

**MORNEAU SHEPELL MANAGEMENT'S DISCUSSION AND ANALYSIS**  
*FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2016*

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## MANAGEMENT'S DISCUSSION AND ANALYSIS

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Morneau Shepell Inc. ("Morneau Shepell" or the "Company") was incorporated pursuant to the laws of the Province of Ontario on October 19, 2010, and as of January 1, 2011, is the successor of Morneau Sobeco Income Fund (the "Fund").

This Management's Discussion and Analysis ("MD&A") covers the three and six months ended June 30, 2016 and should be read in conjunction with the accompanying unaudited condensed consolidated interim financial statements of Morneau Shepell and notes thereto for the three and six months ended June 30, 2016, and the MD&A and the audited consolidated financial statements and notes thereto for the year ended December 31, 2015.

All financial information is presented in Canadian dollars and in accordance with International Financial Reporting Standards, unless otherwise noted. Certain totals, subtotals and percentages may not reconcile due to rounding.

This MD&A contains "forward-looking statements" within the meaning of applicable securities laws, such as statements concerning anticipated future events, results, circumstances, performance or expectations that are not historical facts. They are based on certain factors and assumptions, including expected growth, results of operations, business prospects and opportunities. Use of words such as "may", "will", "expect", "believe", or other words of similar effect may indicate a "forward-looking" statement. These statements are not guarantees of future performance and are subject to numerous risks and uncertainties, including those described in our publicly filed documents (available on SEDAR at [www.sedar.com](http://www.sedar.com)) and in this MD&A under the heading "Risks and Uncertainties". Those risks and uncertainties include the ability to maintain profitability and manage growth, ability to pay dividends, reliance on information systems and technology, reputational risk, dependence on key clients, reliance on key professionals and general economic conditions. Many of these risks and uncertainties can affect our actual results and could cause our actual results to differ materially from those expressed or implied in any forward-looking statement made by us or on our behalf. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. All forward-looking statements in this MD&A are qualified by these cautionary statements. These statements are made as of the date of this MD&A and, 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. Additionally, we undertake no obligation to comment on analyses, expectations or statements made by third parties in respect of us, our financial or operating results or our securities.

To assist investors in assessing our financial performance, this discussion also makes reference to certain non-IFRS measures such as EBITDA, adjusted EBITDA, EBITDA margin, adjusted EBITDA margin, Free Cash Flow, Normalized Free Cash Flow, twelve-month rolling Normalized Payout Ratio, and twelve-month rolling Normalized Payout Ratio including changes in adjusted non-cash operating working capital. EBITDA and adjusted EBITDA are intended to represent an indication of Morneau Shepell's capacity to generate profit from operations before taking into account management's financing decisions and costs of consuming tangible capital assets and intangible assets, which vary according to their vintage, technological currency, and management's estimate of their useful life. Accordingly, EBITDA comprises profit before finance costs, income tax expenses, depreciation and amortization, while Adjusted EBITDA represents EBITDA before taking into account certain unusual expenditures. EBITDA margin represents EBITDA as a percentage of revenue, and Adjusted EBITDA margin represents Adjusted EBITDA as a percentage of revenue. We believe both EBITDA and Adjusted EBITDA are useful measures in evaluating our performance and we utilize them to monitor compliance with debt covenants. We also believe that Free Cash Flow, Normalized Free Cash Flow, the twelve-month rolling Normalized Payout Ratio, and the twelve-month rolling Normalized Payout Ratio including changes in adjusted non-cash operating working capital, are useful supplemental measures of Morneau

Shepell's ability to generate cash after deducting capital expenditures required to maintain or expand the business. We also utilize them to make decisions related to dividends to shareholders. These ratios, however, are non-IFRS measures and therefore, should not be seen as a substitute for cash flow from operating activities. Free Cash Flow is defined as cash provided by operating activities adjusted for capital expenditures. Normalized Free Cash Flow is defined as cash provided by operating activities, adjusted for changes in non-cash operating working capital, capital expenditures, current income taxes (net of income taxes paid) and certain unusual expenditures.

Non-IFRS measures do not have any standard meaning prescribed by IFRS and therefore may not be comparable to similar measures presented by other issuers. Non-IFRS measures are reconciled to IFRS measures elsewhere in this MD&A.

## **OUTSTANDING SHARE DATA**

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The Company is authorized to issue an unlimited number of common shares and 10 million preferred shares. Each common share entitles the holder to one vote at all meetings of shareholders and represents an interest in dividends declared by the Company and an undivided interest in the net assets of the Company. As at August 3, 2016, Morneau Shepell had 53,104,152 common shares, nil preferred shares and \$86.0 million aggregate principal amount of 4.75% convertible debentures outstanding. In the event all of the outstanding 4.75% convertible debentures are converted into common shares of the Company by the holders prior to their maturity date, the total number of common shares to be issued would be approximately 3,400,000. The number of long-term incentive plan ("LTIP") units, including those that remain unvested, that are outstanding and may be converted to common shares is approximately 2,850,000.

