Banco de Chile: Comments on the First Quarter 2016 Financial Results

(VICTORIA GUBBINS – INTRODUCTION)

Good morning, it's a pleasure for me to share with you our comments on Banco de Chile's first quarter 2016 financial results. Today with us we have Rodrigo Aravena, Chief Economist and Senior VP of Institutional Relations; Pablo Mejia, Head of Investor Relations; and Daniel Galarce, Head of Research.

We will begin with a brief overview of the economic environment, followed by an analysis of Banco de Chile´s 1Q 2016 results.

I will now turn the call over to our Chief Economist, Rodrigo Aravena.

(RODRIGO ARAVENA- ECONOMY)

Good morning, it's a pleasure for me to share with you my comments on the economic environment in Chile.

Please turn to slide number 2.

GDP is still expanding at a below-trend pace. According to the Central Bank National Accounts, the activity posted 2.1% expansion in 2015, following a modest 1.9% increase in 2014. Therefore, GDP has accumulated a 2.0% growth in the last 2 years, well below the 5.3% posted between 2010 and 2013. The GDP breakdown showed that gross investment remained in negative territory, falling by 1.5%, while consumption continued to support the expansion, by growing 2.2%.

We think there were both external and domestic variables explaining the local slowdown. Among external factors, we highlight the lower growth in China, a country that represents nearly 25% of our total exports, worse terms of trade due to the drop in copper prices –even with the fall in oil prices- and the recession in Latin America.

These factors have partially offset the positive contribution caused by the weaker currency. Between domestic factors, the persistence of pessimistic private expectations has played a critical role in this negative cycle.

Based on this scenario, expected growth for this year has been continuously adjusted, mainly due to the worse external conditions, as was outlined in the baseline scenario recently released by the IMF. Global conditions are relevant for Chile, as it is the most open economy in the region. The moderation in global growth and the sharp adjustment in copper prices will likely lead to a GDP expansion below 2.0% this year. Preliminary estimates for 2017 are pointing towards an expansion between 2.0% and 2.5%, still below-trend.

Despite the relatively low economic growth, the unemployment rate has been hovering around 6% in previous months, which is even lower than in 2012, when the economy grew twice as much than it is today. However, there are two main temporary factors behind this: first, the contribution from a dynamic housing sector, as a consequence of the increase in VAT considered in the 2014 tax reform. Secondly, the expansionary fiscal policy has also led to a higher job creation. However, the breakdown of the labor market shows a deterioration of the employment composition, that is, an increase in self-employment and a modest contraction in the waged employment, resulting in lower growth of the real wage bill—although it is still in positive territory and continues to support retail sales, as you can see in the bottom-left chart. It is also worth mentioning that the nationwide unemployment rate increased to 6.3% in march from 5.9% in February, according to the National Institute of Statistics.

Please turn to slide number 3.

The Chilean peso remains weaker than a year ago, as seen on the top-left chart. It has been largely explained by both the lower copper price and the less hawkish tone by the FED. In the Chilean economy, the weaker peso has generated several macroeconomic adjustments.

One of them is the higher-than-expected CPI, which has remained above the 3.0% target since the beginning of 2014. In March, it posted a 4.5% annual increase. Most part of the persistent inflation can be explained by the continuous increase in tradable inflation, as seen on the top-right chart. Since below-trend growth will likely persist, the convergence of inflation is likely, although at a very gradual pace, because the lagged effects of weaker currency. In all, it's reasonable to expect a CPI around 3.5% at the end of this year.

The second main consequence of the weaker currency is the adjustment of external accounts, as seen on the bottom-left chart. Particularly, the current account deficit has fallen to 1.4% and 2.1% in the last two years, after posting a 3.5% and 3.8% deficit in 2012 and 2013, respectively. Such narrowing is noticeable, especially considering the lower copper price, commodity that represents more than half of total Chilean exports. In this context, Chile's current account deficit is one of the lowest in LATAM.

Finally, on the economic policy side, the government announced a reduction in the fiscal spending for this year equivalent to 0.25% of GDP, due to worse perspectives in the long run copper price. It confirms that fiscal policy will be less expansionary relative to the last year. On monetary policy, the central bank has maintained the interest rate at 3.5% since December, despite the high inflation rate. Basically, the Central Bank has justified this decision on the weak external scenario and the downward adjustment in GDP expectations in the policy horizon. Therefore, we cannot rule out that the Central Bank will maintain the interest rate this year, and then will resume the tightening cycle by few increases only in 2017.

Now I will pass the call over to Pablo Mejia, our Head of Investor Relations to give a review of Banco de Chile's first quarter financial results.

(PABLO MEJIA- BCH FINANCIAL RESULTS)

Thank you Rodrigo and good morning everyone. My comments will follow the presentation starting on page 4.

