Credito Real – Earnings Call 4Q16

February 23, 2017

10:00 AM CT

Operator: The following is a recording for Manuel Perez of IRSTRAT on Thursday, February 23, 2017 at 10:00 AM Central Time. Good morning and welcome everyone to the Credito Real fourth quarter Conference Call. Credito Real issued its quarterly report on Wednesday, February 22, 2017. If you did not receive a copy via email, please do not hesitate to contact us in Mexico City at +52-555-228-9753. Please note that the presentation and the 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 information discussed in today's call may include forward-looking statements on Creditor 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 advise any forward-looking statements. With us this morning from Creditor Real, we have Mr. Angel Ramanos, CEO and Mr. Carlos Ochoa, Deputy CEO. They will discuss on the more important strategic financial and operating aspects of the fourth quarter 2016. I would now like to turn the call over to Mr. Ramanos. Sir, please begin.

Angel Ramanos: Thank you operator. Good morning everyone and thank you for taking part in our quarterly call. We are pleased to disclose of the Company's reporting net income increased by 12.4 percent during 2016 reaching over Ps. 1.5 billion. More remarkable than the figure itself is that the fact that this was achieved during a year in which the Mexican reference interest rate increased by over 250 bps, clearly affecting our Net Interest Margin. The new reality implies coping with higher interest rates a more volatile economic environment from now on. During 2016, we made important decisions towards facing this new reality firstly by diversifying our original footprint, we will be able to mitigate local interest rate hikes by changing the composition of our portfolio. As of this year in the credit weight close to 20 percent of the book with Net Interest Margins well above 40 percent. We believe that by year end close to 25 percent of our business will be served in the Central American Region. Another relevant decision made in 2016 was the refinancing of most of US dollar-denominated debt and extending the liquidity profile of the Company to over 40 years. The issuance of the senior notes in 2016 was the largest single refinancing exercise in the story of the Company. During the year, the Company refinanced over 60 percent of its total liabilities and by doing so rating agencies, banks and debt capital market investors reiterated the conference business model. The economic outlook for this year remains just as challenging. The pressure over the Net Interest Margins shall continue throughout the year. As such, we have repriced all of our products to the end consumer increasing not only what the reference rate has increased but some more or future rate hikes we expect throughout the year. The effects on our revenue line for increasing pricing to our customers shall be seen until mid-2018, when all of the new loan originations form an important part of the total loan book. We plan to grow our portfolio in the range of 10 percent in the year concentrating our efforts on our most efficient and profitable products which are Instacredit, payroll loans and Don Carro. It is important to highlight that today we have no currency risks as 100 percent of our dollar-denominated debt has a full cross currency swap covering both interest and principal to maturity. As for our debt in Mexican Pesos, 25 percent is fixed and the rest floats with a spread over the Mexican reference rate. We are actively looking for ways to efficiently fix rates for more of our peso-denominated debt. Maintaining at the quality and the most efficient use of our resources with cost-reduction initiatives will be priorities for the Company in 2017. With this I leave for more detail on the numbers with Carlos Ochoa.

Thank you.

