Q4 2018 Earnings Call

Company Participants

- Alexsandro Broedel Lopes, Executive Finance Director & Head of Investor Relations
- Candido Botelho Bracher, President & Chief Executive Officer
- Milton Maluhy Filho, Chief Financial Officer and Chief Risk Officer

Other Participants

- Carlos G Macedo, Analyst
- Domingos Falavina, Analyst
- Eduardo Rosman, Analyst
- Jason Mollin, Analyst
- Jorge Kuri, Analyst
- Jörg Friedemann, Analyst
- Marcelo Telles, Analyst
- Mario Pierry, Analyst
- Natalia D. Corfield, Analyst
- Nicolas Riva, Analyst
- Philip Finch, Strategist

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Itaú Unibanco Holding Conference Call to discuss 2018 Fourth Quarter Results. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will be given at that time. As a reminder, this conference is being recorded and broadcasted live on the Investor Relations website at www.itau.com.br/investor-relations. A slide presentation is also available on the site.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Actual performance could differ materially from that anticipated in any forward-looking comments as a result of macroeconomic conditions, market risks, and other factors.

With us today in this conference call in São Paulo are Mr. Candido Bracher, President and CEO; Mr. Milton Maluhy Filho, Executive Vice President, CFO and CRO; and Mr. Alexsandro Broedel, Group Executive Finance Director and Head of Investor Relations.

First, Mr. Candido Bracher will comment on 2018 fourth quarter results. Afterwards, management will be available for a question-and-answer session.

It is now my pleasure to turn the call over to Mr. Candido Bracher.

Candido Botelho Bracher {BIO 3158644 <GO>}

Hello. Good morning to all and thanks for participating in our fourth quarter and 2018 full year earnings conference call. Starting the presentation on slide 2, here we show the main highlights of our performance for the quarter. Recurring net income was BRL 6.5 billion which resulted in an ROE of 22.7% in Brazil and 21.8% in the consolidated figures. The results from commissions, fees and insurance performed particularly well this quarter, growing 6.2% over the preceding period. This performance was mainly driven by our asset management and investment banking units. Our financial margin with clients, or NII, also increased over the last quarter especially as a result of the growth of our individuals and SMEs credit portfolio.

Despite this growth, our NPL ratio remained stable in the period. The increase in cost of credit this quarter was caused by higher impairment charges and corporate bonds. Expenses in the fourth quarter are usually higher than in the third quarter especially as a result of the full impact of the annual collective agreement with the bank employees, unions, and seasonally higher expenses related to commercial activities. In the fourth quarter, this increase was up 1.2%. Lastly, our individuals and SMEs portfolio increased 5.7% and 4.9% respectively in the quarter, continuing the same trend seen throughout 2018. On the other hand, the negative forex variation on Latin American portfolio and the decrease in the corporate book led to the stability of the total credit portfolio seen in the quarter.

Talking about the full year 2018 on page 4. Before we proceed with a deeper analysis of our performance during this year, it's worth to mention that the Brazilian economy performed somewhat differently than what we had expected at the beginning of the year. GDP growth is likely to stay at 1.3% and not 3% as we earlier forecasted. The truck driver strike was one of many factors that contributes to this weak performance which naturally results in a lower demand for financial services products. Additionally, when we released our 2018 guidance we expected the exchange rate to be around BRL 3.50 per $1 at the end of 2018 and not the actual BRL 3.88 year end rate. Higher forex rates contribute negatively to our cost and expenses numbers and positively to LatAm results. With this factor in mind, we can now check how accurate was our guidance for 2018 which, I remember you, we did not alter throughout the year.

I'm now on page 5. We can see that despite the differences between the forecasted and the actual macroeconomic scenarios, out of the 14 ranges provided we performed below our expectations only on two of them. One was non-interest expenses on the consolidated range and the other was fees in Brazil. Despite the deviations, our recurring net income was well within the implied range of guidance.

Moving now to page 6. We show that our recurring net income for 2018 BRL 25.7 billion with an ROE of 21.9% in the consolidated. This led to a value creation of BRL 9.2 billion, a 12% growth when compared to 2017.

On the next few slides, we will comment on the performance of each of the lines we forecasted for the year. On slide 7, we show that our total credit portfolio grew 6.1% in 2018, above the midpoint of the guidance. This performance was a direct result of our individuals and SMEs portfolios that they have grown beyond our expectations, amounting to 10.3% and 14.4% in 2018 respectively. Origination remained over the 20% mark over the year in the individuals and SME portfolios. Origination on the corporate book was not strong enough to compensate for amortizations during the period, resulting in a decline of 4.7% of the total book in effect. This weak demand does not imply a reduced relationship with our large corporate clients as we continue to advise and help them access the capital markets where we play a leading role in distribution and origination of corporate debt.

