2Q19 Earnings Call Transcript

July 26th, 2019

10:00 AM CT

Operator: The following is a recording of the Credito Real Second Quarter 2019 Earnings Conference Call for Manuel Perez with IRSTRAT on Friday July 26, 2019 at 10:00 AM CT. Good morning, and welcome, everyone, to Credito Real's Second quarter 2019 Earnings Conference Call. Credito Real issued its quarterly report on Thursday, July 25th, 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, Chairman and CEO and Mr. Carlos Ochoa, Deputy CEO. They will discuss on the more important strategic financial and operating aspects of the second quarter 2019. I would now turn the call over to Mr. Romanos.

Angel Romanos: Thank you, Operator. Good morning, everyone, and thank you for joining us today. Credito Real posted another quarter of positive results, reaffirming the performance achieved during the first quarter of 2019 and walking through the accomplishment of its Guidance, with a resilient commercial operation and metrics, despite the subpar behavior of the Mexican economy. Domestically, the effects attached to the change in the federal administration are momentarily lowering GDP growth. Although, we remain optimistic on the prospects of the second half of the year, as key macroeconomic variables, such as inflation, exchange and interest rates remain stable. Separately, we are also enthusiastic about the government support on credit origination for SMEs and expansion of the country's financial inclusion, as these endeavors lay down a solid base for the medium- and long-term development of our sector. Especially noteworthy this period was the double-digit increase in the consolidated loan portfolio, boosted by our articulated strategy of sustainable and flexible growth that arise as a firm fundamental behind our good numbers, which this quarter was greatly supported by the performance recorded in our international operations. Additionally, the continuous upscaling of our leasing and SMEs' credit products bring forth a substantial support for the P&L and Balance Sheet, as we kept the pace in the addition of lower risk assets with attractive yields. Turning now to our results breakdown. In Mexico, Payroll origination was certainly affected by the economic slowdown. Although, key metrics as the portfolio quality growth and average loan behaved steady and better than expected. And, as it has been over the last quarters, we kept focused on the incorporation of creditworthy clients, who meaningfully contribute to our industry-leading non-performing loan ratio, of just 1.5%, as of quarter-end. Moreover, it is important to tell that we are undertaking a crusade for efficiency, at all operating levels, as we are endogenously seeking to offset higher costs of financing, towards the consolidation of a more lean and effective structure. In relation to Small and Medium-sized Enterprises segment, loan origination continues strong, posting a 99% annual growth, with enough room for further market penetration, as we foresee favorable industry dynamics along the year. Meanwhile, Used Cars in Mexico posted a similar performance to Payroll, with a lower loan origination, but showing a stable customer base and average loan. Moving on to our business segments outside Mexico, Used Cars USA regained traction, mostly in the operation of CRUSAFin, despite the adverse migratory environment, as loan origination solidly increased 99%, with a very stable NPL ratio, of only 0.6%. In this regard, it is also important to note that we expect further momentum, as the ongoing generation of better economies from the new operating and commercial structure ramps up, thus providing us improved margins and wider brand visibility. Lastly, against the persistent weakness in the economic activity in Nicaragua and Costa Rica, Instacredit recovery moved forward, with loan origination increasing 14% versus the same period last year, reaching 841 million pesos. In addition, portfolio quality greatly improved, as the NPL ratio dropped from 6.4% in the second quarter of 2018 to 4.8% this quarter, driven by the adjustments performed to our collection standards. Before these numbers, we also anticipate positive prospects for our performance in Central America, as we plan to endure resiliency; drawing on the further consolidation of an efficient and flexible institutional design, able to be adapted and succeed amid different challenges. Now, shedding broader color on recent developments over the quarter. We kept advancing in the operation of our share buyback program, believers of our Company´s future and stock value, by acquiring 2.3 million shares, equivalent to 52 million pesos. Separately, pursuant of our commitment to deliver attractive returns to our investors, we settled our record-high dividend payment in our history: 70 cents per share, for an aggregated amount of 268 million pesos. As for the financing front, during the quarter, we drew down 1.6 billion pesos from three credit lines, appointed to working capital needs and which extend our banking creditors' base. These operations, coupled with the credit limit increases and corporate debt placements carried out in previous quarters, strongly contribute to widen our financial flexibility to pursue our strategic and operating targets. Wrapping up, although pleased with the results obtained so far this year, we will continue with the hard work, to enhance our business platform and contribute to the financial inclusion in Mexico, while offering competitive and differentiated products of credit in the international markets where we operate. Finally, I want to take the opportunity to congratulate Carlos Ochoa, our Deputy CEO, for being recognized by second year in a row in the two top rank CFO's in the practice by Institutional Investor magazine, as well as his Investor Relations team that has been also well-ranked in different activities of its function, which constitutes an instrumental piece of our operations, since the first day of our inception into the public markets. Now, Carlos will discuss on greater detail our financial performance for the quarter.

