Banco de Chile: Comments on the Fourth Quarter 2014 Financial Results

Good morning, it is a pleasure for me to share with you our comments on Banco de Chile's fourth quarter 2014 financial results.

Please turn to slide number two. To begin, we will discuss the developments in the Economic Environment and the results of the banking industry, followed by a review of Banco de Chile's results.

Please turn to slide number three, which contains the economic highlights.

Chile's activity remained weak in the last quarter, as shown by the Monthly Economic Activity Indicator on the top left, although there was a recovery in the last months of the year. Available data suggests that the activity posted a 1.7% expansion in 2014, due to the expected 1.6% expansion in 4Q from 0.8% in the previous quarter. Therefore, the economy achieved its second consecutive year with a below trend growth.

Several indicators demonstrate that domestic demand led the slowdown. Specifically, the 4.5% contraction in capital goods imports in 4Q14 indicated that gross fixed investment stayed in negative territory, although there was a moderation in its pace of reduction. You can also see a moderation in private consumption growth, as both retail and supermarket sales reduced their annual growth in last quarter to 0.8% and 1.2% respectively. On the other hand, there was a significant improvement in the contribution from net exports, led by the higher dynamism of exports, mainly due to the positive impact of the weaker exchange rate. It is also worth mentioning that the unemployment rate was 6.0% in 4Q14, confirming that labor conditions remain tight, in spite of the weak economic growth.

Please continue to slide number four.

As you can see on the upper left hand chart, headline inflation has remained above the upper bound of the central bank range, 4%, since 2Q14, despite the slowdown in local activity. Particularly, it followed an upward trend until October of last year, when it posted a 5.7% annual rate, due to the higher tradable inflation led by the weaker exchange rate. However, headline inflation has fallen in recent months as a consequence of lower international energy prices, which is an important component in Chile's CPI basket. Core measures, including CPI core and CPI excluding food and energy have been increasing, which lifts doubts relative to second round effects over other prices. Factors such as the below trend economic growth and the fall in oil prices could help to mitigate this risk.

As a result of the weak economic growth, anchored long term inflation expectations, and the lack of a significant improvement in the most relevant leading indicators, such as consumer and business confidence, the central bank reduced the overnight rate by 100 bps in 2H14, finishing the easing cycle in October, when the rate was decreased to 3.0% as you can see in the upper right hand chart.. Therefore, monetary conditions are currently in expansionary territory since the interest rate is close to 0% in real terms. In this context, the central bank has maintained a neutral bias in the last press releases, suggesting that a change in the interest rate is not the most likely scenario, at least in the short term.

On the bottom left, the graph shows how the exchange rate weakened for the most part of the year. This can be attributed to several factors including the stronger multilateral dollar, a more expansionary monetary policy in Chile and lower copper prices. Particularly, the Chilean peso lost 13% of its value against the dollar in 2014.

Public finances remain strong. According to official figures, there was a fiscal deficit equivalent to 1.6% of estimated GDP in 2014, slightly below the official estimate released in October. In 2013, the deficit was -0.6% of GDP. The breakdown shows that this worsening was largely due to the weak 1.5% increase in fiscal revenues, led by the 8.2% real annual contraction in copper revenues. On the other hand, fiscal spending rose by 6.5%, as a consequence of the 7.4% increase in its capital component.

However, the structural balance of the central government was only -0.5% of GDP and total fiscal savings represented 12.9% of GDP, suggesting that Chile still has enough room to make countercyclical policies.

It is important to highlight that there is a broad consensus that economic growth will improve this year. According to the last central bank estimate, economic growth would increase to a range between 2.5% and 3.5%, while analysts from the private sector are expecting a 2.6% expansion this year, according to the economic expectation survey conducted by the central bank. However, both figures continue to suggest that Chile will grow below its potential.

The key factors behind the recovery are the lagged effects from interest rate reductions, the expansionary fiscal policy and the positive contribution of the net exports due to the weaker currency and the recent improvement in terms of trade, despite the fall in copper prices. Finally, it is important to mention that Chile is facing important risks this year, especially the downside risks in China´s economic growth and the possibility of unexpected negative effects coming from the beginning of a tightening cycle in the U.S.

Please turn to slide number 6 for a review of the main figures for the Chilean banking system.