On slide 8, we present our financial margin with clients. The 2.2% increase was mainly caused by the average loan book growth and change in the mix of our credit portfolio to our higher interest-bearing products. Also of note was the margin in our Latin American operations which benefited from forex and credit growth as well. These effects were partially compensated by the negative impact of the lower Selic rate in our liabilities margin and our working capital. It is worth to highlight that while the average Selic rate declined 335 basis points in 2018, our gross net interest margins remained relatively stable and our risk-adjusted NIMs expanded 50 bps in the same period.

On slide 9, we show that our financial margin with the markets declined 12.7% over the year. This was mainly caused by the reduction of the Selic rate and its impact on the hedging strategy of our investment outside Brazil. Despite that, I mean, this has been largely anticipated by ourselves and we even managed to remain a bit above our guidance in this item.

Turning now to slide 10. The cost of credit reached BRL 14.1 billion in 2018, in line with the midpoint of the guidance and it represented a decrease of 21.9% when compared to 2017. The cost of credit ratio for the full year declined 80 basis points. NPL ratios for individuals and SMEs behaved well during the period and the increase observed in the corporate book is mainly represented by companies that were already appropriately provisioned. This dynamic resulted in a reduction of the coverage ratio as we already indicated that would happen in previous conference calls.

Slide 11 shows our revenues from services and insurance which grew 5.5% in 2018, reaching the bottom end of our guidance for the year. The main positive highlights were our current account and asset management fees as well as our investment banking business. Also important was the performance of our credit card fees where we had a solid performance in the issuing business, growing not only our client base and transaction volumes but also revenues. On the other hand, there was a reduction in revenues in our acquiring business despite the increase in transaction volumes. The reduction in our acquiring business exceeded our expectations as a direct result from higher competition in the segment and corresponding changes in our commercial strategy.

Now turning to slide 12, we show our non-interest expenses. During 2018, we intensified our investments especially on our acquiring and insurance operations. This led to a 3.3% growth in non-interest expense within Brazil which was in line with our guidance. Due to a deeper devaluation of the real than we originally expected, our consolidated non-interest expenses grew 5% in 2018 which was above our guidance for the year.

On slide 13, we show our capital ratios and the payout for 2018. We finished the year with a Basel III Tier 1 fully loaded capital ratio of 15.9%. If we account the additional dividend distribution announced yesterday of BRL 16.4 billion, our Tier 1 ratio will be 13.5%, in line with our dividend practice. The total dividend payout including the shares bought back through the year reached 89.2%. This payout ratio translates into a dividend yield of 7.5% for 2018.

On slide 14, we present the distribution of added value in 2018. Itaú Unibanco added BRL 73 billion to society that helped to boost the economy and to stimulate the transformational power of thousands of people. Of that value, 30% was designated to our employees; 32% to taxes, fees, and contributions; 33% to our more than 150,000 direct shareholders and approximately 1 million on direct shareholders in Brazil through investment and pension funds; and 3% reinvestment in our operations.

In 2017, we announced our six strategic objectives for the bank, long-term strategic objectives, and broke them down in two categories: continuous improvement and transformation. On slide 15, we present what was delivered in 2018 to materialize the three transformational objectives. These three objectives are strongly intertwined as our main objective is client centricity, and all initiatives presented here were developed to support this main objective. One example is our open investment platform. To open our investment platform, we used new technologies coupled with a complete reorganization of the way we work. We moved from a hierarchical structure to flexible teams, reorganized the communities formed with employees from technology, operations and investment areas. In addition, to attract and retain a more diversified workforce, we are working on improving diversity and changing our recruiting process. We also adopted a new dress code, creating a more relaxed and informal environment.

Now about 2019. On the following slides, we will talk about our expectations for 2019, and on slide 17 we show our macroeconomic forecast for the year. We expect a generally more positive year than 2018 with a 2.5% GDP growth in Brazil. We also expect inflation to remain under control at 3.9% which should allow the Selic rate to remain flat throughout the year. In this scenario, unemployment rate should continue to decline and we expect it to end 2019 at 11.6%.

On slide 18, we present our guidance for 2019. We expect our credit portfolio to grow between 8% and 11% which should translate in a range of growth between 9.5% and 12.5% for financial margin with clients. We expect the financial margin with the market to end the year between BRL 4.6 billion and BRL 5.6 billion. Our cost of credit should grow and we expect it to end 2019 between BRL 14.5 billion and BRL 17.5 billion. Our commissions, fees and results from insurance operations are forecast with an increase between 3% and 6%. As for non-interest expenses, we expect a growth between 5% and 8%. Lastly, we expect our effective tax rate to be between 31% and 33%. The guidance for our Brazilian operation should follow closely the trends forecasted and consolidated.