Carlos Ochoa: Thank you, Angel. And good morning everyone and thank you all for being part of our quarterly conference call. As of quarter-end, interest income reached 2.9 billion pesos, compared to the 2.6 billion pesos recorded in the same period last year, following the growth achieved at the consolidated portfolio. During this quarter, interest expense totaled 1.1 billion pesos, increasing 28% when compared to 856 million in the same period last year. This variation was mainly derived from financing the growth of the period at higher funding costs. Consequently, the financial margin amounted to 1.8 billion pesos in the reporting quarter, an annual increase of 22 million pesos, where the resiliency of our operations in Mexico and improved performance of our international businesses, especially in Instacredit, helped to offset higher funding costs. Provision for loan losses this quarter totaled 335 million pesos, down 26% when compared to the 455 million pesos recorded in the second quarter of 2018, as a result of the continuous addition of high-quality assets. The coverage ratio increased from 180% in the second quarter of 2018 to 205%, a 25 percent points expansion. This variation is primarily explained by our enhanced management of credits, including origination, supervision and collection. Meanwhile, administrative and promotion expenses of the quarter decreased 55 million pesos when compared to the same period last year, reaching 852 million pesos, due to the implementation of different strategies, such as the synergies achieved in Credito Real USA and the consolidation of better operating controls in Instacredit. Net income rose 33 million pesos, up 7% year-over-year. The deceleration of growth rate is result of higher funding costs associated with the issuing of our Senior Notes earlier this year which was more than offset by our free risk-related strategies along with the pursue of operational improvement. Meanwhile, our Return on Average Equity was 12.3% as of June 30, 2019. Excluding the Perpetual Notes effect, the Return on Average Equity was 16.7%. The Return on Average Assets, as of the end of 2Q19, stood at 3.8%. Regarding the Capitalization Ratio, it reached 38.8% as of June 30, 2019. The funding cost recorded a 180-basis points increase, from 11.4% at the second quarter of 2018 to 13.2% as of June 30, 2019, reflecting the rising-rate environment that has prevailed in international and domestic markets over the last twelve months. Nevertheless, the funding cost decreased 50 basis points in a sequential basis. It is important to note the resource withdrawal made from three credit facilities this quarter, in line with our strategy of constantly diversify and improve our funding sources. In this regard, we remain optimistic to find an attractive funding opportunity, as local interest rate has shown a stabilization trend over the last six months. Turning to our portfolio performance. At quarter-end, the consolidated loan portfolio was 41.1 billion pesos, posting a 22% annual growth. Each of our business segments contributed to this achievement, outstanding Mexico's SMEs and Payroll, without minimizing the recovery seen in US and Central America. Moving with greater detail into our credit portfolio, SMEs loan portfolio rose to 5.2 billion pesos, up 82% when compared to the figure recorded in the same period last year, largely driven by the increasingly positive customer response to our commercial offer in this segment. It is worth noting that the contribution of SMEs loan portfolio continued to rise, reaching 12.8% of the Consolidated Portfolio, as of June 30, 2019, from 8.6% in the second quarter 2018. Next in order, Payroll portfolio totaled 26.7 billion pesos, increasing 17% year-over-year this quarter, a slower pace to the previous quarters, but above the average growth rate of the last three years, that reflects the stabilization of the portfolio after the addition of the pensioners' segment years ago. Used Cars portfolio rose 31% when compared to the second quarter 2018, amounting to 3.7 billion pesos. This positive performance was mainly fueled by the commercial synergies generated by our new operational structure in both countries. In the upcoming quarters, we expect to continue gaining traction among our target market, hand in hand with the ongoing consolidation of the recognition of brands in this business. Lastly, Instacredit's loan portfolio expanded 0.3% or 14 million pesos as of quarter-end, to 4.7 billion pesos, supported by the initiatives launched in the previous months, to stabilize its performance. In this sense, we keep vigilant and ready to recalibrate operations if circumstances make it necessary. Separately, our consolidated non-performing loan ratio decreased to 1.5% this quarter, from 1.9% at the end of second quarter 2018, mainly driven by the pursue of continuous improvements in our loan origination and collection standards.

