Banco de Chile 2Q19

Financial Results Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's second 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 afternoon, everyone and thanks for participating in this conference call today. It's a pleasure for me to have the opportunity to talk about the main highlights of this quarter for Banco de Chile, key trends observed in the Chilean economy and the recent performance of local banking industry. After my presentation, Pablo Mejia, our Head of Investor Relations, will provide a deep analysis of the financial results posted by our bank during the second quarter.

Please go to the slide number 2 on Banco de Chile highlights for 2Q19.

The second quarter for Banco de Chile has been impressive in terms of results. We posted a ROAE of almost 23%, well above the levels recorded last year and 1Q19. Our bottom line was also the highest in our history, reaching $192 billion pesos. These achievements have been a result of both solid customer income generation as well as higher non-customer income given favorable shifts in interest rates and inflation. Due to our strong operating income revenues, we were able to show a remarkable efficiency ratio of 43%.

Additionally, it's important to highlight that we have continued to implement new commercial strategies and digital solutions for customers and we are proud to say that this has resulted in 90% of our customers using online banking at Banco de Chile and we continue to see important increases in usage rates in mobile banking, where nearly 60% of customers are using this digital channel. Finally, we increased our free float this quarter by 60%, reaching a level of 44%.

Please go to the slide number 4.

Since the second half of 2018, the global economy has had a clear deterioration. As Chile is the country with the highest integration into the global economy, not only in LATAM, but also among emerging countries, the evolution of external conditions has a critical impact on our economy.

In the last World Economic outlook, the IMF downgraded the estimate for the 2019 and 2020 global GDP growth, arguing that the increasing world tensions have been raising the uncertainty, affecting investment and international trade. As you can see in the upper left chart, there has been a generalized drop in the global industry, where several PMI indexes have fallen even below the threshold of 50 points. This evidence suggests that the negative cycle will last for a longer period.

In this environment, most Central Banks have been moving towards a more expansionary bias in their recent monetary policy meetings, since most of them have opened the door for rate cuts before the end of this year. However, it is important to highlight that the Central Bank of Chile has been the only one able to drop the interest rate in Latin-America, after reducing the rate by 50 bps, to 2.5% in June. Consequently, Chile achieved the lowest policy rate in both nominal and real terms in Latin-America, as can be observed in the upper right chart. This decision confirms the strong ability of the Central Bank to implement counter cyclical policies, which is extremely important in negative cycles, like we have had this year. Undoubtedly, this earlier than expected shift in monetary policy will contribute to offset the worse global conditions.

This change in monetary policy was supported by both, the worsening in global conditions and the weaker than expected local growth. As the bottom left chart shows, the Chilean economy had sluggish growth in 1Q19, in line with the trend observed in most countries. Although part of this disappointing GDP was attributable to temporary factors, such as the heavy rains in several mining zones that reduced the copper production in the 1Q19, we also observed a weak expansion in the rest of the economy. The good news, however, has been the slight recovery observed in recent months. Between April and May, for instance, the GDP was up by 2.4% YoY, which is better than the 1.6% posted in the 1Q19. On a sequential basis, by isolating seasonal factors, the economy expanded at annualized rate of 3.1% in May, after the null expansion recorded in the previous quarter. Therefore, the Chilean economy is performing better than most of its peers.

This marginal recovery has been explained, in part, by the improvement in the labor market. As the bottom right chart shows, both nominal and real wages are growing slightly faster, while the job creation has been supported by waged employment rather than self-employment. These factors suggest that the labor market is providing more support for domestic demand, compensating the negative spillover from the world economy and the decline in domestic confidence.

