Scotia Covenants Limited

Annual Report 1978

Town house condominium; Port Moody, B.C.

Town house; Burnaby, B.C.

Grow with us

Scotia Covenants is a mortgage-lending company that is sponsored and owned by several large Canadian institutions including the Bank of Nova Scotia, all of which are represented on the Board of Directors. It is regulated and supervised by the Federal Department of Insurance under the Investment Companies Act of Canada.

Mortgages are made on residential, commercial and industrial properties throughout Canada by Central Covenants Limited, a wholly owned subsidiary. The Mortgage Insurance Company of Canada has insured 82% of the mortgage loans and Central Mortgage and Housing Corporation has insured 17% of the mortgage loans.

Scotia Covenants issues short term promissory notes and term notes at attractive interest rates. The short term notes have a term of 1 to 365 days and a minimum amount of $50,000. The term notes have a term of 1 to 10 years and a minimum amount of $1,000.

Interest on short term notes is paid at maturity and on term notes on one of the following bases:

- semi-annually
- annually
- on maturity with interest compounded semi-annually
- monthly, minimum amount $5,000

The notes are direct senior obligations of the Company and qualify as authorized investments for insurance companies, loan and trust companies and pension funds. They represent a prime investment for individuals and corporations.

Financial Highlights

	1978	1977
Operations		
Income	**$ 36,551,000**	$ 27,521,000
Expenses	**32,183,000**	24,002,000
Income taxes	**2,115,000**	1,690,000
Net earnings	**2,253,000**	1,829,000
Per Share		
Net earnings	**$ 3.28**	$ 3.01
Dividends	**1.65**	1.50
Book value	**22.69**	21.08
Mortgages		
Balance outstanding	**$377,555,000**	$287,949,000
Credit Extended to the Company		
Total bank lines	**$ 40,000,000**	$ 40,000,000
Bank lines in use	**—**	—
Short-term notes outstanding	**27,833,000**	34,722,000
Term notes outstanding	**277,986,000**	219,055,000
Senior debentures	**33,189,000**	9,318,000
Subordinated debentures	**11,272,000**	11,677,000
Capital		
Common shares	**$ 12,179,000**	$ 10,171,000
Retained earnings	**4,538,000**	3,417,000
Total	**16,717,000**	13,588,000

DIRECTORS

R. T. M. Allan, Associate Treasurer
Sun Life Assurance Company of Canada,
Montreal, Quebec

*T. R. Alton,** President
Scotia Covenants Limited, Toronto, Ontario

•**G. R. Blake,** Vice-President and Treasurer
The Equitable Life Insurance Company of
Canada, Waterloo, Ontario

J. E. Brookes, Economic Adviser & President
Greenguard Limited, Montreal, Quebec

R. C. Brown, Partner
Blake, Cassels & Graydon

D. H. Cochrane, Vice-President, Administration, Central and Eastern Trust Company,
Halifax, Nova Scotia

•**D. M. Haines,** Investment Vice-President,
Property Investments, Confederation Life
Insurance Company, Toronto, Ontario

G. C. Hitchman, Deputy Chairman
The Bank of Nova Scotia, Toronto, Ontario

A. A. Hodgson, Treasurer
Aluminum Company of Canada, Ltd.,
Montreal, Quebec

R. R. Holmes, General Manager, Investments
The Bank of Nova Scotia, Toronto, Ontario

*R. M. MacIntosh,** Executive Vice-President
The Bank of Nova Scotia, Toronto, Ontario

A. C. MacLellan, Assistant General
Manager, Mortgages, The Bank of Nova
Scotia, Toronto, Ontario

J. H. McMeekin, Director, Investment Policy
The Imperial Life Assurance Company of
Canada, Toronto, Ontario

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Investors Syndicate Realty Limited,
Winnipeg, Manitoba

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The Canada Life Assurance Company,
Toronto, Ontario

P. E. Reinhardt, Vice-President, Finance
Industrial Life Insurance Company,
Quebec City, Quebec

•**R. E. Waugh,** Assistant General Manager,
Canadian Corporate Banking
The Bank of Nova Scotia, Toronto, Ontario

