique and very much in demand.

The other highlight of the quarter, as I've noted earlier, was the completion of the SOC2 compliance audit for proprietary blockchain technology that is the foundation of our Digital Deposit Receipts, our own internally developed VersaVault technology. In essence, the voluntary SOC2 Audit, conducted by an independent national chartered professional accountancy and advisory firm, verified the nonfinancial reporting controls relating to security, availability, processing, integrity, confidentiality, and privacy of our VersaVault, which we believe will be a significant advantage, from both an end user and a regulatory perspective, now and well into the future.

Our Digital Deposit Receipts were born out of the recognition of the fundamental long-term evolution toward rapid, frictionless transactions in the digital realm.

We continue to advance towards launch of our VCADs in Canada. VersaBank has a long and proud history of being at the leading edge of banking, especially related to technology. Sometimes, that can be protected. What we are already at work (phon) are conservative timelines as we ensure that our stakeholders fully understand these initiatives.

I'd now like to turn the call over to Shawn to review our financial results in detail. Shawn?

Shawn Clarke — Chief Financial Officer, VersaBank

Thanks, David.

Just a quick reminder that our full financial statements and MD&A for the second quarter and year-to-date 2022 are available on our website under the Investors section, as well as on SEDAR and on EDGAR.

And as David mentioned, all of the following numbers reported are in Canadian dollars, as per our financial statements, unless otherwise noted. We do offer US dollar translations of our key metrics in our standard investor presentation, which will be updated for the second quarter numbers and posted to our website very shortly.

On to Slide 9, the balance sheet. Starting with our balance sheet, total assets at the end of the second quarter were $2.7 billion, up 26 percent from $2.1 billion at the end of Q2 last year, and up 11 percent from the end of Q1 of this year.

Our cash balance at the end of Q2 was $198 million, or 7 percent of total assets, down from $272 million or 13 percent of total assets at the end of Q2 last year, and up from $155 million or 6 percent of total assets at the end of Q1 this year.

The year-over-year decrease is the result of deploying our temporarily elevated cash balance into our loan portfolios, while the sequential quarter-over-quarter increase was in preparation to fund new loans in our short-term pipeline.

Our total loan portfolio at the end of the second quarter grew to another record balance of $2.45 billion which, as David mentioned earlier, represents an increase of 34 percent year over year and 11 percent sequentially.

Book value per share increased 8 percent year over year and 1 percent sequentially to $11.94, with the year-over-year increase due primarily to the impact of our common share offering in September of 2021 and higher retained earnings attributable to net income earned in the current period, offset partially by the payment of dividends over the same time frame; and the sequential increase being due primarily to higher retained earnings attributable to net income earned in the current quarter, offset partially by the payment of dividends over the same period.

Our CET1 ratio was 13.66 percent, up from 12.52 percent at the end of Q2 of last year, and down from 14.83 percent at the end of Q1 this year.

Finally, our leverage ratio at the end of Q2 is 11.63 percent, up from 10.46 percent at the end of Q2 last year, and down from 12.69 percent at the end of Q1 of this year.

The year-over-year increases in our regulatory capital levels and ratios, as well as changes in our leverage ratio, were a function of a number of factors, including our common share offering in September 2021 for total net proceeds, adjusted for tax-effected issue costs, in the amount of $75.1 million; retained earnings growth, year over year; and in the case of our capital ratios, changes to our risk-weighted assets and composition.

Both our CET1 and leverage ratios remain well above regulatory thresholds.

On to Slide 10. Consistent with David's earlier comments on reporting, I'll begin with an overview of our consolidated results and then proceed to discussing Digital Banking operations and DRTC individually.

Total consolidated revenue increased 17 percent year over year and 2 percent sequentially to $18.6 million, with the increase driven primarily by higher net interest income in our Digital Banking operations which, in turn, was driven by strong growth in our loan portfolio.

We also generated a higher non-interest income at DRTC. I will discuss each of these in more detail in a moment.

As David noted earlier, consolidated net income for the quarter was dampened by what were predominantly transitory costs associated with specific growth initiatives, including our US Point-of-Sale launch and preparation for the launch of VCAD.

