Banco de Chile 1Q19

Financial Results Conference Call

Operator

Good morning everyone, and welcome to Banco de Chile's first 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, Daniel Galarce, Head of Financial Control, and Cecil Diaz, Investor Relations.

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 thank you for joining us today on our conference call for the 1Q19 Financial Results. It is a pleasure for me to share with you our comments regarding the evolution shown by the Chilean economy and the banking system during the first quarter. After that, Pablo Mejia, our Head of Investor Relations, will review the financial results of Banco de Chile in that period.

Please turn to slide number 3.

Chile had a successful 2018. In brief, we saw an improved scenario, with higher growth rates, better quality of employment and an impressive pick up in private investment. Consequently, Chile achieved the best economic scenario since 2012.

Specifically, GDP rose 4.0%, well above the 1.8% observed, on average, during the previous four years. A comparison between Chile and both the global economy and Latin American growth can be observed in the upper left chart. The recovery was largely driven by private investment, which rose 4.7%, after falling between 2014 and 2017. It is also worth highlighting the lower contribution from fiscal spending, demonstrating that the activity was fully driven by the private sector.

During the last few months, however, we have seen less dynamic growth. The beginning of this year was characterized by weak figures, with an average expansion of around 1.8% in the first quarter, after observing a 3.6% growth in 4Q18. In this environment, the annual inflation rate has remained low, it was 2.0% in March, due to the 0.1% quarterly increase in the 1Q19, well below the 0.7% posted one year ago. Therefore, the Central Bank changed its forward guidance for the monetary policy rate, after announcing, in the March Monetary Policy Report, that the interest rate would be stable for the greater part of this year (now it is at 3.0%). Only three months ago, the Central Bank considered lifting the interest rate to 4.0% this year.

Despite this transitory weakening, it is worth taking into consideration some factors behind this slowdown. First, the economy was negatively affected by heavy rains in the north of Chile, which reduced the copper production. In fact, mining production fell by 5.8% in the first quarter, reducing GDP growth by 70 bps in the period. Since this shock was temporary, the contraction in the mining sector, which represents nearly 15% of GDP, will not last for much longer.

Second, estimates of Global GDP have been falling. This was confirmed by the baseline scenario presented by the IMF in its last World Economic outlook, where they downgraded the global GDP estimate to only 3.3% for this year. Since Chile is an open economy, this change will affect our activity.

Finally, the labor market has shown an unusual lag relative to the economic cycle. Despite the higher economic growth posted since the beginning of 2018, the employment growth has remained subdued, reducing the dynamism of private consumption. In this environment, we have seen a downward trend in GDP forecasts for this year.

In spite of these factors, we think that 1Q19 was the bottom of this temporary slowdown. In other words, we expect in the next quarters the economy to grow faster, as can be observed in the upper right chart. Basically, our positive view is based on three main factors:

First, since the contraction in the mining sector was led by temporary climate conditions, it is reasonable to expect a positive contribution from this sector in the coming quarters. Second, private investment has been getting even stronger, which has been reflected by several indicators, such as the positive trend in capital goods imports, as seen in the bottom left chart, and business confidence remaining in the optimistic zone. If this trend continues, we will see positive spillovers in the labor market, contributing positively to the employment and wage growth. Lastly, the lower than expected inflation rate allowed the Central Bank to adopt a more neutral bias, which is equivalent to having a more expansionary monetary policy. All in all, we are confident that the economy will resume its positive momentum as we saw last year.

In the next slide I'll present our view for 2019 and 2020. Please move to slide number 4.

As I mentioned before, we expect better growth in the future. Specifically, we expect GDP to increase between 3.2% and 3.3% this and the next year, respectively. But rather than the positive rate, the most relevant aspect to consider is the good quality of growth, due to the expected dynamism in private investment, as seen in the two first charts on this slide.

We don't expect material changes in the nominal side of the economy, as can be observed in the two bottom charts. We estimate the CPI will end the year slightly below the Central Bank target of 3.0% (our forecast is 2.7%), as a consequence of the persistent output gap of the economy. However, we acknowledge the existence of an upward bias in inflationary pressures in the short term, as a consequence of the raise in oil prices. We also estimate the inflation to go up to 3.0% only in 2020.

