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Brookfield Real Estate Services Inc.

Third Quarter of 2017 Conference Call

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Ron Boski
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PRESENTATION

Operator

Good morning. My name is Dan, and I would like to welcome everyone to the Brookfield Real Estate Services Incorporated Third Quarter of 2017 Conference Call. All lines have been placed on mute to prevent any background noise.

After the speakers' remarks, there will be a question-and-answer session. If you would like to ask a question, simply press *, then the number 1 on your telephone keypad. If you would like to withdraw your question, press the # key. Thank you.

I would now like to introduce to you Mr. Phil Soper, President and CEO of Brookfield Real Estate Services Incorporated. Mr. Soper, you may begin your conference call.

Phil Soper — President and Chief Executive Officer, Brookfield Real Estate Services Inc.

Thank you, Dan, and good morning, everyone. We appreciate you joining us.

Today with me is our Chief Financial Officer, Glen McMillan. On today's call, I will begin with a brief overview of the quarter, Glen will then discuss our financial results for the third quarter, and I'll conclude by providing some remarks on recent business, operational highlights, and market developments. After that, Glen and I would be happy to take your calls—your questions.

I want to remind you that some of the remarks expressed during this call may contain forward-looking statements. You should not place reliance on these forward-looking statements because they involve known and unknown risks and uncertainties that may cause actual results and performance of the Company to differ materially from anticipated future results expressed or implied in such forward-looking statements.

I encourage everyone to review the cautionary language found in our new release and all our regulatory filings with respect to forward-looking statements. All these documents can be found on our website and on SEDAR.

Year to date, the Company is having a very good year. Cash flow from operations a rolling 12-month basis saw an increase of 5.4 percent to 2.55 a share compared to 2016.

In the third quarter, royalties dipped due to lower sales in the greater Toronto area. I will come back to this later in the call.

Last quarter, we announced an increase of 3.9 percent to our monthly dividend to holders of the Company's restricted voting shares. This announcement increased the targeted annualized dividend to $1.35 per share. As a result, the dividend payable December 29th to shareholders of record on November 29th will be $0.1125 per share.

As at September 30, 2017, the Company's network of REALTORS grew to 18,117, a 3 percent increase compared to the 17,580 at the start of the year, and substantially unchanged from the second quarter of the year.

Despite a weaker Canadian housing market this quarter, over the last three years the Canadian market has grown at rates well above historical averages. The housing market, as measured by transactional dollar volume, the value of all homes sold, was down 10 percent in the third quarter of 2017 compared to the third quarter of 2016.

However, if we exclude the greater Toronto area, which represents about 23 percent of the Canadian market, the rest of Canada grew by 3 percent. We will provide more detailed remarks on the state of the Canadian housing market and specifically the GTA later in this call.

When we look at fluctuations in real estate values, it's important to realize that the Company's revenue is driven by long-term franchise agreements, and our royalties are weighted towards fixed fees. Approximately 72 percent of our annual royalties have been insulated for market fluctuations.

As a result of this strategy, the stability of our structure—the stability our structure provides was certainly evident in this quarter when the GTA's transactional dollar volume dropped 35 percent, but company royalties fell only 3 percent.

With that, I'd like to turn the call over to Glen for a look at our third quarter financial performance.

Glen McMillan — Chief Financial Officer, Brookfield Real Estate Services Inc.

Thank you, Phil, and good morning, everyone. As Phil mentioned, on a year-to-date basis, Brookfield Real Estate Services has generated strong financial results.

Royalties have improved by 6 percent to $34.8 million and cash flow from operations has improved by 7 percent to $25.7 million, driven by an increase in the number of REALTORS in the

Network and continued growth in the Canadian real estate market through the first half of 2017 relative to 2016.

For the first nine months of the year, net earnings were $9.6 million, or $1.01 per share compared to net earnings of $1.1 million, or $0.11 per share last year. Increased earnings for the nine months were driven by improved cash flow from operations, lower mark-to-market adjustments on the Company's exchangeable units, and lower amortization costs associated with intangible assets.

We did see a decrease in sales volume in the GTA and surrounding area in the third quarter, which resulted in a reduction in royalties and cash flow from operations in the quarter compared to 2016. Specifically, our variable franchise fees and premium franchise fees were lower by 10 percent, or $600,000 compared to 2016.