Turning to the balance sheet. As of June 30, 2019, total assets increased 18% or 8.3 billion pesos, compared to the same period of 2018, amounting to 54 billion pesos, reflecting the organic growth achieved in the consolidated portfolio and debt issuances conducted on the last twelve months. As of quarter-end, the Company's outstanding debt totaled 35 billion pesos, up 28% or 7.5 billion pesos more in an annual basis, mostly explained by the replacement of our Senior Notes at the beginning of the year and the second debt issuance under our securitization program conducted in the 4Q18, and to a lesser extent by the incremental balance recorded in bank loans. To conclude, as of quarter-end, Stockholders' equity totaled 15.9 billion pesos, an annual increase of 6% or 918 million pesos, result of the already explained factors. 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 sir. Ladies and gentlemen, to ask your question, please press *1 on your telephone keypad at this time, if you are using a speakerphone please make sure your mute function is turned off to allow your signal to reach our equipment. Again, that is *1 to ask your question. And our first question will come from Carlos Rivera with Barclays

Carlos Rivera: Hi, good morning everyone. My first question is regarding the NIM. We continued to see a decline there, so I want to get your thoughts about the expectations probably for this year and mid-term, I know part of that has been the funding cost which improved actually quarter over quarter, in the second quarter, but as long as you continue growing fast in SMEs, I think is going to be difficult to stabilize that NIM. So, if you could share a short-term and long-term your expectations there. And my second question is going to be on asset quality, the NPL ratio is actually pretty low based on your historical levels. So how much room you think you have there? especially considering that economic activity continues to remain pretty slow in Mexico. So how much lower can you get there? Or what levels we should start to expect? Thank you.

Carlos Ochoa: Hey Carlos, regarding your first question, when it comes to the NIM. You know, the fact that affected the most to the increase in the NIM this quarter, and actually it was not in this quarter, actually it was when we paid down the 2019 senior notes earlier this year, and also we have another amortization of a credit swiss facility this year, and these two amortizations consolidated amounted for roughly, I do not know, probably 10% of the liabilities of the Company. The significant thing about those amortizations is that those were the cheapest debts that the Company had at the time, so basically, we substituted something paying in pesos around 7% with debt paying around 14% or something, so basically that is what explains it the most. However, when it comes to the trend for the NIM as of the end of the year, for starters, we are not expecting more interest rates hikes, and probably, to tell you the true, our best case scenario here in the Company, we intend to be more conservative on that end, and we do not expect interest rate cuts but if at some point we get a 100 basis cut, we could be talking again to NIMs around the 20% which is our benchmark line, right?. So, we do not see that the NIM is going to continue to deteriorate but on the other hand, it could be positively affected if they decide to cut rates over here in Mexico. I do not know if that answers your first question.

Carlos Rivera: Yes, I am just a little bit surprised. Because, if we only look at the yield of the loan portfolio, regardless of what has happened on the funding cost. That continues to come down over the last few quarters and it is probably a combined effect of a lower growth in Instacredit in the past, but also a higher growth of SMEs, which is the product that has the lowest yield. So, I am just trying to think about of how the effect of SMEs, which is the fastest growing segment now, impacts your NIM.

