FINAL TRANSCRIPT

VersaBank

First Quarter Fiscal 2024 Financial Results Conference Call

March 6, 2024 — 9:00 a.m. E.T.

Length: 35 minutes

CORPORATE PARTICIPANTS

Doug Taylor
VersaBank — President & Chief Executive Officer

John Asma
VersaBank — Chief Financial Officer

CONFERENCE CALL PARTICIPANTS

David Feaster
Raymond James — Analyst

Mike Rizvanovic
KBW — Analyst

Stephen Ranzini
University Bank — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to VersaBank's First Quarter Fiscal 2024 Financial Results Conference Call. This morning, VersaBank issued a news release reporting its financial results for the first quarter ended January 31, 2024. That news release, along with the Bank's financial statements, MD&A, 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 this morning's conference call. 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 in to 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 all 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 businesses. Please refer to VersaBank's forward-looking statement advisory in today's presentation.

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

David Taylor — President & Chief Executive Officer, VersaBank

Good morning, everyone, and thank you for joining us for today's call. With me for the first time on these calls is our new Chief Financial Officer, John Asma, who was appointed to that role in December.

Before I begin, I'd like to remind you that our financial results are reported and will be discussed in this call in our reporting currency of Canadian dollars. For those interested, we provide US dollar translations for most of our financial numbers in our standard investor presentation, which will be updated and available on our website shortly.

Now for the highlights. Our first quarter results continued to demonstrate the significant and increasing operating leverage in our highly efficient, branchless, business-to-business digital banking model. 22% year-over-year growth in total assets generated 35% year-over-year growth in net income, marking another new quarterly record for profitability. And that, combined with our continued focus on management of our fixed cost, drove both year over year and sequential improvement in our efficiency ratio to a new record of 40% and 24% year-over-year increase in average return on common equity to 13.4%. Notably, Q1 was a solid quarter for our point-of-sale receivable purchase program business, which expanded by a healthy 7% sequentially as the HVAC home improvement sector, which makes up the largest components of our point-of-sale portfolio, continues to see robust consumer activity. That contributed to another record high, for total assets of $4.3 billion, another meaningful step towards our next milestone of $5 billion and the continued outsized positive impact of our efficiency, our profitability, and our return on equity.

Taking a closer look at Q1 numbers, even with the continued very healthy year-over-year growth, I will highlight that our Q1 numbers were dampened slightly by a temporary contraction of our non-core real estate lending portfolio compared to the end of Q4. You have heard me say in prior calls that we will always look to be opportunistic with our real estate portfolio, expanding and contracting our portfolio depending on opportunities and risks within the market. You've also heard me say that we would be happy to trade lower net interest margin for return on equity if such opportunities arise. Such a situation recently emerged in the evolving regulatory environment has created an opportunity to transition the focus of our real estate portfolio from higher-yielding, higher-risk-weighted real estate loans to a zero risk weighted CMHC-insured real estate loans. We are trading net interest margin for return on equity. This is a great example of our ability of our Bank to be flexible and agile to drive additional shareholder value. As we began this transition in Q1, we saw our real estate portfolio temporary contract from Q4 as we [inaudible] old loans ahead of deploying capital to new zero risk weighted loans. We expect that this strategic adjustment will enhance the return on equity and contribute to stronger growth in subsequent quarters throughout the year. With our very low cost source of funds throughout the insolvency professional deposits, we have a distinct competitive advantage in the CMHC market.

The other item I would note is some ongoing softness in our net interest margin. This is a natural outcome of the growth of that point-of-sale portfolio, which has lower margins but higher risk-weighted returns than our real estate portfolio. So, as point-of-sale portfolio grows, we earn less net interest margin, but we make up the profitability on volume. There's also a natural outcome of the growth of our wealth management deposits relative to our lower-cost and solvency professional deposits to fund strong growth in our loan portfolio. The good news, at least for us, lest for Canadians, is that our low-cost and solvency professional deposits, as expected, are expanding as the number of consumer and small business insolvencies continues to increase and, in fact, both the size of these deposits and the number of accounts is now at an all-time high. And this is as we continue to see the significant increase in insolvencies based on recent data, which is a leading indicator for our insolvency deposits. According statistics Canada, insolvencies in Canada in January were up 34% from the prior year and up 14% from December. We have seen that reflected in our insolvency deposit accounts, which are opened by trustees ahead of being filled with actual deposits, which were up 18% year over year and 6% sequentially. This will go some way toward supporting stronger net interest margins going forward.