Carlos Ochoa: Thank you, Angel. Good morning, and thank you all for taking part in Credito Real's Quarterly Conference Real. During the quarter, we experienced a negative carry driven by the remaining unused resources of the senior notes 2023. This effect is reflected in the investments in securities in line in the Balance Sheet for close to Ps. 1 billion, an endangered expense account in the P&L for over Ps. 55 million. Also, during 2016, we had the effect of a nonrecurring item residual of the unwinding of the Company's 2019 senior notes. Regarding the interest income, during this quarter we reached interest income of close to over Ps. 1.8 billion increasing 48 percent compared to the 4Q15. The increase was mainly due to the growth in the loan portfolio as spurred by Instacredit which contributed to 32 percent of the consolidated interest income in the used car business in the states. Concerning funding, the average funding cost increased from 6.1 percent reported on the 4Q15 to 9.7 percent during this quarter. This increase is explained by higher funding costs of the Instacredit consolidation and an increasing Mexican reference rate and the negative carry effect previously mentioned. Excluding these factors our cost of funds we have reached 7.1 percent. When it comes to the financial margins, the financial margin increased 25 percent to reach Ps. 1.2 billion driven by interest income growth, Instacredit contributed to 36 percent to the consolidated financial margins. Provision for loan losses. Provision for loan losses reached Ps. 290 million during this quarter. Over the year we have gradually built a solid allowance for loan losses balance as displayed by a coverage ratio increment from 117 to 148 year on year. Administrative Expenses. The administrative expenses reached Ps. 806 million during 4Q16 showing an increase of 104 percent when compared to 4Q15. This increase is mainly driven by integrating expenses of AFS and Instacredit and Don Carro. Net Income. In the fourth quarter the net income decreased by 7.2 percent to Ps. 345 million due to a negative carry effect and was above Ps. 55 million, and for 2016 the recurrent net income increased by 12 percent to reach Ps. 1.5 billion. From the cost of key financial ratios, this quarter the return on assets was 3.8 percent driven by a decrease on the Net Interest Margin with return on equity reached 15 percent mainly affected by 138 percent rise in financial expenses. 2016 return on average equity and return on average assets reached 18 percent and 4.5 percent, respectively. The quarterly efficiency ratio increased to 58 percent mainly driven by the integration of the expenses of Instacredit, AFS and Don Carro into Credito Real. During 2016, the recurring efficiency ratio without Resuelve would have been 54 percent. We excused Resuelve since this business does not involve credit risk. Our capitalization ratio improved to 38.8 percent as of the fourth quarter of 2016 compared to the 38.1 percent recorded in the fourth quarter of 2015. Even after the increased debt to finance our recent acquisitions, we still have a capitalization ratio well above the average of the financial sectors. Regarding our loan portfolio, our loan portfolio increased by 36 percent to reach almost Ps. 24 billion at the end of the fourth quarter 2016. The increase is mainly explained by the consolidation of Instacredit and AFS as well as the double-digit growth in the payroll business and the used car segment. Excluding the acquisition of Instacredit, the book increased by 11 percent. We continue to working out portfolio growth with a pension segment which represented above 13 percent of the whole origination during the fourth quarter. Also, nearly 89 percent of the payroll loans came from the three main distributors in which we own equity. Our global good loan portfolio decreased by 57 percent year on year, and the origination was even in this quarter. As we have already mentioned, the market of our durable goods segment has reached a mature stage, the reason which is why we have considered on a gradual exit for this business. Our SME's portfolio increased by 8 percent year on year to total Ps. 1.3 billion as of the fourth quarter 2016. We had an improvement in SME's Net Interest Margin of approximately 600 bps by reprising its loan portfolio above the increase in the Mexican reference rate. Additionally, we improved our NPLs to below 1 percent by focusing on high quality customers and stricter credit policies. Regarding our Group Loan Business, our operators Contigo and SomosUno reported a 45 percent loan portfolio growth. Out of this we recognized the funding part of Ps. 418 million, our Group Loan Partners continue to expand their number of customers while maintaining a strong portfolio performance metric. Our Used Car Portfolio increased by 51 percent year on year reaching almost Ps. 2.8 billion at the end of the fourth quarter 2016. The portfolio increase was driven by the expansion in our US business and as of the fourth quarter of 2016, the used car business in Mexico represents 2 percent of the total portfolio, was the used car business in the states representing 9 percent of the total loan portfolio.Instacredit's loan portfolio represented 18 percent of total loan portfolio and 18 percent of the origination during the quarter. This quarter the non-performing loan portfolio was 2.2 percent compared to 2.4 percent last year. The NPL decreased mainly by the payroll and the SME business. The NPL is in line with a 2-3 percent loan term objective as we have achieved greater diversification in our loan portfolio. As Angel mentioned, during 2017 we will focus our growth in our most profitable businesses, and we will execute the necessary adjustments along for the following quarters to enhance our profitability. With this, I conclude my remarks and now let me turn back the call to the operator to open the line for Q&A.

Operator: Thank you, sir. Ladies and gentlemen, we will now open the floor for questions. If you would like to ask a question, please press *1 at this time. Again, that is *1 if you would like to ask a question. Our first question comes from Tito Labarta from Scotia Bank.

