



Real Matters Q3 2023 Conference Call - Transcript

July 28, 2023

Corporate Participants

Brian Lang, *Chief Executive Officer*

Rodrigo Pinto, *Executive Vice President and Chief Financial Officer*

Lyne Beauregard, *Vice President, Investor Relations & Corporate Communications*

Other Participants

Daniel Chan, *TD Cowen*

Gavin Fairweather, *Cormark Securities*

James Burns, *National Bank Financial*

Martin Toner, *ATB Capital Markets*

Robert Young, *Canaccord Genuity*

Thanos Moschopoulos, *BMO Capital Markets*

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Real Matters Third Quarter 2023 Conference Call. [Operator Instructions] This call is being recorded on Friday, July 28, 2023. I would now like to turn the conference over to Lyne Beauregard. Please go ahead.

Lyne Beauregard

Thank you, operator, and good morning, everyone. Welcome to Real Matters Financial Results Conference Call for the third quarter ended June 30, 2023. With me today are Real Matters' Chief Executive Officer, Brian Lang; and Chief Financial Officer, Rodrigo Pinto. This morning before market opened, we issued a news release announcing our results for the 3 and 9 months ended June 30, 2023. The release, accompanying slide presentation as well as financial statements and MD&A are posted to the Investors section of our website at realmatters.com. During the call, we may make certain forward-looking statements, which reflect the current expectations of management with respect to our business and the industry in which we operate.

However, there are a number of risks, uncertainties and other factors that could cause our results to differ materially from our expectations. Please see the slide entitled Cautionary Note Regarding

Forward- Looking Information in the accompanying slide presentation for more details. You can also find additional information about these risks in the Risk Factors section of the company's annual information form for the year ended September 30, 2022, which is available on SEDAR and in the Investor Relations section of our website. As a reminder, we refer to non-GAAP measures in our slide presentation, including net revenue, net revenue margins, adjusted EBITDA and adjusted EBITDA margin. Non-GAAP measures are described in our MD&A for the 3 and 9 months ended June 30, 2023 where you will also find reconciliations to the nearest IFRS measures.

With that, I'll turn the call over to Brian. Brian?

Brian Lang

Thank you, Lyne. Good morning, everyone, and thank you for joining us on the call today. I'll kick things off by providing an overview of our third quarter performance and some of the key drivers behind our numbers. Rodrigo will then take a deeper dive into our segment financials and I'll wrap up the call with some brief remarks prior to taking questions. We delivered positive results in the third quarter as we saw solid improvements in our financial performance across all 3 of our reporting segments, which brought the business back to positive adjusted EBITDA.

Consolidated revenues and net revenue were up 22% sequentially. In fact, notwithstanding the impact of interest rates and market volumes going forward, this was the first time we posted sequential revenue growth in seven quarters. Consolidated adjusted EBITDA increased both sequentially and year-over-year to \$1.7 million in the third quarter. Our results were driven by sequential net market share gains across all three segments in the third quarter as well as an uptick in market volumes, part of which was attributable to spring market seasonality.

As we noted during our last quarterly earnings call, the U.S. mortgage market seems to be bottom bouncing below 30-year lows. 10-year treasury yields inched higher during the third quarter and spreads remained wide relative to historical averages, which pushed 30-year mortgage rates closer to 7% for a good portion of the quarter. Even with the backdrop of a challenging rate environment and continued housing supply constraints, most U.S. metros saw home price growth stabilize, which helped drive seasonal demand for housing and a corresponding increase in purchase origination volumes. According to the National Association of Realtors, existing home sales increased 7% year-to-date through May. Market refinance transactions were nominal in the third quarter, bottom bouncing off all-time lows. Cash- out refinance transactions remain the principal driver behind the baseline levels of refinance origination we are seeing today making up more than 80% of volumes. We continue to believe that the refinance market will return to more normalized levels in the future and we have capacity in place and the ability to scale the business to meet the demand of higher market or organically driven volume growth.

