



## **Builders Capital Mortgage Corp.**

Management's Discussion and Analysis  
Quarter Ended June 30, 2019

## MANAGEMENT'S DISCUSSION AND ANALYSIS

This management's discussion and analysis (MD&A) has been prepared by Builders Capital Mortgage Corp. (Builders Capital or the company) as of August 28, 2019. It should be read in conjunction with the company's audited consolidated financial statements and accompanying notes for the year ended December 31, 2018, available on SEDAR at [www.sedar.com](http://www.sedar.com) and on our website at [www.builderscapital.ca](http://www.builderscapital.ca). The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS). All financial information is presented in Canadian dollars.

### Notice Regarding Forward-Looking Information

Certain information included in this MD&A contains forward-looking statements within the meaning of applicable securities legislation, including statements with respect to management's beliefs, estimates and intentions, and similar statements concerning anticipated future events, results, circumstances, performance or expectations that are not historical facts. Forward-looking statements generally can be identified by the use of forward-looking terminology such as "outlook", "objective", "may", "will", "expect", "intent", "estimate", "anticipate", "believe", "should", "plans", "continue" or similar expressions suggesting future outcomes or events. Such forward-looking statements reflect management's current beliefs and are based on information currently available to management. These statements are not guarantees of future performance and are based on our estimates and assumptions, which are subject to risks and uncertainties, and could cause our actual results to differ materially from the forward-looking statements contained in this MD&A. These risks and uncertainties include, among other things, risks associated with mortgage lending, competition for mortgage lending, real estate values, interest rate fluctuations, environmental matters and the general economic environment. We caution that the foregoing list is not exhaustive, as other factors could adversely affect our results, performance or achievements. Readers are also cautioned against undue reliance on any forward-looking statements. Although the forward-looking information contained in this MD&A is based upon what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward-looking statements. Except as required by applicable law, we undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

### Background and Overview

Builders Capital is a mortgage lender providing short-term course of construction financing, primarily to residential builders. The company was formed on March 28, 2013 and commenced active operations on December 12, 2013 on the closing of our initial public offering and our listing on the TSX Venture Exchange under the symbol BCF. The company is a mortgage investment corporation (MIC) within the meaning of Section 130.2(6) of the *Income Tax Act* (Canada) and is governed by the laws of the Province of Alberta.

As an MIC, Builders Capital is not subject to income tax provided that we distribute all of our taxable income as dividends to shareholders within 90 days of our December 31<sup>st</sup> year-end. For income tax purposes, such dividends are treated by shareholders as interest income, so that each shareholder is in the same tax position as if their proportionate share of mortgage investments made by the company had been made directly by the shareholder.

The company is structured with two classes of shares: Class A Non-Voting Shares, held by the public, and Class B Non-Voting Shares, held by management and private investors. This two-tier share structure grants dividend priority to the Class A Non-Voting Shares, providing additional security of both principal and dividends to our public shareholders, as detailed under the section entitled Distributions later in this MD&A.

In addition to the Non-Voting Shares, Builders Capital has a limited number of Voting Shares, which are held by the company's principal shareholders.

## **Investment Strategy**

In order to deliver above average risk-weighted returns, our strategy is to invest primarily in short-term construction mortgages that are secured by development stage residential real property. Lending on development property is limited, with mortgages generally provided only in circumstances where a borrower intends to complete the development and build on the land.

Investments in our portfolio are strategically concentrated on:

- First or subordinate mortgages on real estate with a target of up to 75% of property value;
- Mortgages on residential wood frame construction projects; and
- Mortgages on properties located in typically more liquid and less volatile urban markets and their surrounding areas, with a geographic focus on Western Canada.

## **Investment Restrictions**

Our share terms provide for a number of investment restrictions that can only be changed by a vote of all of the shareholders:

- Builders Capital will not make any investment or conduct any activity that would result in the company failing to qualify as a "mortgage investment corporation" within the meaning of the Tax Act.
- We will not invest in asset-backed commercial paper or in securitized pools of mortgage loans, including securitized pools of sub-prime mortgages.
- We will not invest in securities other than first and subordinate mortgages secured by real property and, on a temporary basis only, interim investments consisting of cash and cash equivalents, Government of Canada treasury bills and Government of Canada bonds with a term to maturity of three years or less (although the company shall not be precluded from owning securities of our subsidiaries or affiliates).
- Builders Capital will not engage in securities lending.
- The company will not engage in derivative transactions for speculative purposes and will only take part in derivative transactions in order to hedge interest rate or exchange rate risk.

## **Operations**

Builders Capital provides short-term, course of construction financing to builders of residential, wood-frame construction projects in Western Canada. We believe that staying focused on this niche market reduces overall risk and increases the potential return on our mortgage portfolio. All of our mortgages are tailored to the specific needs of residential builders, giving Builders Capital a competitive advantage in this sector of the construction market.

Our mortgage portfolio and operations are managed by Builders Capital Management Corp. (the manager) under a management agreement. The manager sources and services mortgage loans and directs the company's business operations. Under the terms of the management agreement, the manager provides staff, office space and equipment, as well as the expertise required to operate the business of the company. The manager maintains extensive experience in all aspects of residential construction and in-depth, up-to-date residential real estate industry knowledge in order to make prudent mortgage underwriting decisions and efficiently manage potential mortgage defaults. The manager has the ability to complete any unfinished development projects that Builders Capital may acquire through enforcement proceedings or otherwise in a timely and cost-effective manner. All such actions are conducted by the manager on behalf of the company.

