PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the VersaBank 2020 First Quarter Results Conference Call. I would now like to turn the meeting over to Mr. David Taylor. Please go ahead, Mr. Taylor.

David Taylor, President and Chief Executive Officer, VersaBank

Thank you, Paul, and good morning, ladies and gentlemen. Welcome to VersaBank's 2020 first quarter financial results. We're coming to you from the winter wonderland of London, Ontario.

I have with me today Shawn Clarke, who's our CFO, and Aly Lalani, who's our Treasurer, who are standing by if you have any detailed questions you'd like to ask.

Before we begin, please note that the conference call slides, quarterly results, news releases, and supplemental finance information are available on our Investor Relations page of our website, VersaBank.com. They're also available on SEDAR.

I would like to remind you, 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 management. Actual results could differ materially from our expectations due to various material risks and uncertainties associated with VersaBank's businesses. Please refer to our forward-looking statement advisory which is on Slide 2.

Moving over to the presentation—I'm on Slide 3, where I talk about the agenda. First, what I thought I would do, for those of you that are new to VersaBank, I would review our model and then get into the Q1 results, and then move on to what we have in mind for the future.

Moving to Slide 4, this slide shows graphically the technology model that we have created. Not to go over it in detail, but just to highlight the (inaudible). We use existing distribution channels to distribute our banking products. We've created and maintained state-of-the-art custom banking software that we hope provides us with financial independence from the other banks and other participants in the industry, and we have what we think is a modest risk appetite.

I'm looking at the triangle on the far right. You'll note that we have 92 employees. Just to give you an example of the type of leverage that we use in our Company and how our model is set up, of the 92 employees, about nine of those would have direct interface with our partners. So we have nine relationship people on staff, and the rest are basically support staff. The largest department in that support staff area would be our IT staff, then we have finance and accounting and other administrative (inaudible).

It gives rise to 30 origination partners, but the relationship managers look after 26,000 depositors, 156,000 borrowers, and this quarter we closed with about $1.85 billion in assets.

Turning to Slide 5, this graphically shows you how our deposits are raised. They're raised through a partnership with about 120 or so other corporate entities. We call ourselves a B2B business. We've got some of the logos on this slide that would show the deposit brokers that send us deposits each day, and we've also got some of the logos of the larger accounting firms who we receive deposits from, from their insolvency practice.

Moving to Slide 6, this is sort of the opposite side of our business. This is where we distribute our lending assets. We have about 30 partners that we work with on that front, and that's all across Canada, too. For the most part, those partnerships are composed of point of sale finance companies, and so what we're able to do is indirectly finance everything from hot water heaters to hot tubs and motorcycles all throughout Canada where the financing occurs at point of sale. We also have partners that provide us with commercial mortgages.

Flipping to Slide 7, this is sort of a graphic demonstration of our model, and I used last year's figures to illustrate how the Bank's model works. Last year we would have collected about $88 million in interest income, and we would have paid about $34 million of that out on interest expense, leaving us with $54 million, or about a 3 percent return on our assets. Then, 1.4 percent of that went to some of our fixed costs. That would be $26 million or so, and the rest that was left over we call core cash earnings of about $28 million.

Slide 8 just gives you a visual of the types of real estate projects we often finance, mostly high rise multi-family, but we do some commercial and we do some land development.

The next slide, Slide 9, a visual on some of the items that I mentioned that we finance through our point of sale finance people. Those who are thinking about motorcycles, as I was this weekend, can forget it. It looks like another month before the motorbike comes out.

The next slide is Slide 10, and that shows that we have been reducing our reliance on personal deposits in that the personal deposit market, as I think most of you know that are on the phone, has heated up and is quite a competitive market, and some FIs are paying extraordinary high interest rates, especially on their daily interest savings accounts, in some cases 1 percent higher than we're paying. So we created another channel for deposits to take our reliance off that personal market that does heat up from time to time.

The other market we've created is what we call commercial funding, and Slide 11 illustrates the progress we've made in raising deposits in this channel. This channel is a channel where we add some value to our depositor with our software. We give our depositors a software solution that hopefully makes their life easier, makes it easier to deal with our Bank. They're not decision factors and just interest rates, it's something else. It's convenience. We've done fairly well on this front and it's served to keep our cost of funds at a competitive level.