Our position on lender scorecards helped us deliver sequential market share wins across the board in third quarter. In U.S. Appraisal, we recorded net market share gains year-over-year and we

launched one new channel with an existing client. In U.S. Title, we onboarded the additional market share we won with our Tier 1 lender and we launched one new channel with an existing client. In Canada, we launched five new clients and increased market share in the third quarter.

In U.S. Appraisal, purchase origination revenues were up 25% sequentially and refinance origination revenues were down 2% quarter-over-quarter. Other revenues were up 37% quarter-over-quarter due to higher home equity volumes from market share gains.

I think it's safe to say that the mix of volume we're seeing between purchase and refinance is unlike any market we've seen over the last 30 years. Purchase transactions today make up close to 80% of the volume on a market size that is extremely low by historical standards. The silver lining for our U.S. Appraisal business is that the breadth of our client base allows us to capture the economics regardless of market mix.

We posted strong net revenue margins of 27.5% in U.S. Appraisal in the third quarter as a result of our operating model.

Our team was actively engaged with existing and potential clients during the third quarter leveraging our #1 ranking on scorecards and our position as industry leaders to garner additional market share and to open the door to new opportunities to grow the business. We continued to advance the sales pipeline in the third quarter.

U.S. Title segment revenues were up 17% quarter-over-quarter and up 41% for centralized title. We were very pleased with our performance in title in the third quarter as we held the #1 spot on our Tier 1 lender scorecard and onboarded volume from the market share increase we received at the end of the second quarter. U.S. Title net revenue margins in the quarter were up 840 basis points sequentially, principally as a result of a higher proportion of centralized title volumes. We narrowed our adjusted EBITDA loss in U.S. Title to \$1.6 million in the third quarter from the \$2.3 million loss we posted in Q2 2023. We have worked diligently to reduce our cost base in title over the last 12 months, which included the deployment of technology that has made us more efficient while permanently transforming the cost to run the business at scale. This positions us well for a variety of scenarios, including a lower volume environment in the short term as well as higher expected volumes over the medium and long term.

Canadian segment revenue was up 34% sequentially and adjusted EBITDA increased to \$1.3 million in the third quarter on higher volumes from market share gains.

With that, I'll hand it over to Rodrigo. Rodrigo?

Rodrigo Pinto

Thank you, Brian, and good morning, everyone. Turning to our third quarter financial performance.

I'll start with our U.S. Appraisal segment where we recorded revenues of \$33.5 million, down 42% from the same period last year mainly due to lower addressable mortgage origination volumes partially offset by net market share gains with existing clients and new client additions. Other revenues from home equity and default were up 4% year-over-year.

U.S. Appraisal net revenue was \$9.2 million for the third quarter, down 29% year-over-year. We continued to see strong net revenue margins in the third quarter with an increase of 490 basis points compared to the third quarter of 2022. Our ability to leverage our platform resulted in a significant year-over-year margin increase.

U.S. Appraisal operating expenses declined 36% year-over-year to \$4.4 million in the third quarter. U.S. Appraisal adjusted EBITDA was \$4.8 million for the quarter, a decrease of 21% from the third quarter of fiscal '22. Adjusted EBITDA margins increased to 52% from 47% we posted in the third quarter last year as a result of an improved net revenue margin profile and a reduction of operating expenses.

Turning to our U.S. Title segment. Revenues declined 53% year-over-year to \$2.6 million due to lower refinance origination volumes. Revenues related to centralized title services declined 63% year-over-year. Other title revenues of \$0.8 million representing revenue from home equity services were down \$0.3 million compared to the third quarter of fiscal '22. U.S. Title net revenue was \$1.2 million, down \$2.1 million from the third quarter last year and net revenue margins contracted to 45.2% from 59.2% mostly due to a change in product mix.

We reduced our U.S. Title operating expenses by \$4 million year-over-year to \$2.8 million due to lower refinance market volumes. We recorded an adjusted EBITDA loss of \$1.6 million for the U.S. Title segment compared with a loss of \$3.4 million in the third quarter of fiscal '22, an improvement of 54% mainly due to year-over-year reduction in operating expenses that I just mentioned.

