Banco de Chile 2Q18

Financial Results Conference Call

Operator

Good afternoon and welcome to Banco de Chile's second Quarter 2018 results conference call. If you need a copy of the press release issued yesterday, it is available on the company's website.

Today with us we have Mr. Rodrigo Aravena, Chief Economist and Senior VP of Institutional Relations, Mr. Pablo Mejia, Head of Investor Relations, Daniel Galarce, Head of Financial Control, and Cecil Diaz, Investor Relations Specialist.

Before we begin, I would like to remind you that this call is being recorded, and that information discussed today may include forward-looking statements regarding the company's financial and operating performance. All projections are subject to risks and uncertainties, and actual results may differ materially. Please refer to the detailed note in the Company's press release regarding forward-looking statements.

I will now turn the call over to Mr. Rodrigo Aravena. Please go ahead.

Rodrigo Aravena

Good afternoon. Thank you for joining us on our 2Q18 conference call. It is a pleasure for me to share with you our comments on the Chilean economy and the banking system during the quarter. After that, Pablo Mejia, our Head of Investor Relations, will review the financial results.

Please move to slide number 3.

The Chilean economy continues posting strong signs of recovery. After growing a disappointing 1.6% during the last four years, GDP posted an average rate of 4.7% in the first half of this year, which is the strongest growth since 2012. The pace of this recovery can be seen on top left chart. Chile has been growing faster than its potential rate, in spite of some recent opposite forces, such as the decline in copper prices and more uncertainty in the global economy.

In this context, GDP grew 5.2% YoY in 2Q18, following a strong 4.2% YoY expansion in 1Q18. Although the higher annual GDP rate was explained, in part, from a weak comparison base, the activity has improved in the margin. On a sequential basis, GDP was also strong, revealing that the economy has a real recovery, beyond the statistical effects.

As we also highlighted in our previous conference call, the economy is showing a synchronized improvement across different sectors. While mining GDP expanded 5.1% in 2Q18, the rest of the economy (which represents nearly 85% of the total GDP) increased 5.3%. The breakdown suggests that there was an important recovery in private investment, while private consumption remains strong. The strengthening of the local demand is reflected in the impressive pick-up of Chilean imports and confidence levels, as shown in both charts on the slide.

Chile's CPI remains low, although it has been increasing slightly towards the Central Bank target of 3.0%. In the 2Q18, it was up by 0.7% QoQ, raising the annual rate to 2.2%. The core CPI, which is the measure that excludes food and energy prices, posted a 1.7% annual rate in the same period. Both trends can be seen in the CPI chart on this slide.

Now, I'd like to talk about our macroeconomic scenario for this year. Please move to slide 4.

In general, we expect a similar scenario in comparison to that we outlined in the previous conference call. Better growth, higher inflation and stable rates, at least in the short term. We also expect these positive conditions will prevail for most of the next year.

We are forecasting an economic growth of 4.0% this and the next year, led by an improvement in gross investment, as seen on the top right chart. The recent evolution of several indicators, such as capital goods imports, business confidence and some construction related figures are supporting the positive view on this component of domestic demand.

In relation to inflation, the depreciation of the Chilean peso and the stronger activity will likely generate a normalization in the next quarters. This leads us to expect inflation to be close to 3.0% this and the next year, after posting a 2.3% increase in 2017.

Given this macro scenario, for 2019 we expect a level around 3.25% for the monetary policy rate.

Now, I'd like to present the main trends observed in the Chilean Banking system. Please move to slide number 6.

During 2Q18, the banking industry was able to post solid results, characterized by robust growth, low risk and strong levels of profitability. In general, this trend has been explained by the better economic environment that has translated into a strengthened demand for loans from personal banking and companies this quarter.

Specifically, the industry recorded net income of $649 billion pesos in the 2Q18, which was 6% higher when compared to the figure observed one year ago. As seen on the chart, this result was largely explained by higher operating income. As a result, the system posted an average return on average equity of 14%, slightly above the same period last year.

As you can see in the graph below, there is a strong relationship between GDP growth and the loan cycle. In this context, it's expected that the acceleration of GDP will be reflected in greater growth in the industry, mainly in commercial loans, which have been in negative territory in recent years. Considering that the economy would grow around 4% this and the next year, and that historical elasticity of loans to GDP is close to 2 times. It should not be surprising that real loan growth will reach around 7% to 8% real in the coming quarters.