All investments are subject to a rigorous underwriting review. When sourcing investment opportunities, the manager will conduct an initial review to confirm that a mortgage prospect satisfies our lending criteria and Asset Allocation Model (AAM). The AAM dictates the allocation of the aggregate funded and committed assets, based on geographical, economic sector, term, borrower and loan-to-appraised value criteria.

The manager is then required to perform comprehensive due diligence of the underlying assets. The due diligence process revolves around the manager's system of underwriting loans and evaluating projects and borrowers. This process includes a detailed re-costing of each project based on the assumption that we are going to build it ourselves and an analysis of what the completed project will be worth. This assessment gives us the information we need to ascertain the value proposition inherent in the project. We only loan on projects that we believe are economically sound and for which we have the capability, through the manager, to complete and sell if necessary.

All of the loans we make to borrowers consist of promissory notes secured by collateral mortgages over real property. None of the mortgages are originally written for terms longer than one year. Subject to the satisfaction of Builders Capital's rigorous lending requirements, any or all of our mortgages may be, or may become, revolving in nature.

In some cases, the mortgage is intended to be repaid on or before the end of its original one-year term, which would typically coincide with the building project being completed and sold. In cases where the project has not been completed and/or sold by the end of the term, assuming that the manager is comfortable with the marketing efforts and security position, we will generally renew the mortgage to give additional time for completion and marketing. In these cases, no cash is usually received on the renewal, although we will sometimes require a payment or additional security on the loan.

In other cases, the intention is to continue financing the ongoing construction of projects for a borrower on a revolving basis. In these situations, each time a project is completed and sold, cash is received to pay down the loan balance, in some cases to zero. As the loan balance is reduced, new projects can be added to the mortgage. At term-end, as builders will generally have a number of projects under construction at varying stages of completion, the mortgages are typically renewed and the builder draws down on the renewed mortgage to continue to fund their projects. In these cases, there is a revolving aspect to the loan but, again, no cash is expressly due upon the renewal.

Payments of principal, interest and fees are generally only required on the sale or refinancing of the property forming the security for our loan. However, our loan terms stipulate that we can expect

payments after substantial completion of a project. Further, all of our mortgages are demand loans, which can be called at our discretion.

While our mortgages often revolve, and can continue to be renewed for multiple years, our goal is to keep the terms short on any one project and to have borrowers repay advances against each project on its completion, either through the sale of the property or by refinancing with another institution.

At inception, we target a loan-to-value ratio not exceeding 75%. However, calculating a loan-to-value ratio requires estimates of value, which are subject to uncertainty. For various reasons, including accruing interest, delays in completion of projects and changing market values, this target ratio is sometimes exceeded. We generally become concerned about collectability when any loan exceeds an estimated 85% loan to value ratio.

## **Q2 2019 Summary**

### **Performance Highlights**

- Consistent with our targeted distribution, dividends paid to Class A public shareholders in the first quarter were \$0.1995 per share, representing an 8% annual return on the original \$10.00 issue price.
- At quarter-end, our debt-to-equity ratio was an extremely conservative 1.9%.
- Assets held for sale were reduced by \$2.3 million during the second quarter. Subsequent to the quarter end, we expect to complete additional sales totaling \$840 thousand.
- Earnings exceeded the amount required to pay planned Class A Non-Voting Share dividends by 1.2 times.

### **Business Environment**

- Conditions in our core western Canadian markets remained generally weak through the first half of 2019, with both the number of residential home sales and average MLS sales prices remaining below their 10-year averages. However there are signs that a recovery is starting in our core markets. In its August 15, 2019 Monthly Housing Market Update, RBC Economics stated that “slumping markets out west – including Vancouver, Calgary and Edmonton-are now in early stages of a turnaround.”
- We believe margins on new construction continue to be viable, benefitting from relatively low raw land and sub trade costs in the Alberta market.
- Overall, we believe housing starts in our western Canadian markets will be adequate to support the long-term growth and continued geographic diversification of our business.

## Financial Overview

	<b>Three months ended June 30, 2019 \$</b>	<b>Three months ended June 30, 2018 \$</b>	<b>Three months ended June 30, 2017 \$</b>
Revenues	698,111	845,660	866,259
Total comprehensive income	472,190	492,823	625,909
Total assets	27,789,720	32,234,463	29,102,839
Shareholders' equity	27,258,301	26,522,452	24,941,461
Basic and diluted earnings per share	0.16	0.18	0.26
Cash dividends declared	588,715	542,343	627,214
Cash dividends declared per Class A share	0.1995	0.1995	0.1995
Cash dividends declared per Class B share	0.2096	0.1763	0.2346

