

Unaudited Condensed Consolidated Interim Financial Statements
(In Canadian dollars)

MORNEAU SHEPELL INC.

Three months ended March 31, 2017 and 2016
(Unaudited)

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position

(In thousands of Canadian dollars)

March 31, 2017 and December 31, 2016

	March 31, 2017	December 31, 2016
Assets		
Current assets:		
Trade and other receivables	\$ 62,831	\$ 67,291
Unbilled fees	72,151	61,131
Prepaid expenses and other	11,932	8,159
Cash and investments held in trust	14,207	17,211
Deferred implementation costs	6,827	7,146
Total current assets	167,948	160,938
Non-current assets:		
Unbilled fees	4,613	5,128
Deferred implementation costs	21,761	19,406
Capital assets	34,639	34,499
Intangible assets	226,040	230,572
Goodwill	320,670	320,757
Deferred tax asset	1,956	2,326
Total non-current assets	609,679	612,688
Total assets	\$ 777,627	\$ 773,626

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position

(In thousands of Canadian dollars)

March 31, 2017 and December 31, 2016

	March 31, 2017	December 31, 2016
Liabilities and Equity		
Current liabilities:		
Bank indebtedness (note 4)	\$ 6,159	\$ 3,056
Trade and other payables	62,306	59,157
Income taxes payable	2,636	2,200
Deferred revenue	6,559	5,121
Insurance premium liabilities	14,207	17,211
Future consideration related to acquisitions (note 9)	5,514	5,252
Dividends payable	3,460	3,460
Interest rate swaps (note 4)	1,214	1,625
Total current liabilities	102,055	97,082
Non-current liabilities:		
Long-term debt (note 4)	166,307	166,299
Convertible debenture payable	81,331	81,096
Future consideration related to acquisitions (note 9)	566	2,258
Other liabilities	12,419	12,838
Provisions	3,651	3,764
Deferred tax liability	48,429	48,582
Total non-current liabilities	312,703	314,837
Equity:		
Share capital	552,060	552,038
Contributed surplus	30,591	27,369
Equity component of convertible debenture	1,045	1,045
Accumulated other comprehensive loss	(2,317)	(2,451)
Deficit	(218,510)	(216,294)
Total equity	362,869	361,707
Total liabilities and equity	\$ 777,627	\$ 773,626

Commitments and contingencies (note 9)

See accompanying notes to the unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Income and Comprehensive Income

(In thousands of Canadian dollars, except per share amounts)

For the three months ended March 31, 2017 and 2016

	Three months ended March 31,	
	2017	2016
Operating revenue	\$ 157,837	\$ 149,123
Operating expenses:		
Salaries, benefits and contractors	108,923	102,966
Rent and occupancy	6,990	6,931
Office and administration	16,622	16,647
Depreciation and amortization	9,333	8,697
Total operating expenses	141,868	135,241
Finance costs (note 4)	3,273	3,949
Profit from operations before income taxes	12,696	9,933
Income taxes expense (recovery):		
Current	4,638	3,585
Deferred	(106)	(701)
Total income taxes	4,532	2,884
Profit for the period	8,164	7,049
Other comprehensive income (loss):		
Items that may be reclassified subsequently to profit:		
Effective portion of change in interest rate cash flow hedges	411	573
Foreign currency translation differences for foreign operations	(244)	(1,950)
Income taxes on the above items	(110)	(153)
	57	(1,530)
Items that will not be reclassified to profit:		
Actuarial gain/(loss) on post-employment benefit plans	105	(348)
Income taxes on the above item	(28)	93
	77	(255)
Other comprehensive income (loss), net of tax effect	134	(1,785)
Comprehensive income for the period	\$ 8,298	\$ 5,264
Earnings per share (note 6):		
Basic	\$ 0.15	\$ 0.14
Diluted	\$ 0.15	\$ 0.14

See accompanying notes to the unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Changes in Equity

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

2017	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debenture	Total equity
Balance, January 1, 2017	\$ 552,038	\$ 27,369	\$ (216,294)	\$ (2,451)	\$ 1,045	\$ 361,707
Long-term incentive plan – expense and issuance	–	3,244	–	–	–	3,244
Long-term incentive plan – redemption	22	(22)	–	–	–	–
Profit for the period	–	–	8,164	–	–	8,164
Dividends	–	–	(10,380)	–	–	(10,380)
Other comprehensive income	–	–	–	134	–	134
Balance, March 31, 2017	\$ 552,060	\$ 30,591	\$ (218,510)	\$ (2,317)	\$ 1,045	\$ 362,869