## **BUSINESS OVERVIEW**

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Morneau Shepell is the largest Canadian firm providing health and productivity, administrative and retirement solutions. We deliver solutions to assist employers in managing the financial security, health and productivity of their employees. With almost 4,000 employees in offices across North America, we offer services to approximately 20,000 organizations in Canada, the United States and around the globe directly and through our distribution channel partners.

We derive our revenue primarily from fees charged to clients for consulting engagements, outsourcing engagements, employee and family assistance programs and absence management solution services.

Fees from consulting engagements are charged based on billable hours or on a fee-for-service basis. In some cases, consulting engagements may be billed on a fixed-fee basis, although these engagements are typically much smaller and the services are delivered over a shorter period of time. For some benefits consulting assignments which involve the purchase of an insurance policy underwritten by an insurance company, we may be paid commissions (in lieu of fees) by the client's insurance company, which is a common practice in the industry. These commissions are based on a percentage of the premiums paid by the client to the insurance company and our policy is to disclose them to our client. We assume no underwriting risk as the insurance policy is underwritten by the insurance company.

Our Administrative Solutions practice is characterized by fixed contracts, which typically have three-year to five-year terms. Most outsourcing contracts contain an upfront implementation fee and an ongoing monthly service fee. Implementations usually take three to twelve months and involve transferring the administration of a client's pension and/or benefits plans onto our systems, tailoring our systems and training our employees. Additional services provided that are outside the scope of the outsourcing contract are usually paid on a fee-for-service basis. A small number of contracts contain a large up front customization and implementation fee, with lower ongoing maintenance fees.

In the billing for Employee Support Solutions (“ESS”) services, a portion of the ESS client agreements require payment of a minimum retainer and incremental usage-based fees. The remainder of the ESS agreements are billed based on an actual usage or fixed fees. Most ESS agreements may be terminated by the client upon 30 to 60 days’ notice to us, however, it is typical for ESS agreements to continue for multiple years and many automatically renew on an annual basis.

Fees from Absence Management Solutions (“AMS”) services, such as attendance support and disability management are generally based on negotiated fees or a formula tied to the nature of the service being provided. Like most ESS agreements, most workplace health and productivity agreements may be terminated by the client upon 30 to 60 days’ notice to us; however, it is typical for these agreements to continue for multiple years and many automatically renew on an annual basis. Fees for workers compensation services are charged based on billable hours or on a fee-for-service basis.

Our largest operating expense is compensation and related costs. This includes salaries, annual performance-based bonuses, benefits, payroll taxes, independent service providers and temporary staffing services.

The remaining operating expenses include rent and occupancy costs, technology costs (including equipment leases, telecommunications, and software licenses and maintenance), client service costs (such as printing and travel), training, marketing, office costs, professional fees and insurance.

## 2016 SECOND QUARTER SUMMARY AND OUTLOOK

*In thousands of dollars*

	<b>Three months ended June 30, 2016</b>	<b>Three months ended June 30, 2015</b>	<b>Six months ended June 30, 2016</b>	<b>Six months ended June 30, 2015</b>
Revenue	\$149,251	\$142,420	\$298,374	\$280,812
Organic Revenue <sup>(1)</sup>	\$142,240	\$137,520	\$283,237	\$270,908
Adjusted EBITDA	\$29,533	\$28,060	\$58,359	\$54,704
Adjusted EBITDA margin	19.8%	19.7%	19.6%	19.5%
Normalized Free Cash Flow	\$18,585	\$16,054	\$33,891	\$30,229
Profit	\$8,081	\$9,272	\$15,130	\$17,483

(1) Organic Revenue is defined as revenue excluding acquisitions not in the comparative period and divestitures, and the Health Republic Insurance of New York (HRINY), who was given a wind down of business directive by the New York State Department of Financial Services in 2015, and is calculated as follows:

*In thousands of dollars*

	<b>Three months ended June 30, 2016</b>	<b>Three months ended June 30, 2015</b>	<b>Six months ended June 30, 2016</b>	<b>Six months ended June 30, 2015</b>
<b>Revenue</b>	<b>\$149,251</b>	<b>\$142,420</b>	<b>\$298,374</b>	<b>\$280,812</b>
Acquisitions	\$7,011	–	\$15,137	–
HRINY	–	\$4,900	–	\$9,904
<b>Organic Revenue</b>	<b>\$142,240</b>	<b>\$137,520</b>	<b>\$283,237</b>	<b>\$270,908</b>

**Second quarter:**

We continued to deliver revenue and adjusted EBITDA growth versus the comparative quarter in 2015. Highlights of the second quarter include:

- Revenue and Organic Revenue growth of 4.8% and 3.4%, respectively, versus the comparative period from new business wins and continued growth from existing clients primarily from our Administrative Solutions and ESS lines of business.
- An increase in adjusted EBITDA of \$1.5 million to \$29.5 million versus the comparative period.

We expect our Organic Revenue growth to be slightly lower than our longer term historical performance for the remainder of 2016 due to timing of new client wins. We expect our continued investments in our business and our established and prospective client base will continue to yield positive results for the Company long term.