Tito Labarta: Hi, good morning, Angel and Carlos. Thanks for the call. A couple of questions. The first one is a little loaded to be honest. I'm a little surprised by your loan growth guidance of 5-10 percent for this year. I understand the uncertainty in Mexico and you have a somewhat mature portfolio in payroll ending and some of the other segments are slowing down. But with the acquisitions with Instacredit and AFS in the US, you know, that was supposed to provide some diversification and support for growth. Now, in fact, in the fourth quarter Instacredit grew loans more than 20 percent, used car loans grew 6 percent and your total loan portfolio grew 5 percent in the fourth quarter alone, so I'm surprised that such a big deceleration in growth for 2017. I just want to get a little bit more understanding behind. Also that means are we going to fall this year with the guidance you gave also, or are we maybe 15-16 percent? Is that the new sustainable level of ROE that we should expect? Or, how does the loan growth play into your long-term ROE? And then my second question, there was a big drop in other income operations. It was Ps. 23 million this quarter. It was Ps. 328 million in the third quarter, so I just want to understand that and how should we think about that going forward? Thank you.

Angel Romanos: Tito, this is Angel, how are you? I'll answer your first question first, the growth in the portfolio. We are expecting growth of around 20 percent in both Instacredit and our US business, but it's still a small part of the whole portfolio. We're being very conservative on the Mexico side for the year. So we're leaving that almost unchanged in the year for our projections and that gives you a total growth of about 10 percent for the portfolio, but it's mainly coming from the South American and US operations. As for ROE, yes our ROE was much lower than anticipated in the fourth quarter, but if you see our equity grew almost 50 percent during the year and there were no dividends by the end of the year so that's part of the explanation of why ROE. But once our margins come back and we go back to our dividends, and this is next year because of our loans that we give are on a fixed rate and now we're forming 75 percent of our formula with Mexico on a variable rate, so now we have been able to push up the rates for our end consumers, but that won't show on the numbers until mid-next year when it's more or less the average of the loan portfolio. You will be able to see margins come back to where they were at mid-last year, mid-next year. We recovered our sales assuming that interest rates may still go up in Mexico maybe by 1.5 percentage points, 150 bps, so the net increase will be to interest rates for our consumers. It's like 30 percent more to what interest rates have grown in Mexico. And for the third part of your question, I'll let Carlos answer.

Carlos Ochoa: Yes, and probably also adding a little bit in terms of the ROE. I mean we knew from the beginning of the year that the profitability metrics would be affected by the two elements. First, the increase at the beginning of the year by consolidated Instacredit in February, we knew that the profitability metrics would be affected like that one. We didn't foresee all the increase in interest rates, but the fact it was mentioned we would expect that to normalize over the next year. When it comes to the other expenses, the other income from operations line, what we had in the fourth quarter was an adjustment due to a consolidation in one of the subsidiaries which was Resuelve. There was an issue there and that led to that dramatic decrease in that line. That should normalize to what we saw in the third quarter to what you saw in the last quarter, 3Q16 to the range of 300, 250. Normally that would be it.

Tito Labarta: Okay, thanks, that's helpful. Maybe just one follow-up in terms of the loan growth. I understand this year the slow-down, do you expect it then to pick up also in 2018, so you start to get faster growth because I mean your ROE is going to really be a function of your loan growth? I mean that's really what's kind of driven your performance. You know, if the loan growth stays around 10 percent your ROE will be suppressed, but if the loan growth comes back in 2018 then that can provide some support, so you just want to get some maybe longer term outlook for loan growth after you get through 2017?

Angel Romanos: Yes, we are certain that 2018 will be a much better year indexes wise.

Tito Labarta: Okay.

Angel Romanos: When all the indicators will look much better than this year.

Tito Labarta: Yeah. So the growth would go back about 15 percent, 20 percent. I know it's kind of far out but just want to get a sense of what the sustainable growth for the next years.

Carlos Ochoa: You know our long-term growth guidance is between the 15 percent to 20 percent and probably we should be in the range of the 15 percent in the coming years.

Angel Romanos: And as I said before, Tito, we are being very conservative on the Mexican side but if things don't turn as volatile as we expected, growth may be there this year too. We prefer to be very conservative for our projections.

Tito Labarta: Okay, that's helpful. Thank you.

Carlos Ochoa: Thank you, Tito.

Operator: Thank you. Our next question will come from Ernesto

Gabilondo from Bank of America-Merrill Lynch.

Ernesto Gabilondo: Hi, good morning, Angel and Carlos and thanks for taking my call. Three questions from my side. On the first one, given your loan growth guidance of 5 percent to 10 percent, what can we expect in terms of Net Interest Income or financial margin growth for this year? Also we have seen a couple of quarters with a cost of risk at 5 percent. So I just want to know what you expect for this ratio going forward? Secondly, a follow-up in other income. Can you share with us your growth expectations for fees and other income growth or the average amount per quarter? And finally, can you share with us how much of your funding is fixed and how much is at falling rates, and how do you see the cost of funding at the end of the year? Thank you.

