Q2 2014 Earnings Call

Company Participants

- Angel Santodomingo Martell, Executive Vice President-CFO

Other Participants

- Felipe Gaspar Salomão, Analyst
- Francisco Kops, Analyst
- Natalia D. Corfield, Analyst
- Tim Puls, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon and thank you for waiting. Welcome to the conference call to discuss Banco Santander Brasil S.A.'s Results of the Second Quarter of 2014. Present here are Mr. Angel Santodomingo, Executive Vice President and Chief Financial Officer; Mr. Carlos Galán, Executive Vice President and Financial Accounting and Control Officer; and Mr. Luiz Felipe Taunay, Head of Investor Relations.

The live webcast of this call is available at Banco Santander's Investor Relations site, www.santander.com.br/ri, where the presentation is available for download. All the participants will be on listen-only mode during the presentation, after which we will begin the question-and-answer session, when further instructions will be provided. . We would like to inform that questions can only be asked by telephone. So if you're connected through the webcast, you should e-mail your questions directly to the IR team at ri@santander.com.br.

Before proceeding, we wish to clarify that forward-looking statements may be made during the conference call relating to the business outlook of Banco Santander, operating and financial projections, and targets based on the beliefs and assumptions of the Executive Board, as well on information currently available. Such forward-looking statements are not a guarantee of performance. They involve risks, uncertainties, and assumptions as they refer to future events and, hence, depend on circumstances that may or may not occur. Investors must be aware that general economic conditions, industry conditions, and other operational factors may affect the future performance of Banco Santander and may cause actual results to substantially differ from those in the forward-looking statements.

We would now like to pass the word to Mr. Angel Santodomingo, Executive Vice President and CFO. Mr. Santodomingo, you may proceed.

Angel Santodomingo Martell

Okay. Thank you. Good afternoon. I'm Angel Santodomingo. It is a pleasure for me to present for the first time Santander Brasil results. This time, as you know would be the second Q results, both through the web and through the conference call. I will follow the presentation that we have posted today in the web with regards to this second Q 2014 result.

Starting with the structure of the presentation, I will slightly review the macroeconomic scenario. I will then underline highlights, go through the results and make final conclusion or final remarks.

Before presenting the operation, I want to go through the operation that we announced this morning, which is a joint venture between Santander and Bonsucesso.

We announced the operation early this morning. The operation is a joint venture in between Santander Brasil and Banco Bonsucesso. Santander Brasil will hold 60% of the joint venture while the remaining 40% will be in Banco Bonsucesso's hands.

The investment that Santander will accomplish in the first phase will be R$460 million, and we estimate that the process would be by the end of this year. Probably for those of you that do not know Banco Bonsucesso, Banco Bonsucesso is probably the best player, one of the best players here in Brazil in terms of (3:56) which is the type of lending linked to payrolls. We are developing the joint venture after and strategy during the last year, year-and-a-half in which we were retiring from what we can call the external channel for this type of loans. You sell the loans both through agencies and through external channel, and external channel in our case was being reduced in terms of activity due to quality in the forecast.

With this strategy, or with this agreement, what we are doing is reinforcing that part of the market with one of the best players, as I was saying. The target is then – is we have clearly increased capacity in terms of commercial and distribution channels. We have access to the relationship with profitable commercial agreements and know-how, so both the front office and the back office clearly improved. Then we will also be able to expand our products because we can sell credit cards linked to this product, which do not – is not a common product here in Brazil and is starting to be developed, and Bonsucesso has the knowledge and the capacity as it is already doing.

Let me go through the strategic and financial rationale very quickly. Strategic rationale, I mentioned some of the things but it is a continuation of our strategy to focus in one of – in a segment that is key for us with lower quality, sorry with lower risk but specifically with higher linkage capacities in terms of how you link with a client.

We create an external channel that is what we wanted to be and to have when we started the reduction of what we had one or two years ago. And we do that with a partner that brings capacity, that brings know-how, that is specialized and that ensures, at the end of the day, quality and profitability.

And at the same time, as you can imagine, the format of a joint venture, obviously, is a way of increasing the time to market of the operation.

