1Q19 Earnings Call Transcript

April 25th, 2019

10:00 AM CT

Operator: Following is the recording from Manuel Perez with IRSTRAT on Thursday April 25, 2019 at 10:00 AM CT. Good morning, and welcome, everyone, to the Credito Real's First quarter 2019 Earnings Conference Call. Credito Real its quarterly report issued on Wednesday, April 24, 2019. If you did not receive a copy via email, please do not hesitate to contact us in Mexico City at +52-55-52-289753. It is important to note that the presentation and 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 first quarter 2019. I would now like to turn this conference over to Mr. Romanos. Please go ahead.

Angel Romanos: Thank you, Operator. Good morning, everyone, and thank you all for joining us today. As you can see from our results, Credito Real kicked off 2019 with an outstanding performance under an overall stable environment in Mexico and some headwinds in Central America. In this context, I would like to highlight the double-digit growth rates achieved in the consolidated loan portfolio and net income, the latter including two non-recurring effects related to the unwinding of the derivatives associated to our Senior Notes due 2019 and the negative carry resulting from the obtained proceeds from the placement of our Senior Notes due

2026. In underlying terms, this performance was largely driven by our strategic approach and flexible business model, including the continued incorporation of high-quality assets, which had, once again, a clear positive effect in our profitability and best-in-class non-performing loan ratio. On the macroeconomic environment in Mexico, we perceive a positive balance of risks and opportunities for our long-term prospects of growth, as the healthy level of the federal budget approved for 2019 is expected to be preserved in the coming years of this administration, coupled with a record-high consumer confidence and solid stability in inflation and reference rates. Next in order, on the results breakdown by business segment, Mexico's Payroll continued to add high-quality assets, registering a 20% annual growth in loan portfolio this quarter, totaling 25 billion pesos. Where, the constant and intense incorporation of clients with solid credit profiles remains as its main driving force. As for Used Cars Mexico, loan origination grew vigorously in an annual basis by 114%, amounting to 542 million pesos. Overall, our operational flexibility and strong focus on product innovation allowed us to fully capitalize on the positive environment prevailing in Mexico, marked by a consumer confidence index at an all-time high and a solid pick up in wages. Meanwhile, on Used Cars USA, despite the tougher consumption environment for our target market, fueled by the possible adoption of strictest anti-immigration measures, loan origination increased 34% in the first quarter 2019 in a year-over-year basis, benefitted by the strong generation of synergies between CRUSAFin and Don Carro. Now, let me quickly add that the diligently execution of our plans to accelerate the development of better economies, with an enhanced operating structure, at the newly established platform, "Credito Real USA", has helped us out to offset the anti-immigration headwinds. In addition to the improvement efficiency and larger economies of scale pursued, once fully completed, the operating endeavors in this segment will also allow us to improve our market outreach and visibility, thus opening up new sales and business opportunities. Turning to Small and Medium-sized Enterprises, performance continued at a solid pace with a 68% annual growth in loan origination, driven predominantly by the deeper market penetration of our leasing product. Our future prospects for this segment are very positive, as we expect to gain momentum as the federal government's initiatives to enable SMEs to better contribute in Mexico's growth gain traction. In this sense, we are confident that the work of our Institutional Relations Department will provide a valuable support to tap into these arising opportunities. Lastly, Instacredit performance started to show clear signs of recovery in terms of net income, which rose 86% and 98% versus 1Q18 and 4Q18, respectively. Furthermore, thanks to the modifications conducted to revamp our collection processes in this segment, we managed to improve the quality of the portfolio, as the non-performing ratio contracted 130 basis points from the previous quarter. We are devoting considerable efforts towards the stabilization of Instacredit; seeking at all time to preserve the quality and value of our assets in Central America, confident that our flexible business model will finally allow us to timely recalibrate the operations to the prevailing juncture. In relation to our financing front, we fully amortized our Senior Notes due 2019, through the settlement of approximately 135 million dollars, using the proceeds raised from the issuance of our Senior Notes due 2026. The latter also allowed us to cover our funding needs for all of our maturities in 2019. This transaction shows, once again, our capacity and commitment to timely meet our financial obligations, while enhancing our debt maturity profile to 3.9 years. Another positive development this quarter was the approval of a dividend payment of 70 cents per share, a record figure in the operating path of 26 years of Credito Real, as well as the cancelation of 3.2% of the Capital Stock aligned to comply with our very mandate of offering attractive returns to our investors. To end my discussion, I want to state that these quarterly results illustrate the strength of our business approach, granting us confidence and support to both overcome bigger challenges and take advantage of new opportunities; advancing with a firm first step towards the accomplishment of the goals set at our 2019 Guidance. Finally, I want to thank all our associates, customers, partners, shareholders, investors, analysts and stakeholders for their encouraging dedication and engagement, which motivate us to move forward in the consolidation of this, our Company. And now, Carlos will shed broader color of our financial performance of the quarter.

