3Q20 Earnings Call Transcript

October 29th, 2020

11:00 AM CST

Operator: Good morning, and welcome to Crédito Real's Third Quarter 2020 Earnings Conference call. Crédito Real issued its quarterly report on Wednesday, October 28th, 2020. 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 in 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 Crédito 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 Crédito Real we have Mr. Angel Romanos, Executive Chairman and CEO, and Mr. Carlos Ochoa, Deputy CEO. They will discuss on the more important strategic financial and operating aspects of the third quarter 2020. 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. First and foremost, I hope to find you and your loved ones safe. Before I begin with the discussion of the quarter, I would like to express our deepest gratitude and recognition to all our associates who have worked tirelessly to keep our platform fully operational during these difficult times. Although, the impact of the pandemic on the markets where we operate continued pressuring our results, the gradual economic reopening currently underway, primarily in Mexico, has helped us to regain traction, as it is visible in the reporting period results, the posted numbers last quarter, that was heavily impacted by lockdown measures. In this regard, in the SMEs segment, we are about to conclude relief programs and most of the clients have already returned to pre-pandemic agreed scheduled payments. Furthermore, thanks to the enhancements performed at our digital platform and call centers, especially in Payroll, we were able to achieve an outstanding collection and started first originations through the agreement with Famsa this September. Here, I would like to emphasize that this agreement with Famsa will not imply any incremental risk on our standard operation, as Crédito Real has complete agency over credit analysis and approvals, as well as full control on generated assets, that are expected to reach about 3 billion pesos per year. Bear in mind that this alliance became operational as of quarter-end, therefore its contribution to the P&L will be greatly reflected in the next quarter, when it gains further traction, thus helping us to offset the slowed down dynamics of the new normal towards our presence in the vibrant market of North Mexico. At this point, before discussing our performance by segment, allow me to further elaborate on the last quarter's acquisition of an incremental stake in Crédito Real Arrendamiento: First, this development has no effects on the regular operation, the business is fully incorporated in our structure since 2017. Second, the transaction was agreed since the inception of this venture 3 years ago, with the option of acquire full ownership. And, third and last, the 30 million Mexican pesos disbursement for a 26% incremental stake is not material for Crédito Real, as it is far outweighed by the incremental value contributed by this business that was delivering triple-digit growth rates, with high margins of benefits just before the pandemic. Now, continuing with the analysis of the quarter, Payroll loan origination improved sequentially, returning to levels closed to that of the third quarter of 2019, having solid support from our alternative channels. Similarly, the non-performing loan ratio of this business remained stable, as all Mexican government agencies have timely met their payment schedules. Loan origination in Small and Medium-sized enterprises decreased quarter-on-quarter, but delinquency and collection remain within expected thresholds, thanks to the effectivity of relief programs, expecting that collection of this business will back to pre-COVID levels as most of relief programs end towards year-end. Used Cars Mexico moved forward in its recovery, fueled by a higher demand for affordable alternatives to public transportation, given the contagion risk that this latter represents. While registered record levels in collection, with an stable delinquency under 2% mark. Turning to our international businesses, Used Cars USA origination was favored by the same dynamics of Mexico, thus significantly enhancing its performance versus the previous quarter, while its collection improved before the unemployment benefits granted by the federal government in that country. Following the same trend, despite the implementation of stricter origination policies that heavily prioritized asset qualities, SMEs USA loan origination posted over a 100% sequential growth in origination, with stable collection metrics. On Central America, Instacredit portfolio performance was roughly in line with that of the previous quarter, as COVID-19 lockdown was lifted in Costa Rica until early September, while operations in Nicaragua continued evolving under similar dynamics that those presented at the beginning of the pandemic. Meanwhile, in Panama, a moratorium on payments to banks and financial institutions until December 31, 2020 was approved by the Federal Government. Nevertheless, our exposure to this market is certainly low; and, as of this reporting quarter, not even 10% of Panama’s portfolio was impacted by this policy. In this context, Instacredit’s non-performing loan ratio surged on a sequential basis following write-offs derived from an updated accounting framework related to relief programs for troubled clients, as most aid programs ended this quarter. All-in-all, even when counting on some recovery signs across the markets where we operate, the unprecedent economic uncertainty demands to uphold a solid risk management approach, with a closely watch on the evolution of the situation. Looking ahead, we will continue striving to maintain an adequate capitalization, high-quality assets and strong liquidity, to ensure the long-term stability of our business. In this sense, reflecting our swift access to financial markets, we arranged two new credit lines with Barclays and responsAbility for a total of 75 million dollars. These proceeds helped to enhance our financial grounds before the economic volatility. Similarly, we refinanced all maturities of the quarter, and the remaining balance to be refinanced for 2020 mostly belong to revolving facilities, same that we expect to swiftly conduct with no complications. The volatility surrounding the COVID-19 certainly limit our forecasts endeavors. Nevertheless, we are confident that the portfolio will grow this year around 20%, while maintaining a consolidated NPL under 3%. Before concluding, I want to welcome our new appointed Directors that recently joined our Board; and thank our former Directors who ended their tenure after having an instrumental participation in the consolidation of the Company. To conclude, I want to recap that Crédito Real is a great Company that has been, for over a quarter of century, operating successfully and surpassing difficult challenges as were the 1994 and 2008 crisis; it has conducted several international debt placements rated by the most respected global agencies in different market and currencies; its results are audited by a big four firm, by one of the biggest four firms; its investor relations function has been recognized by Institutional Investor for its transparency and accuracy; and, it has never defaulted in any single financial liability, as our investors and debt holders' trust constitute one of our main pillars at our crusade for the financial inclusion. Please, rest assured of our unwavering commitment to fire-tested expertise to run our business. And, again, thank you all for joining us today. Now I will pass the call to Carlos Ochoa, to get deeper into the numbers of the quarter. Thank you everybody.