## Investment Portfolio

At June 30, 2019

Property Type	Mortgage Portfolio (No.)	Outstanding Balance (\$)	Total Committed Mortgage Principal (\$)	%	AAM Allocation*
<b>Residential</b>					
Single family – Detached	18	10,245,558	21,125,000	55%	100%
Single family – Attached	11	12,714,790	13,890,550	45%	100%
<b>Total:</b>	<b>29</b>	<b>22,960,348</b>	<b>35,015,550</b>	<b>100%</b>	<b>N/A</b>
<b>Geographic Location of Property</b>					
Calgary and Area	18	19,544,896	23,755,550	85%	100%
Edmonton and Area	3	1,206,166	5,800,000	5%	100%
Other Alberta	5	1,594,968	2,290,000	7%	100%
British Columbia	3	614,318	3,170,000	3%	50%
<b>Total:</b>	<b>29</b>	<b>22,960,348</b>	<b>35,015,550</b>	<b>100%</b>	<b>N/A</b>
<b>Interest Rate (excluding fees)</b>					
Less than 10%	2	2,129,955	1,950,000	9%	N/A
10%-10.99%	8	7,237,400	10,485,550	32%	N/A
11%-11.99%	4	4,026,732	4,190,000	17%	N/A
12%-12.99%	13	8,209,541	14,540,000	36%	N/A
Greater than 13%	2	1,356,720	3,850,000	6%	N/A
<b>Total:</b>	<b>29</b>	<b>22,960,348</b>	<b>35,015,550</b>	<b>100%</b>	<b>N/A</b>
<b>Original Funding Date **</b>					
Calendar 2019	6	4,625,158	5,970,000	20%	N/A
Calendar 2018	11	7,273,954	9,770,550	32%	N/A
Calendar 2017	5	5,105,382	6,200,000	22%	N/A
Calendar 2016	2	692,776	3,350,000	3%	N/A
Calendar 2015	2	1,037,926	1,550,000	5%	N/A
Calendar 2014 or earlier	3	4,225,152	8,175,000	18%	N/A
<b>Total:</b>	<b>29</b>	<b>22,960,348</b>	<b>35,015,550</b>	<b>100%</b>	<b>N/A</b>

\*Indicates the maximum percentage of the portfolio allowable under Builders Capital's Asset Allocation Model.

\*\*Loans are originally written for terms of up to one year, but are renewed in cases where a builder continues to roll new security onto the loan facility or if the project has not been sold but is still progressing or being actively marketed.

## Introduction

Real estate markets in the regions in which we operate have suffered a sustained downturn in recent years, with substantial declines in home selling prices and sales volumes and increased marketing times. These trends have impacted the short-term construction lending market that we specialize in. Over the past 8 quarters, we have had to foreclose on a higher-than-normal number of projects. Weak market conditions have also hampered our ability to predict when existing loans would pay-out and when that capital could be redeployed into new lending, leading to lower levels of capital utilization.

Through this challenging market environment, our first priority has been to preserve the capital with which we have been entrusted. We have focused on effectively managing problem loans and foreclosures to reduce our risk. We have also underwritten new loans more conservatively than we would in healthier markets. While this tight management of our business has put downward pressure on our financial results, it has helped to reduce risk and maintain the strength of our portfolio.

An important indicator of our portfolio stability is that we have returned our weighted average loan-to-value ratio approximately to our target level of 75% as at the end of the second quarter, down from a peak of approximately 82% in December 2017. This is a key achievement in a market where sales values have fallen and longer marketing times have increased borrowers' loan costs. We have also completely de-levered our portfolio and are comfortable with the loans on our books. We had no new foreclosures in the second quarter and have none pending. We also reduced the value of our portfolio of foreclosed properties held by \$2.3 million in the second quarter, have closed a sale in August, and have another sale scheduled to close in September.

While we will continue to be conservative in our underwriting, we believe that the timing is right to pursue more builders' loans and to work towards fuller utilization of our capital and increased use of our line of credit. Market forecasters are beginning to see signs of stabilization in our core Calgary and Edmonton markets. We have also seen our borrowers sell, or enter into agreements to sell, a number of properties in recent months and can see the velocity of the turn-over in our portfolio starting to improve. As we increase capital utilization, we anticipate a corresponding gradual strengthening of our financial results.

## Operating Results for the Three and Six Months Ended June 30, 2019

Our mortgage portfolio decreased by 2.7% in the second quarter and by a total of \$4.2 million, or 15.9%, in the first half of 2019, as compared to the same periods in 2018. These decreases were partly due to three foreclosures during the first quarter of 2019, which comprised nine properties and affected \$6.0 million worth of our \$27 million portfolio. We note that the foreclosures were anticipated and allowances were made for them in our fiscal 2018 financial statements.

Of the nine foreclosed properties, four have since been sold, one subsequent to the end of the second quarter. A fifth property is currently under a sales contract with a closing date set in September of 2019. Of the remaining four units, one is a free-standing house in Edmonton, Alberta which is approximately 65% complete and is listed for sale. The remaining three properties are individual units in a townhouse complex with construction completion expected imminently, at which point, all three units will be available for sale.



Cash advances and invoiced interest totaled \$3.9 million in Q2, as compared to \$4.6 million in the first quarter of 2019, and \$8.8 million in the second quarter of last year. For the six months, total cash advances and invoiced interest totaled \$8.5 million, as compared to \$12.9 million in the same period last year. These results reflect weak market conditions and the resulting slow turn-over of our loans, as well as our more conservative lending policies during the market downturn.

The Q2 2019 advances were offset by \$6.5 million in mortgage repayments. Based on an average of incoming and outgoing cash, we turned over 19.9% of our weighted average net invested capital during the quarter, representing an annualized turn-over of 79.9% of capital. As market conditions improve, we expect to liquidate our property inventory positions and source additional profitable loans in order to move closer to our targeted capital turnover rate of nine months. Achieving this target will require turning over approximately 33% of our capital each quarter.

In tandem with underwriting mortgages, we regularly engage in the purchase and sale of mortgages to help ensure full cash utilization and create liquidity as required. During the first half of 2019, we neither bought nor sold any mortgages. This contrasts to the first two quarters of 2018 when we bought \$2.3 million of mortgages and sold \$698 thousand. All of the purchase and sales transactions were conducted with Builders Capital (2014) Ltd., a privately held corporation owned by certain directors of the company.