As a result, net income was down 14 percent, year over year, and down 11 percent sequentially, to $4.9 million. Net income was also impacted by higher salary and benefits costs and higher office expenses incurred as our team returned to work at our offices.

While these specific transitory costs recognized in Q2 will reduce materially in the back half of the year, we expect to see additional expenses associated with our pursuit of an acquisition of a US bank, the magnitude and timing of which will depend on our progress toward achieving this objective.

Earnings per share for Q2 were $0.17, which is down 32 percent year over year and 11 percent sequentially.

The year-over-year decrease in EPS was disproportionately larger than that of net income due to the higher number of shares outstanding, resulting from the issuance of 6.3 million common shares under our US IPO in September of last year.

Strong growth in our loan portfolio was driven predominantly by growth in our Point-of-Sale portfolio and, to a lesser extent, growth in our Commercial Real Estate portfolio.

Point-of-Sale loans grew 51 percent, year over year, and 12 percent sequentially, to $1.6 billion. The increase continues to be driven mainly by strong demand for home finance, auto, and home improvement receivable financing.

As David noted earlier, Point-of-Sale continues to expand as a proportion of the overall portfolio, now representing 66 percent of our total loan portfolio, up from 65 percent in Q1 of 2022.

Our Commercial Real Estate portfolio increased 10 percent year over year and 8 percent sequentially to $796 million. This increase is primarily the result of growth in residential mortgage financing.

Turning to the income statement for Digital Banking. Net interest margin which, as David mentioned earlier, we are now presenting as a function of only interest-bearing loans, which is excluding the impact of cash and other assets for Q2, was up 3.11 percent, compared to 3.22 percent last quarter and 3.55 percent for the same period a year ago.

These declines are primarily the result of our strategy to grow our Point-of-Sale portfolio, which generates lower average net interest margins than the Commercial Real Estate portfolio.

We were also more aggressive with Point-of-Sale pricing in Q2 this year, in order to take advantage of certain growth opportunities that presented themselves.

Net interest income in our Digital Banking operations for the second quarter was $17.2 million, up from $15.1 million in Q2 last year, and up 2 percent from $16.9 million for the same period a year ago.

The increases were both primarily a function of higher interest income earned on higher lending assets, offset partially by lower fees earned on the Bank's CRE mortgage portfolio and higher interest

expense on deposits. The year-over-year trend also reflects higher interest expense in the current quarter, attributable to subordinated notes which were issued at the end of April of last year.

Non-interest expenses for the quarter were $11.8 million, compared to $8.3 million for Q2 last year and $10.6 million for Q1 of this year. Both increases were due primarily to higher costs related to the launch of the Point-of-Sale business in the US and preparation for the commercial launch of VCAD.

We also incurred higher salary and benefits expense attributable to higher staffing levels to support expanded business activity across the Bank, higher costs associated with employee retention, and higher office and facility-related costs attributable to our return-to-work strategy. The year-over-year increase also reflects higher insurance premiums attributable to our listing on Nasdaq in September of 2021.

Turning to cost of funds. Cost of funds for Q2 is 1.38 percent, which is up 10 basis points year over year and 9 basis points sequentially, with the increase due to higher deposit balances and change in our deposit portfolio mix.

Credit quality of our loan portfolio remains very strong. We once again finished the second quarter with no impaired loans and no loans in arrears, which continues to be the case today.

For Q2, we recognized a provision for credit losses, or PCL, in the amount of $78,000, compared to a provision for credit losses in the amount of $312,000 for the same period a year ago, and a provision for credit losses in the amount of $2,000 in Q1 of this year.

Our PCL ratio or, specifically, PCL as a percentage of average loans, was 0.01 percent for the current quarter, compared with a 12-month average of negative 0.01 percent, and which continues to be amongst the lowest of the publicly traded Canadian federally licensed banks.

Turning to DRTC's income statement. Our Cybersecurity Services and Banking and Financial Technology Development operations, DRTC revenue and gross profit, which are generated entirely by Digital Boundary Group's Cybersecurity Services, increased 41 percent and 57 percent, year over year, and 3 percent and 1 percent sequentially, to $2.4 million and $1.4 million respectively.

