Banco de Chile Full-year 2017 and 4Q17
Financial Results Conference Call

[Operator]

Good morning everyone, and welcome to Banco de Chile's Fourth Quarter 2017 results conference call. If you need a copy of the press release issued on Thursday, 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 Officer.

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 Full-year 2017 & 4Q17 Financial Results. It's a pleasure for me, to share with you our comments regarding the Chilean economy and the results of the banking industry during the quarter. Finally, Pablo Mejia, our Head of Investor Relations, will review our 4Q17 financial results and main strategic achievements.

Please turn to slide 3

During the quarter, the Chilean economy continued to show strong signs of recovery. The monthly GDP, as seen on the top left chart, grew faster in the second half of last year. In fact, while the economy was up only 0.5% in 1H17, it completed an expansion of 2.5% between July and November, which is the latest available figure. As a consequence of the higher than expected 3.2% YoY expansion in November, the economy accumulated an annual growth of 2.6% in the quarter ending in that month, the highest figure since April of 2014.

This recovery has been a consequence of diverse factors. One of them is the important improvement in external conditions, which is a critical driver for a country like Chile, where the trade volume is more than half of GDP. The faster growth in several of our trade partners and the increase in copper prices, as you can see on the top right chart, have supported better expectations for Chile. Since copper represents more than 10% of total GDP and is a relevant amount of our fiscal revenues, this surge generates spillovers to different areas of the economy. A second driver has been the normalization of mining activity, after the strike in Escondida, which affected the copper production in the beginning of 2017.

Internal factors are also supporting the growth of the Chilean economy. As seen on the bottom left chart, private expectations have risen significantly, reaching the best levels in more than 4 years. It has been the case of consumer confidence. In December it reached 44 points, accumulating the fifth consecutive improvement and achieving the best number since May of 2014. More importantly, expectations concerning the future 12 months have sharply increased to 66 points, the highest since 2010.

Other figures are also confirming the cyclical improvement. In December, for instance, the unemployment rate went down to 6.4%, and retail sales posted a strong 5.6% annual increase in November, led by a substantial 14.1% YoY jump in durable goods. All in all, these figures reflect that domestic consumption is still supporting the Chilean growth.

Another important factor has been the steady rise of inflation, it has been increasing slightly in the margin, although the annual rate remains in the lower part of the central bank range, which is between 2% and 4%. After posting a monthly increase of 0.1% in December, the CPI accumulated a 0.7% rise in the 4Q17, higher than the 0.1% observed in the previous quarter. As a result, the annual inflation rate ended the year at 2.3%, remaining below the policy target of 3.0%.

Now, I'd like to share with you the baseline scenario for this year. Please move to slide number 4.

There are robust signs of recovery in Chile, anticipating a better environment this year. Actually, we expect the GDP to increase around 3.0% this year, well above the 1.5% observed in 2017. This means the economy is expected to perform its best year since 2013. Although we acknowledge an upward bias in our estimates, we do feel that growth is likely to be even faster.

Consequently, we expect a slight improvement in the labor market. We forecast a decline in the average unemployment rate, from 6.7% last year to nearly 6.5% in 2018, with an improvement in quality of jobs, as a consequence of the expected surge in private demand, particularly investment.

Regarding inflation, we also estimate a gradual increase in the annual CPI, from 2.3% in 2017 to nearly 2.8% in 2018. Even though the economy is expanding faster, the strengthening in the Chilean peso is contributing on the opposite side. All in all, we estimate the CPI to converge to the 3.0% target only in 2019.

Finally, our scenario considers that the central bank maintains the rate at least until the second half of the year, although we acknowledge the possibility of further cuts in the case that inflation remains around the 2.0% for a longer period of time. If the economy continues growing, the central bank would begin a gradual normalization of the interest rate, by increasing it by 25 bps this year and possibly more in 2019.

Please turn to slide number 6.

I would like to go over some of the last trends we have seen in the local banking system. Once again, the Chilean industry achieved solid results, despite the existence of some negative factors such as the weak economic growth and the lower inflation rate. Undoubtedly, it reflects the existence of strong fundamentals and proven capabilities to adapt strategies efficiently to changes in the economic cycle.

In 2017, the system posted a net income of $2.2 trillion pesos, 13.8% higher when compared with to the 2016 figure. As you can see on the chart, this improvement was explained by an important increase in net operating income, mainly due to one offs in many of our competitors, partially offset by higher risk, operating expenses and taxes.