Financial rationale, some data that you may want to know: we are speaking of an initial loan portfolio of approx R$1.1 billion. 60% is payroll loans and 40% is payroll cards. We think and we estimate that it will be accretive since 2016, probably reaching an accretion of EPS of around 1% by 2017. And we are estimating a return on investment of around 17% for 2017, which matches our general criteria of profitability of investments that has been mentioned publicly by our management.

So basically or as a brief summary, this new operation is enabling us to grow with quality in our business that we think may be quite successful going forward.

So once, having discussed the operation, as I was saying before, let me start with the results presentation. The first part is the macroeconomic outlook. As you know, the data you have there is consensus, where the market stands today. The market is with an estimate of a GDP of around 1% - 0.9% for this year and 1.5%, obviously lower than previous years. GDP growth has decelerated and probably will remain in the same levels or a little bit better during the next 18 months. 2015, we think that may be positively impacted by whatever economic policy adjustments are made.

In the rest of the areas, as you can see the market is expecting stable Selic rates as we speak for this year, 100 basis points increase for next year, while inflation and ForEx will have or may have some movement according to the market but within reasonable ranges.

So having spoken a little bit, as I said, about the environment, then we go through the results.

First, highlights. I would like to highlight several areas, first with regards to the balance sheet and speaking about the capital and liquidity strengths of the bank. As you probably know, we are in a comfortable position in both concepts. The BIS ratio has reached 17.9%, well ahead of the minimum of 11% that is the minimum needed level, with core a Tier 1 of 16.3%. And the loan-to-deposit ratio has gone down to 100 basis points in the quarter to 98%, specifically because of our good growth on the liability side.

Speaking about the loan portfolio, the loan portfolio has grown 2% in the quarter, mainly driven by corporates, which grew 4%, while, as I mentioned, the funding from clients grew 3% in the quarter.

And thirdly, sorry, and secondly in terms of results, net profits remained flattish, around 1%, with a total amount of R$1.4 billion in the second quarter with different behavior throughout the P&L. First, NII went down 4% in the quarter. I will further elaborate here because there are too many ideas. One is that the business remains flat, that it is not going down in terms of NII, while we have different impacts in other NII that, as I say, I will elaborate when we go though the slides.

Fees grew 2% over the first quarter, and expenses continued to perform in a positive way. As you may see, they grew only 1% in the quarter, which reflects the efforts that we are doing in terms of efficiency.

Finally in terms of risk, the NPL ratio has gone up close to 30 basis points, 28 basis points in the quarter with a coverage ratio of 159%. But let me elaborate on those two concepts when we get to the risks.

If we move on to the net profit, slide number eight. What I mentioned before, the net profit remains at around R$1.4 billion, 1% in the quarter or 0.6% in the quarter with accum (12:26) number of around R$2.8 billion and a decrease of 2.2%. Obviously, this comparison in terms of semesters is impacted by the capital operation that we announced and executed in the first Q. In terms of like-for-like, adjusting that, the net profit would have increased 5% yearly.

On the next slide is the P&L situation. I would say that in general terms the Brazilian financial sector is obviously adjusting to the environment that I mentioned before. You have impacts, in general terms, on banking activities. You have some change of mix dynamics and we have to analyze all these items to try to concrete and to see how they concrete on the P&L.

But let me give you the first drafts of where we are. In terms of revenues, the NII, as I mentioned, went down 4% in the quarter. This evolution is explained in part by the loan portfolio growth from clearly lower results from market activities and clearly from the capital optimization operation that I mentioned.

I will elaborate on the spread evolution because it is important to see how that is evolving. Fees and commissions increased 2% in the quarter on an annual basis by both sides, again affected by basically two operations that - both of them were already public and explained in the past. If we exclude those two, the growth will be (14:33).

On the loan loss provisions, we remain, we have R$2.4 billion more or less provision for the quarter, R$4.8 billion in the semester. It has gone up in the quarter 4% but still the cost of credit remains around where it has been during the last three quarters, 3.6%, 3.8% and then a strong decrease in annual terms.

Finally, two points, general expenses. The general expenses control continue to reflect, to be reflected on the P&L. We are seeing those numbers are maintained, a situation clearly below inflation and sometimes flow through 0% to 1% which I think is a reflection of the strategy of the bank.

