Q3 2018 Earnings Call

Company Participants

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

Other Participants

- Alexandre Spada, Analyst
- Carlos G. Macedo, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Audio Conference Call about the Earnings Results of B3 for the Third Quarter of 2018. At this time, all participants are in a listen-only mode. Later, we'll 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 will be available after the event is concluded.

I would now like to turn the conference over to Mr. Daniel Sonder, Chief Financial Officer of B3.

Daniel Sonder {BIO 18250247 <GO>}

Hello everyone and good afternoon. I would like to welcome all of you to B3's third quarter earnings call. I'm here with Rogério Santana, Head of the Investor Relations team, as well as the Finance and Investor Relations colleagues. And I'd like to thank them for preparing the documents you have in front of you. Additionally, on behalf of the entire executive team I would like to thank you for your continued trust and support.

I'll start the presentation on slide 3 where we show the operational and financial highlights for the quarter. The third quarter was marked by volatility in the financial markets in Brazil, reflecting the uncertainty regarding the electoral cycle. In this context, we had a solid performance across our business. Average daily volume grew around 19% in the Bovespa segment and value outstanding of Cetip Securities increased by 16%. In the BM&F segment, the retraction of 4% in average volume is a consequence of the decrease in volume of Brazilian reais interest rate contracts, following the outlook of a more stable interest rate in the short-term.

On the right of the slide we see that this operational performance is reflected on our revenues which grew by 9% year-over-year. Our adjusted expenses reached BRL 250 million, 9.5% higher than in the third quarter of 2017, impacted by an increase in the personnel line which we'll explain later in the presentation. EBITDA adjusted for non-recurring items was BRL 779 million, an increase of almost 17% versus the previous year, with a margin of more than 67%, once again demonstrating B3's considerable operating leverage. Recurring net income reached BRL 613 million, a 38% increase, mainly explained by the increase in operating results and by lower income taxes in the quarter.

Regarding strategic developments, our focus remains on consolidating a corporate culture that continues to focus on proximity to our clients and their satisfaction. Operational excellence of our services and ability to innovate are also priorities. And in those lines, we announced yesterday the signing of a binding offer for the acquisition of the controlling ownership of BLK Sistemas, a company that offers a trading screen platform focusing on the development of software and algorithms. This transaction aims to complement the portfolio of services offered by B3 to brokers and institutional investors. Additionally, in August we released a roadmap that contemplates more than 40 products and services to be delivered until the end of 2019, aiming to address the most important demands of our clients.

Now, Rogério will give more details about our operational performance.

Rogério de Araújo Santana

Thank you, Daniel, and hello everyone. I would like to ask you to move forward to slide 4 where you see the revenue performance and breakdown for the third quarter 2018. In the bar chart on the left side, we see that revenues from all the main four segments grew year-over-year, leading to a 9% growth in total revenue. It is important to highlight that the decrease in the line other revenues is explained by an extraordinary revenue related to reversal of contingents recognized in the third quarter 2017. In the case of the increase in the Cetip Liens and Loans segment, it is mainly a consequence of change in the business model of some services we provide in this segment. In the pie chart on the right side you see the breakdown of revenues for the quarter which show the highly-diversified revenue base of our company.

Moving on to slide 5, you will find the performance of financial and commodity derivatives market where we had a 15% revenue increase year-over-year. As you can see, we experienced a significant growth in the RPC in the period explained by the appreciation of more than 26% of the U.S. dollar against the Brazilian real with a positive impact on the RPC of future contracts for FX rate and interest rate in U.S. dollar. The decrease in average daily volume reflected in the lower volume of interest rates in real contracts due to less uncertainty regarding the short-term (00:05:49) infiltrate rate in Brazil. On the other hand, election-related volatility had a positive impact on the bond of (00:05:59) group of contracts excluding commodities.

In slide 6 we have the performance of the equities market in the Bovespa segment where we saw revenue growing almost 14% year-over-year driven by a 19% increase of the ADTV from BRL 8.2 billion last year to BRL 9.9 billion in third quarter 2018. This performance reflects the increasing volatility in the Brazilian market during the quarter translated in the increase of turnover velocity from 69.5% in last year to 73.5% in third quarter 2018. In addition, the average market capitalization increased by 12% over the same period of 2017. Both performances are shown in the bottom right chart in this slide. Trading margin fell 3% year-over-year mainly due to discounts triggered by higher value traded and mix effect.

