Banco de Chile 3Q17
Financial Results Conference Call

Operator

Good morning everyone, and welcome to Banco de Chile's third Quarter 2017 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 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 thanks for joining us today on our conference call for the 3Q17 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 3Q17 financial results.

Please turn to slide number 3.

In general, there are several signs of recovery in the Chilean economy, suggesting that GDP growth will likely increase significantly in 2018, after having four years with an average rate of only 1.5%.

The improvement in the Chilean activity can be seen in the chart on the top left section. The monthly GDP (Imacec) grew by 2.4% year-on-year in August, which is higher than the 0.5% observed in the first half of this year. This recovery has been a consequence of the higher dynamism in the mining sector, which posted a strong 9.2% annual growth in August. It is worth mentioning that the economy is also improving on a sequential basis, since the Imacec rose 7.3% in the quarter ending in August, with an impressive rise of 50% in the mining activity.

In addition to these good numbers, several leading indicators anticipating a further recovery. For example, the breakdown of trade balance, as seen on the top right chart, has shown an upward trend in both exports and imports with durable and capital imports growing at double digit rates.

Following this idea, several surveys are suggesting an improvement in local sentiment, as you can see in the chart on the bottom left section. Specifically, the consumer confidence posted its best level since the beginning of 2015, returning to the optimistic zone. Business confidence also achieved its highest level in more than two years, in line with a very positive year for the Chilean stock market, which measured through the IPSA index, accumulates a return over 30% YTD.

In spite of this, we think the most relevant adjustment during the last few months has been the sharp reduction in the annual inflation rate, which decreased to only 1.5% in September. Consequently, the headline inflation has remained below the target of the Central Bank since October of last year. This evolution can be seen on the bottom right chart. This trend is in part explained by the stronger Chilean peso, reflected in a tradable inflation of 0.0% year-on-year, but also due to the below trend growth that our economy has experienced during the last quarters, reflected in a lower non-tradable CPI.

On monetary policy, the interest rate has been reduced by 100 bps this year, to 2.5%. Despite the Central Bank's baseline scenario does not consider any change in the reference rate until the next year, it acknowledged the existence of a downward risk in the short term CPI. Therefore, a new negative surprise in inflation could lead to an additional cut in order to keep inflation expectations anchored in the Central Bank target figure.

Now, I would like to share with you our baseline scenario for the next year. Please turn to slide number 4.

The positive trend in most leading indicators, the rise in copper prices and the improvement in the global growth are consistent with a higher GDP growth rate. Specifically, we expect it to improve from 1.5% this year to nearly 3.0% in 2018. Our scenario also considers a slight decrease in the unemployment rate, as seen on the second chart.

On prices, we expect a gradual convergence of the CPI to the Central Bank target by the end of 2019. Specifically, the indexation of non-tradable goods, the assumption of a stable exchange rate for the next year and the slow narrowing of the output gap are the main reasons behind of our estimate of 2.8% for the next year. Finally, we expect the Central Bank to maintain the rate in the expansionary level of 2.5% until the second half of 2018, unless the risk lower than expected inflation comes true.

Please turn to slide number 6.

Briefly, I would like to mention the last trends in the Chilean banking industry. As of September, total loans grew 4.9%, year-on-year, a figure that is well below consensus for this year and our estimates that were closer to 7%. This weak dynamism is consistent with low GDP figures seen throughout all of 2017, poor business confidence and with the results from the Bank Credit Survey conducted by the Chilean Central Bank for the third quarter of 2017, which indicates that the conditions of supply remained restrictive for both the retail and wholesale segments. However, the most important highlight of the survey was that no financial institution observed weaker demand from individuals, which was the case in the prior two quarters, and some even found that demand was improving.

In terms of risk, non-performing loans for the system remained relatively stable at 1.96% as of September when compared to a year ago of 1.9%. We expect this level of NPLs to continue for the rest of the year with a possible slight improvement in 2018 when the economy is expected to recover.

