Q4 2016 Earnings Call

Company Participants

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

Other Participants

- Gustavo Lôbo, Analyst
- Marcelo Cintra, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

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

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

Daniel Sonder {BIO 18250247 <GO>}

Good morning. Good morning for those based in North America and good afternoon for those based in Brazil and other regions. We'd like to welcome you to our quarterly earnings conference call to discuss fourth quarter and 2016 full-year results. First, I'd like to read a brief statement on the proposed business combination with Cetip.

As disclosed to the market on February 10, BM&FBOVESPA and Cetip filed a request to the antitrust authority, CADE, for a 60-day extension of the period of analysis of their proposed business combination, pushing the maximum period of analysis to April 24. It's important to highlight that the transaction must be approved by CADE, the Brazilian Securities Commission, as well as the Central Bank of Brazil. Any additional disclosure regarding the subject will be made exclusively through the legal formal channels.

So, I'm going to begin the presentation on slide 3 with the fourth quarter 2016 highlights. I am surrounded by the Finance and the Investor Relations teams, which will be available during the Q&A period as well as my colleague in the executive committee, José Andrade, Chief Products and Clients Officer in the company. And just before I begin, I wanted to thank the Finance and the IR team for once again preparing the materials and putting together all the financial presentations and the releases that you have in front of you. Once again, this is very helpful I hope.

So, we'll open our earnings presentation in slide 3 with an overview of what happened in our operating and financial results during the fourth quarter of last year, as well as in 2016. Then we'll go into some more details in the following slides. On the top of the slide, we see the operating and financial highlights for the BMF and Bovespa segments, as well as for other revenues not tied to volumes traded.

Revenues from BMF segment derivatives remained flat in the fourth quarter 2016 when compared to the same period of 2015, and slightly negative in the full-year comparison. In both quarter and full year, the growth in the ADV was offset by lower average revenue per contract, RPC. In the Bovespa segment, revenues grew 22.5% and 8.3% in quarter and in the full year, respectively, driven by higher ADTV.

Revenues from other business lines showed double-digit growth in both comparisons, highlighting the strong performance of Tesouro Direto. Average assets under custody in this platform increased 76.8% and 82% in the quarter and full year comparisons, respectively.

Moving to the bottom of the slide, in fourth quarter 2016, total revenues totaled BRL 692 million, an increase of almost 15% compared to the same period of last year, while adjusted expenses grew 21.2% impacted by some non-recurring items, which will be discussed in the next slide. In the fourth quarter of 2016, IFRS net income was BRL 927.9 million, impacted by non-recurring items. Excluding those extraordinary items, net income would have been BRL 525 million.

For the entire year of 2016, total revenue reached BRL 2.6 billion, 4.8% above 2015, while adjusted expense totaled BRL 653 million, 6.3% growth in the period, within the budget set for the year and in line with overall inflation. Excluding extraordinary items, net income would have been BRL 1.8 billion. Finally, we distributed BRL 900 million in interest on capital over 2016, representing 62% of the 2016 IFRS net income. As you know, the company is preparing to pay for the cash portion of the Cetip transaction, and this explains why our payout ratio in 2016 was lower than the level in the past years.

We move now to slide 4. We summarize in the table the non-recurring items that impacted our fourth quarter 2016 and 2016 full year, aiming to help you on your analysis. For this reason, we show the amount before and after taxes. As you can see, the largest items in the year were related to our sale of the CME shares and some provisions which we discussed in the third quarter. We can go more into details about these non-recurring items in the Q&A, if you wish.

Moving to slide 5, I would like to highlight some landmarks of the execution of our strategic plan in 2016 by listing some of the strategic initiatives that aim at offering growth opportunities and value creation to shareholders. The first one is the proposed business combination with Cetip. This transaction was approved by the vast majority of shareholders of both companies, and I would like to take the opportunity to thank you once again for all the support in this transformational transaction.

Now, while we await for the conclusion of the analysis by the regulators, we have begun planning some aspects of the integration, always within the boundaries set by regulation to ensure service excellence will be preserved, expected efficiencies will be delivered, and potential synergies will be captured over time. We're very excited about this transaction and we have received nothing but support from clients and staff on both sides.

