Banco de Chile 4Q19 Financial Results Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile’s fourth Quarter 2019 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 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 afternoon everyone and thank you for participating in this conference call. Today, I’d like to share with you our view about the evolution of the Chilean economy, with a special emphasis on the new macro perspectives after the social unrest started in October. After that, Pablo Mejia, our Head of Investor relations, will analyze the financial results achieved by Banco de Chile during the last quarter, and our guidance for this year. As usual, we will finalize this conference call with the Q&A section.

I'd like to start with an overview of the Chilean economy. Please flip to slide number 3.

As you probably know, the last quarter of 2019 was marked by protests as a consequence of the social unrest that started in October, affecting economic growth. As a result, GDP fell 3.4% and 3.3% year on year in October and November, after an expansion of 3.3% in the third quarter. In the chart on the left, you can see how the economy was negatively affected by the social crisis. This weakening can be explained by both, supply and demand factors.

Protests were accompanied by damage to private and public infrastructure, reducing the capacity for growth or, in other words, the aggregate supply of the economy. According to official estimates, the damage was equivalent to nearly US$3Bn, or 1% of the GDP affecting the subway service, as well as retail and transportation sectors, reducing the average working hours. However, these supply shocks should be temporary, as the government announced an ambitious reconstruction agenda that will probably be implemented this year. In fact, there was a strong recovery in the December monthly GDP figure, which posted an impressive 3.5% MoM, and 1.1% YoY, overpassing private expectations. This reinforces our expectations about a temporary slowdown.

There have also been important impacts on domestic demand, which have been reflected by different figures such as business and consumer confidence indicators, and retail sales. However, some figures from retail and manufacturing sectors showed an improvement in December, in line with the trend seen in GDP. Although unemployment has remained stable, as seen in the chart on the bottom left, it is probable that there could be a slight deterioration in the near future, since the labor market has a delay following slower growth. It is important to pay special attention to the evolution of employment, as it has an important impact on the banking sector, especially in terms of asset quality.

Despite this environment, the inflation rate, which is a key driver of our net income, has gradually been increasing during the last months. This trend can be seen in the top right chart, which clearly shows that tradable inflation, which represents nearly 60% of the CPI basket, has led the pick-up in the overall inflation. Consequently, the inflation rate achieved the policy target of 3.0% set by Central Bank, leaving more room for the Central Bank to have a neutral bias in its monetary policy.

The exchange rate had unusual volatility.. As seen in the chart on the right, the Chilean currency depreciated to 840 pesos, reaching the lowest value seen in our history. This led the Central Bank to announce an intervention equivalent to US$20bn, to be implemented by weekly sales of USD in the open market until May of this year. After this measure, the FX strengthened to 750, reducing the gap between the FX value and its long-term fundamentals. Nevertheless, the currency has weakened during the last weeks, as a result of the lower copper prices, given fears on the impact of coronavirus on China's growth. Beyond the short-term volatility, it is worth mentioning the positive impact that the weaker peso should have on net exports offsetting, at least partially, the sluggish growth expected in both consumption and investment.

Now, I´d like to discuss our baseline scenario for this and the next year. Please go to slide 4.

The weaker activity observed in the 4Q19 was likely the bottom of the negative cycle. Particularly, we expect the economy to improve gradually this year, resulting in an overall expansion of around 1.0%. For 2021, we forecast an expansion of 2.5%, which is consistent with a steady convergence towards the potential growth. Our view is based on four main factors.

- First, demonstrations and disruptions have calmed, in relation to October and November. This has made possible a gradual normalization of activities across all economic sectors. The improvement observed in several December indicators is consistent with this diagnosis.
- Next, the government announced a robust countercyclical fiscal plan, in order to address social demands and reconstruction of public infrastructure. Specifically, the finance ministry increased the fiscal spending growth in the 2020 budget to 10%, from the 3.0% set formerly. This change is mostly explained by additional spending of US$5.5Bn on infrastructure, which has a positive fiscal multiplier.
- Third, the multilateral weakening in the Chilean peso generates better conditions for tradable sectors, especially mining.
- Lastly, we expect the Central Bank to leave the interest rate unchanged this year at 1.75%. This interest rate is negative in real terms, around -1.25%, confirming the existence of easing conditions in the monetary sector.