We lowered our approximate loan-to-value ratio ("LTV") to our target of 75.0% in the first half of 2019, which compares favourably to our weighted average LTV of 79.1% at the end of fiscal 2018 and 79.2% at the end of Q2 2018.

Further reducing shareholder risk is our minimal use of leverage. Generally, the only debt that we employ is our line of credit, which is used primarily as a cash flow tool to facilitate making advances to borrowers. In the final quarter of 2017 we borrowed an additional \$1.3 million, secured by our assets held for sale, to mitigate the impact of unproductive assets. We repaid one half of this loan in August of 2018 and the second half during the second quarter of 2019 as funds became available. As difficult market conditions have persisted, we have remained cautious in our lending and worked to reduce our line of credit balance. Accordingly, our debt-to-equity ratio stood at 1.9% at the end of Q2 2019, down from 21.5% at the end of Q2 2018. Keeping our debt to equity ratio reasonably low is a priority for us as it leaves us free from undue influence of creditors and allows us the flexibility to manage our loan portfolio to our best advantage in different types of market conditions.

As at the end of the first quarter of 2019, the total value of our mortgage portfolio, before taking into account our \$273,892 allowance for mortgage losses, was \$23.0 million. This compares to \$27.7 million at the end of fiscal 2018. The \$4.7 million, or 17.0%, decrease was largely the result of Q1 2019 foreclosures, which had the effect of reallocating \$4.9 million in capital from mortgage assets to inventory assets. We expect to be able to re-deploy these assets into productive loans in the near future. As at June 30, 2019, our loan portfolio was made up of 29 mortgages with an average outstanding balance of \$791,000.

### **Revenue**

For the three months ended June 30, 2019, mortgage revenue decreased 17.5% to \$698,000, from \$846,000 in the same period last year. For the six months ended June 30, 2019, revenue of \$1.54 million was down 7.8% from \$1.67 million in the first half of 2018.

At June 30, 2019, the weighted average interest rate on our mortgages was 11.06%, down slightly from 11.59% at June 30, 2018. This change reflects our continuing focus on building a higher-quality, lower-risk mortgage portfolio. Our goal now is to maintain our interest rates around this level.

Second quarter 2019 revenue consisted of \$648,000 in interest and \$50,000 in lender fees charged to borrowers, equating to annualized gross revenue of 9.7% of the weighted average gross share capital. This compares to 12.3% for Q2 2018. The six-month revenue was comprised of \$1.4 million in interest and \$112,000 in lender fees, representing annualized gross revenue of 11.0% of the weighted average gross share capital, compared to 12.4% in 2018.

Lender fees are tied to the negotiation of new mortgages, generally at 1% of the approved loan amount, and are charged for an annual term to borrowers when new loans are made or existing loans are renewed. Lender fees are maximized when turnover in the portfolio is highest. Lender fees in the second quarter decreased by 16% compared to Q2 2018, while year-to-date lender fees were up by a slight 1.7% as compared to the same period in 2018. Lender fees in the quarter were 29.5% lower than management fee expense.

### **Expenses**

Excluding funds set aside to provide for loan losses and interest expense, second quarter operating expenses increased by \$6,000, to \$104,000, compared to Q2 2018. This represents 14.8% of revenue as compared to 11.6% last year. Our goal is to keep operating expenses within 10% of revenues and we will continue to closely monitor our expenses as we work toward this target. Most of our expenses are reasonably fixed and increasing revenues by deploying capital will be key to getting back below the 10% mark.

In anticipation of the Q1 2019 foreclosures, we recorded a \$449,000 provision for mortgage losses in the fourth quarter of 2018. In the current quarter, our provision for mortgage losses was \$100,000, which is on par with our long-term average since inception of \$108,000 per quarter. We are working to reduce this expense going forward.

Management fees were \$72,000 in the second quarter and were calculated on the total gross amount of Class A and Class B Non-Voting Shares outstanding. As we continue to grow our capital base, these fees will continue to increase, but our expectation is that they will be more than offset by increasing revenues.

Interest expense applies to our operating line of credit, which we use as a cash flow tool to fund mortgage draws. Interest expense also applies to the loan drawn in the fourth quarter of 2017, which was secured by assets held for sale and which has now been repaid. A higher utilization rate for our capital will provide better returns in the form of additional interest income, but will also necessitate increased use of our line of credit for funding draws when our own funds are fully employed. As at June 30, 2019, our line of credit was unused, as compared to a balance of \$1.4 million at the end of 2018.

### **Total Comprehensive Income**

We generated earnings per share of \$0.16 in the second quarter of 2019, as compared to \$0.18 in the same period last year. Total comprehensive income was \$472,000, down 4% from \$493,000 in the second quarter of 2018. Year-to-date comprehensive income was consistent at \$1,065,000, as compared to \$1,068,000 in the first half of 2018. Although reasonably stable on a year-over-year basis, these

results are below our historical levels and reflect the negative impact of foreclosures and generally poor market conditions, which have reduced the turnover in our loan book and required us to be more conservative in our lending.

We note that the historically lower total comprehensive income results have not affected dividends paid to our Class A Non-Voting shareholders. Our share terms call for annual dividends of \$0.80 per Class A Non-Voting Share per year, or approximately \$0.20 per quarter, prior to any other dividends being paid. Earnings in the quarter were \$0.16 per share overall, but were \$0.24 per Class A Non-Voting Share. These earnings exceeded the amount required to satisfy the 8% (\$0.20 per share) dividend committed to the Class A Non-Voting shareholders by 1.2 times. With Class B Non-Voting shareholders bearing a much greater proportion of the risk of income fluctuations, even if earnings had been only 84% of their actual figure, the company would still have been in a position to pay Class A shareholders their full, planned quarterly dividend. Given this margin, we anticipate that potential continued fluctuations in our comprehensive income will not affect the payment of our Class A Non-Voting Share dividends.

