

2Q17 Earnings Call Transcript

July 27, 2017

10:00 AM CT

Operator: This is a recording for the Manuel Perez Teleconference with IRSTRAT Thursday, July 27, 2017 scheduled for 10:00 AM CT. Good morning and welcome everyone to the Credito Real second quarter Earnings Conference Call. Credito Real issued its quarterly report on Wednesday, July 26, 2017. If you did not receive a copy via email, please do not hesitate to contact us in Mexico City at 52-55-5228-9753. It is important to note that the presentation and the MP3 recording referred to this call will be available at www.creal.mx. Before we begin the call today, I would like to remind you that the information discussed in today's call may include forward-looking statements on Credito Real's future financial performance and prospects which are subject to risks and uncertainties. Actual results may differ materially and the company cautions not to rely unduly on these forward-looking statements. The company undertakes no obligation to publicly update or revise any forward-looking statements. With us this morning from Credito Real we have Mr. Angel Romanos, CEO and Mr. Carlos Ochoa, Deputy CEO. They will discuss on the more important strategic financial and operating aspects of the second quarter 2017. I will now turn the call over to Mr. Romanos.

Angel Romanos: Good morning, everyone, and thank you for your valuable participation today. I am pleased to inform you that during the second quarter of 2017 we were able to continue with a sequential recovery trend started at the beginning of the year that begins to drive of the Mexican economy. Moving into the quarter with more

detail we recorded Ps. 422 million of consolidated net income, Ps. 48 million more than that recorded in the same period last year. Our operational performance gets further stability as is reflected in the Ps. 33 million sequential decrease in the allowance for doubtful receivables and the 10 basis points for reduction in our investing class NPL ratio. Behind the enhancement in the net income we can find the solid origination of high profile credits in our legacy business of payroll loans in Mexico and a strong business mission in the whole Instacredit Payroll which continues advancing in sufficient integration to our business platform. Here, it is important to note that our business line coupled with the execution of our funding costs pass-through strategy more than offset the effects of an increasing reference rate. In this context, we continue striving in the solidification of our balance sheet and risk profile by fixing the rate of Ps. 2,500 million tranche of our total debt this quarter. Therefore to this date, the fixed rate portion of our debt surpasses the 50 percent mark helping us to decrease our exposure to market fluctuations and bringing further stability to our financial position. Additionally in the financial structure front, we issued in a domestic market Ps. 750 million in local notes through three different admissions which overall were oversubscribed in general 1.5X, proof of the appetite for our securities as the risk adjusted return delivered by the company is getting momentum with our better results and the execution of proven financial initiatives reflected last quarter in the outlook upgrade in Standard & Pooors. In this sense we feel encouraged as quarter over quarter with solid results and a strong balance sheet in hand we are dissipating doubts and ifs over the business model fit of Instacredit. Looking retrospectively after more than one year of the acquisition of Instacredit we are clear of the right decision we made. In this regard, let me share with you that at the end of the second quarter 2017, Credito Real reached an all-time high in number of customers serving over 814,000 clients in six different countries, and originated more than Ps. 4,500 million of new loans, all this without giving up the stability

of our operating metrics as you can see in our Earnings Release. Before ending my participation I would like to take this opportunity to highlight the Bolsa Mexicana de Valores Price Recognition for Corporate Governance of Credito Real which has been deemed the most qualified issuer in this important line as a result of the values and commitment to our shareholders we're leading a daily basis. To conclude, although encouraged by our results and the consolidation of the business segments of the company, we remain aware of the challenges to overcome and we continue striving to enhance our balance sheet and mitigate market risks, always seeking for the best interests of our shareholders and stakeholders. With this, I want to thank you again and leave you with Carlos Ochoa. Thank you very much.

