VersaBank

Second Quarter Fiscal 2024 Financial Results

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CONFERENCE CALL PARTICIPANTS

David Feaster
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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to VersaBank's Second Quarter Fiscal 2024 Financial Results Conference Call.

This morning, VersaBank issued a news release reporting its financial results for the second quarter ended April 30, 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 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 the 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 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 R. Taylor — President and Chief Executive Officer, VersaBank

Good morning, everyone, and thank you for joining us for today's call. With me today is our Chief Financial Officer, John Asma.

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 U.S. dollar translations for most of our financial numbers in the standard investor presentation, which will be updated and available on our website shortly.

Now, on to the highlights.

At the risk of starting to sound repetitive on the calls, the second quarter results once again showed the operating leverage in our highly-efficient, branchless, business-to-business digital banking model, as our loan portfolio continues to grow. Eighteen percent year-over-year growth in total assets generated 15 percent year-over-year growth in net income, and that, combined with a continued focus on management of our fixed costs, drove both a year-over-year and sequential improvement in the digital banking efficiency ratio to a record new 38 percent and a 2 percent year-over-year increase in average return common equity to 12.4 percent.

Notably, Q2 was a solid quarter for our point-of-sale receivable purchase program business, which expanded by a healthy 1 percent sequentially as HVAC home improvement sector, which continues to make up the largest component of our point-of-sale portfolio, continues to see robust consumer activity. That contributed to another record high for total assets of $4.4 billion, another meaningful step towards our next milestone of $5 billion and the continued outsized positive impact on our efficiency, our profitability, and our return on equity. Quarters one and two combined for a strong first half of 2024, with a year-over-year growth in net income and EPS of 25 percent and 29 percent, respectively.

Looking more closely at our Q2 numbers, I will note here that the second quarter is historically the softest quarter for the Bank. This is something that hasn't been readily apparent in the last few years due to hyper growth in our point-of-sale portfolio. Due to the nature of the types of purchases our point-of-sale partners are financing, we historically see lower activity during the winter months. Now, milder than normal winter here in Canada, and, in particular, our most populous market, Ontario, further dampened the number of winter-related purchases, and in our cybersecurity service business, Q2 reflects the start of a fiscal year for many of its claims in contrast to Q1, which, due to the Bank's fiscal year end being October, historically benefits from calendar year-end spending by our customers.

As was the case in Q1, Q2 also reflected our planned strategy to transition a component of our real estate portfolio from higher yielding, higher risk-weighted loans to lower yielding, lower risk-weighted CMHC insured loans. As we ramp up these activities, you'll see the percentage of CMHC loans increase quarter-over-quarter. There will be a little more on this later.

We are also seeing what appears to be some softness in the macro point-of-sale financing market due to elevated interest rate environment and softness in certain parts of the economy. This is the result of a combination of slower growth and the origination by our partners, as well as higher than typical level of early repayments by our consumers. I'll provide more colour on what remains a very positive outlook for our point-of-sale business in a few minutes.

The second item I want to call out in Q2 is net interest margin, which, to a large degree, reflects the success of our focus on growing point-of-sale financing portfolio. That portfolio is lower risk weighted, has lower-yielding loans than our real estate portfolio. Over the past 24 months, the proportion of our point-of-sale financing portfolio has expanded from 66 percent to now 78 percent. That said, Q2 net interest margins are below our near-term expectations. On the lending side, we believe there is still some room for expansion in our Canadian point-of-sale business, and the deposit side, we expect higher-than-normal broker spreads in our wealth management deposits to moderate, while we expect to benefit from continued expansion of our lower cost and solvency deposit portfolio.

The third item of note is that, despite the very strong year-over-year growth in net income and EPS, Q2 profitability was dampened slightly by a number of transitory items that mask the underlying performance of your digital banking operations. A significant component of the 7 percent sequential decrease in net income reflects higher provisions for taxes and a modest increase in noninterest expenses primarily due to lower than typical expenses in the first quarter of fiscal 2024 at DRT Cyber.