Next slide is Slide 12. This just gives you sort of a pie chart which shows the mix of our assets, our lending assets, that is. We hit the $1.1 billion mark. That's quite a number for us. It's quite an achievement for us to crack through the billion in our eCommerce business. This quarter we went over to $1.1 billion, which now composes 63 percent of our lending assets. As shown on the previous slide, these loans and lease receivables that we obtain from the point of sale finance partners are scattered all throughout Canada and, of course, into the population of Canada.

With commercial banking, commercial banking is the most part of those high rise multi-family projects, and that now represents 37 percent of our lending assets and is $605 million. That portfolio we've been letting run down. It was also composed of what we call non-core assets that were priced quite some time ago and had fairly thin spreads, fairly thin margins, so we've been letting them run off and replacing them with higher margin, mainly construction loans and term loans.

Looking at Slide 13, that just shows you a nice chart of the increase in the portfolio size of the eCommerce portfolio. I love to see that. I'm looking for a lot more growth in that area. That's a business that we think is ideally suited to our Bank. We're, of course, adept at providing a software solution and we think, the way the world is unfolding, convenience in banking is a deciding factor over interest rates or—well, to a certain degree over interest rates. We think consumers and businesses go out for the convenient bank over the cheap bank, within a certain limit on interest rates, of course.

Slide 14, you're starting to see what all this wonderful additional banking technology applied to the bank industry has been able to do. These are getting to be very good numbers. You'll notice that our net interest margin has been hovering about 3 percent, a slight 4 basis point dip this quarter. This quarter could be up 4, down 4. It moves around, depending how the portfolio mix changes slightly, but those are big net interest margin figures in comparison to what our colleagues in the banking industry are able to earn.

The net interest income, of course, was $14 million. If you annualize that, it's a little more than we would've achieved in 2019. We're hoping for bigger and better things with that, of course, with all the various projects that I'll talk to you on a future slide, but looking good.

This slide, I'll give you kind of—when I say we have a modest risk appetite, you might say, "What does that mean?" Well, what it means is that our portfolio generates provisions for loss that would be called negligible, as opposed to the industry, which is running around—last year around 35 basis points. This year we're just starting to see the results of the other banks. Some are up, some are down. But as you can see, there's no comparison to the quality of our portfolio versus the other banks.

How does this sort of all work for us? Well, it means our economies of scale are kicking in and the cost to earn a dollar of revenue is decreasing.

The next slide, Slide 17, a nice slide. I called it technology advantage. It just shows that when you're able to leverage your software, put out more and more business without increasing your fixed costs, it goes straight to the bottom line as core cash earnings.

Now, we're getting into the slides that sort of say where the rubber meets the road. Over the past five years, we've turned a 40 percent compounded average growth rate of core cash earnings. We're still on track to do that—well, maybe not quite 40 percent this upcoming year, but quite a nice growth trajectory.

Turning to Slide 19, and I apologize for this one. It's a little busy. Next quarter we'll put it to half-year mark so it's not so much chart. But you get the picture. Our earnings per share has gone up by about five times in the last five years, from $0.07 up to around about $0.35 in the last few quarters. That's fantastic.

The reason I talk about core cash earnings and earnings per share, it kind of levels the playing field. Different FIs report different ways. Some use adjusted earnings, some use net income. What we like to do is say kind of right to the bottom line. This is how much cash the Bank retained after its provisions for cash taxes. Of course, we had very little in terms of provisions for cash taxes in that we have tax loss carry-forwards that we're using up. So, a wonderful trend that we here at VersaBank are proud of, but we are a little bit on the greedy banker's side and are looking for much more.

All right, looking at Slide 20. This just illustrates with respect to leverageable capital. We have loads and loads of capacity. We're almost running at three times what most of the industry is. That means to you as investors, or potential investors, that certain markets we could put on perhaps $2 billion worth of assets without diluting our shareholders (inaudible). That's a tremendous amount of capacity that we're planning to use with some of the new projects that I'm about to talk about.

All right, so this is the fun stuff. We're into what we've been working on. Some of these, of course, I mentioned in the quarterly that hopefully you've had a chance to read. I'll talk about the ones that aren't—the one that is not highlighted, because I think that's probably the one we should end on.