Please turn to slide 7

This recovery is clearly seen on these two charts. The graph on the left shows the quarterly loan growth in real terms on a sequential basis. As can be seen, there is a clear recovery of commercial loans since the 4Q17 and, in fact, this is driving the 2Q18 growth. This trend is consistent with the acceleration seen in the private investment, as I mentioned in the first part of this presentation.

On average, total loans accelerated to 2.6% this quarter or 10.4% on an annualized basis. This acceleration can also be seen on the chart on the right, which shows that Net Loan Origination has grown faster this quarter, especially in commercial loans, which it more than doubled the increase posted in previous quarters.

Now I would like to pass the call to Pablo Mejia, Head of Investor Relations, who will review Banco de Chile's results for the second quarter.

Pablo Mejia

Thank you Rodrigo. Please flip to slide number 9.

Once again, we obtained solid results this quarter, demonstrating our ability to generate robust figures that are consistent with our successful track record. This is not something that we have achieved this quarter, but rather this "consistency in our results" is a characteristic that has differentiated us in relation to all our competitors.

Our net income for the quarter reached $163 billion, 1.7% higher than the level recorded in the same quarter last year and, on a sequential basis, our net income grew by 14% thanks to solid customer income growth from both retail and wholesale segments coupled with excellent risk figures. It is worth mentioning that this result is the second highest in our history. Consequently, we reached a return on average equity of 21%, well above the average in the industry.

Beyond our high return on average equity, it's important to highlight our strong leadership when we take into account credit risk. As you can see in the graph on the right, we achieved a high profitability but with substantially less NPLs than all of our peers. This has been the effect of our long-term strategy, based on responsible growth and prudent risk management policies and practices. We are convinced that this strategy is the best source of long-term sustainability.

How have we accomplished these results? In the following slides I will go into deeper detail.

As we have mentioned in previous calls and as Rodrigo presented a few slides ago, the better economic scenario is beginning to be felt in demand for loans from both companies and individuals. This improving cycle should permit us to begin a period of stronger loan growth in key market segments and to improve our bottom line. We plan to leverage this by taking advantage of several commercial initiatives and intensive use of business intelligence tools to increase loan penetration, cross-sell and up-sell our customer base, which is the main driving force behind organic operating revenue growth. Additionally, we are permanently focused on improving our credit evaluation, monitoring and collection processes, along with achieving more productivity and efficiency in our business support processes.

Please turn to slide 10.

The improvements in the economic conditions have permitted us to retake growth with lower levels of risk.

As you can see in the chart on the left, total loans this quarter grew 3.4% year-on-year, but on a sequential basis we grew at an important level of 2.5%, or 10% on an annualized basis. The year-on-year figure was led by the retail segment, increasing 7.5%, while wholesale loans decreased by 2.4% year-on-year.The opposite trends in loan expansion are consistent with selective growth in personal and SME banking the segments with attractive risk / return relationship and on the other hand, on the low levels of activity shown by the large companies segments. Nevertheless, during the last three months we have seen a strong improvement in lending demand from all segments and especially commercial loans which grew at an impressive level of 3.2%. This was mainly due to foreign trade loans and commercial loans to larger companies that grew 3.4% QoQ, a significant change when we consider that this segment actually decreased in volumes in the last twelve months by 2.4%. The quarterly growth figure in commercial loans was supported by SMEs, which continued increasing at 2.7% in the quarter and 11% year-on-year. We also saw an acceleration during the quarter for the middle and upper income personal banking segment. This higher demand translated into an increase of 7.6% YoY and 2.0% QoQ for consumer loans for this segment and in residential and non-residential mortgage loans, we grew at 7.3% YoY and 2.2% QoQ.

This greater dynamism in retail lending activity is even clearer when we analyze the origination of consumer credit and the acceleration which took place during the quarter of total debtors, as you can see on the charts on the right. Consumer loan origination grew 26% this quarter compared to the same quarter last year and total consumer loan customers in the middle and upper income segment grew 1.4% QoQ, or 5.6% annualized.