Moving to the different concepts, net interest income. The net interest income, I would say you have two main kind of areas on that slide. On the left side, you have the evolution, the total evolution of the NII. That total evolution shows that the red part which is the NII coming from the credit, which is the main source of business, remains fairly stable. It goes on in R$16 million in the quarter but shows that the different dynamics of the business are remaining stable and probably are (16:20) implemented sometimes, obviously probably are symmetric in between the (16:22) and the real, but in any case that is starting to be seen on the P&L.

What goes down significantly on the quarter and on the year-on-year comparison is the "others" and the others in the Q-on-Q that goes basically from R$1.3 billion to R$1 billion. That drop is caused by two items that we have to (16:51) clear in any month. One is I mentioned markets, lower activity results – no, not activity, lower results from markets, of course been impacted by the higher Selic, a position of the balance sheet is affected by a higher Selic. And the second impact is the capital optimization that I mentioned.

A matter of fact, the impact of that capital optimization explains approx 50% of that quarterly evolution that I was mentioning and 40% of the yearly change. And in fact, also excluding that capital optimization, the decline of 4.5% will be or would have been a return of 2.2%.

Let me remember that what has happened is that we have provisioned in second Q, the interest rate cost of the Tier 1 issuance that we made in first Q, changing the criteria due to the Central Bank instructions from deducting those interest rate – that interest rate cost from capital to deducting it from P&L. So in certainty you have two effects, one is that we are provisioning the whole semester but as we did operation by the end of January or early February, you also have three months of provisioning in second Q compared to the two months that come from (18:31) the second Q come from conceptually from the first Q. That is the main impact on the NII.

On the right, you have spreads and the main message there in the spreads is that they remain fairly stable around 9.8%, 9.9% throughout the quarters. We have almost four quarters with stability. The change of mix is still happening but also the pace and the speed and the intensity of that change of mix is clearly reduced. We expect going forward, our spreads will remain around the current levels and in terms of volumes, the quarter evolution is also affected by the pace of commercial activity.

If we look to the volume concept, you can see the loan portfolio in the next slide. The total portfolio what we call here the expanded portfolio which includes not only loans but the rest of the exposure, increased 2% in the quarter and 5% in 12 months, which compares positively or very positively, I will say, with the trends over the last Q that as you remember were negative. We were at around minus 1.5, minus 1.6 in first Q versus 4Q.

I would underline what is impacting negatively the loan portfolio. Well, basically two concepts, payroll lending and SMEs. Payroll lending because I already explained with operation of Bonsucesso that on the external channel, we took that strategic decision sometime ago. Going forward, when this operation is closed and it starts to deliver what we're expecting which is a strong growth, we should see growth coming from here.

On the second part, in terms of SMEs, we are – this has been made public in the past. We are still revisiting the SME model. Our idea is we work with the aim of starting 2015 with that new model which is the Santander Advance concept in the Santander group, and we should start to see a different behavior as I say going into 2015 not before that. It is an strategic segment for us, and we want clearly to reinforce and to have all the tools aligned before starting to grow again.

In terms of segments, in individuals the performance was impacted by what I mentioned. Excluding the payroll product, (21:25) external channels, excluding this, individual loan would have grown 1.3% Q-on-Q and almost 11%, 10.7% year-on-year. On the consumer side, I would like to underline that the conditions of the auto market obviously is affecting all banks. In our case, the drop - it's not a drop because it remains fairly stable. The relative behavior in the rest of the sector is strongly positive. In fact, we have gained 120 basis points in the last year of market share in this business. And this is due to our agreements that we have with Hyundai, with Renault, with Nissan that are paying off clearly in terms of volume and profitability.

If we move to funding, this is good news in the quarter. As you can see, the growth is strong. The total funding from clients is around R$231 billion, has increased almost R$30 billion, R$26 billion in 12 months. Given the different behavior, obviously, between funding and credits, this drives the drop of the LTD ratio to 98%.

I would underline between all the lines that we have there, the good performance of our core - what we call here core deposits, which is the demand deposits and saving accounts, which we are speaking of 2% in the Q and 18% year-on-year.

