Company Participants

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

Other Participants

- Alexandre Spada, Analyst
- Neha Agarwala, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call about the Earnings Results of B3 for the Second Quarter of 2018. At this time, all participants are in a listen-only mode. Later, we'll 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 B3.

Daniel Sonder {BIO 18250247 <GO>}

Good morning. I'd like to welcome all of you to B3's second quarter 2018 earnings call. I'm here with Rogério Santana, Head of the Investor Relations, as well as the Finance and Investor Relations teams of the company. And I'd like to take this opportunity to thank them for preparing the documents you have in front of you. Additionally, on behalf of the entire executive team of B3, I'd like to thank you all for your continued trust and support of us.

I'd like to start the presentation in slide 3. We show the operational and financial highlights for the quarter. As we will show in greater detail during the presentation, we had a very strong performance this quarter with revenues growing in all segments. Average volumes grew 37% in BM&F and 47% in Bovespa, reaching all-time highs in both segments for the second quarter in a row. Once again, our systems were fully prepared to deal with these unprecedented volumes witnessed in some of our markets. This was only possible because, over the past years, we have made significant investments in our IT infrastructure, raising the bar in terms of performance, risk management and systems availability.

On the right side of the slide, we see that our revenues grew by 29% year-over-year, reflecting the very strong operating performance in the second quarter of 2018. For the sake of comparability, it is important to mention that second quarter 2018 had two working days more than in the previous year.

Our adjusted expenses reached BRL 237 million, 4.2% higher than in the second quarter of 2017, impacted by inflationary adjustments that apply on wages and contracts, which represent a significant portion of our expenses. EBITDA adjusted for non-recurring items was BRL 971 million, an increase of almost 44% versus the previous year with a margin of more than 77%.

B3 has considerable operating leverage, which delivers higher margins in periods with strong operating performance such as the second quarter of 2018. Our EBITDA was also positively impacted by the reduction of expenses that are impacted by the market price of our own shares B3SA3.

Our recurring net income reached BRL 857.9 million, an 80% increase, mainly explained by the increase in operating results and by the positive impact of income taxes in the quarter.

And now, Rogério will give some more details about our operating performance.

Rogério de Araújo Santana

Thank you, Daniel. Good morning, everyone. I would like to ask you to move forward to slide 4 where you will see the revenue performance and breakdown for the second quarter 2018. In the bar chart on the left side, we see that revenues from all five segments (00:03:55) year-over-year, leading to a 28% growth in total revenue.

The highlights were that BM&F and Bovespa segments, while the increase in the Cetip Liens and Loans segment is mainly a consequence of change in the business model of some services, which we will analyze in more details in the coming slides. In the pie chart on the right side, we see the breakdown of revenues for the quarter, which shows the highly-diversified revenue base of our company.

Moving to slide 5, you will find the performance of the financial and commodity derivatives market where we had a 39% revenue increase year-over-year. As you can see, we experienced significant volume growth in all group of contracts, leading to all-time high volumes in the segments. The two most significant groups of contracts, the interest rate in reais and the FX rate grew more than 20% year-over-year, while stock index contracts more than doubled in the period.

The average RPC was nearly stable versus the second quarter of 2017, reflecting the appreciation of the U.S. dollar against the real, with positive impacts in the RPC of FX rates and interest rates in U.S. dollar contracts, which was offset by the higher participation of day traders and high-frequency traders in Mini contracts since they pay lower fees than average.

In slide 6, we have the performance of the equities market in the Bovespa segment, where we saw revenue growing almost 48% year-over-year, driven by a 47% increase in the ADTV, which went up from BRL 8.5 billion in the second quarter 2017 to BRL 12.5 billion in the second quarter 2018, all-time high for the segment as well. This performance reflects the volatility in the Brazilian capital markets during the quarter. What was translated in the increase (00:06:09) from 77% one year ago to 89% in the second quarter 2018.

In addition, the average market capitalization increased by 27% over the same quarter of 2017, reflecting the recovering of equities markets in Brazil. Both performance are shown in the bottom-right charts in this slide.

Trading and post-trading margins fell 3% year-over-year due to discounts triggered by volumes and mix effects. We have higher share of institutional investors and day trades which pay lower fees than average and lower participation of equity derivatives in the overall ADTV, since equity derivatives is – the fees that applies on that is higher than the fees that applies on cash market.

Next slide, number 7, we present the performance of the Cetip Securities segment. The value registered of fixed income instruments was up 24%, driven mainly by increasing issuance of bank deposit certificates or CDBs. This increase in turn propelled the outstanding value of fixed income securities which reached BRL 4.7 trillion in the second quarter of 2018, 14% higher than in the second quarter 2017.

It's also worth to mention the recovery we saw in the registration of OTC derivatives which grew 32% year-over-year. This performance is mainly connected to higher volatility in the FX rates that resulted in the increase of demand for hedged products.

Finally, it's worth note that the second quarter 2018 revenue in this segment reflects the impact of sharing of expense synergies captured in the business combination with Cetip. The sharing of these synergies was translated in price discounts amounting to BRL 7.8 million (00:08:20) in the quarter and applied on different services and as a consequence in different revenue lines within the (00:08:27) segment.