DRTC as a whole, however, generated a net loss of $0.5 million in the current quarter, which is impacted by the costs associated with the technology development initiatives that are not yet revenue-generating. This compares to a net loss of $0.2 million in the second quarter of 2021 and net income in the amount of $0.1 million in the first quarter of 2022.

The loss in the current quarter was attributable to higher costs related to investment in specific growth initiatives, including the preparation for commercial launch of the Canadian-dollar version of the Bank's Digital Deposit Receipts, as well as higher salary and benefits expense and higher business development costs.

Finally, before turning the call back to David, I thought it important to note that we remain very mindful of the continuing evolution of the pandemic, the current geopolitical unrest, and the volatility in both Canadian and US macroeconomic conditions. And as a result, we continue to operate at a heightened level of awareness to ensure that our origination and underwriting practices, as well as our broader risk management practices, remain highly disciplined and focused.

I'd now like to turn the call back to David for some closing remarks. David?

David Taylor

Thanks, Shawn. The second quarter was once again demonstrative of the accelerated growth of our Digital Banking loan portfolio, led by our Point-of-Sale Financing business, which demand for types of

goods and services are financed using our solution remain very strong in Canada, and we expect continued momentum throughout the remainder of the year.

We also expect to see continued near-term growth in our commercial mortgage portfolio, specifically related to financing for residential housing properties, as the macro conditions remain favourable. That said, we expect the growth to be somewhat moderated from our view earlier this year.

With anticipated continued strong portfolio growth in Canada, we expect the investments we've made in Q2 to begin to yield results in the second half of the year. Notably, we expect to begin to see the contribution of the rollout of our Point-of-Sale Financing offered in the United States, which we believe has even more potential for near-term contribution than on our previous call at the end of February.

When we were first analyzing the potential for our offering in the United States, we viewed it as an attractive third option for consumer financing firms, alongside their existing bank and public market finance. With public capital much harder to come by, we believe there will be even more demand for our Point-of-Sale offering.

On the deposit side of Digital Banking, we anticipate continued growth in deposit funding over the remainder of the year, driven primarily by insolvency professionals offerings, as the volume of consumer bankruptcies and proposal restructuring proceedings is forecasted to increase significantly due to continued tightening of monetary policy by the Bank of Canada. In fact, some experts have predicted that we may move from a period of record low bankruptcies to a period of very high bankruptcies. We are already seeing a significant increase.

In our Cybersecurity Services business, we have a solid momentum, more than 40 percent year-over-year growth in revenue, as I mentioned earlier, and we expect this will continue in 2022.

All of this points to a solid back half for 2022 and outsized growth potential for 2023 and beyond.

And with that, I'd like to open the call to questions. Michelle?

Q&A

Operator

Thank you, sir. Ladies and gentlemen, we will now begin the question-and-answer session. If you would like to ask a question, please press the *, followed by the number 1 on your telephone keypad. If you would like to withdraw your question, please press the *, followed by the number 2.

One moment, please, for your first question.

Your first question comes from Greg MacDonald of LodeRock Research. Please go ahead.

Greg MacDonald — LodeRock Research

Thank you. Good morning, David. Good morning, guys.

David Taylor

Good morning.

Shawn Clarke

Good morning, Greg.

Greg MacDonald

Guys, I have two questions. The first is kind of a macro one. We just came through earnings season for the big six banks as well. Big banks' CEOs, who are normally conservative, seem to be a little more optimistic on the economic outlook than the market is. I wonder, David, if you could speak to that overall as an issue? I.e., are you seeing things differently than what some of the economists are?

And then, secondly, in context of, of course, your main area of growth focus, in terms of point-of-sale and multiunit residential real estate loans?

David Taylor

Well, thanks, Greg. Well, in our sort of limited scope offering, we are still seeing a lot of growth, obviously, this year and probably leading into 2023, in the Point-of-Sale Financing area as big-ticket consumer items seem to be still in high demand.

