

Q3 2016 Earnings Call

Company Participants

- Daniel Sonder, Chief Financial & Investor Relations Officer
- Rogério de Araújo Santana, Managing Director-Investor Relations

Other Participants

- Henrique Navarro, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen, and welcome to the audio conference call about the earnings results of BM&FBOVESPA for the third quarter of 2016. At this time, all participants are in a listen only mode. Later, we will conduct a question-and-answer session, and instructions to participate will be given at that time. As a reminder, this conference is being recorded and broadcasted live via webcast. The replay would be available after the event is concluded.

I would now like to turn the conference over to Mr. Daniel Sonder, Chief Financial Officer of BM&FBOVESPA.

Daniel Sonder {BIO 18250247 <GO>}

Hello. Good afternoon. It's 1:00 pm in Brazil. Good morning for those of you in the U.S. I want to welcome everyone to our quarterly earnings conference call to discuss the third quarter 2016 results. I'm here with the Finance and the Investor Relations team who have once again worked very hard over the last few weeks to put together very good materials, and I want to take this opportunity to thank them.

And I'm also very happy to share with you that, two weeks ago, a new colleague joined the Executive Board of the company, the senior management team. This is Zucca Andraje. (01:34) Unfortunately, he had another commitment at the time of this call. He was available early-on in the Portuguese call, but he will obviously be someone that is very key in our future, and he will be available to you as things go forward obviously through the IR team and so forth. Zucca (01:59) comes from a 25-year very senior experience in the financial markets, having worked most of his career for Citibank and Bank of America in fixed income and currencies, and in equity derivatives. He is very experienced, has a broad network of relationships in the Brazilian market, which will help us very much. So, we are very confident that his skills will be extremely valuable for what we want to do in our clients and products areas and also very confident that it will be a nice cultural fit and that will be an integral part of the senior decision making group in this company.

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So, without further, let me move into the presentation for the third quarter. I want to take you through page 3 in the presentation where we have an overview of what happened in our operating and financial results during the third quarter of the year, as well as some updates on our strategic initiatives. Then we will go into more details in the following slides. On the left side of the stage, we see the operating highlights in both BMF (sic) [BM&F] (03:15) and Bovespa segments. In the BMF (sic) [BM&F] (03:17) segments, the ADV, average daily volume of contracts, shrank 11.7% reaching 2.9 million contracts in 3Q 2016.

The decline was seen in most groups of contracts especially interest rates in BRL. Additionally, the revenue per contract fell 12.9%, negatively impacted by changes in the mix of contracts traded, as well as the Brazilian real appreciation against the U.S. dollar. On the other hand, we saw a recovering volumes in the Bovespa market, mainly driven by the increase in the average market capitalization.

Additionally, the other business lines showed a solid performance, especially the Tesouro Direto, which positively impacted depository revenue lines. In the middle of the page, we see that our top-line fell 6.3%, mainly impacted by the weak performance in the BM&F segment.

We maintained the diligent expense control during the quarter, adjusted expenses decreasing 5.5% (sic) [5.0%] (04:22) compared to the same period of last year. During the third quarter 2016, we had some extraordinary items related to provisions on legal contingencies. One, regarding success fees provision and the other related to the change in the chance of losing a dispute with a former brokerage house as announced in the material fact of November 1. Both provisions have no cash impact at this point.

Additionally, we also had extraordinary expenses related to the proposed business combination with Cetip. These extraordinary items impacted our IFRS expenses and also the net income. Excluding these items, our operating income would have reach BRL 351 million and the net income BRL 453 million.

Our board approved the payment of BRL 147 million in interest on capital this quarter, which represents 50% of the third quarter IFRS net income. As you know, the company is retaining cash in order to pay for the cash portion of the Cetip transaction. So, the plan for this year is for us to distribute a little over perhaps 50%. We are going to adjust that amount in the fourth quarter in order to use all the interest on capital that the regulation affords us.