As our Canadian point-of-sale receivable purchase program business continues to see steady growth, we are increasingly encouraged by the very positive feedback we continue to receive from potential US partners for this unique and attractive solution. In fact, we just returned from the annual KBW Fintech Conference in New York City last week where we once again had the opportunity to introduce ourselves to a number of potential partners. Our meetings continue to confirm that there is a massive unmet need for our solution and potential partners are eager for us to enter the US market.

With respect to the approval process for our proposed acquisition of US-based Stearns Bank Holdingford, the process does continue to move forward. We continue to have productive engagement with the US regulators and remain optimistic, as we have been at any time throughout this entire process, about the prospects for a favourable outcome. With three weeks left in the calendar quarter, while we still think it's possible that we could receive a decision before March 31st, we have adjusted our expectations to the second calendar quarter of this year. We continue to do everything we can to advance the process as quickly as possible, but respect the need for regulators to be thorough and we continue to appreciate the patience of our shareholders.

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

John Asma — Chief Financial Officer, VersaBank

Thank you, David.

Before I begin, I will remind you that our financial statements and MD&A for the first quarter are available on our website under the investors section as well as on SEDAR and EDGAR. And as David mentioned, all of the following numbers are reported in Canadian dollars as per our financial statements, unless noted otherwise.

Now turning to the balance sheet, starting with the balance sheet, total assets at the end of the first quarter of fiscal 2024 grew 22% year over year and 3% sequentially to a new high of $4.3 billion. Cash and securities were $260 million, or 6% of total assets, down slightly from 7% from both Q1 last year and Q4 of last year. Book value per common share increased to a new high of $14.46. Our CET1 ratio increased to 11.39% and our leverage ratio was 8.44%, both well above our internal targets.

Turning to the income statement, total consolidated revenue increased 11% year over year but decreased 1% sequentially to $28.9 million. The year-over-year increase was driven primarily by higher net interest income, as our digital banking loan portfolio continues to grow, while the sequential decrease was mainly due to the impact of lower gross profits from Digital Boundary Group that are attributable to a seasonally lower service engagements in the current quarter. Consolidated net interest expense was $12 million, down from $12.3 million for Q1 of last year and $12.4 million for Q1 of last year, or sorry, Q4 of last year, I'm sorry, as management continues to focus on managing the fixed expenses line across the business. Consolidated net income for Q1 increased 35% year over year to a record $12.7 million and was up 2% from Q4 of 2023. As David mentioned, notwithstanding the healthy growth, Q1 profitability was slightly dampened by the temporary impact of the transition of real estate loans to higher-return opportunities. Consolidated earnings per share increased 41% year over year and 2% sequentially to $0.48, also a record, with year-over-year increase benefiting from a lower number of shares outstanding due to the buyback program we had in place during fiscal 2023.

The loan portfolio grew just shy of $4 billion at the end of Q1, driven once again by our point-of-sale receivable purchase program, which increased 28% year over year and 7% sequentially to $3.1 billion. Our point-of-sale portfolio represents 78% of our total loan portfolio at the end of Q1, up slightly from the end of fiscal 2023.

Our commercial real estate portfolio expanded 9% year over year but was down 7% sequentially to $831 million at the end of Q1 with the sequential decline due to the recalibration of our real estate portfolio. As a reminder, our real estate portfolio is primarily mortgages and construction loans for residential properties. We have very little exposure to commercial use properties.

Turning to the income statement for digital banking operations, net interest margin on loans, that is excluding cash and securities, was 2.63%. That was 40 basis points or 13% lower on a year-over-year basis and 6 basis points or 2% sequentially. Net interest margin overall, including the impact of cash and securities and other assets, decreased 35 basis points year over year or 12% and decreased 6 basis points or 2% sequentially to 2.48%. As David discussed, Q1 net interest margin was lower primarily due to the strong growth of the POS financing portfolio, which is comprised of lower risk weighted, lower yielding, but higher return on common equity assets than commercial real estate, as well as the transitory impact of the transition of the real estate loans to the higher-return opportunities.

