

Q1 2020 Earnings Call

Company Participants

- Cicero Augusto Vieira Neto, Chief Operating Officer
- Daniel Sonder, Chief Financial Officer
- Marcela Bretas, Head of Investor Relations
- Rodrigo Antonio Nardoni Goncales, Chief Technology Officer

Other Participants

- Carlos Gomez, Analyst
- Felipe Salomao, Analyst
- Marco Calvi, Analyst
- Thomas Peredo, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call about the earning results of B3 for the first quarter of 2020. (Operator Instructions)

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. Good morning, and sorry for being a few minutes late. We were just making sure that everyone was connected to the call. And I just want to start by wishing and hoping that everyone is safe and sound, and taking care of yourselves and your families. And thank you for staying connected and keeping up the coverage of our Company.

We are doing a slightly different format this quarter for the discussion on our results. As you saw last night, we also released an audio version of our earnings release. And so, this call is going to be shorter and have some special guests that have kindly joined us in this discussion, and we will also have hopefully a longer Q&A period, so feel free to send your questions our way.

I just wanted to open with two main messages. One is respecting the main focus of the Company in the last quarter, in the first quarter of 2020 as you hear in more detail from my colleagues in a moment. The priority for B3 was to really be available as a platform for

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our clients to perform all of their businesses, to be the resilient place where investors and brokers and banks, and regulators could look to. I think we performed at -- to a very satisfactory level and this was where most of our attention was focused. We are happy that the investments that we have made over the last many, many years were put to good use and that it works not only when we are expanding our business and thinking about some exciting times and creating new products and so forth, but also when a completely surprising crisis hit us and we have to deal with the volumes that we dealt with. In parallel, obviously we had to change our working habits and I need to again mention how competent and committed our team was in making all that possible.

The second theme that I just wanted to highlight, and hopefully we can discuss that further is that, this is a very atypical and unusual quarter in terms of the financial results for the Company. The completely surprising volumes that we dealt with, obviously turned into high revenues and the operating leverage that we have, makes that become high profits.

It's important however to look forward and to be cautious and realistic about what's ahead. If you look line-by-line in our businesses, there are reasons for concern both on the equity side with lower valuations and lower offerings, on the derivatives side with a potential lower risk appetite from investors on the fixed income side, with possible investments being postponed by companies and their funding needs being less ambitious over the next few quarters, and obviously also in the financing unit which has to do with consumer confidence and maybe hit -- or is already being hit by the lower level of economic activities.

So, in general, we are doing well, the Company is very stable, we have a robust balance sheet and we are extremely focused and committed to our clients and to the stability of the financial system.

And now I'm going to ask my colleague Marcela Bretas to go through some of the numbers, and I just wanted to take a chance to thank all the IR team and the Communications teams for putting together all the materials that you guys have in front of you. Thank you.

Marcela Bretas

Thank you, Daniel. Hello, everyone. Good morning. Hope everyone is safe and well during this challenging time. I'll walk you through some of our operating and financial highlights for the quarter. First, total revenues reached BRL2.1 billion, which was 39% higher than in the first quarter of 2019. The Listed segment delivered BRL1.5 billion in revenues with the ADTV up 72% and ADV up 60%. In the OTC segment, volumes increased close to 20%, but revenues remained flattish due to the pricing schedule change we implemented in January, where we shared some of our operating leverage with our clients and transferred some of the volume-linked revenues to our Technology and Access revenue line.

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In the Infrastructure for Financing business, as Daniel mentioned, we started to feel the negative impacts of the Coronavirus crisis with the number of vehicles financed decreasing 20% over the fourth quarter of 2019 and the number of additions to the Contracts Systems decreasing 16% over the fourth quarter of '19.

Adjusted expenses grew 18% driven by upgrades in our IT infrastructure, salary adjustments by inflation, new hires, as well as the addition of our two new subsidiaries BLK and Portal de Documentos. Our EBITDA reached BRL1.6 billion in the quarter and recurring net income reached BRL1.15 billion.

