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EQB.TO - Q1 2015 Equitable Group Inc Earnings Call

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Shubha Khan *National Bank Financial - Analyst*

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PRESENTATION

Operator

Good morning ladies and gentlemen and welcome to the Equitable Group first-quarter 2015 conference call. Before we begin, we would like to remind you that certain forward-looking statements may be made on this call, including statements regarding possible future business and growth prospects. You are cautioned that such forward-looking statements involve risks and uncertainties detailed in the Company's periodic filings with Canadian regulatory authorities. Many factors could cause actual results or performance to be different from those expressed by such forward-looking statements. Equitable does not undertake to update any forward-looking statements made by itself or on its behalf except in accordance with applicable securities laws.

This call is being recorded for replay purposes. It is now my pleasure to turn the call over to Andrew Moor, President and Chief Executive Officer of Equitable Group and Equitable Bank.

Please go ahead, Mr. Moor.

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

Thank you John, and good morning everyone. Joining me is Tim Wilson, Chief Financial Officer of the Bank.

As always, we are webcasting our remarks with accompanying slides, and those slides will be posted to our website. And as a reminder, we are hosting our annual meeting this afternoon in Toronto, and since we will be making a detailed management presentation there, we've chosen to keep today's prepared remarks brief.

As you saw in the press release, the Bank produced great results for shareholders, including best-ever earnings up 16% year over year and well ahead of last quarter. The Bank's efficiency and effectiveness in capital deployment ROE was strong at 17.9%, well in line with our five-year average of 17.5%.

These results enable our board to add to Equitable's track record of rewarding shareholders with growing dividends. The announced dividend increase brings the annualized rate to $0.76 per common share and 12% above last year and marks the sixth raise in four years.

Our board and management team feel strongly about growing dividends while retaining about 90% of what we earn so that it can be redeployed to generate the high returns on equity we expect of our value creation process. This process allows us to consistently grow book value, which us up another 15% to more than CAD5.5 per share year over year.

After a quarter like this and because it falls so quickly on the heels of our last call, it's very tempting to let the numbers speak for themselves, but let me try to add some color. Our results are fueled by strategy to grow and diversify the Bank's products and services to Canadian consumers while leveraging our existing strengths and maintaining cost-effectiveness, as well as discipline in pricing and risk management.

We're concentrating on specific areas for expansion in both lending and savings, and all contribute to Equitable's record performance and potential. The first is the expansion of the Bank's single-family lending business. We set out to make Equitable a leader in this market six years ago, and the results we've announced in recent periods, including the first quarter, show that we are fulfilling our mandate.

As one of two major players in the alternative space, the Bank's single-family originations reached CAD568 million, a first-quarter record and up 41% from a year ago. As a result, single-family mortgage principal climbed to CAD5.7 billion, up 31% from last year.

I would say there are two drivers of this growth. One, our relentless focus on service is being appreciated by mortgage brokers and borrowers. Understanding our customers' needs and being responsive does make a difference.

And two, we successfully broadened our national lending footprint over the past 10 years and in Eastern Canada over the past half year. This is creating more opportunities for us to serve new brokers and borrowers, as well as to earn national lender status with some of the major brokerage networks, all a boon to our origination volume. The expansion has certainly helped us to more than offset conditions in Alberta, where origination volumes in the quarter were broadly flat to last year's levels as a result of our own tightened credit standards and market weakness.

Enriching our offering to be a more complete single-family lender hasn't hurt either. The Equitable Bank HELOC launched at the end of 2013 is gaining traction, as we thought it would, because it is a perfect solution for one of our key customer demographics: business to self borrowers. Like our overall single-family business, our HELOC provides a good runway for long-term growth, plus it allows us to grow our share of the wallet with customers while earning a more attractive margin than we would typically earn on a single-family mortgage, a win for both our customers and our shareholders.

Staying with single-family, our prime mortgage business, which is our most recent expansion initiative is progressing on plan, which is to say we are building our internal origination capabilities, and as mentioned in earlier quarters, supplementing our activity with mortgages originated through business partners. In the quarter, we closed about CAD191 million of prime mortgages. This was a decent start for a business with significant room for growth and development.