Carlos Ochoa: Thank you, Angel. Good morning and thank you all for being part of our quarterly earnings conference call. In the third quarter, interest income decreased 14.5% year-over-year, from roughly 3 billion pesos to 2.5 billion pesos, reflecting the headwinds caused by the economic effects of Covid-19, in particular, the relief programs for the SMEs. Furthermore, the effects of the consolidation of Crédito Real Arrendamiento also contributed to this decline. However, interest income started to show signs of sequential recovery, increasing by 5.1%, in line to the economic reopening in most of the markets where we operate. And, to a lesser extent, to the normalization of payment schedules of certain troubled clients. Likewise, it is important to keep in mind that the recently formalized alliance with Famsa will be wider reflecting as of the next quarter; helping us to recover operating volume. On the other hand, total income, which includes the revenue of all our businesses reached 2.8 billion pesos, a decrease of 12.6% when compared to the same period last year. Interest expense totaled 1.1 billion pesos, down 7.3% when compared to 1.2 billion pesos in the same period last year, reflecting the positive impact of the environment of lower interest rates, despite a larger debt balance. As a result, the financial margin posted an annual decrease of 19.3%, amounting to 1.4 billion pesos. Nevertheless, on a sequential basis, financial margin climbed 16.1%, largely following the progressive normalization of interest income and gradual recovery of most credit segments. Provision for loan losses increased 38.6% year-over-year, and 24.7% quarter-on-quarter, totaling 504 million pesos. The incremental provisions are essentially result of a prudent decision to build stronger foundations, to face the changes brought by the new normal. Following the higher provisions for loan losses and the effective control over past-due accounts, the coverage ratio increased 38.4 percentage points, standing at 217.3%, an adequate level to face potential loan losses in the short- and medium-term. Administrative and promotion expenses totaled 975 million pesos, up 4.8% when compared to the 930 million pesos recorded in the same period last year. This increase is explained by the recognition of depreciation expenses associated with Crédito Real's Arrendamiento’s operations which were partially offset by the savings program implemented to face the current environment with a lean but effective structure. Net income totaled 199 million pesos, representing an annual decrease of 54.4%, but showing a significant sequential recovery of 51.4% following the already discussed drivers. In this regard, bottom-line performance is expected to improve at a better pace from the fourth quarter 2020 onwards, as relief programs are completed and normalization of economic activities in the markets where we operate moves forward. As of September 30, 2020, given a weakened profitability heavily linked to the pandemic, Return on Average Equity declined 810 basis points against the same period last year, to reach 4.8%. Excluding the Perpetual Notes effect, this metric stood at 6.3%. While, Return on Average Assets was at 1.2%, 270 basis points below the 3.9% posted at the end of third quarter 2019. The Capitalization Ratio stood at 33.8% rate as of September 30, 2020, remaining well above industry levels. To further strengthen this metric, we will continue focusing on a prudent risk management, poised to take immediate actions on our collection and origination processes as required. The funding cost was 8.4%, reflecting both the recent interest rate reductions undertaken by major central banks and favorable terms obtained at new credit lines subscribed so far this year in Crédito Real and in our subsidiaries, as our credit profile has maintained resilient before the context. In this sense, towards year-end 2020, we expect our funding cost will remain in competitive levels. Moving in broader detail to the analysis of the loan portfolio dynamics. Total portfolio amounted 52.7 billion pesos at the end of the third quarter 2020, growing 20.4% year-over-year and 1.4% quarter-on-quarter, driven by a certain normalization of origination activities in our main markets, outstanding the resilience of Mexico Payroll and favorable dynamics in the United States. Small and Medium-sized Enterprises portfolio increased 90.2% versus the same period last year, reaching 11.4 billion pesos, despite the implementation of highly restrictive origination policies that seek to preserve the asset quality, following the solid pre pandemic origination. Payroll totaled 29.4 billion pesos, up 9.0% and 1.4% over the same period last year and previous quarter, respectively; largely driven by the gradual reopening of economic activities in Mexico; and, further efforts to adjust operations to the new normal trends. Used Cars portfolio in Mexico reached 1.3 billion pesos, growing 3.0% on an annual basis, finding a strong catalyst in the shift of public transportation towards other alternatives, including used affordable vehicles.

Instacredit's loan portfolio grew 8.7% year-over-year but decreased 7.0% when compared to the previous quarter, to reach 5.4 billion pesos, reflecting the execution of two lockdowns in Costa Rica as of mid-quarter. The consolidated non-performing loan ratio of this segment was 4.1%, up from the 1.3% recorded last quarter, given the conduction of write-offs at certain accounts in delinquency after the completion of the some relief programs for troubled clients. In our operations in the United States, the Used Cars portfolio reached 2.7 billion pesos and the SMEs portfolio totaled 1.6 billion pesos, increasing 38% and 2%, respectively. Both driven by origination metrics comparable to pre-pandemic levels. Turning to the balance sheet. As of September 30, 2020, total assets increased 28.7% over the same period of 2019, amounting to 73.9 billion pesos, following the total loan portfolio growth, as well as debt issuances and credit facilities subscribed over the last twelve months. Outstanding debt totaled 52.4 billion pesos, up 39.9% on an annual basis, largely explained by: the mark-to-market valuation effect of a higher exchange rate applied to our dollar-denominated debt; the placement of Senior Notes due 2027; a third debt issuance made under our securitization program; and, facilities subscribed and draw down of existing credits over the last twelve months. To conclude, as of quarter-end, stockholders' equity totaled 17.8 billion pesos, an annual increase of 7.9%, following the already discussed 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: At this time will be conducting the Q&A session, if you would like to ask a question please press *1 on your telephone keypad. If you are using a speakerphone, please make sure that your function is turned off to allow your signal to reach our equipment. One moment please as we call for questions. Our first questions comes from the line Ernesto Gabilondo with Bank of America, please shoot your question.