In this environment, we expect the interest rate to remain unchanged throughout this year. There would be an increase in the interest rate in 2020, only if the economy shows convincing signs of recovery.

Now, I'd like to go over recent trends observed in the Chilean Banking system. Please turn to slide number 6.

Loan growth continued strong this quarter, with all the product families growing near the 10% level year-on-year. As you can see on the chart on the right, net loan origination slightly slowed down when compared to prior quarters, in constant pesos, but still maintained a good level of expansion this quarter.

Nevertheless, this quarter was weak in terms of financial results. Net income for the banking industry posted $571 billion pesos, declining 9% when compared to 1Q18. The lower than expected result was mostly explained by the zero variation of the UF, which reduced inflation revenues. Additionally, the existence of higher credit risk provisions and operating expenses also affected the overall results. It is important to point out that the reduction in net income would have been even greater if it wasn't for the incorporation of the Presto and CMR credit card business in the banking figures.

Even though the quarter was weak in terms of results, there are several factors, from a macro point of view, sustaining a positive view for the future. As I mentioned in the previous slide, we expect the economy to increase its economic growth in the next quarters, providing additional support for a further expansion in business volumes. Additionally, the potential rise in inflation will contribute to higher revenues. In fact, since the average quarterly inflation will likely be between 0.6% and 0.7% QoQ over the next quarters, it is also reasonable to expect a pick-up in revenues.

In this environment, we reinforce our positive view for the future, especially for our Bank, which will be analyzed by Pablo Mejia, in the next slides.

Pablo Mejia

Thank you Rodrigo. Please flip to slide number 8.

Net income before taxes for the 1Q19 reached $136 billion pesos, result that was largely explained by the zero percent inflation recorded during the period. If we adjust the 1Q19 with the same level of inflation from the 1Q18, we would have recorded a similar result as in the same period last year. To a lesser extent, this flat growth was also due to higher credit risk provisions resulting from loan growth and one-off effects as well as higher operating expenses. Additionally, we also posted lower treasury revenues. This was partially offset by strong customer income growth. In the next slides we will go into a deeper review of each of these —concepts.

Please turn to slide number 9. Despite the zero inflation for the period, we are proud that we were able to maintain Operating Income flat YoY at $445 billion, thanks to our consistent strategy to grow selectively in the retail and wholesale segments.

As you can see on the charts, this growth was driven by solid customer income which grew 9% year-on-year. The main drivers supporting this growth were our increase in loans in the retail segment, as well as the rise in demand deposits, both growing almost 9% on average year-on-year. We also saw strong fee generation, which rose 16% year-on-year, as detailed on the chart on the right.

This increase in fees was chiefly due to higher net revenues from transactional products because of higher usage rates, greater cross-selling and a growing customer base due to effective commercial plans that pursue to increase penetration of high-income individuals. We also reached very good growth in mutual fund management fees that were up nearly 10% year-on-year while insurance brokerage was up 15.5% year-on-year. It's also important to mention that we entered into new agreements to boost our ATM network, adding at this time 345 new points of service across Chile. As you can see, we are seeing an important increase in revenues in this financial service.

Non-customer income dropped 35% year-on-year as a result of the sharp decline inflation, which negatively impacted the contribution of our structural UF gap position`. If we had the same inflation as the 1Q18 during 1Q19, operating income for this period would have been $476 million, 7% more than the same period last year, reflecting a significant expansion of customer income. Additionally, non-customer income was further impacted by lower revenues from funding and gapping related to repricing of short-term liabilities, in line with the rise in the overnight rate as well as fewer treasury opportunities that led to less trading revenues.

Please turn to slide 10.

This quarter total loans grew 9% year-on-year, in line with the improved private investment growth and business confidence levels remaining in the optimistic zone.

The retail segment continues leading growth, rising almost 11% year-on-year, while wholesale loans grew by 6.1% during the same period. This breakdown is consistent with our focus of growing faster in more profitable segments. Similar to past quarters, SME loans continued to be the fastest growing segment, increasing at a rate of 12.9% year-on-year, while loans to individuals were just slightly behind growing 10.2% year-on-year, thanks to the expansion in mortgage loan book origination of 22.4%. Origination in SME loans grew 15.2% over the same period last year, influenced by our new preapproved SME loans model that was introduced in January. In fact, preapproved SME loan origination nearly double the level recorded last year, as you can see on the chart on the bottom right. We expect that the SME book will continue being a driver for loan growth in the coming years, especially since this segment in Chile has low penetration.