Even though all these factors should contribute to improving the activity in the future, uncertainty will potentially affect investment this year, as seen in the chart on the top right.

Our scenario considers an inflation rate hovering in the range between 3.0% and 3.5% during this year, as a result of two opposite forces: A weaker currency and, on the other hand, subdued GDP growth.

Finally, as I mentioned before, we do not expect changes in the monetary policy rate this year. Since the CPI is within the range of the Central Bank, taking into consideration the important uncertainty, the Central Bank has more reasons to accumulate better information before changing the rate.

Please move to slide 6 to analyze the evolution of the Banking Industry.

Over the last 12 months, loans in the Chilean banking system have grown 10% and increased 3% quarter-on-quarter. The slowdown of the Chilean economy hasn't yet affected significantly loan growth. In fact, the 3% quarter-on-quarter growth is the same growth that we saw in the 3Q19. Nevertheless, we expect that loan growth will gradually fall due the below trend growth as I mentioned earlier. According to the Central Bank survey, for instance, the banking industry has become more restrictive for granting loans and demand has weakened over the last quarter of 2019. The survey indicates that 50% of banks reported more restrictive terms for consumer loans. The survey also indicated that there was less dynamism in the demand side. In this context, 42% of banks saw a reduction in demand for consumer loans as well as an 18% decrease for mortgage loans.

In terms of results, the Chilean banking industry posted net income of $527 billion in the fourth quarter. The decrease was mainly due to significantly higher loan loss provisions, in line with the events seen during the 4Q19 and to a lesser extent, greater operating expenses.

As I mentioned before, we will likely have a challenging year, with a below trend growth and a potential deterioration in the labor market. In this environment, it is reasonable to expect that total loan growth for the industry will reach around 6% in nominal terms.

Please turn to slide 8 to begin our discussion on Banco de Chile

We are very proud to present our main achievements in 2019. We ended the year as the leader of the industry in many aspects, especially in financial results. We were ranked once again first in net income, net operating income as well as in net fees. We also recorded a very strong year in terms of SME and residential loans origination, with a 11.3% and 14.4% year-on-year rise, respectively. These results have been achieved through our superior and consistent commercial and risk management strategy that focuses to grow with adequate risk return relations in key market segments.

As a result of our constant efforts and improvements to give the best service to our clients, we were recognized as having the highest Net Promoter Score and best customer service by Procalidad, a prestigious Chilean non-profit organization. In addition, The Banker and Brand Finance honored our brand as the most valuable in the Chilean banking industry and we also were recognized as the bank with the best corporate reputation in the last decade by Merco.

As a result of our continuing concern to take care and developing of our employees, we were chosen as the best bank to work for in Chile according to University student survey by Merco. Moreover, showing our commitment with the environment, during 2019 we issued our first green bond. It was the first green bond from a Chilean financial institution and it was issued to finance renewable energy for our operations.

Lastly, Deva awarded us as having the best annual report of the banking sector, reflecting our focus on improving our reporting process and opening valuable information to our stakeholders.

Now I would like to pass the call to Pablo, who will go into more detail about our financial results. Please turn to slide 9.

Thank you Rodrigo.

The 4Q19 was challenging. As Rodrigo mentioned, we went from a scenario expecting strong growth in 2020 to subdued GDP with an expected rise of unemployment levels. This undoubtedly will impact growth perspectives for the banking industry in 2020. In turn, October and November were coupled with high credit cost, damage to infrastructure and a drop in confidence levels. Despite this environment, we were able to demonstrate the effectiveness and consistency of our business strategy and the value of our competitive advantages. In the 4Q19 we posted a bottom line of $147 billion pesos, only 3% below the prior quarter and 9% below the same period last year. On a full year basis, we recorded $593 billion pesos, basically in line with our results in 2018.

This is especially noteworthy when we compare our results to those of our peers as you can see on the bottom part of this slide. We clearly outperformed all of these banks in our quarterly and yearly results as well as our ROAE. This leading result is not by chance but is consistent throughout our history. We systematically post more predictable results throughout the economic cycles, clearly setting us apart from our peers and generating greater value for our shareholders.