Carlos Ochoa: Thank you, Angel. Good morning everyone and thank you all for taking part in Credito Real's Quarterly Conference Call. Regarding interest income during this quarter we reached interest income of Ps. 1.9 billion increasing 20 percent compared to the second quarter 16. This increase was mainly due to the growth in the loan portfolio supported by the federal, Instacredit and SMEs which contributed 60 percent, 26 percent and 9 percent, respectively, to the consolidated interest income. Regarding expenses, average cost of funds increased to 11.1 percent as an increase of 370 basis points when compared to the 7.6 percent during the second quarter of 16. This increase is mainly explained by higher reference rate in Mexico. The financial margin increased by 8 percent to Ps. 1.3 billion driven by the interest income growth. Thus, our international businesses contributed to the 45 percent in the consolidated financial margin. Provisions for loan losses reached Ps. 281 million during this quarter representing 4.6 percent of the total loan portfolio. This increase is mainly due to the provisions adjustments made in Instacredit in order to be aligned with Credito Real's policies. Commissions and fees collected increased 96 percent during the second

quarter of 17 to Ps. 209 million when compared to the second quarter 16 integrated by Ps. 121 million commissions from Resuelve and Ps. 88 million from Instacredit. Administrative expenses reached Ps. 781 million during the second quarter showing a 4.6 percent increase when compared to the second quarter 16. This growth was driven by a rise in Credito Real's administrative expenses and an increase of Ps. 39 million associated to the used car segment. However, this effect was partially offset by a decrease in Instacredit's administrative expenses of Ps. 34 million and that decrease associated to AFS and Resuelve of Ps. 90 million. As of the second quarter of 17, net income reached Ps. 422 million showing an increase of 12.7 percent year over year. This keeps us on track for our 2017 guidance. Regarding the key financial ratios, ROE stood at 19.1 percent during the quarter whilst ROA reached 4.9 percent. The quarter efficiency ratio decreased to 49 percent compared to 55 percent in the second quarter of the previous year. To the fourth quarter of 16 the efficiency ratio calculation excludes Resuelve since this business does not involve credit risk. This quarter the cost of risk was 4.6 percent compared to the 3.7 percent during the second quarter of 16 as a result of the increase in the provisions for loan losses line. Regarding our loan portfolio, it increased by 13 percent to reach Ps. 25.1 billion at the end of the second quarter of 17 driven by the double digit growth in Instacredit, payroll and SME. Our payroll portfolio increased by 18 percent to Ps. 16.7 billion supported by the pensioner segment which represents today 35 percent of the total payroll origination during the quarter. Almost 85 percent of the payroll loans originated during the quarter derived from our three main distributors in which we own equity. In addition, the NPL decreased 1.5 percent during the second quarter of 17 when compared to the 2.3 percent which we had in the previous year. Our SME portfolio increased 11 percent year over year totaling Ps. 1.6 billion as of the second quarter of '17. We extended both the average loan term and the average loan amount and starting to focus on larger accounts. Our used car portfolio

increased 2.5 percent year over year, reaching Ps. 2.4 billion at the end of the second quarter while the origination amounted to Ps. 422 million in the quarter. Instacredit's loan portfolio reached Ps. 3.9 billion showing an increase of 26 percent year over year and representing a 16 percent total loan portfolio with an NPL of 4.5 percent. In the lien holders we integrated durable goods and group loan businesses which both registered the loan portfolio of Ps. 411 million during the quarter, decreasing at 62 percent driven by the divestment in durable goods. Moreover, the origination reached Ps. 1.3 million increasing 25 percent year over year, driven by group loans. This quarter the consolidated loan performing loan portfolio was 2.2 percent compared to the 2.3 percent last year. The NPL improved mainly in payroll and used car businesses is still in line to the 2-3 percent long-term objective as we move forward with greater loan portfolio diversification. It is also important to mention that on April 3rd, a dividend payment was distributed amounted 25 Peso cents per share totaling an amount of almost Ps. 100 million to prove our commitment to our shareholders. With this, I conclude my remarks and let me turn back to the Operator to open the line for Q&A. Operator?

Operator: Thank you very much. Ladies and gentlemen, if you have a question, you may press *1 on your touchtone phones now. Again, that is *1 on your touchtone phone now. Our first question will come from Ernesto Gabilondo, Bank of America.

Ernesto Gabilondo: Hi, good morning, Angel and Carlos, and thanks for taking my call. My question is about your cost of funding. I believe you have probably hedged half or more than half of your funding to fixed rates and that cost was reflected in this quarter. I just want to know your expectations for the coming quarters, should this cost of funding be stable or could it increase a little bit more given the last increase in interest

rates? Then I believe it's too soon to think about a potential cut in interest rates, but if this happens at some point can you give us the sensibility on your net income from a potential cut of 100 basis points? Finally, I would appreciate it if you can share with us what are the key dynamics that you are expecting during the second half of the year. Thank you.