## 2016 SECOND QUARTER OPERATING RESULTS SUMMARY

Results of Operations	Three months Ended June 30		Six Months Ended June 30	
	2016	2015	2016	2015
Selected Unaudited Consolidated Financial Information (In thousands of dollars except per share amounts)				
<b>Revenue</b>	\$149,251	\$142,420	\$298,374	\$280,812
Deduct:				
Salaries, benefits and contractor expenses	98,571	95,646	201,537	190,275
Other operating expenses	25,231	22,121	48,809	42,638
Finance costs	4,550	3,661	8,499	7,186
Depreciation and amortization	8,651	8,132	17,348	16,090
Income tax expenses	4,167	3,588	7,051	7,140
<b>Profit for the period</b>	<b>8,081</b>	<b>9,272</b>	<b>15,130</b>	<b>17,483</b>
Add:				
Finance costs	4,550	3,661	8,499	7,186
Depreciation and amortization	8,651	8,132	17,348	16,090
Income tax expenses	4,167	3,588	7,051	7,140
<b>EBITDA<sup>(1)</sup></b>	<b>\$25,449</b>	<b>\$24,653</b>	<b>\$48,028</b>	<b>\$47,899</b>
Adjustments:				
Sublease loss provision	–	–	–	700
Mercer Canada Outsourcing conversion costs	2,487	3,407	5,313	6,105
Reorganization and operational effectiveness initiatives	1,597	–	5,018	–
<b>Adjusted EBITDA</b>	<b>\$29,533</b>	<b>\$28,060</b>	<b>\$58,359</b>	<b>\$54,704</b>
<b>EBITDA margin<sup>(2)</sup></b>	17.1%	17.3%	16.1%	17.1%
<b>Adjusted EBITDA margin<sup>(2)</sup></b>	19.8%	19.7%	19.6%	19.5%
<b>Cash provided by operating activities</b>	<b>\$(6,427)</b>	<b>\$(3,444)</b>	<b>\$8,895</b>	<b>\$6,981</b>
Deduct: Capital expenditures <sup>(3)</sup>	(6,341)	(6,944)	(12,314)	(12,836)
<b>Free Cash Flow<sup>(4)</sup></b>	<b>(12,768)</b>	<b>(10,388)</b>	<b>(3,419)</b>	<b>(5,855)</b>
Add (deduct):				
Changes in non-cash operating working capital	27,626	24,424	29,220	33,190
Mercer Canada Outsourcing conversion – capital	–	84	–	191
Current income taxes, net of income taxes paid	(357)	(1,473)	(2,241)	(3,402)
Adjustments to EBITDA <sup>(5)</sup>	4,084	3,407	10,331	6,105
<b>Normalized Free Cash Flow<sup>(6)</sup></b>	<b>\$18,585</b>	<b>\$16,054</b>	<b>\$33,891</b>	<b>\$30,229</b>
Earnings per Share (basic and diluted)	\$0.16	\$0.19	\$0.30	\$0.35
EBITDA per Share (basic)	\$0.50	\$0.50	\$0.95	\$0.97
Adjusted EBITDA per Share (basic)	\$0.58	\$0.57	\$1.15	\$1.11
Dividends declared	9,857	9,363	19,270	18,723
Twelve-month rolling Normalized Payout Ratio <sup>(7)</sup>	58.3%	70.6%	58.3%	70.6%
Twelve-month rolling Normalized Payout Ratio, including changes in adjusted non-cash operating working capital <sup>(8)</sup>	60.1%	114.5%	60.1%	114.5%

Footnotes:

- (1) "EBITDA" is defined as profit before finance costs, income tax expenses, depreciation and amortization.
- (2) "EBITDA margin" represents EBITDA as a percentage of revenue, and "Adjusted EBITDA margin" represents Adjusted EBITDA as a percentage of revenue.
- (3) "Capital Expenditures" includes additions to capital assets and intangible assets but excludes additions to capital assets and intangible assets acquired through business acquisitions, and is presented net of disposals.
- (4) "Free Cash Flow" is defined as cash provided by operating activities adjusted for capital expenditures.
- (5) Adjustments to EBITDA do not include the sublease loss provision. This amount has been excluded as it has already been added back in cash from operating activities before the change in non-cash operating working capital.
- (6) "Normalized Free Cash Flow" is defined as cash provided by operating activities, adjusted for changes in non-cash operating working capital, capital expenditures, current income taxes (net of income taxes paid) and certain unusual expenditures.
- (7) "Twelve-month rolling Normalized Payout Ratio" is defined as dividends declared divided by Normalized Free Cash Flow for the rolling twelve month period.
- (8) "Twelve-month rolling Normalized Payout Ratio, including changes in adjusted non-cash operating working capital" is defined as dividends declared divided by the Twelve-month rolling Normalized Free Cash Flow, including changes in non-cash operating working capital adjusted for unusual fluctuations. For the twelve-month period ended June 30, 2016, the non-cash operating working capital was adjusted for by (\$10,952), which represents 2014 leasehold inducements receivable related to capital expenditures collected in the third and fourth quarter of 2015 and the year over year change in non-cash operating working capital resulting from the HRINY deferred implementation costs write-off. For the twelve-month period ended June 30, 2015, there were no adjustments to the non-cash working capital.