In terms of net income, during the 3Q17 the banking industry reported a 3.9% decrease when compared to the same period last year. This was mainly due to a rise in operating expenses that grew 3.1% year-on-year and to higher corporate taxes, which were partially offset mainly by higher other operating income and net fees. It's important to highlight, that we are expecting, based on the recent -0.2% inflation figure posted in September, that the fourth quarter will look similar to this quarter in terms of net income because of the low inflation expectations. It's also important to note that the variation of the UF has a lag of about one month to the CPI rate. This means that the low inflation figure of September will affect fourth quarter operating income.

Moving on to the last chart on this slide, return on average equity for the system as of September reached 13.1% reflecting a healthy banking industry despite the weak economy and lower inflation.

Now I will pass the call to Pablo Mejia, Head of Investor Relations, who will discuss Banco de Chile's results for the third quarter of 2017.

Pablo Mejia

Thank you Rodrigo. Please flip to slide number 8.

Net income for the quarter reached $134 billion, 7.5% less than the same quarter last year and 16.2% lower than the second quarter of this year. The main driver for those figures were the surprisingly low inflation rate that we experienced this quarter, as measured by the UF of minus 0.03% and to higher corporate taxes.

Despite this negative effect in inflation on our results, our 9 months 2017 net income is 1.3% higher than the 2016 figure and on a pre-tax basis it increased by 4%. This shows that we were able to face this scenario by continuing to grow recurring income from our target segments, a greater contribution of our subsidiaries and keeping cost of risk and expenses at low levels. We are confident that regardless of this quarter's lower net profit level, we are on track to post full year figures in line with last year and we expect that 2018 will be slightly better, especially when accompanied by an improved economic scenario, higher loan growth and normalized inflation as mentioned earlier by our Chief Economist.

Please turn to slide 9.

As we have mentioned in the past, the key to our successful track record is the result of our customer centric strategy that focuses on delivering sustainable and profitable growth. In the next few slides, we will discuss:

- How we have shifted our strategy in recent years to focus on the retail segment, especially in high-income individuals and SMEs, which is providing the most attractive growth opportunities in the banking industry.
- How our emphasis on customer experience is bearing fruit.

- How productivity is improving, thanks to an emphasis on streamlining processes and investments in technology, and
- How we have managed to keep risk at low levels, despite an important change in mix.

Please turn to slide 10.

One of our main competitive advantages is our large and valuable customer base. We fully understand the importance of this advantage and for this same reason, we are continually reviewing and enhancing our product offerings in order to maintain this leadership position and of course, continue expanding our customer base. As you can see on the chart on the left, current account customers are growing at a rate of almost 6% year-on-year, well above our main competitors. We've achieved this growth through different initiatives and excellence in customer service that helps drive attrition. In addition to this, we have been very proactive in taking advantage of business intelligence to identify and preapprove products to over 1 million potential customers. We also made this information available in the Cloud and provided access to our relationship managers. This initiative together with an appropriate incentive system has permitted us to grow more efficiently – lower the cost per account openings- and become more effective in terms of acquiring better customers that take on more products within the first 6 months of becoming a Banco de Chile customer, as you can see on the charts on the right.

The first chart shows our superior personal banking customer base that represents a market share of 29.8% of total current account balances, well above our peers. Also, on a per customer basis, our customers have 40.7% and 34.3% more funds per account when compared to BCI and Santander current account holders.

The chart in the middle shows our average share of wallet of our customers, which is an outstanding 44% for Personal Banking Consumer Loans and 35% for SME Commercial loans. What is even more striking is the chart on the bottom right that shows how quickly a new customer, on average, reaches the same share of wallet as our mature customer base in loans. As you can see, within 90 days, customers on average reach similar levels of penetration as our overall client base and in the case of SMEs it even surpasses those levels. Also, thanks to this important level of growth in new customers, this provides the foundation for further sales initiatives to cross-sell these clients with other products and services such as mutual funds, stock brokerage and insurance brokerage.

As this slide demonstrated, we are a bank that has a great track record of getting customers to choose us as their primary bank account. If you flip to the next page, number 11, you can see what this means for loan growth and DDA balances.