Ernesto Gabilondo: Hi good morning, Angel and Carlos, thanks for the opportunity. I have 3 questions from my side. The first question is on provision charges, we have seen provisions trending up. So, when do you expect to have the peak in provisions? My second question is on deferred loans. As of September, what is the percentage of your deferred clients that were supposed to return to do their payments? And what is the percentage that will do it in the next months? And from what you have seen in September and October, can you share with us what percentage of your deferred clients are current or delayed? And then my last question is on the potential banking deal to regulate interest rates that is being announced by the Mexican banks and the Mexican Banking Association. Given this is the first time that a banking deal is considering to regulate interest rates and that this is coming from Senator Monreal from MORENA's party, do you think financial institutions charging high interest rates could be the first ones to be in the spotlight? Can you remind us what is the maximum interest rate that you are charging in Payroll loans? And how does it compare to the average interest rates that the banks are charging on Payroll loans? Thank you.

Carlos Ochoa: Hello, Ernesto. Well, addressing the first of your first question, on the part of the provisions. I mean, clearly, what you are seeing in terms of the cost of risk is basically the methodology of expected losses, right? I mean, if you know if you... I would say, what I want to say with this is that, under the current circumstances where you have relief programs... I mean, as of the end of the third quarter, the relief programs amounted for roughly less than 7%. If you think about the relief programs, basically what happens is that those customers under a form of relief program, they are treated as current, right? However, if you think in terms of provisioning, they are not treated as current. And that is why you see that increase... and that is why you see that increase in the provisions. So, we feel comfortable, I mean, having a cost of risk, a consolidated cost of risk just around the 4% level, is something that we have been experiencing in the past, and I think it is very prudent. Also something very important to bear in mind is that the provisions that we built up during this quarter amounted roughly 630... above 600 million pesos, but it is important to mention that you net those out of the collections and past due charges and so on, that during the quarter amounted for roughly 130 million, 137 million pesos. So, that is why at the end of the day, you have a solid 500 million, 500 million pesos that leads to a 4.2% cost of risk. I believe that this is, I mean, especially when you see the trends that we are experiencing in the last business, in particular, in the SMEs, which are the last with the relief programs. We expect them, you know, we expect these customers to normalize their payments on the following 2 quarters maximum. So, I would say that if everything remains as stable as we are seeing, you know, these... the cost of risk, the consolidated cost of risk should be something within this range, 4.2%, 4.5%. And we feel comfortable with that figure because it is something that we have lived in the past. Addressing, basically addressing the relief programs. I already told you that part on the previous answer. Just they are about on a form of relief program, 6.3%. And the bulk of the relief programs that we have granted are clearly on the SMEs front, and we would expect them to normalize over the next couple of quarters. Again, how much of them are paying and how much of them are not paying, you can see that under the NPLs line. Clearly, if the customers are fulfilling the commitments under the relief program, they are treated as current. And if they are not, they are treated as an NPL. So, in Mexico, the NPL ratio still stands at 0.6%, under 1%... under the 1% range. So we feel comfortable with that well. And we are optimistic, I mean, if you know, if there is something that we have been very empathic since the beginning of the crisis is that we have been in very close, very close contact with the customers, trying to understand the current situation and to find a suitable solution for each one. And I think that this is paying off at this point and we will continue to do that in the... and we will continue to do so in the next following months. And addressing the final part of your question, the interest rate caps. I do not know, I mean, probably, this was -- if you look at the headlines in the last couple of weeks, I mean, for starters, we listen to the Minister of Finance complaining about the banks not being aggressive enough in terms of credit granting. And probably the way to look at this one is that this is something related to that, to put some pressure on the banks, in particular, to grant more and more credit. And let us see how it works. Finally, I mean, if you think about the maximum interest rate that we charge in the payroll business, it should be something an APR, it should had an APR around the 50%, 52%, 53%, something within that range. And I think that, that compares very favorable, I do not know how the Payroll products in the... I do not know about the Payroll products for the bank. Because as you know, that is not the top line for them, that is not the top product for them. But it compares very favorable against other products such as their credit cards and so on. So I think we will be ok and again, given the lack of visibility, not only in terms of the performance, but in terms of the... how the federal government is going to implement a number of initiatives, I mean, the most prudent thing to do at this point is, you know, to remain cautious.

Ernesto Gabilondo: Thank you very much Carlos. Just a question regarding on when do you expect the bulk of the SMEs clients were doing their first payment and when they will be doing the rest of their payments? Just to have in perspective, for example, September, you already have certain percentage of clients resuming payments and maybe the next one will concentrate by year-end. So just want to understand when can we see the NPL showing up? I think that will show up maybe in the first half of next year.

Carlos Ochoa: No. I would say that what you are going to see before that is going to see an increase in the interest rate, you know, on the yield line. I mean, I would see that the... what we expect is quite the other way around. I mean, if you... one of the things that we understand about the decline in the interest, on the consolidated income line or whatever, is due to the number of SMEs customers that are not fully paying at this point. So what I am trying to say is that we are seeing... rather than thinking in terms of asset deterioration. Which you can see some part of it, you can see it under the provision line and on the cost of risk altogether. What we would expect for the next couple of quarters is going to be a normalization on the income line. That is basically where we are standing.

Ernesto Gabilondo: Yes. I agree, I understand. But in terms of the NPL cycle, just for example, if supposedly, they have to return in September to do their first payment and they did not, then you have, I think, about between 30 to 90 days, and they become past due loan. I just want to understand, is the bulk of the SMEs paying for the first time was in September, October or it was concentrated at the end of the year?

Carlos Ochoa: Yes. What you will see...

Ernesto Gabilondo: So how many months...

Carlos Ochoa: Yes, yes, I understand. What you will see... probably the effect that you will see is going to be a decline in the coverage ratio. If you look at the decline... if you look at the coverage ratio, how it has been trending the coverage ratio over the past two, three quarters. I mean, for starters, it has been a number of years since we do not have a coverage ratio or provisions over NPLs that stands above the 200% boundary. So the decline that you are seeing from the 240% that we saw in the second quarter, as of the end of the second quarter, that declined to the 217% range that you are seeing now, it is because of that increase on the NPL or because of the charge-off... a charge-off in between. So basically, I would expect, instead of having a, you know, instead of seeing an increase, a dramatic increase on the NPL line, what I would expect is a gradually decline on the coverage ratio due to an increase in the NPLs or to charge-offs. I do not know if this makes sense to you.