We're setting a three- to five-year time horizon for our development and believe we've got a great team in place to lead the charge. We are now actively serving broker communities in the GTA, Calgary and Edmonton.

Like our other bank lines, we seek to differentiate Equitable as a prime mortgage provider through service excellence. We're making good progress, but our team has a realistic sense of the journey ahead, and we understand that we have much to do to develop our offering to match the most competitive competitors in this part of the space.

We see the positive impact of prime mortgage growth on securitization financing mortgages under management, which was up 16% year over year. I would point out the positive earnings pattern that we've generated by building this part of the Bank. In fact, the prime asset file portfolio gives us the ability to recognize almost CAD6 million in pretax earnings if we enter into transactions to hedge some cash flow uncertainty and derecognize the underlying mortgage principle.

Commercial lending is another significant business for the Bank. It does offer the opportunity to maintain a more diversified asset base. As we said on past calls, the large commercial market has become more competitive as liquidity has moved into the space, resulting in reduced margin opportunities. Despite this overall market environment, we've been successful in the quarter in the commercial business, and our small business lending product is showing great success.

With the growth opportunities available in our lending markets, it's vitally important for the Bank to have solid, secure and cost-effective funding sources, and we do. But we're expanding and diversifying these, as well.

Our expansion focuses heavily on developing the market for our brokered Equitable Bank high-interest savings account. I'm pleased to note that [either[balances surpassed CAD0.5 billion in the quarter and at the close of business yesterday sit at CAD551 million.

As a result of being able to meet the needs of more Canadian savers with safe, secure and high-return products including GOCs, our mainstay, our savings business now has in excess of CAD7.6 billion deposits, up 18% from last year and 3% during the quarter. We believe we can continue to advance the Bank's position in the savings market. The next big catalyst in this regard will be the late-year launch of our digital banking capabilities.

This is a very busy time for the Bank's digital banking team, and work will continue through the summer on building and testing our systems to ensure they are robust enough to meet the needs of the consumer marketplace. We're very excited about the prospects of this offering.

Also we note that in the first quarter, we closed our second deposit note offering as part of our funding diversification strategy. This brings me to some comments about the market overall and our credit performance and outlook.

While growth has been strong in our mortgage book, we remain disciplined in our underwriting credit practices in every region of the country including Western Canada. A good way to measure this is our impairment provision. As a reminder, this is the portion of our total provision that reflects the level of losses anticipated on our impaired loans. In the first quarter, it amounted just one basis point of our mortgage book on an annualized basis.

I will take this opportunity to point out that the remaining CAD600,000 represents additions to our collective allowance. This is an important number because adding to our collectives in this quantity is a more conservative approach than that taken by most of our peers and had a CAD0.04 negative impact on EPS in the quarter.

Continue on credit quality, arrears rates also remain low. In Alberta and Saskatchewan, activity in the real estate market has contracted along with employment levels, but arrears rates in those provinces did not increase sequentially. We believe that they will rise in future quarters, but the timing and amount is uncertain.

You heard in our last call that management has extensively stress tested the Bank' s exposure to Alberta and Saskatchewan, and it's reassuring to know that we continue to believe that the risk of incurring any significant credit losses in these provinces is low. Even accounting for conditions in the West, we believe that the Bank will have a solid year in the single-family business, also managing risk effectively.

In terms of our forward agenda, it is unchanged from our last call. Our objectives for diversification, expansion, earnings growth and return on equity are very clearly understood internally. And I can assure you that whether it's growing our client business, our savings business, or preparing for the launch of digital banking capabilities, we will work tirelessly to do things the Equitable way, which in the context of the Bank's performance over many years and quarters means the right way for our customers and shareholders and always with an eye to offering exceptional service.

Now I will ask Tim to provide his analysis. Tim?

Tim Wilson - *Equitable Group Inc. - CFO*

Thanks Andrew. As this is the start of a new reporting year, we always look for ways to enhance our disclosures. We've made a couple of changes that are intended to provide a clearer picture of our lending portfolios, or better align us with market practice. There is a detailed discussion of these changes on page 4 of the MD&A.

In Q1, net interest income grew 16% year over year. The drivers were 10% growth in average asset balances and a 7-basis point expansion in NIM on the continued shift in favor of our higher-margin core lending business.