When we strip away this noise, pretax profitability for our digital bank operations was actually up sequentially, and notably, non-interest expenses in our digital banking operation was down 6 percent year-over-year and down 4 percent sequentially.

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

John Asma — Chief Financial Officer, VersaBank

Thanks, David.

Before I begin, I will remind you that our full financial statements and MD&A for the second quarter and first half of the year 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 otherwise noted.

Starting with the balance sheet.

Total assets at the end of the second quarter of fiscal 2024 grew 18 percent year-over-year and 2 percent sequentially to a new high of $4.4 billion. As David noted earlier, Q2 is historically the slowest quarter for growth due to seasonality on both the digital banking operations and cybersecurity services businesses. While we continue to experience some temporary dampening of our results due to our strategy to transition a portion of the real estate portfolio to CMHC-insured mortgages which will contribute to higher return on common equity.

Cash and securities were $303 million or 7 percent of total assets, consistent at 7 percent in Q2 of last year and up slightly from 6 percent in Q1 of this year.

Book value per share increased to a new high of $14.88, our CET1 ratio increased to 11.63 percent, and our leverage ratio was 8.55 percent, both remaining above our internal targets.

Turning to the income statement.

Total consolidated revenue increased 7 percent year-over-year, but decreased 1 percent sequentially to $28.5 million. The year-over-year increase was driven primarily by higher net interest income as our digital banking loan portfolio continues to grow, while sequential decrease was mainly due to seasonality, as well as the temporary dampening of revenue due to transition of a portion of the real estate portfolio to CMHC-insured loans.

Consolidated noninterest expenses were $12.2 million, down from $12.7 million last year and up slightly from $12 million for Q1 of this year as Management continues to focus on managing the fixed expenses line across the business.

Consolidated net income for Q2 increased 15 percent year-over-year to $11.8 million and decreased 12 percent sequentially. As David mentioned, notwithstanding this healthy year-over-year growth, Q2 profitability was slightly dampened by a number of transitory items that masked positive sequential growth in the pretax profitability for our digital banking operations.

Consolidated earnings per share increased 18 percent year-over-year to $0.45, benefiting from a lower number of shares outstanding due to the buyback program we had in place during fiscal 2023.

The loan growth grew to just over $4 billion at the end of Q2, driven, once again, by our point-of-sale receivable purchase program, which increased 23 percent year-over-year and 1 percent sequentially to $3.1 billion.

Our point-of-sale portfolio represents 78 percent of our total loan portfolio at the end of Q2, up slightly from the end of Q1.

Our real estate portfolio expanded 1 percent year-over-year and was flat sequentially at $828 million as we transition to CMHC-insured loans. As a reminder, our real estate portfolio is primarily mortgages and construction loans for real estate properties. We have very little exposure to commercial use properties.

Turning to the income statement for digital banking operations.

Net interest margins on loans, that is excluding cash from securities, was 2.52 percent. That was 47 basis points or 16 percent lower on a year-over-year basis and 11 basis points or 4 percent sequentially. Net interest margin overall, including the impact of cash, securities, and other assets, decreased 33 basis points year-over-year or 12 percent and decreased three basis points or 1 percent sequentially to 2.45 percent. As David discussed, Q2 net interest margin reflects the strong growth of the POS financing portfolio, which is comprised of low risk-weighted, lower-yielding, but higher ROCE assets than commercial real estate, as well as the transitory impact of the transition of the real estate loans to higher return opportunities.

Cost of funds for Q2 was 4.21 percent, up 94 basis points year-over-year and up 22 basis points sequentially. Cost of funds was again somewhat elevated in Q2 due to the raised rates for term deposits. We continue to expect to increasing 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 PCLs, in Q2 remain negligible at 0 percent of average loans compared to 0.03 percent last year and with a 12-quarter average of 0.01 percent.

I'll now briefly turn to DRTC.

On a stand-alone basis, Digital Boundary's Group's Q2 revenue increased 8 percent year-over-year to $2.8 million and gross profit increased 5 percent to $2 million, both due to higher service engagements. Sequentially, both were down, reflecting the seasonality in the business, as our fiscal Q2 coincides with the start of many customers' fiscal years during which they are often planning and ramping stages of their budgets, projects, and deliverables. DBG remained profitable within DRTC.