Ernesto Gabilondo: Yes, it makes sense to have higher NPLs next year and reducing the coverage ratio but not really increasing too much the provision charges in the P&L.

Carlos Ochoa: That is correct. That is correct. I mean, I believe that as long as we remain with a coverage ratio above the 200% range, I mean, we are confident that the effects that might cost an increase on the NPL ratio is not going to be, you know, it is not going to have a major impact on the P&L.

Ernesto Gabilondo: Ok, perfect. Thank you very much, Carlos.

Carlos Ochoa: Thank you, Ernesto.

Operator: Our next question comes from the line of Nicolas Riva with Bank of America. Please shoot your question.

Nicolas Riva: Thanks Carlos and Angel for taking my questions. I have 2 questions. The first one on Instacredit, so there was a big increase in the NPL ratio this quarter. And I remember that it is kind of reversing the decline that happened last quarter. I believe that you had said last quarter that the decline last quarter also had to do with write-offs in that business. If you can explain to us what drove the increase in the NPL ratio in that business this quarter, I think you mentioned probably some problems... some challenges in Panama to collect on some of the loans. And really, what is your outlook really for the Instacredit business in the next few months? And then the second question, it is a follow-up on the question that Ernesto asked about the restructured loans. And I believe that you said that to see, you know, which of the SME clients that received these loans, the restructured loans are paying, we should also look at the NPL ratio. If I look at the NPL ratio as of September, the 1.8%, let us say, for an SME client where you cut in half the amount that they are paying every quarter, but they have not resumed payments yet, they are not paying you on that restructured loans so far. As of September, that SME client, was that considered performing or not? Thank you.

Carlos Ochoa: Ok. Look, I mean, for starters... I mean, what I would say when it comes to Instacredit is that the figure that you saw in the previous quarter, the figure that was considerably lower to the Instacredit standards was due to a freeze on the assets, right? I mean that was required by the auditors to freeze the assets. And basically, that is what, you know, the combination of that asset freeze and some charge-offs during the period led to a very low NPL ratio for Instacredit standards, right? Now that freeze, you know, the freeze lasted for 3 months, and now what you are seeing, that increase in the NPL ratio, what you are seeing is basically the effect of a normalization in the way you compute the NPLs. I am not... I mean, what I am trying to say altogether is that what you are seeing is that, this figure, the NPL, should be trending upwards to their historical levels, which are around the 5% or probably even higher. If you remember a couple of years ago, when we had the situation in Nicaragua, the NPL ratio for Instacredit is still above the 7% range or something like that. So basically, you know, the... this is more like... during the second quarter was unusual figure due to the freeze. But right now, what you are seeing is that it is trending to their normal levels, right? Very important to mention, and that is something that we consider a lot when it comes to the Instacredit portfolio is to have the right amount of provisions. So if you ask me about the provision levels that we keep on Instacredit, they have remained altogether, they have... they have stood, you know, consistent over the quarter... over the two or three quarters of this year, consistent to pre-Covid levels. And not only that, the management over there in Central America, they made a decision, you know, a very conservative decision, that building up more provision in order to address whatever contingency we might face in the different countries we operate in. So basically, what I am trying to say is that the unusual figure is... the unusual figure is not the 4.1% that you are seeing as of this quarter, but it was in the previous quarter and should be trending to a 6% range if things go as we expect them to go, right?

Nicolas Riva: Ok Carlos, one follow-up there. When you talk about the asset freeze in Instacredit in the second quarter, you are talking about that you could not collect on some of the loans because of government regulations to defer, not to collect any payments on loans in the second quarter?

Carlos Ochoa: No. That only happened in Panama. That only happened in Panama and actually that is a measure that has been extended until the end of the year for the portfolio in Panama. What I mean by freezing the asset is that basically, accounting-wise, all the customers that were current, they remain current. And that is how you see that major improvement. And now that you know now that, now that, that freeze period has ended, basically, what you are seeing is the portfolio rolling over naturally.

Nicolas Riva: Ok. But the point is that you just said that you see room for that NPL ratio in Instacredit to go up to 6%. I am not sure in which time frame, but the point is that you think that there could be an increase there. So, part of the reason why you probably expect the NPL ratio overall to increase up to 3% by the end of this year could be Instacredit?

Carlos Ochoa: We are... yes, a portion of it, yes. But to tell you the truth, we are being very prudent when it comes to Instacredit, especially because we know how that portfolio performs. I mean that you can have NPLs as high as 7% or something like that. So basically, that is the reason, that is the reason why we build up an increase in provisions and so on. So basically, we are taking a more prudent approach on that one.

Nicolas Riva: Ok. thanks very much, Carlos. And then as for my second question, in that example of an SME client in which you restructure the loan, if you can clarify on how you are classifying those clients as of September? And also in this fourth quarter, assuming that they are not paying yet?

Carlos Ochoa: That is right. Look, let me answer, I am going to answer that question, you know, on 2 fronts. For starters, we, except on very specific situations such as restaurants that were closed down altogether, we did not grant grace periods and that is very important to mention. We did not reschedule, we did not grant grace periods, but, and basically, all the relief programs for the SMEs involved a form of payment, that is very important. So, accounting-wise, how do you treat those? If the customer is fulfilling its commitment to the new structure or whatever, to the new facilities under the relief program, that is going to be kept under current -- at current, right? But it is very important, again, you know, address this question under the provision side. Under the methodology, the expected provisions methodology, what you have is that you have two elements. One, which is called the likelihood of the quote; and the other one, which is the severity of the loss. And these two elements, you multiply them, you know, times the outstanding balance of the customer. Whenever you change the structure of the original facility, that affects the likelihood of default. So instead of having a 45% likelihood of default, if you restructure a credit, you increase that likelihood of default to 100%. So basically, what I am trying to say is that it does not really matter that much... well, it does matter clearly. It does matter, the NPL ratio. But what is more important about this, the whole thing, is that you are provisioning the right amount for all those credits, you know, that were restructured or that are under a form of relief program. So that is why you see the increase. That is why, I mean, basically that is the explanation why you see a stable NPL ratio, consistent with our historical levels, but you see an increase in the cost of risk and furthermore, an increase in the coverage ratio. So, basically that is where we are standing. And as I was explaining to Ernesto earlier, you know, the thing that we would expect in the following months is, for starters, NPL ratio increases, but the coverage ratio decreases due to the effect of the expected losses methodology for provisioning. I do not know if this answers your question, Nicolas.