We think that strong fundamentals and other cyclical factors, such as the more expansionary monetary policy, the better dynamism in the labor market and the weaker currency will lead to better conditions for the future. Having said that, I would like to talk about our baseline scenario for 2020. Please turn to slide number 5

We think the first quarter was the bottom of this negative cycle. As I mentioned before, the economy has shown signs of recovery, which we expect to continue in the future. Specifically, we estimate an average economic growth of 3.3% in the second half of this year, which is consistent with an expansion of 2.8% over the whole year. In 2020, we expect GDP to go up by 3.2%, as shown in the upper left chart. There are several factors behind our positive view: first, the lagged effects of the interest rate cuts applied by the Chilean Central Bank this year. Second, the positive trend observed in private investment. Third, the economy has increased its potential capacity for growth, as a consequence of the material increase of immigration to Chile. In fact, the Central Bank of Chile raised the forecast for potential growth from 3.2% to 3.5%.

The inflation rate has remained in the lower part of the central bank range, which is between 2% and 4%. In June, the CPI posted a YoY increase of 2.5%, as a consequence of the 1.2% QoQ change observed in the second quarter. As we have mentioned in previous conference calls, the lower inflation from the below trend growth has been offset by the weaker Chilean peso. As the bottom left chart shows, we expect the CPI to converge to the 3.0% target in 2020.

Finally, on monetary policy, we expect the rate cuts to continue in the future. Since inflation expectations have been anchored to the long-term policy target of 3.0%, and the economy will likely remain growing slower than the long-term rate, the Central bank has room to continue decreasing the monetary policy rate. Specifically, we see two 25 bps rate cuts in the remaining of this year, and the beginning of a normalization process late in 2020, if the economy shows convincing signs of recovery. Our interest rate forecast is shown in the bottom right chart in this slide.

Now. I'd like to briefly discuss the evolution of the Chilean banking industry. Please turn to slide number 7.

Despite the below trend economic growth observed since the last year, the banking industry has maintained solid financial results and high profitability levels.

In the 2Q19, the local banking industry posted a net income of Ch$812bn, which is 42% higher than the same figure of 2018. Therefore, as of June 2019 the total net income was Ch$1,383 bn, representing a 8% increase in comparison to the first semester of 2018, equal to an ROE of 14%.

The positive quarterly results posted by the industry were supported by several factors, including: increased total revenues due to the effect of higher inflation on the structural UF gap held by most of the Chilean banks; loan growth of 10% YoY as of June and risk expenses remaining in low levels.

The chart located in the lower part of the slide shows the strong correlation between GDP and loan growth. On average, the elasticity of loan is close to 2 times the GDP growth. As we expect the economy to increase its growth rate in the future, is reasonable to forecast an acceleration in the loan expansion in the coming quarters, to levels of almost 9% in nominal terms.

The positive result of the industry was in part explained by the outstanding bottom line posted by Banco de Chile this quarter. Pablo Mejia, our head of investor relations will analyze our performance in the 2Q19, as well as the our main strategic initiatives.

Pablo Mejia

Thank you Rodrigo. Please turn to slide number 9.

We are proud to present our second quarter 2019 financial results. This quarter, we recorded the highest quarterly net income figure in our history of $192 billion pesos, well above the level recorded in the first quarter of 2019 and the same period last year. As you can see on the chart on the bottom left, we ranked first in terms of net income generation with a wide difference when compared to our main peers.

This strong result was explained by robust customer and non-customer income growth, which more than offset higher provisions for loan losses, operating expenses and taxes. In the next slides we will go into a deeper review of each of these concepts.

Please turn to slide number 10.

As you can clearly see, operating income this quarter grew strongly by 17.7% over the same period last year, reaching $538 billion pesos, thanks to our superior business strategy that is focused to continue penetrating the retail segment and growing selectively in the wholesale segment.

On the chart to the left is the breakdown of operating income. Revenues were up due to a large increase in customer income that grew 11.5% year-on-year or $41 billion pesos. This was driven by our expansion in loan volumes as well as higher contribution of demand deposits that benefited our funding costs. Additionally, we recorded a strong increase in fee income of 24.6% over the same quarter last year. We will go into greater detail regarding this further on in the presentation.