As of november 2014, loans in the banking industry grew 4.8% YoY in real terms. This growth was lower than the average recorded over the last few years in line with the slowdown, which has affected investment and consumption. Nevertheless, mortgage loans continued growing at a solid double digit rate of 10.5% YoY. This was not the case if we look at consumer and commercial loans which grew at 3.5% and 2.8%, respectively. Looking forward, we expect that loan growth should pick up and end 2015 in the range of 5.0%, consistent with our base economic scenario for Chile.

Despite the slowdown which affected loan growth and different industries negatively in 2014, net income grew substantially in the banking sector, as you can see on the chart on the right. As of November 2014, net income reached $2.3 trillion pesos with a ROAE of 18.8%. This strong result was primarily due to the higher than normal inflation rate experienced in Chile, which affected the UF GAP position banks hold positively, term gapping due to favourable changes in interest rates that were partly a result of the consecutive cuts to the overnight rate, together with good risk indicators and a one time tax benefit on deferred tax assets.

Now I will pass the call to Pablo, Head of Investor Relations which will discuss Banco de Chile's results for the 4Q and Full Year of 2014

On slide number 8, you can see the quarterly and yearly results for Banco de Chile

In spite of non-recurring operating expenses, Banco de Chile has reached an excellent result of $128 billion pesos for the fourth quarter, as you can see on the chart on the left, which actually was the average quarterly net income achieved in 2013. The average quarterly income for 2014 was $148 billion.

On an annual basis, net income increased by 15% YoY and reached $591 billion pesos, as shown on the chart on the right. Proactive management of our net asset position in UF and the accounting benefit from the tax reform on deferred taxes played a fundamental role in this exceptional result. However, these factors were complemented with important progress and improvements in various aspects of the bank, including important developments in technology and innovation in online platforms and the implementation of business intelligence tools, which drove growth in the retail segment. Additionally, we maintained a prudent risk management focus, which kept loan loss provisions under control, and recorded good levels of efficiency.

Moving on, slide number 9 is a review of our operating income.

For the fourth quarter of 2014, operating income amounted to $440 billion pesos, a 12% increase from 4Q13. This result was mainly due to our UF structural GAP, thanks to the UF variation that rose from 0.95% in 4Q13 to 1.9% in the 4Q14, and also, higher income from loans, which presented a 5.9% YoY growth.

For 2014, operating income totaled $1.6 trillion pesos, a 13% increase from 2013. The main drivers for this increase include:

1. First, a larger loan portfolio,
2. Second, a higher demand deposit base which partly offset the negative effect of lower margins due to the consecutive cuts in the overnight rate,
3. Third, a higher revenues from asset and liability management, and
4. Finally, a positive effect on operating income due to hedges we maintain on credit provisions for loans denominated in dollars

Each of these factors will be discussed in further detail on the following slides.

Please turn to slide number 10, which focuses on loan growth.

Loans have grown 5% YoY and 2% when compared to the previous quarter, reaching approximately $22 trillion pesos as of December 31st, 2014.

As you can see on the chart on the left, loan growth was mainly concentrated in retail banking, in line with our strategy to strengthen this business area. As such, growth in this segment grew 12% YoY and 4% QoQ. Today, retail loans account for 54% of our loan book which is a substantial increase when we compare to how we began the year at 50%.

On the table to the right, you can see that this increase is concentrated mainly in mortgage loans, which grew almost 15% YoY. This is followed by consumer loans to the middle to upper income segment, which grew 12% YoY, and to a lesser extent, to small and medium companies with a 9% growth YoY. However, consumer loans in Credichile, expanded a modest 3% YoY.

These results were achieved thanks to our business strategy, which is based on understanding and anticipating our clients' needs. In order to achieve this, we have has used business intelligence tools to gather new information and data, allowing us to create specific clusters and offer each of these a personalized value proposition. This has resulted in high loyalty and retention rates from clients.

In addition, Virtual Banking was significantly improved over the course of 2014 by introducing a new way of accessing products and benefits without having to go to the bank. Specialized sales executives and effective contact protocol are both a part of this new attention model that has shown very positive results in a short time period.

It is also important to mention that we have made significant progress in improving customer experience. Part of the work developed over the year was focused on identifying and establishing emotional relationships with our clients and will now allow us strengthen these bonds in order to increase client loyalty and retention.

The wholesale segment, on the other hand, has decreased its volumes by 2% mostly because of stronger competition from smaller banks, a less dynamic economic environment due to uncertainty and the end of the investment cycle in mining, and to a higher base of comparision due to the fact that in 2013 we granted short term loans to specific wholesale customers for approximately $560 billion pesos. If we exclude this, our loan portfolio would show an approximate growth of almost 4% YoY.