Carlos Ochoa: Thank you, Angel. Good morning and thank you all for being part of our quarterly conference call. Starting with the discussion of the P&L. Interest income totaled 2.8 billion pesos in the first quarter of 2019, a 22.5% increase when compared to the 2.3 billion pesos recorded in the same period last year, this was primarily driven by the consolidated loan portfolio expansion. Interest expense was 1.1 billion pesos, up 44.1% year-over-year, fueled by a larger debt balance on subscribed at higher funding cost, the negative carry associated to the unused proceeds and mostly that. As a result, the financial margin of first quarter 2019 was up 194 million pesos or 12.4% on a year-over year basis, totaling 1.8 billion pesos fueled by interest income growth which offset a higher cost of fund. Allowance for loan losses decreased to 386 million pesos, compared to the 421 million pesos recorded in the first quarter of 2018, enhanced by the collection rate improvement and better performance mainly, in Instacredit and Used Cars. The foregoing led to a 25 percent points expansion in the coverage ratio, from 183% in the first quarter 2018 to 208% this quarter. Separately, administrative expenses totaled 854 million pesos, almost flat year-over-year, as the expenses associated to our organic growth in Mexico was more than offset by the achievement of incremental efficiencies generated in Instacredit and through the ongoing consolidation of the "Credito Real USA" brand. Consequently, net income rose 48.8% during the first quarter, amounting to 624 million pesos, benefitted by a 154 million pesos non-recurring gain from the derivatives unwinding of our Senior Notes due 2019. Adjusted for this concept, net income in the first quarter 2019 totaled 470 million pesos, up 11.3% versus the same period last year, reflecting the combined effect of a strong portfolio growth and the achievement of high operating margins. Regarding our key financial ratios, at the quarter-end, net interest margin contracted to 18.9%, from the 20.8% registered in the same period last year, reflecting the higher funding costs related to the recent placement of Senior Notes. Return on Average Equity stood at 15.7%, 410 basis points above the 11.6% recorded at the end of the first quarter of 2018. Excluding the Perpetual Notes, the ROE at quarter-end was 550 basis points higher than that recorded in the same period last year. Meanwhile, ROA improved to 5%, from

4% in the first quarter of 2018, a 100 basis points expansion. The Capitalization Ratio decreased from 46% at the end of the first quarter of 2018 to 41.9% as of March 31, 2019. This quarter, the funding cost increased, from 10.5% at the end of the first quarter of 2018 to 13.7% following the adjustments of interest rates in domestic and international markets over the last twelve months that were reflected in the rates achieved on our recent debt placements. Adjusted for the negative carry of the non-recurring effect, average cost of fund was 13.2%. It is relevant to emphasize that we are constantly pursuing a greater diversification of our funding sources, to mitigate these effects. Now, allow me to discuss on our loan portfolio dynamics. At the end of the first quarter of 2019, consolidated loan portfolio increased by 22.1% to 38.3 billion pesos, largely supported by Mexico's Payroll, followed by SMEs and Used Cars in Mexico. Payroll portfolio expanded 20.1% year-over-year in the first quarter 2019, totaling 25.5 billion pesos, reflecting the capacity of our distributors network to originate new credits. On the other hand, SMEs loan portfolio totaled 4.4 billion pesos, up 2.1 billion pesos or 87% compared to the first quarter of 2018. As Angel already mentioned, this outstanding growth is primarily tied to the broad market acceptance of our leasing product, which incorporates attractive features for the Mexican companies that amounted to approximately 3 billion pesos, as well as the SMEs incremental dynamism. As a result, the participation of Small and Medium-sized Enterprises segment in the consolidated loan portfolio rose from 7.5% in the first quarter of 2018 to 11.5% as of March 31, 2019. Used Cars portfolio reached 3.2 billion pesos at the end of the first quarter 2019, an increase of 438 million pesos or 15.7% when compared to the same period last year. Used Cars in the States performance started to pick up, thanks to the progress achieved on the consolidation of key commercial synergies. Regarding Instacredit, the loan portfolio increased 1.9% or 83 million pesos at the end of the first quarter of 2019, to reach 4.5 billion pesos, reflecting an incremental dynamism in origination. Finally, non-performing loan ratio continued to improve, going from 1.9% at the end of the first quarter 2018 to 1.6% this quarter, as a result of our comprehensive origination standards, enhanced collection procedures and consistent focus on incorporating high-quality assets.