Please turn to slide 10

4Q19 operating revenues increased 5% when compared to the same period last year and 8% when compared to the full year period. The quarterly and full year rise was generated by solid customer income expansion that rose 13% in the quarter and 12%

for the year, while non-customer income dropped 18% in the quarter and 7% for the year.

Customer income was driven by a 9% year-on-year rise in average interest earning assets that sustained NII growth for both the quarter and the full year. Specifically, our net interest income excluding inflation revenues grew 7% during the 4Q19 and 6% for the full year when compared to the same periods last year. These figures were partially offset by lower overall spreads due to a change in mix as a consequence of greater growth in mortgage and commercial loans together with the negative effect of the lower overnight rate that went down from 2.8% on average in 2018 to 1.8% on average in 2019.

Fees continued to deliver solid results growing 34% in the 4Q19 and 27% for the full year when compared to the same periods last year. This was due to good dynamism of transactional revenues principally from retail products. Services such as higher usage rates derived from our larger ATM network as well as more intensive use of our cards. In addition, we recorded a strong increment in insurance brokerage fees associated with income coming from the joint venture signed with an international insurer and an increase of 10% in gross written premiums. We also had solid revenues from mutual fund management in line with rise in AUM.

The strong results in customer income permitted us to offset lower non-customer revenues owed mainly to higher revenues recognized in the 4Q18 as a result of the adoption of Debit Value Adjustment. To a lesser degree, we also had lower revenues from the position that hedges FX fluctuations in loyalty program fees as well as credit risk allowances for dollar denominated loans, which coupled with the cumulative negative effect of flattened yield curves over the last 18 months on results from term gapping in ALM. These drivers were partially offset by a higher contribution of our UF structural gap position in both the 4Q19 and the full year 2019. This had to do with higher inflation in the 4Q19 as compared to a year earlier. For the full year, although inflation decreased in 2019, the effect of lower nominal rates benefited the funding of the UF structural asset position.

Our focus at the bank has been to promote responsible growth in every segment we serve. We firmly believe that this is the main pillar of our proven and successful track record. We have advanced towards growing our bottom line by selectively expanding in key market segments that provide adequate returns for the risks we take. In the next slides, we will show you in which segments we have grown and the evolution of our asset quality.

Please turn to slide 11.
Total loans grew by 7.5% year-on-year and on a sequential quarterly basis slowed to 1.5%. This trend is in line with both the weaker activity and the results showed by the Central Bank Survey, which concluded that banks have become stricter in terms of risk and that demand of credits has dropped. Nevertheless on annual perspective, according to our strategy our retail segment was the principal source of growth. Loans to individuals rose by 11.4% year-on-year and SME increased just over 10% during the same period.

The main drivers for retail loan growth were mortgages and commercial loans to SMEs. Mortgages grew 14.5% year-on-year and also a similar level in the quarter when annualized. We didn't see a drop this quarter in mortgage growth because these loans were in the pipeline before the events occurred. However, we observed a reduction of about 20% in mortgage applications during October, November and December versus the running rate. SMEs also performed well, posting double digit loan growth of 10% year-on-year and 1.6% on a sequential basis. In fact, origination in this segment remained strong, growing 9% over last year and at a similar level when compared to the immediate prior quarter. It's clear that this was a demanding quarter for this segment and in line with our approach to build solid long-term relationships with our customers, we assisted those clients which had difficulties during this period by providing them flexible financing options at special rates to get their businesses back in order.

On the other hand, wholesale lending, which was accelerating last quarter, slowed and grew only 1.7% year-on-year and on a sequential basis decreased 1.2%. It's important to emphasize that we continually focus on maintaining an adequate relationship of risk and return as well as rational use of our capital and because of the current environment we have taken conservative steps to ensure responsible growth in this segment.

Regarding liabilities, without a doubt, we are the financial institution with the best funding structure in Chile, which remains as one of our most important competitive advantages. We have the highest market share in demand deposits and these represent 38% of total assets. In fact, demand deposits accelerated significantly with a year-on-year increase of 18.2%. The high level of growth during the quarter is associated to our strong credit risk rating and our superior brand positioning that result in flight to quality in times of higher uncertainty. This is proven on the chart on the right, where we are clearly the bank with the greatest net inflows of deposits in the industry during the 4Q19, with 24% of market share of the flow of deposits. In 2019, we also continued placing bond at very good rates, including subordinated bonds, with spreads that were below the average of the banking industry. In fact, we issued bonds not only in Chile but also in Norway, Hong Kong, Japan, Australia and Peru. As a result, as shown on the chart on the bottom right, our cost of funding was once again the lowest in the industry, reaching 2.6% on annual basis.