Referring to the capital distributions, we paid BRL293 million in interest on capital relating to the first quarter of '20 and BRL650 million related to an extraordinary dividend related to 2019.

Now, I'm going to invite Cicero Vieira, our COO to share some of the operating highlights of the quarter at B3. Cicero, please.

Cicero Augusto Vieira Neto {BIO 15177753 <GO>}

Thank you, Marcela. Good morning, everyone. It's a pleasure to be here today. So, as you know, in March 2020, B3 faced a huge operational oppression. It was a full stress-test for its systems and risk management processes for several reasons. First, because we had the highest volatility in the Brazilian stock markets ever. The Brazilian circuit breaker was created in 1997 by Bovespa and since then has been used 23 times.

In March, we had six circuit breakers in the same month, a record. We almost reached seven since on March 12 we had the 10% fall in the Ibovespa in a 30-minute break then a 15% fall in a 60-minute break and then we almost had for the first time a 20% circuit breaker when the Ibovespa reached minus 19.6%, seconds before the Fed made an announcement that brought some relief to the market.

Besides the huge price volatility, there was an exponential growth in the number of trades which stress-tested the capacity of our IT systems. Until the beginning of February, the peak number of trade was about 6 million per day and the average was about 5 million. During the Carnival holiday international market started to react more strongly to Coronavirus news. When markets reopened in Brazil after Carnival, we reached 10 million trades per day, a 66% increase when compared to the previous peak. This level became the new normal.

And in March we reached 12 million trades per day, a 100% increase. This had never happened before. At the same time, the volatility and the number of trades were the highest in our history, 90% of the Company had to start working remotely. These three factors combined; extreme volatility, peak number of trades and remote working meant the biggest operational and resilience distress that ever faced by the Company.

Fortunately, everything worked out quite well. Initially, let me talk about CCP credit risk. During the whole crisis, variation margin was fully paid and collateral was deposited

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always on time. There was no clearing member delay or default. There was no clearing member request to liquidate institutional customer collateral. There was only a marginal increase in the number of retail investor defaults with very small sizes and no systemic impact.

That are no doubt that the investments made in previous years in our risk systems were very important for achieving these results. There are some investments that I would like to highlight. The initial margin calculation system core, which adopts a 99.96% confidence level and is based on such sales probability distribution, something very relevant in severe crisis like this one.

The model used to control growth position limits at investor level, which avoids excessive concentration in derivatives markets. The pre-trade risk system line, which controls the inflow of orders in our matching engine. The dynamic price bands used by the matching engine which trigger price options whenever there is excessive price fluctuation, as well as other tools used by the trading system to mitigate the risk of (inaudible) malfunction.

The second point is IT processing capacity. During the crisis B3 critical systems performed quite well. There was no additional latency in the matching engine, due the exceptionally large number of trade and post-trade systems were also able to cope with additional volume. Now, Daniel will talk a little bit more about this later.

Finally, I would like to say that remote working has performed better than expected. We have about 90% of the Company working remotely and about 10% divided amongst different duty and respecting a minimum distance between people. Employees can access B3's systems via secured VPN connection and interact with each other using different IT applications. We hope that the infection will be contained as soon as possible, but if it's necessary, the Company will be able to work in remote mode for an extended period of time.

So with that, I would like to ask Nardoni to continue the presentation. Thank you.

Rodrigo Antonio Nardoni Goncales {BIO 19905163 <GO>}

Thank you, Cicero. Good morning, everyone. Thank you, Daniel and Marcela. I appreciate the invitation for this conference. And I hope everyone is safe and in good health.

Taking a risk of being quite repetitive bit what Cicero just said, I just wanted to emphasize that in the last few months we have experienced high volatility and a sharp growth in the amount of trade, mainly in the Listed segment. And at the same time the market participants in B3 were pushed to adopt to remote working for the majority of the team, something we have never faced before. This combination has been very challenging and in this scenario, the strength of the technology and of our platforms like resilience, availability, flexibility and security all B3 technology infrastructure in most of the systems has been stress tested, along with the process and the capacity of B3 to respond to the market and the regulators demand and needs.

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The market is together with us in this scenario and the market has been very responsive to the new way of working. The infrastructure prepared to support remote working (inaudible) has also been hard tested and has been producing good results, making it possible to our team to work properly [ph] outside B3 wherever they are.

Some special procedures have been timely structured to make it feasible, like providing extra monitor to those people who really need the device to perform their daily activities and our tech team is well prepared for that. Besides all of this, all the services provided by B3 in all segments were maintained without restrictions and the protection in technology capacity mechanisms have been responding properly to ensure the market functioning in these unique moment and also probably as Cicero mentioned in order to have the Brazilian government through structured initiatives to help the market to pass through the pandemic crisis, B3 has developed and delivered new financial instruments in the OTC platform proving our capability to run new projects and delivery solutions even in a diverse scenario.

Finally, I can say that B3 technology platform and processes are very well prepared to face the challenge imposed by the pandemic crisis. Thank you very much.

Daniel, Marcela, I think that I can hand over to you.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Mr. Thomas Peredo from BTG Pactual. Please, Mr. Thomas, you may start now.

Q - Thomas Peredo {BIO 21712295 <GO>}

Hi, everyone. Congrats for the strong performance and how the Company handled such an increase in volumes at the same time with the impact from COVID forced all of us to move to home option. I have two questions, if I may. The first one is, if you could give a bit more of detail on how has been the behavior of individual investors during the crisis, differently from the past, we have a much lower interest rate this time. So, there is not a Safe Harbor investment as we saw in 2015 and other crisis. And mainly the number of investors, they continue as net buyers in March and May and just wanted to get a sense of how the difference (Technical Difficulty) investors are behaving, how you are seeing the net new money, if the investors that on-boarded the exchange last year continue to bring net new money or if you're seeing a higher flow from new investors as well, which one is more significant and also how has been the performance of the day traders, do they continue to increase their volumes in equities, and many futures is this new individuals that became the traders or individuals that were already acting as the day traders before the crisis and in a sense, which one of these different profiles has been more significant for the increase in the ADTV? That's the first question. Sorry for the long question.

And the second one is, how we can imagine the payout going forward? Eventually, the payouts of the year would be close to the history -- to the historical that you have been

paying. But how could we imagine its distribution throughout the quarters as we can imagine that the coming quarters will be much -- we will see eventually lower pre-tax earnings and eventually the benefits will decrease throughout the quarters? Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Hi, Thomas. How are you? Thank you for the questions. I'm going to give you a few comments on individual investors, and then Marcela can help me out, because she has some numbers with her as well. I just wanted to mention that it's a -- I think happy development for the Brazilian capital markets that we have a stable and growing base of individual investors that are committed to a diversified portfolio, which includes stocks. This is something that obviously had to do with low interest rates, but I think also has to do with the good job that over the last few years the brokerage sector has done in terms of education and staying close to the clients through their network of financial advisors. I think that these things they don't have just one reason they all come together. The fact that there is a number of good companies and good liquidity that people have platforms through which they can access the exchange and put their orders through and that they have good advice and good education, as well as the fact that there is low interest rate, I think, all these things come together to deliver what we have seen, which is growth in retail even during these tough times of asset price adjustments.

It is our view for a very long time that to have a healthy balanced capital markets, you need to have different types of investors well represented within our liquidity and our ADTV, foreigners, institutional -- foreign institutional investors, local institutional investors, treasury and also retail and proprietary trading firm/high frequency traders. So I think all of this is a very positive development.

Maybe Marcela can help us with some of the breakdown and then I will go back and talk about payouts.

A - Marcela Bretas

So, Thomas, just to give a little bit more color on what Sonder just said, individual investors, retail investors were actually increased the amount outstanding in our depository in the first quarter when we compare to the fourth quarter. The foreign investors were the ones that -- they pulled out more money. So at the end of the fourth quarter, they had an outstanding amount of BRL1.1 trillion in our depository and that number fell to BRL970 billion in the first quarter of '20. But foreign investors still represent 41% of the outstanding balance in our depository for cash equities.

A - Daniel Sonder {BIO 18250247 <GO>}

So, just to go back to the payout question, the Company still showing a very strong cash generation. We have some, let's say, financing needs over the next few months, but we believe that we can access different markets for that over the remaining of the year, so that we can keep our payout. The payout target is for the fiscal year is a payout related to the fiscal year of 2020, but we may make some of these distributions in 2021 just like we recently paid out dividends related to 2019. So I think that again having a strong balance sheet and having a strong cash generation are the key pillars, and this would allow us to

continue to make significant payouts to our investors and we will do that prudently over time as well as long as we can access good sources of debt to basically bring our debt level up again to the desired capital structure for the company. But we will do it gradually and with prudence as the markets permit.

Q - Thomas Peredo {BIO 21712295 <GO>}

Thank you.

Operator

Our next question comes from Mr. Marco Calvi from Itau BBA. Please, Mr. Marco, you may proceed.

Q - Marco Calvi {BIO 19854632 <GO>}

Hi, guys. Good morning. So, if I may take advantage of the presence of Cicero in the call, I would like to hear about the regulation of the short selling. We have been observing some changes in the regulation in short selling outside Brazil. So if you could, share your view on if there is an intention of a change in regulation on this? And if not, what you can share about this topic? Thank you.

A - Cicero Augusto Vieira Neto {BIO 15177753 <GO>}

Okay, Marco. Thank you for the question. So first, we are not planning any change in the stock lending market or the short selling system in Brazil. But as you know, there were some restrictions, some changes in Italy, France, Spain, some measures related to short sale bans in those jurisdictions. There were some questions in Brazil, some discussions, but I would like to explain some of the background and how we see it.

First, it's important to notice that stock lending in Brazil is cleared via a CCP, which is not the case in other countries where stock lending is cleared bilaterally and this has many implications in terms of risk management and how stock lending in short positions affect the markets. First, when you have a CCP, as you know, the credit risk of those trade is mitigated by collateral deposits by the borrower.

So according to the Brazilian model, the borrower has to deposit about 125% of the notional value of the transaction as collateral, that's because there is principal risk, the value of the stock and volatility risk, the price, the potential price fluctuation. But I would say that on top of that, it's also important to notice that in the CCP model, there are position limits for each stock that is borrowed by investor and for all investors together. These position limits are set as a fraction of the free float of the stock and also as a fraction of the liquidity of each stock. This is very important to avoid excessive leverage in the market.

One key element is that if the market does not use a CCP and such centralized limit to control positions, borrowed positions could in theory exceed 100% of the free float, which is the case when it's not centrally cleared, but bilaterally cleared. And the reason for this is that the same stock can be borrowed, and then sold, and then borrowed again and then

sold and this chain can repeat itself several times until you could see potentially more than 100% of the free float are borrowed in the markets. This is not the case in the Brazilian infrastructure, as I explained, because of the position limit established by the CCP.

I guess that one final point is that we were analyzing this point in the last month, and there are some numbers that perhaps I can share with you all. So in March 2020, considering all stocks borrowed in our system, the average was 3% of the free float for each stock. So that relatively low. Considering only more volatile stock, the average was 7% of the free floats, not a huge amount.

So in a nutshell, in our view, I would say that the Brazilian stock lending system is working quite well. It helps to improve price discovery and market liquidity. So it is that we do not see a reason for any type of short sale ban or change in the model. And based on discussions that we had with regulators, we believe that they see things in the same way as we do.

Q - Marco Calvi {BIO 19854632 <GO>}

Thank you, Cicero. Very clear. If I may make a second question to Rodrigo, Rodrigo, should we expect an increase in investments, a focus on IT given the expansion in the number of messages we have recently? Thank you.

A - Rodrigo Antonio Nardoni Goncales {BIO 19905163 <GO>}

Yes. Thank you for the question. At B3, we constantly test and review the capacity of our platforms. And also we invest every year to modernize the technology, to ensure that we will be able to handle the volumes growth. Normally, we work basically on historical data plus expectation derived from the market CapEx and we will review our plans and investments. Of course, some adjustments can be done regarding the new CapEx, the sharp growth in trade volume, but not being, how can I say, expressive. So it's just a root [ph] review for our investments, as I said, something that we are used to doing every year.

Q - Marco Calvi {BIO 19854632 <GO>}

Thank you. Thank you. Very clear. Thank you for both of you guys. And again, congratulations on the results.

Operator

Our next question comes from Carlos Gomez from HSBC. Please, Carlos, you may begin.

Q - Carlos Gomez {BIO 15024854 <GO>}

Hi. Good morning. First, congratulations for the very good result. Two simple questions. First, where do you see velocity for stock trading going after these initial increase in the crisis? Where do you think it might stabilize in the coming one or two years?

Second, in the past you have been able to use market disruptions and opportunities to invest in other exchanges, not necessarily as a controller but as a minority partner. Is that something that you are considering at this point or you prefer to continue paying out as you have presently? Thanks.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Carlos. So regarding velocity, what I can say is that we did have a unusual quarter. These periods of volatility are demonstrated by a lot of, let's say, different opinions in the market and a very, let's say, intense desire of investors to move their positions. And that is why in a very short period of time, days or weeks, you have some very intense and unusual activity, which in the calculation, will obviously boost up our trading velocity. I think, it's unlikely that we should see that going forward, the same level that we saw in the first quarter. I think, it's hard to say that how this will perform over the next two years.

However, we have been seeing a trend that even in periods of less tension, volatility is an upward trending line for Brazil in terms of velocity. I think, that has to do with the health of the Brazilian capital markets with the diversity of types of investors with new companies coming onboard with companies deciding to make more of their stock available to investors and that is either through controlling shareholders, divestitures or change from dual-class structure into Novo Mercado or from the process of privatization/divestments from government positions either in private companies or in state-owned companies.

So taking all these things compound and we hope that continues to be the case, we have a strategy of promoting products that also bring this type of additional velocity, so ETFs contribute to velocity and trading between futures and single stocks and baskets and so forth, all these things add to velocity and permit arbitrage, which I think again is a good thing for investors ultimately.

The second point you made was related to investments in other exchanges. That's not a priority for B3 at this point in our strategy. We have a lot of work to do in Brazil, and so not one of the main things that we're looking at at this point in terms of investing in other exchanges outside of Brazil. Our M&A strategy, however, does include looking at selective opportunities in Brazil, adjacent to our business, in things that we consider that would add value to our clients. So as we announced last year two transactions, we continued to look at things that are not transformational, but here and there could add something to our product portfolio and increase the profile and the position of the Company in the future.

Q - Carlos Gomez {BIO 15024854 <GO>}

Very clear. Thank you.

Operator

Our next question comes from Felipe Salomao from Citibank. Please, Mr. Felipe, you may start.

Q - Felipe Salomao {BIO 19237023 <GO>}

Hi, everyone. Good morning. Thanks for the question. Would it be possible to share with us some color on the pipeline for IPOs and follow-ons? I know that I mean the market has been very volatile, but I mean, at the same time, the Bovespa Index is close to 80,000 points, which is not bad far from what it was on late-2018, early-2019 when some deals were already kind of taking place and I mean I suspect that some companies might also face kind of a liquidity constraint which would possibly -- and these companies would possibly need to access capital markets. So how are you seeing the pipeline of IPOs and follow-ons for the next couple of months? Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Felipe. We had before the onset of the Covid crisis, we had about 25 companies that were publicly announced that they were going to access the equity markets. Some of these companies have put their deals and others have kind of maintained the documentation and are still, let's say, officially working on it. So I don't have a precise number at this point to give you like the temperature. What we've been hearing from our clients, from the investment banks, as well as from the corporates is that, we are still very much in the middle of the fog and it's hard to have much visibility.