Moving into the analysis of the balance sheet. As of March 31, 2019, total assets recorded 50.8 billion pesos, up 8 billion pesos or 18.7% when compared to the same period last year, explained by the consolidated portfolio growth and raised proceeds from debt issuances carried out throughout the year. The Company's outstanding debt at the end of the first quarter 2019 totaled 31.7 billion pesos, an increase of 7.4 billion pesos or 30.7%. This variation mostly reflects the placement of our Senior Notes due 2026. Lastly, Stockholders' equity totaled 16 billion pesos as of quarter-end, up 1.6 billion pesos or 11.2% year-over-year. As a final point, it is worth standing that during the quarter we distributed a cash dividend payment of 70 cents per share which represented a dividend payout ratio of 13.6%; the highest dividend paid in the history of the Company. With this, I conclude my remarks. Now let me turn back the call to the Operator to open the line for Q&A.

Operator: Thank you. Ladies and gentlemen, to ask a question, please press the * on your telephone keypad and the 1, that is *1 to ask an audio question please make sure your mute function is turned off to allow your signal to reach our equipment. Thank you. Our first question will be from Carlos Rivera from Barclays

Carlos Rivera: Hi and good morning and thanks for the opportunity to ask questions. My first question is regarding the NIM the Net Interest Margin. So, you mentioned a little bit of a negative carry on this quarter and the adjust of cost of funding. So my question is, once that negative carry reduces, what MIN would you expect and more in general, what other initiatives are you thinking for improving this? you mentioned and if you could provide some color on additional funding strategies, maybe reactivating Instacredit that could be positive for the NIM, just getting a little bit more color there. My second question is regarding the 220 million gain regarding the hedges. Why has this happened? I thought that was hedging up a bond, it is the result of maybe a liability increasing? And then we see the income statement but increasing the liability and the balance. What gave rise to these effects? Thank you very much.

Carlos Ochoa: Okay. Thank you for your question. Well, firstly when it comes to the negative carry, you know, the negative carry during the quarter amounted to something around 45 million pesos, and basically this was due to the, you know, to the senior notes, we paid (inaudible) on mid-March. So basically, we kept those resources for 45 days on our balance, so that led to the most part of it. We expect to have deployed all the resources early next month because we have another amortization of a credit swiss facility and that is due in May, so basically that is when we are going to end up with the negative carry. When it comes to the cost of fund, and one that gears up that one, I mean, the negative carry, we believe the cost of fund should be something around the 13.2% or 13.5% or something within that range. We are seeing, if you look at the time when we issued the Senior Note, our latest issuance earlier this year. Now, if you look at how that bond is trading, one option could be to retrade that one at the lower year, probably something in the 8 and not in the 9 so that could be helpful in terms of reducing the cost of fund and also when it comes to the hedges, the hedges are a little bit cheaper than they were at the time we hedged those at the beginning of February, and finally your last question about the unwinding, well, basically is associated to the mark-to-market of the 2019 notes, I mean if you look at the strike price, the FX strike price that we hedged the 2019 notes, that was at 14-15 pesos, so that led to a significant gain and that explains the non-recurring effect that you see this quarter.

Carlos Rivera: Ok, can you remind us of your hedging policy for the rest of the instruments, the new 2026 and the perpetual, could we have some either gains or losses coming from similar nature to this one when the on live under to mark-to-market of every quarter other than the natural activity that goes with equity just focusing on the P&L. Thanks.

Carlos Ochoa: Right, I mean if you look at our latest issuance especially on the 2023 and 2026, and whatever came in between, the strike price for those is between 18.90-19 pesos something within that range, so if you look at the FX these days is basically within that the same level, so the mark-to-market that we currently have is negligible is mostly associated to the 2019 bond and basically when it comes to our hedging policies we are very conservative on that end and most of the debt that we have is only hedged with a cross currency swap.

Carlos Rivera: Ok, alright, understood. Thank you.

Operator: Our next question will come from Nicolas Riva with Bank of America.

Nicolas Riva: Thank you very much Angel and Carlos for taking my questions, I got two questions, the first one on your Central American business on Instacredit there was a big drop in the NPL ratio in the quarter and my question is what drove the improvement there? And if you can talk about your strategy in Central America going forward I remember that you had said in the past that you have stop originating loans in Nicaragua, that is the first question, on my second question on your funding needs for the rest of the year in the press release you said that you had covered for your maturities for the rest of the year, but I see in the debt schedule about 4.4 billion pesos that you still have due for the rest of the year I know that you issued 400 million in bonds but at least you can tell us if this is tied to revolving credit lines and expect to all this over, thanks.