*Member of Executive Committee
• Member of Audit Committee

OFFICERS

R. M. MacIntosh
Chairman of the Board

G. C. Hitchman
Deputy Chairman of the Board

T. R. Alton
President

J. P. McAvoy
Vice-President

C. Musicco
Vice-President

R. C. Brown
Secretary

H. F. Claxton
Assistant Treasurer

Suite 1410, 401 Bay Street,
Toronto, Ontario M5H 2Y4

C. Musicco, Vice-President (right) with
W. E. Small, HUDAC President

J. P. McAvoy, Vice-President

T. R. Alton, Director and President

To our shareholders and friends:

1978 was a good year for Scotia Covenants, with the mortgage portfolio increasing 31%, earnings per share increasing 9%, and the return on shareholders' equity exceeding 14%.

We experienced a competitive mortgage market, with a good supply of funds and stable interest rates, until the last quarter of the year. Interest rates in the last quarter were forced up by the Bank of Canada in an effort to defend our sagging Canadian dollar, however, there continues to be a good supply of funds with a weak demand for them. These factors have produced a narrowing of the spread between the cost of our funds and the rate at which we lend them.

Earnings

Interest income during the year increased $9 million or 33% to $36 million, while interest expense increased $7.3 million or 34% to $29 million.

Overheads generally grew at a rate commensurate with the 31% growth in size of the Company's portfolio, with the following exceptions.

- Salaries increased only 20% to $337,000.
- Office and general expenses increased 73% to $392,000, with a major component of this expense comprising approximately $100,000, for the implementation and operation of a new computer system, for processing Term Notes. This new system is fully operational and all development costs have been written off. It will enable us to cope with large increases in volumes in an efficient and economical manner.
- Capital tax increased 58% to $510,000. These taxes are paid to the Provinces of Ontario, Quebec, Manitoba and British Columbia in which 80% of our mortgage portfolio is located.

Provincial capital tax is a major portion of our overheads and represents about .15 of 1% in terms of yield on the mortgage portfolio.

The average income tax rate for the year increased to 48.4% in 1978, from 48.0% in 1977, reflecting an increased income tax rate of 1% in Ontario, effective March 1978.

If capital taxes are included with income taxes, our overall tax rate is 53.8% and we are one of the more heavily taxed companies in the country.

Net earnings increased 23% to $2,253,000 and on an earnings per share basis, increased 9% to $3.28 from $3.01 in 1977. The average number of shares outstanding increased 13% to 686,469 shares in 1978.

Our dividend policy is to pay out 50 to 60% of earnings in dividends. The 1978 pay out amounted to 50% with dividends of $1.65 a share. There was a 10% increase in dividends paid per share to $1.65 in 1978 from $1.50 per share in 1977.

Share Capital

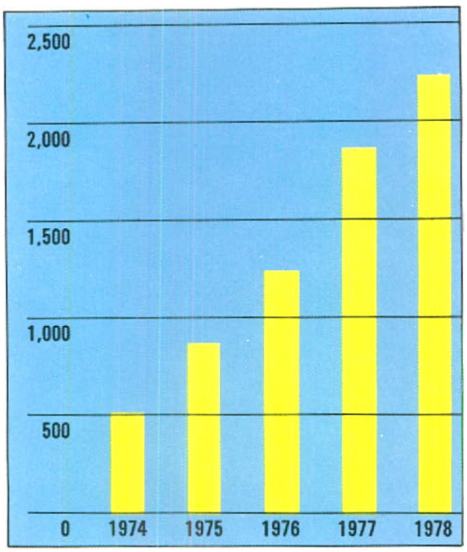
In order to continue growth at a rapid pace, it is necessary to increase our shareholders' equity. In 1978 shareholders' equity increased $3.1 million, with $2 million coming from new shares issued and $1.1 million from an increase in retained earnings.

In December, 1978 shareholders subscribed for an additional 123,983 shares at $25.00 for a total of $3,099,575. This new capital will be drawn down by the Company as required on a quarterly basis, and provides a solid base for future growth.