I will also underline assets under management of balance sheet funds that, as you can see, one quarter we are growing almost half of the full year, 3% versus 6%. So total funding plus assets under management, we're speaking of around R$400 billion, 3% in the quarter and 8% in 12 months.

If we move to fees in the next page, you can see there the evolution. In terms of the total amount of fees, we are speaking of $R5.3 billion, 2% over the same quarter - sorry, over the last quarter and about the same compared to the same period in 2013.

Now, again, here you have two impacts. Just let me remember them because you probably know both of them. One is the life insurance policy renewals that we had - we moved the accountability which was done in 2013 due to that movement, two times, in January and December, and now from that year you have only in December, so if you are going to compare with first Q last year, or first semester last year, you are affected because it was accounted two times in a year. It used to be accounted the full year in January and we moved to December.

The number we have there, the 6.7% is the like-for-like growth. And the other concept that is affecting obviously commissions is the asset management operation, that again we have there the like-for-like evolution instead of the minus 7% in annual terms or minus 1% almost 2% in Q-on-Q.

Probably to understand how the business is evolving, it is the 8% you have at the bottom part of the slide, the year-on-year growth that shows the business evolution and how the business is being developed with regards to commissions.

Moving to the rest of the account, you have general expenses, next page. I don't think here there are many news, but they are all good and positive. But for expenses without including depreciation and amortization, increased only 1% in three months and 2% in 12 months. We continue to be focused in the control of expenses and the delivery of the efficiency plan that we have been sharing with the market and implementing internally is paying clearly off. For the future, we continue to envisage cost growth well below inflation.

Going into the risk part, you can see in the slide number 15, the three probably main concepts with exception of the cost of credit. You have two different behaviors, the over 90 days and the 15 to 90 days. The over 90 days goes up 3% (sic) 0.3% (27:01), clearly pressed by individuals, while the short-term is behaving positively, a leading indicator that is on a positive or had a positive behavior in the quarter with an improvement of 30 basis points.

In terms of coverage ratio, the coverage ratio is 159%, increases in the quarter, but I would say that will remain at very comfortable levels, year-on-year has an strong increase, and we will probably see this ratio being or maintaining comfortable levels going forward.

Probably more important that those ratios because as you know specifically the NPL ratio is a ratio that only explains part of the situation is worth commenting the cost of risk that you have in the next slide.

You have old (27:58) concept, the total provisions that are going up 4%in the quarter. But I would underline the cost of risk that, as I mentioned in my introductory words, remains stable around 3.6% 3.8%, depending on the quarter. The decrease year-on-year is clearly strong but I would say that the Q-on-Q behavior is still in reasonable levels.

To end my presentation a couple of slides. One is with key performance ratios in terms of efficiency and profitability, efficiency reached 49.5% in second Q with an increase of 20 basis points in the quarter, basically explained by the pressure I mentioned on the top line. Recurrence ratio stands at 66.5%, with an improvement of 28 basis points, probably worth more elaborating on profitability and specifically on return on equity.

Return on assets remains fairly stable, but return on equity, I would say that well increases, as you see, 0.4%. Total equity excluding goodwill amounted to R$50 billion with an increase of 4% in the quarter while decreasing 4% in 12 months.

Probably the evolution of return on equity, the other side of the coin of capital optimization plan that I mentioned before and that was affecting the NII. Here you see the positive side, obviously, and that is reflected on the 11.6% of return on equity.

Finally, liquidity and capital, I mentioned the LTD ratio, the loan to deposit ratio going below 100% to 98% due to the behavior I mentioned in terms of deposits, positive performance of deposits. In the capital ratio was modified last Q with issuance of the Tier 1 and Tier 2 bonds, remains at 17.9% as you can see there with a core capital of 16.3%.

So final remarks with regards to these results and the performance of the bank. I would probably like to underline five key points. First one is that the bank remains within a strong balance sheet maintaining strong and comfortable liquidity coverage and capital levels.

Secondly, that obviously the lower economic activity impacts the pace that the business moves. This has meant that the portfolio increased 2% and funding from clients improved 3% in the same period.

