Banco de Chile 1Q18

Financial Results Conference Call

Operator

Good morning everyone, and welcome to Banco de Chile's first Quarter 2018 results conference call. If you need a copy of the press release issued this morning, 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.

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 morning everyone and thank you for joining us today on our conference call for the 1Q18 Financial Results. It is a pleasure for me to share with you our comments regarding the evolution shown by the Chilean economy and the banking system during the first quarter. After that, Pablo Mejia, our Head of Investor Relations, will review the financial results of Banco de Chile in that period.

Please turn to slide number 3.

In general, the Chilean economy continues displaying positive signs of recovery. This improvement has mostly been explained by three main factors: (i) better perspectives for the global economy, which is critical for a small and open economy like Chile; (ii) high copper prices, creating positive terms of trade; and (iii) the improvement in business confidence, which has returned to the optimistic zone for the first time since the beginning of 2014.

Specifically, GDP growth has reached the highest level in more than four years, as seen on the top left chart. After posting a disappointing growth of only 1.5% in 2017, the activity expanded 3.9% and 4.0% in January and February, respectively, with an average of 3.3% in the last 6 months. The breakdown shows a synchronized recovery across different sectors. Mining activity, for instance, grew 16% in 1Q18, as a consequence of both a low comparison base (due to the strike in the mine Escondida) and better perspectives for this sector. Retail sales were also growing, since they expanded 2% in the same quarter, led by the 21% rise in car sales. Manufacturing activity has also grown, after falling several years.

It is worth mentioning that, on a sequential basis, it is, after adjusting by seasonal effects, the GDP has grown at an annualized rate of 3.4% in the last three months, suggesting that the economy is accelerating even in the margin. In other words, the higher growth hasn't been a consequence of only a weak comparison base.

One of the main factors behind the improvement in the Chilean economy has been the rise in business confidence, which has a strong correlation with the GDP growth, as shown in the top right chart. In this context, the pick-up in growth does not appear to be surprising.

The better sentiment has also been observed in consumers, as their confidence measures have also risen to highest levels in four years. This improvement has been led by different factors such as the positive trend in the labor market (in terms that recently job creation has been driven by salaried workers instead of self-employed jobs), the low inflation rate, which increases real disposable income, and the actual improvement observed in several economic figures. In summary, is likely that all components of the GDP (it is, consumption, investment and exports) will be stronger this year.

On inflation, the CPI remains below the Central Bank target of 3.0%. In March it posted a lower than expected 0.2% MoM change, reducing the annual inflation from 2.0% in February to 1.8% now. The core CPI, which is the measure that excludes food and energy, stood at 1.6%. The downward trend in Chile´s CPI has mostly been explained by the stability in the exchange rate (tradable inflation is only 0.9%) and a negative output gap (i.e. the effective GDP is lower than the potential GDP).

In this context, the Central bank has adopted a neutral bias in the monetary policy guidance. Specifically, the board has maintained the interest rate at 2.5% since May of 2017. In its last Monetary Policy Report, the board mentioned that the interest rate would remain unchanged until the next year, due to the assumption of a gradual convergence of the CPI towards the policy target of 3.0%.

Now, I would like to share with you our baseline scenario for this year. Please move to slide number 4.

We expect the positive cycle to continue at least until the next year. Specifically, we forecast an economic growth of 3.7% this year, which is consistent with a lower output gap in the future. Additionally, we think that economic growth would be even better in 2019, in the case that both supportive global conditions and positive expectations in Chile will last for a longer time.

We expect an important recovery in Gross investment this year. Specifically, as shown on the top right chart, the market expects an increase close to 4% this year, after declining for four years in a row. Therefore, investment would be the component of the GDP with the highest increase in its annual growth rate. According to several surveys and estimates, investment growth will be led in different sectors, such as energy, infrastructure, and mining, among others.

In relation to inflation, we expect it to continue in the lower bound of the central bank range. It would be the result of two opposite forces: on the positive side, higher pressures from the pick-up in growth. On the other hand, the stability in the exchange rate would contribute to maintain tradable inflation subdued. In all, it is reasonable to expect an inflation close to 2.5% this year, after posting a 2.3% increase in 2017.

Given this macro scenario, we do not expect changes in the monetary policy rate, which is at 2.5% now. In the case that the economy continues its positive trend, the central bank would evaluate a normalization in the monetary policy, although only in 2019.