Nicolas Riva: It does, Carlos. And I guess what you are trying to say is that we should be looking more at what is going on with your provisions for loan losses because there, you use expected losses rather than what is happening with the NPL ratio. It seems that in the provisions for loan losses, it is a bit more forward-looking right now than looking at your NPL ratio. My only, maybe comment there, and I want to let other people ask questions, but my only comment would be that if I just look at provisions for loan losses, 500 million pesos this quarter, in the second quarter 400 million pesos, 460 million pesos in the first quarter. But if I go a bit further back, it looks like before and after the pandemic in your case, except for the fourth quarter, but there has not been like a big discrepancy or increase in loan loss provisions. And I know that your coverage of NPLs has always been historically high. So probably you did not need to build even a higher coverage of NPLs. But it looks like, in your case, differently from other companies and financials in Mexico, we have not seen such a big jump in provisions after the pandemic. Is that clear?

Carlos Ochoa: Well, I would have to disagree with that one, especially if you look at the... if you look at the cost of risk, it went up from 100 basis, you know, compared to the previous quarter. I mean, when normally trade was under the 3% range, I mean, we are 100 basis points above that one. And that is a lot of money, and that is basically what explains the underperformance that put us,,, that Ernesto has put on our stock. So, I disagree with that one.

Nicolas Riva: Ok, I…

Carlos Ochoa: And probably, what we intend to convey at this point... what we intend to convey at this point is that we are being very prudent when it comes to the risk management of the company. We feel comfortable with the provisions that we have been building, I mean, building provisions above the 500 million pesos net of recoveries from charge-offs, I mean, I would say it is very prudent.

Angel Romanos: It is a big increase from the same quarter last year.

Nicolas Riva: Right, ok. Thanks very much, Carlos and Angel. Thank you.

Carlos Ochoa: Thank you, Nicolas.

Angel Romanos: Thank you.

Operator: Our next question comes from the line of Nik Dimitrov with Morgan Stanley. Please shoot your question.

Nik Dimitrov: Hi there. Many of my questions have been answered, but I have 2 questions. So the first one is I was looking at your net interest margin and if I kind of go back a year ago, right, your net interest margin was north of 17%, at one point, even exceeded 18%. And it collapsed all the way down to 10% in 2Q20. There has been a bit of a recovery in 3Q20. So, I was wondering, in terms of outlook, considering the fact that we are in a low interest rate environment probably for longer, is it realistic to expect that NIM eventually will recover to the 17% area? And if not, where do you see NIM going in the coming quarters?

Carlos Ochoa: Ok. Look, there are two big differences between last year's and this year. And probably the one that has affected the most the NIM in that regard, is the consolidation of Crédito Real Arrendamiento. So just to remind whoever is on the line, just to remind is that in the past, basically, we provided the funds under... we provided, we have exclusivity on the funding for the Crédito Real Arrendamiento, and we provided it as a facility. So basically, we have 6.5 billion pesos, a huge, a massive loan of 6.5 billion pesos that, I mean, we used to charge something around the 15% to 17% interest rate. When we consolidated those... when we consolidated in the second quarter, when we consolidated the arrendadora, basically the effect that that had was to split those 6.5 billion pesos according to the nature of the income of the different businesses, right? Meaning factoring, and you can see the income that generates the factoring business now appears as fees collected. And then you have the rents on the leasing business, you see those under the other income from operations mostly. So basically, that led to an effect, that led to an effect on the decrease on the yield altogether and on forward-looking on the NIM. If you look at the financial margin as of this quarter, for starters, this consolidation that I am explaining you led to a 2%, I would say, a 2% decrease. Basically, that is the explanation for the 2%. On the other hand, what we have is that the mix. If you look at that in the previous year, the SMEs business amounted roughly 12%, 14%, if I correct... if I am correct, 12% or something. And as of the end of third quarter, amounts roughly 20%, 22% or something even above that one. The mix... that effect of the mix, the mix of product that have on the NIM amounts, according to our calculations, and you can see that on the press release, amounts for roughly 1.5%, 1.3%. And then you have all the different situations. So forward-looking, what I would expect is that the NIM should normalize as a result of. One, the relief programs coming to an end, and that is going to happen over the next couple of quarters. So once that we normalize the relief programs specifically for the SMEs business, I mean, that should be trending upwards altogether and helping us in the case of the... in terms of the NIM. Another important thing and something that we have been struggling with over the last two to three quarters has been on the Payroll origination. You know, the Payroll origination, we hit the bottom on the second quarter with an origination, something roughly 900 million pesos or something during the quarter. That was extremely low if you compare to, for starters, what we have, what we experienced over this quarter, that was roughly 1.5 billion pesos or above 1.4 billion pesos or something within that range. So that helps us a lot. That helps us a lot in terms of the yield, and that helps us a lot altogether in terms of the... you know given the NIM that the Payroll product carries. So that is going to be beneficial over the next couple of quarters. And definitely, it is going to be trending upwards. So there are a number of factors that affected the NIM in the last two, three quarters, but I would be... I would expect a normalization of them in the next couple of quarters. Trending upwards, clearly.

Nik Dimitrov: Ok, but you do not have any level in mind?

Carlos Ochoa: No. I mean what we see is that... I mean, what we are expecting is that probably you know, there is going to be a downside in the SMEs portfolio, given that we are not generating new customers, that the approval rates are still low. So probably that is going to relieve some pressure over the NIM due to a change in the product mix. But clearly, that is a figure that we look very closely, and we would expect it to be... I do not know, probably, if it is not going to be in the 17% range, at least something roughly 14%, 15% as things normalize and as we settle, you know, within the right size of the SMEs portfolio.