In Canada, we posted revenues of \$9.9 million for the quarter, a decrease of 37% on a year-over-year basis. Net revenue margins expanded by 550 basis points year-over-year as we continued to leverage our appraiser network in a lower market environment. Our Canadian segment operating expenses declined 20% year-over-year to \$0.5 million. This reduction of expenses combined with the increase in net revenue margins helped increase Canadian adjusted EBITDA margins to 73.7% from 69.6% in the third quarter of '22.

In total, Q3 consolidated net revenue declined 33% to \$12.1 million compared to the \$18.1 million we reported in the third quarter of fiscal '22 largely due to lower market volumes across all 3 segments. Consolidated net revenue margins increased to 26.4% from the 23% we posted in the third quarter of fiscal '22, reflecting the higher net revenue margins in U.S. Appraisal and Canada.

Consolidated operating expenses, excluding stock-based compensation, were down 42% year-over-year to \$10.5 million in the third quarter. As Brian mentioned earlier, we posted positive consolidated adjusted EBITDA of \$1.7 million this quarter, up from \$66,000 in the third quarter of fiscal '22. Finally, I'll briefly turn to our balance sheet, which remains quite strong with no debt and are increasing our cash position to \$42.5 million at June 30, '23 reflecting the positive cash generated from our operating activities during the quarter.

With that, I'll turn it back over to Brian. Brian?

Brian Lang

Thank you, Rodrigo. In summary, we were very pleased with our performance in the third quarter. We were leaders on lender scorecards, we made good progress on market share across the board and we saw our margin profile improve. Our results also reflected moderately better market conditions from a combination of seasonality and bottom bouncing refinance volumes. We posted positive consolidated adjusted EBITDA of \$1.7 million in the third quarter, demonstrating growth on both a sequential and year-over-year basis.

We believe we are very well positioned from an operations perspective to take on additional volumes when the market recovers. As a result of the work we've done over the last 12 months to scale down expenses, our operations today are more efficient and we have permanently transformed the cost to run the business at scale. Because of the cyclical nature of the mortgage market, we've always looked at this business with a long-term lens and that hasn't changed. While we are cautiously optimistic that the market will bottom bounce in the near term, we believe we are on the right trajectory and so our focus is on long-term growth; growth through market share gains with our top-tier blue-chip client base and growth through new client additions. We believe in the long-term earnings potential of our business and we remain focused on our fiscal 2025 objectives.

With that, operator, we'd like to open it up for questions now.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Daniel Chan with TD Cowen.

Daniel Chan

Just wondering if there's any progress on the second title and closing channel with your Tier 1 and how quickly are you expecting that to ramp?

Brian Lang

Dan, thanks for the question. So good news on title from the last quarter was that we were able to onboard the doubling of market share that we talked about at the end of Q2. So the team I think

did a fantastic job, and with that, we also performed at the top of the scorecard for the quarter. So feeling good about where we're at with Tier 1s currently on the title platform. We talked a little bit last quarter about RFPs starting to find their way into conversations and we continue to see that. So we've got a couple of lenders that are definitely starting to move down that RFP process, Dan. So it's hard to time it since they manage the timelines around it. But I would say that we're making progressive, forward actions with the Tier 1s that we have the RFP conversations going on with right now.

Daniel Chan

That's good to hear, Brian. If you do one of these RFPs over the next couple of quarters, what's the timing we should expect for you to get that revenue generation -- to get to revenue generation on these?

Brian Lang

Dan, it's quite similar when we talked about how we onboarded our appraisal customers. So when we look at that onboarding and the ramp on those businesses, we looked at trying to get to 5% to 10% market share year one, and then grow from there 15% to 20% and then up into the 30% in year three. So we'd expect something quite similar to that. As you know, they test and learn a little bit in the first sort of 6 to 9 months and then we start seeing a little more volume. I think in the near term, Dan, the opportunity for us; we've talked about the second channel opening up with our current Tier 1. So the team's quite focused on getting that second channel open by either the end of this fiscal or the first quarter of the next.

Daniel Chan

Okay. And it's been a while since you've launched your first Tier 1 and it sounds like you're performing well seeing that you're at the top of the scorecard there. Surely you've had a lot of key learnings and feedback from that Tier 1. Any chance we could see a faster ramp up just given that you pretty much got a mature product heading into these other two RFPs?