Carlos Ochoa: Hi Ernesto. Thank you for your call. Well, regarding the cost of funds, it's important to mention that during this quarter the Tier, the reference rate here in Mexico increased by probably 50 basis points. You know since the beginning of the year we intended to increase the fixed portion of the total debt and at this point with the 52 percent that we have, we feel comfortable. Our expectation at the beginning of the year which still remains today is that the Mexican reference rate will be increased 150 basis points, that was our view and probably we still have another 25 basis points for the remaining of the year as a max. That's our view. But I don't see coming interest rate cuts not this year, not the next year. I think that we will, our view is that we shall not increase more of our fixed proportion of the debt. We feel comfortable the way it is, especially when you look at the curves now you start seeing a decline over the next couple of years. I think we will keep it like that for the remaining, at least for the remaining of this year. The key dynamics for the second half of the year are going to be focusing still on the growth part of the business and the asset quality. We are making a lot of efforts especially in Instacredit in the Central American business to improve the asset quality, to maintain the asset quality that we have on all our businesses and more specifically in the Instacredit business. Those are going to be the key tasks for the remaining of the year. I'm not sure if that answers your question.

Ernesto Gabilondo: Yes, thank you. In terms of the asset quality, NPL should

remain stable at these levels. And what about your (inaudible 15:27)? I noticed a nice improvement from the first quarter. Because of this where should we be at the end of the year?

Carlos Ochoa: You know, net from the collections that we received from the charge off accounts probably the cost of risk should remain about the same level that we currently have, more or less in the 4.5 percent, net of that one. We feel comfortable that way.

Ernesto Gabilondo: Okay, thank you. Just a follow-up about the interest rates. I agree with you that it's soon to think about a potential cut but given that you have already fixed 50 percent of the funding as you've done this in stability and what should happen if there is a cut of 150 basis points, what can we expect in terms of your net income?

Carlos Ochoa: Honestly, we haven't done it since we are not considering that one for the remaining of the year nor the next year. But in any case, I mean the focus at the beginning of the year as we emphasized a lot is that was to focus our efforts on the pass-through of the increases. Evidently that should have a positive effect on the bottom line, but we haven't performed an intensive analysis you asked me.

Ernesto Gabilondo: Okay. I agree. Thank you very much.

Carlos Ochoa: Thank you.

Operator: Thank you very much. Our next question will come from

Tito Labarta, Deutsche Bank.

Tito Labarta: Hi, good morning, Angel and Carlos. Thanks for the call. A couple of questions. I guess first on loan growth we saw some good loan growth particularly in the payroll business where loans are growing almost 20 percent year on year. By concentrating more on Instacredit loans actually fell now the second quarter in a row where we've seen loans falling at Instacredit. I just want to understand a little bit more of the dynamics there both on the payroll lending segment is probably better than what we were expected. Can that high growth you're seeing on payrolls continue and if you can give us some more color on why loans are falling in Instacredit. Then my second question is on asset quality also between with Instacredit the NPLs pick up quite a bit at Instacredit. I know you mentioned that that's something you're going to be focusing on. If you can tell us a little bit more why it deteriorated so much and can that improve and what you're going to do to improve that. Then also on the payroll lending business we saw actually good asset quality. Can that continue to improve? Thank you.

Carlos Ochoa: Hi, Tito. Thank you for your question. In terms of growth what we are seeing especially in the payroll business, I mean we still see a lot of potential to increase the penetration with the government agencies that we currently work with. Increasing the penetration is going to be one of the main effects. The way we are trying to do that is you know we are improving our operational procedures in order to reach for that. Basically we are changing the procedures over here to speed up the processes in order to keep growing the book. We've been doing that from the beginning of the year and I think the growth that we are experiencing in the payroll business are a result of these changes in the origination procedures. Again, in terms of the asset qualities, the strategies that we've been following for the last couple of years is focusing

our commercial efforts on federal level employees as well as pensioners and the improvements in the NPLs is the proof of that one. We will continue in that path. We continue our commercial efforts in the same path. Regarding the Instacredit, it's important to mention the effect on the FX that you have year on year and quarter on quarter. If you look at the quarter on quarter, the Mexican peso appreciated for over 50 cents or something like that and year on year, it's improved, as of the second quarter of 2016, the peso was pretty much at the same level. The book in Instacredit should be growing probably 15-20 percent which is a rate that has been growing over the last few years and we believe that we could reach growth rates of 20 percent in that business with the same asset quality. We are paying a lot of attention in the origination procedures as well as on the collection part of the business and that should be reflected over the asset quality when it comes to Instacredit.