Please turn to the slide 12.

This quarter we posted a cost of risk of $101 billion pesos. As you can see on the lower left chart, we incurred a net credit deterioration of $32, which was mainly originated in the retail segment as a result of particular circumstances that occurred in October and November. Nevertheless, we posted an improvement in December as a result of better payment behavior and a more normal development of the collection process. Also, volume growth increased our LLPs by $10 billion pesos. Lastly, the lower depreciation of the Chilean peso to the US dollar in the 4Q19, when compared to the 4Q18, had a positive effect on our allowances for loan losses denominated in foreign currencies by $2 billion, partly offsetting the aforementioned impacts.

As you can see in the chart on the top right, total overdue loans remained similar to the beginning of the year, but the mix changed. Specifically, we saw an increase in the above 30 days past due loan books while we saw a reduction in the below 30 day overdue loan book, especially when comparing the 4Q19 to the 3Q19.

We reached a cost of risk of 1.37% this quarter and 1.21% for the full year, which we think are reasonable levels considering the events occurred during the 4Q19.

Please turn to the next slide number 13.

We dedicate important resources to credit risk at Banco de Chile. Thanks to that, we have built a bank with the best fundamentals as to face a weaker cycle of growth in the economy. Over the last decade, we have been conservative and have created the largest buffer of additional provisions amongst private banks, as you can see on the chart to the left. As of December, we have $213 billion pesos of additional provisions, substantially higher than our peers, which is even more important when we consider the implementation of Basel III.

Our coverage ratio including additional allowances reached 220%, as you can see on the chart on the right. This level of coverage is also substantially higher than all of our peers. As a consequence of the prudent and consistent risks policies, we have had stable and low cost of risk and NPL ratios when compared to our peers.

We are confident that our commitment to managing risk prudently and growing responsibly throughout the cycles will permit us to continue outranking our competition, not only in credit risk but also in the bottom line.

Please turn to slide 14 on operating expenses.

Total operating expenses increased 7.5% this quarter and the same level year-on-year. Personnel expenses were the main driver of this increase for both periods as a result of extraordinary bonuses granted to our employees due to their commitment during the events occurred in the 4Q19, an increase in severance payments, and a rise in salaries driven by the effect of inflation.

Administrative and depreciation expenses decreased by $1.3 billion quarter-on-quarter and $31 billion year-on-year. In the 4Q19, we incurred non-recurring expenses of $8 billion in fixed asset related expenses as a result of charge-offs and repairs undertaken on branches and ATMs that were affected during the events that took place. We also grew IT and Communication expenses due to software licencing and development of new IT projects to strengthen our digital platforms and cybersecurity infrastructure. These increases were offset by lower marketing expenses, a reduction in outsourced services and lower expenses related to assets received in lieu of payment.

It’s important to mention that we are focused in improving our efficiency in the medium term from the 45% levels posted in our recent past, as you can see on the chart on the bottom left.

In this context, I'd like to mention some important advances in our strategic priorities that we have made during the last year that not only will support a reduction in the medium term in expenses but also an improvement in operating revenues and customer experience. Please turn to slide 15.

We are proud of our robust and consistent results that we have had over time. However, we are aware about several challenges that we face in different areas, such as the economic environment, social changes, more banking and non-banking competition and new regulations. In order to address this, we have defined four main strategic focuses, as you can see in this slide.

The first of these is to implement further steps in our digital transformation process that the bank has carried out in recent years. As we mentioned in previous conference calls, we have innovated in several fields, including the creation of new websites for companies and individuals, the launching of successful mobile apps for banking, investment products and insurance, which contributed to improving the speed and security of transactions made by our customers. We also made advances in business intelligence, allowing us to accompany and understand even more needs of our customers throughout their life cycle. Additionally, we are working on several improvements in our CRM during the last years, in order to provide better information of our customers to our manager accounts. Thanks to this, today we have a more comprehensive understanding of our customers, improving our service even more. Nevertheless, we are ambitious and want to go further. Based on our agile work methodology, which is centered on simple, fast processes with strong interconnections between different areas, we are continuously improving our road map that aims to strength our offer value. Specifically, we are identifying improvements in our processes with the goal of addressing, more efficiently, the needs of our customers and developing more and better products. We are very convinced that, by doing so, we are building the foundation to for stronger growth in our customer base and, more importantly, to continuing being the bank with the best customer experience in the Chilean industry.