However, as we lead into 2023, I would expect these tightening measures the Bank of Canada's—in fact, I'd probably say another 50 basis points—will start to take their toll. And I would expect to see a dampening of demand for these big-ticket items. Having lived through quite a number of recessions—I hate to say that, the R word—you don't tend to see people buying hot tubs or motorcycles when a recession hits, and that's what we finance in our Point-of-Sale business.

So even though we're growing at 50 odd percent now, and I don't see any end to that this year but, leading into 2023, depending on what the economy does, I would say that would be dampening. Yeah.

With respect to our real estate construction, there's still a very high demand for residential units on the periphery of the major centres. And considering we're just a small player in that area, I would think that our portfolio will sort of maintain the size it is, with a little bit of growth.

Greg MacDonald

Yeah. And there are longer cycles involved in that area as well. Okay. Thanks for that colour.

The second question, specifically on Point-of-Sale, really good growth sequentially, up 12 percent, to your point. And you talked a little bit about the trends in terms of consumer spending. Can you talk specifically to the decision to be more aggressive in pricing in the Q2? I think you defined it in the press release as going after certain high-growth opportunities. Thanks.

David Taylor

Yes. And so, primarily, our growth in this area is in the home improvement, home financing area, as it was a few quarters ago. Sort of an aftermath of the pandemic, people are likely spending more time at home, looking around and thinking about home improvements, and that's what's carrying through. So that's the component of our Point-of-Sale that we see the largest growth. Now with going forward, I think that'll just probably start to dissipate too. And leading into 2023, as I said earlier, I would expect that will slow down somewhat.

The pricing concessions that we've given to some of our major partners are primarily in that area. And what we're doing now is we're expanding our market share in Canada. I think we're very close to being the largest point-of-sale financing company in Canada. So it was a little bit of pricing concession, but it results in a lot of volume. And we expect we'll have a lot more volume going forward due to that pricing concession.

Greg MacDonald

I see. So that was a strategic decision made based on funding partner relationships and things like that. Is that the way I should read it?

David Taylor

Absolutely. Yeah. Absolutely. It was—with sort of a slight reduction in pricing, it gave rise to a significant increase in volume. And as you know, we have a lot of capacity in our balance sheet capacity, to almost double our size with the capital we have for those types of assets. And we like them. It's what we're designed for. It's highly scalable, very low risk. So that's the Canadian market.

And then we've got the US market, of course, where we've got the beachhead transaction. We're looking at another one fairly soon. And the thesis that we've walked into the States with, that we thought this would be a popular new product, it's holding very well. In fact, pricing is better in the States than in

Canada, partially as a result of the meltdown in the capital markets area, where a lot of point-of-sale companies were getting cheap money, and partially because of the convenience of being able to hitch directly up to our bank and get timely, economical, reliable financing.

Greg MacDonald

Okay. Thanks, David. That's good colour.

David Taylor

Thank you, Greg.

Operator

Your next question comes from William Wallace of Raymond James. Please go ahead.

William Wallace — Raymond James

Hi. Thanks for taking my question. I had a few questions I wanted to ask this morning, if I could and maybe, just straight away, following up on the previous line of questioning.

I'm guessing, since you only have one partner, you probably aren't willing to quantify where you are with US Point-of-Sale as of the end of the fiscal quarter. But what I am wondering is, if we kind of just think about this conceptually, if you are going to try to enter US more aggressively, you're also pricing more aggressively in Canada, can the US pricing offset the negative impacts of the Canada pricing? Or are we more likely to see, as rates rise and your trustee deposits come off of their floor—it seems like we could be setting up for margin compression, rather than stability or even expansion, in the near term.

So can you just kind of help us—I mean, we see the growth potential. I'm just trying to kind of get a sense of the bottom-line impact, once we start to see this transition into the US versus what you're doing in Canada with pricing.

David Taylor

Well, that's a good question, Wally. There's, of course, competing forces at play on our net interest margin. One is the sort of bonus that we get, in that as the Bank in Canada increases its overnight rate, we're positioned to gain a little bit of more net interest margin. I think our statement showed approximately $5 million additional net interest income in a 12-month period with a 100-basis point increase. And we've seen it—I think, as of today, we'll probably see the 100-basis point increase. So that tends to widen our net interest margin somewhat.