## **ANALYSIS OF SECOND QUARTER 2016 OPERATING RESULTS**

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### ***Revenue***

Revenue for the three months ended June 30, 2016 increased by \$6.8 million, or 4.8%, to \$149.3 million compared to \$142.4 million for the same period in 2015. Excluding revenue from acquisitions not in the comparative period and HRINY in 2015, our organic revenue grew by \$4.7 million or 3.4%. The increase is primarily coming from our Administrative Solutions and ESS lines of business as a result of increased activity with existing clients and new client wins.

### ***Salaries, Benefits and Contractor Expenses***

Salaries, benefits and contractor expenses for the three months ended June 30, 2016 increased by \$2.9 million, or 3.1%, to \$98.6 million compared to \$95.6 million for the same period in 2015. Excluding the net increase in compensation expense of \$1.0 million resulting from acquisitions not in the comparative period net of the wind down of HRINY in 2015, compensation expense increased by \$1.9 million. The increase is mainly attributable to higher reorganization and operational effectiveness initiatives costs of \$1.6 million, and \$0.3 million from general increases to support the Company's continued growth net of adjustments for variable compensation expenses.

### ***Other Operating Expenses***

Other operating expenses for the three months ended June 30, 2016 increased by \$3.1 million, or 14.1%, to \$25.2 million compared to \$22.1 million for the same period in 2015. Excluding the net increase in other operating expenses of \$0.2 million resulting from acquisitions not in the comparative period net of the wind down of HRINY in 2015, other operating expenses grew by \$2.9 million due to general increases required to support the Company's continued growth.

### ***Finance Costs***

Finance costs for the three months ended June 30, 2016 increased by \$0.9 million, or 24.3%, to \$4.6 million compared to \$3.7 million for the same period in 2015. The increase is mainly due to higher non-cash interest expense related to the 5.75% convertible debentures converted and redeemed during this quarter, and higher accretion interest related to discounted liabilities.

### ***Depreciation and Amortization***

Depreciation and amortization for the three months ended June 30, 2016 increased by \$0.5 million, or 6.4%, to \$8.7 million compared to \$8.1 million for the same period in 2015. The increase is due to higher amortization of internally developed software.

### ***Income Tax Expenses***

Income tax expenses increased by \$0.6 million to \$4.2 million compared to \$3.6 million for the same period in 2015 primarily due to a higher effective tax rate driven by our US results.

### ***Profit for the Period***

As a result of the changes noted above, the profit for the three months ended June 30, 2016 decreased by \$1.2 million to \$8.1 million compared to \$9.3 million for the same period in 2015.

### ***Key Financial Measures: EBITDA, Adjusted EBITDA, Free Cash Flow and Normalized Free Cash Flow***

#### ***Adjusted EBITDA and EBITDA***

Adjusted EBITDA increased by \$1.5 million, or 5.3%, to \$29.5 million compared to \$28.1 million for the same period in 2015. The increase is primarily due to growth in revenue of \$6.8 million, partially offset by an increase in salaries and other operating expenses of \$5.4 million after EBITDA adjustments. These adjusted EBITDA items do not constitute a part of the Company's on-going operating expenses, and are described in the analysis of the six months ended June 30, 2016 operating results section below.

EBITDA increased by \$0.8 million to \$25.5 million compared to \$24.7 million for the same period in 2015.

#### ***Free Cash Flow***

Free Cash Flow for the three months ended June 30, 2016 decreased by \$2.4 million to \$(12.8) million compared to \$(10.4) million for the same period in 2015. The decrease is primarily due to lower cash generated from operating activities of \$1.9 million as a result of a change in non-cash working capital, and accelerated finance costs paid of \$0.7 million on the redemption of all the 5.75% convertible debentures that remained outstanding (see discussion of convertible debentures in the capital resources section below), partially offset by lower capital expenditures of \$0.6 million.

#### ***Normalized Free Cash Flow***

Normalized Free Cash Flow for the three months ended June 30, 2016 increased by \$2.5 million to \$18.6 million compared to \$16.1 million for the same period in 2015. The increase is mainly due to higher cash generated from operating activities before non-cash operating working capital and EBITDA adjustments of \$2.0 million and lower capital expenditures of \$0.6 million.

## **ANALYSIS OF SIX MONTHS ENDED JUNE 30, 2016 OPERATING RESULTS**

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### ***Revenue***

Revenue for the six months ended June 30, 2016 increased by \$17.6 million, or 6.3%, to \$298.4 million compared to \$280.8 million for the same period in 2015. Excluding revenue from acquisitions not in the comparative period and HRINY in 2015 organic revenue grew by \$12.3 million or 4.6%. The increase is



primarily coming from our Administrative Solutions and ESS lines of business as a result of increased activity with existing clients and new client wins in both Canada and US.