We had another quarter of good profits, despite the weaker economic environment and an inflation rate that on annualized terms was slightly lower than the figure estimated for 2016. Net income for the quarter was up 13.5% YoY, reaching $133 billion pesos with an ROAE of 19% and earnings per share reached $1.38 pesos, up 12% from the same period last year. This result was also similar to the last three quarter's earnings and as shown on the chart on the right, enabled us to post once again extraordinary net income market share, reaching 27.9% as of this quarter, demonstrating our superior ability to generate attractive returns for our shareholders thanks to a consistent strategy that is capable of adapting to challenging economic circumstances, outstanding risk management and well-diversified customer base.

Please turn to slide 5.

Loan growth was up 12% YoY, benefiting from important developments and strong growth in key business segments, which added over $2.6 trillion pesos in loans. As you can see on the table on the right, the retail segment was the main driver behind this increase with an annual expansion of 15.3% versus 8% recorded by the wholesale segment. Undoubtedly, mortgage loans set the trend with an annual growth of 18%, closing the quarter with a volume of Ch$6.5 trillion pesos. Robust residential mortgage loan demand caused by the anticipated impact of the tax reform, and attractive interest rates are the factors that mainly explain this growth.

Total consumer loans also presented a solid increase with an annual growth of 12%, ending the quarter with a stock of $3.8 trillion pesos. The middle and upper income segment drove this growth with a 14.7% YoY increase, while the lower income segment basically maintained loan volumes stable, growing only 1.3%, consistent with our prudent risk approach, as this business area is more vulnerable during negative cycles. Retail commercial loans grew at similar levels to the middle and upper income segment, increasing 14.3% YoY. The growth in consumer and retail commercial loans was supported by implementing strategies that use business intelligence analytics in the design of sales campaigns, improving pricing by channel, customer and risk profiling and fine tuning the segmentation of our portfolio. As a result, we improved the coordination of sales efforts among different service channels, optimizing our product offering and the end result drove sales. As part of our multi-channel distribution strategy, we are also continuing to enhance our network by implementing new branches and service points for private and preferential banking as these segments have shown greater dynamism in recent quarters and have lower relative risk within the personal banking segment.

We also continued to make good progress in our customer loyalty initiatives. This quarter we added Iberia Airlines to our existing travel loyalty program, which provides our customers with more alternatives to accumulate travel rewards for international flights. This new benefit is part of our permanent effort to enhance our loyalty programs, thereby consolidating and increasing our relationships with customers and reinforcing our value proposition.

All of the efforts in strengthening our relationship with customers are not only intended to grow in assets but also in deposits, particularly those from the retail segment. We believe that growth in retail deposits will be crucial in light of the new liquidity standards that will make this source of funding more valuable. These improvements have allowed us to post double digit growth in demand deposits of 12% YoY, which added over $800 billion in deposits.

Please turn to slide number 6.

The banking industry continued showing signs of slowing growth this quarter, in line with the weak economy. Total loans for the system grew only 0.7% QoQ versus our reduction of -0.2% during the same period.

The slight drop in Banco de Chile's QoQ loan growth was a conscious and strategic decision where we refocused our commercial efforts to grow in segments that present a better risk return relationship. Specifically, in wholesale commercial and mortgage loans, we increased the requirements from customers in terms of spreads in the flow of new loans due to our expectations of higher risk and anticipating the future implementation of Basel 3, which could have higher capital requirements for banks. Consumer loans on the other hand, continued growing strongly at 2.1% QoQ, well above the industry average of only 1.5%, supported by the successful implementation of the previously mentioned initiatives.

Please turn to slide number 7.

Customer income drove operating income growth this quarter, which reached $411 billion pesos, up 7.7% YoY. Thanks to the rise in our loan volumes, together with strong demand deposit growth, we grew customer interest income by 4.9% YoY. Fee growth also remained strong, growing 7.4% YoY, driven mainly by transactional products of the retail segment. This increase is clearly seen in the chart on the upper-right, where the proportion of non-lending revenues to lending revenues has gone from 1x to almost 1.2x, due to greater cross-selling. In turn, non-customer income grew sharply, 15.6% YoY, as a result of higher inflation, a decrease in charges related to CVA for derivatives and higher income from the management of fixed-income securities held for trading.

Also on the chart on the bottom-right, our margin from loans slowly began showing improvements in the 1Q16 after a period of decreasing trends. The evolution was due to a variety of factors including mix and aggressive competition. Specifically, strong growth in mortgage loans on an industry level and our further expansion in consumer loans focused on customers with higher incomes - and lower margins – decreased our overall spread. However, this quarter, we are pleased to say that new loans of all products have shown improvements in spreads and this should hopefully continue throughout the remainder of the year.

These positive results were complemented by effective risk management that allowed us to maintain our loan loss provision low, closing the quarter at only 1.1%, as demonstrated on the next slide, number 8.