The third key line would be asset quality. You have the NPLs rising 28 basis points with the early leading indicators improving.

Fourthly, as we mentioned in first Q conference call, we see the year with top line growth, sorry, with top line pressure. We already said and announced that our performance would come more from the lower part of the P&L than the upper part of the P&L.

As I mentioned, the evolution on the NII reduction in the second Q was specifically impacted by the change of accounting system in optimization plan of the capital and on the activity in the markets, that was offset, specifically the capital optimization plan, by higher ROE. And finally, we continue to deliver on what we said, which is productivity and efficiency plans that are leading to expected results.

Probably the most important point is to continue with the focus to transform the bank into a client-led bank, by continuing the efforts that we are doing on the commercial side, to increase loyalty, to increase transactionality, that will not be reflected in the short term but we expect it to be reflected more on the medium term.

Management priorities have to continue to deliver on the lower part of the P&L, while we continue to build that upper part of it. These, as I mentioned, should be the case for the following quarter. With this, I finalize the presentation and I guess that I open or we open the floor for questions.

Q&A

Operator

Thank you. Our first question is from Natalia Corfield of JPMorgan. Please go ahead.

Q - Natalia D. Corfield {BIO 6421991 <GO>}

Hi. Thank you for the call. My first question is with regards to asset quality. You mentioned that early delinquencies have improved, whereas 90 days has deteriorated. How do you see that going forward given that the economy in Brazil is showing weak metrics? That's my first question.

The second question is with regards to the macro prudential measures. I'd like to know, if you think this is going to impact your results, if you're thinking of lending more because of what you're going to have in the liquidity front, the impact in your Basel ratio (34:28) if you could give more color on that, it would be great as well. Thank you.

A - Angel Santodomingo Martell

Okay. Thank you, Natalia. Well, I would say on the quality side, as we mentioned, we have different behaviors there. Probably you have a little bit of everything. You have a little bit of environment affecting the situation. You have also – you probably remember by the end of last year, we had some (35:01) that are probably now doing its affect on the NPL ratio, but probably that is more a political (35:10) issue. And thirdly, as you mentioned that the early indicators are improving specifically in SMEs. I would say going forward that we should probably evolve with how the macroeconomic situation evolves.

I always prefer to speak about cost of credit. I feel myself much more comfortable there because it probably registers a little bit better what is undergoing on the quality discussion. And well, probably the cost of credit either remains, goes slightly up, but I wouldn't expect huge or strong changes Q-on-Q. I would expect to remain at similar levels or even with some increases but I'm underlining the sum. I don't want to send any message on a different direction.

With regards to the macro prudential measures, if they're going to impact us, well, yes, the answer is yes. So they're going to impact us in two ways. One is in taking commercial decisions. As you know, the new measures put a focus on both increased lending and acquisition of portfolios, in certain type of portfolios. And obviously, we are working since last Friday to see and to minimize the impact as quickly as we can of that measure and to increase on the car lending and the payroll lending, et cetera, so that we are able to close it (36:59). But I will not discard short-term impact; short term means some impact in the first or two months until we are able to generate that activity. We are speaking in our case of around R$6.5 billion for you to have that quantity in mind and this is what we want to cover or to be able to generate in the next few months, so that we are able to offset any potential impact.

Q - Natalia D. Corfield {BIO 6421991 <GO>}

Okay. And your Basel ratio? (37:39)

A - Angel Santodomingo Martell

Sorry, could you repeat that?

Q - Natalia D. Corfield {BIO 6421991 <GO>}

Your Basel (37:44) ratio?

A - Angel Santodomingo Martell

Ratio, yeah we have around 25 basis points.

Q - Natalia D. Corfield {BIO 6421991 <GO>}

All right. Thank you.

Operator

Our next question is from Timothy Puls of Morningstar. Please go ahead.

Q - Tim Puls {BIO 18413050 <GO>}

Hi. Thanks for taking my question. I was just wondering if you could expand a little bit about what some of the individual sectors in your loan portfolio; it looks like you had some good growth in industrial and looks like the services and other category fell a bit. So maybe if you could just expand upon what's going on in those sectors within Brazil.