Now, I'd like to go over recent trends observed in the Chilean Banking system. Please turn to slide number 6.

Once again, the industry was able to achieve solid results, demonstrating the existence of solid fundamentals and strong management capabilities to adapt strategies in different economic cycles.

During the 1Q18, the recorded a net income of $630 billion pesos, which was 2.0% higher in comparison to the figure posted one year ago. On the whole, as seen on the chart, this result was largely explained by higher operating income (it expanded by 6.5%), driven by the higher inflation rate, provisions remaining in low levels and operating expenses rising by 5.3%. As a result, the system posted an average ROAE of 13.6%, similar to the 14.0% observed the same period of 2017.

In terms of the portfolio of the industry, we have seen a slight recovery of the total loan growth, in line with the higher dynamism of the domestic activity. This trend can be seen on the left chart. Specifically, total loans grew by 3.6 % YoY in 1Q18, which is higher than the 2.9% observed last quarter. Once again, mortgage loans led the growth, as they expanded by 7.7%, although at a slower pace when compared with the previous quarter. Consumer loans remained strong (they grew 5.2%) but commercial loans are still subdued, since they rose only 1% YoY. These figures are consistent with the GDP breakdown, where private consumption is supporting the economic activity and private investment remain weak. However, it is worth mentioning that we expect to see higher growth in the coming quarters due to the positive economic scenario, as previously.

Now I will pass the call to Pablo Mejia, Head of Investor Relations, who will discuss Banco de Chile's results for the first quarter of 2018.

Pablo Mejia

Thank you Rodrigo. Please flip to slide number 8.

Net income for the quarter reached $143 billion, 2% higher than the level recorded in the same quarter last year. The increase in net income was driven by focusing our growth in segments with higher profitability, moderate increase in volumes, improved spreads and a proactive management of our UF asset exposure that provided higher revenues from inflation and lower cost of funds in the quarter. These effects were partially offset by a higher loan loss provisions due to a low comparison base, higher corporate taxes and a one-time expense related to end of a negotiation with one of our trade unions. When adjusted for this one-time expense, net income for the quarter would have reached $147 billion, 5% higher than the same quarter last year and just over 3% with respect to the fourth quarter of this year.

We are confident that with the improved economic scenario and our strong competitive advantages should deliver better dynamism in loan volumes and cross-selling opportunities that should drive customer income growth in the coming quarters.

Please turn to slide 9.

Our consistent and very successful track record has been a result of our customer centric strategy, that focuses on delivering sustainable and profitable growth by promoting greater penetration in the retail segment, strengthening customer experience and improving productivity while taking appropriate levels of risk for the returns that we aspire. In the following slides, I will go over the results we have obtained in each of these strategic pillars and we will discuss how the improvement in the cyclical conditions of the economy combined with our competitive advantages will provide the foundation to retake growth and to continue to record attractive returns for our shareholders.

Please turn to slide 10.

Total loans this quarter grew 1.8% year-on-year and on a sequential basis we grew 1.7% which is in line with the improved confidence levels experienced both by companies and individuals.

The year-on-year growth figure was driven by the retail segment, increasing 6.9% year-on-year, while wholesale loans decreased by 5.5% year-on-year. This breakdown is consistent with our focus of growing faster in more profitable segments and with the lag that is common when companies begin to become more positive with the economic environment and the time it takes to reactivate postponed projects. In fact, when compared to the 4Q17, our wholesale segment showed an improvement, growing 6.4% on annualized basis.

Within the retail segment, SME commercial loans were the fastest growing product at increasing 10.9% year-on-year, whereas loans to individuals grew almost 6% year-on-year, thanks to the mortgage loan book and middle and upper income loans. We expect that SMEs will continue to lead growth in our loan book, especially since this segment in Chile has very low banking penetration.

Within personal banking, we expect that the better consumer confidence levels and improvement in the quality of jobs should continue to increase the demand for consumer loans. In fact, figures for March 2018 already showed an important increase, where we grew our consumer loan book by 2.2% over the prior month, which is also significantly higher than the level posted in the same month last year. As you can see on the chart on the top right, quarterly consumer loan sales have grown by 26% year-on-year. This clearly is showing how the better economic environment is helping support better balance sheet figures.