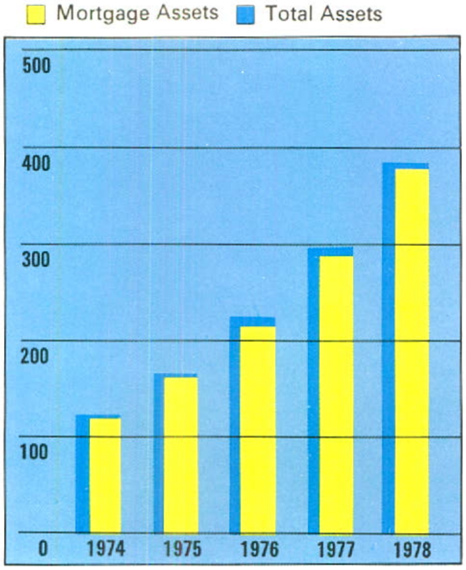
Mortgage Portfolio

The past year was very active in terms of mortgage approvals with total approvals amounting to $156 million. Mortgage advances increased 15% to $141 million; loan repayments increased 54% to $39 million and sale of mortgage loans declined 53% to

Net earnings after tax
(In thousands of dollars)



Assets
(In millions of dollars)
Mortgage Assets Total Assets



$14 million. Overall, the mortgage portfolio increased 31% or $90 million to $378 million.

We have a strong commitment to make mortgage loans on single family dwellings with 70% of our portfolio invested in this category. In 1978 73% of loan approvals were for single family homes, with the majority of these homes being located in smaller communities, such as towns, villages, and rural areas across Canada.

Commercial and industrial loans for stores, offices, warehouses, and industrial plants accounted for 22% of loan approvals in 1978, with the balance of 5% of approvals for rental residential buildings, such as apartments and town houses. A large portion of income property loans are also made in smaller communities of Canada.

In the past year we commenced making uninsured loans on prime properties where the loan to value ratios did not exceed 75% of value. The making of prime uninsured loans has broadened our market for lending and enabled us to be competitive with other mortgage lenders. Uninsured loans represented just over 1% of the portfolio at year-end.

Financing

The Company's lending operations are financed by the sale of Short-term Promissory Notes, Term Notes and Debentures.

In February, 1978, we issued a $25 million 9¼% Debenture due February 15, 1984. This was a public underwritten issue and was well received by the market.

Term Notes outstanding increased by $59 million to $278 million in 1978. These notes have a term of 1 to 10 years and are sold by a group of investment dealers and a chartered bank.

At year-end, the Company was in a strong financial position. The level of debt due in one year was 20% and is at the lowest level in the past five years.

In past years, we have issued a prospectus for the issue of Term Notes and a separate prospectus for the issue of Debentures. As these securities are similar in nature, we are planning to issue only one prospectus in 1979, which will cover the issue of Term Notes sold by agents on a day-to-day basis and, also, will cover the sale of Term Notes to an underwriter, as principal, for distribution to the public. The use of one prospectus should simplify the raising of debt through our sales agents and underwriters.

Staff

One asset which does not appear on our balance sheet is the dedicated group of employees whose contribution was essential to recording another successful year. We also appreciate the encouragement and counsel which was received from our Board of Directors.

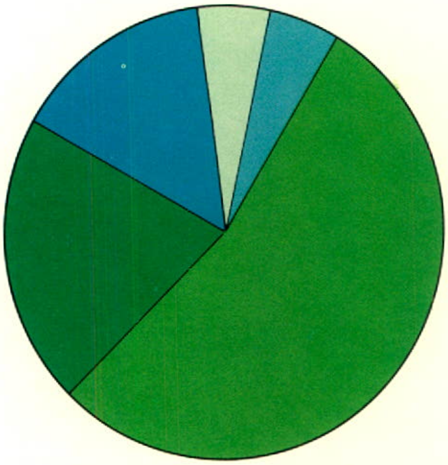
Outlook

In the current climate of high rates, an abundant supply of funds, and slow demand, we expect our growth rate to moderate in 1979. The outlook is for reduced interest rates later in the year which will strengthen demand for funds and provide an atmosphere of more normal interest spreads. We are optimistic that when the new year closes, our efforts in 1979 will have produced another year of growth in assets and profits.