With this, we conclude this presentation and are now open to any questions you may have. Thank you.

Q&A

Operator

Ladies and gentlemen we will now begin the question-and-answer. Our first question comes from Jason Mollin, Scotia Bank.

Q - Jason Mollin {BIO 1888181 <GO>}

(00:15:57-00:16:17) forecast for loan growth. Obviously you're forecasting improvement versus what was going on in 2018, but it is pretty impressive because Itaú Unibanco has been able to show very consistent returns on equity in the 20-plus percent range through a very challenging period. Things are getting better. How much better should things get and are we on that path to seeing things much better and is that part of the guidance expectation? Is things are that much better? Or I just think versus some of your peers we've seen somewhat more aggressive expectations for 2019 and I just wanted to get your perspective on what's in this outlook that you're forecasting. Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Good morning, Jason. I'm not sure I got the whole of your question because you were cut in the beginning. But if I understand well, you are asking me to comment on our guidance and our forecast for the 2019. Is that it?

Q - Jason Mollin {BIO 1888181 <GO>}

Yes. What are the assumptions going into this expectation for GDP growth and your expectations for Itaú Unibanco's operations? For instance, in terms of reforms, is pension reform going to get done, is that part of this expectation for growth this year or really that's not part of this expectation at all or it'll be a 2020 event? So what's going into this? If you can provide some color to the background of what's going into this outlook.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Sure. The approval of the pension reform is definitely included in these expectations. One, we expect – I mean, this does not have so much an impact on growth for this year which, I mean, our forecast is 2.5% which, under revision by our economic team now, may end up between 2% and 2.5%. But the approval of the pension reform will not only guarantee this growth as you create a whole environment of optimism in the economy which we think will boost demand for credit and investment. So yes, this is a premise of these projections. You've seen them. I mean, we have grown total credit portfolio this year in 6.1% and we are expecting to grow between 8% and 11% for next year.

One point which is very important is that the average balance of credit, the average portfolio, is expected to grow significantly this year which was not the case in 2018. In 2018, the average balance portfolio was lower than 2017. This is why this year, we expect a significant increase in the financial margin with clients. A good part of this improvement is based on the fact that the average portfolio is going to be significantly higher. Another part of this improvement in the financial margin is due to the mix change, I mean, to the fact that the mix is moving from clients with a lower PD to clients with a higher PD – individuals and SMEs.

This in one hand helps to boost financial margin with clients. On the other hand, it also increases cost of credit, and this is the explanation, I mean, why we are forecasting a bit higher cost of credit and fee rates. Not only portfolio growth but it's also the change in mix, but all this with a background of a growing economy and optimistic mood in financial markets as a result from a stable fiscal front as a consequence of the approval of the pension reform.

Q - Jason Mollin {BIO 1888181 <GO>}

So when we look at the guidance for the effective tax rate for Brazil of 32% to 34%, that's not assuming any material changes in the – I guess that assumes the change in the social contribution but no additional changes, no change in the tax deductibility of interest on capital or other changes in the corporate tax rate. Is that correct?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Precisely, Jason.

Q - Jason Mollin {BIO 1888181 <GO>}

Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome.

Operator

The next question comes from Jörg Friedemann, Citibank.

Q - Jörg Friedemann

Thank you very much for the opportunity to make questions. I have two questions. The first, it came to me as a surprise the cost of credit guidance. Understood the bridge explanation about the mix change, but in the midpoint of the guidance the cost of credit implied a growth of almost 14% versus 2018 which is not only more than the loan growth expected for the year but also the top of the financial margin with clients. We saw that NPL for the large corporate segment continues a bit volatile, so could you elaborate a bit further if there is any specific case that should we see at the moment (00:22:27) rising provisions in 2019? And also if possible, it would be interesting to get your sense about the evolution of impairments, discounts, and coverage which is at very comfortable levels at 221%. This is the first question.

And the second question, following the math (00:22:51) in terms of non-interest expenses in 2018, you came with this 5% to 8% OpEx growth guidance for 2019 which is above inflation even in the bottom of the range. From where this growth should primarily come in 2019? You commented about the merchant acquiring business impacting 2018. Should it happen again this year or is there anything else such as IT investments, etcetera? Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you, Jörg, for the two very good questions. First then on the cost of credit. Here, I mean, there is no specific case. There's nothing in the horizon that we see which is not already provisioned or accounted for, so there's no surprise here. We see this as a natural evolution of the provisions due to portfolio growth in one hand and the mix in the balance of the portfolio in the other hand. So the portfolio growth of course, I mean, demands new provisions. And the fact that our mix is evolving towards credits with individuals and SMEs which have a higher probability of default, I mean, this commenced according to our expected loss model that is what drives always our forecast, this is what drives, I mean, this growth in provisions.