DRTC’s net loss of $162,000 in Q2 of this year compares with a net income of $433,000 last year, with the difference mainly due to higher expenses and higher people costs to support past and expected expansions in business activity. The decrease from net income of $435,000 in Q1 of this year was primarily due to some positive compensation adjustments in the comparable quarter.

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

David R. Taylor — President and Chief Executive Officer, VersaBank

Thanks, John.

The outlook for strong near and long-term growth in VersaBank remains very favourable. We expect improved sequential growth in our point-of-sale financing portfolio with the benefit of seasonally higher summer sales, as well as a ramp-up in loan originations in our CMHC insured finance facilities in our real estate portfolio in the third and fourth quarters. As of April 30, we had commitments of nearly $440 million, which is a very solid start and a number we expect to continue to steadily grow. Notably, only a small amount of these commitments has yet been drawn down actually by our loan partners, meaning that we expect to begin to see the growth in this portfolio starting in the second half of this year and accelerating into 2025.

Notably, as the Canadian banking industry sees the impact of sustained elevated interest rates and some softness in the economy, the advantage of our branchless, business-to-business, digital banking model really comes into focus. For several quarters now, you have heard me give the caveat that any comments around our short-term growth potential of our point-of-sale business with economic impact. We may be seeing some of that now. While this may slightly delay reaching our next total asset milestone of $5 billion to Q1 of next year, it doesn't impact the resulting operating leverage or the benefit to the return on common equity as we expand our portfolio.

On the deposit side, insolvency deposits grew sequentially for the fourth consecutive quarter as Canadian consumer and small business insolvencies continues to increase. According to Statistics Canada, insolvencies in Canada in April of this year were up 24 percent from April last year. Consumer insolvencies were up 23 percent, while business insolvencies were up more than 60 percent.

Accordingly, we are continuing to see the number of accounts in our insolvency deposits increase from an already record high levels by 18 percent year-over-year and 4 percent sequentially. As a reminder, these accounts are opened prior to the funds being deposited, so they are very solid leading indicator our future expansion of our deposit base.

As we continue to benefit from the operating leverage from growth in Canada, we look forward to a decision from the U.S. regulator authorities with respect to our proposed acquisition of a U.S. bank. A favourable decision will be transformational, enabling us to drive our assets to multiples of growth from Canada alone and fully capitalize on the operating leverage of our branchless B2B digital banking model. I'm pleased to report that I do not have an update on the potential timing of a decision from a U.S. regulator. That's because, based on the information we have to date, we continue to anticipate a decision before the end of this month. That said, the timeline remains at the discretion of the regulators, and we respect their prerogative to adjust as necessary for the integrity of the process.

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

Q & A

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. To ask a question, you may press then star, then the number one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question, please press star, then the number two. One moment, please, for your first question.

Your first question comes from the line of David Feaster with Raymond James. Please go ahead.

David Feaster – Analyst, Raymond James

Hey. Good morning, everybody.

David R. Taylor — President and Chief Executive Officer, VersaBank

Good morning, David.

David Feaster – Analyst, Raymond James

I just wanted to start out on the organic growth side. You talked about the softness in Canada, some of the risks to achieving that $5 billion asset level this year, but you're also pretty bullish on partner additions in Canada, expansion in the U.S., and the pipeline's healthy. I'm just curious, how do you think about the organic growth trajectory within that point-of-sale business, the pipeline of partner additions in both Canada and the U.S., and then are you looking to expand products? I know HVAC has been a key driver, but is there an opportunity to expand the product set to potentially help accelerate growth? Just curious your thoughts on that side.