In order to maintain distributions on the Class B Non-Voting Shares, we have been actively working to raise capital from the sale of additional Class A Non-Voting Shares. Increasing the number of Class A Non-Voting Shares in relation to the Class B Non-Voting Shares will improve the Class B Non-Voting share returns in any period during which our net earnings exceed an 8% overall return on capital. On March 31, 2019, we issued 30,000 Class A Non-Voting Shares and on April 9, 2019 we issued an additional 750,000, all for \$10.00 per share. Our ratio of Class A to Class B Non-Voting shares now stands at 2.1:1, up from 1.4:1 after our initial public offering. Our share terms limit the ratio to no greater than 3:1.

#### **Share Issuance Costs**

Year-to-date share issue costs relating to the additional capital raised were \$28,000. Total share issue costs since inception now stand at \$2.4 million, including professional fees for offering document preparation; offering, agent and brokerage fees and commissions; and other marketing and offering costs. In accordance with IFRS, these share issue costs are accounted for as a reduction in the value of the equity of the company. These costs are, however, deductible for tax purposes over a five-year amortization period.

Our intent is to restrict shareholder distributions to less than 100% of net income in order to utilize the tax deductibility of these payments. This distribution policy will, over time, have the result of retaining income equal to the offering costs within Builders Capital, which will increase the Net Asset Value of the company while ensuring that no corporate taxes are paid. Because of the two-tier share structure, and the priority on distributions that the Class A Non-Voting Shares hold over the Class B Non-Voting Shares, we expect the restriction in distributions to come primarily from the portion of income otherwise available for distribution to the Class B Non-Voting shareholders.

#### **Statement of Financial Position**

At June 30, 2019 total assets were \$27.8 million (Q2 2018 – \$32.2 million), \$4.5 million (16.2%) of which was tied up in assets held for sale. The balance is primarily funded mortgages. The \$4.4 million change in total assets since June 30, 2018 is primarily the result of funds received on the pay-down of mortgages being utilized to pay off debt.

At June 30, 2019 assets held for sale included one building lot in Richmond, British Columbia, one completed home in Saskatoon, Saskatchewan, and one incomplete single family home in Edmonton, Alberta, all of which are currently listed for sale. Assets held for sale also included five townhouse units in Calgary, Alberta of which one has since been sold, one is under a contract for sale closing in September, and three are nearing construction completion and expected to be offered for sale in the third quarter. All of the properties held for sale are being carried at their estimated fair market value.

Liabilities at June 30, 2019 totaled \$0.5 million (June 30, 2018 – \$5.7 million) and were comprised of: dividends relating to the fiscal quarter paid on July 31, 2019; our trade payables; the balance due to Builders Capital Management Corp. and deferred lender fees.

The company was in compliance with all bank covenants relating to the line of credit and the loan payable and had no off-balance sheet arrangements during the year.

## Quarterly Financial Information

	Quarter ended June 30 2019 \$	Quarter ended March 31 2019 \$	Quarter ended December 31 2018 \$	Quarter ended September 30 2018 \$	Quarter ended June 30 2018 \$	Quarter ended March 31 2018 \$	Quarter ended December 31 2017 \$	Quarter ended September 30 2017 \$
Revenues	698,111	845,714	884,185	870,441	845,660	828,979	842,234	854,603
Total comprehensive earnings	472,190	593,228	292,116	563,880	492,823	575,892	533,613	595,960
Total assets	27,789,720	30,146,336	28,918,136	29,898,420	33,234,463	30,060,233	31,418,419	30,005,779
Shareholders' equity	27,258,301	26,653,051	26,250,889	26,768,731	26,522,452	25,679,439	25,683,552	25,296,956
Earnings per share	0.16	0.21	0.10	0.20	0.18	0.21	0.20	0.23
Cash dividends declared	588,715	491,066	552,658	493,450	542,343	583,522	545,664	565,362
Cash dividends declared per Class A share	0.1995	0.1973	0.2016	0.2016	0.1995	0.1973	0.2016	0.2016
Cash dividends declared per Class B share	0.2096	0.1247	0.1890	0.1247	0.1763	0.1763	0.2521	0.2057

## Distributions

Under our two-tiered share structure, Class A Non-Voting shareholders are entitled to receive annual dividends of 8% in preference to all other shareholder distributions. Once these dividends have been paid, Class B Non-Voting shareholders are entitled to receive total annual dividends of up to 16%. At our fiscal year-end, any remaining income available for distribution after these dividends are paid is allocated pro-rata between the classes of shares, including the Voting Shares.

On June 19, 2019, based on income for the second quarter of 2019, our Board of Directors declared a dividend of \$0.1995 per Class A Non-Voting Share to shareholders of record on June 30, 2019. This distribution was paid on July 31, 2019 and is recorded as payable in the accompanying consolidated financial statements. The dividend amount was calculated to provide an annualized 8% return on the \$10.00 initial Class A Non-Voting Share price.

Subsequent to the quarter-end, on July 30, 2019, again based on income for the second quarter of 2019, the Board declared a dividend of \$0.0997 per share to Class B Non-Voting shareholders of record on that date. This distribution was also paid on July 31, 2019. This dividend is not recorded in these consolidated financial statements as it was declared subsequent to the year-end.