### ***Salaries, Benefits and Contractor Expenses***

Salaries, benefits and contractor expenses for the six months ended June 30, 2016 increased by \$11.3 million, or 5.9%, to \$201.5 million compared to \$190.3 million for the same period in 2015. Excluding the net increase in compensation expense of \$3.0 million resulting from acquisitions not in the comparative period net of the wind down of HRINY in 2015, compensation expense increased by \$8.3 million of which \$5.0 million was attributable to reorganization and operational effectiveness initiatives costs and \$3.3 million from general increases to support the Company's continued growth net of adjustment to variable compensation expenses.

### ***Other Operating Expenses***

Other operating expenses for the six months ended June 30, 2016 increased by \$6.2 million, or 14.5%, to \$48.8 million compared to \$42.6 million for the same period in 2015. Excluding the net increase in other operating expenses of \$0.4 million resulting from acquisitions not in the comparative period net of the wind down of HRINY in 2015, other operating expenses grew by \$5.8 million due to general increases required to support the Company's continued growth.

### ***Finance Costs***

Finance costs for the six months ended June 30, 2016 increased by \$1.3 million, or 18.1%, to \$8.5 million compared to \$7.2 million for the same period in 2015. The increase is mainly due to higher non-cash interest expense related to the 5.75% convertible debentures converted and redeemed during this quarter, and higher accretion interest related to discounted liabilities.

### ***Depreciation and Amortization***

Depreciation and amortization for the six months ended June 30, 2016 increased by \$1.3 million, or 7.8%, to \$17.3 million compared to \$16.1 million for the same period in 2015. This increase is due to higher amortization of internally developed software and acquired customer relationships, and higher depreciation of information technology hardware.

### ***Income Tax Expenses***

Income tax expenses for the six months ended June 30, 2016 remained the same at \$7.1 million compared to the same period in 2015.

### ***Profit for the Period***

As a result of the changes noted above, the profit for the six months ended June 30, 2016 was \$15.1 million compared to \$17.5 million for the same period in 2015.

### ***Key Financial Measures: EBITDA, Adjusted EBITDA, Free Cash Flow and Normalized Free Cash Flow***

#### ***Adjusted EBITDA and EBITDA***

Adjusted EBITDA increased by \$3.7 million, or 6.7%, to \$58.4 million compared to \$54.7 million for the same period in 2015. The increase is primarily due to growth in revenue of \$17.6 million, partially offset by an increase in salaries and other operating expenses of \$13.9 million after EBITDA adjustments. These adjusted

EBITDA items do not constitute a part of the Company's on-going operating expenses. Below is a description of the six months ended June 30, 2016 adjustments:

- Mercer Canada Outsourcing conversion costs represent systems and service improvements required to support the clients acquired in November, 2012. The process commenced immediately after the acquisition and we have substantially completed the original planned conversion. As a result of the savings we realized from the original conversion, we decided to convert the remaining clients acquired which were not included in the original conversion. Based on our project plan this additional conversion is expected to finish in the third quarter of 2017.
- Reorganization and operational effectiveness initiatives represents severance and professional fees incurred as a result of the loss of HRINY, and corporate reorganizations and employee terminations to achieve post-acquisition planned synergies.

EBITDA increased by \$0.1 million to \$48.0 million compared to \$47.9 million for the same period in 2015.

### **Free Cash Flow**

Free Cash Flow for the six months ended June 30, 2016 increased by \$2.4 million to \$(3.4) million compared to \$(5.9) million for the same period in 2015. The increase is primarily due to higher cash generated from operating activities of \$2.8 million as a result of change in non-cash working capital, and lower capital expenditures of \$0.5 million, partially offset by higher finance costs paid of \$0.9 million due to the redemption of all the 5.75% convertible debentures that remained outstanding (see discussion of convertible debentures in the capital resources section below).

### **Normalized Free Cash Flow**

Normalized Free Cash Flow for the six months ended June 30, 2016 increased by \$3.7 million to \$33.9 million compared to \$30.2 million for the same period in 2015. The increase is mainly due to higher cash generated from operating activities, before non-cash operating working capital and EBITDA adjustments, of \$3.1 million, and lower capital expenditures of \$0.5 million.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Cash Flows**

The following table provides an overview of the Company's cash flows for the periods indicated:

#### **Cash Flow Information**

Selected Consolidated Financial Information:

<i>Cash provided by (used in): (In thousands of dollars)</i>	<b>Six months ended June 30, 2016</b>	<b>Six months ended June 30, 2015</b>
Operating activities	\$ 8,895	\$ 6,981
Financing activities	(2,569)	6,821
Investing activities	(12,761)	(13,052)
Increase/(decrease) in cash	\$ (6,435)	\$ 750

Cash provided by operating activities for the six months ended June 30, 2016 increased by \$1.9 million to \$8.9 million compared to \$7.0 million for the same period in 2015. The increase is primarily due to an improvement in cash generated from operating activities of \$2.8 million, partially offset by higher finance costs paid.

Cash used in financing activities for the six months ended June 30, 2016 increased by \$9.4 million to \$2.6 million compared to cash provided by financing activities of \$6.8 million for the same period in 2015. The net proceeds raised from the issuance of the new \$86.0 million convertible debentures were used primarily to pay down amounts borrowed under the credit facility and to fund the redemption of the previously issued convertible debentures that remained outstanding. As a result, the change is primarily due to lower utilization of the credit facility required due to an increase in cash provided by operating activities and lower cash required to be used in investing activities compared to the same period in 2015.