Brian Lang

Well, Dan, I'd say the biggest driver of that will be volume. So we'll have to see where the volume's at as they're bringing on us as a new vendor. And I think if we're continuing in a bottom bouncing environment, it might be a little tougher to ramp with a lot more speed. If there is some more volume coming in, then you're right, we could see a quicker ramp than maybe what we've expected in the past. And as you mentioned, I mean we have had that Tier 1 on the platform for a couple of years and it's sort of right in line with that getting to 20% that we expect in the second year. We're pretty well on course for that this year with this Tier 1.

Operator

Your next question comes from Richard Tse with National Bank Financial.

James Burns

It's James filling in for Richard. I was just wondering with CoreLogic leaving in the market, do you see any more competitors exiting at some point and how might that impact your market share moving forward?

Brian Lang

James, you mentioned one of our competitors exiting and so that is definitely a part of the increase in share that we saw on the appraisal side of the docket this past quarter. We actually had really solid growth with one of the Tier 1s that used to be a customer of our competitors. So very solid progress with that Tier 1 pushing them up sort of near the front of our market share expectations of getting to 50%. So really good quarter there. As far as other competitors, I mean we'll have to see, James, how things shake out over the next couple of quarters. There are only a handful of big national players, as you know, that we compete with. So there's been a little bit of movement, but frankly, I wouldn't say there's been a significant amount of movement there. In the title side of the ledger, we compete with the big title insurance companies so we don't see a lot of movement necessarily there and a couple of other title companies that we compete with. There's definitely -- further down the mix, there are lots of vendors that are probably struggling in this environment and we've seen some of those. But I think at the top of the house, I'm not sure there's going to be a significant move in the competitive field, but of course we'll have to see.

Operator

Your next question comes from Thanos Moschopoulos with BMO Capital Markets.

Thanos Moschopoulos

Can you remind us how we should think about net revenue margins as volumes recover? So let's say in a scenario where we have a strong recovery, volumes start trending up 30%, 40%, 50%. Do we start to see the volumes maybe -- the net revenue margin pull back a little bit in the near term as you build scale capacity or what would the dynamic be there?

Brian Lang

Good question, Thanos. As you know, our focus has been on our '25 targets on both the net revenue and adjusted EBITDA margin line. And so right now you're seeing in the appraisal business that we are hitting those targets between 26% and 28%, at the 27.5%. And so I think, Thanos, you should expect us to stay within that range. So even as volume comes on, I think we've now put the business in such a place from an operating cost standpoint that we should be in good shape. I've mentioned before that we've got capacity at the current volumes. So on the appraisal side, we've still got 30% capacity. Where you'll see more torque of course is on the adjusted EBITDA line because of that capacity that we've got. So we'll continue to make our way towards that 65% to 70% [adjusted EBITDA margin] and in this past quarter you saw some improvement there, Thanos, as you mentioned. And on the title side, we will definitely see that continue to tick up once we get more

volume. So the refinance base is very low right now. So we'll definitely see some uptick as you saw again in this quarter on our net revenue line.

So with [title] volume as you've mentioned, I mean if the volume is where it is now, then we'll probably see something similar for the next couple of quarters. But if we were to get a big bump, you would definitely see that line go up towards our 60% to 65% target that we laid out. And on the adjusted EBITDA side, that's where there's a bit of a drag right now simply because we need to have the operating cost structure that we've got now. We've brought that down to sort of a minimum operating model. And so the new volume that comes on, we've got lots of capacity on the title side, 3x to 4x the volume we could be doing right now, but that's what we need to have for being a national provider. So I think there's going to be a lot of torque right now in the business, Thanos, if we were to see that. And I'd mentioned a little in my opening that the fact that we've reduced the operating cost, some of them permanently which is really digitizing some of the workflow, that would only incrementally add to the torque that we'd see in the margins.

Thanos Moschopoulos

Great. And can you update us in terms of what you're seeing in the industry as far as, I guess, appraiser capacity. What I mean by that is obviously you have your network that's going to allow you to scale very well as volumes rebound. Do we have a situation though where some appraisers are exiting the profession? And so maybe you'll do fine as long as the proper -- maybe there'll be some industry constraints and maybe that helps you incrementally gain share. What's the dynamic you're seeing in that regard?