Total loans this quarter grew 1.8% year-on-year completely driven by the retail segment, increasing by 8% year-on-year, while wholesale loans decreased by 6.5% year-on-year. This breakdown is consistent with our focus of growing faster in more profitable segments and with both unattractive growing conditions and specific credit behaviour trends in the corporate sector. Within retail, SME commercial loans were the fastest growing product at 11.2%, whereas loans to individuals grew just over 7% year-on-year, thanks to the mortgage loan book and middle and upper income commercial and consumer loans.

Regarding SMEs, and in line with our customer centric strategy in the retail segment, we continued our approach in promoting long-term relationships. This quarter we continued to hold SME conferences in several cities across the country, which have a very important turnout rate. At these events we bring together our SME customers to share and discuss important topics for their business presented by local industry leaders, success stories from our own SME customers, as well present benefits that we can provide them through diverse alliances that go from education to discounts on certain services and products. Additionally, these events provide this segment important networking opportunities where clients have the opportunity to meet with Banco de Chile representatives and other business owners. We are confident that by providing the best customer experience to our SMEs through initiatives such as these events, 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 favourable risk return equation.

On the other hand, we expect that the dynamism of mortgage loans that grew 9.0% year-on-year, in line with the average in the industry, should continue decreasing marginally and stabilize around 7.0% in real terms for us and the industry next year. As per middle-upper income consumer and commercial loans, these grew by 6.9% year-on-year while loans to Credichile customers, our consumer finance area, decreased during the period in line with our to our prudent approach to grow in this segment.

In terms of wholesale loans, this segment decreased 6.5% year-on-year, mainly due to sluggish investment, very strong competition that drove down spreads and made it more difficult to grow with an adequate level of risk and return, along with certain prepayments from customers from the Salmon Industry which also affected positively LLP for the quarter. By customer segment, Corporations with annual sales above $140 million dollars per year represented over 70% of this decrease. We expect that as the economy improves, we should see a rebound in commercial loan growth from this segment, given a scenario of improving expectations and historically low interest rates that should promote new investment projects.

As per funding, we continue to lead the industry in cost of funding thanks to our solid deposit base, and in particular due to our demand deposits from our retail customers as well as lower spreads reached when we issue debt. Through the initiatives that I described earlier and by having a focus on delivering excellent service quality, improving attrition levels and concentrating on providing better benefit programs to promote product usage rates, our customers prefer Banco de Chile to other banks when saving their funds. This has resulted in important increases in DDAs growing 7.1% year-on-year, mainly from current account balances associated to personal banking, which were up 7.9% year-on-year and other demand deposits related primarily to our corporate segment. This performance keeps us as the leader in DDAs in the banking sector with a market share of 22.6% as of September 2017. This coupled with our outstanding rating from risk agencies, which support better funding spreads when we place bonds and time deposits, has provided us with the lowest cost of funding in the industry of 2.5% in local currency, as you can see on the chart on the bottom right.

Please turn to the next slide, number 12.

Operating income came in at $404 billion this quarter, down 5.5% from a year earlier, on an unadjusted basis. However, this lower result was mainly due to the impact of negative inflation this quarter of -0.03% on our structural gap of UF indexed assets. This effect can be clearly seen on the chart on the left under non-customer income and in NIM as shown on the top right chart.

However, it is important to point out that we achieved a noteworthy year-on-year increase in customer income from our retail segment, which grew 5.7%. This clearly demonstrates the results of our efforts to grow in the most profitable segments that, despite high competition, has permitted us to maintain higher spreads than last year, as you can see on the chart on the top right. This improvement allowed us to partially offset the negative effect of lower inflation.

Our efforts to achieve greater customer experience and the improvements in our loyalty program are clearly reflected in the evolution of fee income, which continued growing at positive rates. Fees were up 4.6% year-on-year, chiefly due to higher net revenues from transactional products because of greater cross-selling and a growing customer base. In addition, this quarter was particularly favourable for our subsidiaries, which reached an important increase in fees related to mutual fund management and insurance brokerage. Overall, our 9 month year to date fee income posted an increase of 8.8% which allows us to continue leading the Chilean industry with a market share of 21%.