Cash used in investing activities for the six months ended June 30, 2016 decreased by \$0.3 million to \$12.8 million compared to \$13.1 million for the same period in 2015. The decrease is due to lower additions to intangible and capital assets of \$0.5 million, partially offset by higher acquisition related payments of \$0.2 million compared to the same period in 2015.

### ***Dividends to Shareholders***

Monthly dividends were declared for shareholders of record on the last business day of each month and were paid approximately on the 15th day of the following month. Monthly dividends were \$0.065 per share during the quarter. The Company continued to declare the same monthly dividend amount in July 2016.

We consider the amount of cash generated by the business in determining the amount of dividends to pay to shareholders. We do not generally consider profit or loss in setting the level of dividends as this is a non-cash metric and is not reflective of the level of cash flow that we generate.

The twelve-month rolling Normalized Payout Ratio at June 30, 2016 was 58.3% compared to 70.6% for the same period in 2015. The decrease in the Normalized Payout Ratio is primarily due to higher Normalized Free Cash Flow during the past twelve months and lower capital expenditures.

### ***Capital Expenditures***

Our capital expenditures typically include information technology hardware and software (external and internally developed), leasehold improvements, and office furniture. Such amounts are expected to be funded from our operating cash flow. Additional capital expenditure requirements may result from significant business expansion. Capital expenditures for the three months ended June 30, 2016 decreased by \$0.6 million to \$6.3 million compared to \$6.9 million for the same period in 2015 and the decrease for the six months ended June 30, 2016 was \$0.5 million to \$12.3 million from \$12.8 million in the comparative period. The decrease in capital expenditures for the three months ended June 30, 2016 is due to reduced leasehold improvements and office furniture expenditures (net of leasehold inducements) of \$0.7 million. The decrease in capital expenditures for the six months ended June 30, 2016 is due to reduced leasehold improvements and office furniture expenditures of \$1.7 million (net of leasehold inducements) primarily due to the completion of the Toronto downtown offices consolidation in the comparative period, partially offset by an increase in hardware and software purchases of \$0.9 million.

## Contractual Obligations

### Commitments

We lease office space and selected equipment under operating lease agreements with terms ranging from one to fifteen years. We also have revolving loans under the credit facility arrangement and convertible debentures described under the section "Capital Resources".

A summary of contractual obligations, which outlines the year the payments are due is as follows:

<i>(In thousands of dollars)</i>	<b>Total</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021 and thereafter</b>
Long-term debt	\$ 181,855	\$ –	\$ 181,855	\$ –	\$ –	\$ –	\$ –
Convertible debenture	86,000	–	–	–	–	–	86,000
Operating leases, net	101,084	7,745	14,460	13,417	12,558	12,307	40,597
<b>Total</b>	<b>\$ 368,939</b>	<b>\$ 7,745</b>	<b>\$ 196,315</b>	<b>\$ 13,417</b>	<b>\$ 12,558</b>	<b>\$ 12,307</b>	<b>\$ 126,597</b>

We are party to various subleases to which we would be liable for the rental payment in the case of a default by the subtenants. The minimum payments and the aggregate sublease income related to these premises have been netted against the operating leases amounts reported above. We consider the risk of default by the subtenants to be low therefore no accrual has been set up.

### Contingent Consideration

The purchase price for Dion Durrell Workers' Compensation, Bensigner Du Pont & Associates, Inc. ("BDA"), and the U.S. health and welfare benefits administration business of Ceridian are contingent on future business results and the estimated remaining installments of \$0.6 million, \$2.6 million (\$2.0 million U.S.), and \$1.6 million (\$1.2 million U.S.), respectively, are due in 2016 and 2017. These contingent future installments have been recognized as an acquisition liability on the statement of financial position at their estimated discounted amounts as at June 30, 2016.

In addition there is \$0.2 million of contingent consideration due from 2016 through 2018 for other smaller acquisitions.

We have no material contractual obligations other than those described in this MD&A and have no off-balance sheet financing arrangements.

### Capital Resources

The following table provides an overview of our capital resources:

<i>(In thousands of dollars)</i>	<b>As at June 30, 2016</b>	<b>As at December 31, 2015</b>
Cash	\$ –	\$ 1,900
Bank indebtedness	4,535	–
Long- term debt, net of debt issuance costs	181,404	241,846
Convertible debenture, net of issuance costs	80,627	73,760
Shareholders' equity	371,294	301,114

As at June 30, 2016, our working capital increased by \$14.2 million from \$78.6 million at December 31, 2015 to \$92.8 million. The increase is primarily attributable to an increase in trade and other receivables and unbilled fees because of the revenue billing cycle in accordance with contract terms and growth in the business, an increase in prepaid expenses and other assets due to the timing of vendor payments, and a decrease in trade and other payables due to the annual bonus payment and timing of payment to vendors. Additional details related to the changes in working capital from year end are included under the selected statement of financial position data section below.

