Banco de Chile 4Q18 and Full Year Results

Financial Results Conference Call

Operator

Good afternoon and welcome to Banco de Chile's fourth quarter and Full Year results conference call. If you need a copy of the press release issued yesterday, it is available on the company's website.

Today with us we have Mr. Rodrigo Aravena, Chief Economist and Senior VP of Institutional Relations, Mr. Pablo Mejia, Head of Investor Relations, Daniel Galarce, Head of Financial Control, and Cecil Diaz, Investor Relations Specialist.

Before we begin, I would like to remind you that this call is being recorded, and that information discussed today may include forward-looking statements regarding the company's financial and operating performance. All projections are subject to risks and uncertainties, and actual results may differ materially. Please refer to the detailed note in the Company's press release regarding forward-looking statements.

I will now turn the call over to Mr. Rodrigo Aravena. Please go ahead.

Rodrigo Aravena

Good morning everyone and thanks for joining us today in this conference call for the 4Q18 and full year results. It is a pleasure for me to share with you our view and forecasts of the Chilean economy and recent trends in the banking industry. After that, Pablo Mejia, our Head of investor Relations, will review financial results posted by Banco de Chile during the quarter and the year.

I would like to start with an overview of the economic environment in Chile. Please move to slide number 3.

The Chilean economy had a successful year. After posting a weak expansion of 1.7% on average between 2014 and 2017, there was a strong recovery in 2018. This confirms our positive expectation from last year, as we mentioned in previous conference calls. Specifically, the activity grew 3.1% year on year in November, resulting in a 3.1% average growth in the last three months. Therefore, if the monthly economic activity figure reaches at least 2.5% in December, which is highly likely, the economy would expand 4.0% in 2018, achieving the best performance since 2012. Consequently, Chile is growing faster than its potential rate, having important implications on employment, inflation and interest rates.

The breakdown of GDP reveals that private investment is driving growth. In the third quarter, for instance, while the overall activity was up 2.8%, gross investment expanded 7.1% year on year, after increasing by 7.0% in the second quarter. This improvement has been a consequence of several factors such as better expectations, higher dynamism in the mining sector and the recovery in the housing sector. Total consumption, on the other hand, decreased its growth rate from 4.2% to 3.5% in the same period. Available information for the fourth quarter suggests that private investment has remained strong. The upward trend in capital goods imports, which can be seen in the upper right chart, shows the strengthening of private investment.

Additionally, the annual inflation rate has remained stable, as seen in the lower left chart. In 2018, the CPI posted a 2.4% increase on average, in line with the 2.2% last year. The core CPI, which is the measure that excludes energy and food prices, posted an average of 1.9% in 2018, also in line with the 2.0% observed in 2017. This trend has been the result of two opposite forces: on the positive side, the recovery in growth has driven more inflation in non-tradable goods, while the stability in the Chilean peso has reduced the pressures from tradable goods. In this context, the overall inflation ended the year at 2.6%, still below the Chilean Central Bank target of 3.0%.

The evolution of the labor market has been extensively discussed in Chile. There is an apparent “decoupling” between the improved activity levels and the weaker than expected labor market. In fact, a deeper evaluation was released in the last Monetary Policy Report, where the Central Bank mentioned the possibility of some structural changes in the labor force. However, it is worth mentioning the improvement seen in the composition of employment, which can be seen in the bottom right chart. While in 2016 and 2017, for instance, self-employment supported job creation in Chile, the trend today is the opposite: new jobs in Chile are salaried, while self-employment is declining. This reflects that the quality of employment is improving.

Now, I’d like to present our baseline scenario for this year. Please move to slide number 4

In general, we expect 2019 to be a positive year for Chile, since GDP will continue growing above its trend and faster than our Latin-America peers with a slightly rising CPI.

In particular, we estimate an economic growth of 3.5% for 2019, following the 4.0% level posted in 2018. It is important to consider that Chile continues to expand above its potential rate, in spite of the material increase in external risks and lower commodity prices. Undoubtedly, this trend reflects the existence of strong fundamentals and positive cyclical drivers of the Chilean economy, which are offsetting worse external conditions. As we saw in 2018, private investment should continue leading domestic growth. The evolution of both, GDP and investment, can be observed in the two upper charts in this slide.