Nik Dimitrov: Ok. Ok. Got it. And one quick question. I have seen some lenders come up with a second relief program for borrowers that were in a first relief program, but they are still struggling to repay their borrowings. I just want to make sure that that is not going to be an option for Crédito Real, right? All the guys that already...

Angel Romanos: We are not thinking…

Nik Dimitrov: Sorry, go ahead.

Angel Romanos: Sorry. We are not thinking on any second relief programs at the time. And the relief programs that we had were very limited and are having a good result. So we do not believe we will make a second relief program of any kind.

Carlos Ochoa: Yeah, and furthermore on that side is that... and that we have been very empathic about this since the beginning of the crisis is that we do not campaign solutions. So basically, if some particular customers have a particular situation, I mean, you cannot abstract yourself on the reality of the customer. So, we need to find a suitable solution. But we... definitely we are not going to do what the banks did. We do not intend to create a problem that we do not have yet. That is basically the rationale.

Angel Romanos: Exactly.

Nik Dimitrov: Ok, ok, got it. Thank you.

Carlos Ochoa: Thank you, Nik.

Angel Romanos: Thank you.

Operator: Our next question comes from the line of Natalia Corfield with JPMorgan. Please shoot your question.

Natalia Corfield: Thank you very much for taking my question. I have two questions and the first one is related to your collections. I have seen a decline from the second quarter to the third quarter in terms of collection. You had around like 9 billion pesos in the second quarter, now you have around 8 billion pesos. So, my first question is related to that, like what is really driving this decline? And particularly because origination has been increasing, so I wanted to reconcile the decline in collections and increase in origination.

Carlos Ochoa: Yes. For starters, the increase in the origination happened during September. So, you do not get to see the full effect, I mean, it has started mid-August or something like that. But basically, the recovery in the origination started as of the end of the quarter. So, you are not going to see the effect of that one on the collections front. So that is for starters. But if you look at what happened, probably the... if you look at the payroll business, which is the collection for the payroll business, has remained extremely stable. What happened during the first in the previous quarter, what happened in the... is that we collected past due amounts or something unusual collection, that was as of the 3Q20. But it has remained very stable. The 2.1 billion pesos on the second quarter, and it is consistent to what we collected in this quarter. So the decline that you see that went down from the 8.6 billion pesos to the 7.8 billion pesos that we are looking, comes mostly from the SMEs front. The increase that you see in the second quarter, if I am correct, that was also associated to factoring which were you know, short-term products that we are originating less than... you know, something in the range of 45 days or 60 days or something. And you get to see the origination as well as the collection during the same period. Since we have been more cautious in terms of originating new credits or new facilities altogether, specifically in the SMEs, that leads to a decline. So it is the combination of both. So in a nutshell, what I would say is that as long as the collections remain in the 8 billion pesos range, we feel comfortable.

Angel Romanos: Natalia, if you see the page on collection on the report, you can clearly see that SMEs declined from 3.2 billion pesos to 1.7 billion pesos in the quarter, and that is exactly what Carlos was explaining. It is due to the factoring business, which we have been extremely cautious, but it is very short-term loans. And second quarter included pre-COVID business, where we were growing a lot on that business. And you see the collection on the same period that you originate a loan.

Natalia Corfield: Ok. So clear... so if we see that around the 8 billion pesos, this is the number you feel comfortable about? And are we... is this the expectation that we should have for the next quarters, something around 8 billion pesos?

Angel Romanos: Yes, I think that is correct.

Carlos Ochoa: Yes, as a rule of thumb, I mean, that is where we can sleep at night.

Natalia Corfield: Alright. And then just another follow-up on asset quality and relief programs. You had more or less 8.6% of your portfolio under relief programs in the second quarter, now you have 6.3%. Just to have a little bit more of color, like on the loans that are out of the relief programs, like what is the percentage that are really current at this point?

Carlos Ochoa: It would be what is not. Basically, that is what you see under the NPL, that is what you see under the NPLs. And if you want to address this, I mean, probably the right way to see it is that you... again, if you look at the provisions that we have built, in particular, for the SMEs, and that is also included in the press release, I mean, you can see that the coverage ratio for the SMEs, in particular, is very conservative. So, it would be the same case.

Natalia Corfield: But it comes... would it already be an NPL? Like because the NPL, I understand you would wait 90 days. So that is why I am asking the opposite, like how much of the loans that were out of the relief programs are actually paying?

Carlos Ochoa: Yes. I would have to look into those figures, but it is because it is going to be a difference between the NPL, and there is also the charge-offs, right? I do not know if you follow me. So what I am trying to say is that whoever does not fulfill the new commitment under the relief program is going to be treated as an NPL and to some extent, eventually, that will lead to a charge-off, right? So as long as you have... that is why, I mean, that is why it is very important to not only look at the NPL ratio, but also to look at the provisions, on the provision side. I do not know if this makes sense to you.

Natalia Corfield: Ok. I think I get it because your... like all under your relief programs, even under your relief programs, customers were still required to make some sort of payment. I think that is what… Ok.

Carlos Ochoa: Yes. Yes, On the one hand, yes. But at the end of the day, even if you... it does not matter if he makes... under the relief program, if he makes payments or he does not, you are going to provision it.

Natalia Corfield: Right. No, I am just trying to understand because like to become an NPL would be overdue by more than 90 days. So that is something...

Carlos Ochoa: That is right.

Natalia Corfield: Probably clients that are not paying, they are still not in your 90 days NPL ratio.

Carlos Ochoa: That is right. That is right. And it is also important to bear in mind that it is not only that they make payments, but they have to make the full installment, not only a payment, right?

Natalia Corfield: Ok, right. So well, but at the end... so I do not know... like if you could provide, does not need to be now, but like the percentage of... the percentage that has been paying current, that would be great because then it would solve the problem of who has not been paying because probably it is not still in your NPL ratio, I believe.

