

VersaBank**Third Quarter Fiscal 2024 Financial Results Conference Call**

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CORPORATE PARTICIPANTS

David Taylor

VersaBank — President & Chief Executive Officer

John Asma

VersaBank — Chief Financial Officer

CONFERENCE CALL PARTICIPANTS

David Feaster

Raymond James — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to VersaBank's third quarter fiscal 2024 financial results conference call.

This morning, VersaBank issued a news release reporting its financial results for the third quarter ended July 31, 2024. The 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. And if you're listening to the webcast but wish to ask a question in the Q&A session following Mr. Taylor's presentation, please dial into the conference line, 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 telephone and via the internet, beginning approximately one hour following completion of the call. Details on how to access the replays are available in this morning's news release.

I would like to remind our listeners that the statements about future events made on this call are forward-looking in nature and are based on certain assumptions and analysis made by VersaBank's 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 today is Chief Financial Officer John Asma.

I'd like to begin today's call by discussing one of the most important announcements in the history of our bank, the closing late last week of our US acquisition. It's been a long process, spanning more than two years since we first announced the transaction in spring of 2022.

Now this was no mean feat, what we understand to be a relatively rare occurrence in the United States. There were many who thought it wouldn't be possible. However, with a rock-solid foundation based on our branchless, digital B2B model, a proven track record of innovation, earnings growth, and no loan losses, and a truly unique, risk-mitigated offering in our Receivable Purchase Program, we presented the US regulators with a very compelling proposition.

I'd like to take this opportunity to publicly thank all those at VersaBank for their tireless efforts on both the regulatory approval process and the acquisition itself, the incredible team at Stearns Financial for being great partners throughout the transaction, and our advisors for their ongoing counsel throughout this initiative.

This is a transformational event in VersaBank's growth trajectory. We are now able to bring our unique and highly attractive RPP solution, which has been successful in Canada, to the largest point-of-sale financing market in the world.

With the closing of the acquisition on schedule last Friday, we are now in the process of finalizing our first post-transaction RPP partner in the United States. And on the deposit side, we are now able to

raise economical, FDIC-insured deposits to fund this program, and we have the mechanisms in place to do that.

In a few minutes, I'll discuss how we were able to launch the RPP in the United States; this, with virtually no capital expenditures, minimal additional operating expenditures, and very low execution risk.

Turning to our financial results, preparations for the closing of our US acquisition and broad launch of our RPP program in the US gave rise to a fair amount of noise this quarter. We viewed this in three categories.

One, we maintained higher cash balances in preparation to fund the capital requirements of the US subsidiary, following the closing of the SBH acquisition. The higher cash balances temporarily depressed our net interest margin, which was already dampened by what we typically experience when interest rates decline.

The rates we pay on our Canadian term deposits decrease more slowly than the Government of Canada rate, so there is a period of catch-up. Of course, we benefit in the same way when interest rates were rising.

Three, non-interest expenses increased due to acquisition-related costs, some of which were specific to the third quarter, and some of which were being incurred ahead of the asset growth and revenue generated by the launch of our US RPP. I will note that there will again be onetime costs in the fourth quarter, given the acquisition formally closed in Q4.

We achieved another record high for total assets, up \$4.5 billion, driven by 11 percent year-over-year growth in our loan portfolio.

As expected, we saw seasonal pickup in the growth in our Canadian RPP Point-of-Sale business, which expanded 4 percent sequentially, even as discretionary spending in Canada generally remained soft.

Growth also continues to dampen by higher-than-typical putbacks from loans that have gone 90 days in arrears to our partners, due to higher defaults among the borrowers. This, of course, is exactly how our model's supposed to work. The defaulted loans go back to our partners, and we are made whole by the cash holdback. You can see this very clearly in our provision for credit losses, which was zero in Q3.

You can see the continued performance of our business model in our year-to-date fiscal 2024 results, with all key metrics trending in the right direction.

Most notably, net income for the first nine months of this year is up 15 percent, and EPS is up 17 percent.

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 financial statements and MD&A for the third quarter and the nine months are available on our website under the Investors section, as well as on SEDAR and EDGAR.

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 third quarter of fiscal 2024 grew 13 percent year over year and 3 percent sequentially to a new high of \$4.5 billion.

