Banco de Chile 3Q18

Financial Results Conference Call

Operator

Good afternoon and welcome to Banco de Chile's third 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 morning. Thank you for joining us on our 3Q18 conference call. It is a pleasure for me to share with you our comments about the main trends observed in the Chilean economy and the banking system during the last quarter. After that, Pablo Mejia, our Head of Investor Relations, will review the financial results of our Bank.

Please move to slide number 3.

As we have mentioned in previous conference calls, the Chilean economy continues growing, confirming the existence of a positive cycle,. GDP has increased 4.4% between January and August, posting the strongest growth since 2012, well above the 1.5% observed last year. The pace of this recovery can be seen in the top left chart. In this context, Chile has reached one of the fastest rate of expansions in Latin-America during this year.

It is worth mentioning that Chile has improved its economic growth, in spite of some recent opposite forces, such as the decline in copper prices, the slowdown of some trade partners and the increasing uncertainty in the global economy. It suggests that the positive cycle of our economy is mostly explained by local factors, which are supporting the domestic demand. The upward trend observed in confidence figures is a good example of this. In the bottom right chart can be seen the pickup in both consumers and business sentiment indexes, remaining in the optimistic zone, which is above the threshold of 50 points.

The economic recovery has been contributing to more inflationary pressures. In the 3Q18, for instance, the CPI went up by 0.7% when compared with the previous quarter, raising the annual inflation rate to 3.1% in September. As seen in the top right chart, the headline CPI has returned to the Central Bank's target of 3.0%, after remaining below this number during the last two years. Additionally, the core measure, CPI excluding food and energy prices, is also picking up, which is consistent with the stronger economy.

In the labor market, however, there have been opposite signs. On the positive side, there has been an improvement in the quality of jobs, since employment growth has been led by salaried jobs. In previous years there was a drop in private employment, which was partially offset by self-employment and fiscal jobs. On the other side, there has been a sluggish growth in wages, lifting some doubts regarding the future contribution of private consumption to economic growth. Therefore, it is important to pay special attention to the evolution of the labor market in the future.

Now, I'd like to talk about our macroeconomic scenario for this year and 2019. Please move to slide 4.

In general, we expect a similar scenario in comparison to what we outlined in previous conference calls. In other words, we expect GDP to remain growing faster than the potential rate, with inflation hovering around the CPI target and higher interest rates.

Specifically, we are forecasting an economic growth of 4.0% and 3.8% for this and the next year respectively, led by strong gross investment, as seen on the two charts on the bottom of this slide.

The recent evolution of several indicators, such as capital goods imports and business confidence are still supporting this view.

In relation to inflation, the weaker Chilean peso and the stronger activity will likely contribute to maintaining the CPI around the current level. This leads us to expect that inflation will be close to 3.0% this and the next year, after posting a 2.3% increase in 2017. Given this macro scenario, the Central Bank began a tightening cycle this month, when the board raised the interest rate to 2.75% (from 2.5%). We expect further adjustments in the policy rate, to 3.5% by the end of the next year. It is also likely that the neutral overnight rate, which is around 4%, will be achieved by 2020.

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

This quarter we continued to see a positive trend in demand for loans, similar to what we observed in prior quarters. Total loans picked up to 9% because of a strong acceleration in commercial loans, in line with the better economic environment and higher business confidence. On the chart on the right, this improvement in commercial lending activity can be clearly seen in net originations in commercial loans.

It's important to mention that the recovery of the dynamism of commercial loans has occurred in an environment where consumer loans have also increased their rate of growth in the margin, while the velocity of mortgage loans has remained without major changes showing that this product is more inelastic compared to variables related to economic activity versus other lending products.

As you can see in the graph below, there is an important relationship between GDP growth and the loan cycle. We expect that higher level of GDP will be reflected in greater growth in the industry, as has already been seen in commercial loans. If we consider that the economy should grow around 4% this and the next year, and that historical elasticity of loans to GDP is close to 2 times. So, we expect that real loan growth will reach around 7% to 8% real in the coming quarters, or around 10% to 11% nominal.