Second, we have had significant progress in the equity space of the Clearinghouse integration project. As you know, this is a project that is expected to deliver capital as well as back-office efficiencies to market participants, and it has been a key focus of our company. We look forward to delivering it in the next few months.

We also continued to focus on products and market developments. We hired market makers with inflation-linked contracts in addition to some other enhancements. A new ETF referenced in the Bovespa Index was launched, increasing to 15 the number of ETFs available. We are in the process of reviewing our special listing segments rules, aiming to raise the bar in corporate governance standards for companies listed in the Novo Mercado and Level 2 segments.

Innovation in IT is key to preserving our excellence in providing high-quality services and products for our clients. Recognizing that, our board of directors established an IT Committee with outside experts in order to further help the company in monitoring new technologies that may bring opportunities or impacts to the business.

Finally, we advanced in implementing our strategy in Latin America. We acquired 4% of the Mexican Exchange and 10% of the Colombian Exchange, while increased our stake in the Santiago Exchange to approximately 10.4%. Additionally, in January 2017, we acquired 8.6% of the Lima Stock Exchange and appointed a representative for the board of directors of that exchange.

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

Rogério de Araújo Santana

Thank you, Daniel. Hello everyone. I would like to ask you to move to slide 6, where you can see on the left side chart that shows the greatest contribution to revenue in the fourth quarter 2016 came from the Bovespa segment, shown as cash equities and equity derivatives in the charts and reflects pick-up in volumes in this segment.

Revenues not tied to volumes kept its positive performance and also contributed to revenues growth, mainly due to the strong performance of Tesouro Direto as Daniel mentioned a few minutes ago. Finally, roughly 20% of the company's top line were U.S. dollar-linked in this quarter, slightly lower than the level we saw in the previous quarters, mainly as a consequence of the appreciation of the Brazilian real against the U.S. dollar in the period.

Moving to slide number 7, you will find details on the performance of the financial and commodity derivatives market. Revenues in the BM&F segment, as we call, (09:25) was flat in the year-over-year comparison, since the 55.9% increase in the total ADV was offset by the decrease of 35.8% in the RPC in the comparison with fourth quarter 2015. As we can see in the chart on the right side, the higher ADV in interest rates in reais and Mini contracts drove total ADV's growth.

On the other hand, the lower RPC in all group of contracts and change in the mix with higher participation of Mini contracts resulted in a significant reduction in the average RPC in this segment. The Mini contracts have an RPC that is significantly lower than the average of other groups of contract, so a higher participation of them in the overall volumes had a negative impact on the average RPC, as shown in the bottom right side of the slide.

Note that last year, in the fourth quarter 2015, Mini contracts represented roughly 25% of total ADV and contributed for almost 4% of the BM&F segment revenues; while in the fourth quarter 2016, we see the representativeness of Mini contracts in the total ADV increasing to roughly 34%, while the revenue contribution was slightly lower than 7% of the segment. Additionally, the Brazilian real appreciation against the U.S. dollar also had a negative impact in the average RPC since in fourth quarter 2016, 48% of the revenues in this segment were U.S. dollar-linked.

In slide number 8, we have the performance of the equities market where we saw 25% growth in the ADTV. This growth was driven by the 21.6% increase in the average market capitalization that reached BRL 2.3 trillion (sic) [BRL 2.51 trillion] (11:27) in the fourth quarter 2016, combined with higher turnover velocity that reached 82.3% versus 79% in the fourth quarter 2015.

On the other hand, trading and post-trading margin reached 5.064 basis points in the fourth quarter 2016, or 3.6% decrease year-over-year. This reduction is explained by a higher participation of day trades in the overall ADTV for which fees are lower than the average, and higher participation of volumes connected to the expiration of options on equity indices for which trade and post-trading fees do not apply to most of the volumes.

Moving to slide number 9, we highlight other sources of revenues that are not related to volumes traded. This group of revenue, as you can see in the gray piece of the charts, represented 23% of total revenues in the fourth quarter 2016 and grew 18.5% year-over-year. This growth resulted from solid operating performance of some products and services, notably the Tesouro Direto as previously mentioned. It is important to highlight that this group of revenues was also impacted by a BRL 16.9 million non-recurring and no cash reversal of provision connected to change made by the company to its health care plan in 2016.