Cash and securities were \$401 million or 9 percent of total assets, up from 7 percent in both Q3 last year and Q2 of this year.

Book value per share increased to a new high of \$15.23.

Our CET1 ratio increased to 11.75 percent, and our leverage ratio was 8.54 percent, with both remaining above internal targets.

Turning to our income statement. Total consolidated revenue increased 1 percent year over year and decreased 5 percent sequentially to \$27 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 temporary dampening of cost of funds as Canadian interest rates fall, which was exasperated (sic) by the higher cash balances.

Consolidated net interest expenses were \$13.5 million, up from \$12.9 million last year and \$12.2 million for Q2 of this year.

The primary year-over-year and sequential increases were due to costs related to the US bank acquisition and preparation for the launch of our Receivable Purchase Program in the US.

As David noted, we will see additional acquisition-related costs in the fourth quarter, returning to a normalized cost structure in Q1.

Consolidated net income for Q3 decreased 3 percent year over year and 18 percent sequentially to \$9.7 million or \$0.36 per share, with the decrease driven by the factors described above.

Our loan portfolio grew to a new record \$4.05 billion at the end of Q3, driven, once again, by our Point-of-Sale Receivable Purchase Program, which increased 16 percent year over year and 4 percent sequentially to \$3.2 billion.

Our Receivable Purchase Program portfolio represented 80 percent of our total loan portfolio at the end of Q3, up from 78 percent at the end of Q2.

Our real estate portfolio contracted 9 percent year over year and 10 percent sequentially to \$745 million as we continue to transition to CMHC-insured loans, which is because they are 0 percent risk-weighted and require no regulatory capital.

We have current commitments outstanding of \$570 million, with \$125 million outstanding at the current time, which we anticipate growing over the next several quarters.

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 our Digital Banking operation. Net interest margin on loans, that is excluding cash and securities, was 2.41 percent. That was 28 basis points or 10 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 34 basis points year over year or 13 percent, and decreased 22 basis points or 9 percent sequentially to 2.23 percent.

Q3 net interest margin reflect the continued growth of the Receivable Purchase Program portfolio, which is comprised of lower risk-weighted, lower yielding, but higher ROCE assets than Commercial Real Estate, as well as temporary increases in cost of funds, as due to the decreases in interest rates in Canada.

Cost of funds for Q3 was 4.17 percent, up 55 basis points year over year, and down 4 basis points sequentially.

The temporary upward pressure from interest rates is being offset by the benefit of continued expansion of our low-cost insolvency professional deposits, as insolvency activity in Canada continues to steadily increase.

Our provision for credit losses or PCL in Q3 remained negligible at 0 percent of average loans, compared to 0.02 percent last year and with a 12-quarter average of 0 percent.

Before turning the call back to David, a quick review of our Cybersecurity business, DRT Cyber.

On a stand-alone basis within DRT Cyber, Digital Boundary Group revenues for Q3 increased 8 percent year over year to \$2.5 million, and gross profit increased 5 percent to \$1.9 million, both due to higher services agreements. Sequentially, both were down slightly, primarily as a function of the timing of service engagements.

DBG remained profitable within DRTC. DRTC's net loss of \$106,000 in Q3 of this year was comparable with a net loss a year ago and an improvement from a net loss of \$162,000 in Q2 of this year.

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

David Taylor

Thanks, John.

As we enter the US market with our Point-of-Sale Receivable Purchase Program in a meaningful way, we still field a lot of the questions around how and why we're able to do what we do in our RPP with no loan losses to date. Let me take a minute to walk through the model.

For those viewing our presentation, our graphic uses an example of a home hot water heater loan, but the model works for virtually any good or service that can be financed at the point of sale.

As part of our master agreements with our RPP partners, embedded in the economics of every loan we purchase, is what we refer to as a cash holdback, an amount of cash that we hold on our balance sheet as a deposit. These cash holdbacks are aggregated in a pool for each partner. The amount of these cash holdbacks is based on the multiple of historical default rates for similar types of loans and borrowers,

the key word here being multiple. In other words, the cash holdbacks are multiple times in excess of what would be considered a worst-loss case scenario.

With our partner acting as administrator of the loan that is exclusively dealing with the end customer, we receive monthly payments until the loan is repaid. If and when the loan goes 90 days in arrears, we automatically return that loan to our partner to deal with the collections. At the same time, we automatically debit the partners' cash holdback account, making us whole on the loan.