David R. Taylor — President and Chief Executive Officer, VersaBank

Well, first of all, in Canada, there tends to be a dampening effect of the winter months on consumer purchases, and even in the HVAC projects that people undertake, so this half year, we saw the impact of that. In previous years, we've had such rapid growth it's overwhelmed the tendency of Canadians not to get onto car lots and entertain new purchases; hot tubs and barbecues and such. The second half of the year, I do expect to see a resurgence in the consumer purchases, and we're already seeing that in May. It's up a fair amount from April, so that's just a typical Canadian thing.

The other thing about the Canadian consumer is, according to the stats people, they tend to have some savings, so they tend to be a little more enthusiastic about buying in what might be seen as recessionary times than otherwise, so for the half year coming, I see a bit of a resurgence. It would be a better half than the last half. Now, with respect to new products, yes, indeed, we are having a look with new partners that have some innovative point-of-sale type financing products, really cool ones. I won't talk about exactly what they are now, but really cool, ideally suited for our Bank's model, so we're looking at that going forward, too. In Canada, and in the States, as I was saying, we're hopeful the regulator comes to a decision by the end of this month, but if not, there's a fair amount of moving factors in the United States now. I just saw a recent report from the Fed about a large—a huge quantity of large bad loans in the portfolio, so I hope to come to a positive conclusion by the end of this month, and that, of course, allows us to bring our product to United States where we think there's tremendous demand for it.

David Feaster – Analyst, Raymond James

Okay. That's great, and then you did touch on some of the softness in the labour market in Canada and some of the softness there. Obviously, your credit’s phenomenal, but I'm curious about how is credit of the underlying receivables for your partner been? Has there been any change there, and how are the retailers, your partners doing just given some of the softness that you talked about? Are you having any issues from the health of their balance sheets just as the consumer may be weakening a little bit?

David R. Taylor — President and Chief Executive Officer, VersaBank

Yes, well, yes, we definitely are seeing that. Our partners are experiencing higher than they have in the past of defaults and it’s in various sectors. Retail purchases slowed down, which translates through to us to less volume, and it also has another ironic impact on us that is an odd characteristic of our Bank versus all the other banks. When our partners experience more defaults, given the way we structure the arrangement, that means we put the defaulted loans back to them more rapidly than we would otherwise, so it reduces the net increase in the portfolio, because defaults, to us, mean repayments as we're repaid as a loan defaults, so we've experienced higher than average repayments in this last half than we would otherwise because of the higher than average defaults in our partners’ portfolios, so that certainly illustrates how our model is different than other banks.

Other banks presently are whining about credit issues and they're putting up larger provisions, as they should, for the credit losses, and we don't, because we have our partners' cash standing guard against a loss for us, but that does mean more rapid repayments, because someone's going to see how we debit their account and see a reduction in portfolio, so that had an impact on the growth in Q2 also.

David Feaster – Analyst, Raymond James

Okay. All right. That's helpful, and then maybe last one, just could you touch on the funding side? I'm curious what you're seeing there. You talked about some of the tailwinds on the trustee side, which is great, but funding costs are continuing to rise. I'm curious where do you think we are there? Are you seeing things starting to stabilize? Just curious how you think about funding your growth trajectory looking forward and ultimately the impact on the margin?

David R. Taylor — President and Chief Executive Officer, VersaBank

Well, I hate to use the word great with respect to insolvencies, because obviously that means a lot of poor folks are 60 percent increase in small business insolvencies and 20-odd percent increase in consumers. Not good for the economy, but it's very good for our deposit growth. As I was saying earlier, it's a leading indicator. The more accounts we open, the more insolvencies there are, the greater that portfolio of deposits grows. It's getting to record levels now, but I see that continuing on for the next year or two because there's a fair lag effect.

The accounts are opened and then they fill up with the proceeds of the liquidation of the estates. That usually takes about a year and a half, two years, so we're starting to see the beginning of it, and I would expect the insolvency deposits to peak out around $1 billion dollar Canadian over the course of next, say, eight months, nine months, 12 months. It's getting back to normal levels. Sad times for Canadians, but we designed this deposit business as a counterbalance to recessionary times for our Bank.

David Feaster – Analyst, Raymond James

Makes sense. Thanks, everybody.

Operator

Thank you. Once again, if you would like to ask a question, please press star, one.

