Q3 2014 Earnings Call

Company Participants

- Cícero Augusto Vieira
- Daniel Sonder
- Eduardo Refinetti Guardia
- Rogério de Araújo Santana

Other Participants

- Alexandre Spada
- Carlos Macedo

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Audio Conference Call about the Earning Results of BM&FBOVESPA for the Third Quarter of 2014. 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. Eduardo Guardia, Chief Product and IR Officer of BM&FBOVESPA.

Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Thank you. Hello, everybody. Welcome to the BM&F third quarter earnings call. I have with me today our CFO, Daniel Sonder; and our IR Officer, Rogério Santana. I will start with a few highlights, and then I will hand over to Rogério who will walk you through the numbers in more detail. One of the quarter's main highlights is clearly the increase in volumes compared to the previous quarter. Although total revenue growth came almost flat compared to the third quarter 2013, we have observed a 15.5% growth over the second Q 2014, reflecting recovery in volumes for both the equities and derivatives segment.

In comparison with the third Q 2013, the BM&F segment average daily volume rose 7.3% but was offset by the 6.4% fall in the average rate per contract in the same period. For this reason, both revenues came flat year-over-year. In the Bovespa segment, total revenue was up 2.5% in comparison with the third Q 2013. Although average daily trading value was roughly flat year-over-year, the increase of 9.9% in market capitalization and the 2.6%

margin increase more than compensated the turnover velocity decrease, which reached 66.8% versus 73.7% in third Q 2013. It is important to emphasize that although the company's total revenue was flat compared to the third Q 2013, net revenue was up 2%. It is explained by a 24% reduction in the (02:48). This was due to a once and for all share (02:53) effect explained by the use of tax credit.

From the operational point of view, I would like to highlight our continued effort to keep expenses growing below inflation. Adjusted expenses reached R$146.8 million in the third quarter 2014, a 2.3% decrease compared to the second Q 2104. In the nine months through September 2014, adjusted expenses grew 2.5% significantly below the inflation in the same period. Concerning the financial results and net income, these results were affected by the company's adherence to the tax relief program. As we have already disclosed to you, this tax dispute was related to the deductibility of expenses from Bovespa Holding's IPO. With the adherence to the program, the amounts under dispute was reduced from R$123 million to R$69.2 million.

This one-off impact was accounted as income tax, R$45 million, and as financial expenses R$18 million. And these one-off expenses explain the 4.6% reduction in the financial results, and the 11.5% reduction in the adjusted net income. Before I hand over to Rogério, I would like to make three more comments. Firstly, concerning price adjustments and expenses. In September and October, we announced a number of actions aimed to improve our pricing structure and incentives. The price adjustments are set to take effect in 2015, and the main measures we announced were the elimination of fee discounts for DMA, Direct Market Access, in the DMS segment and the rebates paid to local lenders in the securities lending market.

Concerning listing, the analysis fee we currently discount from the annuities we charge from issuers will no longer be discounted. And in addition, we will now charge analysis fee for services we provide in connection with tender offers, IPOs and follow-on. The prices of market data products and services will be adjusted. And we are also introducing additional distribution products and services. We also revised the fees related to custody and depository receipts. And last but not least, today, we announced an important change in the key structure of the interest rate contract. We have reduced the fees for contracts with maturity up to 210 days, in 44% on average. And we have increased the fees of contracts with maturity over 210 days, in 35% on average. The impact of this change is revenue-neutral for the company. Nevertheless, we do believe that the fee reduction of the contracts with short maturity (06:22) should result in higher volumes.

Secondly, concerning our strategic projects, on August 18, we implemented the derivative phase of the new integrated Clearinghouse and of our new risk methodology, the CORE, CloseOut Risk Evaluation. This integration project creates a unified platform, offering greater integration and automated treatment of process, combined with capital efficiency for final customers.

The delivery of this complex and challenging project was an important achievement for us and for all market participants that were involved in this implementation and which are now benefiting from it. The first implementation stage has been designed for financial and commodity derivatives in addition to OTC derivatives, such that customers trading in these contracts now have the ability to benefit from our integrated risk management capability. We successfully kept down margin requirements by approximately R$20 billion without adding any additional risk for investors and market participants. We will now be working on the implementation of the equities module.

My last comment is that the day before yesterday, BMFBOVESPA and S&P Dow Jones Index announced the signing of a Memorandum of Understanding for the creation and launch of new co-branded equity indexes for the Brazilian market. The new indices will be calculated, published, and globally commercialized by S&P Dow Jones. The idea is to launch new indices based on market factors as dividends, volatility, and multi-assets, also based on risk control, value and sectorial indices, each based upon established and recognized S&P Dow Jones methodology. Any new index will be designed to potentially serve as the basis for investment product based on index.