T. R. Alton
President

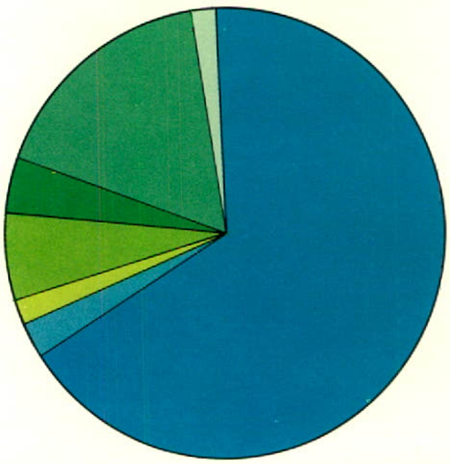
February 6, 1979

Mortgage Portfolio
as at October 31, 1978



Geographic distribution

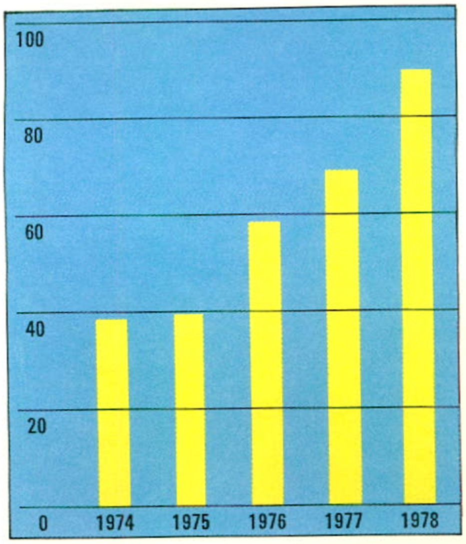
	Percent of Portfolio (in Dollars)
Atlantic Provinces	4.9%
Quebec	5.3%
Ontario	53.7%
Prairie Provinces	19.6%
British Columbia	16 5%
	100 0%



Type of loan

Type of Loan	Number of Loans	Amount (in 000's of Dollars)	Percentage of Total Portfolio
Single Family	8,373	$252,826	67.0%
Joint Loans	3,682	10,986	2.9
Total single family	12,055	$263,812	69.9
Vacation	293	5,960	1.6
Rental - Apartments and Townhouses	135	23,863	6.3
Nursing Homes	16	14,752	3.9
Total residential	12,499	$308,387	81.7
Commercial and Industrial	331	64,455	17.1
Unamortized Discounts and Accrued Interest		4,713	1.2
Total portfolio	12,830	$377,555	100.0%

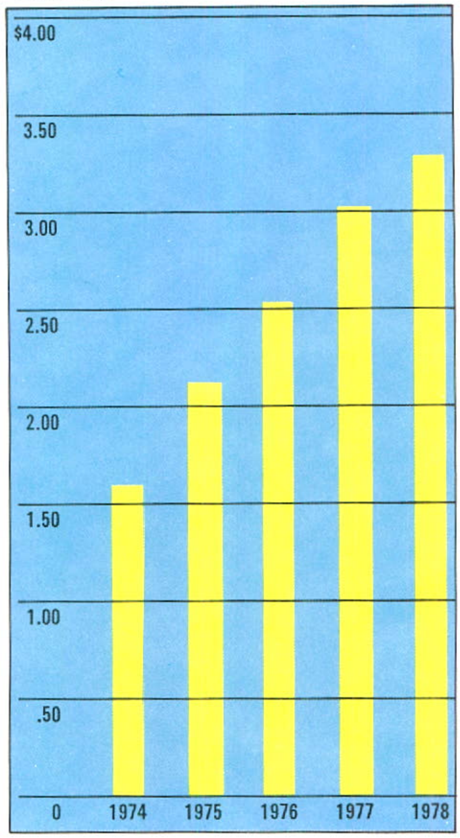
Increase in mortgage assets
(In millions of dollars)