Despite this result, we concentrated our efforts on cultivating our relationships with wholesale customers by increasing significantly on-site visits which enabled us to manage risk more effectively and integrate a more strategic advisory orientation to our products and services that we offer.

Please turn to the next slide, number 11, on financing.

Funding remains one of our most important competitive advantages thanks to our leadership in zero interest bearing demand deposits and our first rate risk rating.

Demand deposits account for 25% of total liabilities and have grown by 16% YoY thanks to our efforts to improve relationships with customers in order to not only be their first choice for loan purposes but to also be their main bank for all financial services. As a result, demand deposits in retail grew 17% due to commercial initiatives that strengthened relationships, which we started mentioning in the previous slide. Some of these initiatives include 60,000 gross new current accounts, 110.000 gross new payroll and pension direct deposit agreements, and new innovative mobile apps that also help to strengthen ties, among others.

In the wholesale segment we also grew strongly in relationship building with our customers by increasing significantly the amount of onsite visits and improved the family office platform, resulting in a more effective product and service offering.

We also grew 16% YoY in debt issued which is mainly composed of bonds and are a more stable source of funding. As a consequence, debt issued which is a more stable source of financing grew to represent 18% of funding and time deposits dropped to 35% from levels that were well above 40% in the past, as a result of our growth in DDAs and Bonds.

Please turn to slide number 12 on Operating Margins.

This slide brings together what we have mentioned and discussed so far in the previous slides.

First, you can see that the blue line, which is the total operating margin for 2014, outperformed the levels achieved in 2013 and 2012. This was mainly accomplished by higher non customer income, the purple line. During 2014, we successfully managed our UF GAP position on our balance sheet to take advantage of the higher inflation to generate more revenues. In addition we profited from term gapping, repricing of liabilities and revenues from hedges that have a negative offsetting effect in fee income and provision expenses. These revenues compensated the lower margin generated in our fee business, represented by the red line, which is due mainly to regulations and to the negative effect of the depreciation of the exchange rate, since it directly affects our obligations related to our loyalty programs that are denominated in dollars.

Additionally, interest income from customers, the green line, fell approximately 20 bps YoY due to lower margins from our demand deposits, which is a result of the important decrease experienced by the overnight interest rate.

It´s important to highlight that despite the fact that the overnight rate dropped during the year, we almost completely offset this lower DDA margin by growth, so revenue generation from DDA´s remained relatively flat YoY. In terms of loan spreads, we also were able to mantain them flat YoY thanks to our sustainable business model, which aims at maintaining a solid risk/return relationship.

On the bottom right you can see that as of November 2014, we rank second Operating Margin. This is very impressive, due to the fact that we are not the most retail focused bank in the industry and still have room to grow in this area.

Please turn to slide number 13 on Loan Loss Provisions.

This past year we have faced various external factors that influenced risk expenses, including economic deceleration, slower investment and potential changes in the unemployment rate and composition. Nevertheless, our loan loss provisions have increased mostly because of extraordinary effects rather than credit deterioration.

For the quarter, Banco de Chile presented $74 billion in loan loss provisions, 9% above the same figure in the 4Q13. On an annual basis, LLP grew 18% YoY which is mainly explained by:

1. Loan growth, which expanded an average of 7% YoY in 2014, concentrated in the retail portfolio. This explains approximately $12 billion of the variation recorded in loan loss provisions.
2. In second place, because of higher additional provisions. During 2014, a total of $22.5 billion pesos were destined towards additional provisions, compared to the $10 billion established in 2013. The higher charge is consistent with both, our prudent risk approach and our outlook regarding potential risk in different economic sectors, especially if the economic recovery takes longer than expected.
3. Third, because of the negative impact from the exchange rate on US$ denominated allowances. This accounts for $8 billion and was driven by a peso depreciation of about 15% in 2014.
4. Finally, because of net deterioration of approximately $10 billion which involves the release of allowances for loan losses of around Ch$9 billion in 2013 as a result of the improvement in the financial condition of a specific corporate customer.

This resulted in an increase of our LLP ratio from 1.2% in 2013 to 1.3% in 2014. If we adjust this ratio by removing additional provisions and FX effects, the result is a ratio of 1.18%.

In this matter, we continued to post solid figures when compared to the industry with non-performing loans reaching only 1.2%, substantiall below most of our competitors. Additionally, it's important to mention that we remain as one of the safest banks in the local industry with a coverage ratio of almost 2 times.

Please turn to slide number 14 on Operating Expenses.