We strongly believe that the agreement also paves the way for a closer relationship between the two sides, including expansion into other asset classes, particularly fixed income. We see this partnership as a very important step towards increasing our opportunity in the development of the Brazilian capital markets. This move will improve our ability to launch new products based on the new indices, particularly new ETFs, options, and futures.

Now, I would like to hand over to Rogério.

Rogério de Araújo Santana

Thanks, Eduardo. I would like to ask you to move to page number four where you'll find some details on the Bovespa segment performance. As you already know, ADTV reached R$7.3 billion in 3Q 2014, slightly higher than the third quarter of 2013. This flat volume scenario results from a combination of almost a 10% increase in the average market capitalization that was offset by reductions based on other (09:45) velocities that as Eduardo mentioned in the first slide, fell from 73.7% one year ago to 66.8% in 3Q of 2014.

Considering that volumes were flat, the increasing revenues from the Bovespa segment was explained by a 2.6% growth in trading and post-trading margins. This growth reflects a positive mix effect in this quarter where the main change were, lower participation of local institutional investors and day traders in the overall volumes. Remember that this kind of investors they pay lower fees compared to the average price, combined with higher participation of equity derivatives that we charge higher fees than average. As you know, market activity was quite weak in the beginning of this quarter, notably in July when the turnover velocity fell to levels below 6%. Then from mid-August, volumes started to improve as we got closer to the election for President in Brazil. As a consequence, volumes grew more than 80% over the previous quarter and reached all-time high levels in October.

Moving to slide number five, we see information on volumes and prices in the BM&F segment. Here, different from what's happened in the Bovespa segment, volumes grew, but was offset by reduction in price. The ADV reaches 2.7 million contracts, a 7.3% growth over 3Q 2013, mainly driven by higher volumes of mini contracts and the interest rate in U.S. dollar contract. As you can see on the top left of this slide. The average RPC fell 6.4% and was impacted by the mix effect with higher participation of lower priced contracts, notably mini contracts and options, coupled with higher participation of day traders in the overall (11:51) we also charged lower fees.

Additionally, the Brazilian real depreciation against the U.S. dollar in the periods negatively impacted the average RPC, since around 44% of our revenues in this segment is priced in U.S. dollars. Turning the page to slide number six, once again we see how diversified our revenues are reflecting our fully vertical integrated and diversified business model. There was no significant change in this chart compared to the previous quarter with derivatives markets being the main source of revenues for the company and cash equities trading revenues representing closer to 6% of total.

Now, I will pass the floor (12:38) to our CFO, Daniel Sonder who will drive you through our expenses and the other financial highlights.

Daniel Sonder {BIO 18250247 <GO>}

Thank you Rogério and Eduardo. I would like to ask you to move to page seven please where we start to detail some of our expenses. As we can see in the chart, adjusted expenses, which is a (13:03) cash expenses fell 2.3% year-over-year, which we consider a significant result considering that most of our expense line are typically subject to contractual or, otherwise, mandatory adjustments that run slightly above average inflation.

Our largest expense line is personnel, representing roughly 50% of total. Excluding stock option expenses, our adjusted personnel expenses fell 2.2% in comparison with three quarter 2013. This was driven by, one, a reduction in accrual of bonus expenses for the quarter, reflecting a more challenging environment for volumes. Second, a higher amount of personnel expenses being capitalized as investments, mainly in connection with implementation of the derivatives base of our new integrated Clearinghouse which occurred in mid-August. And, lastly, by some additional adjustments in headcounts which we executed.

There is a 11.5% year-over-year reduction in IT and data processing expenses, and that is mainly explained by what happened last year when we saw a slightly higher concentration of these expenses in the third quarter. Although in the third quarter of 2014 we have already seen some additional expenses related to IT maintenance contracts for our new Clearinghouse, it is important to remind you that the full impact of these new recurring maintenance contracts will be fully felt only in the fourth quarter of this year.

Another example that I wanted to point out of efficiency comes from the communication line. That fell 30.3% year-over-year. This reflects, among other things, our effort in reducing our spending for mailing statements to investors who hold positions in our depository. We are planning to move to fully electronic mailing system, electronic mailing and SMS system next year. I also want to explain the significant growth in other expenses from the third quarter last year. This is due to an increase in donations and contributions made by us, including the transfer to BSM, our self-regulatory organization, of the fines which are collected by BM&FBOVESPA from market participants, and also, an increase in the contributions to a higher education grad program, which we sponsor called Ciências sem Fronteiras.