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

Daniel Sonder {BIO 18250247 <GO>}

Thank you. In the next slide, slide 10, we show the expense breakdown for the quarter. For the year 2016, adjusted expenses were BRL 653 million, within the guidance of BRL 640 million to BRL 670 million, and representing a 6.3% growth versus 2015, in line with overall inflation for the period. In the fourth quarter of 2016, adjusted expenses were BRL 207 million, a 21% increase year-over-year. Adjusted personnel expenses, which exclude long-term incentive plans, were 19.1% higher, mainly explained by the annual salary adjustments of 8.6% applied in August 2016 and higher bonus expenses. This has to do with how we provision bonuses over the first three quarters of the year since there was no increase in total bonus expenses for the company versus 2015.

The growth in data processing, our second largest expense item, is explained by inflation adjustments to some IT maintenance contracts, and the impact of the appreciation of the U.S. dollar against the Brazilian real between January 2015 and December 2015, given that a cash flow hedge was set-up for a portion of these contracts denominated in foreign currency in those months. We also had in the fourth quarter 2016 an BRL 18 million expense related to the transfer of proceeds to our self-regulatory organization, BSM, compared to only BRL 8.3 million in fourth quarter last year.

We move now to slide 11; we issued new debt in December 2016 in order to be prepared for the payment of the cash portion of the proposed business combination with Cetip. As a consequence, the company's financial leverage has increased temporarily. On the top of the slide, we provide this new debt profile, beginning with the bilateral loan of $125 million at 2.57% per annum interest with equal monthly amortizations of $10.4 million plus interest and final maturity on January 2, 2018.

It's important to point out that the monthly amortization of this loan will be matched against our U.S. dollar-denominated revenues from derivative contracts, hedging this revenue against changes in the exchange rates. By adopting this cash flow hedge method of accounting, any gains or losses related to exchange rate variations on the loan and on most of the U.S.-denominated revenue in the derivatives market will be booked in the shareholders equity, no longer impacting the company's quarterly results until the loan matures.

We also issued BRL 3 billion in debentures at a cost of 104.25% of the DI rate, roughly 50 bps over the benchmark, and with semi-annual interest. We have the final maturity on December 1, 2019 with 50% principal payment on December 1, 2018.

Finally, our U.S. dollar senior unsecured notes in the amount of $612 million issued in July 2010 has a final bullet maturity on July 2020, and semi-annual payments of – coupon payments of 5.5%. In March 2016, the principal amount of the 2020 notes was hedged against changes in the Brazilian real versus the dollar through swaps, and in September 2016, the company entered into NDFs, non-deliverable forwards, to hedge certain coupons. It's important to highlight that this higher financial leverage is a temporary situation due to the Cetip combination, and we expect to pay down this new debt within a three-year period assuming the business performs according to plan.

Moving now to slide 12, we highlight our financial robustness with a solid cash position, which is an important part of the business of being a credible counterparty in the financial markets. Total cash amounted to BRL 14.7 billion at the end of the year composed by BM&FBOVESPA's own cash and third-party cash, mainly related to collateral pledged in cash by clients.

On the left-hand blue side of the graph, we can see the third-party cash which amounted to BRL 2.3 billion, mainly composed by market participants' cash collateral of BRL 1.7 billion. It's important to highlight that the company earns interest on most of this cash balance. On the right side, represented by the green bar, you'll find BM&FBOVESPA's own cash, composed of restricted and unrestricted cash amounting to BRL 12.4 billion as of December 2016.

BM&FBOVESPA's own cash includes the necessary cash to run the day-to-day activities of the company that totals between BRL 2 billion and BRL 2.5 billion. This amount includes approximately BRL 1 billion including house's required safeguards. The remaining adds to the liquidity that supports our activity as a central counterparty and general corporate needs.

Excluding this cash position that is necessary to run the business, we have almost BRL 10 billion in available cash including BRL 5.5 billion in gross proceeds from the divestment from CME Group and BRL 3.4 billion in proceeds from the debt transaction concluded in December 2016. As mentioned before, we are retaining the significant additional cash position to fund the proposed transaction with Cetip.