2016	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debenture	Total equity
Balance, January 1, 2016	\$ 477,500	\$ 23,312	\$ (202,295)	\$ (2,850)	\$ 757	\$ 296,424
Long-term incentive plan – expense and issuance	–	1,039	–	–	–	1,039
Profit for the period	–	–	7,049	–	–	7,049
Dividends	–	–	(9,413)	–	–	(9,413)
Other comprehensive loss	–	–	–	(1,785)	–	(1,785)
Balance, March 31, 2016	\$ 477,500	\$ 24,351	\$ (204,659)	\$ (4,635)	\$ 757	\$ 293,314

See accompanying notes to the unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Cash Flows

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

	Three months ended March 31,	
	2017	2016
Operating activities:		
Profit for the period	\$ 8,164	\$ 7,049
Items not involving cash:		
Depreciation and amortization	9,333	8,697
Finance costs (note 4)	3,273	3,949
Long-term incentive plan expense	3,244	993
Income taxes	4,532	2,884
Change in provisions	(113)	(98)
Other	(314)	(395)
	28,119	23,079
Change in non-cash operating working capital (note 8)	(5,955)	(1,594)
Cash generated from operating activities	22,164	21,485
Finance costs paid	(4,015)	(4,462)
Income taxes paid	(4,033)	(1,701)
Cash provided by operating activities	14,116	15,322
Financing activities:		
Change in revolving loan (net)	(71)	382
Dividends paid	(10,380)	(9,413)
Repayment of promissory note	–	(2,500)
Cash used in financing activities	(10,451)	(11,531)
Investing activities:		
Business acquisitions	(1,696)	(447)
Additions to intangible assets	(1,894)	(3,322)
Additions to capital assets	(3,178)	(2,651)
Cash used in investing activities	(6,768)	(6,420)
Decrease in cash for the period	(3,103)	(2,629)
Cash/(Bank indebtedness), beginning of period	(3,056)	1,900
Bank indebtedness, end of period	\$ (6,159)	\$ (729)

See accompanying notes to the unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

1. Organization and nature of the business:

Morneau Shepell Inc. was incorporated pursuant to the laws of the Province of Ontario on October 19, 2010 and is a continuation of Morneau Sobeco Income Fund, which was converted from an income trust structure into Morneau Shepell Inc., effective January 1, 2011.

Morneau Shepell Inc. and its subsidiaries (the "Company") provide health and productivity, administrative and retirement solutions to assist employers in managing the financial security, health and productivity of their employees. The Company's principal and head office is located at One Morneau Shepell Centre, 895 Don Mills Road, Suite 700, Toronto, Ontario, M3C 1W3. The Company offers its services to organizations that are situated in Canada, in the United States and internationally.

References herein to the Company represent the financial position, results of operations, cash flows and disclosures of Morneau Shepell Inc. and its subsidiaries on a consolidated basis.

These unaudited condensed consolidated interim financial statements were approved by the Company's Board of Directors on May 4, 2017.

2. Basis of preparation:

These unaudited condensed consolidated interim financial statements for the three months ended March 31, 2017 and 2016 have been prepared in accordance with International Accounting Standards 34, Interim Financial Reporting, as issued by the International Accounting Standards Board ("IASB").

These interim financial statements do not include all the disclosures required by International Financial Reporting Standards ("IFRS") for annual consolidated financial statements and accordingly should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2016 prepared in accordance with IFRS as issued by the IASB.

3. Significant accounting policies:

(i) Changes in accounting policies:

The accounting policies applied by the Company in these unaudited condensed consolidated interim financial statements are consistent with those applied by the Company in its consolidated financial statements as at and for the year ended December 31, 2016.

MORNEAU SHEPELL INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

(ii) Future accounting changes:

IFRS 15, Revenue from Contracts with Customers (“IFRS 15”)

On May 28, 2014, the IASB issued IFRS 15. The new standard is effective for fiscal years beginning on or after January 1, 2018 and is available for early adoption. The standard contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. New estimates and judgmental thresholds have been introduced, which may affect the amount and/or timing of revenue recognized. The Company intends to adopt IFRS 15 in its financial statements for the annual period beginning on January 1, 2018.

We expect the application of IFRS 15 will impact our financial statements in respect of timing of revenue recognition and the accounting for deferred implementation costs related to certain groups of clients within our Administrative Solutions line of business. We are working through our project plan and have made progress in our implementation of IFRS 15, but it is not yet possible to make a final determination of the impact of the new standard on our financial statements. We expect to report more detailed information, including estimated quantitative financial effects, in our 2017 annual consolidated financial statements.