Next, slide number 7 represents the performance of the Cetip Securities segment. The additional value of securities and contracts registered in the quarter was up 36% mainly driven by the increasing registration of OTC derivatives and throughput transactions. This increase, in addition to the increase of 13% in the issuance of fixed income instruments cover the outstanding positions registered (00:07:44) in our platform which reached BRL 7.4 trillion in the third quarter 2018, 16% higher than the previous year. This operational performance led to an increase of 13% in revenues compared to the same period of 2017 and amounted to BRL 312 million in the quarter. Finally, it's worth to note that the third quarter 2018 revenue in this segment reflects the impact of sharing of expense synergies captured in the business combination with Cetip. The sharing of these synergies was translated in price discounts amounting to BRL 7.6 million and applies on different revenue lines within this segment.

In slide 8 we show revenue for the Cetip Liens and Loans segment which grew 29% over the third quarter 2017. When analyzing the different revenue lines in this segment, the increase of 18% in Liens revenues (00:08:57) reflects the 5.5% rise in the number of new vehicles financed in the period and certain adjustments to our pricing schedule (00:09:08). Regarding the Contracts System, the increase of 40% in revenues is explained by the implementation of the new business model for this service in the states of São Paulo, Santa Catarina, and Pernambuco starting from the first quarter of 2018.

Just to remember, the Contracts System service has been impacted by changing the business model triggered by a federal regulation released in September last year. Following this regulation, each state is adapting its own model differently (00:09:45) We can say there are three different models adopted by each state. In one of these models for example, B3 is no longer offering its services and this is the most negative one for us. A second model adopted in the states of São Paulo, Santa Catarina, and Pernambuco introduced a new player in the chain (00:10:08), and as a consequence B3 is earning roughly 30% liens (00:10:13) in the model in place before the regulatory change. Finally, we have the case of (00:10:20) state that adapted its model to the new regulation without any significant impact to B3. The models that will be adopted by states that haven't changed on regulation is still unclear and we need to monitor how it will evolve going forward. We can go in more details on that in the Q&A session.

It's also important to highlight that the company's market share in the Contracts System contracted to 65% in the third quarter 2018 versus 72% in the third quarter 2017. This reduction is explained by the fact that we did not offer the Contracts System services in the state of Minas Gerais in the third quarter 2018. Now, I will hand over the presentation back to Daniel who will detail our expenses and other financial highlgihts.

Daniel Sonder {BIO 18250247 <GO>}

Thank you, Rogério. In slide 9 we show the behavior of the company's adjusted expenses. Our adjusted expenses reached BRL 250 million, a 4.2% increase year-over-year, reflecting mainly the increase in personnel expenses from provisions for annual salaries adjustments. Also, employees' profit sharing and reduction of expenses capitalized as our projects impacted the personnel line. As we disclosed in December 2017, all the decisions and measures that were necessary to entirely capture the expense synergies of the merger were made and executed by the end of last year. As a consequence, since the first quarter of 2018 we can see the full impact from the synergy gains from the combination with Cetip.

In the next slide, slide 10, we demonstrate our financial robustness with a solid cash position which is an important part of the business of being a credible counterparty in the financial market. Total cash amounted to BRL 8.9 billion at the end of the quarter composed by B3's own cash and third party cash mainly related to collateral pledged in cash by clients. In the light blue bars you will find B3's own cash composed of restricted and unrestricted cash amounting to BRL 6.2 billion in the third quarter of 2018. This amount includes necessary cash to run the day to day activities of the company that totaled between BRL 2.5 billion and BRL 3 billion, and BRL 360 million in interest on capital that we're already paid in early October 2018. It is worth mentioning that this level of cash position reflects also the amortization of BRL 1.5 billion in debentures scheduled for December 2018. The bar from the left side of the chart show third party cash which amounted to BRL 2.8 billion mainly composed by market participants cash collateral of BRL 2.1 million. It's important to highlight that the company earns interest income on most of this cash balance.

Moving to slide 11, you can see the company's debt profile and amortization schedule. Currently, our financial leverage is temporarily higher with a gross debt to adjusted EBITDA ratio of 1.8 times in the third quarter of 2018. Our target is to reduce this ratio to 1 time by the end of 2019 following the debt amortization schedule you see in the bar graph on the upper left side. As mentioned before, we have a BRL 1.5 billion debt amortization scheduled for December 2018. Considering the company's existing cash position and the cash generation we forecast for the remainder of the year, we believe we'll be able to amortize this debt while at the same time keeping a payout ratio between 70% and 80% of IFRS net income. In the first nine months of 2018 our payout ratio was 67% of our IFRS net income which means we are likely to increase distributions to shareholders to meet our payout guidance subject to board approvals.

I would like now to conclude the presentation and open up the Q&A session. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session from investors and analysts. Our first question comes from Carlos Macedo, Goldman Sachs. Mr. Carlos Macedo, your line is open.

