Banco de Chile 1Q17
Financial Results Conference Call

Operator

Good morning everyone, and welcome to Banco de Chile's first Quarter 2017 results conference call. If you need a copy of the press release issued on Monday, 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 and Daniel Galarce, Head of Financial Control.

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 1Q17 results. To begin I'll present some comments regarding the macro environment in Chile and discuss our strategy and how we have been accomplishing the goals we have set. After this, Pablo Mejia, our Head of Investor Relations, will discuss our 1Q17 financial results.

Please turn to slide number 3.

In general, the Chilean economy continues posting a similar trend to that observed in the previous quarter: sluggish economic growth, low inflation and interest rate cuts.

In particular, the economy grew only 0,2% in March, following a 1.3% contraction in February. As a consequence, the GDP grew 0.2% in the first quarter, after increasing by 0.5% the previous quarter. However, it is worth mentioning some important aspects: First, the subdued growth was largely explained by the contraction in mining activity, as seen on the top left chart, as a consequence of the strike in the biggest mine in Chile –Escondida-, which lasted 42 days. These types of shocks generate only a temporary impact in GDP. In the same chart, you can see the rest of the economy has remained in positive territory. Second, we have seen better global conditions, as both copper prices and global activity are higher than expected. In this context, we think that 1Q17 was the turning point of this negative cycle.

In the labor market, the unemployment rate remains low, as seen on the top right chart. In March, it posted a slight increase to 6.4% (from 6.2% in February), well below the average observed in similar cycles. However, it is important to mention that job creation has been driven by self-employment rather than waged employment, reflecting that labor conditions are weaker. Jobs in both mining and construction sectors are falling.

Inflation remains in the lower part of the Central Bank range. In March, annual inflation stood at 2.7%, while the CPI that excludes food and energy remained at 2.2%. Both the stability in the Chilean peso and the higher output gap have explained the downward trend in inflation. You can see its evolution in the bottom left chart.

Despite the weak growth, there are several leading indicators anticipating a recovery over the next quarters. For example, consumer goods imports have risen significantly, as seen on the bottom right chart. Additionally, the positive return in the Chilean stock market and the marginal recovery in private expectations are also suggesting the possibility of better macroeconomic conditions in the near future.

Now, I would like to discuss our macroeconomic baseline scenario. Please turn to slide number 4

We think that the 1Q17 marked the turning point in the negative cycle. Since the weak growth was led by temporary effects (strike in Escondida), and external conditions are better, we expect an upward trend in the GDP growth throughout the year. Our 1.6% estimate for 2017 is consistent with an average expansion of 2.2% between the second and the fourth quarter. We expect 2.8% for 2018, in line with the potential growth of Chile.

On inflation, we expect the CPI to remain around the current levels, reaching 2.8% at the end of this year. This forecast is the result of two opposite forces: a positive contribution from the weaker currency, and negative from the below trend growth.

Finally, we see room for a lower monetary policy rate. This year, the Central Bank has reduced the rate three times, totaling 75 bps. In its April meeting, the board maintained an easing bias, signaling the existence of more room for further cuts.

Now I'd like to talk about our strategic focus and key initiatives. Please turn to slide number 7.

As we have mentioned in previous conference calls, our strategy is based on three pillars:

1) Customers at the center of all our decisions,
2) Focus on efficiency and productivity, and
3) Strengthen the relationship with society and our commitment to Chile´s economic development.

Regarding customers, we have defined three main lines of action: Continue developing digital banking initiatives mainly through expanding our remote channels, advancing in the implementation of a new CRM platform, and strengthening our loyalty programs, all of which are critical to expanding our client base by improving customer experience, and supporting a sustainable and profitable growth in the long-run.

We are convinced that banking is changing. Customers are going less to branches and are demanding better alternative contact channels. This has driven us to streamline our branch network, optimize how we offer services in our branches, and invest in remote banking platforms. In this context, we have achieved significant progress over the last two years, which has translated into being recognized as the bank with the best digital banking presence. These and other initiatives have been critical to achieve our excellent results. Our net promoter score, which evaluates net recommendation, reached 76% in March, leading the Chilean Banking industry. Additionally, the number of current account holders grew 6.7% YoY, equivalent to approximately 50,000 new customers, which outreaches the expansion recorded by our main peers within the same period.

We also continued making progress in implementing our new CRM platform, which is building in house, taking advantage of the knowhow we have accumulated using our current system. The new platform will be used by all commercial segments, from Corporate banking to Banco Credichile, providing a complete on-line 360 degree view of our customers. This has been one of our main projects during the last year and we are confident that it will allow us to offer a better and faster service to our customers.

In terms of our loyalty programs, we have recently entered into a new alliance with British Airways, which further expands the benefits we provide customers when they use our credit cards. This agreement enhances the existing travel alliances that we have with Delta, Iberia and SKY airlines. Through improvements in our loyalty programs, we have been able to attract new customers, increase usage rates and revolving credit on our cards while strengthening relationships, which is in line with our selective and profitable growth strategy.