#### *Long-term debt*

The long-term debt, net of debt issuance costs, decreased by \$60.4 million from \$241.8 million as at December 31, 2015 to \$181.4 million as at June 30, 2016 due to repayments of amounts borrowed under the Company's credit facility agreement from the proceeds received from the issuance of convertible debentures (see discussion on the issuance of convertible debentures under the convertible debentures section below).

The Company has a credit facility agreement maturing on November 29, 2017 which provides for a revolving facility of \$300.0 million (including a swing line of \$7.0 million).

The interest rates for the credit facility agreement are floating, based on a margin over certain referenced rates of interest. The applicable margin may vary up and down depending on the ratio of our consolidated debt to Adjusted EBITDA as defined in the credit facility agreement.

We are in compliance with all of the required financial covenants.

#### *Interest-rate Swap*

In February 2014, the Company entered into a forward starting interest-rate swap agreement to hedge against the variable interest rate component on \$160.0 million 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 \$160.0 million 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.

#### *Convertible debentures*

On March 27, 2012, the Company issued \$75.0 million principal amount of 5.75% Convertible Unsecured Subordinated Debentures (the "5.75% Convertible Debentures") for net proceeds of \$71.4 million with a maturity date of March 31, 2017. The 5.75% Convertible Debentures were convertible at the option of the holder to common shares at a conversion price of \$15.00 per common share, and the Company had the option to redeem the 5.75% Convertible Debentures after March 31, 2016 at a redemption price equal to 100% of their principal amount plus accrued and unpaid interest. In May 2016, the Company issued a notice of redemption for the remaining outstanding 5.75% Convertible Debentures. During the six months ended June 30, 2016, 5.75% Convertible Debentures in the principal amount of \$72.4 million were converted by holders to common shares. In June 2016, the Company exercised its option to redeem all the \$2.5 million principal amount of 5.75% Convertible Debentures that still remained issued and outstanding for cash.

In June, 2016, the Company issued \$86.0 million principal amount of 4.75% Convertible Unsecured Subordinated Debentures (the "4.75% Convertible Debentures") for net proceeds of \$82.0 million. The 4.75% Convertible Debentures pay interest semi-annually on June 30 and December 31, commencing with the initial interest payment on December 31, 2016 and have a maturity date of June 30, 2021.

These debentures are convertible at the option of the holder to common shares at a conversion price of \$25.10 per common share. The Company has the option to redeem the 4.75% Convertible Debentures on and after June 30, 2019 and at any time prior to June 30, 2020 at a redemption price equal to 100% of their principal plus accrued and unpaid interest provided that the weighted average trading price for the 20 consecutive trading days ending five days preceding the date on which the notice of redemption is given is at least 125% of the conversion price of \$25.10. On and after June 30, 2020, but prior to the maturity date, the 4.75% Convertible Debentures will be redeemable at a redemption price equal to 100% of their principal amount plus accrued and unpaid interest. On redemption or maturity the Company may elect to repay the principal and satisfy its interest obligations by issuing common shares.

## SELECTED STATEMENT OF FINANCIAL POSITION DATA

The following table provides an overview of our selected statement of financial position data:

<i>(in thousands of dollars)</i>	<b>As at</b>	
	<b>June 30, 2016</b>	<b>December 31, 2015</b>
Current assets	\$ 170,114	\$ 156,410
Non-current assets	598,142	599,238
Current liabilities	77,272	77,761
Non-current liabilities	319,690	376,773

### Current Assets

Current assets as at June 30, 2016 increased by \$13.7 million to \$170.1 million from \$156.4 million as at December 31, 2015. The increase is primarily attributable to an increase in trade and other receivables and unbilled fees of \$9.1 million due to growth in the business and the revenue billing cycle in accordance with contract terms, an increase in prepaid expenses and other assets of \$5.4 million due to timing of vendor payments, and an increase in cash and investments held in trust of \$1.9 million. This was partially offset by a bank indebtedness balance as at June 30, 2016 compared to a cash balance of \$1.9 million at December 31, 2015 year end.

### Non-current Assets

Non-current assets as at June 30, 2016 decreased by \$1.1 million to \$598.1 from \$599.2 million as at December 31, 2015. The decrease is primarily due to lower intangible assets of \$4.9 million due to amortization of intangible assets in excess of additions, partially offset by an increase in the non-current portion of deferred implementation costs of \$3.4 million.

### Current Liabilities

Current liabilities as at June 30, 2016 decreased by \$0.5 million to \$77.3 million from \$77.8 million as at December 31, 2015. This decrease is primarily due to the lower trade and other payables of \$14.6 million due to timing of payment to vendors and the payment of the annual bonus, and the repayment of the \$2.5 million promissory note issued as partial consideration for the acquisition of Groupe AST (1993) Inc. This was partially offset by a bank indebtedness balance of \$4.5 million compared to a cash balance as at December 31, 2015, an increase in insurance premium liabilities of \$1.9 million, an increase in deferred revenue of \$4.8 million due to timing of consideration received from customers in accordance with contract terms, and an increase in the current portion of future consideration related to acquisitions of \$3.7 million due to future consideration payable for BDA and the U.S. health and welfare benefits administration business of Ceridian becoming a current liability.