Moving now to slide 13, we see the financial results. Fourth quarter financial results amounted to BRL 188 million, a decrease of 35% over the fourth quarter of 2015. This comparison was impacted by an extraordinary dividend of BRL 173 million paid by CME Group last year, which added to the number in the fourth quarter of last year and offset the growth in financial revenue from higher cash balance carried by the company during 2016.

On the right side of the slide, we show the financial expenses that were mainly impacted by the derivatives cost to hedge the 2020 notes which totaled BRL 67.6 million in the quarter. This amount reflects the costs of the hedge for the principal and some coupons of the 2020 notes. Other impacts shown are BRL 17.6 million in interest of the debentures issues in December and BRL 11 million cost of stand-by facilities of BRL 2.7 billion which were engaged by the company in connection with the transaction with Cetip, but were not drawn.

In slide 14, we show the company's cash generation before payment of interest on capital, dividends, or repurchase of shares. The cash generated in 2016 reached almost BRL 2.1 billion, an increase of 19% year-over-year. The net cash from operating activities was positively impacted by the higher financial revenue coming from a higher cash position.

On the right side of the slide, we show the cash destination for the fourth quarter made up of BRL 221 million in CapEx, BRL 188 million in investments in Latin America, and BRL 532 million in interest on capital paid in 2017, with reference to 2016. We also highlight the BRL 826.7 million in first quarter 2017 obligations, which include BRL 368 million in interest on capital already paid in January, BRL 400 million for the settlement of the FX swap as of December, and BRL 59 million in interest on the 2020 notes, already paid in January. Considering all this, the cash retained in the company amounted to BRL 330 million.

We conclude in page 15, where we show the time line for the business combination with Cetip, which is currently in the regulatory analysis process. And as you may already know, we filed a request to CADE, the antitrust agency, for a 60-day extension of the period which will extend the analysis until a maximum April 24. The extension was required in order to allow us to send additional information to the regulators and also to coordinate the action between the several regulators we're interacting with.

I would like to end now this presentation and open our Q&A session. Thank you.

Q&A

Operator

Ladies and gentlemen, we'll now begin the question-and-answer session for investors and analysts. Our first question comes from Gustavo Lôbo, JPMorgan.

Q - Gustavo Lôbo

Hi, everyone. I have two questions. First one is regarding operating expenses. And in the quarter, there was this increase in personnel expenses. I was just wondering how much of it or if any of it is related to projects being concluded and some personnel expenses migrating from CapEx to OpEx?

And then my second question is regarding your guidance for 2017, it implies a total OpEx growth of 3.428%. Just wanted to understand what are the trends extracted to each one of the lines, namely personnel expenses which be impacted by this shift from CapEx to OpEx, and potentially the IT expenses or any other U.S. dollar-denominated expenses that can be benefited by the stronger BRL? Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Gustavo. So, with regards to your first question, we have not yet seen a significant migration from our expenses from CapEx to OpEx. The items that were a little bit higher in the fourth quarter in terms of expenses were some provisions that we made for some changes in the management of the company that have taken place and will take place in 2017 as well as, as I mentioned, we accrued slightly lower bonuses during the first three quarters and this was adjusted in the fourth quarter. So, it's sort of an one-off into fourth quarter that basically made the total bonus line equal to what it had been in end of (24:25) last year. Our adjusted personnel expenses, if you look at the adjusted personnel, it grew by 4.6% only. So we have not yet seen this effect, if you are correctly pointing out, which we will begin to see in 2017 in fact.

Regarding the guidance for 2017, we do not give sort of details broken down guidance by expense lines. We do give the general number, which obviously makes the commitment of the company in terms of where it sees expenses going and yet preserves some flexibility for management to manage between lines as the year progresses. So, we are going to begin in 2017 to experience the end of these projects and therefore some additional expenses in personnel, but we are taking measures with that in mind in order to keep overall growth aligned with inflation once again.

Q - Gustavo Lôbo

That's very clear, thank you. One more quick question, if I may. You have all of these investments in Latam exchanges. Given the very big size of BM&FBOVESPA this not that much material for you, but just wanted understand, what can we expect from this relationship that you have with these other exchanges? Should we expect a new revenue line related to it, or just an improvement in relationship with our neighbors; what is exactly the rationale here? Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Okay. Well, thank you again. I think I've addressed this a few times already, but I think it's always good to touch on it again. I think we have moved sort of along this project in the direction that we had intended from the outset. We have completed four investments, we have allocated BRL 280 million in this, which is less than $100 million. Again, it's not money that we don't think is a lot, but in the context of everything else that we're doing, we think this is a sound amount to invest in a diversified opportunity through several exchanges. So, it's not putting all the eggs in one basket.