During the third quarter, we also signed an alliance with GOL airlines, which allow our customers to accumulate travel rewards with credit cards purchases. Previously, the bank signed alliances with Delta, SKY, Iberia and British Airways. Therefore, today we believe that we have the best loyalty program in Chile, which has been a key part of our value proposition.

Before moving on to the next slide, I believe it's important to highlight that the negative effect of inflation on our numbers is temporary and that we are estimating that in 2018 inflation should gradually converge to the Central Bank target, which is 3,0%. We expect that the fourth quarter will also have a low inflation rate that could affect temporarily our numbers. Nevertheless, we have made important progress in line with our long-term business strategy in key projects that should permit us to keep a sustainable and consistent growth in customer revenues in the future.

Undoubtedly, the clear trend shown by our retail customer income has been the consequence of a business strategy focused at reinforcing customer experience, improving digital contact channels and taking advantage of business intelligence tools. On the next slide, number 14, you can see how our emphasis on customer experience is bearing fruit.

Our focus over the last few years has been centred on improving our customer experience by providing better benefits, improving virtual contact channels, empowering relationship managers and implementing suitable incentive systems that put the customer first. These changes, among many others, have resulted in a positive trend of our net promoter score, which reached this quarter 75%. As you can see on the chart on the top left, this clearly marks a difference with our competitors. This emphasis together with a powerful brand, as you can see on the chart on the top right, allows us to be in a superior position when attracting new customers and growing our loan book and fee based services. Specifically, the Brand Asset Valuator measures the value of a brand based on four pillars i)Differentiation ii) Relevance iii) Esteem and iv) Knowledge. According to this measure, Banco de Chile has the strongest brand in the industry, as seen on the chart on the top right. Our Bank is within the 14% of strongest brands in Chile, which is well above other banks in Chile. The combination of our powerful brand coupled with excellent customer service has also allowed us to record low levels of attrition. When we combine this competitive advantage with business intelligence, we see new and important growth opportunities to continue penetrating the retail segment and improving cross selling.

As we have said in past calls, digital banking platforms have moved from being novelties to necessities. We are proud to say that we are the best digital platform in the industry, based on a wide array of independent surveys and on our net promoter score on mobile apps. The importance of having a robust digital platform is clear when we take a look at how online and branch transactions have been evolving. On the chart on the left, in the row named Digital Banking, you can see that in only one year, personal banking online transactions volumes have increased by 30% and today represent over 50% of total transactions. On the chart on the right, you can see how important mobile banking has become. Specifically what we see is that the growth of transactions has been mainly driven by the mobile phone and to a lesser degree the webpage, while branch transactions have seen a reduction of 6.4% year-on-year. We expect that this trend of customers going less to branches to do their everyday banking needs will continue. For this reason, today 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.

In terms of business Intelligence, we are focused on implementing new initiatives in order to continue growing at attractive levels but with an adequate relationship between risk and return. For this reason, our risk department has improved our preapproved consumer loan model for the middle and upper income segment, which reinforces risk intelligence tools. These improvements will generate a series of benefits such as more efficient admission processes, better management of pre-approved loans and improved collection management. This new model has shown excellent results when back testing with historical information, it is very flexible and it can be adjusted very easily based on risk appetite we wish to assume.

Additionally, we continue streamlining processes and implementing new technologies that have translated into improved productivity and cost reductions, as described on the following slide, number 16.

Total operating expenses remained relatively flat year-on-year, decreasing by 0.1%. Despite this flat growth in expenses, our efficiency ratio increased from 46.2% in the 3Q16 to 48.8% in the 3Q17 due to the impact of negative inflation on operating income. This is even more clear when we look at the ratio of operating expenses to total average assets, which improved by 11 basis points year-on-year, ending the quarter with a level of 2.45%.

The main driver for this reduction in expenses was the result of lower personnel expenses that dropped by 2.5%, due to a lower headcount from the optimization of our branch network and merger of our external sales force subsidiary into the bank, which occurred in the 1Q17. This was partially offset by higher severance indemnities.