First, I talked about raising U.S. dollar deposits. Well, this is a breakthrough in the small FI industry in that CDIC has announced that it will insure U.S. dollar deposits as of April 30 this year. Up until April 30, I believe, U.S. dollar deposits have really been an exclusive area for the large banks in that Canadians saving up their U.S. dollars for perhaps a trip to Florida that I might be looking out the window at today, have likely been storing those U.S. dollar deposits with a large Canadian bank and that we small banks would not have had CDIC deposit insurance on.

But, as of April 30, good Canadians can store their U.S. dollars with us or with any of the other small FIs that have systems and software are able to accept U.S. dollars. We're looking forward to that because it's a brand new channel for us to take on U.S. dollars. We have the systems set up and ready to receive in U.S. dollars. As you know, our deposits flow through our partners, so hopefully our partners are able to accept. I'm sure some will be by that time. We look forward to receiving your savings and saving them safely and securely in our Bank, and I'm sure you'll be happy to know that CDIC is providing their usual deposit insurance on it.

So that's an exciting one for us. As I said in the quarterly, we have opportunities now and then to provide U.S. dollar loans, and there's nothing like having U.S. dollar deposits as a natural economic hedge.

The other thing CDIC has said they'd do in their press release and on their website is insure longer-term deposits. This is really good news for us, too, in that up until April 30 it's always been five-year GICs, five-year deposits. We often have opportunities to make much longer-term loans, in fact some quite lucrative ones. Like I say, in the hot water heater industry they usually lease out for 10 years. We have a bit of a struggle about using derivatives going out 10 years because we don't particularly like derivatives. So now there's the opportunity to raise longer-term deposits and match longer-term assets that have usually a little better yields on them.

Getting on to the prepaid cards and secured cards, I've talked about that. We have a partner we've lined up. We are proof in principle (phon) with MasterCard, and our guys are working feverishly bringing that product to market through one of our partners. Hopefully next quarter or soon after we'll have some good news that we have a card out there for good Canadians looking to deal through our partners.

We are on a hunt for suitable an acquisition. There's quite a few we've had a look at. We've got plenty of capital to buy complementary corporations or other financial institutions that would fit our model. Up until now, they've been priced a little high. That's sort of a downside of a high liquid feverish market is price expectations seem to be way up there. But we're still on the hunt, and hopefully we find some complementary ones that we can tuck into our Bank and grow more rapidly than we have been organically, although the organic side might pick up, too, with the highlighted one.

DRT Cyber, well, as you folks know that have been listening for a while, we decided to sort of squirrel away our pool of software development that we have been working on, in some cases for years, to enhance our Bank, particularly in the area of cyber security. As most of you know, we came out with I think it's the first digital safety deposit box to replace the traditional steel boxes that banks have in the basement. DRT Cyber has that product for our Bank and for other banks that wish to use it. Mind you, there doesn't seem to be a whole lot of interest here in Canada, but we have provided that technology to our partners in Europe that have been using it to a certain degree.

Other areas that we work on for our Bank is cyber security with respect to penetration testing and surveillance of our systems to ensure that no one's probing, no one's getting in, all those kind of good things we have as a goal in DRT Cyber.

There's other software projects that we're working on that I'll probably just leave unmentioned for the time being that we might be able to bring at least in beta testing. Next quarter I'll be able to tell you what we've got there. Some that we'll be able to get to market rather rapidly. Again, this is all software that our Bank is the first customer, first to use, but I see the applicability in the entire industry and to other corporations, and even governments that have the same issues as banks do with respect to keeping their data safe from those prying eyes that seem to be trying to get in and have a look, at the very least, at people's personal data.

So that's on the unshaded projects. The one that I highlighted in yellow is the new Direct-Connect app, because this was sort of a breakthrough for us. This allows us to go directly to the mortgage markets. This is CMHC mortgages, conventional mortgages, and these are mortgages that would be considered in the (inaudible) category, are available be booked through this app. Since the press release is our usual modus operandi, the same we've used over the years when we come out with a new product, we hope that we can test it all out with a large player so we get a really good test of how our system works and get some really good feedback as to what it needs to do in order to please our partners. Thank you to the Cortel Group for agreeing to be our beta tester on this project. There may be another diverse type of partner in this area, too, so we get a good wide spectrum view of how our app works.