IFRS 9, Financial Instruments (“IFRS 9”)

In July 2014 the IASB finalized IFRS 9. The standard is effective for fiscal years beginning on or after January 1, 2018 and is available for early adoption. The new standard includes revised guidance on the classification and measurement of financial assets, a new ‘expected loss’ impairment model and introduces a substantially-reformed approach to hedge accounting. The Company intends to adopt IFRS 9 in its financial statements for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard is not expected to be significant.

IFRS 16, Leases (“IFRS 16”)

In January 2016, the IASB issued IFRS 16. The standard is effective for annual periods beginning on or after January 1, 2019, with earlier adoption permitted for those entities that have also adopted IFRS 15. The new standard provides a comprehensive model for the identification of lease arrangements and their treatment in the financial statements. IFRS 16 supersedes IAS 17, Leases, and its associated interpretative guidance. IFRS 16 applies a control model to the identification of leases, differentiating between leases and service contracts on the basis of whether there is an identified asset controlled by the customer. Among other significant changes, the distinction between operating and finance leases is removed and assets and liabilities are recognized in respect of all leases. Furthermore, IFRS 16 requires a front-loaded pattern for the recognition of lease expense over the life of the lease. The Company intends to adopt IFRS 16 in its financial statements for the annual period beginning on January 1, 2019. The extent of the impact of adoption of the standard has not yet been determined.

MORNEAU SHEPELL INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

4. Long-term debt:

The Company's long-term debt obligations can be broken down as follows:

	March 31, 2017	December 31, 2016
Revolving loans	\$ 167,315	\$ 167,385
Less: debt issuance costs, net of accumulated amortization	(1,008)	(1,086)
	\$ 166,307	\$ 166,299

The Company has a credit facility agreement (the "Credit Facility Agreement") that matures on December 20, 2020 and provides for a revolving facility of \$300,000 (including a swing line of \$14,000).

At March 31, 2017, the Company had utilized the following amounts under the Credit Facility Agreement:

- \$160,000 of BA loans under the revolving loan. The BA loans are renewed on a monthly basis, bearing interest at the one-month BA rate plus an applicable margin of 1.45%.
- \$5,320 (US \$4,000) of US Libor loans under the revolving loan. The US Libor loans are renewed on a monthly basis, bearing interest at the one-month US Libor rate plus an applicable margin of 1.45%.
- \$1,995 (US \$1,500) of US Base Rate loans under the revolving loan. The US Base Rate loans are renewed on a monthly basis, bearing interest at the one-month US Base Rate plus an applicable margin of 0.45%.
- \$5,696 of the swing line available. The swing line carries interest at prime plus an applicable margin of 0.45%.

As at March 31, 2017, the Company complied with all the required financial covenants.

(a) Interest rate swaps:

The Company entered into a forward starting interest-rate swap agreement in February 2014 to hedge against the variable interest rate component on \$160,000 notional amount borrowed under the Credit Facility Agreement for the period from January 5, 2015 up to and ending November 29, 2017. The notional amount of this swap is \$160,000 and is used to fix the variable component of the interest rate at 1.98%, before the applicable margin, for the duration of this period and has been designated as a cash flow hedge. The fair value of the interest rate swap at March 31, 2017 was a liability of \$1,214 (December 31, 2016 - \$1,625).

MORNEAU SHEPELL INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

5. Dividends:

The monthly dividend rate, approved by the Board of Directors, was \$0.065 for the three months ended March 31, 2017 (2016 - \$0.065). Dividends declared for the three months ended March 31, 2017 were \$10,380. The Company continued to declare the same monthly dividend amount in April 2017.

6. Earnings per share:

Basic earnings per share was calculated by dividing profit attributable to common shareholders by the sum of the weighted average number of common shares outstanding during the period, plus vested LTIP awards.

Diluted earnings per share was calculated using the basic calculation described above, and adjusting for the potentially dilutive effect of total number of additional common shares that would have been issued by the Company on unvested LTIP awards and the conversion of the convertible debenture.