Carlos Ochoa: Yes. We will look into it and try to be more clear about that one.

Natalia Corfield: Ok, thank you.

Carlos Ochoa: Thank you, Natalia.

Operator: As a final reminder, if you would like to ask a question please press *1 on your telephone keypad. As a final reminder, please press *1 on your telephone keypad if you would like to ask a question.

Our next question comes from the line of Matthew Breckenridge with DSC Meridian. Please shoot your question.

Matthew Breckenridge: Hi gentlemen, thanks for taking my question. I have a question about the change of the Board members.

What is the normal period for when -- time frame for when Board members change? It is usually after a shareholder vote. What was different about this period?

Carlos Enrique: Sorry, changing what? I didn't get that part.

Matthew Breckenridge: The members of the Board of Directors. You had 4 -- you had 1/3 of your members of Board of Directors resign.

Ángel Romanos: Yes. Mainly, the changes in the Board of Directors was people that weren't coming to the Board anymore. We have a lot of associates from our businesses where we had a majority stake and that are not longer -- no longer strategic for Crédito Real like Resuelve Tu Deuda and the car business, the CR-Fact business. So we asked those people to step down of the Board. And we brought people that we believe know more about the company and have been more involved in the company. We're still trying to make the Board more institutional, bringing more outsiders. And that you will see in the first quarter of the coming year.

Matthew Breckenridge: Okay. Yes, but I mean, usually, that's at the AGM, no? And then it's in the -- it's -- it would be in the new year. Is that the usual period?

Carlos Ochoa: Not for us. I mean, if you look at the changes in the past, that we've made in the past, they do not obey a particular month in the calendar. But in any case, what is important as well is that those changes need to be ratified at the shareholders' meeting. So in any case, I mean -- and the shareholders meeting is going to be held in next January, as such...

Ángel Romanos: February.

Carlos Ochoa: Yes.

Matthew Breckenridge: Okay. Going to the cash flow statement. There was a inflow of cash from the derivative book. Did you take off hedges for interest rate or for currencies?

Carlos Ochoa: No. Basically, what we did, and it was with a 50 million euros tranche on the euro, on the euro hedge, we recouponed it to -- from the 19% to 20%. It was basically 1 peso. I mean, we recouponed 1 peso above. So basically, that's what we did. In any case, I mean we feel it was prudent at the time and following a very conservative approach on the hedging and the strategy -- in the hedging and strategy of the company.

Matthew Breckenridge: Sorry, I don't understand. So you rolled your hedging down, so that...

Carlos Ochoa: No. We recouponed it. We changed the strike price from the -- we increased the strike price from 1 pesos over, I'm not sure, 50 million pesos -- 50 million euros.

Matthew Breckenridge: And you were able to release -- okay. So -- yes, so that's 60 million dollars roughly. You're able to release that much money?

Carlos Ochoa: That's right.

Matthew Breckenridge: Okay. Next question is, what is in the short-term and long-term investments? What makes up the short term investments? Are they government bonds?

Carlos Ochoa: Short-term, they -- short-term investments, they are -- that is basically how we manage cash. That is basically we consider cash under the 2 lines, cash and the cash equivalents and investments in securities, whereas the long-term investment in shares, that's the participation in the subsidiaries where we hold equity stakes.

Matthew Breckenridge: Okay. All right. And then my last question is what percentage of -- let's go back to the NPLs and people who are under, I guess, you know? relief programs. If I am a customer and I am making 50%, hypothetically, of my original contracted payment, what are you doing with the other, in my example, 50%? Are you capitalizing that? Or is it just forgiven for the period?

Carlos Ochoa: No, no, no. I mean, every customer has a specific solution. Every customer gets a specific solution. And at some point, they have to end up paying the original amount. But I mean, what we can do and what we have been doing is, I do not know, especially, as you can imagine, for example, in the case of the restaurants, I mean, we could not be very strict with them during the lockdown. So probably, in those cases, we extended -- we granted grace periods. Or basically, I mean, what I am trying to say is that at some point, this is going to end up, you know? probably by extending the duration of those facilities or, you know? at some point, you know? the solution -- there can be a number of solutions, you know? extraordinary payments on their side, once that things normalize. I do not know, it is a very broad question.

Matthew Breckenridge: No, I understand. So my question -- but my question is specifically. If the customer has an original contracted rate and a relief program to me means that they either are getting relief on the amount of interest and their principal payment dates. So it is one or both of those. And my question is, if a customer is getting relief on interest payments, are you capitalizing the difference between the original contract rate and the amount they are actually paying in cash? Or are you -- and what you are telling me is you are not forgiving it. So are you capitalizing it? And then the second question is, is that different, the difference between the contract rate and the amount they are paying -- actually paying under the relief program? Is that going through interest income? Or is it showing up someplace else?

Carlos Ochoa: Look, I mean, the -- it is not a straightforward question, that one because the solution can be, as I was telling you, a number of solutions. In any case, the original amount is going to have to be paid. And basically, that is -- it is going to be paid in full. And basically, you know? probably a good way to summarize it is going to be you are extending the duration of those facilities. If I have to be succinct in terms of an answer, I would say that we are going to, in most of the cases, we are going to extend the duration of the facility.

Matthew Breckenridge: Ok. Thanks, I am finished.

Carlos Ochoa: Thank you.

Operator: Our next question comes from the line of Rodrigo Sanhueza with PineBridge Investments. Please shoot your question.

Rodrigo Sanhueza: Hi, thank you for taking my question.

My question is regarding growth. I know that you are with a very comfortable capital position, but -- and you already stated also that you are going to be very conservative on your SMEs portfolio. But I was wondering if you could provide us more color on what is going on, on your Payroll portfolio growth and also in the other segments that you are in business. Could you provide us with a breakdown on -- or your expectations on how growth is going to look going forward?