In terms of non-customer income, we also had important results thanks to the spike in inflation that reached 1.22% this quarter and drove this source of revenue up by 40.2%, or $39 billion. Similarly, the decrease in nominal and real interest rates, following the 50 bps. cut in the reference rate by the Central Bank, also benefited our positions in fixed-income securities held for trading and AFS.

On the chart to the right, you can observe the impact of inflation on NIM. Last quarter, we recorded NIM of 3.79% with zero percent inflation. This quarter, our NIM rose by 75 basis points, mainly as a result of higher inflation amounting to 1.2%.

Throughout our history, Banco de Chile's focus has been to promote a strategy of responsible growth in every segment we serve. We believe that this has been at the core of our solid track record. As a result, today we have a larger percentage of our portfolio concentrated in low risk segments such as high net worth individuals, high quality SME customers and a blue-chip wholesale book, all of which allow us to lead the industry in operating revenues, net of provisions, as percentage of our interest earnings assets, with a 5.5%. This figure denotes wide gap with all of our peers. Its important to mention that every 10 basis points of operating margin translates for us into almost 3 billion pesos of additional revenues on an annual basis.

Please turn to slide 11.

Fees this quarter grew strongly, posting $112 billion pesos, up from $90 billion the same period last year. Fees were mainly driven from the retail segment products and services. Insurance fees grew significantly, up $9.2 billion pesos, or 33% due to a 19% increase in annual written premiums and the first-time recognition of the income related to the 15 year joint venture agreement with a prestigious international insurer. Transactional products also had superb growth during the quarter with card fees growing $5.3 billion pesos, in line with the changes we have made to in our loyalty program as well as royalties payments and ATM fees that were up $3.4 billion pesos thanks to the expansion of our ATM network given a commercial partnership achieved with an important retail company by the end of 2018. Finally, Mutual fund management fees have grown substantially, up $2.6 billion, due to revisions on management fees of certain kinds of funds, changes in mix and an expansion in assets under management.

Consequently, we have been able to enlarge our leading position in terms of net fees amongst our peers. We consistently rank first with an overall market share of 20.3% and as a percentage of operating revenues, we reached 21.9%, well above all of our peers, as shown on the charts on the bottom of this slide. This level of is a result of our premium customer base, reflected in our market share in personal banking current account deposits that normally ranges from 25% to 30% as well as our excellent market share in AUM.

Please turn to slide 12.

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.

The sharp reduction in the overnight rate by the Chilean Central Bank in June caught everyone by surprise and consensus today is expecting more rate cuts in the coming months. We expect that this will benefit us during the next 3 months as a result of the repricing of short-term liabilities and in the medium term we should gradually see an impact in NII. The bank's sensitivity to a reduction of 100 basis points over a 12 month period is negligible, however in the medium term, more than 3 years, the impact is about 30 basis points in NIM.

As you can see on the charts, demand deposits are a very important source of funding for Banco de Chile by representing 26% of total liabilities, where more than half is coming from the retail segment. In terms of market share, thanks to our effective commercial strategies, service quality and our ability to cross-sell and maintain customers that use our bank as their primary account, we have maintained our leading position with an stake that hovers 23%. This market-leading position together with solid credit risk ratings, has permitted us to post once again the lowest cost of funds in the industry with an average of 2.3% in local currency.

Please turn to slide 13.

Total loans this quarter grew by 8.7% year-on-year. The retail segment continues to be the driving force behind these figures, rising 11.1% year-on-year, while wholesale loans only grew by 4.9% during the same period. More importantly, on a quarter-on-quarter basis, our loan portfolio grew 2.3%, which denotes a 9.5% annualized growth rate. Both, the retail and wholesale banking segment posted quarter-on-quarter expansions of 2.3%.