It is very important to consider that growth has not only increased in quantity, but also in quality. Actually, we are also selling consumer loans more efficiently and with less risk than in the past. I mention this for two reasons: the first of them is that we have been able to grant more loans through online channels, which benefits clients in terms of product delivery times and security; in addition to greater efficiency for the bank. The second is that we have also substantially improved the supply of pre-approved loans, which, in addition to allowing us greater efficiency in the credit granting process, has been able to reduce the expected loss of the most recent sales flows.

Please turn to Slide 11

Simultaneously, with our positive figures in loans, we continued to show a solid track record in the acquisition of new current account holders. In effect, we grew at a strong pace and increased 7.2% year-on-year as you can see on the chart on the top left and checking account originations grew 36% over the same period last year. This has been possible thanks to three main factors:

> First, towards the end of 2016 we internalized and reorganized external sales force subsidiary. This meant making important changes in incentives, which led to significant productivity gains, as you can see on the chart on the bottom left.

Second, the implementation of several business intelligence actions that allows us to attract new customers as well as acting proactively to retain them when we see signs of possible attrition.

Finally, we provide an attractive value proposal, based on better products, benefits and an excellent post sale customer service.

Please turn to Slide 12

One of the main competitive advantages of our bank is the robust liability structure. Our strong growth in current account balances, significant increase in checking account originations and excellent attrition levels allowed us to grow our demand deposits by 13.1% year-on-year versus the industry that grew 9.6%. This progress once again permitted us to maintain the highest market share in the industry in this source of funding of 23% and to post the lowest cost of funds of only 2.6% in local currency. Additionally, it's important to mention that we have the strongest franchise in high net worth individuals with a total market share of in personal banking current account deposits of over 30% and an average balance per account of $3 million pesos, well above all of our competition.

In terms of Capital, the local banking industry continue to use Basel I. As of June, our total capital ratio reached 14.1% with a Tier 1 ratio of 11.2%, both of them above most of our peers. We feel comfortable with these levels, especially in view of the imminent approval of Basel III in Chile, which the market expects to occur in the coming quarters. In any case, the current bill considers that the application of Basel III will be gradually phased in during a six year time frame.

Please move to slide number 13.

Banco de Chile continues to have the best service quality, which is an essential part of our long-term strategy. On this slide you can see various charts that confirm this reality.

For example, our bank has a net promoter score of 73 points, which is not only the best in the market, but is also well above the average level of our peers. This difference is even greater in mobile banking and high-income segments. It's also worth mentioning that our bank has a very strong brand, which translates into the highest top of mind in the Chilean banking industry.

In previous conference calls, we mentioned that the customer experience is a core competence in our strategy, for which we have implemented various digital solutions, strengthened loyalty programs and improved a series of processes, among others. I would like to take the opportunity to highlight the important improvements in this area, such as the significant reduction in numbers of problems received, which in just two years has been reduced to almost half, as well as the improvement in the attrition rate, which is already located below 6%. We believe that these advances are essential to continue having the best customer base in the local industry.

On the next slide, we begin our discussion on our financial results. Through our successful strategy of attracting new profitable customers and developing strong long-lasting relationships, operating revenues, driven by retail customer income, continued to grow as you can see on the next slide number 14.

Total operating revenues for this quarter came in at $457 billion, up 2% year-on-year and on a sequential basis 2.7% or 10.8% annualized. As you can see on the charts on the left, this growth was led by customer income from retail side, which is in line with our strategy and market conditions.

Retail customer income expanded at a pace of 3.6% year-on-year and accelerated to about 2%, or 8% annualized, when compared to the 1Q18. This mainly due to our change in loan mix that is geared towards more profitable segments as well as lower cost of funds from our strong growth, as mentioned on the prior slide, in demand deposits.

Wholesale customer income decreased by 2.2% year-on-year but grew over 5% QoQ completely due to better economic scenario and our ability to take advantage of this growth.

Non-customer income grew as well thanks to a higher contribution of our UF net asset exposure, a positive effect in foreign exchange in instruments that hedge allowance and certain fee expenses denominated in us dollars, along with higher revenues from trading and available-for-sale instruments, primarily explained by favorable shifts in interest rates. Those effects were partially offset by a negative impact of credit value adjustments for derivatives.