Carlos Ochoa: Well, in terms of the net income what we would expect as we guided for this year, we would expect it to be the growing up to 5 percent. As we told you yesterday while our call, Ernesto, we prefer to be more on the conservative side because as Angel was mentioning, what we expect for this year is that the Mexican reference rate will increase by 150 bps at least. So we prefer to be more cautious in terms of guiding the net income growth in that sense.

Ernesto Gabilondo: Sorry, it's more net interest income, not really the net income.

Carlos Ochoa: Right. Yeah, on the top, look at what we would expect in that sense is that it should remain above the 20 percent, and where it was we intend to do in that sense is, you know, increasing, changing the mix of the composition of the portfolio by increasing the participation of our businesses outside of Mexico. I think that if we maintain the Net Interest Margin above the 20 percent, 21 percent or something in that range, that should lead combined with a reduction in the expenses side, that should lead to a growth in the net income up to the 5 percent that we guided.

Ernesto Gabilondo: Okay perfect, and about your cost of risk?

Carlos Ochoa: The cost of risk should be trending towards the 4 percent, normally it would be like that, and also what we you see in the terms of the cost of risk that is moving towards the 5 percent, it was due to the standardization of the definitions of NPLs as well as the definitions of charge-offs. Just to remind everyone on the line the definition that we had for NPL is that we keep on the Balance Sheet the fourth quarter between the NPLs is between 1 and 90 days and 180 days past due and after 180 days we charge it off. So basically what you see in the businesses outside of Mexico applying these charge-off policy leads to a higher cost of risk but it’s netted on the other income side by the income that you generate in repossessing the assets or collecting from the charge-off account. So the net effect should be close to the 4 percent or in the range of the 4 percent.

Ernesto Gabilondo: Okay perfect. Then I will allow you answer the second and third question.

Carlos Ochoa: Could you remind me that it was the third question was in terms of the cost of funds. Right now it’s like 25 percent what we have in fixed. We have 25 percent normally in that range. The idea is, you remember before the issuance of the senior notes last year, it was a proportion of the debt that was fixed. It was in the range of 45 percent to 50 percent. We intend to keep that range of fixed debt within our books and we have done it so because the volatility in the market makes it very, very expensive. Basically what we've been doing, it's like waiting for the right time in order to increase the proportion that is fixed, of fixing the debt. Right? But that should be in the range of 45 percent to 50 percent of the total debt will be fixed.

Ernesto Gabilondo: Right. Thank you. And the second one was a follow-up in other income. I just want to know your expectations for that line. I don't know if you can guide an average amount per quarter, and what are you expecting for this growth?

Carlos Ochoa: If you see the most visible part, well at least the more dynamic part in the other income line will be the fees charged by Resuelve. As of this year, in 2016, Resuelve the income generated, the fees generated by Resuelve were in the range of Ps. 450 million in the year. Normally it's in the range of above Ps. 100 million per quarter and that should continue for this year and probably will be a little bit higher, probably in the range … It will increase by I don't know probably 10-15 percent that business. So by the end of the year the other income line should be in the range of the Ps. 500 million, more or less, only for the Resuelve business.

Ernesto Gabilondo: Perfect. And for fees growth?

Carlos Ochoa: Those are the fees. Actually just to remind you that Resuelve is the fee basis that we have.

Ernesto Gabilondo: But the combination of fees and other income should be around about Ps. 100 million per quarter, or?

Carlos Ochoa: The other income is also pretty much the same. If what we are seeing in terms of collecting charge-off accounts, they amount for like Ps. 100 million per quarter. That trend should continue over this year. So the combination of the two businesses, Resuelve and the other income collected from charge-off accounts that should amount for Ps. 800 million.

Ernesto Gabilondo: Okay, thank you very much, Carlos. Much appreciated.

Carlos Ochoa: You're welcome, Ernesto.

Operator: Thank you, as a final reminder, please press *1 at this time for any questions. Our next question comes from Alessandro Arilant from Bank of America.