Carlos Ochoa: I will start with your second question and yes, basically most of the other than a couple of amortizations that we have for this year and a maturity that they are two or just one for the Credit Swiss facility which is due in May amounting 23 million dollars, so basically that will be kind of the only amortization that we have, as for the remaining part what you see on the 4.4 billion mostly are associated to the revolving lines, those we have it for a number of years, so we do not see a big problem or we do not see any problem at all, rolling them over. Instacredit, I mean the efforts that we made in Instacredit we probably started by half last year and what we have been doing over there, is reinforcing our collection procedures over there, we are exchanging best practices between the companies and we had been clearly and very close to the Company to Instacredit, and they made a great effort over there and we started to see some progress as we like, on the other hand another thing which have been different locally is that the situation in Nicaragua is starting to cold down, I mean as they have many many problems over there, as you can see, but however I mean if you think that the problems on Nicaragua started a year ago already, the situation has cold down, and they basically are returning to normality and the demonstration that you saw at the beginning of April last year, they have cold down, so that had help us a lot when it comes to the collection in Nicaragua, and basically on the other hand the collections in Costa Rica improved dramatically as well as the origination of loans in Costa Rica and basically what we know from Costa Rica is that the situation in the country has dramatically improved from last year, also if you look at the FX the colon has stabilized compared to the period that you saw last year, also we are more positive, I mean, I would say that in general terms that the atmosphere in Central America is way more constructive than it was last year.

Nicolas Riva: Thank you very much Carlos.

Operator: Thank you, our next question is from Ernesto Gabilondo from Bank of America.

Ernesto Gabilondo: Hi good morning Angel and Carlos, thanks for taking questions, my first question was already answered, was what Nicolas asked, so just a couple of questions, the first one is in change of your fees line, we think it came lower than expected so can you elaborate on why came lower and how much we think per quarter for this line going forward, and then the second question is your opinion if the central bank will reduce rates this year and if you can remind us your NIM sensitivity to a potential cut in interest rates of 100 basis points. Thank you.

Carlos Ochoa: Yeah, well when it comes to the commissions and fees collected lines, if you see a drop compared to what you saw last year this is due to the reclassification of the commissions charge in Instacredit, as you might remember during the last quarter, the fourth quarter 2018, the auditors, I do not want to use the word vote, but suggested us to change the commissions and move it from the commissions line to the interest line and this is consistent with the IFRS 9 so basically that is the change, to put it differently what you see on the commissions and fees collected line right now is mostly associated to our Resuelve business what we would expect from that business is as long as they remain something around 150 million per quarter so by the end of the year we have some fees collected around 600 million pesos that should be ok for us.

Angel Romanos: Hello Ernesto, on your second question, we really do not expect at least the Central Bank to raise interest rates anymore, we expect them to keep them at where they are now and maybe we will get a lower main interest rate by the last quarter if things are going ok and If the United States does not have to raise interest rates anymore, which looks as it does not, so maybe we would have a lowering of interest rates, and that has an effect on our whole balance sheet of about a 100 million pesos.

Ernesto Gabilondo: Perfect, thank you very much Angel and Carlos.

Carlos Ochoa: Thank you Ernesto.

Operator: Our next question would be from Ivan Fernandez with Pictet Group.

Ivan Fernandez: Hi, thanks for the call. I have a few quick questions, the first one is, on page 4 of the earnings release you talk about the net income for the quarter 624.6 million pesos including the 220 million derivative gain but then at the same note you say that the net income adjusted for that gain is 470 million but again, if I take the 624 and subtract the 220 derivative gain I come up to 404 not to 470, could you explain that difference, please?

Carlos Ochoa: Yes, the difference are taxes.

Ivan Fernandez: Okay, thank you. The other question is, how much was the issuance fees that you paid in the first quarter for the bond issuance that you mentioned on the earnings release?

Carlos Ochoa: I would have to get back to you on that one to give you the precise figure of the issuances because as you know, most of the fees paid for the issuances are amortized through the whole duration of the issuance, so we will get back to you on that one.

Ivan Fernandez: Okay, and the last question is, I noticed that the payroll origination amount for the quarter moved down substantially, that is deliberate or there is some, maybe an additional hurdle you guys have seen in that space for origination?