Core lending NIM itself increased a very healthy 7 basis points on more efficient management of our lower margin liquidity asset and prepayment income levels. We also benefited from improvement in pricing on single-family renewals, the effect of which was offset by mix changes within the book.

Securitization financing NIM was down 14 basis points over the year, primarily because of the maturity of large volumes of mortgages that we originated back when spreads were extraordinarily high following the financial crisis. Those mortgages have now largely matured, and we expect less compression in future quarters.

Sequentially, net interest income was also up as a result of asset growth and in spite of lower mortgage prepayment income and lower income on our equity securities portfolio. Andrew discussed our growth outlook earlier, and those expectations should support low double-digit growth in net interest income on a year-over-year basis for the remainder of 2015.

Relative to quarter one, though, we expect NIM will decrease slightly as we move through the year. This reflects a combination of factors that were discussed in more detail in Q4, including the high relative growth of the single-family portfolio, which is lower spread, but generates a higher ROE, and the convergence of growth rates in our core lending and securitization financing portfolios, which means that we will benefit to a lesser extent than in prior periods from a shift in mix towards the high-margin core lending business.

One last note on revenue is that securitization gains were up sequentially and compared to last year, reflecting higher derecognized volumes and a higher gain on sale rate. The rate of gain is up due to changes in the underlying cash flow discount rates.

In simple terms, the gains really represent the NPV of the future spread on derecognized loans. In Q1, the discount rates that we apply in these NPV calculations decrease along with the benchmark rate as you would expect. Because we were using a lower rate to discount the future spread, the NPV was higher, really just Finance 101.

We expect these gains to be higher than in 2014 and somewhat volatile going forward as interest rates continue to move and as we originate more prime single-family mortgages. Our intention is to sell the IO strips from these high mortgages, and when we do so, we will recognize a gain on sale. The decision to sell the strips will be based on the economics of each individual pool, however, so the volumes derecognized may not be consistent quarter to quarter.

Turning to noninterest expenses, they increased USD3.3 million over last year. 27% of the higher cost reflected the growth of our existing franchise, and the remainder was for what we refer to as investments in our future.

Most of our expenses relate to our existing business, things like hiring great people to support our higher levels of origination and investing in our risk function to make sure that we prudently manage our growth. Examples of investments in our future are FTE and marketing dollars in support of key strategic initiatives.

We believe it's important to spend in both categories in support of the Bank's growth, service excellence and performance. But of note, because of our non-branch cost advantage, the Bank's efficiency ratio for the quarter remained well ahead of the big banks and our regional peers at 32.4%.

As expected, our efficiency ratio was also markedly improved from quarter 4 when we accelerated our initiative investment. We expect our efficiency ratio to remain around current levels for another quarter before moving up in the second half on higher marketing spend to support consumer brand awareness.

Our capital ratios continued to surpass minimum regulatory standards and most industry benchmarks. We expect to continue operating above these key benchmarks as we grow, including the new Basel III leverage ratio, which we began to report in Q1. This ratio replaces the ACM framework, as you're probably aware.

At quarter end, our leverage ratio was 5.5%. I realize this doesn't mean as much without an associated minimum regulatory standard, but that standard is set for each and every bank individually and is kept confidential. What I can say is that we are fully compliant.

To sum up our prepared remarks today, it was a record quarter, fueled by solid performance in our core lending business and the successful application of our diversification and growth strategies. Our credit performance was outstanding, and we expect this will continue as a result of our risk management discipline. And we expect more growth and high ROE to be the order of the day at Equitable as we move through all of 2015.

That concludes our prepared remarks, and now we'd like to invite your questions. John, can you please open the lines to our callers.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Shubha Khan with National Bank Financial.

Shubha Khan - *National Bank Financial - Analyst*

Good morning. A couple questions with respect to the accounting change related to mortgage broker compensation, or origination cost generally.

My first question in that regard is just trying to understand what the nature of the transition. Was all compensation to brokers fully expensed in each quarter in the past? Or was there a portion of broker compensation that was maybe captured in the net interest margin and therefore amortized over the life of the mortgages, and only additional incentive compensation was then flowed through non-interest expense?

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

That's definitely a question for Tim.