Our NIM is consistently higher than the average of the industry. This quarter we reached 4.46% in line with last year and 18 basis points higher than the 1Q18. The QoQ rise was mainly due to higher inflation that we experienced this quarter.

In terms of total net fee income, we grew 2% year-on-year. This reduced level of growth was related to three factors. First, we incurred a few one-offs in credit and debit card fees due to a change in our loyalty program as well as the negative impact of the depreciation of the peso to USD that affect our USD fee expense allowance for that same benefit program. Second, wholesale related fees were slightly down due to the past economic cycle, which reduced demand for all company banking products. Excluding wholesale and credit card related fees, net fees increased strongly by 10%, chiefly due to higher revenues from our subsidiaries (insurance, mutual funds and stock brokerage) and retail transactional products. In terms of wholesale, we are confident that these fees should begin to show a gradual improvement in the second half of this year following the greater activity as we begin to observe in this segment.

Please turn to Slide 15

Total operating expenses increased 7.2% year-on-year, which was mainly due to non-recurring operating expenses related to a technological incident that took place in the quarter. This was partially offset by a reduction in marketing and outsourced services. Excluding this one-time charge, operating expenses would have grown by 2.1% year-on-year, below inflation.

This quarter we completed successfully agreements with all of our trade unions ahead of schedule. This was accomplished thanks to our good relationships we maintain with our employees and unions.

Salary expenses remained flat year-on-year, however it's important to note that this year we begin to differ this expense based on a straight-line method over the course of the term of the contract, which in this case was 36 months for the agreements reached with the unions.

Before moving on, I would like to emphasize that we have been focused on controlling costs and personnel expenses by implementing changes to improve productivity across the entire organization. On the chart on the right, you can see how our productivity levels per employee have continued to improve, up 8.4% YoY. We are also working on improving both the origination process and our distribution network that is increasingly focused on incorporating digital banking and automating certain services and back-office tasks. This has allowed us to maintain good levels of efficiency as you can see on the chart on the bottom right. If we adjust these ratios for these one-time expenses, our efficiency ratio would have shown a slight improvement with respect to the same quarter in 2017.

We pride ourselves on having a solid track record of risk management and prudent credit policies. Please turn to Slide 16

This quarter we once again posted excellent levels of cost of risk, which were below our expectations. Our LLP ratio reached only 0.82% and a loan loss provisions was merely $53.8 billion pesos, 13.4% lower than the same period last year. As demonstrated on the charts to the right, this improvement was due to a net quality improvement mainly in the retail segment and to a lesser degree a release of provisions due to two large corporate customers prepaying their loans. This was partially offset by a negative effect of the depreciation of the Chilean peso in allowances denominated in US dollars (although this is hedged and reflected in financial income) and growth that was primarily in the retail segment.

I think it's important to emphasize once again that our track record and that these levels of risk are not by chance. At Banco de Chile we are very meticulous when it comes to risk management. We invest a large amount of resources to ensure we implement and maintain the best standards and risk management throughout the life cycle of our customers. By clearly understanding the economic environment and the industries that we do business in, this assists us greatly to identify risks and to take necessary actions to limit our exposures if they occur.

Please turn to Slide 17 for highlights

We are very happy with our results. Our bottom line this quarter was one of the strongest in our history and we have generated over $300 billion pesos as of June. Our return on average equity for the first six months reached 19.5% and we are confident that with the improved economy we should end the second half strongly.

The improving economy is becoming apparent in many indicators. Loan growth is increasing by 2.5% quarter-on-quarter, or 10% annualized. Consumer loan origination also continued growing versus the same period last year at 26%. Not only that but we have also continued growing our customer base at important levels. Current account sales increased 36% over last year.

Thanks to this base of new customers and taking advantage of cross-selling opportunities, we grew retail customer income by 4% year-on-year, net fees by 2% but if we exclude wholesale fees and credit cards, we grew the rest of our fees in double digit levels. The stronger economy is also showing through in cost of risk which has helped to report low figures of only 0.8% this quarter. Finally, our Basel ratio remained above 14%, which allows us to be well prepared for the implementation of Basel III in Chile.

Thank you for listening and if you have any questions, we would be happy to answer them