For the 4Q14, operating expenses totaled approximately $217 billion pesos, increasing 28% when compared to the same quarter last year. This increase was due mainly to non-recurrent personnel expenses for about $45 billion which was associated with the collective bargaining agreement that took place with our unions in December this year. We are very pleased with this process that took place as we were able to reach an agreement well before the final deadline. The benefits agreed upon were extended to to ununionized workers, which inspires a positive work environment and strengthens the relationship with the entire workforce.

For the full year, our cost base was affected by various extraordinary effects including:

1. First, the effect of non-recurrent personnel expenses related to bonus paid in the bargaining agreements mentioned earlier.
2. Second, an increase in personnel expenses of about 5%, which is completely in line with inflation. Salaries are adjusted for CPI every May and November. This year adjustments totaled over 5% , and
3. Third, administrative and other costs increased by 9% YoY, posting $330 billion in 2014. Its important to note that most rental and service agreement contracts in Chile are also indexed to inflation. So the higher than normal inflation during the year also affected admin expenses. Additionally, we also incurred higher expenses related to IT and communication expenses, branch network, and in lesser degree to outsourced services associated with internal developments.

In terms of our efficiency index, we posted an excellent efficiency ratio of 43.4%, despite the one-time charge related to the bonus with our labor unions. If we look at November figures, which don't include this charge, we led the industry with an efficiency ratio of 40.9%. Obviously, this figure, along with the figures posted by our competitors, were significantly influenced by high operating revenues due to the positive effect that inflation has on our numbers, but even if we exclude this effect, the ratio would remain very good at a level near 44%.

Please turn to slide number 15.

As you know, we have had an attractive and consistent level of profitability during the last years. Even when we have raised capital, we have quickly put that capital to use and generated high return, substantially more than our peers in both ROAE and ROAA. Currently, both ROAE and ROAA have reached 1.3x and 1.4x our peers.

In the long term, we believe that we can maintain a sustainable ROAE above 20% because:

1) First, we have room to continue to improve our loan mix, to become a bank that is more focused on the retail segment
2) Second, we believe that we can continue increasing the profitability of our wholesale book by further improving our relationships thus increasing number of products per customer, and
3) Third, there is still room to continue improving our productivity levels which should translate into sustainable improvements in our efficiency ratio.

In terms of 2015, we expect a good year in terms of core revenue growth in line with our expectations of the modest recovery of the economy. Nevertheless the normalization of inflation will have an important effect on our bottom line and that of the industry's. This is particularly true for the first quarter of 2015 which we estimate inflation to be negative for the quarter as measured by the UF.

Please turn to slide number 16, where we would like to highlight some of the main accomplishments of 2014.

First, Banco de Chile has been able to successfully adapt to new and more demanding customers who seek easy and fast access to financial services and products through various online platforms. In 2014, we launched three mobile apps which allow customers to remotely access their financial information and make transactions quickly and securely. These applications have put us in the forefront of the Chilean Banking industry in terms of innovation.

For second year in a row, Banco de Chile was awarded first place in the Merco ranking for renown corporate reputation. This consolidates the corporation's prestige and reaffirms the trust that customers and the community have in the Bank, which is also reflected in our excellent risk classification.

We have made organizational and cultural changes in the Bank to adapt to new and more demanding customers, which is why we have created a new strategy to approach our customers and establish real relationships in order to give them a better and more personalized customer experience. This initiative has brought us to implement the best service standards and practices, and also to listen and understand our customers. The new information taken from these rewarding experiences have allowed us to integrate our strategy into the products and services we offer.

Another achievement for the Bank this year was its fundamental role in the largest M&A operation in the history of Chile. Banchile Citi Global Markets was in charge of conducting this merger, which undoubtedly consolidates Banchile as a key player in the local corporate market.

Other achievements include the implementation of new business intelligence tools, which have allowed us to improve our efficiency in branches and sales productivity; a better value proposition, which seeks to personalize the products and services offered to clients; and finally, efficient funding management, where we have continued to diversify our liability structure by placing debt abroad.

These accomplishments, together with the secondary offering by LQIF, have consequently resulted in a stronger presence in the stock markets, increasing our trading volumes by 86% YoY and ranking us first in terms of the most traded financial institution stock in the Chilean Stock Exchange.

To wrap up, we have succeeded in achieving these goals because of our customer centric strategy, our important focus on risk management, and our capacity to adapt to new and more demanding environment.

Now, if you have any questions we would be happy to answer them.

Closing Sentence

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