Brian Lang

Sure. So I think it's pretty status quo on the network side of things, Thanos. I think where we've been focused is and where the industry is frankly focused is bringing more appraisers in. So we're very involved in some what I think are quite unique training programs with the Appraisal Institute with Chase. So we're working in partnership to bring more in with a real focus on diversity. So I think there's a real focus in the industry to start bringing in more talent. And right now, as you can imagine with the volumes where they are, there is a lot of network capacity to manage. So I think we're in really good shape.

Operator

Your next question comes from Gavin Fairweather with Cormark.

Gavin Fairweather

Maybe just to start out, you referenced the business efficiency gains a few times. Can you maybe just give us some examples of some of the areas where you found some efficiency in the business? And I don't know if you'd want to put a number on kind of the productivity gains that you've uncovered throughout the cycle.

Brian Lang

So Gavin, the focus has definitely been around taking a look at the processes that we currently manage the workflow on both sides of the business. I think we've really dug in the last 12 months on the title side of the business with the volume where it's at and so where we're seeing real improvements. As you know, there's a couple of different big components to the workflow. One is around the title search area so I think we've really found some ways to digitize some of the work that folks were doing in the past. I think we can do a lot more of that now in an automated fashion. As well as at the end of the process, there is a lot of bouncing that goes on with documents at the end. And so again I think the team has done a really great job of finding ways to automate some of the processes around there. So when I talk about reducing some of the operating costs permanently, that's really what we're looking at. The other piece to that, Gavin, is with the move to the cloud, which we've talked about. There's real advantages that are built into that. And so frankly, pivoting from title to appraisal, we're spending a good chunk of time on appraisal right now looking at how we automate some of the quality areas, some of the appraiser management areas. So I think in this type of environment is exactly what the team should be focused on and we're already seeing some good results from that.

Gavin Fairweather

Awesome. And then maybe just a couple from an industry perspective. Just on the abnormally wide spreads, I guess when you speak to your lenders, is there some catalyst or sort of macro conditions that they point to that should lead to some spread compression? Are you hearing anything on that front?

Brian Lang

Well, I think the broad answer to that, Gavin, is just that there's still some uncertainty in the industry. I mean I think that's really what's driving it so I think we'll see after this quarter. As you know, last quarter one of the concerns was just around the Tier 2, Tier 3 banks. What was that going to look like? How was their capital management looking? So we'll have to see how that plays out with results coming out this quarter. And the Fed then moving around their sort of position on pausing on rates and moving rates back up again. So when you have that, Gavin, when you have some of that uncertainty as to what the next little while looks like; we still have inflationary conversation, we have recession conversation; all that sort of stuff unfortunately adds for the uncertainty. And so that's why I think, as you say, I mean we've had historically high spreads for a while. So when we look into 2024, we think there's some opportunity there. I'd be very surprised if over time with the market hopefully settling that they wouldn't start bringing those spreads to a much more reasonable normalized long-term average, which I think is 170 [bps]. So that tells you how off we are at 300 [bps].

Operator

Your next question comes from Martin Toner with ATB Capital.

Martin Toner

Do you have visibility on the spread between what people are refinancing at versus what they had before they refinanced? And the reason I ask is there is this perception that people only refinance if they are a certain amount in the money. And so just wondering do you have visibility on that? And maybe you could talk to that last point regardless.

Brian Lang

So I mean I'd start sort of at the top of the house, Martin. So when we take a look at refinance, as you know, the majority of refinance right now is 80% cash-out, right? So that is individuals that are making, I assume, life decisions of one form or another; they're getting prepared for weddings, they're sending kids to college, those sorts of things. So to your question, I'm not sure whether in the money is necessarily driving the desire for them to cash out. It's a life event, right, they need cash out of their home and so again that's 80% of the volume that's going through there. And then on the rate side, I think it just sort of depends, right? So as we mentioned, there is still a significant opportunity that's now growing. We've mentioned in the past that as people are getting mortgages now at 6%, 7%; there's a pool that's growing, which we look at as very, very opportunistic, right, high rate mortgages. And so right now we actually got some more data this morning, which is pointing to the fact that about 15% of mortgages are now 5% plus. So for us again as we look forward, that pool is expanding. The rates right now look like they're 6.75% to over 7%. So that pool is only going to continue to expand and so all we need is the rates to start moving more towards that 5%, which will open up a significant amount of opportunity.