Tito Labarta: Okay, thanks, Carlos. That's helpful. Then I guess that is the main impact on Instacredit wise in the coming is because of the currency. As the currency perhaps stabilizes and with the good growth you're seeing in the payroll lending business your guidance for loan growth for the year was 5-10 percent. Can you surpass that guidance or is there a potential upside I should say to that guidance and also could that also mean that your net income guidance is maybe somewhat conservative 0-5 percent if you have better loan growth than expected.

Carlos Ochoa: You know, if you look at the company growth rate of the book of over 13 percent I mean we believe that we can continue with same trend for the remaining of the year. If we continue this one probably we should be growing the book by 15 percent by the end of the year.

Tito Labarta: We should use the 15 percent as a new guidance for loan growth?

Carlos Ochoa: No, I think it's too early to say. It's too soon to say that once, but we believe that we can continue with this same trend for the remaining of the year.

Tito Labarta: Okay. Fair enough. Then I didn't understand the last thing you mentioned on the Instacredit on the asset quality, was there something specific that led to the spike in NPLs or?

Carlos Ochoa: No. I mean it's something we see something normal in that one. If you remember when we consolidated the business, if you take a look at the tiers when we consolidated first a year ago but what the NPLs of Instacredit were pretty much in the same range as they are currently at this point. It should be pretty much stable.

Tito Labarta: Okay. Then maybe the low NPLs that we saw in Instacredit were not sustainable? This 4.5 percent level is more what we should expect for Instacredit?

Carlos Ochoa: It's pretty much, I would say it's more in the 4 percent.

Tito Labarta: 4 percent. Okay, alright, that's helpful. Alright, thanks a lot Carlos.

Carlos Ochoa: Thank you, Tito.

Operator: Thank you. Our next question will come from Claudia Benavente, Santander.

Claudia Benavente: A follow-up question. I was wondering since you're holding in a foreign gap assesses less liability linked to a fixed interest rate, how much of it is hedged and should you have the benefit from the repressed high interest rates that we could expect for 2017. That's it.

Carlos Ochoa: Hi Claudia. I didn't get the first part of your question?

Claudia Benavente: I was wondering since you have a positive gap of assets less liabilities linked to a fixed interest rate, if we should observe a benefit on your results next year considering these assets reprice more than the liabilities next year or if you have that position hedged?

Carlos Ochoa: Definitely. I mean we think, as I was saying earlier, we think that height process, the height in interest rates here in Mexico are almost done, at least for this year, and as you can see from the trend in our yield and especially on our name as well, you might see the effect of the repricing effects on all of our products. The traffic yield passing through the interest rate hike, we are already perceiving that on our P&L. We feel comfortable as I was saying, we feel comfortable with the fixed portion of the debt that we have and if at some point the interest rates increases, well that should benefit the company.

Claudia Benavente: I'm sorry, that was not my question. It seems you have

more assets linked to a fixed interest rate than liabilities and the duration is about three years, so this should start repricing to the higher levels of current interest rates starting in 2018. I was wondering what would be the benefit of that position or if that position is currently hedged so we might not see any benefit from that.

Carlos Ochoa: Okay, sorry, sorry. I misunderstood your question. Yes, you are right about that one. All of our products especially except for the SMEs are at a fixed rate. Basically the hike in the interest rate has a negative effect over the last few quarters and that's why we were repricing that one. But that's the nature of our business. Right? In these segments of the population and especially with these products, all the products are at a fixed rate.

Claudia Benavente: That's probably from 2018 we should see all those efforts revised to the higher level of interest rates, right?

Carlos Ochoa: Yes.

Claudia Benavente: As those assets expire, therefore we could see probably important benefits due to that profit gap.