As per financing, we continue to lead the industry in cost of funding thanks to our robust deposit base, and in particular due to our demand deposits from our retail customers as well as low spreads reached when we issue long-term debt. DDAs grew almost 8% year-on-year as you can see on the chart on the bottom of this slide. This performance allows us to continue leading the market in terms of DDAs and consequently permits us to deliver a lower cost of funding of only 2.5% in local currency.

These excellent results are largely due to our effective business strategies that have permitted us to grow our customer base strongly. Please turn to slide 11.

As you can see, we have continued to expand our retail current account holders at attractive levels of 6.4% year-on-year. This growth has been possible thanks to effective initiatives that leverage business intelligence to not only grow accounts strongly but to also retain customers better and to expand our customer base effectively with clients that use Banco de Chile as their primary account. If we analyze our customers, we have built a bank with the highest net worth of personal banking clients. There are many indicators that show this but one way to look at this is through the metrics on the chart on the right. The average balance per personal account is significantly larger than any of our competitors and this advantage not only provides us with customers that have a higher profitability potential but also gives us a better funding structure.

Additionally, we also have the largest number of debtors in Chile as you can see on the chart on the bottom right, where we clearly standout from our peers.

This successful strategy of attracting profitable customers and developing a high net worth client base has been the driver of operating revenues as you can see on the next slide, number 12.

Total operating revenues came in at $445 billion this quarter, up 5.3% year-on-year and 2.4% on a sequential basis. As you can see on the charts, this growth was driven by non-customer income which grew 15.5% year-on-year as a result of the positive inflation impact on the contribution of our structural UF gap on our balance sheet together with higher revenues from trading and available-for-sale instruments, primarily explained by favorable shifts in interest rates and inflation in the 1Q18 as compared to the 1Q17.

On the other hand, retail customer income expanded at a pace of 3% year-on-year. This level of growth is explained by to a one-time lower commission expense posted in the 1Q17 related to a change implemented in our credit card loyalty program. If we exclude this, customer income would have grown 6.1% year-on-year. The main drivers for this growth were a result of improvements in credit lending spreads together with a change in loan mix that is geared to more profitable segments and an improvement in recurring net fees of 13%, as detailed on the chart to the right of this slide. This increase was chiefly due to higher net revenues from stock brokerage (which almost doubled in traded volumes), mutual fund management, insurance brokerage, and transactional products because of greater cross-selling and a growing customer base due to effective commercial strategies that pursue to increase penetration of high income individuals. In terms of wholesale customer, we posted a slight year-on-year increase of 0.7%, despite the reduction of loan volumes in this segment. We are confident that wholesale customer income should begin to show a gradual improvement in the coming quarters as soon as companies begin to increase demand for commercial loans.

Undoubtedly, the clear trend shown by our retail customer income has been the consequence of a business strategy focused at reinforcing customer experience by providing the best products and services through the channels that clients demand. Please turn to slide number 14.

At Banco de Chile we worked vigorously to enhance the products and services that we offer by implementing effective changes in service models in branches, improving customer contact channels such as the implementation of world-class mobile apps and new online banking platforms for retail and wholesale customers as well as streamlining processes, among other initiatives. These changes have resulted in improving our net promoter score, which is a very critical test that measures customer service. Through an independent research company, banking customers are contacted to rank their overall experience with their bank based on a scale of 1 to 7. We are proud to say that over the last few years, we have improved our ranking significantly, placing us first amongst our peers with a ratio of 73%, as seen on the upper left chart. We also have the strongest brand name measured by different metrics. On the top right chart is Brand Asset Valuator, or BAV for short. This measures the value of the brand based on Brand Vitality which refers to the current and future potential a brand holds in it and Brand Stature which refers to the power of a brand. As you can see, our brand reached the highest percentile in the local industry, clearly marking a large difference with our closest competitors. This is the basis of our competitive advantages that allow our powerful brand to attract new customers more easily and in turn grows our loan book and fee-based services.

In terms of digital banking, online monetary transactions are continuing to take a more important role and are growing in double digit rates. What's even more impressive is the role that mobile banking is taking. Branch monetary transactions are growing only 1% per year, reflecting that clients are beginning to prefer to interact with the bank using remote channels, as you can see in the breakdown on the chart on the right, where mobile transactions are growing 61% year-on-year and internet transactions are increasing nearly 17%. We expect that this trend will continue and for this same reason we are adjusting the services offered by our branch network in order to capture synergies and to promote and sell more complex products and services or to provide personalized financial advisory of our account managers to customers that require it.