A - Angel Santodomingo Martell

Well, yes, you have a strong growth in the market in mortgages and we are growing strongly in that segment. You have in the rest of the segments, I already explained payrolls and the rest of segments you have different behaviors but we are outperforming in cards. I also mentioned the market is growing - depending on the moment, close to 10% and we are flattish there, 0.8%.

And in payrolls, I mentioned, I mean the market is strongly going up and we are strongly going down but that was a proactive decision that we took, as I mentioned, one year ago, a little bit more than one year ago. And now, we are clearly maintaining the strategy of being in that segment, but clearly with the operation of Bonsucesso that you know the growth coming from that segment.

I would say those are the main lines of - or the ones that may be underlined in the behavior of the - some of the personal lending.

Q - Tim Puls {BIO 18413050 <GO>}

Thank you very much.

Operator

Our next question is from Felipe Salomão of Morgan Stanley. Please go ahead.

Q - Felipe Gaspar Salomão

Hi, gentlemen. Thank you for the opportunity. Actually it's a follow-up question on a previous question. When you say that the potential impact of the macro prudential measure was up $R6.5 billion, you are talking about the amount of some deposit (40:50) that will no longer be remunerated by Selic and that you have to lend either through auto loans or through payroll loans, right?

A - Angel Santodomingo Martell

Yeah, Felipe, sorry, probably I didn't say the full sentence. Yes, we are speaking of balance sheet, obviously, not at all in P&L terms or things like that. And yes, I am speaking of the amount of liquidity that goes into the non-remuneration part of the Selic or the compulsory and that we are working hard to, as soon as possible, find ways by acquiring portfolios, by lending - operational quality, obviously, levels - by lending in the context that were disclosed by the Central Bank and, as I said, to minimize the impact. But in any case, we will have some impact because even moving quick - as quick as we can as this starts in less than one week or in 10 days, we are not going to fulfill everything in the first week or weeks, and this is the impact I was referring to but...

Q - Felipe Gaspar Salomão

Okay. Very clear. Just another follow-up question on this. And the impact of 25 basis points on the BIS ratio is a positive impact, right? Just to make it clear.

A - Angel Santodomingo Martell

It is positive, yes.

Q - Felipe Gaspar Salomão

Okay. That's great. Thank you very much.

Operator

Our next question is from Francisco Kops of J. Safra Bank. Please go ahead.

Q - Francisco Kops {BIO 17215088 <GO>}

Hello, everyone. I would just like to discuss a little bit about credit spreads. We are seeing from Central Bank data that spreads are going up in some ways sharply. And I know there is a mix effect here but I'd like to explore a little bit more the credit spread and what we can expect going forward, based on these trends you are seeing on the overall market. Thank you.

A - Angel Santodomingo Martell

Well, I will say that spreads in general terms are stabilizing in some case. Our experience at least is that production spreads are improving. In fact, out of the variations that we see in NII, the spread impact is - the mix impact is important but the spread, theoretically, on the front side is improving.

So well, we have probably to wait (44:04) because you have two gains here. In the segment that you are growing and how you are evolving in production, no? But I will say that we are not kind of worried in terms of spread evolution. We see it or we are already seeing a positive evolution on the front book.

Q - Francisco Kops {BIO 17215088 <GO>}

So when you – when we look to this little decrease of 10 basis on your credit spread, I mean we think the products we could expect evolution but I mean that basically was just a mix effect here, right?

A - Angel Santodomingo Martell

Typically, yes. What we see is that the trend is kind of flattish, I would say, I will not go into one direction or the other but basically the answer is yes.

Q - Francisco Kops {BIO 17215088 <GO>}

Thank you.

Operator

So no further questions. Thank you. The Q&A session is over, and I wish to hand the call back over to Mr. Angel Santodomingo for his concluding remarks.

A - Angel Santodomingo Martell

Okay. Well, thank you very much for being there and for attending this call. Anything you need from now on, we are all at your disposal, specifically the Investor Relations team, and hope to see you in the next quarter. Thank you.

Operator

Banco Santander's conference call has come to an end. We thank you for your participation. Have a nice day. Thank you.