Q - Carlos G. Macedo {BIO 15158925 <GO>}

Yeah, I was on mute. Hi, Daniel and Rogério. Sorry about that. So a couple of questions. First, on your product pipeline you so kindly laid out in your website 40 products out there. I think in the past you've obviously come out with new products. The problem is that many times the materiality of the impact on your financials, on your net income and revenues, wasn't that significant. Could you highlight for us which products you think have the biggest chance of actually having a big impact on what you do? And, again, there are 40 products out there, so maybe just in general you can name a category of product instead of a specific product as a response. Second question, you talked about amortizing, taking the net debt EBITDA level down to 1 times by the end 2019. Does that mean you expect to rollover the debt that is due in 2020 or is the decision still has to be made in terms of paying it down? Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Okay. Thank you, Marcello. This is Daniel. I'll start with the product pipeline and Rogério will jump in to also complement on that answer. I think that the product pipeline should be seen obviously as a way to generate additional revenues for the company but also as a way to tighten the relationship and align the views about market development between our clients and ourselves. We have, as you know from following us for quite some time, invested a lot of effort over the last few years to build a very robust infrastructure in terms of trading platform, the post trading platform, the system, the big centers, and just the overall capacity of our company to deal with larger volumes and an increase in complexity and speed of transactions.

Now, the next phase that we foresee for our development is to put more ideas on the shelf and to allow the market to have greater sophistication in terms of the choices of products or strategies that they can use to transact in our market. And that is very much, let's say, the context in which we have worked for several months with our clients to align those product priorities. I'm giving this bigger answer or broader answer to your question because it is actually quite hard to say that one of these products or two of them are going to be the most successful ones and are going to be responsible for the majority of the revenue that come out of that pipeline. It is a combination of ideas that I think together will bring benefits to us and to our clients. And it's quite difficult for us to really know which one of these products will a have greater volume in the future. So maybe Rogério wants to (00:19:05)

Q - Carlos G. Macedo {BIO 15158925 <GO>}

Maybe another way to think about it is which one – I mean, there probably are some that your clients have asked for more frequently, saying if we only had this it would really help us. Are there any there that you could point to in that sense?

A - Daniel Sonder {BIO 18250247 <GO>}

Yeah. I would say that the, I mean, all of the features are things that people have been asking for, also the securities. The improvements in (00:19:35) have been something that we've been talking about for quite a while. So maybe those two clusters of (00:19:42)

A - Rogério de Araújo Santana

Yes. If you allow me to add something and address the second point brought by Carlos regarding products. So each of these products, some of them address the needs, the agreement from different group of clients and some other address the needs of a specific group of clients. So for example, in the (00:20:11) it is something that we have hold from brokers specializing in the trading platforms that it will be a very interesting product for the clients. And (00:20:22) probably it's going to have a positive side effect by allowing other institutional investors to implement the different kinds of strategies (00:20:37). The sophistication in the platform that Daniel mentioned address actually the needs in the agreement for local institutional investors that are generally more transparent in the rate (00:20:57) profit in this business.

So as Daniel mentioned, when you look at it, at this pipeline we have the idea and strategy to launch as much products as we can with low CapEx related to that, with low additional OpEx. I think we are leveraging on the existing infrastructure that we have. And each of this product will have a different, let's say, maturity period. Some of them will move forward very fast; some of them will awhile to move in this direction, and this is something that we need to monitor and we hope to be fast and keep developing this kind of things.

Q - Carlos G. Macedo {BIO 15158925 <GO>}

Okay. Thank you. (00:21:57).

A - Rogério de Araújo Santana

Yeah. Touching on your second question, Macedo, regarding...

A - Daniel Sonder {BIO 18250247 <GO>}

I'm back here. I'm sorry. So maybe I'll pick up on the second question regarding the debt schedule, right? Okay. So the company, as you all know, took on some additional debt for the acquisition of Cetip. We have been amortizing this debt we have at the end of this year and the beginning of next year. And by the end of next year we should be below or at around 1 time total debt to EBITDA, and that is the target that was established at the time of the merger for us. Then we would stay around that level which we think we would do by either rolling existing maturity in the bond or retiring that debt and issuing new debt. That is more of a question of pricing and currency exposure and so on. We don't intend to change our current policy of not having currency exposure on our liabilities. And so if we were to issue another bond, we will hedge that if we can access the local markets which we have done successfully recently in the large debenture that we should then – we would probably do that and do it directly in reais. And that is then basically the plan at this point. This is something that we frequently review and we constantly analyze. (00:24:05) We should have lower or less debt. 1 time total debt to EBITDA is an extremely conservative number and there is definitely a job of us of frequently analyzing and reviewing that. And if there's any different decision by the board we'll obviously communicate that.