The US market, as you said, is wider than the Canadian margin. And we've only given up a few basis points when we talk about aggressive pricing. So looking at those components, it tends to mean a wider margin. And as you know, we've started reporting as US banks do. So I'm thinking around a 3 percent, 3 percent-plus margin is in the works, although the other forces at play could move it around temporarily, quarter by quarter.

With respect to the trustee deposits, even though they're coming off their floor, I think, on average now, we're paying about 30 basis points. I expect the volume of trustee deposits will increase dramatically, in that we're coming off a 35-year low in bankruptcies, and we've still been building deposits, as we've been signing up the last few insolvency firms in Canada. But we could very well be going into a 35-year high for insolvencies, and that would mean a lot more deposits coming out of that area.

As I say, today, they're only 30, 40 basis points in total, so it really is still a very economical way for us to raise sticky deposits. And the volumes could double in the upcoming year, and it wouldn't be hard to see, with the market penetration we now have in that industry.

And as I say, we're already seeing the signs of the increased interest rates on the marginal borrowers in this country. You're starting to see credit card debt attract higher provisions. You're starting

to see subprime attracting higher provisions. It's already coming in. So on one side, I'm not a happy guy for Canada's economy. But on the other side, it means a lot of deposits from the trustees.

William Wallace

And those deposits, how are they priced—new deposits that come out?

David Taylor

They're priced over prime, so they're floating rate, and there's various pricing, kind of, which we're dealing with, depending on what's involved. But on average, I would say prime minus 3, prime minus 2.75, somewhere around there, all in, so an economical source of deposits.

William Wallace

So the way you can get benefit to margin is, if you're already to 50, acceleration in growth in those deposits is able to offset the need to fund out of your wholesale channel. It's pricing, and even though it floats with a beta of 1, you get a higher spread on those versus the wholesale?

David Taylor

Yeah. Absolutely. Yeah. That—

William Wallace

Okay. And—

David Taylor

—we expect the trustee to average around $1 billion, and it's only $600 million, $700 million right now.

Shawn Clarke

$600 million and change.

David Taylor

So yeah. This is a historic low for those types of deposits in Canada, and there's a bit of a lag effect, of course, when you come off a 35-year low. It takes six, seven months before you start to see the insolvency deposits, so.

William Wallace

Okay. Now in the US entry, you mentioned, I believe you said you feel like you have one potential new partner. To aggressively grow in the US, how many new partners do you need? And what does the pipeline look like? It seems like it's taking a while to sign on partners. We thought, maybe, after the first one, you'd kind of have the model and the agreements—the master purchase agreement would be good for all the interstate commerce rules, et cetera.

Can you talk a little bit about your expectation of how that partner base might grow in the US? And why it seems to be a longer pipeline than maybe we had anticipated, as far as getting these deals signed up?

David Taylor

Well, mainly, the slowdown was just the haggling over the legal documentation. As you know, in Canada, we have what we call a master purchase and sale agreement. It's kind of the central document. And that did take awhile to get sorted out to comply with the US law. And we did sign the first deal, and I think we got about $35 million, right now, on that deal.

The next one is right behind it. The documentation now holds, so the next one will be signed up very soon and then be funded shortly afterwards. So it's coming along. And these are just sort of beachhead transactions for us to get used to the US law and get out lawyers to tidy up the documentation.

I think, with the lack of funding coming out of the capital markets—this is what we experienced in Canada, too, when we initiated this program many years ago—it means there's a huge demand for alternate source of funding and for point-of-sale companies.

So now we've got the paperwork taken care of, we've got a couple of example transactions, I can see opening up the floodgates and, I expect, will be a huge spend for us. Kind of the constraint will be human resources and putting it together and a funding source in the United States, of course. And I think everybody knows that we're planning to acquire a US bank to enable the funding in US dollars for these types of transactions, so.