Through our focused and prudent risk management approach, loan loss provisions ended the quarter roughly at same level as last year, $65 billion and even decreased when comparing LLP ratios.

As you can see on the chart on the bottom, provision expenses from volume growth and the impact of local regulatory changes related to the implementation of new definitions of impaired loans and the possibility of substituting debtors for determining provisions for guarantees and factoring, loans were completely offset by the positive effect of allowances for loan losses denominated in US dollars, as there was a strong appreciation of the Chilean peso this quarter as compared to depreciation last year. Meanwhile, the intrinsic credit quality of the aggregate portfolio has remained almost unchanged thanks to certain macroeconomic variables, such as employment, that has not yet affected credit quality of individuals, in addition to adequate levels of risk in company segments.

As we've mentioned in prior calls, we pride ourselves that comprehensive risk management is a cornerstone of our business strategy and a distinguishing element with respect to our peers. Thanks to this philosophy, which is deeply present throughout the entire credit cycle, NPLs remained at reasonable levels and well below those presented by our peers, as you can see on the chart on the right.

Our credit risk strategy takes into account the current and future economic environment and in-depth knowledge of target customers and markets. We then manage our credit risk in two large segments. First, for the retail segment, we rely on automated processes for individuals on a group basis and, for the most part, parametric models for small and medium-sized businesses. Second, the bank manages credit risk in the wholesale segment using case-by-case analysis for large companies and corporations.

Organizationally speaking, we have tried to place risk teams as close as possible to business areas. This arrangement allows risk officers to participate throughout the entire loan process until a decision is made and then perform subsequent monitoring, ensuring ongoing control and consequently, significantly reducing losses.

Please turn to slide number 9 on Operating Expenses.

As you can see on the chart on the left, operating expenses increased 8.4% YoY. This was mainly due to:

- Personnel expenses that increased $12 billion pesos YoY, which was the result of inflation-indexed salary adjustments, higher variable compensation, and higher severance payments.
- Administrative and other expenses posted a $4 billion peso YoY increase due to more marketing costs related to commercial campaigns intended to reinforce brand recognition and loyalty programs, and also, higher IT and communication expenses. Additionally, we had higher depreciation charges related to the renewal of our stock of ATMs and more expenses in security transportation services. The increases in expenses from these last two items come about from the implementation of stricter security standards.

In terms of efficiency, our ratio increased from 46.9% in the 1Q15 to 47.2% this quarter, mainly due to second round effects of inflation and FX on certain line items such as personnel and IT Expenses, but still compares very favorably to our main peers and the industry as a whole. Cost control is a permanent challenge for all organizations, and is the reason why an important part of our business strategy is to keep costs down. In this regard, we initiated a project called Pro 2 that focuses on optimizing internal processes in order to improve efficiency and service quality, as well as to decrease operational risks. Improvements will be implemented in sales and post-sales processes related to mortgage, consumer and SME commercial loans, cash management and treasury. We have also begun to implement a paperless project that focuses on reducing costs associated with managing hard copy documents, streamlining workflows, electronically tracking digital documents and reducing fraud risks associated with paper copies. These initiatives should allow us to better serve our customers, help to keep our efficiency at adequate levels.

Please turn to slide number 10.
On this final slide, you can see how Banco de Chile has outperformed peers in four different aspects this quarter thanks to the various initiatives mentioned throughout this presentation including projects to improve our value proposition to key segments, process optimization, sales effectiveness, service quality, among others.

On the top left you can see that we lead among our main peers with a 6.7% operating margin. This is due to a mix of factors including an excellent and diversified loan portfolio, a high cross-sell model, low cost of funds due to demand deposit leadership, excellent risk rating and an effective business strategy.

Second, our LLP ratio remains at very low levels, once again reflecting our effective risk policies and capacity to adapt to a challenging economic scenario.

Third, our efficiency ratio of 47.2% compares well against our peers and has room to improve through new projects and initiatives similar to those recently mentioned.

And finally, on the bottom right you can see a comparison of ROAE for Banco de Chile and our peers. Undoubtedly, we continue to lead the industry in terms of ROAE of 19.4% this quarter due to our superior competitive advantages and our demonstrated capacity to implement our strategy.

To close, I believe that these results are a consequence of Banco de Chile´s 120 years of history and experience of customer service and dedication. Our primary focus is to offer our clients from all segments the best possible customer experience. Along these lines, we have implemented various initiatives that enhance their experience through significant advances in mobile banking, a new online banking site for companies, better uptimes, streamlining credit processes and improving customer complaint response times. We are also working on various additional projects, which we are confident will make a difference and continue to position us as the leading bank in Chile.

Thank you for listening to our presentation. If there are any questions, we would be happy to answer them.

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