It seems like some of the companies will have their business disrupted. So I think that their priorities are possibly now going to be internally in terms of fixing their expenses or revenue generating capacity in the face of this crisis, which may be prolonged in terms of the macroeconomic impact and the hit on consumer confidence and so forth. I think, so, maybe they won't be as determined to access the market, maybe their growth plans are not going to be as ambitious as they were before. The other side of this equation is obviously the valuation discussion. I think, you are absolutely correct to mention that the drop in the Bovespa just brings us back to 2018. But once people have seen the valuations that they were discussing before, some issuers may consider that they are not willing to go to market at these new prices.

Having said that, I think, you bring up an interesting point, which is that the need for capital might be there as well [ph] in terms of refinancing or restructuring balance sheets post the crisis. So you might see some people even that were not on the radar for equity issuances, looking at the market as a source for capital infusion and so forth. We are very pleased that this morning or two days ago, we had the pricing of a small IPO. We just, it started trading this morning in a fully online virtual ceremony, with the ring of the bell done through computers. But, I think, it's a good sign that some people took the step of bringing a new company public and doing that in a way that attracted the diversified pool of investors.

So we remain active, we remain ready, we remain in close touch with our client issuers and we hope that this will resume at some point. But it's still very early to give you, let's say, a concrete number and say, this is what we expect to see in the next six to 12 months.

Q - Felipe Salomao {BIO 19237023 <GO>}

Okay, Sonder. Thank you for sharing the temperature. Thank you very much.

Operator

Our next question comes from the webcast and it's from Otavio Tanganelli from Credit Suisse.

He wrote, hi, congratulations on results and thanks for taking my question. I wanted to know if we have any updates on the public consultation of CVM related to competition multiple exchanges. Do you think very high volumes recently increased the incentive for another exchange to start operations?

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Otavio. The public hearing is going on. The CVM was kind enough to postpone the deadline for turning in the answers by the market. So this is expected to be done by the end of June. We are obviously working hard in the Company to prepare our answers. I think, the CVM brought up some interesting points for discussion in the market, some of which we were already familiar with, some of which came more in the form of questions and let's say ideas that they wanted to float to see how the market reacted and - - pardon me. So we are working on this. We know that other market players are also working that the buy-side and the sell-side community are looking at some of the market structure ideas that the regulator brought, and that we are going to have some, I think, a healthy interesting debate. I think that the -- what just took place actually is, I think, a demonstration over the last few months of the healthy state of the Brazilian capital markets infrastructure. But when you are hit by such a sudden and intense shock and are able to deal with it and everybody (Technical Difficulty) in the markets, not only for trading but also the whole clearing and settlement infrastructure works very, very well. I think that's a good sign. Obviously, the merits of the discussion on fragmentation we all know and we trust that the regulator is going to take all these points into consideration when they review.

In terms of new players, we don't have any news that we can share that are different from what has been already reported and known. We have a player that has been discussing, setting up an exchange in Brazil for quite some time. We had a pending issue with them that was negotiated and settled through mediation over the course of the last quarter of 2019. So that page has been turned. And I assume that they continue to work and eventually if they're ready and they have support from market participants and so forth, they will submit their request to the regulators. We stand ready in B3 to provide clearing services, depository services, as we have announced and we have committed formerly to the regulators. So we are ready and our strategy is to be the platform of choice for our clients, for our investors and continue to prove the value of B3 in the future whether there are competitors or not.

Operator

This concludes today's question-and-answer session. I would like now to invite Mr. Daniel Sonder to proceed with the closing statements. Please, Mr. Daniel?

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you very much. Thanks for following. And please send us your feedback. We again changed slightly the format of this conversation and also introduced a new media format last night. So please let us know if you like it and especially if you don't like it, because we need to get your feedback, so we can move forward. Thanks a lot and have a great day.

Operator

With that, this conclude the B3 audio conference for today. Thank you very much for your participation. Have a good morning and thank you for using Chorus Call.

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