Carlos Ochoa: That's right. I mean that's right. You know that the main challenge at the beginning of the year was the profitability was the main challenge because most of our products were priced at the lower interest rate and we were already with a much higher cost of funds. Now that you are starting, that portfolio it's paying down, so you start to see an increase in the yield because of the pass-through that we've been doing lately.

Claudia Benavente: Okay, thank you.

Carlos Ochoa: Thank you, Claudia.

Operator: Thank you very much. Once again, ladies and gentlemen as a quick reminder, if you would like to ask a question, please press *1 on your touchtone phone now. Our next question will come from Velasco German, BBVA.

German Velasco: Hello, good morning, Angel and Carlos. Thanks for the call. Just a follow-up question. Carlos you mentioned that the cost of funds is currently at 11.1 percent. Should we expect this level to be the highest level for this year or should we expect another increase in the cost of funds? On the net income guidance at the beginning of the year you mentioned that it is probably that you would grow between 5-10 percent, so I was wondering if there was any chance you can increase your net profit above that level? Thank you.

Carlos Ochoa: Hi German. I just think that the cost of funds should be stabilizing at this level and this is due to two facts. First, our view is that the hike is feeding the reference rate here in Mexico is coming to an end. We only expect to have 25 more bits for the remaining of the year. That should be about, and on the other hand, again, due to the efforts that we are taking to fix over half of our debt, probably the cost of funds should be stable at this level that we currently see. In terms of the guidance, I mean what we expect is that we expect that the trends that we are seeing for this quarter should continue for the remaining of the year. That's our view on those.

German Velasco: Okay. Okay. Thank you, Carlos.

Carlos Ochoa: Thank you, Herman.

Operator: Thank you. Our next question will come from Benjamin Theurer, Barclays.

Benjamin Theurer: Hi, good morning, Angel, Carlos. Thank you very much for taking my question. I just wanted to elaborate a little bit on the business in the US. I assume that the business is still let's say not in the best of shape in terms of demand, growth and the whole environment still not eased. But we've seen obviously a decline in the loan portfolio and I guess it's also a lot of FX related here similar to what you've mentioned just in Instacredit. But the fact that and thank you very much by the way, very much appreciated, you now break down the three different regions, Mexico, Central America, US. It shows there was a significant deterioration in the net loss on the US business. Just to understand, I mean obviously it's challenging, but what is your outlook for the US business? Where do you want to take that and when do you believe that this business is actually going to contribute again in terms of net income instead of being a drag on results? Thanks.

Carlos Ochoa: Hi Ben. Thank you for your question. Overall, I would say that the business in the States is a very important element for the company. As we've mentioned very often the view, or our view for the business in the States is that at some point probably one-third of the business within four to five years is going to be in the States. That's the potential that we see. Having said that, I mean we're still facing the challenges of a growing business. If you look at the effect on the expenses side, for

example, leaving aside the FX, the expenses on setting new branches is over there. That's been taking a lot of cash and that reflects on the net income of that business. On the other hand, as you can imagine, this year has been very challenging due to the changes in the political landscape in the States. Basically we've been very cautious in terms of loan origination and that's had an effect over the growth, but we prefer to be cautious until we have a more clearer picture about what's going to happen over there. But in any case, we believe as I was telling you, we believe that definitely it's going to be one of the key elements of growth. I would say and probably to wrap this up the bright part of the story is that if you look at the percentage of the net income that comes from the businesses outside Mexico that amounts for the 45 percent and only in the case of the US business that amounts to close to the 10 percent. That trend should continue and that shows the importance of the businesses outside Mexico for Credito Real.

Benjamin Theurer: Okay. Perfect. Then just to confirm. I mean you've now basically you group together what used to be I guess groups and durable and durable still on the way to basically go to zero so we can assume that the majority of what is currently in over is basically what used to be the group loans, correct?

Carlos Ochoa: That is correct. This is correct and we made those changes in the presentation for simplification.

Benjamin Theurer: Yeah, that's fine. Perfect. Thank you very much. That's all on my side.

Carlos Ochoa: Thank you, Ben.

Operator: Thank you. Our next question will come from John Haugh, Morgan Stanley.