Carlos Ochoa: Yes, definitely the NIM, I mean if you think in those terms with the NIM you are correct. I mean, the interest rates that we charge overall for the SMEs business here in Mexico is something around the 25-27%. So, when you compare that to whatever we charge in the payroll business is consistently lower. However, I mean if you think about the good thing about the SMEs on the other hand, is that that has been the main driver in the improvement of the cost of risk. Especially because you know, they have way larger average ticket size and that helps us a lot in terms of the cost of risk. So basically, the way we are addressing the pressures over the NIM is, what can we do? both in terms of the efficiency ratio and also in terms of the cost of risk, in order to minimize whatever effect we have on the cost of fund.

Carlos Rivera: Okay, understood. Let us move onto the asset quality question.

Carlos Ochoa: I mean, we are very pleased about the asset quality. I mean, for starters think about the SMEs business model. I mean, if you think about a SMEs business model, we are just, we are relying on a relatively small customer base, and we keep adding new products for customers that have been with us for a number of years. So, we are not concerned about asset quality and if you think about this business model with higher average ticket sizes, that help us in terms of the cost of risk. So that is mainly the main driver that you have been seeing when it comes to the cost of risk. Well, it is also worth mentioning you know, the improvement that we are seeing in Instacredit and the efforts of our team based there in terms of collecting and in improving the origination standard, I mean, we believe that they are paying off at this point. And to tell you the truth is hard to say, I mean, how much lower these can be brought down because they are already way down, you know, 1.5% as of this quarter, we feel comfortable with that number, and I believe that it could be around that figure for the remaining of the year.

Angel Romanos: And so, answering your second question, this is Angel Romanos. We still see a huge opportunity on the SMEs sector, even though the economy might be decelerating in the near future. Because the need for money is so big and we are working a lot with the development banks in Mexico, to get the customers through them. And we have such a big pipeline for that, but we are cherry picking all of our customers, we have very strict rules of who we do and who we do not. But we do expect to keep growing on that. At bank, go away from that segment, another company to compete there, we see a great opportunity to pick up the best customers and remain with a good non-performing portfolio (inaudible).

Carlos Rivera: Okay. So just to make sure I understood about asset quality, so you are not concerned about asset quality in Mexico, despite the country going to very slow rate of growth

Angel Romanos: Not for now, because we are very cautious of who we lend to. I mean our payroll business has always been counter-cyclical. And on the SMEs as I told you, our pipeline is so big, we are authorizing less than 20% of what we get, so we really cherry pick our customers.

Carlos Rivera: Okay, great. Thank you very much.

Angel Romanos: Thank you.

Operator: Thank you, our next question comes from Ivan Fernandez with Factset.

Ivan Fernandez: Hi. Good morning and thanks for the courtesy, Ivan Fernandez of Factset. A few questions for you guys, please. The first one is expanding on this NIM question from the previous caller, can you be more detailed and tell us where do you think your cost of that will be, in the third quarter and the fourth quarter approximately?

Carlos Ochoa: Yeah. It should be around the 13.2% or 13.5% that you are seeing right now. If you look, if you compare the cost of fund as of the 3Q, which was around 13.7% it was explained by the, you know, the negative carry that we used to have at the time. At this point, now that we have most of the old resources deployed, it came down to the 13.2%. But as conservative as we are on our hedging strategies here in the Company, I do not see it going down further than the 13.2%-13.5% that you are seeing.

Ivan Fernandez: Okay, thank you. Second question is on that income guidance for the year. Since the beginning of the year, you guys have been guiding for a double-digit growth in net income. I was wondering if you are reiterating that guidance at this point in the year, and also if you could clarify whether that 10% growth in net income is including the exceptional gain, the one-off gain that you had in derivatives in the first quarter of over 150 million pesos or excluding it?

Angel Romanos: No, it is excluding that one-time item. And we do believe that we can make the number by the end of the year.

Ivan Fernandez: Okay, thanks. The other question is, when I look at the trend of origination amount, so I can see that in the payroll line you have been originating a smaller amount than your previous trend, think you were originating 1.6 billion-1.8 billion per quarter, and the last, let us say five quarters or so and now for the last couple of quarters itself is something like 1.35 billion. So, I was wondering, if that is intentional? or if you are struggling to originate assets in the payroll? which is your core business.