In relation to inflation, we expect only a gradual convergence towards the target of 3.0% set by the Chilean Central Bank. Despite GDP recovery and its subsequent impact on the output gap, the evolution of the exchange rate will be critical, since tradable goods represent more than half of the CPI basket in Chile.

In this environment, we expect the Chilean Central Bank to continue increasing the interest rate. After leaving the rate unchanged in November and December, the board raised the rate by 25 bps yesterday. In our opinion, the above trend growth would leave room to continue adjusting the interest rate, although at a slower pace than the board assumed in the quarterly monetary policy report. All in all, it is likely one additional hike rate within the next few months, although the new Central Bank scenario will be released in March.

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

Total loans growth for the trailing twelve months picked up to 9.4% in November 2018. As seen on the chart in the left, the growth was driven by the acceleration in commercial loans, which also expanded by 9.4%, significantly better than the weak 1.8% observed at the beginning of 2018 and contractions observed in previous years. Consumer loans remained strong, by posting 9.6% expansion rate, while mortgage loans were more stable, confirming that this product is less elastic to the economic cycle. All in all, these figures are in line with the recovery observed in the economy, especially investment, as I mentioned earlier.

The net origination breakdown on the chart on the right clearly shows the impressive expansion of commercial loans, growing 5 times higher than one year ago, with a contribution of 61% to the total loan origination.

We highlighted in previous conference calls the existence of an important relationship between the loan cycle and GDP growth. This thesis was confirmed by the numbers observed in 2018, where the elasticity was nearly 1.8x, in line with the historical average of 2.0x. Looking forward, we expect that the positive economic cycle will be reflected in solid growth rates for the industry. If we consider that the economy would grow by 3.5% this year, led by a strong private investment growth, it is reasonable to expect a nominal expansion of around 9% - 10% in loans for this year.

On the regulatory side, the New General Banking Act. was enacted this month, after it remained in congress for almost four years. This is an important step in our regulation, since this change will allow a convergence towards the best global standards of capital requirements and corporate governance framework of the new regulator. The implementation of the new requirements will be divided in two stages: first, the integration of the current Superintendency of Banks to the Financial Market Commission before January 12th of 2020, although the Finance Ministry announced that their intention is to complete this integration by June of this year. Second, within 18 months of the date that the CMF assume the duties and regulatory scope of the SBIF, specific requirements must be defined by the new regulator, such as weightings for calculation of risk weighted assets and the determination of systemic buffers, among others. Despite this uncertainty, we feel comfortable with our current capital levels, as long as reasonable parameters are implemented in Chile.

Now I would like to pass the call to Pablo Mejia, Head of Investor Relations, who will review Banco de Chile's results for the fourth quarter.

Pablo Mejia

Thank you Rodrigo. Please turn to slide number 8.

We are pleased with our financial results this year and the progress that we have made. We ended the year with a bottom line of $595 billion pesos, 3.3% above the same period last year, proudly ranking us first in the Chilean banking industry in terms of net income attributable to shareholders with a market share of 25%. If we look at this figure before taxes, our bottom line grew nearly 9% year-on-year, clearly reflecting the successful results of our business strategy. As you know, our effective tax rate increased this year because we have accrued sufficient earning to fully pay-off the debt that our shareholder, SAOS, has with the Chilean Central Bank. The annual installments of this debt were a tax deductible expense for Banco de Chile. On a quarterly basis, net income came in at $162 billion pesos, 13.5% above the same quarter last year and well above the prior quarter.

In terms of ROAE, we posted 19.8% for the quarter and 18.7% for the year, both of which are in line with our guidance and expectations.

It's also very noteworthy to highlight how we compare on an annual and quarterly basis to our peers. On the charts on the right, you can see how we clearly lead the industry in net income generation in both the quarter and the year. We believe that this is a result of our consistent long-term commercial strategy that is focused on delivering products through world-class digital and physical distribution channels and backed by an excellent team that provides top-tier customer service while managing an appropriate level of risk return in our portfolio.

Please turn to slide number 9 on total operating income.