Ángel Romanos: I will answer you on the Payroll program. Payroll was very complicated at the beginning of the COVID because, as you know, we do this on site, person to person. So there were no government employees at the offices. And our salespeople were not able to be on the streets either selling the loans. So it was very slow. We were originating like half of what we were on a daily basis last year. And by the end of September, it has become more regular and the Famsa deal is helping us a lot. We are starting to originate with them around -- I will tell you numbers. Last year, we originated about 25 million pesos per day on the Payroll business. At the beginning, in the middle of the pandemic, we were originating about 12 million pesos to 13 million pesos a day. And today, we are back to 20 million pesos, 22 million pesos a day. And this is because of 2 reasons. One is Famsa, that we did not have a big presence in the north of the country. And we are starting the deal with Famsa. I would say we are at 40% of the potential of that deal. And then a lot of people are coming back to the offices on government agencies, and we have our people there starting to sell loans. So we believe that the fourth quarter will be good in origination and should be close to what we originated in the last quarter last year.

Carlos Ochoa: Sure. And if you look at the other -- the different lines of business, given the visibility that we have at the time, we feel optimistic on the Used Cars businesses on both sides of the border. The Used Cars business in the states have been performing extremely well, and we see a spike in the demand. And that is something similar that we are experiencing over here in Mexico. If you look at the official figures, you know the demand for used cars has increased roughly 20%, where there has been a decline in the demand for new cars. So I think that we are profiting from that. And I would say that, that, you know? -- the trends that you are looking in those 2 business, given the visibility, again, given the visibility that we have at the time, I mean, that's going to help us. There are other aspects, you know? more challenging. For example, what is going to happen in terms of Central America. In Central America, you know? we have a challenging situation in Panama as well. But I do not know. I mean, what we can say is altogether is probably in terms of having the best use of our equity, probably it's going to be in our best interest to, you know? downsize a little bit, as I mentioned, to downsize a little bit the SME portfolio here in Mexico and to focus on the most profitable or with the highest NIMs -- the products with the highest NIMs. All in, I would say, that the 20% that we are seeing right now, I think it is something doable with the combinations of what Ángel mentioned and the other 2, 3 lines of business. So that is where we are standing given the visibility that we have at the time.

Rodrigo Sanhueza: Okay, thank you. That's clear. And maybe just a quick follow-up on the Payroll, again, since you are doing this deal with Famsa and you are known -- correct me if I am mistaken, but that your collections are direct transfers from the government. Is there any changes on your collections procedures? Are you targeting other customers differently from what you have been doing these past years? I noticed also that your ticket slightly decreased. So I was wondering how should we understand that and also how should we understand this going forward, given the economic backdrop.

Carlos Ochoa: No, we do not intend to change that. And probably the good thing. If you look at the Payroll portfolio as of the end of the third quarter, if you look at the -- one of the good, good things about our portfolio is that right now, as of the end of the third quarter, we have a concentration of around 90% of the book, 90%, 9-0, with federal or pensioners. So basically, that helps us a lot in terms of asset quality. I mean -- and that is definitely one of the strengths that we have. The collection for those segments have been extremely, extremely reliable over the past 3 years or so. So we do not intend to change that one.

Rodrigo Sanhueza: Okay. Perfect. And I have a second question on liability management. I do not know if you are planning something regarding your perpetual bonds or any other international relations?

Carlos Ochoa: So those are -- that is still a couple of years ago. I mean -- and given the present circumstances, you cannot do much about them. But definitely, once that the markets are open, I mean, we will look into that, we will look into it. And as you may know, I mean, the company, I mean, one of the -- we've been very prudent when it comes to the liability management, when it comes to addressing our financial needs. And definitely, but it's not the time right now to focus on that one. What we are very pleased at this point is to see all the support that we are getting, not only from local or international banks, but also from development agencies and things like that. And that is definitely going to -- altogether, the -- our flexible, the difference in instruments and the different latitudes where we can operate when it comes to the liabilities, I think that puts us in a very good position.

Rodrigo Sanhueza: Ok, thank you, Carlos and Angel.

Ángel Romanos: Thank you.

Carlos Ochoa: Thank you, Rodrigo.

Operator: Our final question comes from the line of Nik Dimitrov with Morgan Stanley. Please shoot your question.

Nikolai Krassimirov: Hi there, sorry, this is just a follow-up. The NPL definition that you used for the factoring business, is what, is it 90-plus days or it is something else considering how short that business is?

Carlos Ochoa: No. 90 days.

Nikolai Krassimirov: 90 days?

Carlos Ochoa: Yes, yes. Basically, we have the -- the NPL definition is the same all across our products. 90 days, and we charge-off at 180 days.

Nikolai Krassimirov: How is that working out in practice? If the invoice that you are purchasing is like 2 months, right, 60 days, and it goes in default, so it does not get captured by the NPL definition?

Carlos Ochoa: At some point, it will. And the thing -- yes, I mean, you have a point over there, but at some point, it will, right? And basically -- and the bad side of it, if you look at this way, is that given that your provision under expected losses, you provision a certain amount at the beginning, but once that it becomes NPL, well definitely that should increase the provisions. But that is normally how it works.

Nikolai Krassimirov: So, you basically kind of -- I understand what you are talking about. But in terms of when it is going to flow into NPLs is, you kind of delay the recognition until it hits the 90 days and then you recognize it despite the fact that it went delinquent way before that, right?

Carlos Ochoa: I mean you could have a point on that one. But normally, the duration for those facilities are under the 90 days, yes. But they are more than 45 days. I mean if you think that we generate value with the 60 days range or something on the average, they are more like 60 days. So yes, you have a point. Definitely, you have a point, but that is how it works.

Nikolai Krassimirov: Ok, alright, thank you guys.

Carlos Ochoa: Take care Nik.

Operator: With no more questions in the queue, this concludes our question-and-answer session. Thank you for joining us on the call today. You may now disconnect your lines, and have a wonderful day.

Carlos Ochoa: Thank you, everyone.

Ángel Romanos: Thank you, everyone.

Operator: Thank you. With no further questions in queue, this will conclude our question-and-answer session. Thank you all for being on today's conference call. You may now disconnect.

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