Consumer loan growth has remained at high levels of nearly 10% year-on-year, thanks to our solid retail commercial strategies together with our robust preapproved consumer loan model that recorded a 16% increase in originations over the same period last year, allowing us to continue growing at record levels above $450 billion per quarter, further improve productivity and operating efficiency levels.

Without a doubt, our growth trend in our retail segment has been accomplished through a business strategy that is focused on reinforcing customer experience by providing the superior products and services through the channels that clients demand. Please turn to slide number 11.

We have worked actively to enhance our financial services for our customers. We have enhanced customer contact channels, as well as streamlined processes and implemented BI tools to drive sales, among other initiatives. These have had successful results, as you can see on the charts on the right. Current account origination has had strong growth figures, up 9.1% YoY, placing us first in terms of our peer group in net personal checking account origination. We have done this by improving both delivery times of products and sales per account manager, as seen on the chart on the bottom right of this slide.

Additionally, as we have mentioned in previous conference calls, we are in the process of rolling out a new CRM / Commercial Platform, which is being developed in-house and is expected to be fully operational this year. This new platform should not only allow us to improve service quality and customer loyalty, but also will continue boosting productivity and efficiency levels.

Nevertheless, all of these results would have been much more difficult to achieve if it weren't for our strong brand, as you can see on the following slide, number 12.

The Banker together with Brand Finance, recently published their research for the strongest banking brands in the world. We are very proud to be ranked first amongst Chilean Banking Brands with a AAA- rating, according to Brand Finance, which means that we have a very strong brand name, that is valued at $1.7 billion, substantially higher than our local peers. We are also pleased to see that we have risen 17 spots in the global ranking, expanding the gap with our peers.

This ranking is completely in line with our ranking in top of Mind, where we rank first with a wide difference to our peers. We also continually reinforce our apps and continue to rank well above our competitors with a rating of 3.8 on average on the apple and google play app stores, as seen on the chart on the right.

When we combine our excellent brand together with superb customer service, as shown by our net promoter score ranking, we can use this to attract new customers more easily and retain customers, as show on the chart on the bottom right, in turn allowing us to grow our loan book at a lower cost and drive fee-based services through cross-selling initiatives.

Please move to slide number 13.

We continue to be the financial institution with the best funding structure in the country, which is clearly one of our most important competitive advantages.

As Rodrigo mentioned, the Chilean Central Bank began this year increasing interest rates with a 25bp hike. However, it is likely that the board will maintain interest rates this year without changes and that the normalization process will continue next year. Consensus today points to a level around 3.5% by the end of 2020. We have in turn, gradually increased the maturities of our liabilities from 11 to 22 months during the last years, mitigating the temporary short-term impacts of the rise in rates. In the medium term, we expect to have higher NII as a result of higher rates as our assets reprice and yield curves steepen, particularly in local currency. This is important for all banks, but we are most benefited from the rise in rates since we have the largest portion of our liabilities that are represented by DDAs.

As you can see in the slide on the top left, demand deposits represent 27% of total liabilities, where more than half is from the retail segment. This together with our strong credit risk ratings, has permitted us to post once again the lowest cost of funds in the industry of only 1.8%, and allows us to have a very attractive NIM.

Please turn to slide 14 on operating expenses.

Total operating expenses increased 8% year-on-year which was due to an increase of $6 billion pesos related higher salaries and other benefits for $3 billion, severance indemnities related to organizational restructuring and an increase of $1 billion related to variable compensation in line with high level of sales of financial products and services.

The main driver in administrative and depreciation expenses was related to IT projects that have been made to improve productivity in our operations such as our new CRM platform and to a lesser extent, building and other maintenance expenses linked to a new commercial partnership undertaken this quarter that will increase our ATM network in approximately 30% this year. It's important to note that the application of IFRS 16 did not have an impact on our results. As a result of this, Administrative expenses dropped by $7 billion this quarter and Depreciation and Amortization increased by a similar amount as the prior concept of rents now are reflected as amortization of intangible assets.