Additionally, as we have mentioned in previous conference calls, we are developing a new CRM Platform, which is being made in-house the first release is expected to be implemented during the last quarter of this year. This new platform should not only allow us to improve service quality and customer loyalty, but also productivity and in turn should benefit our efficiency ratio in the future in line with our strategy.

Furthermore, we are convinced that we must continue optimizing and streamlining processes in order to improve productivity in both front office and back office activities. Please turn to slide 16 on operating expenses

Total operating expenses increased 6% year-on-year which was mainly due to the one-time effect of a payment $5 billion pesos related to the bonus that is paid to staff when a negotiation with a trade union is completed and an increase of $5 billion pesos related to other diverse administration expenses. As a result, our efficiency ratio reached 45.9% this quarter. Excluding this one-time expense, operating expenses only grew 3.5% year-on-year and our adjusted efficiency ratio reached 44.7% this quarter, 73 basis points lower than last year.

We are committed to continue optimizing the operations of the bank by streamlining processes and implementing new technologies to automate labor intensive tasks. We are also working in improving both the selling process and our distribution network. Based on a value offering that is increasingly incorporating digital banking, we have restructured our branch network, reduced headcount and automated certain services and back-office tasks. Nevertheless, we have been implementing these changes gradually in order to ensure that our customer experience remains high. In fact, we have been able to implement these changes, while improving our net promoter score. Going forward, we are confident that our focus on cost control and new projects will translate into better productivity, customer experience as well as higher levels of efficiency.

We pride ourselves on having a solid track record of risk management and prudent credit policies. Please turn to the slide 18.

This quarter we posted a LLP ratio of 1.1% and a cost of risk of $70.9 billion pesos. The year-on-year increase is mainly due to a normalization of the wholesale segment and a change in loan mix that is geared more towards retail than wholesale loans when compared to the mix one year ago. The charts on the right show this, where the extraordinary low level of cost of risk in the wholesale portfolio in the 1Q17 is due to provision releases from prepayment of certain loans to customers in the fishing and retail industries (shown as deterioration this quarter), completely offsetting the good performance that we have experienced in personal banking loans, as you can see in the chart on the bottom right. Thanks to the good performance, especially in our retail segment, NPLs showed a downward trend over the last quarters and registered the lowest figure in the 1Q18 of 1.17% versus 1.22% a year earlier.

It's important to mention that a key part of our risk management strategy is centered on the high involvement of the board of directors and upper management as well as the important human and financial resources allocated to develop strong credit acceptance, collections, and monitoring practices. During the last quarters, we have been working on updating our admission models of personal banking and fine tuning our pre-approved risk model. Both of these adjustments, together with higher demand from customers, have contributed in the acceleration of consumer loans that we have seen in this first quarter. Nevertheless, I have to emphasize that we are committed to growing responsibly and that these changes have been made in line with our proven track record of prudent risk management policies.

Please turn to the next slide, number 19.

I think it's important to mention that today we are more confident about economic outlook than in previous quarters. As Rodrigo mentioned, 2018 is looking very positive and this should be reflected in our performance.

Some key results this quarter were our ability to grow net income, despite a normalization of loan loss provisions, higher corporate taxes, and a one-time expense related to the negotiation with one of our trade unions and the one-time lower expense in fees in the 1Q17. We also continued posting good growth in retail customer income that offset the slower growth that we experience in the wholesale segment. This was sustained by impressive growth levels in recurring net fees and consumer loan sales which expanded 13% and 26%, respectively. As per risk, NPLs decreased 5 basis points thanks to the good performance of our retail book and our efficiency ratio adjusted for one-time expenses improved 73 basis points from the same period last year. Finally, our Basel ratio remained above 14%.

Before moving on to questions, I want to highlight that we firmly believe that our consistent customer centric strategy that is focused on providing the best customer experience, leveraging the use of technology to grow and our superior competitive advantages should permit us to continue delivering solid and reliable results. This without a doubt, ought to contribute to preserving our profitability figures and to continue creating value for our shareholders.

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