So again, the beachhead's done, established. And then, thankfully—again, I sound like a grim reaper here—capital markets are not providing the economical funding, or the very cheap funding, or the unbelievably cheap funding they were providing for point-of-sale companies. So that just means a tremendous opportunity for us. So I'd say you're going to see it rapidly increase towards the end of this year, as our Point-of-Sale team cranks it up in the States.

William Wallace

Okay. You mentioned the resource commitment as a potential drag to quickly being able to sign on partners. Let's move on to the—

David Taylor

Yep.

William Wallace

—expense line. So you highlighted in the prepared remarks, both you and Shawn, that you had all these transitory expenses related to VCAD and US Point-of-Sale entry, but it hasn't been quantified yet,

so. There was also the comment about some expectation of elevated expenses around the pursuit of a US bank charter. So help us peel back the onion.

Like what is the basic spend—so let's take out any elevated expense that should be one-time for M&A and take out stuff that's one-time for VCAD and Point-of-Sale entry. What is the run rate expense? And how should we expect that to grow, moving forward?

David Taylor

Shawn, you've got some numbers on that, I think.

Shawn Clarke

Sure. So, Wally, if you look at—about 25 percent of our costs quarter over quarter—or the increase quarter over quarter—can be attributable to some of the new initiatives that David and I discussed over the course of the call, that we expect those costs—as we mentioned, are expected to ramp down but, concurrently, we expect expenses associated with our pursuit of a US acquisition to ramp up.

We expect those costs, you'll see incremental increases, quarter over quarter, through the third quarter, the fourth quarter. And we expect, if we're successful in completing an acquisition or closing the acquisition by the end of our fiscal period, we would expect to see those costs drop off mid to late Q1 of 2023.

William Wallace

Right. But drop off to what? To 25 percent of the increase in the second quarter? So we take out $250,000, roughly, to get to a run rate of about $11.5 million?

Shawn Clarke

That'd be a decent level, Wally. The issue will be, though, as David mentioned, what we're still working on in terms of our projections is what will the additional staffing requirements be, as a function of our—of a potential US acquisition and, of course, supporting the US POS initiative.

So I think, in terms of a run rate of 25 percent of where we are right now, quarter over quarter, would be a very, very conservative view in terms of where our NIEs will be over the course of 2023. And again, you'll see it ramp up over the course of 2022, ramp back down.

But I think where we're still trying to come to grips with is in terms of what the resource requirements will be to support the existing POS business, the growth of that business, and the integration of that business with a potential US bank acquisition.

William Wallace

Okay. Okay. Okay. So if I take—I just want to make sure I'm 100 percent understanding. The expenses went from $10.6 million to $11.8 million; 25 percent of that increase is what you would consider transitory, so 75 percent of that increase is staffing, et cetera, that's here to stay. And from there, once we get past whatever costs there are around pursuing a US bank charter, you're trying to figure out how much growth from there will be required to support growth in the US?

David Taylor

That's correct.

William Wallace

And then, obviously, if you buy a charter, that will come with more expense. Sure. I understand that. I'm just trying to get to the base kind of run rate to think about from a modelling perspective. So the pressures are pretty meaningful. Last quarter, you suggested that the first quarter run rate was probably a decent run rate. So where's all the creep coming from? Is it US Point-of-Sale? Are you expanding

resources in Canada? You have to pay people more to keep people? Just kind of help quantify why there's so much creep.

Shawn Clarke

It's all of the above, Wally. So a big thing for us is we're seeing it across the finance service industry—is retention of people. It's very difficult, and hiring new folks, in terms of incremental wage increases to bring new staff on board. We are struggling to acquire new staff as it is and seeing, in our view, notable increases in base wages, in terms of bringing those folks on board, signing bonuses, et cetera, and retention amounts for folks that are already with us, key—well, all of our—all our staff in general, to maintain, make sure those staff remain with us, key to our success in the future.

So salaries and benefits certainly are a big driver of that cost base, so the creep is, quite frankly, in investing in new and maintaining existing staff, as well as trying to—the costs associated with researching, sourcing, and working to identify and potentially acquire a US charter has been a little more expensive than anticipated, but we think the benefits on the other side will be disproportional.