With respect to efficiency and productivity, we are focused on two main initiatives. First, Business Intelligence is by far the most important tool that has improved several key commercial activities. One that I would like to highlight is the exclusive development of personalized pricing platform in loan interest rates for retail customers. Specifically, account managers are provided, in real time, with a range of spreads for a particular customer, which takes into account the level of penetration and the customer's credit risk profile. This mechanism has several advantages, such as reducing lead times, fewer manual processes and a more accurate relationship between risk and return. A second group of initiatives aims to optimize our sales model and branch network. In this context, we reached important synergies after merging our promarket subsidiary into the Bank's operations, reducing the headcount by approximately 320 employees. Additionally, as customers continue to use more our digital platforms, we have optimized our branch network by means of integrating several Credichile offices, our consumer finance division, into Banco de Chile branches, while others were merged with other Credichile branches. This process was carried out taking the utmost care of affecting as minimally possible customer service. These initiatives, among many others, have permitted us to continue improving efficiency indicators as you can see in the chart on this slide.

Finally, the bank has continued working in several activities that strengthen its relationship with society, a critical aspect to ensure the bank´s sustainability in the long run. In this regard, our strategy considers the following areas:. Overcoming adversity, Supporting for entrepreneurship and providing development of access to quality education and financial literacy. More information of our activities can be found in our 2016 sustainability report, which is available in our webpage.

With respect to our main actions during 1Q17, we actively contributed during the severe forest fires with volunteer workers, collection campaigns and direct donations. We also held a national entrepreneur summit, with the purpose of training and promoting a group of selected entrepreneurs. Also, we recently released an Inclusion Policy for people with physical disabilities that defines guidelines of justice, respect and equality. By openly defining these concepts, we recognize inclusion as a way to contribute to the development of a country with more equal opportunities for everyone.

Now I would like to pass the call to Pablo, who will go over the results in the Banking Industry and Banco de Chile.

Pablo Mejia

Thanks Rodrigo. Please turn to slide, number 8.

Despite the persistent weak economic environment, we ended the quarter strong, with a bottom line of $140 billion pesos, equal to an ROE of 19%. We achieved this by growing operating income by 3% YoY, thanks to improved spreads and higher fee revenues that compensated lower non-customer income. Also worth mentioning is the evolution of risk in our portfolio where the positive LLP effect of the reduction of wholesale loans more than offset the slight deterioration we cautioned in previous calls and have finally begun to see industry-wide in the consumer loan book. Finally, through strict cost control, operating expenses decreased YoY by 1%.

Before moving on, it’s important to also highlight our capital base. Today we have an outstanding Basel Ratio of 13.9%, above the average in the industry and our main peers as of February 2017. More importantly, our Tier 1 ratio increased from 10.2% in the 1Q16 to 10.8% this quarter. This trend is in line with increasing regulatory requirements seen across the world that are expected to be implemented in Chile soon.

Please turn to the next slide, number 9, on Operating Revenues.

Operating income grew 3% YoY thanks to strong customer revenues that rose almost 7% YoY, and continued to show a positive trend in spite of a weak economic environment. This result offset lower non-customer income.

Specifically, the growth in revenues was due to:

- First, an increase in loans and deposits, as you can see on charts on the right. Loans grew a moderate but focalized 3.7% YoY and demand deposits were up 5.9% in the same period. Our effort to grow profitably together with our proactive management of lending pricing derived in an increase of 13 basis points YoY in spreads, as shown on the bottom right.
- Second, a rise in net fees of 12.7% YoY chiefly due to transactional products as a result of cross-selling, a larger and growing customer base due to effective commercial strategies that prioritize an increase penetration of high income individuals, and the revision of our loyalty program resulting in a one-time recognition of lower commissions expenses.
- Third, the positive effect of exchange rates on hedges and lower cost of funds owed to repricing on short-term interest-bearing liabilities as they reprice quicker than assets. This is the expected effect of the reduction of the overnight rate in the short-term.

These positive effects were partially offset by lower revenues from trading activities due to a strategy of reducing interest rate sensitivity of the trading book in an environment of historically low interest rates and the effect of lower inflation on net interest income that –measured as UF variation– increased 0.47% during the quarter. This figure when annualized only almost reaches 2%, well below the 3% annualized inflation reached in 1Q16.

In summary, it is important to mention that our proven business strategy and the progress in our key strategic projects has permitted us to keep a sustainable and consistent growth in customer revenues. While this progress has slowed due to lower dynamism of the economy, which has affected significantly demand for loans specifically from our corporate customers, we managed to record another quarter of solid and diversified revenue generation, particularly driven by customer income, that allows us to be more resilient during economic cycles of low growth as we are currently facing.

On slide 10 is a breakdown of our loan portfolio by product and segment.