Operator

Your next question comes from Robert Young with Canaccord Genuity.

Robert Young

[Audio Gap] Where would you put that cash if that turns into a trend? I know you haven't been active on buyback or anything like that. So how do you think about that cash if it's stabilized and growing?

Brian Lang

Rob, I appreciate the optimism. So as you said, good news the cash is growing again. And so listen in the short term right now, as you know, it's all about making sure we've got a healthy balance sheet. We're talking to more Tier 1s about getting into the title business. So I think at least in the near term, Rob, the focus will definitely be on continuing to hold on to the cash that we have. Looking longer term, that will be -- we'll have to see how it grows and then we'll talk of course around the strategic opportunities that might present themselves. But right now definitely the focus is on investing in the core business, which we continue to do. I just mentioned talking about continuing to drive down the cost base through automation using technology. So that's I think where we will continue to focus our efforts and continue to maintain a really healthy balance sheet.

Robert Young

Okay. And then on that effort to work down the cost base, I think you already touched on this a bit so I apologize if it's re-covering past ground. But is that net revenue margin benefit or is it OpEx benefit or is it both? And then hard to maybe quantify, but like how much more do you think you can do there?

Brian Lang

So a lot of that's around adjusted EBITDA. Rob, that's really affected because, as I say, I mean for us, the real focus in the business right now, we have initiatives going on around how do we scale as efficiently as possible. So that's really I think where the focus of the capabilities will hit the balance sheet, or sorry, the P&L, I think we'll get a little bit out of maintaining that net revenue margin by doing some of the things that we're looking at doing on the appraisal sort of management side of things.

Robert Young

Okay. Maybe I'll ask this in a slightly different way. If you look at your 2025 targets, do you think these cost benefits and the ability to scale maybe at a slightly lower cost, could it drive to maybe potentially setting the higher EBITDA expectation in 2025 or is everything still relatively similar to the way you would have looked at it a couple of years ago?

Brian Lang

Yes. I think it's pretty close, Rob, because there's lots of other things going on in the business around mix and such. So I think the focus absolutely is on the targets that we've got today. I think this stuff will help enable us to get there and the plan will be to get there hopefully with a little more volume. As you know, that's really what we need is just some more volume in the system to see the scale dynamics really play their way through.

Robert Young

Okay. Maybe last question. I think I'll benefit from this, hopefully others would as well, but just the home equity volumes. Can you just sort of remind us how that differs from the core? And if you look out to a better market, is that something that you will keep a footprint in or is that something that you would wind down over time? Maybe just give us a sense of how that changes the business and I'll pass the line.

Brian Lang

Sure, thanks Rob. So on the home equity front, as the business plays out, we definitely need to make sure that we service our Tier 1 customers with the products that they demand. And so although the core origination business of course is by far the large proportion of our business and the profitable part of our business and the one that we can really drive margins through, we do continue to offer home equity and other like type products. So I guess answer number one, Rob, will be yes, we will continue to provide home equity. This particular quarter -- past quarter is actually quite a

representation of a Tier 1 lender that continues to provide us with great market share from an origination standpoint, but also continues to require that we continue to supply good home equity services to them. And so we've actually grown our home equity market share with them commensurate with the origination increase in market share. So really sort of strong growth around that. To your point, the margin profile is a little bit more challenging for us compared to the core origination. But as you've seen this past quarter, we have brought on some good home equity volume, but you're still seeing that 27.5% net revenue margin on the appraisal business. So I think the team is doing an excellent job as we bring on home equity volume of making sure that we're continuing to keep our eyes on the unit economics and the net revenue type margins.

Operator

[Operator Instructions] There are no further questions at this time. Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines.