Y 2016 Earnings Call

Company Participants

- Rafael Augusto Sperendio, Head of Investor Relations
- Werner Romera Suffert, Chief Financial Officer

Other Participants

- Gustavo, Analyst
- Mario Pierry, Analyst
- Thiago Batista, Analyst

Presentation

Operator

Good morning, everyone, and thank you for waiting. Welcome to BB Seguridade's Fourth Quarter 2016 Earnings Conference Call. This event is being recorded and all participants will be in a listen-only mode during the company's presentation. After this, there will be a question-and-answer session. At that time, further instructions will be given. (Operator Instructions) The presentation is available in the Presentation to the Market section of BB Seguridade's website at www.bancodobrasilseguridade.com.br.

Before proceeding, let me mention that forward-looking statements that may be made during this conference call regarding expectations, growth estimates, projections, future strategies of BB Seguridade are based on management's current expectations, projections of the future events and financial trends that may affect the business of the Group and do not guarantee future performance, since these projections involve risks and uncertainties that could extrapolate the control of management. For more information on statements of the company, please check on the MD&A.

With us today are Mr. Werner Suffert, BB Seguridade's CFO; and Mr. Rafael Sperendio, Head of Investor Relations. Please Mr. Sperendio, you may now begin.

Rafael Augusto Sperendio {BIO 18963159 <GO>}

Good morning, thanks everyone for participating in our conference call to discuss our 2016 results. So, beginning here on page number three, we have main highlights of the company for the year. We have first one here, our net income, with a BRL4.1 billion, a growth of 4.1% within our revised guidance of 4% to 8% growth in net income.

It's worth noting here is that, if we were to set apart the effects that we had in changes in tax rates and the social contribution and also in tax expenses and VAT at the broker, we estimate that the net income would have been roughly 8% higher in 2016. So, it was an external effect that impacted our results and we also would like to highlight that this was not dependent on our operating performance.

The second one, our performance in life and rural business segment, when we look at these business specifically, the adjusted net income grew by 2%, while the earnings before taxes and profit sharing grew nearly 6% with a very good performance in premiums written in life, rural and in mortgage life. The only line that was weak in this business was credit life and I'm going to cover it in more details later.

For P&C, in SH2, our adjusted net income fell 40% due to weaker net investment income and a higher loss ratio, mainly in auto insurance.

For pension plans, this was the main highlights for the year; contributions grew 28% with a lower redemption ratio, leading to an increase of 28% in net inflows, equivalent to 50% of the total net inflows in the Brazilian pension plans industry. And the outcome here, and AUM reaching BRL198 billion with an increase of 33% in the last 12 months.

For premium bonds, our net income grew by 16%, driven by higher net interest margin, while the broker, the revenues grew by 8%, driven by the very good performance that we had in life, rural and pension.

And finally, the last point that I would like to highlight here is the distribution of BRL3.3 billion as dividends, equivalent to 82.3% payout, considering the accounting net income.

Moving to page four, we have a brief summary of our adjusted net income, segregating the one-off events. So, we had two extraordinary events in 2016. The first one was the deferred tax asset of PIS and COFINS together [ph] VAT taxes in Brazil at SH1 and SH2 as an outcome of the changing the methodology for calculating the tax expenses for these companies.

So, if I were to summarize, we moved from a cash basis methodology to the accrual basis methodology, so this resulted in a deferred tax asset of temporary differences related to claims to be paid, claims incurred but not reported and claims incurred but not enough reported. So, and when we look at the global impact here, as the deferred tax assets were impacted by provisions recorded in 2016, as well as in previous years, we segregated the portion related to the previous years as an extraordinary effect, which amounted to 23 million post taxes.

The second event was the impairment loss related to the goodwill that we have in SH -- referred to SH2, it's booked in the holding company that we call BB Seguros, in a total amount to 176 million pretax, a 116 million net of taxes. So these goodwill arose from the partnership with MAPFRE in 2011, but due to the deterioration in the scenario, as compared to the one expected when the partnership was captured, we were forced to record this impairment now in 2016.

So, as I mentioned in the first base, setting apart the extraordinary events, our adjusted net income reached 4.1 billion, 4.1% higher compared to the one presented in 2015, while the accounting net income was up BRL4 billion and it's worth noting that the distribution of dividends was not affected by the impairment and our payout ratio, as I mentioned previously, 82%, was even higher than the 80% that you observed since the company became listed.

Moving to page number five, we have a brief overview of our financial results and its contribution to the earnings. So, the combined net investment income grew by 3%, equivalent to 31% of the adjusted net income. And the variables that affected our financial results in 2016 were as defined in the positive side, the higher average Selic rate as compared to 2015, as you can see it on the upper left-hand side, and the downward movement of the forward yield curve, which brought positive mark-to-market effect in our fixed rate portfolio.

On the Selic side, we had on the bottom left-hand side, the decline in the inflation rate, which brought a negative impact on the accrual of the inflation protected securities classified as held to maturity.

On page six, I'm going to cover the performance per business line from now on. So starting with life and rural, BB MAPFRE SH1. Premiums written fell by 3%, driven by credit life, which dropped 48% this year. But on the other hand, we had a very strong performance in all the other products, like term life grew 16%, rural rose 14% and mortgage life grew 29%.

Regarding the operating performance for this business, the loss ratio deteriorated slightly as compared to 2015, due to a higher frequency of claims in credit life and the El Nino effects that impacted the rural portfolio. We also saw an increase of 20 bps in the commission ratio this year.

And regarding G&A, we showed an improvement of 1 percentage point, which partially offset the increase in both the loss and the commission ratio. And the outcome of this dynamic's, combined ratio worsened by 1.2 percentage points in 2016.

On page eight, we can see that despite the worsening performance of the combined ratio, we managed to deliver 7% growth in underwriting results, coming from mainly the increase in premiums earned. Net investment income was flat as compared to 2015 and the net income grew by 2% in 2016, with a return on equity of 44%.

On page nine, we have the sales performance of P&C, so premiums written dropped by 7% in 2016, impacted by the weak performance in auto insurance, which declined by 18%. And in this segment, specifically, we have been observing a very difficult scenario due to the reduction in sales of brand new cars for the fourth year in a row, we went back to the same level of sales of new cars we had in eight, nine years ago.

And the frequency of robbery and theft that we can see on next page also affected the loss ratio for this company, which increased by 4.5 percentage points in 2016. And the commission ratio increased slightly, driven mainly by the independent brokers channel and the G&A ratio improved by 0.4 percentage points, but not enough to affect the increasing loss and the commission ratio, which lead the combined ratio for this business to reach 104% in 2016.

On next page, we can see that the deterioration in the combined ratio drove the underwriting results down to 200 million loss in 2016, while the net investment income dropped by 11%. This year we had an -- of course, remember [ph] in that, we had an unfair comparable basis in 2015. So in 2015, we had the benefit of high inflation and also some benefits coming from the change in the foreign exchange rate, which benefited the financial results for 2015. In 2016, we didn't have these effects. And then, the outcome here was the 40% decline in the net income to 250 million, with a return on equity of 7% for the P&C business.

For Brasilprev on page 12, we can see the contributions grew by 28% to BRL47 billion, redemption rate was down 50 bps to 8.8% of the total assets under management, and as a result here, net inflows reached BRL29 billion, an increase of 25% and accounting for 50% of the total industry as I mentioned in the beginning of the presentation. So, the AUM reached BRL198 billion, 33% higher as compared to 2015. Management fees grew by 26%, with the average management fee following the downward path 1 bps to 2 bps per quarter, reaching 1.15% in 2016. And the main reason here is the mix pretty much concentrated in high net worth residuals along with the dilution of the participation of the defined benefits pension plan in the assets under management. So, the net income grew by 17%, with a return on average equity of 42% for this company.

For premium bonds on page 13, we can see that collections dropped by 13% in 2016, explained by the decrease in the average ticket, we can see that the total bonds outstanding increased by 7%, and this is basically explained by the higher participation of monthly payment bonds, which have a much lower average ticket as compared to the single payment.

Net investment income grew 42%, driven by the increase of 1.6 percentage points in the net interest margin here, as a result of the higher average Selic rate, as well as the downward movement of the forward yield curve, which led to a growth of 16% in net income despite the decline in collections.

The last business line that we want to cover here, BB Corretora on page 14, commissions grew by 8% this year, driven mainly by the strong sales performance in life, rural and pension plans, with a contraction in the net margin here, this was basically explained by the increase in the VAT, as I mentioned in the very beginning of the presentation from 4.65% to 9.25% for PIS and COFINS, and the net income reached 1.6 billion, 7% higher compared to 2015.

On page 15, we have our guidance for 2016. So, as we already covered in the first page of the presentation, the adjusted net income grew by 4.1%, so within the revised range of the guidance for the year.

And finally, on page 16, we provide our guidance of adjusted net income growth for 2017, 1% to 5% growth as compared to the adjusted net income reported for 2016. So, we believe that 2017 is still a transition year, we expect a negative impact on the financial results due to fall in interest rates along with the inflation rate converging to the midpoint of the target bend, so, this is -- for sure, will impact our financial results in -- throughout 2017.

But on the flip side, we expect that the growth of our non-interest operation results will more than offset the weak performance in financial results, especially in the second half, we are -- as we expect a recovery in segments that did not perform really well in 2016 like credit life, as an example, or even premium bonds. And that's why we ended up with 1% to 5% growth range for 2017.

So, this is all we would like to cover, and which finishes the presentation and we are now open for the Q&A session. Thank you.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Thiago Batista from Itau BBA.

Q - Thiago Batista {BIO 15398695 <GO>}

Yeah. Hi, guys. Good morning and thanks for the opportunity. I have basically two questions; the first one is regarding the pension business. Could you comment about the outlook you are seeing for this product and if you believe it will be possible to continue to outperform the market growth in '17?

And the second question is about the potential launching of new products or (inaudible) or the remodeling of products in '17. Last year, we saw a good impact of the -- in the sales of life products following the remodeling that you did in this product. Is it possible to see any new product or any remodeling of products during this year?

A - Rafael Augusto Sperendio {BIO 18963159 <GO>}

Hi, Thiago, Rafael speaking. So, considering the pension performance, for sure, we had an amazing year for 2016. But we expect that the competitors will now focus more in pension than they have focused in 2016, taking in all the advantages of all the discussions surrounding the pension industry in Brazil, like the pension reform, and the population realizing that maybe they need an additional source for savings and mature, in order to, as a complimentary source to the retirement provided by the social security.

So we had two benefits coming from this reform, people realizing that they need an additional savings and also, the ones that want to retire early than what is proposed in the pension reform, that the expectation is that, it's going to be approved by -- maybe in the end of this semester or even in the beginning of the next semester that if the people that are starting to contribute to the pension plans, let's say, to the social security, if they want to retire at 50, 55 instead of 65, they need to have an additional source for their retirement.

So, looking at all the current pension industry, we will take the advantage of this very positive scenario and all the news surrounding with the pension reform, and this is going to be very positive.

When we look at the market share that we have, we think that it is a fair market share when we look in terms of contribution or even in the assets under management, but in terms of net inflows, we reached 50% of the whole industry. So this is not really in line with the market share that we see as a fair market share when we look at assets under management, for example. So we expect that the industry will recover, for pension, specifically, we can increase in line or slightly above the industry in terms of contributions, but in terms of net inflows, we should bounce back to something around 30% or one-third of the whole industry, like we have in contributions in assets under management.

A - Werner Romera Suffert {BIO 18657101 <GO>}

So, Thiago, Werner, to answer your second question regarding new products that we have added last year, and I will say that the main products that we added in 2016, like products, as we mentioned, in premium bonds products, we will capture this new premiums flowing from these new products just now in 2016 -- 2017, sorry, because most of these products was launched just in the third and fourth quarter of last year.

So the impact that we will have will start more consistently from now on. So, we don't have any other new products being added this year to face or to deal with this operational increase that we expect for 2017. What we believe is that we have room to increase these premiums flowing from these products that we launched last year, and now the sales force, they understand these products, the new features that we have embedded in these products and this will be enough to increase the top line and a better performance in the underwriting risks and commercial costs that we have in this -- acquisition costs that we have in these products, this will guide us to better technical margins and increase in our operational results. This is how we are facing this transition year that will be 2017.

Q - Thiago Batista {BIO 15398695 <GO>}

Okay. Thanks for the explanation, Werner and Rafael.

Operator

Our next question comes from Mario Pierry with Bank of Brazil.

Q - Mario Pierry {BIO 1505554 <GO>}

Hi, it's actually Mario Pierry from Bank of America Merrill Lynch. Two questions, as well. The first one is related, and I'm going back to Brasilprev, if you can discuss a little bit about the competitive environments and the outlook for pricing, especially as the Selic comes down, if you would expect prices to come down as well?

Second question is related to the SH2, what is the strategy here, combined ratio well above 100%, 105% throughout the year? What is the strategy to improve the results from SH2? That's it. Thank you.

A - Rafael Augusto Sperendio {BIO 18963159 <GO>}

Hi, Mario, thank you for the question. I'm going to cover your first question, and then Werner will discuss about all the strategy related to SH2. So, considering the outlook for pension in Brazil, we have 1.15% as the average management fee right now. But when we look at the average Selic rate, if I am not mistaken, it was something around 13.8% in 2016. So, the estimate for 2017, with a Selic rate reaching maybe single-digit by the end of the year and maybe 10.8% as an average, but we expect that the whole industry will be under pressure to reduce management fees. This is a total main flow and a very expected movement.

What we will try to do is not just lower management fees, but change the way that we are managing the assets. So we have to raise in this segment, if we keep just managing fixed income, we do not have any alternative other than to reduce management fees. But if we move and we add more value to the investors in terms of increasing the return in terms of diversification or even we have now the possibility of investing abroad and also going to the stock market, we can justify a higher management fees. So this is another direction that we are planning to move on.

And then on the flip side, we did also to change the culture. Of course, that we have many alternatives provided by the regulator like investing in abroad, as I mentioned, and investing in equities, and also in private securities, but we also depend on the risk appetite of the clients for pension plans. So this is going to be a totally different scenario that we can even say that this will -- is going to be a new experience for the industry in Brazil. We had it in 2013 when Selic went down to 7% but for a very short period of time.

If I were to make a comparison, the average management fee in the market is around -- something around 1.2%. If we were to go back 13 or even 15 years ago, it was twice as higher as the one that we are seeing in the market right now. So, this is going to be a completely different environment. We will try to offset it by changing our investment profile and asset allocation, trying to also change the investment, the savings culture of the Brazilian population, but for sure, this is not an easy job, we need to know that the industry will change a lot in the next years.

A - Werner Romera Suffert {BIO 18657101 <GO>}

So, Mario, regarding the performance in SH2, and the combined ratio that we reach in -- reached in 2016, yeah, I think it's worth noting that the loss ratio for the industry as a whole increased a lot this year and we have the impact of this new auto fleet reducing year-over-year and we bounce back to the numbers from 2008. So the new cars in the market are in the same level that we had in 2008, and this, of course, impacted a lot SH2.

But we have some initiatives in place, we are replacing our auto portfolio in the regions where we have lower competition, comparing with the Southeast where the competition is higher. So this is a way that we are facing this issue.

Of course, we have some months until this strategy starts to have an impact in the portfolio as a whole, but this is one thing. The other thing is trying to have more premiums funds from the bancassurance side of SH2, where the margins are higher and be more selective in the independent brokers side, where we have more competition and where we are facing, I would say, the loss ratio is higher with very high acquisition costs. And even reducing G&A ratio, we reached this very high combined ratio in 2017 -- 2016, sorry.

So that's how we are facing this year for 2017. We believe that the margins will be a little bit better than 2016, but the first quarter results, I'd say, the first and second quarters, we still are very cautious about the performance in SH2, because of the competition that remains very high and that our strategies regarding the pricing of the auto portfolio is still in place. But to have this full impact, we will need some months to reach the full potential of this strategy. So the first quarters, we will still have numbers that will be below our long-term combined ratio for SH2.

Q - Mario Pierry {BIO 1505554 <GO>}

It was very clear. Thank you very much.

Operator

Our next question comes from Gustavo with JPMorgan.

Q - Gustavo {BIO 3795669 <GO>}

Hi guys. Two questions on my end, both quite quick. The first one is actually a follow-up, you said that competition remains tough in the auto segment. Just wanted to understand if it's getting worse or if it is improving? It would be expected that with high robbery and theft and the declining interest rates, players would get more rational. So I just wanted to understand if the competitive environment is improving or not?

And second question is regarding the impairment of SH2. Just wanted to understand, if it affects in any way your capital position or the company's ability to distribute dividends. I guess not, just wanted to hear a confirmation from you. Thank you.

A - Werner Romera Suffert {BIO 18657101 <GO>}

Hi, Gustavo, Werner speaking. I will start with the second question and after that we move to the first one, regarding SH2 and auto insurance. But the impairment that we have had this quarter impacted in our ability to pay dividend is zero. We will remain paying the same level of dividends that we have nowadays. And as I explained in the Portuguese earnings call, we are -- we have some -- we are studying and looking these numbers to see if we are -- even -- if we have some room to increase this in the long-term, but our goal is to remain at least at 80% in the adjusted net income view, but trying to move to a higher number as soon as possible and as soon as we have, we will be able to sustain the same level, the new level of payout.

And moving to the SH2 questions regarding the auto insurance. We believe that the competition will remain very tough in the first quarters, but when you look at the competition all across the country, we have different levels of competition. So the margins are higher in some regions like the Northeast and the North in Brazil and the Middle East also, but comparing with the South and Southeast. So we are very positive that we will be able to re-price our portfolio in these regions where the competitions are lower. And we will try to -- we started this strategy last year, so we will start to have the impact of it in 2017.

But when you look in the market, the auto insurance and the players in these regions, in the Southeast, and the South of Brazil, the competitions remain very high here. And in these regions, we believe that the re-pricing is bit tougher and in the independent broker portfolio will be very difficult to do this in the beginning of the year. So we have room to do this in the bancassurance side, and we will try to move as soon as possible to move this strategy to the whole portfolio as soon as possible. But for the independent brokers, we believe that this will be, I would say, a medium-term strategy that will take place during the year of 2017, maybe in the end of the second quarter on.

Q - Gustavo {BIO 3795669 <GO>}

Perfect. Thank you.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I'd like to invite Mr. Rafael Sperendio to proceed with his closing statements. Please, Mr. Sperendio, go ahead.

A - Rafael Augusto Sperendio {BIO 18963159 <GO>}

I would like to thank you all for joining our conference call for the fourth quarter of 2016. And only to emphasize that when we look at the current [ph] scenario for 2017, it's still a transition period. We are going to face a tough scenario for financial results, but when we exceed level of interest rates maybe reaching single-digit, seeing the inflation under control, this is the perfect environment for developing the insurance industry in the country. So, we are seeing these scenarios very positive for the future, despite the negative impact that affect the short-term results, but when we look at it on a sustainable basis, it's going to be a very good scenario for BB Seguridade and all the insurance industry in the country.

So, thank you all once again and have a good day.

Operator

With this, we conclude the BB Seguridade's conference call for today. As a reminder, the material used in this conference call is available on BB Seguridade's Investor Relations website. Thank you very much for your participation. Have a nice day. You may now disconnect.