The chart to the right shows the breakdown of loans by segment. In loans to individuals, the main driver for growth was mortgage loans, and commercial loans to SME customers led growth, both increasing more than 12% year-on-year. The strong level of mortgage loan growth is due to strong demand of properties together with very attractive rates that have recently become even more appealing for customers due to the prevailing scenario of low long-term interest rates.On the chart on the bottom left you can see how originations has sharply increased by 45% over the same period last year in residential mortgage loans. Our excellent performance in SME commercial loans was thanks to our effective commercial strategies that focus on bringing customers closer to the bank as well as our new preapproved loan models for these types of customers. As you can see on the chart on the bottom left, SME commercial loan originations grew sharply at 12.2% year-on-year. Since SME penetration in Chile is very low, we expect that the SME book will continue posting attractive growth rates in the medium term.

In terms of our wholesale segment, growth was driven by loans to Middle Market companies, which increased 8.6% year-on-year. The corporate area grew more slowly at 3.6% year-on-year but when compared to 1Q19 accelerated to 3.6% or 10.8% annualized. Also, worth noting is that during the 2Q19 our corporate division managed to close important long-term lending deals that contributed to the quarter-on-quarter growth posted by the segment. Similarly, We expect loan growth in this segment also to show a recovery in the coming quarters as soon as the investment regains dynamism.

It is indisputable that a key part of our success in growing the retail loan book has been our focus of continually improving our customer experience by providing them with superior products and service channels that they demand. Please turn to slide number 14.

The investments we have made in recent years are permitting us to implement a significant transformation in our retail banking service model. Since 2015, we have been developing many IT projects to create the best customer experience for our customers and to improve commercial activies as well as operating efficiency. In 2017, we began test a pilot service model in 16 branches. Results were very positive in improving sales, customer experience and even job satisfaction. Consequently, we have decided to rollout this program across the entire branch network.

The three key changes of this model are:

1) First, we are continuing to optimize the branch network by combining some Credichile branches into Banco de Chile locations in order to improve productivity and customer experience. This process takes advantage of our strong brand and permits us to have better economies of scale.

2) Second, a significant improvement in our personal banking service model, which is focused at providing tailored services to all segments that we serve. This involves expanding account manager responsibilities so they manage both assets and liabilities of our customers. This has been facilitated through our new CRM platform that permits account officers to have a full 360 degree understanding of our clients, thus enhancing cross-sell opportunities in credit and non-credit products and services.

3) Third, we are improving several activities at the branch level. We are implementing modern self-service equipment across all of our branch network. These new

terminals and ATMs will permit our customers to perform essentially all the functions that today require the assistance of a teller or customer service executive. We have also seen important improvements in customer experience through the use of greeters. All this technological investment will allow us to centralize activities, achieving simpler processes that will free up time that our account managers carry out in operative processes. Thanks to automation, our relationship managers will have more time to spend in commercial activities, increasing the productivity of our sales force.

Please turn to the slide 15.

This quarter we posted a cost of risk of $67.9 billion pesos. As you can see in the upper right, we incurred a net credit deterioration of $15.6 which was mainly originated in the wholesale segment. Nevertheless, this figure was influenced by very good credit behavior in the 2Q18. We also recorded $6.8 billion higher provision expenses due to higher volume and change in the mix towards retail loans. As mentioned earlier, our growth has been concentrated more in personal and SME banking, which have higher risk than wholesale customers but also have much higher spreads. Lastly, the appreciation of the Chilean peso to the US dollar, when compared to the 2Q18, benefited our allowances for loan losses denominated in foreign currencies by $8.2 billion, partly offsetting the aforementioned impacts.

In terms of cost of risk, we reached 0.96% this quarter and 1.12% for the full year, completely in line with our guidance.

It's important to highlight that we strive to have the best credit risk policies in the industry and this translates into very stable and low NPL ratios as well as higher coverage ratios. As you can see on the chart on the bottom left, our delinquency ratio compares very favorably to our peers, and actually decreased when compared to the 1Q19 and 2Q18. In terms of coverage ratio, we lead the industry with a level close to two times, while our main competition only has levels around 1.2 times.