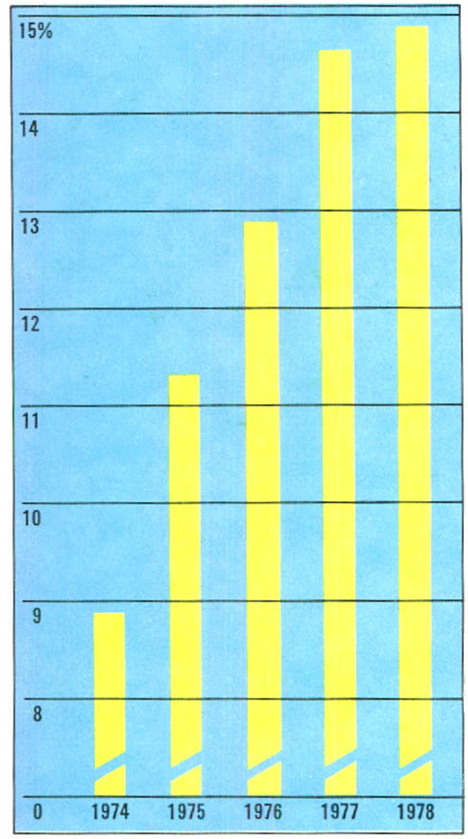
Matching of mortgages receivable and debt
as at October 31, 1978 (in thousands of dollars)

Year	Maturity of Mortgages	Maturity of Debt
1979	$ 41,666	$ 68,439
1980	40,076	55,917
1981	66,490	66,698
1982	78,740	55,643
1983	109,537	56,717
Later	41,046	46,866
	$377,555	$350,280

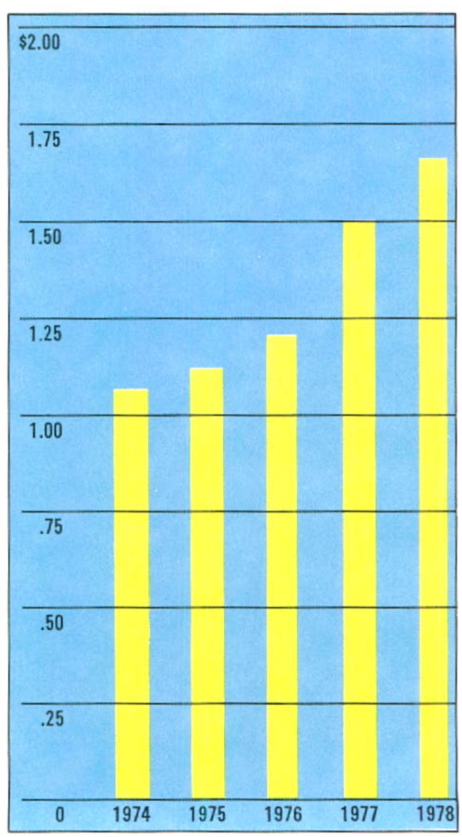
Earnings per share
(Based on weighted average daily number of shares outstanding)



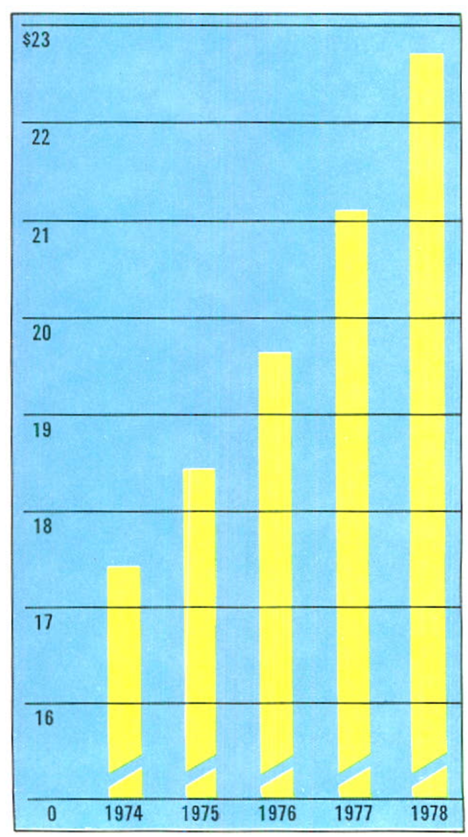
Rate of return on average shareholders' equity
(Annual after tax income as a percentage of average shareholders' equity for the year)