For next year, the way we are thinking about pay outs is that we will aim, assuming that our projections are correct in terms of the performance of the business, we would aim at distributing about 80% of our net income, and that is the number that would allow us to not only maintain a robust cash position in 2017, but also amortize and make all the payments related to the proposed combination with Cetip. The form that we would that in 2017 is similar to what we have done here, which is to pay roughly 50% of accounting net income each quarter, and then adjust at the end of the year to reach our target, and also to use interest on capital up to the amount permitted.

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On the right side of the slide, on page three, we present updates on some long-term strategic initiatives that aim at offering growth opportunities and value creation. On the proposed business combination with Cetip, currently we are waiting for regulatory approvals and working on the planning of the transaction. We hired third-party consultants to help us on that, and to assure that the strategic and confidential information of both companies are preserved, respecting the ground rules set by antitrust authorities.

The second phase of the new integrated BM&FBOVESPA Clearinghouse is moving forward. In August, we moved to the parallel production phase. The deployment is planned for first quarter 2017. This is a key project for BM&FBOVESPA and for the market as a whole.

Now, Rogério will give some more details about our operational performance, before he starts though, I'd just like to give a brief disclaimer. As you might have read on Friday night, we released a relevant notice to the market mentioning the fact that our board has approved a \$3 billion local debenture issuances - issuance, whose use of proceeds will be for the cash portion of the business combination with Cetip. Under securities regulation in Brazil, CVM rule 400, we are now not permitted to discuss any of the details of the transaction beyond what has been publically released. So I'm not going to reference that in my comments going forward, so that we make sure we stay within regulations and can move forward with this distribution of securities in a manner that is consistent with our timetable. Thank you.

Rogério de Araújo Santana

Thank you, Daniel. Hello, everyone. I would like to ask you to move to slide four, where we see the breakdown of revenues of the company. It's different from what you see in the previous quarters. The chart on the left side shows that the financial and commodity derivatives market, we've seen the BM&F segment hurt 3Q 2016 revenues with the combination of lower ADV, and also lower RPC, as Daniel already mentioned.

On the other hand, the greatest contributions to revenues on the third quarter 2016 came from the Bovespa segment, which is from recovering volumes, which was mainly in concentrating the end of the quarter, especially in the month of September, which was - and also we saw no volumes related to revenues growing as well as indicated in the previous quarters and contributing to offset part of the weak performance we saw in derivatives market.

Finally turning to percent of the companies top line, where our U.S. linkage in the third quarter 2016, slightly lower than the 25%, we saw in the previous quarters, mainly as a consequence of depreciation of the Brazilian real against the U.S. dollar in this period.

Moving to slide five, you will find the details of the performance of the financial and commodities derivatives market. Here the declining revenues on the BM&F segment was driven by a 11.7% decrease in total ADV, coupled with the decrease of 12.9% in the revenue per contract in comparison with the third quarter of 2015.

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As you can see in the charts on the right, the ADV was lower in most group of contracts, especially in the case of interest rate in real contracts, which went up 32.7% in this period. On the other hand, Mini contracts ADV increased more than 66% in comparison with third quarter 2015. The Mini contract have an RPC that is significantly lower than the average of the other group of contracts. So a high participation of Mini in the total ADV has a negative impact on the average RPC as showed in the bottom right side of the slide.

Note that last year in third quarter 2015, the Mini contracts represented 18% of total ADV and contributed for 2.9% of revenues in the BM&F segment. While in the third quarter 2016, we see the representativeness of Mini contracts increasing to 34% of total ADV, but the representativeness of revenues created by this group of contracts was only 6.6% of the segment. This is the main reason for the 12.9% reduction in the RPC year-over-year. Additionally, the Brazilian real appreciation against U.S. dollar also had a negative impact. Since third quarter 2016, 51.9% of the revenues in the BM&F segment were U.S. dollar linked.