## Liquidity and Capital Resources

Cash flow and liquidity are critical to our success. We monitor both daily to ensure we can meet the expectations of our borrowers.

In the second quarter of 2019, the real estate market in Calgary picked up somewhat and a number of our borrowers who had been having difficulties selling completed properties were able to sell and pay down their mortgages. This resulted in strong liquidity in the quarter, to the point where we now have surplus cash available.

During the three months ended June 30, 2019, mortgages were funded in the amount of \$3.9 million, bringing the year-to-date total to \$8.5 million. Second quarter repayments amounted to \$6.5 million, for a year-to-date total of \$9.8 million. In addition, we received \$515,000 on the sale of foreclosed inventory. As our mortgages are predominantly short-term in nature, the continual repayment by borrowers of existing mortgage investments creates liquidity for ongoing mortgage investments and funding commitments.

Our mortgage portfolio turns over approximately annually. We expect that borrower repayments will remain at a reasonably consistent level through the balance of 2019 and plan to continue funding mortgages in amounts approximately equal to mortgage repayments received. It is likely that a number of our mortgages will be renewed as they come due, as discussed earlier under Operations.

Liquidity risk for the company arises primarily from the prospect of committing to a mortgage for which sufficient funds are not available to make draws as requested by the borrower. As noted in the table titled Investment Portfolio above, we have mortgage commitments to borrowers totaling \$35 million, which exceed the current amounts funded by \$12.0 million. We anticipate funding these commitments through the repayment of existing mortgages. Should mortgage repayments fall short of our commitments, we have a number of tools to manage liquidity and to ensure that commitments can be met. Included are our \$4.5 million line of credit, detailed cash flow planning procedures, and Builders

Capital's well-established network of affiliates and mortgage industry contacts, through which mortgages can be sold or syndicated as required for cash flow purposes. In addition, our mortgage documents include language whereby a borrower cannot compel the company to advance funds. Our primary goal is to minimize unused cash balances, while ensuring that borrower needs and other commitments can always be met.

Since inception, almost all of the sales and purchases of mortgages, which have both helped keep the mortgage book full and been a source of liquidity as required, have been to and from related parties, in particular Builders Capital (2014) Ltd. ("BCL"). BCL is a privately held corporation, of which Builders Capital directors Sandy Loutitt and John Strangway are also both directors. The company has often been reliant on BCL as a vendor and purchaser of mortgages and as a source for liquidity, including at certain times of low cash flow, for payment of dividends. This reliance means that if BCL was unwilling, or unable, to act as a purchaser or vendor of mortgages, the company would have to leave a larger margin for error in our cash management practices, which could reduce profitability. The company expects to continue to be able to rely on BCL as a source of liquidity in the future. It is unlikely we could find another party that could provide liquidity as quickly or as efficiently.

We are prepared to increase our issued capital and regularly make solicitations for investments in Class A Common non-voting shares. Should such shares be issued, the proceeds will be used for general cash flow and for expansion of our mortgage portfolio. Builders Capital is financed, and will continue to be financed, primarily by the issuance of common shares.

According to our share terms, Class A Non-voting shareholders have an annual right to redeem their shares on October 31 each year at 95% of Net Asset Value. Payment for the redemptions is to be made on November 30 each year. During 2018 we received a redemption request for 1,200 shares, which were redeemed on November 30, 2018 for \$10,920.

### **Related-Party Transactions**

Our manager is a company controlled by Sandy Loutitt and John Strangway, both of whom are also directors of Builders Capital. The manager receives a management fee calculated as 1% per annum of the book value of the share capital of the company. Management fees amounted to \$71,000 for the quarter (2018 - \$69,000) and \$141,000 for the six-month period (2018 - \$135,000).

In addition to the management fee, the manager charges lender fees directly to borrowers both on loan originations and on loan renewals, with 28.6% of these fees being paid to the company and the remaining 71.4% going to the manager. The company collects these fees from the borrower, both on our own behalf and on behalf of the manager, by adding them to the principal amount of the mortgage, generally on the first advance to the borrower. The company then pays the manager's share of the fees to the manager, regardless of whether or not any payments have been received on the mortgage. Such payments to the manager are generally made within 30 days of having been charged to the borrower. Renewal fees are also charged to the borrower and paid to the manager during the term of the mortgage. During the quarter, the amount of these fees collected on behalf of the manager totaled \$124,000 (2018 - \$272,000) and \$215,864 for the six month period (2018 - \$306,000).

In general, mortgages are purchased when the company has excess cash on hand, quality mortgages are available to purchase, and opportunities to immediately fund additional mortgages are not available. The acquisition of mortgages helps us to minimize excess balances and maximize interest revenue.

Mortgages are sold when, despite the line of credit being fully drawn, additional cash is required, or is forecast to be required, to fund mortgage draws and commitments. Often, mortgages purchased are subsequently sold back and vice versa. The purchase and sale of mortgages sometimes results in balances due to or from related parties being outstanding for short periods of time. These balances are unsecured and non-interest bearing. No mortgages were purchased or sold in either Q1 or Q2.

## Market Outlook

The following discussion is qualified in its entirety by the Notice Regarding Forward-Looking Information at the beginning of this MD&A and by the section entitled Risks and Uncertainties that follows this Outlook section.

While an oversupply of housing inventory is expected to continue to weigh on Western Canada's real estate markets in the near term, there are signs that a recovery is starting. In its August 15, 2019 Monthly Housing Market Update, RBC Economics stated that "slumping markets out west – including Vancouver, Calgary and Edmonton-are now in early stages of a turnaround."