However, our bias towards fixed fees and strong growth in the number of REALTORS in the Company Network contributed to a 5 percent, or $300,000, increase in fixed franchise fees, offsetting much of the negative market impact.

The Company generated cash flow from operations of $9.2 million in the third quarter, or $0.71 per share, a slight decrease as compared to 9.3 million, or $0.73 per share, for the same period in 2016.

In the third quarter, the Company generated net earnings of $5 million, or $0.52 per share, compared to a net loss of 1 million, or $0.11 per share, for the same period in 2016, with the improvement, again, driven by lower mark-to-market adjustments on the Company's exchangeable units and lower amortization costs on intangible assets.

Administration expenses for the quarter and year to date are lower than their respective periods in 2016, primarily due to the reduction in bad debt expense as a result of better collections in accounts receivable. This quarter's administration expenses are higher than the second quarter when we recorded bad debt recoveries of $162,000.

In the third quarter, the Canadian residential real estate market closed down 10 percent to $59.3 billion in total transactional dollar volume compared to the same quarter last year. This reflects a 12 percent decrease in units sold, partly offset by a 2 percent increase in average home prices across the country. However, as Phil noted, outside of Toronto the Canadian real estate market grew by 3 percent.

For the 12-month period ended September 30th, the Canadian market closed down 1 percent at $285.5 billion, reflecting a 5 percent decrease in units sold, partly offset by increased selling prices of 4 percent.

Earlier in 2017, the Ontario government introduced certain measures designed to cool housing markets. This has resulted in a reduction in housing activity, particularly in the GTA and surrounding areas. And for the three months ended September 30th, the GTA market experienced a decrease in transaction dollar volumes of 35 percent down to $13.7 billion compared to the third quarter of last year. This reflects a 38 percent decrease in units sold, partly offset by a 3 percent increase in prices.

For the rolling 12-month period ended September 30, 2017, the GTA closed up 2 percent, primarily due to higher selling prices.

In the third quarter, the Vancouver market showed signs of returning to health. For the three months ended September 30, 2016—2017, the greater Vancouver market increased by 22 percent on a transaction dollar volume basis when compared to 2016. The Vancouver market faced significant challenges in the first six months of the year, as a result of government policies implemented in 2016 designed to moderate the significant increase in selling prices witnessed during 2015 and 2016.

Partly as a result of these policies, the region suffered a 23 percent loss for the rolling 12-month period ended September 30th, closing at $35.1 billion. Substantially all of the decrease was due to lower unit sales.

Phil will now provide additional insights into the markets and an update on our operations.

Phil Soper

Thanks very much, Glen. The strength of the Canadian economy continued to be a positive contributor to the country's real estate market in the third quarter, which helped mitigate the sharp housing market correction in the greater Toronto area.

At 6.3 percent, Canada’s unemployment rate is low by historical standards and quite supportive of housing. People buy homes when they have jobs.

Industries from retail through to energy have posted solid results this year, particularly middle of 2017 and on, and equity markets have responded with solid gains, all of which has removed the need for crisis-level lows and fiscal stimulus.

As a result, and a further sign of policymaker’s confidence in the economy, the Bank of Canada did raise its benchmark interest rate on September 6th.

Overall, as noted earlier, when we remove the greater Toronto area, the Canadian market increased 3 percent. Regions that faced significant challenges in recent years have improved with varying results, which we’ll look at closer in a moment.

These regions include Vancouver, Calgary, and Canada’s second-largest city by population, Montreal.

When we examine the GTA, it appears to be following a similar trend to what we saw in Vancouver housing with its 2016 correction. The GTA market correction began in April 2017, and continued through the third quarter; however, with employment and population growth on a positive track, the Toronto market began to grow again in August with sales volume increasing 7 percent compared to July.

Furthermore, the greater Toronto area sales volumes for the month of October made a significant increase by almost 12 percent over the previous month, with price appreciation up 2.3 percent for the month over the same period in 2016.