In the slide six, we have the performance of the equities market, where we saw 5.9% growth in the ADTV. This growth was mainly driven by the increase in the average market capitalization that reached BRL 2.4 trillion in the quarter, almost 10% increase versus third quarter 2015. On the other hand, the turnover velocity was slightly lower reaching 69.4% versus 70.8% in the year before, partially offsetting the market capitalization increase in this period.

It's worth to mention that the ADTV recovery was mainly concentrating at the end of the quarter, reflecting change in the macro and political environment as I already mentioned. Trading and post-trading margins reached 5.2 basis points in the third quarter 2016, roughly flat in comparison with the same year - a year ago.

Moving to slide nine, we highlight other sources of revenues that are not related to volumes. You may know that one of the drivers of the company's strategy is to increase the revenue coming from this group of products and services. This group of business line as you can see in the grey piece of the pie chart represented 22.4% of total revenues in the third quarter 2016. And in aggregate, grew 3.5% year-over-year. This growth results from solid operating performance of some products and services notably secured planning and Tesouro Direto. The last one is under in the depository line.

The negative highlights here was the market data revenue line that fell 19.2% year-over-year impacted by reduction in the number of clients and the immigration of clients to cheaper market data packets and also the appreciation of the Brazilian real against the U.S. dollar since most of these revenues are priced in U.S. dollar.

Now I will pass the word back to Daniel who will detail our expenses and other financial highlights.

Daniel Sonder {BIO 18250247 <GO>}

Hi, Rogério, thank you very much. We move now to slide eight where I wanted to go over the expense breakdown for the quarter. Our adjusted expenses decreased 5.5% (sic) [5.0%] (14:46) year-over-year, mainly driven by lower adjusted personnel expenses and other non-recurring expenses that affected last year's results.

Our adjusted personnel expenses, which excludes long-term incentive plans were 3.3% lower, explained by higher capitalization of hours related to the development of the equity space of the BM&FBOVESPA Clearinghouse, which offset the salary increases given collective bargaining agreements from last year to this year.

The growth in data processing, our second largest expense item is explained by inflation, adjustments to some IT maintenance contracts, and the impact of the appreciation of the U.S. dollar against the Brazilian real between the end of 2014 beginning of 2015, and the end of 2015 beginning of 2016, given that the cash flow hedge was set-up for portion of these contracts denominated in foreign currency in those months.

Marketing and other expenses decrease 64% and 21%, respectively, driven by two non-recurring expenses in 2015 at the third quarter. One related to organization of the financial markets conference and the other related to a write-off of BRL 6.4 million.

We move to slide nine, where we try to zoom in the extraordinary items. We summarized in the table the non-recurring items that impacted our results this quarter, aiming to help analyst and investors and their analysis. For that reason, we show the amount before and asset taxes. First, we had extraordinary provision of BRL 183.9 million related to the change in the prospect of receipts of a legal contingency related to the Spread Corretora case, which is now assessed as a probable loss. This decision follows the opinion of our legal advisors after a decision of the lower court was upheld on appeal.

This lawsuit concerned the cancellation of exchange membership. The second extraordinary item refers to the provision of one success fees to legal advisors in the amount of BRL 47.4 million. From three quarter 2016 onwards, we start to make provisions for lawsuits, where we think that the prospect of defeat are assessed as possible or remote. Therefore, we do not provision the amount of the lawsuit itself, but rather provision the success fees only. And last, we booked in this quarter, some expenses related to the proposed business combinations with Cetip which amounted to BRL 7.2 million in three quarter 2016. This expense is composed by transaction cost and expenses with the planning of the business integration.

We move to slide 10 to talk about the financial highlights. Financial results reached BRL 221.5 million, an increase of 157.5% compared to third quarter 2015. On the blue bars of the chart, we show the financial revenue totaling BRL 325 million, which includes the interest of the proceeds coming from the divestment from CME Group shares. Considering we intent to retain those proceeds until the settlement of the proposed combination with Cetip, it will positively impact financial results until that transaction is concluded.