In our primary market of Calgary, Alberta, improvements in full-time employment rates, more affordable home prices and relatively stable lending rates have contributed to a recent increase in home sales.

In British Columbia, Royal Bank Economic Research predicts that economic growth will be boosted substantially as construction begins on the liquified natural gas project in Northwestern BC. While housing affordability is still a significant concern in the large urban markets of BC's Lower Mainland, we believe that employment growth will drive housing demand in other areas of the province and our goal is to source projects in regions where demand is predicted to be strong.

Accordingly, we anticipate that opportunities to source quality projects with good builders in our core Alberta and BC markets will improve.

In Saskatchewan, Royal Bank Economic Research predicts nominal employment growth of approximately 0.3% in 2019, which is expected to weigh on housing demand. This is reflected in a predicted housing starts level of just 4,300 units for the province in 2019. Given these conditions, we do not anticipate making any loans in the Saskatchewan market in 2019.

Going forward we expect to further reduce our portfolio of foreclosed properties. Over the past 18 months, we have foreclosed on 12 properties and sold or conditionally sold seven of them. We have also reduced the weighted average loan-to-value ratio on our portfolio to approximately 75.0% and believe that there is sufficient equity in the majority of the loans in our portfolio to minimize the risk of further loan losses. As always, however, it remains possible that we will need to take additional steps to collect on some of our mortgage assets over the coming months. That said, we believe that the necessary safeguards are in place to assure our ability to maintain the Class A Non-Voting Share dividend at 8% per annum.

These safeguards include maintaining a prudent debt-to-equity ratio, generally restricting our lending to 75% of what we believe to be the fair market value of a property at any given time, and taking adequate allowances for expected credit losses allowing us to build a cushion of funds to further protect investors. In addition, by investing only in short-term mortgages, we maintain the liquidity necessary to preserve



capital. In the event that we believe a market has become too risky, we will work on converting our investments to cash, and will forego returns in order to protect the capital with which we've been entrusted.

Finally, safeguards built into our share structure give Builders Capital's public Class A Non-Voting shareholders priority on all capital and income distributions over our Class B Non-Voting shareholders. In the event of a serious decline in the earning potential or value of our portfolio, Class B shareholders would forego all distributions until the Class A shareholders have received both their 8% return and, in the case of a dissolution, their capital. As demonstrated during recent quarters, with the impact of both our increased allocation of funds against potential loan losses and unproductive assets, borne entirely by Class B Non-Voting shareholders, this structure is functioning as intended.

Going forward, we will focus on more fully utilizing our capital and growing our business. Given the size of the marketplace, our current relatively small market share, and the opportunities that exist to expand our geographic footprint, we are well positioned to continue sourcing high-quality lending opportunities.

## **Financial Instruments**

Our primary business purpose is to invest in mortgages which accordingly are the only significant financial instrument that we carry and are the source of virtually all of our revenues. These financial instruments expose us to risks which are managed as follows:

### **Credit Risk**

Credit risk is the risk of loss associated with the counterparty's inability to fulfill its payment obligations. Credit risk arises principally from our lending activities. Any instability in the real estate sector and an adverse change in economic conditions in Canada could result in declines in the value of real property securing our mortgages. We mitigate this risk by adhering to our investment and operating policies.

All mortgages to which we commit are individually evaluated by our underwriters using credit risk assessment tools and are assigned risk ratings in accordance with the level of credit risk attributed to each loan. Each new mortgage is approved independently and in accordance with the authorization structure set out in our policies. Our underwriting approach places a strong emphasis on the value of the mortgage security and an assessment of the financial viability of the construction project being financed.

We have clearly defined underwriting policies and procedures that we adhere to in our mortgage approval process. These include a maximum projected loan-to-value ratio, standards with regard to the asset quality and marketability, geographic market restrictions and requirements regarding the overall credit quality and integrity of borrowers. We also actively analyze external market conditions including prevailing real estate values and employment conditions in the markets in which we lend. In all cases, our mortgages receivable are secured by registered charges over real property.

We utilize an internal risk rating system to categorize each mortgage in the portfolio on the basis of the perceived risk of a potential credit loss. The risk assessment of each mortgage assigned at the underwriting stage is subsequently revised based on changes in market conditions and on factors specific to the mortgage and the borrower. One of the main factors in considering whether the credit risk of a mortgage has increased significantly is the estimated loan to value ratio. Loan-to-value ratios can change due to declining property values, as well as other factors such as the inability of the

borrower to continue to inject equity into the project. Mortgages are considered to be impaired when the expectation is that full collection of principal and interest is no longer likely.

Our lending is for construction purposes, and all loans are made only on the strength of mortgage security over real property. The value of the underlying security is subject to change for a variety of factors, including the degree of completion of the construction, possible deterioration in structures left incomplete and market forces which can cause values to either increase or decrease.

In the case of mortgage impairment, probable recovery is determined using a combination of updated property-specific information, historical loss experience and management judgement to determine the impairment provision that may be required. The primary factor in assessing a mortgage as low risk would be a loan to value ratio which is low enough to make a potential credit loss extremely unlikely.

Although we write mortgages for periods of one year or less, the mortgages are often renewed based either on the borrower's ongoing requirement for capital for additional projects, or because the project which was originally financed has not been completed and sold. In each case, prior to renewal, we assess the mortgage for impairment.