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 third quarter.

Pablo Mejia

Thank you Rodrigo. Please flip to slide number 8.

Once again, we had another successful quarter in terms of core revenue and business volume growth. On an adjusted basis, we grew our bottom line by 19.2% over the same quarter one year ago and maintained a similar level quarter on quarter, equal to an ROAE of 20%.

On an unadjusted basis, we posted $128 billion this quarter. This lower result was due to an increase in loan loss provisions as a result of an implementation of new risk group models, non-recurrent effects in operating expenses and, to a lesser extent, a higher effective tax rate that went from 15.4% in the 2Q17 to 20.3% in 3Q18. The rise in income tax expense was due to an increase in the corporate tax rate from the tax reform and the fact that we have accrued sufficient income to provide a large enough dividend to fully repay the remaining balance of the subordinated debt owed to the Chilean Central Bank and, consequently, we are no longer recording a tax benefit related to these payments. These higher expenditures were partially offset by accelerating growth in both the retail and wholesale segments in terms of loan and fees along with strict cost controls and normalization of inflation. It is important to highlight that despite these impacts, we are less than 1% below the market leader in the year to date bottom line. On the following slides we will go into greater detail of these changes.

On the next slide, number 9, we can begin to see how our financial results for the quarter developed.

Total operating revenues for this quarter grew to $465 billion pesos, up 15.0% year-on-year. As you can see on the chart on the left, this growth was led by non-customer income, which posted $99 billion pesos for the quarter due to a normalization of inflation that went from nearly 0% to 0.7%, or 2.9% if this figure is annualized, which is in turn completely consistent with the inflation target rate for the Chilean economy.

Nevertheless, customer income, coming from our core business, grew strongly 6% this quarter when compared to the same period last year. This was driven by the good performance in both retail and wholesale banking segments.

The wholesale figures were supported by a more dynamic economy that increased demand for commercial loans, together with an important increase of demand deposit balances, which grew 12% year-on-year. Additionally, we saw important improvements in fees in this segment, specifically from investment banking.

In terms of Retail customer income, the expansion was mainly due to our change in loan mix that is geared towards more profitable products, as well as a lower cost of funds from our continued improvements in demand deposit balances and solid growth in fees. More specifically, retail fee growth for this segment was driven by mutual funds, distribution deals carried by our securities brokerage and a 24% increase in stock turnover, as well as higher insurance brokerage fees. On the other hand, ATM and checking account administrations fees also went up, in line with the strong growth we have achieved in checking account origination. Card fees fell this quarter versus the same quarter last year due to the almost 4% appreciation of the Chilean peso to the USD in the 3Q17 and a 2% depreciation of the Chilean peso in the 3Q18 related to our loyalty program points. Adjusting for this, Card fees would have grown in double digits.

Our Net Interest Margin has remained consistently higher than that of the local industry thanks to a good loan mix and superior funding costs. This quarter we reached 4.4%, 100bps higher than the same period in 2017, mainly due to normalized inflation.

Please turn to Slide 10 on loans

The improved business environment coupled with our more positive view of the economy has permitted us to retake growth in wholesale banking while maintaining a solid expansion in retail banking.

As you can see in the chart on the left, total loans this quarter continued to accelerate, growing 6.3% year-on-year and on a sequential basis went up 2% or 8% annualized. In line with our strategy, the retail segment continued to support growth, expanding 8.6% year-on-year while the wholesale segment managed to grow for the first time since 1Q16, up 2.8% on a 12 month basis. On top of this, we recorded for a third quarter in a row, positive QoQ growth for this segment. This acceleration is consistent with the improvement seen in private investment this year.

On the retail side, we continue seeing improving growth trends in both Personal and SME banking portfolios. Our personnel banking portfolio grew 7.6% YoY, driven by consumer loans to middle and upper income individuals. Total consumer loan originations this quarter reached record levels of $570 billion pesos, 26% higher than last year, as shown on the chart on the right. This was driven by the recent relaunch of the preapproved consumer loan model, which I will go over in greater detail on the next slide, and higher consumer demand, which together permitted us to grow 27 basis points in market share year to date, the increase posted by a bank during this year. Additionally, as you can see on the chart on the bottom right, consumer loan debtors continue an upward growth trend that began by the end of last year.