In terms of the portfolio for the industry, total loans grew only 2.9% in real terms, year-on-year, slightly higher than the 2.4% increase posted last year. The breakdown showed a figure consistent with the GDP composition: commercial loans decreased 0.2%, in line with the reduction in gross investment, while housing and consumer loans increased by 8.2% and 5.3% respectively, consistent with the resilience observed in private consumption. However, it is important to mention that the better dynamism expected for this year in the economy should translate into an improvement in loan growth, especially in commercial loans.

Please move to the slide number 7.

Despite that total loans to GDP or loan penetration in Chile hovers just over 90% as a percentage of GDP, which is relatively high when we compare Chile to other emerging markets, there is still substantial growth potential to continue expanding retail loans. When analyzing loans by product and segment, we find that loans to corporates and mortgage loans represent around 60% of loans to GDP. If you take a closer look at the charts to the right, SMEs and middle market companies only represent 38% of total commercial loans, but represent 99% of debtors. This clearly shows the huge potential to continue penetrating the SME segment with loans and fee based products.

Loans to individuals also have potential to continue increasing. First, consumer loan penetration is in line with our Latam peers and second, even though mortgage loans represent 26% of GDP, this level is relatively low when compared to more developed markets. For example, the chart on the bottom of this slide, shows a comparison of total house hold debt to total loans for OECD countries. As you can see, Chileans have very low debt levels when compared to more developed countries, prominently demonstrating that there room to also continue penetrating this segment. These two segments are precisely what we are focusing at Banco de Chile to grow.

However, it is important to mention that the better dynamism expected for this year in the economy, which would be led by a surge in private investment, should translate into an important improvement in loan growth, especially in commercial loans. For 2018, we are expecting that total loan growth, in the Chilean banking system, will pick up to levels between 5% to 6%, in real terms. This will be driven by mortgage loans and consumer loans, growing above 6%, followed by commercial loans that we expect to grow just above 4%.

Now I would like to pass the call to Pablo, who will go into more detail about our strategy and our financial results.

[Pablo Mejía]

Thanks Rodrigo. Please turn to the next slide, number 9, to begin the discussion of the BCH Financial results.

Despite that 2017 was sluggish in terms of economic growth, inflation and loan demand, we posted once again strong financial figures. Net income for the year reached $576 billion, 4.3% higher than 2016, and we continued to maintain attractive levels of profitability of 19.3%. It's also important to point out that this was obtained despite a higher corporate tax rate that went from 24.0% in 2016 to 25.5%. On a pre-tax basis, net income for the year was 7.8% higher than 2016. On a quarterly basis, we generated net income of $142 billion pesos, 14.8% higher than the same quarter last year, mainly due to lower loan loss provisions.

We were able to obtain these figures by developing tailored commercial strategies that improve our customers' experience and also drive recurring income. Additionally, we have been concentrated in maintaining adequate levels of risk return, improving productivity and controlling expenses proactively.

Please turn to slide 10.

We have consistently demonstrated our ability to deliver sustainable and superior profitability for our shareholders, thanks to our long-term customer centric growth model. The next few slides will go over how we have shifted our strategy to focus on the retail segment. We will also discuss how our emphasis on strengthening customer experience is helping to build the foundation for success in this more competitive environment, and we will go over the positive financial results, thanks to the improvements that we have made that has driven productivity. Lastly, we will examine how we have managed to keep risk at these very low levels, despite an important change in mix.

Please turn to slide 11

Our large and diversified customer base is clearly one of our main competitive advantages. First we have the largest customer base of debtors in the industry with a market share of 18.7%, as you can see on the chart on the top left. Also, thanks to solid business initiatives that take advantage of new technologies, as well as how we proactively use business intelligence to target new customers, we have been able to build a large current account customer base that is growing faster than all of our main peers (bottom left) and that it is even composed of higher net worth individuals. One way to see this is by examining current account balances, where we maintain 2.9 million pesos per account on average, while the closest competitor bank has nearly 40% less average balances. Additionally, we have a higher overall market share of 30.1% in personal banking current account balances. It is also important to highlight that not only are we growing in new bank accounts, but that these customers are taking on other products as well. In only 90 days, new customers reach the average loan share of wallet that our overall customer base maintains, as you can see in the charts on the bottom right.

The importance of this high net worth customer base is clearly more apparent when we analyze our loan book and deposits. Please turn to slide 12.