## **Non-current Liabilities**

Non-current liabilities as at June 30, 2016 decreased by \$57.1 million to \$319.7 million from \$376.8 million at December 31, 2015. The decrease is mainly due to the repayment of \$60.6 million of the long-term debt from proceeds received from the issuance of the 4.75% Convertible Debentures, and a decrease in the non-current portion of future consideration related to acquisitions of \$3.3 million. This was partially offset by an increase in the convertible debentures balance of \$6.9 million due to issuance of the 4.75% Convertible Debentures net of the conversion and redemption of all of the remaining 5.75% Convertible Debentures outstanding.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

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In our year ended December 31, 2015 audited consolidated financial statements and accompanying notes, and in our 2015 annual MD&A, we have identified the accounting policies and estimates that are critical to the understanding of our business operations and our results from operations. The unaudited condensed consolidated interim financial statements for the three and six months ended June 30, 2016 have been prepared using the same accounting policies consistent with those applied in the audited consolidated financial statements for the year ended December 31, 2015. Our critical accounting estimates and assumptions remain substantially unchanged.

### ***Future Accounting Changes***

We have reviewed new and revised accounting standards that have been issued, but are not yet effective. See note 3 of the unaudited condensed consolidated interim financial statements for the three and six months ended June 30, 2016 for further information.

## **RISKS AND UNCERTAINTIES**

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The results of operations, business prospects and financial considerations of Morneau Shepell remain subject to a number of risks and uncertainties and are affected by a number of factors outside of our control. For more information about our risks and uncertainties, please refer to our 2015 annual MD&A. The risk and uncertainties remain substantially unchanged from those disclosed in our 2015 annual and fourth quarter MD&A.

## SUPPLEMENTARY SUMMARY OF QUARTERLY RESULTS

Selected Unaudited Consolidated Financial information (in thousands of dollars except per share amounts)

Quarter ended	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014
Revenue	149,251	149,123	145,696	140,778	142,420	138,392	131,195	132,703
Profit (loss) <sup>(1)</sup>	8,081	7,049	2,422	(3,487)	9,272	8,211	461	7,235
EBITDA	25,449	22,579	16,748	7,391	24,653	23,246	15,819	22,321
Adjusted EBITDA	29,533	28,828	25,211	25,886	28,060	26,644	22,581	24,429
EBITDA margin	17.1%	15.1%	11.5%	5.3%	17.3%	16.8%	12.1%	16.8%
Adjusted EBITDA margin	19.8%	19.3%	17.3%	18.4%	19.7%	19.3%	17.2%	18.4%
Earnings per share (basic)	0.16	0.14	0.05	(0.07)	0.19	0.17	0.01	0.15
Earnings per share (diluted)	0.16	0.14	0.05	(0.07)	0.19	0.16	0.01	0.15
Normalized Free Cash Flow	18,585	15,308	18,178	13,177	16,054	14,175	13,446	9,357
Dividends declared	9,857	9,413	9,379	9,365	9,363	9,360	9,358	9,359
Twelve-month rolling normalized payout ratio	58.3%	59.8%	60.8%	65.9%	70.6%	74.8%	74.1%	70.6%
Twelve-month rolling normalized payout ratio, including changes in adjusted non-cash operating working capital	60.1%	58.7%	66.5%	89.0%	114.5%	107.5%	98.1%	108.0%
Total assets	768,256	757,357	755,648	762,021	775,921	772,449	756,655	759,968
Total long-term debt <sup>(2)</sup>	262,031	316,292	315,606	325,686	323,923	303,904	295,310	300,590

Footnotes:

(1) The profit for the quarter ended September 30, 2015 included the write-down of deferred implementation costs and impairment charges totaling \$15,100 related to HRINY.

(2) Includes convertible debentures.

### Disclosure Controls and Procedures

Our disclosure controls and procedures have been designed to provide reasonable assurance that all relevant information is identified to our Disclosure Committee to ensure appropriate and timely decisions are made regarding public disclosure.

The Chief Executive Officer and the Chief Financial Officer have concluded that the disclosure controls and procedures are appropriately designed as at June 30, 2016.

### Internal Control over Financial Reporting

Management is responsible for designing internal controls over financial reporting, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS. In designing these controls, Management used the *Internal Control – Integrated Framework* (COSO 2013 Framework) published by The Committee of Sponsoring Organizations of the Treadway Commission.

The Chief Executive Officer and the Chief Financial Officer have concluded that the internal controls over financial reporting are appropriately designed as at June 30, 2016. No changes were made in our internal controls over financial reporting during the second quarter ended June 30, 2016, that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.



### **Additional Information**

Morneau Shepell's shares currently trade on the Toronto Stock Exchange under the symbol MSI. Additional information relating to us, including all public filings and our Annual Information Form, is available on the SEDAR website ([sedar.com](http://sedar.com)) and on our own website at [morneaushepell.com](http://morneaushepell.com).

The content of this MD&A reflects information known as of August 3, 2016.