The second focus is related to reduce and manage operational risks in an environment of increasing use of technology in the banking sector. In particular, we have worked on strengthening cyber security, not only on reinforcing our perimeter and transactions, but also on raising the awareness of our employees. We are conscious that the main way of reducing the number of threats is by promoting safe conduct of our workers. In this context, during 2019, more than 80% of Banco de Chile staff participated in a training program on issues related to information security, with an impressive increase in actions that mitigate potential attacks.

Furthermore, we have continued implementing several improvements in the service models of our branches, a project that began in late 2018, which basically aims to move towards a more intensive use of digital technologies. In particular, we have ended a successful transformation of more than 100 branches, by the incorporation of new self-service terminals, which promote even more the use of digital tools by our customers. In addition to that, we have automated several back office activities, allowing a reduction in several manual processes, which allow account managers to have more time to service better the needs of our customers. For this year we plan continue deepening this initiative to complete the remaining branches.

Another area that has received special attention in our strategy is productivity. In order to improve our efficiency, we have carried out a series of actions that aim to increase our income without raising our recurrent costs. Some areas where was have been reducing expenses include external advisory activities, new roadmap for internal processes, more efficient supplier auctions and optimization of the physical space, among others.

It is important to mention that we have been implementing these measures only gradually, in order to maintain our superior quality of service we deliver to our customers. We aspire to have a gradual improvement in our efficiency ratios in the long term.

Finally, our strategy pays special attention to the main basis of our long-term sustainability, mainly through actions in the environmental, social and corporate governance areas. We are proud to have issued the first green bond in our history, as well as to have carried out a series of actions to support our SME clients who were affected by the events of October and November. We also held a national entrepreneurial challenge contest, in which more than 50,000 micro-entrepreneurs participated, and we also trained more than 7,000 people in financial education. In this context, I would like to highlight that we are the bank with the greatest improvement in the ESG disclosure in Chile, according to the index released by Bloomberg. We are convinced that these focuses, together with our strong competitive advantages, will allow us to maintain our leadership in the industry.

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Summing up, we believe that our results for 2019 compare positive against all our peers and with our own performance of previous year, when taking into consideration the economic environment and the impact of the events that occurred in the 4Q19. Our higher level of loans coverage ratio and additional provisions provide us with an excellent capability to cope with a slowdown in business activity. Additionally, we are confident that our sound risk policies support our profitable business model that is focused maintaining an adequate risk-reward ratio.

Finally, before moving on to questions, I would like to mention some key takeaways.

- In terms of GDP growth, we expect that activity to grow by 1.0% in 2020, which should translate into a banking industry loan growth of approximately 6% nominal. Loan growth will most likely be concentrated in the retail segment while larger companies will probably continue to delay their investment decisions. However, as we mentioned in the first part of this presentation, we expect a recovery in both, GDP and loan growth for 2021.

- In this environment, we expect NIM to remain around 4.1% this year.

- Due to the below trend growth this year and the potential increase in unemployment, we believe cost of risk for us and industry could increase. We can't rule out that this ratio could reach a level of around 1.4% this year. Given our prudent and conservative approach to credit risk, we believe risk expenses may increase, but below our peers. Since we expect the economy to improve in 2021, a lower cost of risk in 2021 is very likely.

- We expect that top line growth should slow but given our emphasis on cost control, this should still translate into slight improvements in our efficiency ratio. We expect a level of around ~44% for 2020.

- With inflation hovering around 3.2% for 2020, this should imply an effective tax rate of ~23% for the year.

Our solid fundamentals, superior risk management and sound strategy should permit us to maintain a sustainable ROAE of around 18% in the medium term. In line with our baseline scenario, ROAE should be slightly below this level in 2020.

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