As to the outlook for impairments, discount, and coverage, I continue to expect that coverage may be lower although our forecast do not necessarily indicate that. But as I already said in previous calls, I mean, at these levels of coverage I think they are astronomically (00:25:06) high and they are justifiable in view of the many precautionary provisions that we made for corporate credits which were severely affected in the recession of 2015-2016. As the situation evolves, these credits should either default, and in this case the coverage would fall because the provision would be used to cover these clients or they should improve and that provision should be reversed and also the coverage would drop in this case. The same thing would account for impairments. I mean, in our case impairments, they behave just like credit. Just like in accounting terms, it's different for deferred credit bonds that we have against discount. We expect recovery rates and discounts to stay flat, so with no major change this year.

Moving now to non-interest expenses. So this projection from 5% to 8%, the main cause for this is the growth in business in general. There are many expenses that are tied to the level of business, so the quantity of transactions. These are variable costs. And since we are expecting to grow significantly, costs should fall. Another important effect is the investment we have made throughout 2018 that will bear the full weight on costs in 2019.

Q - Jörg Friedemann

Perfect. This is very clear. Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome, Jörg.

Operator

The next question comes from Carlos Macedo, Goldman Sachs.

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

Thanks. Good morning, gentlemen – Candido, Milton, and Alexsandro. A couple of questions. First, just following up in Jason's question on loan growth. Last quarter, you talked about potentially increasing the risk appetite for the bank. Does the guidance say, the 8% to 11% in Brazil that you reported that you put out today, contemplate a higher risk appetite or is that something that could still happen, and if it could still happen or hasn't happened what could lead that to happen?

Second question. IFRS 9 is coming. You put out thankfully – thank you – in the spreadsheet in the website the financial statements under IFRS 9. They're significantly more volatile than what you report under Brazil GAAP. Because we don't expect you to exactly know the exact details, but is that something that we should expect once you move to IFRS 9 what's the bank looking to IFRS 9? Is it something that's going to drive a lot more volatility in your cost of risk, is it going to lead to charges? I mean, just a little bit of color on IFRS 9. Thanks.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Okay. Thank you, Carlos. As to the growth in total credit portfolio, 8% to 11%, I mean, this reflects not as much this. It's more the shift in mix towards more individuals and small and medium companies. I mean, this reflects that we are open for business in the bank. So, I mean, all the credit portfolios are open and, I mean, we have appetite to grow the portfolio according to the demand we may have at the adequate cost, at a great price for risk. So we are really, I mean, here completely open for new transactions.

What reflects the IFRS 9? We have already been accounting in IFRS 9 for some time. Our provisions are already adequate to the demands of this accounting method. And I think you are right, I mean, this method is more volatile slowly, but it's the nature of the beast (00:29:59). There's no avoiding that. I mean, our figures in IFRS 9 would be a bit more volatile in what concerns provisions.

(00:30:17)

A - Alexsandro Broedel Lopes {BIO 17663830 <GO>}

Carlos, just – can you hear me?

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

Yes, I can hear you Alexsandro. Go ahead.

A - Alexsandro Broedel Lopes {BIO 17663830 <GO>}

Just to note that we already release our figures in IFRS 9 quarterly. So, you can see from the past few quarters that our numbers in IFRS 9 are identical – almost identical to our numbers in Brazilian GAAP. So we already incorporated the expected loss modeling of IFRS 9 into our Brazilian GAAP numbers. So – and as Candido mentioned, the main difference is the volatility in the numbers, but we already incorporated that on Brazilian GAAP.

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

Okay, thank you. Just going back, Candido, to the question. You said that your – the bank is open for business. And is that – just from understanding where you are today versus where you were before, do you believe that the posture the bank has today is different than what it was say six months ago or 12 months ago?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

I didn't understand your question. Could you repeat it (00:31:24)?

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

Sure, sorry Candido. You said that the bank is open for business, and what I wanted to understand is if there has been any shift in that posture compared to 6 months ago or maybe 12 months ago if the – if 12 (00:31:38) from six months you consider the bank was also open for business.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Yes, we are more open for business than we were 12 months ago.

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

Okay, perfect. Thank you, Candido.

Operator

The next question comes from Philip Finch, UBS.