One might ask, why would a point-of-sale finance company want to work with us if they retain the lending risk? There are several reasons, all of which are rooted in our proprietary software, which is the foundation of our RPP value proposition for our partners.

One, the economics make sense. Because of the efficiency of our branchless digital B2B model, there's enough margin for both the Bank and our partners to do very nicely.

Two, we typically provide our partners with 100 percent of the value of the loan compared to, say, 70 percent to 80 percent through their conventional financing sources. That means less need for their own capital and significantly higher return on equity for them.

Three, because we can purchase loans on demand even daily, we significantly reduce their liquidity needs. And I will note here that our goal is to advance in real-time purchasing.

And four, our software automates everything. It's seamless, and it just works.

Importantly, we are looking to replace all of our financing of our potential RPP partner—excuse me. Importantly, we are not looking to replace all the financing of our potential RPP partner. Funding diversification on their part is smart. We just want to be an additional, convenient, economical source of funding that will allow them not only to grow their business faster, but also more profitably. It's definitely a win-win.

The other question I get is, how can you possibly do this with no CapEx, hardly any additional OpEx, and very little risk? Because our RPP business essentially operates in the Cloud, expansion to the US requires little more than signing up with Microsoft at their US Azure datacentre, which was done months ago. We can facilitate US deposit raising and US RPP lending from our existing technology centres in Canada.

With our US acquisition licence, we are just erasing the border. Yes, we will have a de minimis amount of additional OpEx in the US, primarily for our leadership team. And we plan to add few dedicated US RPP account people as we ramp. But these amounts are negligible relative to the revenue we expect business to drive over the long term.

Our US Receivable Purchase Program opportunity, alongside our anticipated continued steady growth in Canada, is expected to generate strong, sustainable expansion of our loan portfolio for the years to come. It will enable us to further capitalize on the significant operating leverage in our model to drive growth in profitability and the return in common equity and efficiency that is among the very best in North American banking industry.

Continued growth in our POS RPP in Canada alone will push us past the \$5 billion milestone. In addition to RPP POS growth, we expect near-term expansion in our real estate portfolio, which exists to capitalize on decades of experience in this sector to generate additional returns with very low risk.

We are in the process of transitioning much of this portfolio to zero-risk-weighted CMHC-insured loans, meaning they require no regulatory capital, which will further enhance our return on common equity.

Finally, with respect to net interest margin, while we do expect to see some continuing short-term pressure as interest rates in Canada decrease, we will also continue to benefit from the expansion of our insolvency professional deposits, as bankruptcies in Canada continue to trend upward.

We also expect a higher net interest margin contribution from our US RPP portfolio, due to more favourable economics for the solution there.

To conclude, despite the acquisition-related noise, our third quarter results continue to demonstrate the considerable operating leverage in and very low-risk nature of our branchless digital B2B model, a model that we have proven out in Canada and that we are very confident we will see the same success in much larger, faster-growing US market.

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

Q&A

Operator

Thank you, sir. Ladies and gentlemen, we will now begin the question-and-answer session. Should you have a question, please press the *, followed by the number 1 on your touch-tone phone. You will hear a prompt that your hand has been raised. Should you wish to decline from the polling process, please press *, followed by the number 2. If you are using a speakerphone, please lift the handset before pressing any keys.

Again, should you have a question, please press *, 1 on your telephone keypad. One moment, please, for your first question.

Our first question comes from the line of David Feaster from Raymond James. Go ahead, please.

David Feaster — Raymond James

Hi. Good morning, everybody. Congratulations on closing the deal.

David Taylor

Thank you, David.

David Feaster

So we've got—with the deal now closed, I was hoping maybe you could start with just how conversations are going with new partners in the US, how demand's trending, and maybe the growth trajectory that you're expecting, and then just remind us of those better economics on the RPP program in the States that you were alluding to.

David Taylor

Yeah. Well, the reception we've had in the United States is tremendous. And some partners have patiently waited for us to finally be able to operate in the States and one that—one we're working with right now to conclude and get them operational.

There's a multitude of others that we'll be signing up over the course of the next year that they've been convinced for the last few years that it's going to work very well for them. So a super reception in the United States and one already in the hopper, a very patient one that stuck with us through the process that, maybe in a month or so, we'll be fully operational.