Angel Romanos: In part it has been intentional as we get used to the new government, and we evaluate again all of the contracts we have, and who we want to lend and who we do not want to lend. And, on the other part is just marketwise, that the government is also installing itself, and they do not know how things work yet perfectly. But we are, in the last two months you will see on the third quarter, we are going back to the amounts we were originating on the last year. And for us, it is good to be having a better mix of origination with other products.

Carlos Ochoa: And you know, in addition to that. If you think about the origination grade that we experienced over the last couple of years, that was mostly driven by the pensioners, which was a new product at the time. Right now, that is some more matured product and that also explains the decline in the origination of our payroll business overall.

Ivan Fernandez: Thank you. And the last question is, I notice you guys have stopped to buyback in the last few weeks, I guess that was because of the blackout leading up to the earnings result. Do you intend to restart the buybacks straight away or what is the plan for that for the coming month?

Carlos Ochoa: Yes, I mean, we are convinced that the price does not reflect the value that we are creating, and we want to be very emphatic about how competent we are with the future in our business model. So, we will continue to be more, probably more in the form of market making. But yes, we definitely will continue with the buyback.

Ivan Fernandez: Okay, thank you.

Carlos Ochoa: Thank you.

Operator: Thank you, again, to ask a question you may press *1. Our next question comes from Nicolas Riva, with Bank of America Merrill Lynch.

Nicolas Riva: Yeah, thanks very much. Just one follow up on asset quality. So, your NPL ratio came down in the quarter, 10 basis points, it is very low, below 2%. But we saw that in some of your peers, the NPL ratio increased, and I mean the peers in the non-bank financial space, and I notice that in that space, some players are more into personal lending, leasing for SMEs. But given that you are kind of branching out into other segments, like SMEs lending. What is your view in terms of where Mexico is in the credit cycle right now? thanks.

Carlos Ochoa: Well, I mean, is I was saying, you know? It is hard to, as I was telling you at the beginning you know. What is driving the cost of risk lower during these years is the way higher average ticket size with the SMEs product. As Angel stated, you know earlier, we are being very selective in terms of credit origination and that, coupled with our business model of adding new products, that helps us a lot. It is hard to stay. How these can be, I mean, how things can evolve in the country due to the changes in the macro aspects. That If you look at the NPL trends that we have experienced over the last couple of years, especially the last year, comparing to last year, mostly it is explained to the, you know, to the improvement that we made in Instacredit, in Central America and all the efforts that our team based there has made.

Nicolas Riva: Thanks, Carlos.

Carlos Ochoa: Thank you.

Operator: Thank you, our next question comes from Natalia Corfield, with JP Morgan.

Natalia Corfield: Good morning Charles, thank you for taking my question. My question is with regards to the credit lines, that you have disposed of. I am curious to know the standard of those credit lines, and I am asking because I notice, it is like in the deterioration in the debt maturity profile of Credito Real, there is now more debt maturing next year. So, if you could clarify that for me, it would be great.

Carlos Ochoa: No, I mean, if you think about the maturities that we, if you think about the back lines that we tapped in earlier this quarter, I mean, the duration of those normally is 3 to 5 years, you know, on the average, they are like, three years. And I do not see a particular deterioration on the liquidity, on the debt profile of our liabilities, actually is quite the opposite, when you think about how the debt profile was at the beginning of the year because most of the, what you are seeing right now, most of them are revolving credit lines with banks that we have been working for a number of years. So basically, we rolled them over, and we are confident that that is not going to change.

Natalia Corfield: All right, just to confirm, so those are 3 to 5 years, and I am asking just to.....

Carlos Ochoa: The average is, let us say 3 years because we do no to get much longer than that in Mexico and the bank lines that we draw they were facilities from Mexican bank.

Natalia Corfield: Right, okay, I am asking because in the press release, I see, about 6.1 billion pesos maturing in 2020, and looking at press release of 1Q19 this number was 3.4 billion, so there was an increase of around 3 billion.