Total loans this quarter grew only 0.2% year-on-year. Retail loans were far more dynamic than the wholesale segment as a result of the lackluster economic environment that kept corporate loan demand weak and the implementation of our strategy, which prioritizes growth in certain segments. For this reason, it's important to point out the great benefit that we maintain for having of a well-diversified loan book. That is, when one segment slows down, or when we do not see an adequate balance between risk and return, other segments are capable of offsetting that weak performance. Retail loans grew 7% while the wholesale segment dropped by 9%. Within retail, SME commercial loans were the fastest growing product at 10.4%, whereas loans to individuals grew 6.3% year-on-year, thanks to the mortgage loan book and middle and upper income loans. Regarding SMEs, we continued our strategy of building strong long-term relationships with clients. This quarter we held numerous SME conferences across in many cities throughout the country. These events consist in panel discussions and presentations that help our customers grow their business and gives them a unique chance to network with other entrepreneurs. We also continued reinforcing customer experience by adding new features to mobile apps, successfully introducing a new investment management app, launching a new company banking webpage and entering into new loyalty programs with British Airways and GOL Airlines from Brazil, amongst other initiatives. We are confident that by providing the best customer experience to our customers through initiatives such as these, coupled with excellent customer service and deeper use of business intelligence, we will be able to continue taking advantage of new growth opportunities, while maintaining a favorable risk return equation.

As per funding, demand deposit accounts grew at 6.1% year-on-year, well above loan growth, and we continue to lead the industry in cost of funding thanks to this solid deposit base. Our leadership in Cost of Funding, particularly in local currency, as you can see in the chart on the bottom right of 2.5% is due to our solid demand deposit base from both retail and wholesale customers that choose to bank with us over our competitors, as well as lower spreads reached when we issue debt thanks to our strong risk ratings of A from S&P and Aa3 from Moody's. Thanks to our strong rating, we continued placing debt in foreign markets at very attractive spreads. We recently placed long-term unsecured bonds in Germany and Japan, totalling nearly US$275 million with tenors that went from five to twenty years. It's also important to note that most of these placements were accompanied by cross currency swap hedge accounting in order to neutralize any effects associated with changes in FX and tenors that could hit our cost of funding. Locally, we also issued bonds for an amount of approximately US$650 million denominated in UF with tenors ranging from four to twelve years. In terms of our capital ratios, thanks to our more sustainable dividend policy that was changed a couple years ago from 70% cash to 60%, our Basel Ratio ended the year with a solid 14.5% and with a Tier I capital ratio of 11.5%, both figures higher than our main peers.

In terms of the adoption of Basel III, the Finance Ministry sent mid-year a bill reforming the General Banking Law. In January 2018, the bill was passed by the lower house and now is pending further approvals. There is still a lot of information that needs to be set by the regulator such as buffers and risk weightings. Based on our estimates, we think that we will not require any additional capital to comply this new standard, as long as the new standards are implemented gradually.

Please turn to the next slide, number 13.

Operating revenues decreased 1.5% year-on-year mainly due to a higher comparison base given a one-time sale of AFS instruments of approximately $59 billion pesos in 2016, and in a lesser extent, to lower inflation recorded in 2017 of 1.7% versus the 2.8%.

As you can see on the chart on the right, through effective commercial strategies that have leveraged new business intelligence tools to concentrate growth in key market segments which provide more attractive returns with adequate levels of risk, we were able grow customer income by 5.3% year on year, offsetting almost completely the negative effect of lower inflation and the one-timer that I mentioned earlier.

Specifically, strong growth in loans to SMEs and personal banking provided us with higher lending spreads, as you can see on the chart on the bottom right, and by effectively cross-selling our customers, **we grew fee income by 26.4 billion pesos, or 8.2% year-on-year, as you can see on the following slide number 14.**

The increase in fees was due to:

- First, greater use of transactional products, such as credit cards, ATMs and checking accounts, which together totaled approximately $15 billion pesos, boosted by a one-time expiration of loyalty program points that reduced fee expenses.
- Second, greater contribution from the mutual fund and stock brokerage for about $9 billion pesos. This increase was achieved thanks to greater risk appetite from investors, which translated into a higher trading volumes in our stock brokerage business and an expansion of assets under management,
- Third, higher fees from insurance brokerage of about $2 billion pesos, associated with higher premiums, thanks to successful sales strategies,
- Finally, more deals in Financial Advisory services for approximately $1.4 billion pesos.

Thanks to these proactive commercial efforts to continue growing our fee based business, we were able to maintain our leadership position in this source of income with a market share of 20%.