With respect to cost of funds, cost of funds for Q1 was 3.99%, up 104 basis points year over year and up 13 basis points sequentially. Cost of funds again was somewhat elevated in Q1 due to the elevated rates for term deposits. Going forward, we expect to increasingly benefit from the continued expansion of our insolvency professional deposits as insolvency activity in Canada continues to steadily increase.

Our provisions for credit losses, or PCL, in Q1 remained negligible at negative 0.01% on average loans compared to 0.05% last year and with a 12-quarter average of 0%.

I'll now briefly turn to DRTC. On a standalone basis, Digital Boundary Group Q1 revenue increased 24% year over year to $2.9 million and gross profits increased 31% to $2.1 million, both due to higher service engagements. DBG also remained profitable within DRTC. Total DRTC revenue, including that from services provided to digital banking operations, increased 36% year over year and was down 32% sequentially to $2.5 million. DRTC's net income of $435,000 was an improvement over the net loss of $516,000 a year ago but down from a net income of $1.2 million in Q4 of last year.

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

David Taylor — President & Chief Executive Officer, VersaBank

Thanks, John.

Building on 2023, which was by far our best year in the history of the Bank, fiscal 2024 is off to a very solid start. The year is unfolding slightly ahead of expectations for our point-of-sale receivable purchase program, providing continued confidence in our ability to surpass our next total asset milestone of $5 billion during 2024 fiscal year and the efficiency and return on equity that naturally fall out of that as we hold increases in our fixed costs to more or less in line with inflation. Notably, we should achieve this $5 billion milestone before any potential contribution from the broad launch of the RPP in US, should we receive favourable regulatory approval for our proposed US acquisition. While we do continue to see some signs of potential slowdown in the broader economy due to the current interest rate environment, we are seeing resiliency in the sectors in which we participate, hence our confidence in our growth outlook for this year.

Q1 positions VersaBank for another year of healthy growth and profitability. As I mentioned earlier, we expect to recapture the dampened profitability in Q1 throughout the year as we capitalize on the zero risk weighted CMHC insured mortgage opportunity. Again, we may trade some net interest margin for return on equity. The more successful we are with the zero risk weighted CMHC loan program, the more we still continue to have, by far, the highest net interest margin amongst Canadian banks, and unlike our peers, we give nothing back for loan losses. And as noted earlier, we expect some favourable impact on cost of funds as the increased insolvency activity should drive continued expansion of this low-cost deposit source. Provisions for credit losses should, of course, remain low, with the start of the year tending to a negative provision as a result of our highly risk mitigated lending practices, in particular the holdback model for the point-of-sale receivable purchase program on loans and leases. Finally, we are seeing solid momentum in our cybersecurity services subsidiary, which we expect to continue throughout the year. This remains a tremendous opportunity in a rapidly growing market and we expect continued growth and success going forward.

With that, I'd like to open up the call to questions. Operator?

Q & A

Operator

Thank you. Ladies and gentlemen, should you have a question, please press the star followed by the one on your touchtone phone. If you would like to withdraw your question, please press the star followed by the two. If you are using a speakerphone, please lift the handset before pressing any keys. One moment please for your first question.

Your first question comes from David Feaster from Raymond James. Please go ahead.

David Feaster — Analyst, Raymond James

Hey. Good morning, everybody.

David Taylor — President & Chief Executive Officer, VersaBank

Good morning, David.

David Feaster — Analyst, Raymond James

I just wanted to start out maybe, you know, with all the moves that you guys have done, you talk about kind of shifting towards lower risk, lower yielding but lower risk, less capital intensive lending. You've done a great job driving operating leverage and taking expenses out. Just kind of given the scalability of the platform, I'm just curious, how do you think about the profitability profile as we look forward in the next year or two? Where do you think profitability kind of shakes out?

David Taylor — President & Chief Executive Officer, VersaBank

Well, it's probably grow at the pace that you've been seeing in the last year and this quarter improved somewhat. The ROE will increase fairly dramatically. We're shooting for about 16.5% once we get to the $5 billion milestone. And that's because the CMHC mortgages absorb no capital and they're easily matched against the insolvency portfolio. The insolvency portfolio is priced at approximately prime minus 2 and the CMHC construction mortgages average around prime minus, say, 25 basis points, so it nets the bank 175 basis points with a perfect match, and that's sort of free from a return on equity point of view.