Total operating revenues for this quarter grew to $506 billion pesos, up 16.6% over the same quarter last year. As you can see on the chart on the left, this growth was led by non-customer income, which posted $137 billion pesos for the quarter due to the recognition of debit value adjustments on our derivative portfolio, a normalization of inflation and the positive impact of the depreciation of foreign exchange rate hedges.

Nevertheless, we continued to see good profitability from customer income, thanks to consistent growth in our core business that permitted us to post an increase of 5.3% this quarter when compared to the same period last year. This was driven by good growth in our average loan portfolio and DDAs. In terms of our NIM, we reached 4.4% this quarter, in line with the same period of 2017.

For the full year figures, we saw similar trends. Non-customer income rose by 33% as a result of a positive effect of inflation and gains from treasury activities, while Customer income increased by 4.1%. This was driven by our expansion in DDAs, a rise in our average loan balances and fees. NIM increased from 4.2% in 2017 to 4.4% in 2018, mainly influenced by higher inflation and strong demand deposit growth that benefited our cost of funds.

It's important to highlight that we are a leader in net interest income generation through our superior loan mix and outstanding funding base, which no competitor has been able to develop. Our NIM almost 90 basis points above the average in the industry and this translates into a relevant difference in net income. This means that we generate about $270 billion pesos more per year in net interest income than if we had the same NIM as the industry. In terms of profitability, this is equivalent to almost 7% of return on average equity. If we include our superior risk management ability, operating margin, net of risk, as you can see on the chart on the bottom right, our difference increases even more when compared to our main competitors.

Please turn to Slide 10 on loans

We are more than satisfied to see that we have ended the year in line with our expectations for our portfolio, which picked up growth throughout the second half of the year. This resulted in an increase of almost 10% year-on-year and we had another excellent quarter that rose 3.2% when compared to the 3Q18, or 12.8% annualized.

As you can see in the chart on the left, the retail segment expanded 10.3% year-on-year while the wholesale segment caught up in the second half of the year, posting an annual increase of 8.8%. These figures have been possible due to our solid commercial activities and an improved environment and confidence as seen in Chile's investment figures.

On the retail side, which is our target growth segment, we continue to see improving growth trends in both Personal and SME banking portfolios. Our Personal Banking portfolio accelerated to 9.5% YoY, driven by consumer loans to middle and upper income individuals. Total consumer loan originations this quarter reached record levels of $2.1 trillion pesos, posting an impressive 25% growth over last year, as shown on the chart on the right. Additionally, as you can see on the chart on the bottom right, consumer loan debtors continue an upward growth trend. These successful figures have been made possible thanks to proactive commercial activities, a new preapproved loan risk models for the consumer book and higher consumer demand. As a result, we posted a 28 basis point market share increase in consumer loans as of November.

SME banking loans also continued its trend from the last quarters, accelerating 13.4% year-on-year. This was fostered by higher demand from customers as well as our positive outlook on the economy that allows us to adjust appropriately our risk return relationship of these loans. On the charts on the right, you can see that SME loan origination grew by 17% year-on-year and loan debtors rose by 3.5%. We expect to maintain these good levels of growth and cross-sell in 2019.

As a reminder, at the beginning of 2018, we launched a new preapproved loan model for the consumer book that had very successful results. The new models are very versatile and allows us to quickly adjust our risk appetite. It also improves efficiency and productivity as more than half of these loans are granted online via the mobile phone or our website. These successful results persuaded us to develop a preapproved commercial loan model for SMEs. Today the model is up and running and our account managers have access to this information to help expand our penetration in this segment during 2019. We are currently working on making this available through our online channels, so that SME customers can take these loans independently from their account managers. We are certain that this new capability will provide us strong support for growth in this segment.

For 2019, we expect that the industry as a whole should post levels around 10% nominal loan growth and our goal is to gain market share in our key focus areas of loans to middle and upper income individuals and SMEs. Nevertheless, since we are a universal bank, we want to begin growing gradually and prudently in the lower income segment. This area today only represents 2.4% of total loans, almost half of what it represented a decade ago. We plan to expand this area by continuing to improve productivity, leveraging business intelligence and further incentivising the use of digital platforms.