SME banking also continued its trend from the last quarters, growing in double digits of 12.5%. This growth was fostered by higher demand from customers as well as our positive outlook on the economy that allows us to adjust accordingly our risk return relationship of these loans.

As mentioned earlier in the presentation, our expectation for 2019 is that the banking industry should post levels around 10% nominal loan growth and our intention is to gain market share in our key focus areas of loans to middle and upper income individuals and SMEs. We also expect, as long as demand and business confidence remains positive, that we should be able to gradually retake part of the market share that we lost in wholesale lending in 2019. We plan to do this by continuing to leverage business intelligence, increasing share of wallet and managing customer relationships proactively through comprehensive and sophisticated value offerings, which is especially important in the wholesale segment, where we continue to see high competition.

Please turn to Slide 11

A key element of our business strategy over the past years is summarized on this slide. All of our focus has been on working diligently in preparing the bank for a new digital era in both the back office and the front office. In this new context, we firmly believe that we must provide the same level of customer service that we have offered in the past through excellent relationship managers but today that must be done by also using new digital solutions. Customers today demand that we know more about them, with less contact and they demand faster delivery times.

As you can see on the slide on the left, we have, amongst other initiatives, focused our back office digital transformation efforts on deeply understanding our customer base and their life cycles by creating new contact channels to provide our products and services.

The first main achievement was based on generating a database that was populated with numerous sources of information that included data provided directly from customers and other publicly available sources. This allowed us to better understand who our customers were and what characteristics they had in common, which permitted us to generate new strategies on how to cross-sell.

After this, we began to develop a series of tools in order to provide better service to our customers and to attract new ones. This included:

- Building database that has over 1 million potential customers, which a large portion of these have been preapproved with products by our credit risk areas. This has been made available to our account managers via an application accessible remotely, allowing us to increase significantly our productivity of current account origination levels. Also, we are not only increasing the size of our customer base but we are bringing in customers that actually use our bank. A new current customer entering into the bank reaches similar loan share of wallet levels as our historical customers within three months. As you can see on the chart on the right, current account originations have grown at record levels of 19% in the 3Q as compared to the same period last year and an impressive rate of 31% year to date. This equals to over 7% YoY growth or almost 56 thousand new accounts; ranking us first with a large difference when compared to our main peers.

- We developed algorithms to identify key events in customer life cycles to maximize lifetime value and retention. This drove sales of diverse credit and non-credit products as well as helped improve our attrition levels to around 6%.

- We also generated a personalized pricing system for retail customers: This platform uses the information we have available from internal and public sources and assesses customer risk profile. With this we can provide more competitive conditions based on the actual risk of the customer instead of basing the rates on which segment the customer is in, as we used to in the past. Also, this new platform frees up time of our supervisors and managers to work on other more value-added activities.

- We implemented a proactive customer relationship management system that allows us to continually monitor customer behavior in order to trigger alerts if there are signals that we may be reducing our share of wallet of a customer. This way we can be proactive to fix problems instead of reactive when customers call to close their account.

- We also developed a new Sales Campaign Manager that uses the data we have acquired and permits us to send out commercial offers to clusters of customers that have similar life events. For example, a customer that purchases an airline ticket probably needs travel insurance. Today we can target only those customers with a travel insurance offer. This has also been very successful and much more effective than sending out mass campaigns to all of our customer base.

- We launched a new advanced preapproved loan model for the consumer book with successful results, as I mentioned earlier. This new model is very versatile and allows us to quickly adjust our risk appetite and has proven itself to be more accurate than our prior model in determining and limiting risk. Also, more than half of these preapproved loans are taken online through (mobile or website), thus improving efficiency levels. Additionally, we are currently working on a preapproved commercial loan model for SMEs which we are certain will provide strong support for further growth and efficiency in this segment. We expect that this new model will be implemented by early 2019.