Before moving on to the next slide, I want to remind everyone that in July we will be implementing the new standard model for provisioning SME loans, which will not have a material effect on our bottom line. Actually, we expect the impact to be much lower than the levels that have been reported by our peers in the industry.

Please turn to slide 16 on operating expenses.

Total operating expenses increased 9.5% year-on-year. This rise was influenced by several strategic projects which should permit us to improve our cost structure in the coming years. Currently, we have three main projects occurring simultaneously at Banco de Chile.

First, digital transformation has become one of our main short-term challenges. As a result, we have continued working diligently to continue implementing new products, services, tools and automated processes in order to digitally transform Banco de Chile by means of a comprehensive front-to-back of all of the processes involved in our operations. Second, as I mentioned, we recently finished a pilot program that tested a new branch model. Throughout the rest of 2019 and 2020, we will be transforming our branches network into this new model. Lastly, we are in the first phase to implement an efficiency program at Banco de Chile. We are currently identifying processes that could be improved and streamlined to allow the bank to maximize returns without affecting customer experience.

The chart on the right shows a breakdown of the expenses related to these projects. More than 70% of the additional expenses this quarter were related to these initiatives while only $5.7 billion pesos were related to recurring expenses. It's also important to highlight that recurring expenses grew 0% in real terms.

Due to our strong operating revenues, our efficiency ratio improved to 43% this quarter. However, we expect that we should end the year with a level close to 44% to 45% for the full year. In the medium term, when all of our strategic projects have been implemented, we believe that we will be able to reach a significant advance in efficiency. As you can see on the chart on the bottom right, which shows a comparison of efficiency ratios amongst different banks, we believe that we yet have the oportunity to improve our cost structure.

Please turn to the slide 17.

As is widely known and 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 on April 30, 2019. This final payment triggered the dissolution of SM Chile and SAOS. Registered shareholders of SM Chile, as of May 31, 2019, received Banco de Chile shares, increasing our free float from 27.7% to 44.3%. This impacted positively our index on the Santiago Stock Exchange and we expect that in August our share will have an important change in the MSCI indexes. Actually, on the local exchange, we are the company with the highest weighting of 11% in the IPSA index. All of this has translated into a 27% increase in daily trading volumes. We also expect that this will improve our visibility in the market.

Please turn to the next slide, number 18.

Before moving to the Q&A section, I would like to close by emphasizing some of the points we discussed in the presentation and also by providing our guidance for the future.

As Rodrigo mentioned at the beginning of the presentation, we believe that the Chilean economy will gradually increase its dynamism. Since we expect GDP growth to increase from 2.8% this year to 3.2% in 2020, we believe there is room for some recovery in loan growth to levels close to 9% in nominal terms. In addition, the potential increase in inflation to 3.0% will generate an additional boost to treasury revenues.

We strongly believe there is space for further efficiency improvements. In addition to the cost discipline we have had, which was reflected in a recurring expense growing zero in real terms this quarter, we think that the implementation of projects we are currently working on, such as the digital transformation, the efficiency program and the implementation of a new branch model, will allow us to sustainably improve the efficiency ratio. We estimate that in the medium term the efficiency ratio should improve by nearly 3 percentage points.

The cost of risks has remained in line with our guidance, which is between 1% and 1.1%. Given our prudent risk policies, the economic outlook and our healthy loan portfolio, we expect this ratio to remain at current levels over the foreseeable horizon.

In this context, we reaffirm our view that Banco de Chile will be able to maintain a sustainable ROE between 18% and 20% over the mid-term.

I would like to end this conference call by highlighting the important increase in the free float, which occurred after the payment of subordinated. We believe that this will provide us much more visitibility and hopefully this should translate to greater trading levels.

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