On the next slide, number 16, is a review on how our digital strategy is bearing fruit and of our new digital initiatives.

Digital banking platforms have continued to increase their importance in everyday banking. Customers are coming into branches less and are using digital channels more intensively. We are continually focusing our efforts in improving our customer experience through these channels and we are consistently challenging ourselves to come out with new and better apps with more features that customers appreciate. Saying that, we are proud that we are considered to be the best digital platform in the industry, based on a wide array of independent surveys and on our net promoter score on mobile apps. On the chart on the left, you can see that in only one year, personal banking online transactions volumes have increased in double digit rates by 31% and today represent over 50% of total transactions. On the chart on the right, the increasing importance of mobile banking continues. Specifically transactions have been mainly driven by the mobile phone and to a lesser degree the webpage, while branch transactions have seen a reduction of 2.2% year-on-year. We expect this trend to continue and for this reason our efforts are focused on streamlining processes, implementing smart ATMs and gradually beginning to decrease the size and density of our branches while improving significantly our digital contact channels. We are also implementing a new CRM that should improve customer experience and also productivity across all segments of the bank.

By streamlining processes and using new technologies across different front and back office areas, we have been able to drive productivity and reduce costs, as described on the following slide, number 18.

As you can see on the chart on the left, total operating expenses remained basically flat year-on-year, increasing only by 0.1%. Despite negligible growth in expenses, our efficiency ratio increased from 45.4% in 2016 to 46.2% in 2017 due to effect of the one-time sale of AFS instruments of approximately $59 billion pesos in 2016 that increased operating income and the negative impact of lower inflation over our operating income this year. In terms of operating expenses to total average assets, this ratio improved, moving from 2.6% in 2016 to 2.5% in 2017.

Through projects aimed at improving customer experience and by keeping a permanent focus on cost control, we have been able to optimize how the bank is run, and thanks to this, we have been able to show important advancements in productivity. Moreover, if we compare our growth in expenses this year, as you can see on the chart on the bottom right of this slide, we are the only bank that has been able to keep cost low. For the coming years, we are very confident that these initiatives should continue to bear fruit, which will consequently maintain expense growth lower than operating income and continue to improve our efficiency and productivity levels.

Prudent risk management is one of the fundamental pillars of our success and continues to be a part of our long-term strategy. We ended another year with low levels of cost of risk, as you can see on slide 20.

Despite another challenging year, we recorded a decrease of 24% in provision for loan losses, which reduced cost of risk ratio from 1.25% to 0.93%. This reduction was due mainly to two factors. First, in 2016 we recorded additional allowances of $52 billion pesos. Second, a net credit quality improvement of nearly $42 billion pesos year-on-year, which was related to both the credit behaviour of our retail segment and to the wholesale segment as it had important improvements in the credit profiles of specific customers while other corporate customers, specifically in the Salmon industry, reduced their exposure with us.

I think it's important to highlight we have achieved these levels of risk, not only due to an improvement in the credit behaviour of customers as a whole in Chile but also to our prudent risk management approach that is deeply present throughout the life cycle of our customers. This no doubt assists us to identify risks more easily before they occur and implement strategies to minimize our exposures.

Please turn to the next slide, number 21.

Before we move on to questions, I would like to go over some key financial highlights for 2017. We finished the year once again with great figures. Net Income attributable to shareholders was the highest in the industry with a market share of 26%, equal to $576 billion pesos. We grew this figure by 4.3% year-on-year, despite the weak economy, low inflation and higher taxes (Pre-tax income grew by 7.8% YoY). We also continued penetrating the retail segment and proactively managed lending spreads across all of our business segments, permitting us to continue to grow sustainable core revenues as customer income expanded by 5.3% year-on-year and net fees grew 8.2% during the same period. Cost of risk also came in at very good levels, reaching only 0.93% and we continued implementing new technologies and streamlining front and back office operations that permitted us to maintain operating expenses flat. These results were essential to reduce the negative impact of low inflation that affected non-customer income and higher corporate taxes.

Finally, when we look at the year ahead, we are very confident that 2018 will be much more dynamic. Business and consumer confidence has already begun to show signs of improvement, there is a consensus in terms that GDP growth will more than double and inflation should return to the Central Bank target range of 3%. All these factors should help us continue to post attractive results for our shareholders. We expect that our strategic priorities, which are deeply focused on digital transformation, will permit us to take greater advantage and gain market share during the better economic cycle that is quickly approaching.

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

Thank you for listening and participating in our call; we look forward to sharing our next quarter's results with you.