Q - Philip Finch {BIO 3252809 <GO>}

(00:31:59) thank you for the presentation. I have two questions as well please. First your guidance for fee growth is well below that for loan growth. So can you elaborate what challenges you are seeing in the fee business side and what measures you are taking to mitigate them? And the second question is really to ask about your plans to – whether you are going to issue anymore 81 (00:32:23) hybrid instruments this year? And if so, would it be reasonable to assume that additional dividends could also be paid in the year ahead? Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thanks for the two very good questions. What concerns fees, I mean, yes, as a matter of fact, I mean the guidance 3% to 6% is significantly below the guidance for our financial margin (00:32:50). The reason here is mainly the negative impact we expect from the acquiring business. We expect fees in the acquiring business to be lower in 2019 than they were in 2018, so they extract from the fee loans (00:33:10). And this is the single cause for this lower guidance in the fees growth.

What concerns 81 (00:33:21), we do not intend to make new issues about 81 in the short-term. We are at a level of around 1.1% of 81(00:33:28), the ceiling as you know is 1.5% and we like to leave some room for devaluation of the currency, which could – we don't want to have – these expensive issues are not serving us in terms of capital needs. Having said that, we have just issued BRL 3.50 billion in 81 (00:34:00) which are not completed in this 13.5%, which is just announced because they have not been recognized as capital yet by the central bank, so we do not consider them. And looking forward to the next year, when we make the calculations again to bring the capital back to 13.5%, this structure will be there and will increase the degree of sale (00:34:30).

Q - Philip Finch {BIO 3252809 <GO>}

Okay. Thank you very much. Very helpful.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Yeah. Thank you.

Operator

Our next question comes from Eduardo Rosman, BTG Pactual.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Hi. Good morning, everyone. I have two questions which are somewhat linked. The first one is on the value creation and the second one is on kind of a growth expectations and dividends. So starting with the first one, when we go to the slide 6 of the presentation, we can see that the gap between the ROE and the cost of equity is very similar to 2014 levels. But if we take into account only the Brazilian operations, it's probably the best performance you have in quite a while, right. If you look into the gap between the ROE in Brazil and the Selic rate, I think that the gap is between 15% to 20%. So my question is, do you think this is sustainable? What should we expect going forward?

And then my second question which has kind of a link to this first one. I want to understand if it makes sense to grow faster, i.e. reinvest more your capital even at a low ROE, if you think that the cost of capital will keep moving down, right. So my understanding here is that with the lower cost of equity, you could still generate the same value even with a low ROE given that the risk will be lower, right.

So I want to understand if you think that makes sense to you. If it's that the way you look at the bank, if that's the way you run the bank? And I'm asking that because I'm trying to understand where your dividend payout can go, right. In 2018, you had like almost 90%

payout which is pretty high. It seems that you are getting closer to your quarter one target. So I want to understand as well what should we – we should take into account when forecasting the events (00:36:32)? These are my questions. Thanks a lot.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thanks, Eduardo. Very good questions. Let me first start by saying that I have no payout target whatsoever and I have no orientation from the board or from anyone about what the payout should be. The clear orientation is that Level 1 capital should be 13.5% every year and the dividends in excess of this – and capital in excess of this should be paid out as dividends after accounting for potential acquisitions or potential changes in regulatory situation that may demand more capital or the normal growth of business. In effect of this we should distribute the (00:37:27).

And you are right when you note that when we have been enjoying a return on equity above 20% and the cost of capital has been reducing. When I look at the cost of capital in Brazil, I see that the cost of capital in Brazil is may be 3%, 4% higher than it is for international banks, at least for American banks, European banks, at least from what we hear from say aside analysts and from what our models indicate. So despite the fact that the interest rate is much higher – I mean the cost of capital, we think is already not so much higher than the cost of capital in developed markets.

How much lower can our cost of capital go? How much less can this difference be? And I mean if the cost of capital we spend in the U.S. can it be (00:38:32) in Brazil especially considering that this are long-term investments? So I say this – to say that I think there is a limit to how low cost of capital can sink in this situation. So the increase in value creation which is our main laws in how we establish our policy is – will have to be made through grossing in balance sheet and to have grossing (00:39:06) in nominal, return of the bank in nominal profit. So, I think that this all puts us in the direction of – including the balance sheet of growing our business as long as you can do it above cost of capital, significantly above cost of capital.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Okay. Candido, thank you. Thank you very much for your answers.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome.

Operator

The next question comes from Mario Pierry, Bank of America.