Your next question comes from the line of Mike Rizvanovic with KBW Research. Please go ahead.

Mike Rizvanovic – Analyst, KBW Research

Hey. Good morning. David, I wanted to ask you a quick question about the mortgage renewal cycle, not in terms of the direct impact obviously, but just the indirect impact. If we do have higher rates for longer or just maybe call the rates settling at a higher level even if the Bank of Canada starts a cutting cycle, there's no necessary guarantee that mortgage renewals won't be painful for a lot of borrowers, so in the context of a deleveraging cycle potentially in Canada on the consumer side, what are your thoughts on how that could impact the demand for POS for you? Obviously, it's been a very, very resilient book. Your growth has been phenomenal there. A little bit of a slowdown this quarter, but if we do get this dynamic where Canadians are just not borrowing as much, what's the downside on your view with respect to how much you could grow POS?

David R. Taylor — President and Chief Executive Officer, VersaBank

Well, it would definitely have a dampening effect. Last year, we grew our POS by about 30 percent. At the beginning of this year, I was hoping for around 20 percent. I'd say it'd be a little less than that even, so, yes, those factors do dampen POS purchases. Just anecdotally, you’re not going to the motorcycle shop to buy a motor bike if you just had to renew your mortgage at twice the rate than it was before, so it definitely has a dampening effect, but we still have the potential to grow in the order of around 15 percent year-over-year. Mind you, that's half of last year.

Mike Rizvanovic – Analyst, KBW Research

Okay, that's helpful, and then maybe just a quick one, a numbers question on the margin. A bit of compression. I think five straight quarters now, you've seen it come down quite a bit here. What is your—and apology if I missed it in your prepared remarks, but any colour you can provide on margin trajectory just in light of what you're seeing on the deposit side, the gross yields? Are you looking at some sort of level of stability in the coming quarters, or is there upside, more downside? What are your thoughts on the NIM?

David R. Taylor — President and Chief Executive Officer, VersaBank

Well, there's a number of factors, some expanding margins, some contracting the margin. The CMHC mortgage portfolio serves to contract our margin in that we're probably averaging about only 175 basis points on our CMHC construction mortgages vis-à-vis conventional construction that would be, say, 300 basis points, so the faster we book CMHC mortgages, the more compression that we'll see. Mind you, considering there's no capital used in the CMHC loan, the return equity figure does well with the addition of the CMHC, but that serves to compress our margin, and then as we move more into the higher the percentage of point-of-sale is of our total lending portfolio, that serves to compress our margin too.

Now, on the other side, the inverted yield curve that we've suffered with for quite a few years now in Canada, they may be coming—that might—maybe I'm just wishful thinking here, but that might be dissipating a little bit. You may see the yield curve flattening out a little bit, and we tend to fund in the short end of the yield curve and our loans tend to have a duration on the longer end, so we get pinched on that a little, so if there's a God over there that looks after bankers, maybe that yield curve will sometime in the future start sloping upward again, and that helps, so you have those two factors that compress the margin, which actually are pretty good, because the more CMHCs we book, even though the margin’s down, that's a wonderful low-risk new source of net interest income for the Bank, and more POS is better, too, but if the yield curve would straighten out and head up as it traditionally does, it would be positive for us.

Mike Rizvanovic – Analyst, KBW Research

That's very helpful. Thanks for your insights.

David R. Taylor — President and Chief Executive Officer, VersaBank

You're very welcome.

Operator

There are no further questions at this time. I would like to turn it back to Mr. David Taylor for closing remarks.

David R. Taylor — President and Chief Executive Officer, VersaBank

Well, 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. Today, I've actually very lucky and blessed. I'm sitting here in New York City, speaking to you from the New York Athletic Club, and looking forward to meeting some potential investors here in this is fabulous city. It's a beautiful day looking out over Central Park, so I hope you all have a wonderful day, and if you have any further questions you want to ask me, you could drop me an e-mail. I’m always happy to talk to my investors and potential investors, and thank you again.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you all for participating. You may now disconnect.