As you can see, total loan growth remained in the mid single digit levels, increasing 3.7% YoY, in line with the slowdown in the economy. By product, this growth was led by mortgage and consumer loans growing 8.8% and 5.4%, respectively. Housing loans have been trending down for the last quarters, for us and the industry, due to the end of the tax benefit for real estate construction companies, which generated an above average historical demand. We expect that the deceleration will marginally continue and growth rate should stabilize around 5% in real terms. Consumer loan growth has been concentrated in middle and upper income segments and has been driven through strong commercial initiatives such as the loan pre-assessment for over 200,000 potential customers, which was complemented by the personalized pricing model implemented in March that Rodrigo mentioned earlier. This has been made available in a platform in the cloud so our account managers have remote access to this information, thus driving productivity gains. In commercial loans, SMEs continue to drive growth with an increase of 11% YoY while wholesale loans continued weak, decreasing 3% YoY in line with the low investment rates that has limited the financing needs and demand of companies. The strong growth seen in SMEs has been due to a variety of factors including:

- First, there is room to grow as the segment is characterized by low penetration levels.
- Second, effective commercial strategies and trainings that have improved productivity of account managers
- Third, use of business intelligence to better target new customers
- Fourth, on-site visits by account officers to improve relationships with customers

Please turn to the next slide, number 11, on Loan Loss Provisions.

In a challenging environment, Banco de Chile continued posting good levels of risk in 1Q17 with loan loss provisions of $63 billion and a LLP ratio of 1%, both figures similar to those posted last year.

As you can see more clearly on the charts on the right, total loan loss provisions remained relatively flat due to the reduction in loans of our wholesale customers, and the effect of non-recurrent regulatory changes occurred in the first quarter 2016. This was partially offset by the negative effect of the lower appreciation of the Chilean peso in the current quarter when compared to a year earlier, which affects our allowances denominated in dollars. Additionally, this figure was affected by our strategy of expanding the retail segment together with a tempered deterioration in payment behavior, mostly concentrated in consumer loans, aligned with the macroeconomic environment.

Please turn to the next slide, number 12, to take a closer look of the evolution of risk in our Consumer Loan book.

As you can see on the two top charts, the banking industry has experienced greater level of risk in the consumer loan portfolio reflected in both an upward trend in delinquency ratios and larger charge-offs to average loans indicators. Banco de Chile follows this trend but continues to outperform the industry by posting lower levels of non-performing loans, in spite of holding a much larger consumer finance segment as a percentage of total consumer loans as compared to other banks, described on the bottom left chart. On the other hand, this mix results in higher charge-offs ratios that we more than offset with better levels of interest yields than our peers, as described on the top and bottom right charts. This demonstrates our superior portfolio. Our interest yield on consumer loans, net of risk, is higher than our main competitors and we have been able to continue to grow strongly with only marginal effects on spreads.

It's important to mention that a key to our proven capabilities in managing asset quality is 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 at Banco de Chile.

Please turn to the next slide, number 13, on Operating Expenses.

As we mentioned earlier and in previous calls, one of our strategic priorities is to increase productivity and efficiency. In that regard we have taken several measures of cost control, with some of them already bearing fruit in this quarter where total expenses decreased YoY by 1%, giving us an efficiency ratio of merely 45.5%, a noteworthy level when we consider this has been achieved in an environment of low inflation recorded this period. Specifically, personnel expenses decreased 4% YoY mainly associated with a reduction in variable compensation due to lower headcount. This occurred due to merging operations of our external sales force subsidiary, promarket, into the bank and the optimization of our branch network as Rodrigo previously mentioned. Also during the quarter, we posted a reduction in severance indemnities due to a higher than normal level of these expenses in the 1Q16.

On the other hand, administration expenses increased only 3% YoY largely due to higher IT expenses. Specifically, these expenditures in IT reflect our commitment to operational and customer experience excellence and are in line with our strategic focuses that aims to put the customer at the center of our decisions and continue improving our operating efficiency, through projects that are centered on increasing productivity in our branches and back office activities, expanding online contact channels and digital banking services, redesigning core processes and automating back office activities.

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

Please turn to the next slide, number 15.

Before we move on to questions, I would just like to highlight a few key ideas that we mentioned in this call.

First: There are good reasons to expect that the 1Q17 was the turning point of the negative economic cycle in Chile. This should gradually translate into a more dynamic banking activity by the end of the year.

Second: Digital banking platforms have moved from being novelties to necessities. In this regard being leaders in digital innovation and transformation has become one of our priorities. We are optimizing our branch network and reinforcing all remote channels in order to provide the customer experience our clients demand and to improve overall productivity in the bank.

Third: We are focused on delivering responsible growth. This means that we aim to preserve profitability in the lending business. This has resulted in slower growth in wholesale lending due to weak demand as a consequence of sluggish investment growth and strong competition leading to aggressive pricing in some deals. This also means taking a cautious and prudent stance in retail lending and taking care of spreads as we have seen a slight increase in NPLs industry wide. Nevertheless, we are confident that our unique credit risk management approach, which is deeply present throughout the entire credit process, should continue to allow us to project and control risk well throughout the economic cycles we face.

We believe that our strong strategy, competitive advantages and solid customer income-generating capacity will permit us to maintain our robust track record in net income and profitability. Now if you have any questions, we would be happy to answer them.

Q&A Session

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