John Haugh: Good morning, Carlos and Angel. Thanks for the call. One of the questions has been answered already. One quick thing, two quick things. Is there any, considering that you seem to be digesting Instacredit, are there other areas of growth or potential MNA that you guys might be thinking at this point?

Carlos Ochoa: Hi John. I mean we believe that we've been doing well with the digesting as you say of Instacredit. As you see the effect of the businesses of all the MNA that we did in the past are starting to, we are starting to see the benefit of those. In those terms I think that, well, I don't think so, I'm certain that the inorganic growth is the key element of growth for the company and in that sense we're always looking for opportunities and that's it. If at some point we see something that interests us and that aligns with the main strategy of the company, we might pursue it.

John Haugh: Then lastly, we know you successfully refinanced a lot of US dollar notes last year. Are there any thoughts about extending some of your shorter-term paper into maybe longer-term dollar notes or anything like that?

Carlos Ochoa: If you look at the liability, the ratio on the liability side which is close to the four years which is 3.7 years, and if you compare that one to the asset side which is way below two years we feel comfortable the way that way it is. Basically right now what we are doing is focusing on the most form of funding and not focusing ourselves in that duration.

John Haugh: Okay, so more of the local market type issuance if any.

Carlos Ochoa: One of the advantages of the local market is that that's the most efficient in terms of cost. What we've been doing lately as you might see is we are issuing on the short term. We are issuing Ps. 250 million monthly with the same duration. That means six months on the average, so we will continue to do that strategy for the remaining of the year until we start rolling it over like the shorter-term notes in the local market.

John Haugh: Okay. Thanks, fellows, I really appreciate it.

Carlos Ochoa: Thank you, John.

Operator: Thank you. Again, ladies and gentlemen if you would like to ask a question please press *1 on your touchtone phones now. Our next question will come from Natalia Theodozio, JP Morgan.

Natalia Theodozio: Good morning Carlos. My question is actually a follow-up on the MNA question. Do you have any updates on Credito Maestro? Do you know by any chance how much an acquisition of the entire portion of Credit Maestro would impact your capitalization?

Carlos Ochoa: Hi Natalia. No. Basically we're still working on that one and probably the main element for that position is going to be how much money can we save from consolidating Credito Maestro, but we still haven't made a decision in that sense.

Natalia Theodozio: I think you have until the end of this year for a decision or you have an option to buy I think this year and then they have an option to sell next year. Do you mind just reminding me of the conditions?

Carlos Ochoa: Yes, that's correct. We have the option. We have the call option for the remaining of the year whereas our part in Credito Maestro they have the two options for the next year.

Natalia Theodozio: Alright, but still you haven't made a decision on that?

Carlos Ochoa: No. As I was telling you that's still a work in progress. I mean we're still analyzing all the benefits that we could get from consolidating that one. If that's agreed for the company, if that's a positive we might pursue it.

Natalia Theodozio: Okay, thank you.

Carlos Ochoa: Thank you, Natalia.

Operator: Thank you. Our next question will come from Gabriel Nobrega, UBS.

Gabriel Nobrega: Hi everyone. Thank you for the opportunity to ask questions. My question is more on margins. I just wanted to get a little bit more color of what you guys are expecting for the rest of the year and do you expect your margins to be flat in 2018? Thanks.

Carlos Ochoa: I mean, yes, we believe that given all the pass-through that we are already seeing the effects of the pass-through in many of our products and in the payroll business and with the portion of the debt that we currently have fixed, we believe that we could sustain the news for the remaining of the year in the range of 20 percent or 21 percent. Also that's going to be positively affected when the Instacredit roll up gains weight within our books. But overall, in short, I would say that we expect the NIMs to be in the 20 percent or probably a little bit higher for the remaining of the year.

Gabriel Nobrega: Should we expect that for 2018 as well?

Carlos Ochoa: I would say that for the next year, for 2018, especially in the second half of 2018, by that time we will see the whole effect of the repricing in the payroll business so evidently that should be improving for the 2018 and especially for the second half of 2018 probably should improve.

Gabriel Nobrega: Alright, that's very clear, thank you.

Carlos Ochoa: Thank you.

Operator: Thank you very much ladies and gentlemen. With no questions in the queue, the question and answer session concludes. Thank you all for being in today's conference call. You may now disconnect.

###