David Feaster — Analyst, Raymond James

That's helpful. And then maybe just touching on the point-of-sale growth, you know, growth accelerated this quarter. Curious if we could talk maybe a bit about some of the drivers behind that. How much is demand from existing partners, adding new partners, additional growth in the US? And just kind of any colour on the health of the consumer in Canada and kind of how you think about the breakdown between Canadian growth and US growth, even exclusive of Stearns.

David Taylor — President & Chief Executive Officer, VersaBank

Well, it was primarily from existing partners in Canada. And the biggest driver was the HVAC home improvement area, which tends to be super-prime or prime Canadians looking to replace inefficient furnaces and such with the new energy-efficient furnaces and more insulation. So I think it's about 70-odd percent of our portfolio now flows from that area and that's what sort of dampened the impact of sort of a recessionary time or higher interest rates. Folks are still, quite rightly, believing that they should, it makes economic sense to replace an old furnace. So that's helped.

Now this is normally a down quarter for us on point-of-sale in that, in Canada, there's a little less activity when it's winter than there is in the spring and summer and fall. So this bodes well with a 7% sequential growth quarter over quarter and we're not into the spring time warmer climes that tend to bring people out to used car lots and new car lots and all the things you buy in the summertime. So it bodes well. But that's strictly the Canadian market. We haven't done much in the US market. We're just sort of waiting patiently for our US banking license so that we can expand that market.

David Feaster — Analyst, Raymond James

And then just wanted to get an update on DRT Cyber. It sounds like revenues are seasonally slower, as expected, a little less intercompany work, but curious how the pipeline is, how is demand trending, and just any new products or additions or just kind of expansion of that business that you're working on?

David Taylor — President & Chief Executive Officer, VersaBank

In the cybersecurity business, it is growing 20%, 30%, and with the rate we're at now it probably ends up, in US dollars, around $10 million in revenue this year. It's getting pretty close to that in the seasonally down quarter. We're always working on improving our product offering in the cybersecurity area, but there are some products that we have in DRT Cyber, such as the VersaVault that we talked about a few years ago. I think we're the first in the world to create a digital vault that's ideally suited for storing cryptocurrency keys and such, bitcoin keys, and that is empty. The vault is empty in that we see that as being an incompatible business with our banking operations. But that vault is, if it was to be used by somebody else perhaps, it would be ideal for this resurging interest in bitcoin. That's what it was designed for, to facilitate the storage of those what are getting to be very high-value digital assets.

David Feaster — Analyst, Raymond James

That's great. Thank you.

David Taylor — President & Chief Executive Officer, VersaBank

That was good, David. Thank you. I'm in Florida by the way. I'm in your neck of the woods.

Operator

Ladies and gentlemen, as a reminder, if you have a question, please press star one.

Your next question comes from Mike Rizvanovic from KBW. Please go ahead.

Mike Rizvanovic — Analyst, KBW

Good morning.

David Taylor — President & Chief Executive Officer, VersaBank

Good morning, Mike.

Mike Rizvanovic — Analyst, KBW

Good morning, David. Quick question on the POS in Canada, and thanks for the colour, I think you've given us a pretty good sense of demand and how trends are moving directionally. But just in terms of your partnerships, do you have capacity to add anything that would be meaningful? I'm just thinking through perhaps a potential slowdown with your existing partner base. Can you supplement that with some sort of growth that comes from additional partners or have you sort of run the gamut on that and you're saturated in the Canadian market?

David Taylor — President & Chief Executive Officer, VersaBank

No, we think there's some ideal partners that should be dealing with us that aren't yet. So I'd like them to sort of try it and see if they like it and, as has been in the past for the others, they probably will like it and start utilizing us. But there are still some partners left in Canada for us to deal with. In the States, there is a huge number sort of lined up at the door. The KBW conference that you guys sponsored, and thank you for the invitation, in New York City, I must have met a least a dozen ideally suited partners that, ah, and some are actually very familiar with our operations in Canada and are keenly interested. So in Canada we've still got some room to grow with partnerships and in the United States we have a tremendous opportunity.

Mike Rizvanovic — Analyst, KBW

Okay. But is it fair to say that you're not really seeing anything in the near term in the pipeline in Canada? You're sort of running with the existing partner base?