William Wallace

Okay. Okay. And I've kind of hijacked this call. I'm sorry. I just have one last question. David, why is it taking so long to get VCAD launched officially? It just seems like every time we talk, it should be any week now—

David Taylor

That's a good question.

William Wallace

—and it's taking months. So any comments there—

David Taylor

Yeah. That's a good question, Wally. I had believed that it would be fairly soon, but it is taking longer.

I guess one of the factors is, with the meltdown in the stablecoin industry, it's created a fair amount of, I'm going to say, nervousness or concern amongst regulators. And even though our Digital Deposit Receipt is sort of apples-to-orange comparison to the stablecoins that have turned out not to be that stable, we're in a—we've got an atmosphere of nervousness that has slowed down the final launch of the program—and ironically, considering our Digital Deposit Receipt is positioned to be the safe harbor for folks that misguidedly thought they were putting their money in something stable. But nevertheless, there's a fair amount of nervousness out there.

William Wallace

And so is that to suggest that there's a chance that the regulators just don't allow it to launch?

David Taylor

I think that is always a chance. I certainly hope not, in that I think the Generation Zs and Millennials, and Xes, even, have shown that they really want those kind of deposit vehicle, as they've gone to nonbank issuers to get something they thought was stable. And a statistic that I saw recently was that there's a tiny bit of retention when a Baby Boomer's wealth moves on to the Zs and Xs and Millennials when Baby Boomers finally expire.

So the new generation wants this type of deposit vehicle. They want to do this kind of banking, and the mainline, old-school kind of banks really haven't reacted to that. There are some banks in the States, of course, that definitely think the same way we do, but it's left kind of a void in the marketplace for these younger people, who don't want their grandfather's banking. And we have the product, we believe, is ideally suited for them.

And so I hope the regulators see that because, unfortunately, if you don't, the Baby Boomers and such—or the Zs find themselves going to unregulated entities and then, in some cases, suffering.

William Wallace

Okay. Well, fingers crossed, I guess. I'll step out and let somebody else ask a question. Thanks, Dave.

David Taylor

Well, thanks, Wally. Good questions.

Operator

Your next question comes from Bradley Ness of Choral Capital. Please go ahead.

Bradley Ness — Choral Capital

Okay. Yes. Hello, guys.

David Taylor

Hi, Brad.

Bradley Ness

Just following—hello. Yeah. Following Wally's question line here. So on the VCAD, what do you think it'll take to get the regulators comfortable? You guys have a great relationship with your regulators, so you should be pretty dialled in here.

David Taylor

Well, frankly, Brad, I think it just—it'll take some time in that, that nervousness that I spoke about—that's prevalent throughout the world, of course—has pervaded Canada too. But I think it's just a matter of time. We're providing our regulator with as much information as we can about the product.

As you know, we believe it is a safe, secure place for Canadians to put their hard-earned money and not have to risk it with other unregulated, supposed stablecoins or areas where they've—some of them have unfortunately lost their money. So we think it behooves our regulator and behooves ourselves as a bank to be able to provide depositors with that safety and security.

But we did enter into a period of time where there's a ton of nervousness, and it was a bit of a shock to see some of these so-called stablecoins—well, one shrunk to almost nothing—

Shawn Clarke

It vaporized.

David Taylor

—vaporized. So that was a shock to the entire world's regulatory community.

Bradley Ness

Okay. I don't know why they were so concerned about the algorithmic stablecoins when they're not really regulating stablecoins, but—because your stablecoin's not algorithmic, so I don't know why regulators would be concerned.

But let me just jump on—

David Taylor

Yeah. And I'll just—

Bradley Ness

—yeah. Remind me what—

David Taylor

—emphasize for a second, if you like. Yeah. Ours isn't, yeah, a stablecoin, so to speak, and it is a Digital Deposit Receipt. It can function as a stablecoin, if it becomes prevalent, popular. But it's issued by

a bank, and all of our deposits are digital. They've been digital since I created that method of issuing deposits in 1993 with telephone modems and sort of rudimentary systems. They're all digital. It's just these are highly encrypted Digital Deposit Receipts, and then they get that appellation.