Q - Mario Pierry {BIO 1505554 <GO>}

Good morning, everybody. Just a quick question on your operations outside of Brazil. Candido, as we look at your profitability clearly you're delivering ROEs above 20% in Brazil and lower outside of Brazil. So if you can tell us, first, how satisfied are you with the results that you're showing outside of Brazil, and if you can be specific about the countries. And what do you think how long will it take for profitability in these other markets to start to improve and hopefully get to the levels that you have in Brazil? Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you for the question, Mario. So just so to – to have this more clear. Our biggest operation outside of Brazil is Chile by far. Then we have (00:40:41) also has Colombia which is a smaller operation, and then we have Paraguay and Uruguay which are large operations for the size of the country but are not large operations when compared to Brazil and Argentina which is a small operation with our operations outside of Brazil.

Another thing I would draw to your attention to is that in Chile specifically and also with some countries in Latin America, we consider the cost of capital to be below the Brazilian cost of capital. So we are prepared to have a return on equity that which is lower than in Brazil.

To comment on each country. First, Argentina is very small. We are improving there. It used to be a – we used to lose money in the retail market there, now we are making some money, a little money but it's really very small to count. In Uruguay we have a mature operation, stable market share, the highest profitability in the country. I see it improving, but I don't see anything transformational happening in Uruguay. I see in a way (00:42:07) just keeping the good position in the market we have there and improving marginally with a lot of effort.

Paraguay is a more dynamic economy than Uruguay, I mean it has been growing over 4% in the year. And we have in Paraguay in the last quarter of this year we had an ROE of 24%. So, it's a profitable operation. I think there we can really still really move a lot.

And then Chile, well how satisfied am I? And we see that we have made a significant change in Chile. In the results we have just developed our profit for the Chilean operation and for the Chilean Bank, and it was $320 million compared to $80 million the year before. So I think that the bank has been really turned around there and we are happy with that.

But since I have here by my side Milton Maluhy who used to be the CEO of the Chilean operation until a month ago. I'll ask him to not to say how satisfactory he is, but to give you a bit more of color in the Chilean situation (00:43:37).

A - Milton Maluhy Filho {BIO 15220856 <GO>}

Just to go through a little bit about Itaú CorpBanca, the local team will make this conference call in the next few weeks. So then you can go through the managerial numbers, something that we can't do here. It's telling you about the increasing profitability that we've had locally. I think we did a very good year in Chile, moving forward a 13% (00:44:08) what I think with the Chilean banks. Of course, the second block of banks, after the two major banks that we have there, it has significantly improved.

On the other hand, we still have a challenging Columbia. As we had anticipated, we were looking for a breakeven for 2018 and we achieved. So (00:44:35) what we expect. We would like to have the profitability of course in this operation and this should impact positively Chile in the coming years. So, we are very positive about Chile, I think we consolidate at the merge in Chile. In Colombia, we still have to consolidate the profitability of the bank, but I think we are in the right direction. We have discussed and reorganized our value proposition in both countries and we are satisfied and positive about the coming years.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. That's clear. Let me ask then a follow-up question then related to your appetite for acquisitions outside of Brazil. You had said in the past that the high taxes that you face in Brazil made it unlikely that you could pursue other acquisitions. However, if we were talking about a tax reform in Brazil when we do see a lower tax rate would that change your views for future expansion outside of the country?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

No, (00:45:44) Mario. So this would imply for instance in Chile reducing the tax rate from 40% to 27% (00:45:53). So it really makes a difference when you'll make calculations on the value of businesses.

Q - Mario Pierry {BIO 1505554 <GO>}

All right. Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you.

Operator

The next question comes from Jorge Kuri, Morgan Stanley.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Good morning, everyone. I calculated at the midpoint of your guidance range, net income growth of 11%, part of it due to the lower taxes. At the operating income level, I'm getting to around 7% earnings growth. So, what – I wanted to ask you how would you characterize that 7% relative to what you think you could do over the long-term? Are we halfway in the recovery? Is it almost there? How do you think on a fully recovered economy your earnings growth should trend over time, and again how does this compare to that? That's my first question.

Second is, if you can be a bit more specific about the guidance on commissions and fees, which you said is low because of the acquiring business. What do you expect ex-acquiring if you can help us with that what's happening with the asset management business, investment banking business and all of the rest of your fee products, I granted the level of disruption that we're seeing there is not a significant to us in the acquiring business, but just wanted to see what trends you're seeing there. Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you for the question, Jorge. Listen, your first question was difficult. (00:48:00) how do I see earnings growth going forward beyond 2019. But I am saying (00:48:09) under the assumption that the pension reform be approved, which means saying that we will stabilize the relation net public debt (00:48:21) over GDP. If this is the case, then we should be able to remain with a low inflation for a longer period of time. Interest rates could be even lower than they are. And I think that Brazil, which is our main market, would see sustainable growth well above this 2.5% (00:48:47) figure which we forecast for this year.