Please turn to Slide 11

Over the past 3 years, we have implemented many initiatives in business intelligence that have begun to bear fruit. Some of the advances that we have made are listed on the left side of this chart. In summary, we began a journey that started in 2015 to improve our productivity and commercial strategy by leveraging business intelligence tools. This encompassed collecting data and improving our segmentation of customers. By having this information, we were able to build a solid customer acquisition database to drive sales and improve productivity. Once this was completed, we continued deepening business intelligence by developing algorithms to identify key customer life cycles in order to maximize lifetime value and retention. We also made a new pricing platform and adjusted protocols that allowed us to price our products more accurately based on the actual risk of customers. This was followed by the implementation of a campaign manager platform that clusters certain customers that have similar characteristics to offer them appropriate products and services. All these improvements were also accompanied by effective changes in how the bank operates. We aligned incentives with our mid-term strategy in order to drive online sales and we made enhancements in service models to improve our customer experience, among others. By implementing a plan that focused on this action, we have been able to make significant advances in our goals.

As you can see on the right part of this slide, we have seen an important improvement in productivity. Current account origination increased by 26% for the full year and 12% for the quarter. In the last years, we were the fastest growing bank in the industry in terms of net personal checking account origination with a large difference when compared to our peers. Productivity in checking account origination per employee also over the years increased sharply, from 2.3 accounts in 2014 to 3.9 in 2018, an improvement of 70% versus 2014.

Please move to slide number 12.

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

As you can see on the charts, online monetary transactions grew 24% this quarter while branch transactions decreased 5.5%, in line with expectations. In turn, more than half of our online transactions are being made on the mobile phone and are growing 59%, as you can see on the chart on the right. Currently 84% of our current account customers use either mobile or online banking and more than 70% of our customers are younger than 50 years old. We expect that these numbers continue to increase as our customer demographics change and that our preapproved products will continue to take greater importance, in line with the greater use of technology.

Finally, it's also important to highlight that we continue to be the bank with the highest rating on the Apple app store and Google Play with a huge difference when compared to our peers, as seen on the chart on the bottom right.

Please move to slide number 13.

We are the bank with the best funding structure in Chile, which is one of our most important competitive advantage and a differentiating factor in an environment of rising interest rates, like we are seeing today.

As Rodrigo mentioned, the Chilean Central Bank began increasing interest rates with a 25bp hike. We expect that this will continue over the course of the next 12 months with an additional 25 bp increase and consensus points to a level around 4% in 2020. In line with this, we have increased gradually 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. However, in the medium term, we expect to have important benefits in our NIM as a result of higher rates. This is particularly important since we are the financial institution with the largest share of DDAs in the local industry and these hikes should benefit Banco de Chile the most. 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, and also as you can see on the chart on the bottom right, DDAs to total loans represent 33%, substantially more than all of our main competitors and the average in the banking industry. This combined with our excellent risk ratings, has permitted us to post once again the lowest cost of funds in the industry of only 2.7%. This competitive advantage is also very important for us. In other words, for every 10 basis points of lower cost of funding, we generate before taxes an additional $23 billion pesos.

Please move to slide number 14 on Operating Expenses.

Total operating expenses increased this quarter by 8.7% when compared to the same quarter last year and rose 7.4% for the full year.

On the chart on the top right is a breakdown of operating expense growth for the full year of 2018. The most relevant rise in expenses was the salaries that rose $33 billion pesos and administrative expenses for $20 billion pesos. The breakdown of this is shown on the table at the bottom of this slide. The increase in personnel expenses was largely influenced by benefits provided to our employees as a result of the collective bargaining agreement we had earlier in the year with our unions. It's important to mention that we implemented a new accounting standard to record bonuses paid to unionized employees, which defers the expense based on a straight-line method over the period of the agreement. For the employees that qualify to receive the bonus from the negotiations but were not unionized, these are register as expenses when the funds are disbursed.

The remaining $9 billion peso increase was related to variable compensation and inflation adjustments on salaries.

The rise in administration and other expenses was due mainly to higher IT expenses in line with all the advances we have made in digitalization of the bank, advisory services, marketing expenses and strengthening cybersecurity. Finally, in other expenses the main increase was related to the cost associated with the charge-off related to the cybersecurity incident. However, it's important to note that the reimbursement associated with the insurance policy covering this event was recorded in operating income according to local GAAP and fully offset this charge-off.