The economics in the US are slightly better than Canada in that the US bank cost of funds runs about 1 percent lower than the equivalent rate in Canada, particularly recently in that our deposit rates in Canada, as I was mentioning, are a bit sticky. They don't come down quite as fast as the Bank of Canada rates. So theoretically, there's about a 1 percent improvement in the RPP program in the US versus Canada. And we've been averaging, say, approximately 250 basis points in Canada, so a fairly significant improvement in profitability in the States.

David Feaster

That's terrific. And just to that point, I was hoping you could touch on the funding growth side in the States. You just talked about the lower deposit costs. Could you just touch on the time line? I mean, like can you immediately, with the deal closed, start driving deposit growth here in the States? And just walk through your strategy for funding growth in the US.

David Taylor

And the answer's yes, we can immediately start raising deposits. In fact, we already are at our retail outlets in Holdingford, over the counter, of course. And thankfully, we have recently signed up with your company, Raymond James, to supply us with deposits. And there's another large company, a brokerage firm, that we have the documentation to sign. Between the two, your company, David, and the other one, gives us tremendous reach into the deposit market.

So those two are—yours is signed, and the other one is likely to be signed today sometime. That's plenty of deposit access for our little bank. I'm sure, over the course of the year, there'll be more signing up with us, but with those, you and the other one, that is more than we could possibly ever use.

David Feaster

That's great. I love to hear it. And then just one quick modelling question. You called out some one-time costs in the quarter. Could you quantify those?

And maybe quantify what was in this quarter and some of the one-time charges you might expect next quarter?

David Taylor

Well, it's about \$700,000 or so that was directly associated with the US tax decision in Q3. It'd be consulting fees as ... An ongoing expense will be additions to our payroll. This'll be the hires of the

senior people in United States to run the shop. There was also a picnic celebration that we had in Canada (phon) at my farm that had a bit of a bill on part of the \$700,000. So those were direct expenses associated with the US acquisition. Then there'd be miscellaneous-type expenses, a lot of travel costs, meetings, and then the additional board members (unintelligible) and such, that's started to go through in the quarter.

The other thing that impacted us this quarter, that John alluded to, was with the Bank of Canada dropping rates, the Canadian deposit rates fall with the Bank of Canada, but they lag. So it's happened this quarter. We're raising about \$120 million additional, that'll be over and above what we normally raise in deposits, in order to fund the US acquisition. So we're raising it just at the wrong time because the Bank of Canada dropped their rate, and our deposit rates hadn't quite dropped, that being the change in deposit market. It hadn't quite dropped in lockstep with it.

So we probably, all in, squeezed our margin, and it cost us in the order of about \$600,000 and odd in additional interest expense. But of course, it goes away. The rates have almost caught up again now. But I suppose we just had another drop in the Bank of Canada so, hopefully, our deposit rates catch up faster than they did the last time.

David Feaster

And based on the disclosures, it's about a three-month lag. Is that right?

David Taylor

Yeah. And we've got a nice graph for you, Dave, if you want to have a—we graphed this. It's painful to see it, of course. And it didn't used to be like this years ago. I've been banking 47 years. And it used to go—like it was tied together with steel, steel bar. But for some reason, the Canadian deposit market sort of lags, which means that we banks pay a little more than we should be paying in the short run, while the deposit rates catch up with the reduction in the Bank of Canada rate.

David Feaster

Okay. That's helpful. Thanks, everybody.

David Taylor

Well, thank you, Dave. Looking forward to seeing you downstairs. For all those—

David Feaster

Sounds good.

David Taylor

I'm at the windy—I'm in the windy city today, and it actually isn't windy. It's a beautiful, beautiful day looking out on the lake here, clear blue skies.

David Feaster

Thanks again.

Operator

Thank you. Everyone, just a reminder, should you have a question, please press *, followed by the number 1 on your touch-tone phone.

There seems to be no further questions at this time. I'd now like to turn the call back over to Mr. Taylor.

David Taylor

Well, I'd like to thank everybody for joining us today. And I'll look forward to speaking to you at the time of our fourth quarter. And for those that are attending the Raymond James conference here in Chicago, I look forward to talking to you downstairs in a few minutes. So long. Over and out.

Operator

Thank you, sir. Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines. Have a lovely day.