- Finally, we are on the final stages of completely rolling out our new CRM Commercial Platform. This system is being developed in-house in our innovation center. The most fundamental part of this new platform is that it will be used corporate wide and has be programmed together with each area of the bank who will actually be using the platform. This has been possible by taking advantage everything we learned by using our previous world-class platform and developing one that takes the best characteristics of that platform and adds better usability to fit our needs. Our account managers will have access to information regarding customers which we call 360 degree view and it will manage the entire pre and post sales process of products. We expect important productivity gains, for example we will reduce the time it takes to open a current account from 25 minutes to only 8 minutes, as shown in the chart. This will free up a huge amount of time of our account managers to do other commercial activities and allow us to continue improving our efficiency.

It's also worth highlighting the importance of our branch network. Despite that we have been optimizing the network by reducing branches, we believe that branches still serve a purpose for our business model and especially because we are a universal bank that attends all segments of Chile. A large number of these branches are located in areas outside of Santiago and this is precisely where a significant part of GDP is generated, especially industry, energy, infrastructure, mining, and SMEs; as well as personal banking customers. Thanks to this network, we not only have sales people in regions but also risk managers that are closer to projects, allowing us to understand risks better. This provides us with a superior local knowledge which in turn helps maintain and reduce cost of risk.

Please move to slide number 12.

Digital transformation in our front office has been concentrated in enhancing our customer’s experience by providing world-class online banking solutions together with our leading mobile apps.

We strongly believe that mobile banking will continue to increase its relative importance as a distribution channel. As you can see on the charts on the left, online transactions are growing at 26% YoY, well above the trend that has been seen at the branch level. The charts on the top right present how mobile banking today accounts for 55% of total online transactions. Also today 84% of our current account customers use either mobile or online banking, up from 80% one year ago. This is clearly the result of an important change in our composition of customers as well, more than 70% of our personal banking customers are younger than 50 years old, they are considered middle and upper income individuals and our focus is to continue increasing our customer base which includes bringing in younger customers into the bank. In fact, customers under the age of 35 years old represent 38% of total current account clients and over 60% of new customers are younger than 35 years only. On the chart on the bottom left you can also see how insurance premiums have increased thanks to the launch of our insurance app.

Finally, I think it's important to highlight our superior rating on mobile banking. The chart on the right shows how we compare to other banks in terms of real customer ratings of banking apps on the Apple and Google Play stores. Its impressive how we rank well above all of our competitors. This leading position has been a result of our admirable innovation centers and technological developments units that have more than 300 people working there helping to create new ideas and developing world-class apps and other digital channels that customers demand and appreciate. I am confident that we will continue developing new and exciting banking services through our commitment and the resources we make available to drive innovation at Banco de Chile. I think it's also important to mention that a leading company called GfK Adimark and University Adolfo Ibañez just this month recognized Banco de Chile as the most innovative financial company in Chile.

Please move to slide number 13.

As everyone is probably aware, we are the bank with the best funding structure in Chile, which is a competitive advantage and an important mid-term differentiating factor in an environment of rising interest rates, like we are seeing today.

As Rodrigo mentioned, the Chilean Central Bank this month began increasing interest rates with a 25bp hike. We expect that this will continue over the course of the next 12 months with an additional 75 bp increase. In the short-term, we should have moderate impact of repricing of our liabilities that reprice faster than our assets. However, our strategy over the last few years has been to increase the average maturities of our liabilities from 11 to 22 months, which should limit the minimal short-term impacts of the rise in rates. In the medium term, and as long as the yield curve steepens, we expect to have important benefits in our NIM from positive repricing of our assets and gapping between short and long-term. This is particularly important because we are the bank with the highest market share in demand deposits in the Chilean banking industry and these hikes should benefit the most. As you can see in the slide, DDAs represent 26% of total liabilities, where more than half is from the retail segment, and also represent 32% of total loans, substantially more than all of our main competitors and the average in the banking industry.