We find that there's dialogues that we can begin with these exchanges, we needed to be investors first. Now, we're going to move into getting board seats and trying to influence the discussion. And further down the line, I think we can look at a few opportunities, which will have to do with attracting investors and issuers from those markets into our exchange, and also trying to see if there are some product initiatives or other cooperations that we can do in order to increase the liquidity in those markets and therefore the value of our investments.

So, we can make money either through additional revenues that are brought our way or through the pick-up in the value invested in these exchanges. These are however long-term initiatives. There is no cookie cutter formula that will work in every country. In each place we're going to have a different set of interactions and plans, and as they become more concrete, we will share that with the market. But this is a medium- to long-term project and I think we're moving along in the speed that we had envisioned.

Q - Gustavo Lôbo

Understood. Thank you very much.

Operator

Our next question comes from Marcelo Cintra, Goldman Sachs.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Hi. Good morning, everyone. Thank you for taking my questions. I have two questions actually. The first one it's somewhat an update and a follow-up follow up on your comments regarding the business combination with Cetip. On slide 15, you show here that the deadline for CADE on the transaction would be on April 24, the possible final deadline could also be May 24. I'd just like maybe some clarifications here. Is CADE – will CADE be able maybe to ask for another maybe 30 days extensions following this 60 days or the April 24 would be the final deadline for the transaction? I'd just like some visibility on that. And then, I'll follow up with my second question. Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Marcelo. So, this is a slide that was put together with the help of our legal team, because technically it is in fact possible for them to ask for an additional 30 days after the first 60 days have expired. However, we have been interacting with them and with the CVM and we agreed with them that we would request the 60-day period. So I think it would come as a surprise to us at this point if they were to ask for the additional 30 days between April 24 and May 24.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Oh, okay. Thank you. That's very clear. And my second question is just I'd like to hear from you, like you mentioned that you expect to pay down all the debt in three years. But what is the dividend payout ratio that you are considering under this assumption? I'm just asking this in order to maybe better understand if it's possible to have 80% payout ratio in 2017 or if this 80% payout ratio could be postponed maybe to around 2018 or something like that?

A - Daniel Sonder {BIO 18250247 <GO>}

Yeah. So, thank you. So, we don't give out a very sort of straight guidance on payouts because the board and us, we'd like to keep flexibility for every meeting for us to consider how the business is doing and our needs. (31:27) However, having said that, under reasonable business assumptions, it seems to us that we could probably have pay out in the range of 70% for the next three years, and yet still pay down the debt in that period.

How would that be possible? The fact of the matter is that, that's a ratio calculated on IFRS net income and there is a lot of non-cash items that will impact our IFRS net income. So, you have the current goodwill, you have future additional goodwill and amortization of intangibles that will come our way after the completion of the combination. So, there's a lot of non-cash items that impact the bottom line, and that's why the payout ratio sounds pretty high.

But in general, what we are working with is to pay the maximum interest on capital we can on every single one of these years and don't do any buybacks. And that would allow us to have a robust distribution to shareholders and yet amortize debt.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. Perfect. And if I may just a quick follow-up, on the non-cash items that you mentioned, of course you have the goodwill amortization from the merger between BM&F and Bovespa. I'd just like to understand (33:08) the amortization of the goodwill should be ending by the end of 2017, so you wouldn't have this benefit in 2018. Does it make sense or you're still having any benefits on 2018 as well.

A - Daniel Sonder {BIO 18250247 <GO>}

No. You're correct. The goodwill of the Bovespa transaction is in its last year; 2017 is the last year. So, as of 2018, we don't have that anymore. We will have the new one.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. That's perfect. Thank you very much.

Operator

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

A - Daniel Sonder {BIO 18250247 <GO>}

Well, I just wanted to thank everyone for joining the call, and more broadly, for following our company and keeping up with our information. As always, please make sure you reach out to the investor relations team if you have any more specific questions that we were unable to properly address in the call. Thank you so much. Bye-bye.

Operator

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