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On the other hand, the financial expenses, red bars, were impacted by the cost of the hedge of the principal amount of the 2020 bonds, which totaled BRL 62 million in the quarter. The cost of this hedge is 79% of CDI on approximately BRL 2.2 billion. Additionally, in September 2016, the company setup a hedge on the coupons of the 2020 bonds, and the cost of this hedge amounted to BRL 0.8 million in the third quarter 2016.

The coupon on the 2020 bonds also affect the financial expenses as was the case before. We issued - since we issued the notes in 2010. In the third quarter, this expense reached BRL 33 million.

Moving now to slide 11. We always like to highlight our financial robustness, which is with a solid cash position, which is an important attribute of the business of being a credible counterparty in the financial market. Total cash amounted to BRL 10.7 billion at the end of the quarter, composed by BM&FBOVESPA own cash, as well as third-party cash, mainly related to collateral pledged by clients.

On the left side, where the blue bars are, we see that third-party cash amounted to BRL 2.2 billion, mainly composed by market participants' cash collateral of BRL 1.7 billion. It is important to highlight that although company does not own this money, because we have a liability of the same amount, it does earn interest on most of this cash balance.

On the right side represented by the green bar, you find BM&FBOVESPA'S own cash, composed of restricted and unrestricted cash amounting BRL 8.5 billion in third quarter 2016. BM&FBOVESPA's own cash includes the necessary cash to run the day by day activities of the company that totals between BRL 2 billion and BRL 2.5 billion. This amount includes approximately BRL 1.1 billion in Clearinghouse's required safeguards. The remaining balance supports our activity as a central counter-party and general corporate needs.

Excluding this cash position that is necessary to run the business, we have approximately BRL 6 billion in available cash including the BRL 5.5 billion in gross proceeds from the divestment from CME Group shares.

As mentioned before, we are retaining the significant additional cash to fund the proposed transaction with Cetip.

Slide 12, we show the company's cash flow generation before any interest on capital for other distributions. The cash generated in three quarter reached almost BRL 567 million, an increase of 37% year-over-year. The net cash from operating activity was positively impacted by the higher financial revenue coming from a higher cash position.

On the right side of the slide, we show the cash destination for the third quarter 2016, which is made up of BRL 41 million for CapEx, BRL 215 million for IoC distribution related to the second quarter and cash retention of BRL 310 million. The company maintained large capacities to generate cash, one of the main strengths of our business model.

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Finally, we move to page 13. And we show the timeline for the business combination with Cetip. Currently, as mentioned, we are waiting for the regulatory approvals for this transaction.

The regular deadline to have CADE's approval, which corresponds to 240 days, is February 23. As you already know, during the third quarter, CADE declared its Transaction Act of the combination - I'm sorry, the Concentration Act as complex. This was a procedural act and it was expected in a merger of this size. It simply allows CADE to continue in its diligence in a way that we already anticipated and had discussed with our legal advisors and the market.

Although this gives CADE the possibility to extend the deadline from February all the way up to May, this has not been the case in most cases that we follow. So, we expect that CADE will maintain the regular 240 day table for the transaction.

As to the approval of the transaction, Cetip shares will be converted into BM&FBOVESPA shares within five days, that's also the time when we need to have the cash at hand to make the capital increase in the intermediary company that will be used for the transaction, and thereafter in 35 project days at the maximum we will make payments to Cetip's former shareholders.

So, this is - these are my opening remarks, and I'd like to end this part of the presentation now and open for Q&A.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session for investors and analysts. Our first question was sent through the internet through our live webcast from Mr. Ian Seaman with Challard Magney. (24:58) Reported net income has been reduced this year, by some non-cash or not.? Will dividends be paid as a percentage of this lower number or we would adjust for these events?

A - Daniel Sonder {BIO 18250247 <GO>}

Hi Ian, thank you very much, for your question. We are not adjusting for the non-recurring item. We are, however, adjusting for the loss in the investment of CME and some other related - in fact. So, we're paying 50% out of accounting net income this year excluding the loss which we saw in second quarter, which was related to CME. So, that's where the 50% comes from. If you want, I'll be happy to get the IR team to get in touch with you and explain that further. Thank you.