On the other hand, administrative and other expenses increased by 2.2% year-on-year. This was mainly due to an increase in IT expenses and costs related to leasing operations and outsourced activities mainly related to credit evaluation and data processing. This was partially offset by important cost reductions in marketing and in our distribution network, in line with the reduction of branches and less maintenance on our recently renovated ATM platform.

We firmly believe that our commitment to operational excellence and productivity are completely in line with our customer experience goals. This means that by improving how we interact with customers through better service channels and delivery times, we improve, in the medium term, our productivity and efficiency levels. For example, by providing a platform that has a high uptime and solves customers problems of entering into a branch and waiting in queues, we improve both customer experience and operating expenses. This means that the strategic projects that are being undertaken in IT should continue to help us improve our Net Promoter Score and control costs better. The important investments in IT have been one of the main reasons how we have been able to continue growing without increasing our head count or branches. In fact, as you can see in the charts on the right, we reduced our head count by 4.9% year-on-year and continued optimizing our branch network with a reduction of 19 branches year-on-year. This was done with the customer in mind and we saw during this same time frame improvements in our Net Promoter Score.

Going forward, we are confident that our permanent focus on cost control and superior commercial and operational initiatives will continue boosting productivity and customer service, resulting in better efficiency and lower attrition levels.

Risk management has also been one of the main pillars of our success and we are confident that this will continue in the future thanks to our long-term sustainable risk management approach. Please turn to slide 18.

Despite the challenging environment, we recorded another quarter of low levels of loan loss provisions reaching only $50.4 billion and a LLP ratio of merely 0.79%, both figures well below those posted last year.

As you can see, the reason for the sharp reduction in loan loss provisions over the same period last year was principally the effect of an improvement in the good credit performance of the wholesale segment. Specifically, some customers in the Salmon industry that were classified in riskier categories repaid their debts with us, thus also reducing significantly allowances for loan losses related to those loans, and others have improved their credit profile. In a lesser degree, the appreciation of the Chilean peso affected our allowances denominated in foreign currencies positively by $3.2 billion pesos. This effect is hedged in the P&L line Net Foreign Exchange Transactions.

Before going into our closing remarks, I think it's important to highlight that this lower figure of cost of risk is not only a result of an improving economy but also to our proven capability of managing risk throughout the entire credit risk and economic cycle. At Banco de Chile we invest substantial human and financial resources to develop our prudent risk management approach. This together with the high level of involvement of the Board in risk and business decisions help us to identify risks more easily before they surge and implement adjustments to minimize our exposures. This ability to manage risk effectively should assist us continue to posting the consistent returns that our shareholders have come to expect from us.

Please turn to the next slide, number 19. Before we move on to questions, I would just like to go over a few key ideas that we mentioned in this call.

The customer business results for the 9-month period were outstanding. This is aligned with our historical approach of being a traditional bank that prioritizes initiatives to create sustainable core revenues in the long-run. Thus, we continued posting good growth in customer income that expanded 6.0% year-on-year, thanks to proactively managing our lending spreads and expanding our retail customer base, which also drove fee income. Furthermore, we recorded very good levels of cost of risk of 0.92% and controlled operating expenses effectively meanwhile we continue investing in technology and business intelligence initiatives. These results were crucial to offset the negative impact of low inflation that affected non-customer income and higher corporate taxes due to the tax reform during this period versus the same period last year. Accordingly, our track record of generating a consistent bottom line is demonstrated once again this quarter by posting a slight increase in net income of 1.3% year-on-year, almost 4% if we look at this before taxes, and record an ROAE of nearly 20%.

Finally, I think it's important to highlight that this last quarter of the year will be also challenging in terms of net income, completely due to the temporary negative effect of non-recurrent low inflation figures. Nevertheless, and as you can see in our track record I would like to emphasize that Banco de Chile is committed to a strategy which its main goal is to create value in the long run through stable customer revenues. We firmly believe that our competitive advantages coupled with our superior business intelligence and our robust long-term customer centric initiatives will permit us to continue with our successful business approach and take greater advantage of the better economic cycle that lies ahead.

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