But the ultimate goal, of course, is for our Bank to go directly into the retail mortgage market, and this is a big chunk of balance sheet capacity that we haven't used up until now that is available for a bank with standard risk weighting to use. CMHC (inaudible) the analysts on the phone (inaudible) 30 percent risk weight, conventional type 35 percent, and others; so lots and lots of capacity. We've got high hopes for this one, and as we've done in the past, partnered with the big guys, (inaudible) solvency practice, the big solvency firms.

As we did early on and to create the deposit broker business back in the early '90s when this was unknown in the banking industry, those who've been dialing in for a while will know we partnered with a large independent brokerage firm, or financial planning firm, out of Winnipeg. That would be Rice Financial. We worked with them. They were the largest on the (inaudible) at the time. Created the software, and then after that provided it to the smaller firms and then, of course, the large bank or brokerage firms to create a deposit broker industry. So, this is us doing it again, shining on, the genius come out, and we're all set to go.

So, Paul, I'll turn it over to you for questions.

QUESTION AND ANSWER SESSION

Operator

Thank you. We will now take questions from the telephone lines. If you have a question and you're using a speakerphone, please lift your handset before making your selection. If you have a question, please press star, one, on your telephone keypad. If at any time you wish to cancel your question, please press the pound sign. Again, please press star, one, at this time if you have a question. There will be a brief pause while the participants register. We thank you for your patience.

We have a first question, and it is from Steven Boland. Please go ahead, sir, your line is now open.

Steven Boland

Thanks. Good morning, guys. First question. You mentioned the U.S. deposit products. What would be the offset in terms of loans? You obviously don't want to have a currency mismatch, so what kind of loans, or what opportunity do you have to do U.S. denominated loans?

David Taylor, President and Chief Executive Officer, VersaBank

Were you looking at U.S. dollar receivables in the eCommerce area, Steve?

Steven Boland

So that would be in the eCommerce segment that—like, your partners, do they do a lot of those types of loans, or is it U.S.—like, are they located in the U.S. or Canadian located loans, but in U.S. dollars?

David Taylor, President and Chief Executive Officer, VersaBank
Well, without giving secrets away for our partners, some are located in the United States, some are located in Canada doing business in the States. There seems to be quite a market and, of course, it would be naturally hedged by the U.S. dollar receivables. But we're not averse to bridging any currency gap with forward contracts.

Steven Boland

Okay, that makes sense. Then, just the second question, you mentioned in the press release about the growth in the eCommerce segment was new partners as well as more business from existing partners. Could you just maybe go into that a little bit, like how many new partners there are, is it just one that's come in and provided a lot more volume? Maybe give a little more description, Dave?

David Taylor, President and Chief Executive Officer, VersaBank

A handful of new partners, and quite small. Generally speaking, our existing partners are larger, would give us a bit more business, and the handful of the new guys gave us a little bit. All added up.

With respect to growth in that area going forward, we are talking to some fairly large new partners with the enhanced product for U.S. dollars, and we may be improving some of our services that we have out to our partners. Some of them are taking advantage of our daily purchase program. Others aren't. Perhaps more would like that with maybe other things we can do for them, i.e. bring on a secured credit card, that sort of thing.

Steven Boland

Okay, I think that's it for me.

David Taylor, President and Chief Executive Officer, VersaBank

Thanks, Steve.

Steven Boland

Thanks.

Operator

Thank you. Once again, please press star, one, on your telephone keypad if you have a question. Please press star, one.

We have a new question now from Paul Campbell. Please go ahead, sir, your line is open.

Paul Campbell

Thanks very much. Good morning. I just have a question, David, overall on the ROE. Everything looks to be going in the right direction, costs under control, NIMs pretty stable at a good level. Obviously, credit quality very good, and asset growth is continuing. But ROE is not really moving into those double-digit levels after tax. Do you have a sense of when that might kick in as a trend?

David Taylor, President and Chief Executive Officer, VersaBank

Well, Paul, there's two things that are impacting ROE. One is what Warren Buffet some time ago called anchor (phon) of equity. The odd thing about piling away core cash earnings, which flows directly into our regulatory capital, it creates a bigger denominator and actually depresses ROE, all things being equal.