Consequently, our efficiency ratio increased to 49.7% this quarter but this was principally due to the negative effect of inflation on operating income. Adjusting operating income with the same inflation level that we had in 1Q18, our efficiency ratio would have reached 46.4%, similar level to the 1Q18 figure. Nevertheless, if we consider operating expenses as a percentage of assets, is clearer that our cost base has evolved in line with our business activity, as reflected by our stable cost-to-assets ratio of 2.5%.

Despite the worse efficiency ratio this quarter, there is lots of room to improve in the future. As Rodrigo mentioned in the beginning of this call, the expected increase in inflation should have a positive impact in revenues. Additionally, after a period of testing and evaluation, we are beginning to implement a plan to adjust our service model in our branch network and at the same time streamline processes in order to improve productivity in both the front office and back office operations. These changes will be based on providing a value offering that is increasingly incorporating technology to boost online banking, self-service terminals in branches and universal relationship manager that not only handles a customer's debt but also their savings products. Historically, a relationship manager in Chile only handles customers debt products. This project will be implemented gradually over the next 18 months and will optimize the consumer finance branch network.

Please turn to the slide 15.

This quarter we posted a cost of risk of $89.2 billion pesos. As you can see in the upper right chart, half of the year-on-year rise was due to our strong growth, especially in the retail book, that are higher risk but the returns are also much higher than the average loan book. The other half was originated in an increase in allowances as result of two main factors. First, our risk model is conservative and is influenced by seasonality effects. In particular, in the 4Q18 we recorded lower than normal levels of cost of risk in line with a low level of delinquencies that were below 1.1%. On the other hand, in the 1Q19 our NPLs normalized to 1.17% and as a result, we posted higher cost of risk this quarter of 1.27%. Second, the incorporation of the Falabella and Líder credit cards, called CMR and Presto, into the banking industry's figures added certain variables that impacted risk models negatively, such as level of indebtedness and delinquencies, among others. Nevertheless, we are confident that our cost of risk level will return to our guidance between 1.0% and 1.1%.

It's important to highlight that we strive to have the best credit risk policies in the industry with the highest coverage ratios of nearly 200% and the most prepared bank to face negative cycles. We achieve this thanks to the high involvement of the board of directors and upper management as well as the financial resources allocated to develop our risk strategy.

We also believe, as a result of these prudent policies, that the new SME standard provisioning model will not have a material impact on our bottom line and will be well below the levels reported by our peers in the industry. Finally, I have to emphasize that we are committed to continue growing responsibly and that we are confident that our cost of risk will return to levels of around 1.1% in the coming quarters.

Please turn to the slide 16.

As you know, we reached a very important milestone in our history on April 30th. Thanks to our successful track record, our shareholder SAOS, with the profits that we generated, fully paid-off all the debt it owed to the Central Bank of Chile. With this payment, we ended the last traces of the financial crisis that affected Chile in the 1980s, 17 years before the original deadline agreed with the authorities, as you can see on bottom of this slide. This final payment triggers the dissolution of SM Chile and SAOS. 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%. This will have very positive impacts on our index weighting on the Santiago Stock Exchange and MSCI indexes. In fact, on the local exchange, we will be the company with the highest weighting of a level near 10% and we expect that this should translate into improved visibility and liquidity of our stock.

Please turn to the next slide, number 17.

Some key results this quarter were our ability to grow customer income by 9%, partially offsetting the negative impact of inflation during the quarter, which affected significatively non-customer income. We continued expanding our customer base by adding nearly 30 thousand new current account clients each quarter and posting good loan growth especially in retail segment where SME loans grew by almost 13% year-on-year and Personal banking loans was up 10% YoY.

Risk was above trend, but this was influenced by our growth in retail loans and to temporary effects which we expect should normalize and return to a range closer to 1.1%.

Our adjusted efficiency ratio, reached 46.4%, in line with the levels posted last year and we expect that we should continue seeing improvements in the medium term, as a result of some of the initiatives we mentioned earlier.

Before moving on to questions, I want to highlight that we firmly believe in our long-term customer centric strategy that is focused on providing the best customer experience in all the segments we serve by leveraging the use of technology to grow. We are confident that with the positive economic scenario and solid capital and credit risk coverage levels together with our competitive advantages should permit us to continue delivering good growth in loans and present cross-selling opportunities that should drive customer income in the coming quarters and the bottom line.

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