The following details the earnings per share, basic and diluted, calculations for the three months ended March 31, 2017 and 2016:

	Three months ended March 31	
	2017	2016
Profit attributable to common shareholders (basic and diluted)	\$ 8,164	\$ 7,049
Weighted average number of common shares (in number of shares):		
January 1	53,228,470	48,272,449
Shares issued on redemption of LTIP ¹	1,381	–
Vested LTIP awards	1,927,975	1,498,384
Basic	55,157,826	49,770,833
Dilutive effect of unvested LTIP awards	612,584	645,891
Diluted	55,770,410	50,416,724
Earnings per share:		
Basic	\$ 0.15	\$ 0.14
Diluted	\$ 0.15	\$ 0.14

¹ During the three months ended March 31, 2017, 1,594 (2016 - nil shares) were issued on redemption of LTIP units.

Due to its anti-dilutive effect, the potential issuance related to the convertible debenture has been excluded from the earnings per share calculation.

MORNEAU SHEPELL INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

7. Segmented information:

The Company provides health and productivity, administrative and retirement solutions to assist employers in managing the financial security, health and productivity of their employees. As at March 31, 2017, aggregation of operating segments was applied to determine that the Company had only one reportable segment.

The Company operates primarily within two geographical areas: Canada and the United States. The following details the revenues and total assets by geographical area, reconciled to the Company's unaudited condensed consolidated interim financial statements:

	Three months ended March 31,	
	2017	2016
Revenue:		
Canada	\$ 136,825	\$ 129,880
United States	21,012	19,243
Consolidated total	\$ 157,837	\$ 149,123
	March 31, 2017	December 31, 2016
Total assets:		
Canada	\$ 713,568	\$ 712,779
United States	64,059	60,847
Consolidated total	\$ 777,627	\$ 773,626

MORNEAU SHEPELL INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

8. Supplementary cash flow information:

Change in non-cash operating working capital for the three months ended March 31, 2017 and 2016 was as follows:

	2017	2016
Trade and other receivables	\$ 4,460	\$ 613
Unbilled fees, current and non-current	(10,505)	(4,205)
Prepaid expenses and other	(3,773)	(2,827)
Deferred implementation costs, current and non-current	(2,167)	(493)
Trade and other payables	4,592	1,992
Deferred revenue	1,438	3,326
	\$ (5,955)	\$ (1,594)

9. Financial instruments:

Financial instruments carried at fair value:

Fair value represents management's estimates at a given point in time. The fair value of the Company's financial assets and liabilities, with the exception of convertible debentures and long-term debt, approximate their carrying values due to their short-term nature. The following table summarizes information regarding the carrying value, fair value and level used to determine the fair value measurement of the Company's financial assets and liabilities carried at fair value:

	Carrying Value and Fair Value		
	March 31, 2017	December 31, 2016	Level
Assets carried at fair value:			
Cash and investments held in trust	\$ 14,207	\$ 17,211	2
	\$ 14,207	\$ 17,211	
Liabilities carried at fair value:			
Bank indebtedness	\$ 6,159	\$ 3,056	1
Interest rate swaps	1,214	1,625	2
Future consideration related to acquisitions	6,080	7,510	3
	\$ 13,453	\$ 12,191	

MORNEAU SHEPELL INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

(In thousands of Canadian dollars)

For the three months ended March 31, 2017 and 2016

During the three months ended March 31, 2017, there were no transfers between any levels.

The future consideration related to acquisitions is a financial instrument carried at fair value through profit or loss. The fair value of the future consideration related to these acquisitions is determined considering the estimated payment, discounted to present value. The total aggregate contingent consideration remaining to be paid for these acquisitions ranges from a contractual amount of \$nil to maximum of \$7,206.

The following table indicates the changes in the future consideration related to acquisitions during the three months ended March 31, 2017:

	Future consideration related to acquisitions
Balance at January 1, 2017	\$ 7,510
Settlements of contingent consideration	(1,696)
Foreign exchange	(44)
Accretion	310
	\$ 6,080

Financial instruments carried at amortized cost:

The carrying values of trade and other receivables, trade and other payables, insurance premium liabilities, and dividends payable are amortized cost and approximate their fair value because of their short-term nature.

The convertible debenture payable and the long-term debt are financial instruments carried at amortized cost whose carrying values do not equal their fair market values. The convertible debenture payable has a carrying value of \$81,331 (December 31, 2016 - \$81,096) and a fair value of \$90,756 (December 31, 2016 - \$90,300). The fair value is determined using quoted market values (Level 1) for the convertible debentures at the end of the period. The long-term debt has a carrying value of \$166,307 (December 31, 2016 - \$166,299) and a fair value of \$167,315 (December 31, 2015 - \$167,385). The fair value is determined based on the cost of borrowing for a company with a similar risk profile (Level 2).