So what has happened is we have accumulated a significant amount of surplus capital for what's required to fund our present book. If we were to do kind of a calculation—some banks used to in the past, they call it return on employed capital—then we'd be up there with the other guys. But we have kept back those capital for the opportunities that I've spoken about, perhaps acquisitions, hopefully we can find a complementary one, and we've kept it back for the other factor that impacts ROE, and that's scale.

What our plan is is to sit on that surplus capital and then hopefully find something to buy with it and employ it into (inaudible) asset categories as rapidly as we can so you'll see employed capital become capital and scale deliver a lot more top line earnings. That's the plan.

If I didn't have all those opportunities, then—if I couldn't think of anything new to do, which never happens, theoretically you crank the dividend up and bring it back down.

Paul Campbell

Okay, thanks.

Operator

Thank you. Once again, please press star, one, on your telephone keypad if you have a question.

We now have a question from Peter Leacock. Please go ahead, your line is open.

Peter Leacock

Good morning, David. Actually, my question was essentially covered by your answer to Paul, which was to do with have you given some thought with the excess capital to buy back shares or maybe increase the dividend given that the stock's trading at quite a discount to book value. But I think you sort of adequately outlined why you want to preserve that capital for other opportunities.

David Taylor, President and Chief Executive Officer, VersaBank

Yes, Peter, and you're up early in the morning. You calling me from Vancouver?

Peter Leacock

I'm a little further south today, in Mexico.

David Taylor, President and Chief Executive Officer, VersaBank

Oh, good for you. Yes, that's always an issue banks have is you're accumulating surplus capital and, for an odd reason our stock's trading less than book. I'm not quite—well, I guess I have a little more insight into why that might be now in that our new IR firm, LodeRock, has just completed a perceptual survey of that total so they can rectify the misconceptions in the marketplace that were outlined in this perceptual survey.

But if we didn't have a spot to use the capital, then yes, indeed, a share buyback is of course a good idea. At 75 percent of book value, of course you do.

But with these new projects, particularly the Direct-Connect, that gives us access to non-brokered CMHC, (inaudible), and the other (inaudible) type mortgages without the usual brokerage commissions and probably not quite as price sensitive as those that go through the very heated broker market. It looks to us that that's a good avenue for thi capital, low-risk, meets our risk appetite, and large volumes. The reception that we received from the hopeful partners, it looks like another one of those products we build—you know, you build it, they will come sort of things. It's something the market has been waiting for. That's what I'm getting from the people I've spoken to say. "Hey, it's a breath of fresh air."

You can do this mortgage directly with a streamlined app, a call centre to deal with the paperwork, and all that sort of stuff. It provides convenience at the point of sale of a home purchase versus convenience at the point of sale of a motorcycle. Basically, we took our model and we said okay, let's get to the biggest market there is in retail purchases. It's not RVs, it's not motorcycles, it's not hot tubs, it's homes. We've taken that strategy to the home market. I expect there will be those that emulate us, and they probably (inaudible) launch, as usual. But we've got first (inaudible) advantage again, and we've got a big partner. We hopefully have another partner in a different type of home sales area, and we're looking for big things in this product.

Peter Leacock

Okay, thanks for the explanation, David.

David Taylor, President and Chief Executive Officer, VersaBank

You're very welcome, Peter, and good luck in the south there. Make sure you get the sunscreen on. You guys coming from Vancouver down to places without cloud cover are at a bit of risk.

Peter Leacock

You're right about that. It's been a gray, wet winter on the West Coast.

David Taylor, President and Chief Executive Officer, VersaBank

Yes, I missed you last time. It was indeed.

Operator

Thank you. There are no further questions registered at this time. I will return the meeting back to Mr. Taylor.
David Taylor, President and Chief Executive Officer, VersaBank

Well, thank you, everybody, for dialing in. These are exciting times for VersaBank, of course. It took us quite a few years to create the digital bank that you see today, and it took quite a few years for the marketplace to evolve to the point that a digital bank like ours can take advantage of new consumer sentiment and desire for speed and convenience. We're all set to go, and if these new markets, new channels that I've spoken about (inaudible) VersaBank keen and excited. Hopefully, next quarter we can talk about all the progress we've made on those fronts. So thank you again for joining us. Signing off from the winter wonderland in London, Ontario.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time and we thank you for your participation.