Alessandro Arilant: Yes, good morning gentlemen. Just a follow-up question on the discussion and your earlier comments on the financial policy. I know that Mexico is in the spotlight and that you could have a lot of changes this year, especially with politics in the US and that you want to keep higher than usual cash balance. You also mentioned about your funding strategy and the interest rates that you want to have, fixed versus floating. My question is particularly looking at the dollar bonds. You do have a call option coming in March for the 2019 dollar bonds. I'm just wondering if you think it would be prudent to exercise the call, you know, reducing the cash balance or refinancing in the local market even though 100 percent of your dollar debt is hedged if that would make sense now in the next few weeks. Thank you.

Carlos Ochoa: Hi, Alessandro. You know, on an interest hedging level is what we intend to do is to fund our operations locally. Right? So basically the intention would be diversify the sources of funding in pesos and for the business in the states do the same and equally in the Central American business. That's on the more strategic level. When it comes to the senior notes the call that we have the next month, we haven't decided yet what we are going to do with that one because that proportion of the debt is already fixed and it's quite convenient for us because we have a material marching market on that one. So we haven't decided what to do with that one. I mean I would say the important part of the story when it comes to funding is right now we will have a strong Balance Sheet in terms of the cash that we handle, and we also have under our own bank line for over Ps. 2 billion and we're still negotiating with the bank increasing the bank line. We feel comfortable that the liquidity is not going to be an issue for this year. I'm not sure if that answers your question?

Alessandro Arilant: Yes, no, no, sure. I understand. I know that there's a balance between the liquidity and also the local funding. Right? But your dollar debt is it hedged and I imagine you have a gain on that in terms of market to market, correct?

Carlos Ochoa: Right, that's correct. That's correct.

Alessandro Arilant: That's great. Thank you so much.

Carlos Ochoa: You're welcome.

Operator: Thank you. Our next question coming from Herman Velasco of BBVA.

Herman Velasco: Hi, good morning Carlos and guys. Thank you very much for the call. Just a quick question regarding the loan growth. You mentioned that you are going to be very cautious in the Mexico business, but you also said that the business Instacredit will increase around 20 percent and maybe the business in US will grow double digits. What are your expectations about the payroll business in Mexico because it has grown above 10 percent, so it is a little bit difficult to think that business is going to increase below 10 percent? That would be my question.

Angel Romanos: Hello Herman, this is Angel Romanos. We're not saying that we won't grow our business in Mexico. What we're saying is we're being cautious on what we project for our business in Mexico. Business is being good, the first month was very good. What's going over in February has been good, but we are cautious because there's a lot of instability in the currency interest rates so we don't want to get over excited about Mexico very slow, although we may grow our portfolios in Mexico. We're not being cautious on the way we originate or really stopping our way of doing business. We're just being cautious in the way we project for our business in Mexico.

Herman Velasco: Okay, so do you have a number in mind of what would be a reasonable increase for the payroll loans?

Angel Romanos: Well, our projections we're leaving it even, but we may grow that business between 5 percent and 10 percent if things go good in Mexico.

Herman Velasco: Okay, okay, thank you. Thank you, Angel.

Angel Romanos: Thank you.

Carlos Ochoa: Thank you, Herman.

Operator: Once again, please press *1 if you would like to ask a question. Our next question comes from Claudia Benavente from Santander.

Claudia Benavente: Hi, thanks for the call. Just wanted to know what were the terms of the treaty credit obtained for $110 million? I understand the interest rate in passive terms was at 7.22 percent. Was this loan hedged? What were the terms of the hedge in that? Thank you.

Carlos Ochoa: Hi, Claudia. Yes, actually that loan was for refinancing the loan that we got in the previous year for the acquisition of Instacredit. So basically what we did is that we extended the maturity of that loan. In terms of the loan, it's a three-year loan with three amortizations due at the 18th month, at the 24th month and also 40 percent at the 36th month. Both the principal and interest rates are fully hedged and as you already mentioned the interest rates that we will be paying for that loan is for 7.22 percent in pesos, Ps. 16.

Claudia Benavente: Okay, the thing is I was comparing it to your last bond additions last year and you had the coverage both in terms the interest rate and the FX. So and that effect right now is only to have this fixed interest rate at 7.22 percent, right?

Carlos Ochoa: Yes. As for that loan regards, yeah there was an improvement from the interest in the previous year was at 9.15 percent, but once you add the cost of hedging the principal that led to, I don't know, it was something in the range of 12 percent. So there was a major improvement regarding that loan in terms of interest rate.

Claudia Benavente: Perfect. Thank you.

Carlos Ochoa: You're welcome.

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

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