Dividends per share



Book value per share



Consolidated Statement of Earnings

For the year ended October 31, 1978

	1978	1977
Income		
Interest –		
Mortgage loans	$ 34,782,674	$ 26,515,210
Short-term investments	1,227,795	494,374
Gain on redemption of debt	37,646	128,104
Leasing income	9,338	24,610
Other	493,717	358,491
	$ 36,551,170	$ 27,520,789
Expenses		
Interest –		
Debentures	$ 3,180,134	$ 1,303,258
Term notes	24,540,811	18,608,784
Bank advances	1,422	4,963
Short-term promissory notes	1,289,864	1,770,796
Amortization of debt discount and expense	726,759	504,894
Trustees' fees for debentures	12,515	8,087
Bank charges	94,875	92,712
Short-term promissory note expense	40,259	54,551
Mortgage servicing fees	995,971	740,910
Salaries	337,495	281,842
Office and general	392,396	226,862
Legal and audit	15,329	37,688
Capital and place of business taxes	510,237	323,241
Rent	35,244	34,614
Directors' fees	10,104	8,520
	$ 32,183,415	$ 24,001,722
Earnings before income taxes	$ 4,367,755	$ 3,519,067
Provision for income taxes		
Current	$ 1,428,900	$ 1,084,800
Deferred	686,100	605,200
	$ 2,115,000	$ 1,690,000
Net earnings for the year	$ 2,252,755	$ 1,829,067
Earnings per share	$ 3.28	$ 3.01
Weighted average daily number of shares outstanding	686,469	608,158

Consolidated Balance Sheet

As at October 31, 1978

	1978	1977
Assets		
Cash	$ 137,085	$ 114,661
Short-term investments – at cost, plus accrued interest, which approximates market	5,275,649	9,377,253
Mortgage loans – at amortized cost, plus interest due and accrued	377,554,952	287,948,859
Lease receivable	—	195,668
Unamortized debt discount and expense (note 1)	2,073,012	1,527,390
	$ 385,040,698	$ 299,163,831

	1978	1977
Liabilities		
Accounts payable and accrued interest	$ 14,678,792	$ 8,247,349
Income taxes payable	401,897	278,820
Short-term promissory notes	27,832,513	34,721,598
Terms notes (note 2)	277,986,140	219,055,542
Senior debentures (note 2)	33,189,000	9,318,000
	$ 354,088,342	$ 271,621,309
Subordinated debentures (note 2)	11,272,000	11,677,000
Deferred income taxes (note 1)	2,963,500	2,277,400
	$ 368,323,842	$ 285,575,709
Shareholders' equity		
Capital stock (note 3)		
Issued and fully paid –		
736,900 shares (1977 – 644,550 shares)	12,179,276	10,170,664
Retained earnings	4,537,580	3,417,458
	$ 16,716,856	$ 13,588,122
	$ 385,040,698	$ 299,163,831

Signed on behalf of the Board

R. M. MacIntosh, Director

T. R. Alton, Director

Consolidated Statement of Retained Earnings

For the year ended October 31, 1978

	1978	1977
Retained earnings – beginning of year	$ 3,417,458	$ 2,504,044
Net earnings for the year	2,252,755	1,829,067
	$ 5,670,213	$ 4,333,111
Dividends	1,132,633	915,653
Retained earnings – end of year	$ 4,537,580	$ 3,417,458