Although this is outside of the third quarter, we believe that the ongoing improvements shown in the greater Toronto area are relevant, so we're sharing it with you for that reason. And it does point to the fact that Toronto appears to have moved through this correction at this point in time, and is moving towards a healthy 2018 spring market.

The decline in the GTA's unit sales were triggered with the introduction of the Ontario Fair Housing Plan, as Glen mentioned, which pushed potential buyers to the sidelines for several months as they gauged the potential impacts of new policies on home prices. We believe the uptick in the greater Toronto area August sales volume reflects those buyers gaining confidence in returning to the housing market.

And particular with first-time buyers, which are usually our largest cohort by unit sales, of course they don't have the value of their own home to worry about because they have no home. They just don't want to buy houses if they believe the prices of those homes are sliding.

British Columbia's economic indicators continue to be positive, and forecasters raised their expectations for provincial growth. At quarter-end, BC had the lowest unemployment rate across the country, and this trend continued in October. The unemployment rate there is at a very low 4.9 percent.

Greater Vancouver showed signs of fully emerging from its correction, with healthy unit sales and price appreciation both up 10 percent this quarter compared to the same quarter last year.

Quebec's unemployment rate hovered at 6 percent this year, better than the national average, and the strongest jobs performance for the province in over 40 years. We've been talking about the emerging economic renaissance in Quebec for, oh, probably two years now, and have invested significantly in the province. And it has paid dividends for the business, and of course, for our shareholders.

The greater Montreal area saw a 9 percent increase in unit sales during the quarter compared to the same period last year. This is the region's best third quarter results since 2009. It's also the 14th consecutive year-over-year quarterly increase.

In regards to price appreciation for the quarter, single-family homes in greater Montreal area and the province both appreciated by 5 percent.

Alberta's economy continues to recover from the recession triggered in 2014 by the precipitous drop in oil prices. Drilling activity has increased from 2016 levels, and the unemployment rate has also improved, dipping to 7.9 percent in September 2017.

Year to date, unit sales in Calgary are about 7 percent above last year's level, which is reflective of the strengthening economy there.

It's worth noting that the regulator that oversees chartered banks in Canada, the Office of the Superintendent of Financial Institutions, which we call OFSI, is introducing new measures aimed at ensuring Canadians can afford their mortgage obligations if interest rates rise materially. For that reason, we call it a stress test.

Starting in January 2018, homebuyers will have to prove they can meet their mortgage commitments if interest rates rise above the five-year benchmark rate published by the Bank of Canada, or 2 percent above their contracted mortgage rate, whichever is higher.

This will impact move-up buyers more than first-time buyers. Previous measures that regulators have taken have been aimed at first-time buyers through insured mortgage—mortgage insurance regulations. These are aimed at the broader population.

While impact estimates from the banking sector vary—in other words how many people will not be purchasing homes that would have without these rules in place—it is certain that some people who would buy a house today will not be able to get financing to buy that same house after January 21st, and will step back from the market at least temporarily. However, it's worth noting that clients who renew their mortgage with their current chartered bank, financial institution will not be subjected to this stress test.

In the third quarter of 2017, the Company continued to invest in products and services that support our brokerages to attract and retain top performers. In the quarter, the Royal LePage brand launched new features and functionalities to support Smart Studio, Royal LePage's integrated marketing program to assist company realtors in managing their sales, marketing, and CRM, or customer relationship management activities.

In fact, it's the only—we are the only company in Canada that offers an integrated CRM that was built for Canada and Canadian real estate and provided simply by membership in the Royal LePage network. So it's been met with a lot of satisfaction within the network.

During September, Royal LePage launched a consumer brand campaign through social media specifically focusing on the Facebook channel. Canada's Real Estate Company, Find your Happy Place campaign was designed to raise the profile of the brand through social channels.

During the quarter, Via Capitale launched (unintelligible), Salespeople Plus, which is a highly effective tool for realtors to better market themselves. Another product, (unintelligible) or House Selling Plus was launched to better market homes through social channels.

Via Capitale also launched a new series of courses accredited with the provincial regulator to meet continuing education requirements for their realtor licence in that province. The Company has continued to build brand awareness, industry-leading public relations, and media awareness programs.