If you move to the next page, page number eight, I just wanted to emphasize the nine-month performance of adjusted expenses, which, in the first nine months to September 2014, grew only 2.5% in comparison to the same period of 2013, significantly below inflation. As mentioned, most of our expense lines would grow above average inflation, if we did not adopt a very strict expense discipline.

You can see in the table that all of our main expense lines are decreasing in real terms, reflecting our commitment with expense control and the pursuit of greater efficiency that is part of the culture of this company.

Adjusted expenses in the nine months 2014 reached R$417 million. And in accordance with our expense guidance for the year from R$585 million to R$595 million, we should see some increase in expenses in the fourth quarter of this year vis-à-vis the previous quarters as happened in other years.

This will be the case, because we will, then, in the fourth quarter, have the full impact of wage increases linked to our annual collective bargaining agreement on the personnel line. Second, we expect to see the increase in recurring IT expenses from the maintenance of our new Clearinghouse. And, third, we would transfer additional resources to fund BSM regulatory activities in 2015 as we did in 2012.

Nonetheless, even considering this foreseen fourth quarter quarter-over-quarter increase, our full year 2014 adjusted expenses should grow between 1.6% and 3.3%, again, below inflation.

Finally, on the last page of my segment, which is page nine, you see the financial highlights. You can see on the left side the breakdown of our cash position and financial investments as a central counterparty for the markets we manage. We must and will continue to be a robust and resilient and have a very conservative financial position. This profile is expressed through our cash and financial investments.

However, due to our cash flow generation which is strong, we are able to, at the same time, keep that robustness in our balance sheet and yet not compromise our commitment to returning capital to our shareholders. We have maintained a payout ratio of 80% of accounting net earnings and combined that with an intensive share buyback program that already reached 4.1% of our free float this year.

Finally, just to point out, our financial results were impacted by an increase in financial expenses of R$18.1 million, which was connected to the REFIS, the tax program which was mentioned earlier in the presentation.

I'll turn it back to Eduardo Guardia for his closing remarks.

Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Thank you, Daniel. If you move on to page 10, we give you an overview of the deadline for the next phase of the Clearinghouse integration, which is the integration of the equities Clearinghouse. This phase includes the cash market, equity derivatives, and security lending. Our objective is to complete the IT development in the fourth quarter of 2015. And once it is completed, we will discuss a detailed deadline for the certification and production parallel with market participants and regulators.

It is very important to emphasize that the go-live is subject to the Central Bank approval and revenues of market participants. Cícero has joined us, and I'm sure he will be glad to give you more detail on the Clearinghouse integration process during the Q&A.

Moving on to page 11, we emphasized a very important aspect. The capacity and resilience of our IT infrastructure has (19:50-20:17)

Operator

Ladies and gentlemen, please hold. Ladies and gentlemen, please hold. BM&FBOVESPA audio conference will resume shortly. Mr. Eduardo, you may proceed.

Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Okay. I apologize that we have a problem with our connection. So I was on page 11 and I was mentioning that we are completing today 486 uninterrupted trading days with the PUMA platform. Concerning the new Clearinghouse, less than three minutes after its launch, we have already handled record volumes in the BMF segment without any problem. So the message is that the investments in trade and post-trade platforms ensured the resilience of our systems in a period of message and trade peaks. Ms. Furtado is also with us to give you more detail on that during the Q&A.

So these were our initial comments. Now, we would like to open up the call for your questions. Thank you very much.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Mr. Carlos Macedo with Goldman Sachs.

Q - Carlos Macedo {BIO 15158925 <GO>}

Thank you. I have a couple of questions. Good afternoon, gentlemen. So first one is regarding the implementation of the Clearinghouses. And when you first launched this a few years ago, you were talking about concluding it at the end of 2014. And now, we're looking at the end of 2016. Just wondering if there's any chance that this gets delayed, given the Central Bank approval process, if it can get – brought earlier? And what implications would be for CapEx in those years where – over the next couple of years?

Second, you talked about changes in pricing and new products that you're launching – sorry, changes in pricing for the several products that you have including on the derivative side. I was wondering this month of November, you already have the impact of trading with the higher – of the higher volumes in October impacting your pricing.

On the equity side, I was wondering if you're considering, given the outlook for volumes is a little bit more subdued now, given the low market cap, if you have any intentions in adjusting the pricing for equities in the next several quarters.

A - Cícero Augusto Vieira

Thank you, Carlos. Regarding the first question about the timeline for the integration of our four CCPs, originally, we thought that it could be possible to work in the integration of all CCPs simultaneously, and also to test that with more than 70 brokers that have to connect to the new CCP. Further, we realized that it wouldn't be feasible, it wouldn't be realistic to have about 70 brokers testing the integration of the four CCPs simultaneously and the timeframe was adjusted, as you know.