With this scenario and view, I think that the levels of – the level of earnings growth that we are seeing this year is pretty sustainable and could even be increased. I think it's a very positive scenario for the country and I think the idea that you have a stable low interest in Brazil can make a very significant change in economic behavior – in the behavior of economic actors in general. Of course, it could also bring more competition. It would bring a reduction in some specific margins. So all the things that happen around our virtuous (49:38) cycle, is in play, but I see this as very positive for our business.

Without mentioning, the efficiency gains, which will come from technology advance, I mean, we are already – I mean, implied in our guidance for this year that we are already increasing our efficiency in almost 1% despite the increase above inflation and in costs. And I think we could increase it even more with all the investments, which we are making in technology.

Now, coming to your second question. I think that if we don't take into consideration that the drop in fees from the acquiring business, we could be at least one point above the range, which we kept even from three to six.

Q - Jorge Kuri {BIO 3937764 <GO>}

All right. Thanks for your answers.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you.

Operator

Our next question comes from Marcelo Telles, Credit Suisse

Q - Marcelo Telles {BIO 3560829 <GO>}

Hi, hello, gentleman. Thanks for your time, Candido, Milton, and Alexsandro. I have a couple of questions. The first one, I was wondering if you could give a little more clarity regarding your NII growth assumption for 2019. I mean, when you look at both altogether, the margin requirements and the 12-year margins, would you – you are growing almost 10% or you expect to grow at almost 10% your NII at the midpoint of your guidance. And if you look at the fourth quarter and we look at the carry each of 2019, we are talking about roughly 2% growth, right? So compared to some of your peers, you do seem to have a much more optimistic expectation regarding NII growth.

So what you're seeing there, I mean, do you consider any potential pressure on quite the spreads (52:13) or you think you really don't see that happening anymore since you have adjusted your portfolio already? And are you seeing any potential gains on your funding side as well? So if we could explore that number which I think, to me, it did surprise on the upside, that will be great.

And my other question is with regards to your excess return. I know there are some questions already related to that, right, but currently your excess return is quite high compared to some of the previous levels and you – and despite all the competition and potential pressure (52:57) spreads you feel confident that you can maintain that sort of excess return at least like in the short to medium term, is that a fair assessment?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you for your questions, Marcelo. First on NII, you mentioned optimism, as I said I mean – our all our guidance here is based upon the approval of the pension reform and a scenario in which the Brazilian economy grows between 2% and 2.5% this year. So this per cases (53:40) as in all the items of our forecast. This is the optimistic part, if you will. The rest, there's more mathematics than optimism. So in financial margin with clients, the main explanation for the growth in financial margin we acquire is a technical fact, which is the fact that the balance, the average balance in 2019 will be significantly higher than it was in 2018 which was – to compare to the fourth quarter of 2018.

So, this was not the case in the previous year. In the previous year, we have grown the concessions in credits very vigorously, but it took us a long time to replace the credits which were paid. And so there was no growth in average portfolio in 2018 over 2017. And we expect a significant growth in average portfolio this year. This explains more than 50%, much more than 50% of the change in margin. And it also applies to these volumes. They also refer to the volumes in liabilities, not only in assets.

Besides that, there is this effect of mix and not moving from credits with a more probability of default, to progress to higher probability of default, but with a higher margin. As I mentioned before, I mean, we are paying the price for this extra loss in our cost of credit line. That grows accordingly because of this change in mix. But so I feel this line of financial margin in this client is very much in line with the whole focus. I don't think this line is more aggressive or more difficult to make than the rest of the – than the other lines of the guidance which you see.

Then, you make a question about excess return. We live in a very competitive environment in Brazil, I think you see how our competitors behave and how we are fighting for market (56:34) in every market and so on. I think that what drives our ability to show this good returns is how able we are to compete. So, if the results will be sustainable, if we can keep our competitive stance in the market and we are investing a lot and working hard to be able to make it and even to improve it.

So, yes, I think this is – these returns are sustainable. Of course, I mean, and as in a previous question was made, if the cost of capital is significantly reduced, then there will be a general trend to reduce margins, and maybe this phenomenal returns may suffer. But we are not seeing that yet, and we are confident that we are able at the foreseeable future to maintain this return on equity.

Q - Marcelo Telles {BIO 3560829 <GO>}

That's very helpful, Candido. Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you, Marcelo.

Operator

The next question comes from Domingos Falavina, JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Thank you, Candido, Alexsandro, Milton and the teams there (58:09) as well, also for taking the question. Mine is just more regarding the expense side. We noticed when we compare to peers a little bit more of an investment project I guess going on in Itaú, and I was just wondering which lines exactly do you intent like (58:24), are you assuming branch expansion? Is this more like on which product line, even more IT driven back office? Just spend a little bit more what Itaú had in mind as far as where to deploy the expenses?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

If I understood your question, you're asking more about our costs, right?