Via Capitale launched its third quarter TV and consumer web campaign, and also in the quarter Royal LePage generated almost 80 percent more media impressions than our largest competitor. And year to date, the Company's number of impressions is more than double our nearest competitor.

In addition to publishing the Royal LePage House Price Survey, which is a significant driver of quarterly consumer impressions, brand impressions, the Royal LePage company also published its Peak Millennial Survey, which resulted in over 100 million consumer impressions across the nation.

The quality of this research and the resulting media impressions is strong. In the third quarter of 2017, the Company accounted for over 64 percent of Tier 1 media coverage generated by the Company and its leading competitor.

In conclusion, while the GTA and surrounding markets saw a significant drop in unit sales during the quarter, the region showed promise as sales increased 7 percent in August over July, and our business strategy of a bias towards fixed-fee revenues limited the impact to only a 3 percent reduction in royalties.

Other major markets are on positive trajectories, as I mentioned before and Glen touched on, with Calgary showing signs of emerging from recovery and Vancouver now we consider to be a healthy market, and of course Montreal, as I spoke to, is posting near-record growth.

The Company is continuing to find new ways to create and enhance products and services across our brands that resonate in the Canadian real estate community. As we pass new milestones in brand awareness and media relations programs, we look for ways to create highly engaging contact. The success of this Royal LePage Peak Millennial study is a good example of how the Company has a finger on the pulse of Canadian housing consumers and realtors and the media.

With that, I will turn the call back to Dan, our Operator, and open up for questions.

Q&A

Operator

And at this time, if you would like to ask a question, please press *, followed by the number 1 on your telephone keypad. Again, that's *, followed by the number 1 on your telephone keypad. We'll pause for a moment to compile our Q&A roster.

And your first question comes from the line of Ron Boski (phon), a private investor. Please go ahead.

Ron Boski — Private Investor,

Good morning. Why do you provide such generous dividends ongoing compared to the banks? Thank you.

Phil Soper

That's a good question. The Company has its roots as an income trust, so it began as a royalty-focused dividend paying firm and has always stayed that way.

I'll turn things over to Glen to comment on the payout ratio.

Glen McMillan

Thanks, Phil. So the Company's strategy is to continue to grow through the acquisition of franchise agreements, and allocates its capital according to that. And so to the extent that they have excess capital in addition to that growth capital, the rest is paid out to shareholders.

That's really the rationale for it.

Phil Soper

It is a high-income investment, and many of our owners, institutional owners, hold Brookfield Real Estate Services Inc. in their high-income yield portfolios or funds.

Operator

And again, if you would like to ask a question, that's *, followed by the number 1 on your telephone keypad.

Your next question comes from the line of John Rolf with Argand Capital. Please go ahead.

John Rolfe — Argand Capital

Hi, Phil. I was just wondering with the weakness in the GTA, have you folks seen any increased interest in agents from other weaker competitors to come over to the Brookfield brands? Or is that something that really only happens during a more extended downturn?

Phil Soper

Yeah. You know what? You've hit the nail on the head and obviously a keen observer of this industry because that's exactly my assessment. This particular correction in the GTA has been mild, and in fact, shorter than we anticipated. It really is a reflection of the strength of the regional economy and the structural shortage of housing relative to the growth in household formation. So there's more people who want homes than we have to provide them, and it's putting upward pressure on the market.

So in a more significant downturn like 2008/'09 or even 2012, we do see some of this flight to quality where some of the successful but marginal realtors find that they need the strength of a national brand to compete effectively in the marketplace. And so they turn to strong companies like ours.

But this particular correction hasn't been significant enough to, well, put a dent in the roster of registrants, licensed realtors in the province. So we haven't seen that. Now we have been growing faster than our competitors, but that is as a result of broad-based policies and strategies that drive the business in all times, not just corrections.

John Rolfe

Okay. Great. Thanks very much.

Operator

And we have had no further questions join the queue at this time. I would now like to turn the call back to Mr. Soper.

Phil Soper

I wish to thank everyone once again for participating in today's call, wish you a happy Remembrance Day if you're in Canada, Veteran's Day if you're in the United States, and look forward to hearing from you in our next quarterly earnings call in three months' time.

Operator

Thank you to everyone for attending today. This will conclude today's call, and you may now disconnect.

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