Operator

Our next question comes from Henrique Navarro with Santander.

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Q - Henrique Navarro {BIO 16188960 <GO>}

Hi, everyone. Thank you for taking my question. My question is regarding the amount of cash that you always describe as needed to run the business. This has been described as being between BRL 2 billion and BRL 2.5 billion. I'm doing my math here in order to see how much you would need for the Cetip merge, and you just did a BRL 3 billion debentures in order to fund for that. And what I want to say is that in my accounts there is some a very good amount of cash available. So, maybe this BRL 2 billion, BRL 2.5 billion is a bit exaggerated. So, I would like to know from you what's the, I would say the minimum required amount of cash needed to run the business and with - if we consider this BRL 3 billion debenture, how much in excess over the required amounts to pay for Cetip, you end up after this debenture is fully placed? Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Navarro. This is a good question. So, the way we have been managing BM&FBOVESPA alone is to always have a cash balance between BRL 2 billion and BRL 2.5 billion. If you look historically, before we saw the first tranche of CME back in the third quarter of 2015, that's roughly where we had been for a few quarters. So, that number is that.

When we join forces with Cetip, we're going to be a slightly bigger company with more operating expenses and so forth. So, we feel that probably a number between BRL 2.5 million and BRL 3 million would be the most likely number for us to have instead of that.

In addition, we need to - we're sort of preparing to access the market. And in that exercise, we took into consideration, a few aspects which will be coming away in the next few months, right. First is a combination itself. So, it is still unclear what exactly the date will be because that depends on regulatory approvals. But also once we have the approvals, there are certain restrictions as to when and how we can access the cash that is in Cetip before we fully integrate the two companies. So, we are taking certain precautions for that, so that we know we have cash at hand in our company to make all the payments necessary.

The other issue that is important to note in which might have been overlooked is the following: we hedged, over a period of one year, the bond that we issued. And that is in our financial statements. We basically locked in the BRL amount of that exposure, but because the BRL amount of the debt is going down, because of reais appreciations versus the dollar, we owe some money in the derivative length of that transaction. So, as a total, the amount that we basically owe between derivatives and debt hasn't changed. But there is a different composition between what we owe in the debt and what we owe in the derivatives, and most importantly perhaps, there is a cash flow timing difference between that, because we hedged for one year. So, come April of 2017, we will have to settle the derivative part of this, although we owe less reais and the debt we will have to pay the derivatives counterparties for this transaction. I am just reading out the number for September 30, 2016, which we released on Friday, is BRL 334 million as of September 30.

So that obviously puts an additional strain on our cash, which we are prudently provisioning for and funding ourselves for.

Q - Henrique Navarro {BIO 16188960 <GO>}

Okay, understood. And just one more question on the third Q, we had this one-off items, we more or less knew beforehand because you either have talked about that with investors or what is the material fact and et cetera. So, my question is for the 4Q, is there going to be any one-offs or can we expect a clean results?

A - Daniel Sonder {BIO 18250247 <GO>}

I would like to correct you, but we don't discuss one-off items with any particular investors in bilateral meetings. We just released a public notice, Fatos Relevantes, regarding the provision of BRL 184 million regarding the lawsuit. We didn't do it in the past, we're not going to do this in the future to discuss one-off items.

Q - Henrique Navarro {BIO 16188960 <GO>}

Okay. Thank you.

Operator

This concludes today's question-and-answer session. I'd like to invite Mr. Daniel Sonder to proceed with his closing statements.

A - Daniel Sonder {BIO 18250247 <GO>}

Everyone thanks again for dialing in. We appreciate your time. We appreciate you following our company and doing the work. We hope that the materials we provide are helpful to you and please get in touch with our IR team anytime you need. Thanks everybody.

Operator

That does conclude the BM&FBOVESPA audio conference for today. Thank you very much for your participation. Have a good afternoon, and thank you for using Chorus Call.

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