Tim Wilson - *Equitable Group Inc. - CFO*

Your latter statement was the right one. The majority of our broker-related commissions and expenses flowed through net interest income before this quarter. There was a residual amount related to certain incentive payments for brokers exceeding certain volume thresholds that flowed through our marketing expense line. In the past, that was a relatively insignificant amount, but it started to grow in significance along with our originations. Because it was growing, because our practice, I think, is inconsistent with general market standards and also with the way we treat regular broker commissions, we decided to change the treatment in Q1.

Shubha Khan - *National Bank Financial - Analyst*

Okay, but if you were to take just the dollar amount paid to brokers, has that increased in line with the origination growth? Or would it have been at a faster pace? What's happened?

Tim Wilson - *Equitable Group Inc. - CFO*

We haven't changed the basic structure of our commission. The amount's really grown in line with originations.

Shubha Khan - *National Bank Financial - Analyst*

So there's no reason to believe these costs are becoming more significant because competitive conditions have tightened and so you need to compensate brokers more to maintain market share, or anything like that?

Tim Wilson - *Equitable Group Inc. - CFO*

It just reflects our success in the single-family market and growing originations.

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

Absolutely we obviously like working with our broker partners and making sure they are being properly rewarded, but we have not been trying to increase broker comps to increase volumes.

Shubha Khan - *National Bank Financial - Analyst*

That's perfect. And then just last question is on a separate topic.

Credit quality obviously very strong, but just if I have to split hairs here, there was an uptick in early-stage delinquencies to 84 basis points, I think, from 60. Is that entirely attributable to seasonal factors? Or was there some weakness in specific markets? And I'm thinking particularly of Alberta.

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

Certainly, as I mentioned in my remarks, there's no sequential increase -- or no material sequential increase in Alberta and Saskatchewan. So it's more broadly across the book for two or three larger single-family loans, for example, that were in that early-stage bucket, and the team is still looking at them. I believe one or two of them may have cured. But it's something were keeping an eye on for sure. So we will see how that rolls out in Q2. We don't see it -- at this point, we have no evidence of general deterioration in the books, but that's a litmus test we need to keep looking at.

Tim Wilson - *Equitable Group Inc. - CFO*

To build on that Shubha, we looked at this over a long period, and that early arrears number does tend to be volatile. So you will see movement up or down quarter to quarter, and broadly speaking, the rate we are at now is within the normal historical range.

Shubha Khan - *National Bank Financial - Analyst*

Okay. Sounds great. Thank you.

Operator

(Operator Instructions)

Graham Ryding with TD Securities.

Graham Ryding - *TD Securities - Analyst*

Good morning, gentlemen.

I was just wondering if I could focus on Alberta and Saskatchewan. Perhaps I could get some color around your origination volumes. Sounds like they were flat year over year in Alberta. Perhaps maybe on a percentage basis, looking at 2014 and year to date relative to your overall origination volumes, in those markets would it be comparable to how your overall portfolio plays out 9% of your uninsured book and 16% overall?

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

In terms of the volumes in the quarter consistent with the overall -- can you -- clearly the volumes in the quarter, I'm not sure quite --

Graham Ryding - *TD Securities - Analyst*

I will try to be clear.

The distribution of your origination volumes from Alberta and Saskatchewan -- is that comparable to the distribution of your overall portfolio? I.e., are you originating roughly 9% and 16% of your mortgages from those markets, in line with your overall book? Or is your origination volumes from those markets slightly higher?

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

I wouldn't like to guess on a technical question like that, but I'm sure Tim can get back to you with that answer. Certainly, in the quarter we saw a decreased share of our overall volumes originated in the quarter. The share attributable to Alberta and Saskatchewan was lower, and we expect it to be lower again in this current quarter.

Some color on this: we changed our lending criteria back in December, which we did a little bit of tightening and we have tightened again in December. And of course we had a pipeline of loans lined up then that closed in the quarter that we are currently discussing. So in the early part of the quarter, we didn't see the impact of our tightened credit standards. We do expect volumes in Alberta in this current month to be down about 30% year over year or so, which again is a reflection, I think, of the tightened credit standards and the uncertainty in the market -- those two things together. And you should see LTBs on the originations start dropping meaningfully in Q2.

Graham Ryding - *TD Securities - Analyst*

Okay. That gives me some context around that.