Mortgages which were funded prior to the end of the previous fiscal year, and which have been renewed due to delays in completing the construction or the sale of the underlying security rather than due to a revolving arrangement for ongoing construction having been made, and for which no specific allowance has been recognized, can be considered to be past due, but not impaired as management considers collection to be reasonably assured due largely to the estimated value of the mortgage security held.

### **Market Risk**

Market risk is the risk of loss that may arise from changes in market factors such as interest rates and foreign exchange rates.

#### **i) Interest Rate Risk**

Interest rate risk arises from the possibility that the value of, or cash flows related to, a financial instrument will vary as a result of changes in market interest rates. We manage our financial instruments with the objective of mitigating any potential interest rate risks. The interest rates on the company's mortgages receivable are fixed for the term. Therefore, we are not exposed to significant cash flow interest rate risk. As at June 30, 2019, our mortgages receivable are subject to fair value interest rate risk as a decrease or increase in market interest rates will decrease or increase the fair value of the fixed rate financial asset. Any change in market interest rates will, however, have no impact on our cash flows or comprehensive income for the year as mortgages receivable carry a fixed rate of interest.

#### **ii) Foreign Currency Risk**

We do not have assets or liabilities denominated in foreign currency.

### **Liquidity Risk**

Liquidity risk arises from the possibility of not having sufficient ability to obtain debt financing or equity capital to fund future growth or meet our obligations as they arise and become due. Furthermore, liquidity risk also arises if we are not able to obtain financing on favorable terms.

Our main liquidity requirements will arise from mortgage acquisitions, manager fees and distributions to shareholders. All of the aforementioned liquidity requirements, except for mortgage acquisitions, are

generally funded from cash flows earned on mortgage interest and fees. Mortgage acquisitions are generally funded through equity issuances. Our financial condition and results of operations would be adversely affected if it were unable to obtain additional funds through equity issuances or financing, or if we were unable to meet our other liquidity requirements from ongoing operating activities.

Our approach to managing liquidity is to ensure that we will have sufficient financial resources available to meet our liabilities as they become due. This includes monitoring of cash, line of credit, loan payable and accounts payables and accrued liabilities. We intend to mitigate our liquidity risk by not entering into property acquisitions unless we have secured or are confident that we can secure the appropriate capital (debt and/or equity) to fund the particular acquisition. Liquidity risk is also mitigated by the terms offered to investors, which state that all redemptions are at the discretion of management and are dependent on the circumstances, and to borrowers, which state that the company is never obligated to advance additional mortgages or funding.

### **Responsibility of Management and the Board of Directors**

Management is responsible for the information disclosed in this MD&A and has in place the appropriate information systems, procedures and controls to ensure that the information used internally by management and disclosed externally is materially complete and reliable. In addition, our Board of Directors and Audit Committee provide an oversight role with respect to our public and financial disclosures. Both have reviewed and approved this MD&A and the accompanying consolidated financial statements for the quarter ended June 30, 2019.

### **Outstanding Share Data**

The company's authorized share capital as at August 28, 2019, consists of 1,000 Voting Shares, of which 100 were outstanding at year-end; an unlimited number of Class A Non-Voting Shares, of which 1,979,570 are outstanding; and an unlimited number of Class B Non-Voting Shares, of which 924,576 are outstanding.

### **Risk and Uncertainties**

There are two primary areas of risk for us as a lender. The first is the risk that borrowers will fail to meet their obligations and repay mortgages as they come due. Secondly, there is a risk that sufficient quality investment opportunities will not be available to keep our capital fully deployed. As our primary goal is the preservation of our investors' capital, even at the expense of potential returns, we consider the risk of borrower default to be our primary concern.

A robust new home construction market greatly reduces both of these risks, as it provides a strong marketplace into which builders can sell their completed projects, it maintains or increases the value of the security for our loans, and it provides an ongoing source of new projects and borrowers. A downturn in the market that substantially decreases security values could have a significant negative effect on our business. We cannot predict the performance of the housing market in the future with certainty.

In order to mitigate these risks, we restrict our loan amounts to a target of up to 75% of what we consider the fair market value of the security to be. The 25% equity component is a requirement for our borrowers and we believe it provides us with a sufficient margin for error in the event of a drop in property values. The short-term nature of our loans also gives us the flexibility to convert our entire portfolio of mortgages to cash within a reasonable time period, if economic conditions warrant. We also

maintain sufficient construction expertise to allow us to economically complete any project on which we have loaned funds.

Our share terms provide that the Class A Non-Voting shareholders have a priority over other shareholders with respect to both the payment of dividends at an 8% rate, and any potential return of capital. This creates a significant reduction in the risk profile of the Class A Non-Voting Shares, as an impairment in the value of the mortgage portfolio, or a lack of funds available for distributions, will always be absorbed, to the full extent of their investment, by the Class B Non-Voting Shares before the Class A shareholders' rights are affected. We believe that this structure substantially reduces risk for the Class A shareholder.

Other risks and uncertainties exist for our business that are typical for business in general and for lenders in particular. These include changes in interest rates, potential environmental issues associated with the mortgage security, borrower solvency, any significant changes in competition, changes in tax legislation and other factors as described under Forward-Looking Information.

The company was named in a lawsuit brought by a potential purchaser of a property under construction on which we held a mortgage claiming the amount of \$50,000. Subsequent to the quarter end we settled this suit for a payment of \$10,000.

### **Additional Information**

Additional information about Builders Capital is available on SEDAR at [www.sedar.com](http://www.sedar.com) and on our website at [www.builderscapital.com](http://www.builderscapital.com).