Consolidated Statement of Changes in Financial Position

For the year ended October 31, 1978

	1978	1977
Source of funds		
Net earnings	$ 2,252,755	$ 1,829,067
Items not requiring an outlay of funds –		
Amortization of debt discount and expense	726,759	504,894
Deferred income taxes	686,100	605,200
Funds provided from operations	$ 3,665,614	$ 2,939,161
Net increase in short-term promissory notes	—	5,250,280
Net increase in senior debentures	23,871,000	—
Net increase in term notes	58,930,598	53,621,315
Net increase in subordinated debentures	—	9,765,000
Change in other assets and liabilities – net	5,282,139	2,870,598
Net decrease in cash and short-term investments	4,079,180	—
Decrease in lease receivable	195,668	127,657
Issue of shares	2,008,612	1,292,671
	$ 98,032,811	$ 75,866,682
Application of funds		
Redemption and repayment of –		
Senior debentures	—	$ 1,426,000
Subordinated debentures	$ 405,000	—
Dividends	1,132,633	915,653
Net increase in cash and short-term investments	—	3,793,905
Net decrease in short-term promissory notes	$ 6,889,085	—
	$ 8,426,718	$ 6,135,558
Increase in mortgage loans	$ 89,606,093	$ 69,731,124

Auditors' Report to the Shareholders

We have examined the consolidated balance sheet of Scotia Covenants Limited as at October 31, 1978 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at October 31, 1978 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

COOPERS & LYBRAND
Chartered Accountants
November 17, 1978

1. Significant accounting policies

Consolidation

The consolidated financial statements include the accounts of Central Covenants Limited, a wholly-owned subsidiary.

Unamortized debt discount and expense

Debt discount and expense are amortized on a straight-line basis over the original outstanding term of the related debt.

Deferred income taxes

Income taxes otherwise payable have been deferred by claiming, for tax purposes, debt expenses in excess of amounts charged against earnings and a mortgage reserve. The amount deferred has been provided for in the accounts, except for an amount of $364,200 which relates to the period prior to October 31, 1968.

2. Indebtedness of the company

Ranking of Indebtedness

Short-term promissory notes, term notes, senior debentures, and bank borrowings are direct senior obligations of the company, ranking equally but prior to subordinated debentures.

Maturities of indebtedness

The following table indicates the principal repayments of all indebtedness:

Year ending October 31,	1978	1977
1978	—	$ 74,307,640
1979	$ 68,438,513	22,199,000
1980	55,917,000	47,565,000
1981	66,698,500	52,495,500
1982	55,643,000	53,743,000
1983	56,716,640	3,293,000
1984	25,124,000	1,905,000
1985	13,547,000	13,028,000
1986 and after	8,195,000	6,236,000
	$350,279,653	$274,772,140

Term notes

The average interest cost on outstanding term notes for the year was 9.50% (1977 – 9.62%). Term notes are due as follows:

Year ending October 31,	
1978	—
1979	$ 40,539,000
1980	55,465,000
1981	65,521,500
1982	53,448,000
1983	54,136,640
1984	2,114,000
1985	2,087,000
1986	2,322,000
1987	1,148,000
1988	1,205,000
	$277,986,140

Senior debentures

The senior debentures consist of:

5⅞% Series A due March 1, 1985	$ 3,545,000
6¼% due September 1, 1990	4,005,000
7¼% due February 15, 1982	1,272,000
9¼% due February 15, 1984	24,367,000
	$ 33,189,000

Subordinated debentures

The subordinated debentures are subordinated to the senior debentures, term notes, short-term promissory notes and bank borrowings and consist of:

8% due May 15, 1983	$ 1,862,000
9¼% due April 15, 1985	9,410 000
	$ 11,272,000

In addition to the fixed rate of interest of 8% on the debentures due May 15, 1983 participating interest of 2% for the fiscal year 1978 is payable on May 15, 1979.

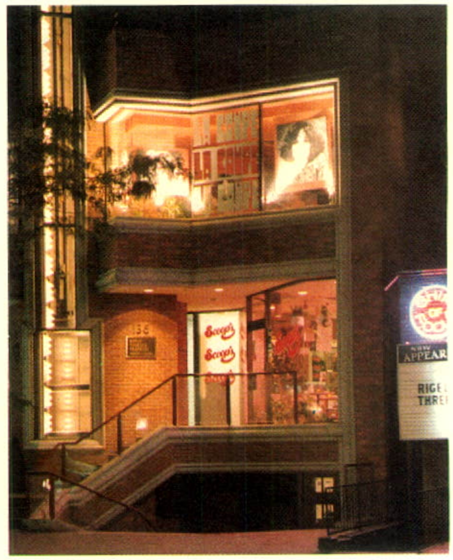
3. Capital stock

During the year the company issued 92,350 shares for a cash consideration of $2,088,612.