That said, the launch of the first phase in August this year, as Eduardo said, was extremely successful. We had no major IT incidents. We released to the market almost $9 billion in collateral deposits.

The second point is that we are very confident that knowing that now, we're going to work on phase two that we're going to finalize internal testing and also internal IT development by the end of next year.

And then the implementation in production environment is going to happen in 2016, and that's really going to rely on external factors, such as Central Bank approval, and also the testing cycles and process of brokers that have to connect to the CCP. One aspect, which is very important, is that we can now benefit from the experience acquired during the first phase. So brokers now understands exactly what we mean by production parallel tasking, by what we mean – with the new environment and how this process unfolds over time. So although we have more accounts in the cash equity CCP, so the number of trades and the number of accounts is larger, which brings some additional complexity to the new phase. The track is non-FAS (25:51), it's a non-process because it was going to replicate what we have successfully implemented during the phase one.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Carlos, concerning your second question...

Q - Carlos Macedo {BIO 15158925 <GO>}

(26:06).

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Okay. Go ahead.

Q - Carlos Macedo {BIO 15158925 <GO>}

Just one second, Eduardo, if you would allow me. Cícero, thank you for your answer. Maybe, Eduardo, you could also help answer this follow up. So the CapEx range that you have for 2015 is between R$190 million and R$220 million given that the development in 2016 will be more – it won't be as much development but rather implementation and waiting for Central Bank to approve and all that. Would it be realistic to believe, to assume that following this development phase in 2015 that CapEx will decline below the levels that you're already guiding for the year, for 2015 and 2016?

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Yes it is, Carlos. We have already given you the guidance for this year, for next year. As you know, CapEx is already declining. When you look to the numbers for 2013, 2014 will be below 2013, 2015 will be below 2014, and that's our expectation. We have no reasons today to revise the guidance, so we expect to see CapEx going down. And of course, this guidance is already considering all the investments we have to make in the Clearinghouse integration. So that's – we don't expect to see any change in the guidance. Certainly any material change in the guidance for the next years in CapEx will continue to go down. So that's our view.

Going to your second question on pricing, I would say that with the announcement that we made today about the interest rate futures, and the announcement we made last week about the depository fees, I think the most important changes that we had to announce, we have already done that. So I don't expect, going to your question, to see – we don't expect to see any relevant change in the fee structure going forward, particularly in the equities segment. We have made a lot of important change in 2011, 2012, 2013 in the equities fee structure, and we don't expect to see anything in the near future.

Q - Carlos Macedo {BIO 15158925 <GO>}

Thank you, Eduardo.

Operator

Our next question comes from Alexandre Spada with Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi. Good afternoon. I have two questions, actually. First one related to the share buyback program. We can see BVMF3 is currently below the average buyback price executed year-to-date, which is R$10.6, as written in your press release. Can we assume that at this current price level the company will resume a faster execution of its buyback program?

And also, is there a cash or a net cash threshold below which the company would not be willing or capable to continue executing the buyback program?

A - Daniel Sonder {BIO 18250247 <GO>}

Alexander, this is Daniel here. Thanks for the question. I think that as we have done in the past, we try to manage that process quite carefully and looking at it periodically also with the support of our board. Historically, we have, I guess, used the buyback program to be a complement to our dividend policy in terms of returning capital to our shareholders, the capital generated in the company. We don't see, at this point, any reason for why we should significantly change upwards or downwards our cash position. So I think that the best way for you to look at this is essentially to look at cash generation for the year, look at how much we have paid in dividends, and how much we have purchased. And that's kind of how we look at it.

We, of course, have tried, given those restrictions that I mentioned to you, or those concepts that I mentioned to you – we try to be a little bit more aggressive when prices are down as we did in the beginning of the year. But I think that the key message here is that financial robustness is our top – number one priority. And after that, we try to just simply return capital to shareholders in the best way possible.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you. And if you allow me a second question, could you provide an update on the disputes over the goodwill amortization?

A - Daniel Sonder {BIO 18250247 <GO>}

Yes. There is really no update since I think we last spoke to you, guys. We have, as you know, appealed the decision from late last year to the same first-level chamber of the CARF, to the appeals board and the tax authority. We haven't been heard yet. And we might be heard next month again or the following, there's – every month there is the expectation that we might, that our case might be heard. So we haven't got any news for you except that we are still in the same stage that we were before.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you.

Operator

This concludes today's question-and-answer session. I'd like to invite Mr. Eduardo Guardia to proceed with his closing statements.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Thanks. I just want to thank again for joining us today. Should you have any other question, please do not hesitate to contact us. Thank you very much.

Operator

This concludes BM&FBOVESPA audio conference for today. Thank you very much for your participation. Have a good afternoon and thank you for using Chorus Call.