Carlos Ochoa: No, it was mostly, there was a seasonality this year. And it was probably associated to the coming of the new administration and everything, and that lasted for the first couple of months. And but the, you know, it went back to the original dynamic on March. So we would expect the, you know, to see the same trends than we are seeing on the first quarter for the whole year.

Ivan Fernandez: Okay, so you are expecting to be slower for the whole year on the origination for payrolls?

Angel Romanos: No, the first two months were slow, but March was as expected and as we ended the last year, and April is coming a bit up of last year, so we expect to grow the portfolio at the end of the year.

Ivan Fernandez: Okay, Thank you. And so just to go back to your first answer, so the 220 million derivative gain just to be clear, is a pre-tax gain, the after tax is about 150.

Carlos Ochoa: That is correct.

Ivan Fernandez: Ok, thank you very much guys.

Carlos and Angel: Thank you.

Operator: Thank you. Our next question would be from Natalia Corfield with JP Morgan.

Natalia Corfield: Thank you for taking my question, I have doubt on margins, you mentioned the negative carry of the bond and discussed it, but I understand that your cost of funding went up nevertheless, so it is fair to assume that this is your new level of margins, or is there is something else that can help you with those margins in 2019? And, on asset quality, you can see that Instacredit is getting better, however you are growing SMEs and used cars, so what can we expect in terms of asset quality for 2019? Those are my two first questions.

Carlos Ochoa: Okay, well, when it comes to the cost of fund, I think that the 13.7% that you see right now would be the highest that we are going to see this year, and especially because of the negative carry, once that this normalizes, I mean, that should be around 13.2% or 13.X% (thirteen point something), I would say that it should remain that way and then and basically, we replaced it with what we expect to be the highest cost of fund, so the cost of fund should be within the range that I am mentioning the 13.2-13.5% for the remaining of the year. If nothing changes, for example, the interest rate cuts or whatever, I do not know if that answers your question.

Natalia Corfield: It does, so, but then basically, your margins are going to be not as high as they used to be in the past, because your cost of funding is higher now.

Carlos Ochoa: Yes, this is going to have an effect on the margins, but probably is going to have an effect also, when it comes to the, you know, the concentration with the SMEs, you know, the yield that we charged over there is considerably lower to what we have on the payroll, for example. So the combination yes, should have some pressure over the NIM, but in any case, we believe that that should be close to the 20% or something. And this is going to be, I mean, the way to reach for that 20%, is as long as the business in Instacredit gains weight, I mean, that should help us with the consolidated NIM of the Company.

Natalia Corfield: Okay, but for now we can expect lower margins, at least until you activate Instacredit, the pressure from the high cost of funding and the growth from the lower used(inaudible) segments and will probably bring, already brought margins down this quarter (inaudible) so they are going to be lower from what they used to be in the recent past.

Carlos Ochoa: I would say, and that basically is our best-case scenario this year, is that the margin, the NIM is going to be around the 20%.

Natalia Corfield: Okay, thank you.

Carlos Ochoa: Okay, and when it comes to asset quality I mean as we mentioned during the call, I mean, the efforts the collection efforts that we made in Central America, you know, the results of those efforts, you know, you can see them, I do not think, if you look at our origination standards on both our businesses, the SMEs and also on the Used Cars business, we do not expect that there is going to be a change in terms of the NPL, I mean, just to remind you, you know, when it comes to the approval rates for the used car business, they are around the 30%, so basically, what I am trying to say is that we are very conservative on that end, on that line of business and its similar to what we had on the SMEs, just look at the number of customers that we have, I mean, if you look at the customer base that we had at the end of the first quarter, they do not amount to six hundred customers. And basically, that's consistent with our business model in which we are very close to the customer, that we have a very loyal and recurrent customer base, and we do not expect changes due to both the collection efforts and the origination standards of the Company. So yes, you can see that the NPL should remain in line with what you have seen over the last couple of quarters.

Natalia Corfield: Alright, okay, fair enough. And lastly, a follow up on origination. Do you have the number of originations that you are expecting for 2019? and the number of collection for 2019?

Carlos Ochoa: I mean, when it comes to the origination, probably, I mean, the best way to describe it is that we expect the group to grow 20%, so we need some math in all those lines of business. Yeah, but at the end of the day, we expect the group to grow at least 20% and for the collection, we would have to get back to you on that, as we did on the last quarter.

Natalia Corfield: All right, thank you very much.

Carlos Ochoa: Thank you Natalia.

Operator: With no further questions in the queue, the question and answer session has concluded. Thank you for being on today's conference call. You may now disconnect.

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