Please move to slide number 14 on Operating Expenses.

Total operating expenses increased 7.3% year-on-year, which was mainly due personal expenses, as shown on the top right chart.

During the first semester of this year, we successfully completed three collective bargaining agreements with our unions. We also began to apply a new accounting standard to record the customary bonuses paid to unionized employees at the end of these negotiations. This entails deferring this expense based on a straight-line method over the period of the agreement of 36 months. As a result, we recorded in the 3Q18 recurring higher expenses for this concept of $3.9 billion pesos.

In terms of non-recurring expenses, we booked $6.9 billion pesos mainly associated to bonuses paid to non-unionized employees. These bonuses are recorded in the month they are incurred as they do not qualify to be deferred over the course of the agreement that was signed with the unions.

Finally, there was an increase of $3.2 billion pesos mainly related to inflation adjustments on salaries. The bank adjusted salaries for inflation in May and November of each year.

Before moving on, I want to highlight that we are putting an important emphasis on controlling expenses as well as improving front and back offices processes by implementing new commercial and back office tools and streamlining procedures.

Through these improvements, our productivity, as shown on the chart on the right, has consistently improved, reaching $1.2 million pesos of retail loans per employee, almost 11% better than last year, reaching an efficiency level of 45.5% this quarter. We are confident that we can continue improving this level of efficiency through our effective cost management strategy and by delivering superior top line growth.

Please move to slide number 15.

Loan loss provisions this quarter reached $95.3 billion, equal to a ratio of 1.43%. This higher level of cost of risk is chiefly due to a one-time charge related to a the implementation of new group based provision models of approximately $39 billion, mainly affecting consumer loans and the acceleration in growth that we have been experiencing. This was partially offset by a good performance in our wholesale book.

It's important to mention that the provision charge for the new model does not reflect deterioration in the portfolio. It takes a prudent risk approach that includes new factors which have translated into a higher conservative coverage ratio. Additionally, NPLs remained flat YoY and decreased QoQ, confirming the quality of our portfolio. Adjusting for this effect, our loan loss provisions ratio would have reached 0.84%, in line with the prior quarters.

It is important to reiterate that our long-term consistent strategy is based on prudent risk management policies that ensure the sustainability of our business for our stakeholders. This undoubtedly has been the main driver of our success and has differentiated us significantly from our competitors.

Please turn to Slide 16

We are very excited to highlight that as of July, we have accrued sufficient net income to fully repay the subordinated debt that one of our shareholders maintain with the Central Bank from the financial crisis of the 80s. This final installment should take place at the end of April of 2019 and beginning May 2nd, SM Chile shares will no longer trade on the stock market. Registered shareholders of the SM Chile A, B and D series shares will receive approximately 3.4 Banco de Chile shares while SM Chile E stock holders will receive one Banco de Chile share for each of their respective shares of SM Chile. Once this occurs our free float will increase from 27.7% to approximately 44% and our stockholder structure will become simpler with LQIF holding directly 51.2% in Banco de Chile, Ergas group which has been a shareholder since the merger of Banco de Chile and Banco Edwards in 2002 holding 4.5% and the rest will be held in free float.

It's also important to mention that last week we made changes to our ADR program and on November 15 our ratio of local shares to ADRs will change from 600 to 200. This was done to align our ADR price with other bank share prices, which could also help improve trading volumes.

Please turn to Slide 17 for highlights

We are pleased with our results this quarter. Despite that our bottom line was below the levels that we have seen in prior quarters due to the one-time provision charge related to the implementation of new group-based risk models, we have made important advances across all business lines.

For a third quarter in a row, our wholesale segment has posted positive growth. This together with strong figures in the retail segment have permitted us to record a 6.3% increase in total loans.

Consumer loans origination was the highest in our history, up 26% YoY and retail income was dynamic thanks to healthy fee growth from our subsidiaries and also to robust current account origination that drove current account administration fees.

Finally, through an effective cost management strategy, we reached 45.5% efficiency level, despite higher than regular costs associated with the collective bargaining agreement.

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