Q - Domingos Falavina {BIO 16313407 <GO>}

Yes.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

So let me say, the most important part of the cost increase is tied to volumes. These are variable costs which vary as the bigger volume of transactions increases. There are different types of costs so this is the next thing. So since portfolio is increasing 8% to 11% since the financial margin is increasing 9.5% to 12.5%, I mean, these all drives an increase in non-interest expenses higher than inflation.

Despite that there were two types of investments last year which were made throughout the year and that this year we will bear the full impact of this cost. And this was mainly hiring people, hiring people to distribute the acquiring products and this is what matters to stabilize our market share in the acquiring business last year and this year, we bear the full cost of this new hires.

And in our projects, in the insurance activity where we are distributing third-party insurance so we also hired an insurance specialist, who are now seeking in our branches, in many of our branches. So I'd say these are the three main items of the cost increase. Important to mention that despite this cost increase, our efficiency index will improve by almost 1% according to our guidance.

Q - Domingos Falavina {BIO 16313407 <GO>}

That's very clear, Candido. Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome, Domingos.

Operator

The next question comes from Natalia Corfield, JPMorgan.

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

Thank you for the question. And I have actually one question on issuance and I apologize if it had already been asked as I joined the call a little bit later. I'm curious to know about your views on the international capital markets, and this is because you placed a local AT1 very recently, I think at the beginning of January, at a very good price. And importantly, it was well below the levels where your AT1s are trading internationally. So, I'm wondering if this means that you guys are not planning to access the international capital markets in 2019, if you're going to be in – focused on the local markets given the liquidity that you have there and it's like, if you could give color on that, I would appreciate. Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you for your question, Natalia. Yes, as a matter of fact, I mean we are very satisfied with the issue we made earlier (01:02:01) in the local markets. We have identified pockets of demand, significant pocket of demand in the local market and an opportunity to do this, I think just to have some room to issue AT1. This room is now much smaller and we have 1.1% of AT1 issue, as you know the CD is 1.5%, but we have to account, to leave some room for currency devaluation since a part – a significant part of our AT1 is denominated in dollars. If there is a currency devaluation, it will grow in percentile terms and we do not want to run the risk of having idle AT1 because it's a product too expensive to let it idle in our book. So I am not foreseeing going to the market in the near future. We are not leaving it and – but I think it will be some time before we tap the markets again. I mean, we are at very comfortable levels of capital.

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

Right. So, in terms of AT1s, I understand that you already accomplished what you want. And – but what about other types of issues? Like, even a senior – would the international market be (01:03:36) or not at all because you have – you can have it very cheaply in the local market.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

No, I wouldn't say that. I would say, I mean, no, we're just looking at the markets and if there is a good opportunity of tapping international markets then we'll see. Demand for (01:03:54) international and then we'll see, demand for the credit investment (01:03:58) there is no reason why we wouldn't do it.

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

Right. But in terms of like pricing nowadays it's – which one is better for you, internationally or local?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Still local markets, still look better for us.

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

All right. Okay. Thank you very much. That answers my questions.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

(01:04:21)

Operator

The next question comes from Nicolas Riva, Bank of America.

Q - Nicolas Riva {BIO 20589225 <GO>}

Yeah. Thank you very much, Candido, for taking my question. Just one on capital, so we saw an important drop in the level of common equity tier 1 after the additional dividends and increase on capital, now it's 12.5%. I believe that in the past you have said that your target was around 12% for the CET1, you can confirm, is that still the case? And, therefore, we should assume that you're basically done in terms of (01:04:55). Thanks.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

I'm not sure I understood your question but if I think I understood I mean our – I mean, we want to have 13.5% of level one capital out of which, as much as possible, AT1s. So up to 1.5% of AT1 and at least 12% in quarter two. This is – I mean what our risk appetite expresses, expressed by our board in the case. And so clearly we come back to this level as we are coming back now to the level of 15.5%.

Q - Nicolas Riva {BIO 20589225 <GO>}

Okay, thanks, Candido.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome.

Operator

This concludes today's question-and-answer session. Mr. Candido Bracher, at this time you may proceed with your closing statements.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Okay. So thanks everybody for participating and for the very good questions. I mean, we look forward to the next calls when we expect to materialize the guidance which we provided now. Thank you.

Operator

That does conclude our Itaú Unibanco Holding earnings conference for today. Thank you very much for your participation. You may now disconnect.