Carlos Ochoa: As for 2019 we have just two amortizations. A 30 million facility from BNP and whatever have of CS facilities was 40 million. So, that the combination of those two amounts for roughly 80 million dollars, and that is the most reasonable part in terms of amortization. As for the rest is, as I was telling you, mostly those are revolving credit lines with banks that we have been working for a number of years already.

Natalia Corfield: And then your amortization is for 2020?

Carlos Ochoa: That is correct.

Natalia Corfield: But how much is it?

Carlos Ochoa: Yes, as I was telling you, the BNP is a 30 million dollars plus another amortization worth 44 million dollars of the CS facility and those are the most reasonable ones.

Natalia Corfield: And those you. You have those before in the previous quarter?

Carlos Ochoa: No, because those are due in 2020.

Natalia Corfield: Okay, alright. I think I will follow up later with you. But thank you very much.

Carlos Ochoa: Perfect Natalia, thank you.

Operator: Thank you, our next question comes from Joshua Raizin with Cedar Street Asset Management.

Joshua Raizin: Thanks for taking my question. We are seeing a number of new U. S. Institutional Investors in the shareholders' ledger, but the share price still has not really responded. Looking around the world where you do not see any similar name trading anywhere near this valuation, and it continues to trade substantially below fundamental value. How does management think about the share price? and at what point which you consider doing further buybacks as opposed to capital allocation to the one? thank you. Thanks.

Angel Romanos: I do not know if I understood your question perfectly, but we are buying back shares. Not only as a Company but as employees and the original owners. We are not on a quiet period. And we have been accumulating shares and we love, we are looking so cheap at this price, and we do not understand the divergence between our bond prices and the stock price. Our 2026 bonds are trading at 1.12, our 2023 bonds are trading at 1.05-1.06 with a yield of 5.30%. So, we really do not understand the divergence and we will keep buying shares as long as they are cheap as they are.

Joshua Raizin: What do you think that the equity market does not understand about the name that allows them to valuate at such a cheap level?

Angel Romanos: Excuse me?

Joshua Raizin: Why is it that you believe the equity market, seems not to understand the name as the same way as the credit market? And what can the Company do in terms of either investor outreach or, dialogue with the market, in order to improve the (inaudible) valuation?

Angel Romanos: We go through a lot of those all year round, to try to explain the Company to investors, we do not know if it is a matter of liquidity on the stock, if it is a matter of not understanding the stock. But I mean, we have been a be a public company since 2012 and the Company has never been understood. And we are making better numbers every year and still growing in our business and as long as we still create value, we can, someday the stock market will recognize that, and meanwhile we have more share for ourselves at these prices, which is not bad for us.

Joshua Raizin: Thank you.

Operator: Alright, thank you. As a final reminder, please press *1 on your telephone keypad, if you would like to ask a question. Thank you, our next question comes from Manuel Gonzalez with Signum Research.

Manuel Gonzalez: Hi. good morning, congratulations on your quarter results. I just have a quick question. I was wondering if you had some kind of strategy to rise your credit rating with the agencies. I mean, I do not know, you have something? some strategy to do? looking forward to reach an investment level or something.

Carlos Ochoa: Well, that is a good one. I mean, well, that is definitely a good one. I mean, we have been in very close touch with the rating agencies, and especially because we do not want surprises over there. I mean, we clearly, we are certain that they are said, you know, that our rating, it is a differentiator between other, non-banking financial institution, and in that sense, I mean, we would love, you know, we would like clearly we would love to be upgraded. I mean, probably we are on the, if you look at our rating trend over the last four or five years, I mean, probably that is something doable, according to our view it is, according to their view it is not, but let us say, I mean over there, I mean, we cannot we confirm their methodology. But, I mean, just wait and see, I mean, at some point, that is bound to happen. I say.

Manuel Gonzalez: Okay, thank you.

Operator: Thank you.

Angel Romanos: Thank you all.

Operator: All right. At this time, there are no more questions in the queue, and then our Q&A session has concluded. Thank you for being on today's conference call. And you may now disconnect enjoy the rest of your day.

Carlos Ochoa: Thank you.

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