Crypto, which is—some people say marker—is wrong. There's something wrong with that. No. It's highly encrypted, and that's what we like. And all our data's encrypted, but this is a little more instructed (phon).

Sorry to interrupt there, Brad, but for anybody else listening, that's our point of view as a bank. We're planning to issue a site that's super-secure and super-encrypted.

Bradley Ness

Got you. Thank you. Remind me what I should think about, like profitability goals, let's just say in fiscal 2023. It seems like, recently—I've been involved for a year, and the more you grow, the lower your profitability gets. So just remind me what I should expect for like 2023. Or what are your goals?

David Taylor

Well, a net interest margin north of 3 percent, calculated the way US banks do, I think is reasonable. It should be slightly better than that, but. I think that's a reasonable margin for us to hold onto in the Point-of-Sale business where we're expanding. And as we've seen from the past results, just in Canada, we've been growing 50 percent.

Moving into the States—and this is all dependent on our success in acquiring a US lending platform—I would say 50 percent growth would be easy for us to do, even despite—you can call that, perhaps, an impending recession, as I was saying earlier. But the market in the United States is so large, and the point-of-sale companies are—well, a lot of them are finding themselves—the well's dry when it

comes to funding. So I would say you could expect that type of top-line growth in assets, mainly Point-of-Sale, of course, with that type of 3 percent-type spread.

Now as Shawn was saying earlier, the dampening effect is primarily associated with our endeavours to launch VCAD, to acquire a US bank, to list on the NASDAQ, retain staff. So those are the things that you do to build your business and so, yeah, we're spending money to build the business for the future, which I think should be heartening.

In the past, those types of expenses might've been capitalized, years ago. But now, they're—

Shawn Clarke

They're IFRS.

David Taylor

—now they're IFRS, they're expensed. So it does hit our income statement, but these are expenses that we're incurring for future growth.

If we were to stand still, yeah, you wouldn't see any of that. I mean, we probably wouldn't have to have as many staff, either—

Shawn Clarke

No.

David Taylor

—yeah.

Bradley Ness

Okay. So what I'm hearing is the major profitability metric you're focused on in 2023 is the net interest margin above 3 percent.

David Taylor

And part of—

Bradley Ness

A lot of the banks talk about, like, they would rather—they're focused on like return on equity here, which brings per-share growth. So it sounds like that's not as important, so maybe the sub 6 percent ROE is something we should expect going forward?

David Taylor

Well, as we utilize our excess balance sheet capacity, ROE, of course, goes up—goes way up. And we've got about—approximately, we could grow—depending on the asset mix—but we could grow about double our size. So that has a dramatic impact on ROE. So what you're seeing us do is basically what we said we'd do. We'd go into the States. We would launch our Point-of-Sale program. We did. Yeah, we incurred a ton of legal expenses to do that and worked it through, bit of marketing there and travel.

And now, we're—got our sights on a US bank acquisition to round out the lending platform that provide economical US dollar-denominated deposits, a platform to do lending throughout the States. And that doesn't come without expenses, just travel and consulting fees and tons of legal stuff.

Shawn Clarke

Brad, I think your comment about 67 percent ROE is not an unreasonable target as we move through this development phase. We would think that you would start to see those returns start to expand in the back end of 2023, assuming we're—a key driver there would be in terms of we were successful in the completion of a US acquisition and able to get that business online and contributing to the consolidated results.

So not ignoring ROE by any means and very aware of shareholders' concern for that metric, but one that we think will see some compression as we move through this—we think is a material growth phase.

Bradley Ness

Okay. Okay. Thank you, gentlemen.

David Taylor

Thank you, Brad.

Operator

There are no further questions. I will now turn the conference back over to Mr. David Taylor for closing remarks.

David Taylor

Well, thank you. I'd like to thank everybody for joining us today, and I look forward to speaking to you at a time of our third quarter results at the end of the summer. Thank you again.

Operator

Ladies and gentlemen, this does conclude your conference call for this morning. We would like to thank you for participating and ask that you please disconnect your lines.