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

We will get back to you with that precise number.

Graham Ryding - *TD Securities - Analyst*

I'm just trying to get a feel for what percentage of your origination volumes come from those markets.

Secondly, I guess you provided some good color around -- you do think there's potential for arrears in those markets to increase, but you're comfortable with your stress testing that credit losses should be minimal. How should we think about how you would provision for -- if that were the case, if you were to start to see some price pressure and some employment weakness, does your general provisioning increase to reflect that? Or do you just provision based on what you actually see in potential losses?

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

I think -- I won't speak ahead of Tim looking up -- I will speak ahead of Tim talking about the perspective.

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But we provide at the rate of about 57.5 basis points on a collective allowance for our Alberta loan portfolio. Our experience of life of loan loss over many years at the five-year periods are 60 months into the life of the loan, and we have about a 12% historical loss -- 12 basis point historical loss experience over 60-month period. So we believe our collective allowance more than reflects what's required to make sure we get adequate reserves in that bucket for cycles through the market.

So I think unless we saw something really extreme happen, which would suggest losses were going to be above 57 basis points -- which seems like a very extreme and difficult scenario that we don't see playing out at this point -- that you would simply see it flowing through as specific provisions in each period under consideration.

Graham Ryding - *TD Securities - Analyst*

Okay. Great. Thank you.

Operator

(Operator Instructions)

Graham Ryding with TD Securities.

Graham Ryding - *TD Securities - Analyst*

I will throw a couple more in if I could.

The CAD191 million of single-family insured that you originated in the quarter -- did I read it right that CAD56 million of that you originated in-house, and the remainder you sourced through partners?

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

That's right.

Graham Ryding - *TD Securities - Analyst*

And then my second question, just on the capital front, with the leverage ratio. It sounds like you're considering moving to a different methodology for your risk-weighted assets through the end of the year, perhaps. And if that does end up freeing up some capital, do you still anticipate having enough capacity with your leverage ratio if that were the case?

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

I think you're reading there about the AIRB program that would lead to more advanced approaches to risk-weighting assets. That's a multiyear project; it's certainly not something that would get done this year. And you see a number of standardized banks -- what I term is the mid-four: the Canadian Western Bank, Laurentian, and ourselves, Manulife --that second group of banks. Many of us are thinking about using more sophisticated approaches to measuring risk, and that would then lead you to advanced approaches; you would have different approaches to risk-weighting assets.

I don't think we see the primary benefit of that or even the benefit of that as freeing up capital per se, but it would allow us to compete across a broader range of asset classes and measure risk in a more refined and accurate way. So I don't think you should have any expectations that there's anything more -- that's probably a three-year-type project, to give you some context for AIRB. And there's a bunch of conversations going on at the Basel level around risk weighting and banks, which get very technical but could change that whole picture in any event. So this is a bit of a watch and see period.

The bottom line on the leverage ratio is, we've got plenty of room right now, and the newly reported leverage ratio is clearly within the compliance level set by OSFI, and as Tim talked about in his part of the script. The ability to derecognize some of the short mortgages does have the impact of giving us more room on the leverage ratio. So we're pretty comfortable with the position we got in that area at this point.

Graham Ryding - *TD Securities - Analyst*

Okay, great. So we shouldn't necessarily think about you having less capital requirements going forward? If not, it would be the same or higher, in line with the industry?

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

I think -- we're pretty comfortable at the levels we're at. Maybe the total capital ratio is a little bit high, but certainly from a CT1 and Tier 1 level, I wouldn't expect to see some meaningful changes over the next little while.

Graham Ryding - *TD Securities - Analyst*

Great. Thank you.

Operator

(Operator Instructions)

Mr. Moor, there are no further questions at this time. Back to you, sir.

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

Thanks, John. As there are no other questions, we hope to see you at our shareholders meeting, which begins at 4:15 Eastern time today at the TMX Broadcast Centre here in Toronto. If you can't make the meeting, it will be broadcast at www.EquitableBank.ca. Otherwise, we look forward to reporting our second-quarter results in August. Thanks for listening and goodbye for now.

Operator

Ladies and gentlemen, that does conclude our conference call for today. We thank you for your participation. You may now disconnect your lines and have a great day.