Adjusting for the impact of the effects of collective bargaining and by taking into consideration this one-time expense, expenditures would have grown only by 3.3%, just slightly above inflation and in line with our guidance.

In terms of efficiency, we ended the quarter with a level of 43.5%. This was influenced in part by higher than normal non-customer operating income, as I explained earlier. Adjusting by this effect, we reached a ratio of 45.3% for the year.

Before moving on, I want to highlight that one of the areas that we are putting special attention is operating expenses. We are in a process of improving the front and back offices processes and streamlining procedures. This together with a focus on cost control has allowed us to improve our productivity across all areas of the bank. We expect this should continue and will translate into better levels of efficiency in the years to come. We are confident that we can achieve this especially with all the technological improvements that we have implemented company-wide, that not only allows us to improve further our productivity but also to deliver superior top line growth and better customer service.

Please move to slide number 15.

Loan loss provisions this quarter reached $61 billion, equal to a ratio of 0.9%. This level of cost of risk is in line with our running rate, except the immediate prior quarter which was higher due to a one-time charge related to the implementation of new group-retail based provision models of approximately $39 billion.

As we mentioned in the third quarter, this provision charge did not reflect deterioration in the portfolio, as proven in our figures this quarter. It took a prudent risk approach that includes new factors which have translated into a higher conservative coverage ratio.

Loan loss provisions for the year reached $281 billion pesos equal to a ratio of 1.07%, in line with our guidance. However, 83% of the expansion of $46 billion pesos in loan loss provisions corresponds to the mentioned update of group-based model and can be seen in the chart on the right. The rest of the increase is related to volume growth and mix of $21 billion pesos and higher $21 billion related to the negative effect of the depreciation of the Chilean peso against the US dollar on our allowances for loan losses denominated in dollars. This was almost offset by $34 billion in net credit quality improvements for both the retail and wholesale banking segments. In terms of NPLs, we actually recorded a decrease this quarter to 1.09%, down from 1.19% from last year and 1.15% from the 3Q18, confirming the quality of our loan portfolio.

We firmly believe that our excellent track record has been a result of our prudent risk management practices that focuses on growing responsibly throughout all the economic cycles.

Please turn to Slide 16

As you know, this year we reached a very important milestone. Thanks to our successful growth track record over last couple of decades, our shareholder SAOS, with the profits that we generated in 2018, will fully payoff in 2019 all the debt it owes to the Central Bank of Chile, 17 years before the deadline agreed with the authorities. Thus, ending the last traces of the financial crisis that affected our country in the 1980s.

The final installment will take place at the end of April of 2019 and SM Chile and SAOS will be dissolved. 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 this should translate into improved visibility and liquidity of our stock.

Please turn to Slide 17

Before moving on to our final slide of highlights for the year, I want to emphasize our capacity of generating consistent leading levels of net income with the best risk return relationship among the Chilean Banking Industry. As you can see on this chart, we are the bank with the best combination of risk return in Chile. This has been accomplished by effective business strategies that have permitted us to attract a solid customer base in every segment that we serve. These clients not only drive interest income but also allow us to produce the highest levels of fee income in the industry as we are in most of the cases their primary bank. This coupled with our focus of growing responsible through prudent risk management practices has created the best risk return profile customer base.

Please turn to Slide 18 for highlights

2019 was exceptional. We ended the year with a very healthy bottom line of $595 billion pesos, ranking us once again first in net income for equity holders of the Chilean banking industry. We achieved this through our consistent commercial and risk management strategy that allowed us to grow loans in 2018 by almost 10% together with very good cost of risk of only 1.07% and a low NPL ratio of 1.09%.

It's also important to highlight that our wholesale segment retook growth, increasing 9% year-on-year and retail loans continued showing the most dynamic activity, increasing 10% year-on-year. As mentioned in the presentation, consumer loans origination was the highest in our history, up 25% YoY and current account origination was up 26%. This helped support fee growth on a continued basis.

We are confident that in 2019 we will see a stronger expansion in all business areas, in line with the postive economic indicators in investment, allowing us to reach high single digit levels of business growth.

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