Q - Carlos G. Macedo {BIO 15158925 <GO>}

Okay. Perfect. Thank you.

Operator

The next question comes from Alexandre Spada, Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, gentlemen. Thanks for taking my questions. I have two. First one is can you provide an update on the arbitrage process involving your potential competitor? We haven't been hearing anything about that for a long time. So is that process maybe halted somehow or is that still ongoing?

A - Daniel Sonder {BIO 18250247 <GO>}

It's ongoing and it's confidential so that's why we don't talk too much about it. So it's ongoing and there's movement on both sides in terms of putting forward their claims. And we don't have a very clear view of when we should expect a conclusion, but it's likely that it's going to be in 2019 at some point.

Q - Alexandre Spada {BIO 16687974 <GO>}

Is there some sort of a deadline or that can just complete for much longer?

A - Daniel Sonder {BIO 18250247 <GO>}

There's no formal deadline. The parties and the independent arbiters determine basically the flow of the procedures, and that's why the view from today is that this should be concluded next year at some point.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay, clear. Thank you. So moving on to another subject. The payments of dividends in IoC have been not following a clear pattern since the acquisition of Cetip which is distorting EPS growth year-over-year almost every quarter. So do you plan to have a more predictable pattern for dividends in IoC distribution going forward or should we expect these type of uneven distributions throughout the year in the following years?

A - Daniel Sonder {BIO 18250247 <GO>}

Look, we changed a little bit the procedures this year for IoC to sort of have a little bit more efficiency to make sure we can use the maximum amount during each one of the quarters. So we moved it a little bit ahead of the actual closing of the quarter. And as of now, we expect that to be the way that we do it, to continue to sort of indicate to the market what our payout ratio for the year is going to be and then do the distributions a little bit ahead of the closing of each one of the quarters.

Q - Alexandre Spada {BIO 16687974 <GO>}

And then on a quarterly basis and probably each quarter presumes the payout that you have is a target for the company? Does that make sense?

A - Daniel Sonder {BIO 18250247 <GO>}

Say it again?

Q - Alexandre Spada {BIO 16687974 <GO>}

I mean, so you will be paying out every quarter?

A - Daniel Sonder {BIO 18250247 <GO>}

Yes.

Q - Alexandre Spada {BIO 16687974 <GO>}

And in each quarter, if your payout is supposed to be between 70% and 80% which is what I think it'll be proceeding, then the market should expect each quarter to have the payout somewhere between those two amounts?

A - Daniel Sonder {BIO 18250247 <GO>}

Correct, correct, absolutely correct. That's exactly what we want to do. We want to even make it a little bit more even during the year among the different quarters.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. That's clear and that's going to be quite helpful. Thank you, Sonder.

Operator

The next question comes from Florian Gueritte from Alquity in the webcasting. Could you please expand a bit more on the acquisition you announced in terms of its size, the business model, competition? What are the benefits of combining your businesses?

A - Daniel Sonder {BIO 18250247 <GO>}

I'm sorry. I couldn't quite hear. Can you repeat that, please?

Operator

Sure. The question comes from Florian Gueritte, Alquity. He asked could you please expand a bit more on the acquisition you announced in terms of its size, the business model, competition? What are the benefits of combining your businesses?

A - Daniel Sonder {BIO 18250247 <GO>}

Okay, sure. It was a small acquisition both in terms of the amounts that are being paid to the founders of the company as well as the revenue impact. We have agreed with the sellers not to disclose those amounts. And because of the lack of materiality for us, we also think that's fine at this point. However, the rationale for this is quite compelling for us. BLK is a very respected company that's been operating for several years in Brazil and has been one of the leaders in developing software and algorithms for the buy-side/asset manager industry as well as for brokers. They have a relevant market share in that segment and a solid business model, again, baptized (30:19) by the innovation and the resilience of the platforms and the algorithms that they have built. We find that this is an activity, an area, and a business that in one hand is adjacent to what we are already doing. It helps in terms of developing our markets and building additional liquidity and sophistication and strategies into it. And finally, it adds value to both clients of the company and brings us closer to the buy-side and to the brokers by complementing the suite of things that we do for them. So we found, again, a good team, a solid reputation, and an attractive opportunity for us to enter in this activity which is to the benefit of our clients.

Operator

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

A - Daniel Sonder {BIO 18250247 <GO>}

I just wanted to thank everyone for joining the call for following our Investor Relations releases. And please feel free to reach out to anyone in the team if you have further questions. Thank you very much and have a good afternoon.

Operator

That does conclude the B3 Audio Conference for today. Thank you very much for your participation. Have a good afternoon and thank you for using Chorus Call Brazil.