Properties Financed by Central Covenants Limited

Apartment; Fort McMurray, Alberta

Vacation; Wakefield, Quebec



Commercial; Toronto, Ontario

Industrial; Mississauga, Ontario

Ten Year Financial Summary

	1978	1977	1976	1975
Mortgage loans				
Amount of loans outstanding	**$377,555,000**	$287,949,000	$218,218,000	$159,512,000
Amount of loan advances	**141,299,000**	123,331,000	85,791,000	48,472,000
Amount of loan repayments less tax advances	**38,817,000**	25,128,000	9,760,000	9,280,000
Sale of mortgage loans	**14,103,000**	29,527,000	18,437,000	—
Average amount of loan outstanding	**29,428**	23,770	19,364	16,615
Number of loans outstanding	**12,830**	12,114	11,269	9,600
Loans more than 3 months in arrears	**1.16%**	.61%	.24%	.30%
Mortgage insurance claims – paid in full	**36**	11	8	1
Debt outstanding	**$350,280,000**	$274,772,000	$207,562,000	$151,685,000
Shareholders' equity	**$ 16,717,000**	$ 13,588,000	$ 11,382,000	$ 8,494,000
Net earnings				
Gross income	**$ 36,551,000**	$ 27,521,000	$ 20,335,000	$ 14,313,000
Debt expense	**29,887,000**	22,348,000	16,617,000	11,665,000
General and administrative expense	**2,296,000**	1,654,000	1,210,000	916,000
Income taxes	**2,115,000**	1,690,000	1,231,000	882,000
Net operating earnings	**2,253,000**	1,829,000	1,277,000	850,000
Extraordinary item – loss on sale of mortgage, less income taxes	—	—	—	—
Net earnings	**2,253,000**	1,829,000	1,277,000	850,000
Per share				
Net operating earnings	**$ 3.28**	$ 3.01	$ 2.53	$ 2.14
Extraordinary item	—	—	—	—
Net earnings	**3.28**	3.01	2.53	2.14
Dividend record	**1.65**	1.50	1.20	1.10
Book value	**22.69**	21.08	19.59	18.41

1974	1973	1972	1971	1970	1969
$119,831,000	$81,597,000	$51,265,000	$34,778,000	$32,398,000	$34,301,000
44,598,000	37,530,000	24,100,000	8,931,000	1,972,000	5,542,000
5,569,000	6,633,000	4,851,000	3,566,000	3,065,000	1,297,000
995,000	804,000	2,968,000	2,988,000	800,000	1,098,000
13,440	10,140	5,952	3,990	3,174	3,014
8,817	8,047	8,613	8,716	10,206	11,015
.24%	.26%	.30%	.40%	.39%	.19%
—	2	10	8	3	1
$114,250,000	$80,850,000	$48,810,000	$34,864,000	$30,193,000	$31,828,000
$ 6,555,000	$ 4,946,000	$ 3,387,000	$ 3,205,000	$ 2,993,000	$ 2,968,000
$ 10,201,000	$ 6,452,000	$ 4,261,000	$ 3,165,000	$ 3,231,000	$ 3,057,000
8,478,000	4,946,000	3,058,000	2,133,000	2,527,000	2,367,000
665,000	450,000	319,000	286,000	293,000	311,000
549,000	534,000	425,000	381,000	213,000	195,000
509,000	522,000	459,000	365,000	198,000	184,000
—	—	—	—	32,000	40,000
509,000	522,000	459,000	365,000	166,000	144,000
$ 1.57	$ 2.10	$ 2.08	$ 1.72	$ .93	$ .87
—	—	—	—	.15	.19
1.57	2.10	2.08	1.72	.78	.68
1.05	1.05	1.01	.75	.41	.40
17.43	16.74	15.19	14.88	13.97	13.85