David Taylor — President & Chief Executive Officer, VersaBank

That's true. We are working on some new partnerships that actually are in the States, because they are so sort of keen that, despite us not yet having the US license, we're sort of cobbling together a Canadian solution for them even despite them operating in the States.

Mike Rizvanovic — Analyst, KBW

Okay. That's helpful. And then just one quick one on Stearns and the timing of the close, and I fully understand why there has been such a long delay just given what happened last year with the US regional banking sector, and I'm just wondering, you sound confident on the closing, and I appreciate the conservative viewpoint on saying that it probably lands in the second calendar quarter, but is there any risk at all that this does not get approved in your view? I'm not sure if you can even make that commitment on that commentary, but is there any potential roadblock that could derail the acquisition altogether?

David Taylor — President & Chief Executive Officer, VersaBank

Well, never say never. I think there's a tiny risk that wouldn't close, but being sort of a quantitative guide, 99.9%. yes it would close. I don't know of any impediments to the close. I think the product we're offering to the United States is unique and will have a huge benefit for the US economy. The point-of-sale companies that we're talking to provide a good portion of point-of-sale financing in the States and what we're providing them with is an economical alternative source of funds. They already have sources of funds, of course, but ours is kind of the new mousetrap. It's efficient to probably have to have less equity and less liquidity in that we can buy loans and leases on almost a real-time basis. So it's a very attractive product. I think the US regulators realize that, that we're bringing something to their economy that will be very helpful and, in the final analysis, it means more economical pricing for small businesses and consumers as our funds flow through the model.

Mike Rizvanovic — Analyst, KBW

I appreciate that. I'll take that 99.9% to reflect a very confident view at this stage. Thank you. Thank you, David.

David Taylor — President & Chief Executive Officer, VersaBank

Yeah. Like I say, in the banking world, you don't ever want to say 100%. I would say it's pretty close to that. I can't think of any reason why the US regulators wouldn't want us to present this product to their consumers and small businesses. It's worked well in Canada for the last dozen years and think it'll work just as well, maybe even a little bit better given the size of the market and the solution that we're providing has been refined over the last few years.

Mike Rizvanovic — Analyst, KBW

Thank you. Thank you, David. Really appreciate the colour.

David Taylor — President & Chief Executive Officer, VersaBank

No problem, Mike. Hey, Mike, you're up in Toronto, right? Don't feel bad, but I had to come down here to Florida to catch up on a few things. That being sunshine.

Mike Rizvanovic — Analyst, KBW

You always have to [inaudible], don't you?

Operator

Ladies and gentlemen, as a reminder, should you have a question, please press the star followed by the one.

Your next question comes from Stephen Ranzini from University Bank. Please go ahead.

Stephen Ranzini — Analyst, University Bank

Hi, David. Congratulations to you and your team on another great quarter. I was just curious if you could provide some colour around the status of getting approval for buying back more shares.

David Taylor — President & Chief Executive Officer, VersaBank

Well, Steve, it's not on the list of our things to do right now. We put that program on pause in that, as our share price is tending to go over book value, the great opportunity we had in the past at three quarters of book isn't there anymore and it's quite likely, I think, you know, [inaudible], I think the stock price should continue upward to well over book value. Secondly, we're sort of in a static scenario while our application is in to finish the purchase of Stearns Holdingford and not looking to enter another variable into our capital.

Stephen Ranzini — Analyst, University Bank

All right. Thanks so much, David, and keep up the great work.

David Taylor — President & Chief Executive Officer, VersaBank

Thank you, Steve. Hopefully it's warming up in Michigan.

Stephen Ranzini — Analyst, University Bank

Well, it was 75 the other day. It was like summer in the middle of winter.

David Taylor — President & Chief Executive Officer, VersaBank

Wow. Wow. Bring on that global warming.

Stephen Ranzini — Analyst, University Bank

Very unusual weather.

David Taylor — President & Chief Executive Officer, VersaBank

Yes. Yes.

Stephen Ranzini — Analyst, University Bank

We'll take it. Every day in Michigan that it doesn't snow is a good day.

David Taylor — President & Chief Executive Officer, VersaBank

Indeed. Good talking to you, Steve.

Operator

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

David Taylor — President & Chief Executive Officer, VersaBank

Well, thank you again, everybody, for signing in to join us for this call and I look forward to speaking to you at the time of our second quarter results.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for joining and you may now disconnect your lines. Thank you.