In slide 8, we show revenue for the Cetip Liens and Loans segment, which grew 20% over the second quarter 2017. When analyzing the different revenue lines in this segment, the increase of 17% in Lien revenues reflects the 8.8% (00:08:51) rise in the number of vehicles financed and certain adjustments to our pricing schedule for this service.

Regarding the Contracts System, the increase of 28% in revenues is explained by the implementation of the new business model for these services in the states of São Paulo starting from January 2018 and Santa Catarina starting from April 2018. I will go in more details on that in the next slide.

It's also important to highlight that the company's market share in the Contracts System fell to 63% in the second quarter 2018 from 74.6% in the second quarter 2017. This reduction is explained by the fact that B3 has not offered the Contracts System service in state of Minas Gerais starting from September 2017.

Moving to slide 9, the Contracts System services has been impacted by changing the business model, triggered by a federal regulation released in September last year. Following this regulation, each state of Brazil is adapting its own model differently. So far we can say that there are three different models adopted by the states.

The first model, for example, was adopted in Minas Gerais state and it impedes B3 to offer its services as I mentioned in the previous slide. A second model was adopted in the states of São Paulo and Santa Catarina, and it introduced a new player in the (00:10:37). And as a consequence, B3 is earning roughly 30% less than in the model in place before this regulatory change. Finally, we have the case of Rio Grande do Sul that adopted a new model without any significant impact to B3 economics.

In the states that we operate that hasn't changed their model, we see two possible outcomes from when they adapted. Adopt the model in similar manner as São Paulo and San Catarina states, and B3 preserves around 70% of the economics of the business or implement the business – the same model of Minas Gerais, meaning that B3 will no longer be able to offer its services in these states.

You can see the share of these two group of states that have not adapted their models yet. In the two lines in the bottom of the table, you see in the slide, and we can go in more details in the Q&A section on where each state is in this process.

It's important to mention that the State of Pernambuco, which is one of the states within the transitioning states group in the table, switches to the same model adopted in São Paulo and Santa Catarina as from this week. The impact of the migration of Pernambuco on revenue-linked expense is already contemplated in the guidance, which is close to the (00:12:09) market last quarter. So we are not expecting any changing on that at this point.

Now, I will hand over the presentation back to Daniel, who will detail our expenses and other financial highlights.

Daniel Sonder {BIO 18250247 <GO>}

Thank you, Rogério. In slide 10, we show the behavior of the company's adjusted expenses. Adjusted expenses reached BRL 237 million, a 4.2% increase year-over-year, reflecting mainly the increase in personnel expenses from annual salary readjustments.

As we disclosed in December 2017, all the decisions and measures that were necessary to entirely capture the expense synergies of the merger were made and executed by the end of 2017. And as a consequence, since the first quarter of 2018, we can enjoy the full benefit of the synergy gains from the combination with Cetip.

In the next page, slide 11, we show 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 8 billion at the end of the quarter, composed by B3's own cash and third-party cash, mainly related to collateral pledged in cash by clients.

In the light blue bars ,you find B3's own cash composed of restricted and unrestricted cash amounting to BRL 5.7 billion. B3's own cash includes the necessary cash to run the day-to-day activities of the company that totaled between BRL 2.5 and BRL 3 billion. The cash balance at the end of the second quarter of 2018 includes BRL 452 million in interest on capital that's already paid out in early May 2018.

The bars on the left side of the chart show third-party cash which amounted to BRL 2.4 billion, mainly composed by market participants cash collateral of BRL 1.8 billion. It is important to highlight that the company earns interesting income on most of this cash balance. I misspoke earlier when I said that the interest on capital of BRL 452 million had been paid in May, it was actually paid in July.

And finally moving to the last slide, which is slide 12, you will see that the company's debt profile and amortization schedule is depicted there. Currently, our financial leverage is temporarily higher with a gross debt to adjusted EBITDA ratio of 1.8 times in the second quarter of 2018. Our target is to reduce this ratio to 1 time by the end of 2019, following debt amortization schedule you see in the bar graph on the upper-left-side.

As you see in the chart, we have a BRL 1.6 billion (00:15:05) debt amortization scheduled for December 2018. Considering the company's cash position at the end of second quarter and the cash generation we forecast for the remainder of the year, we believe we'll be able to amortize the debt while at the same time keeping a payout ratio between 70% and 80% of the IFRS net income.

In the first half of 2018, our payout ratio was 63% of our IFRS net income for the period, which means they're likely to increase distributions to shareholders in the second semester to meet our payout guidance subject to board approvals.

I'd like to end the presentation now, we had a strong quarter. This was thanks to our clients' trust in us. This was thanks to their business also being strong, and we are very happy that we've been able to meet the demands of additional investors and people who want to seek our markets to entertain their investment strategy, hedging strategies and funding strategies. So this is obviously a key priority of the company that our clients do well, so that we can do well. And I think we have a number of initiatives here to secure that going forward.

And I'd like to open the Q&A part of the discussion right now. Thank you very much.

Q&A

Operator

Ladies and gentlemen, we'll now begin the question-and-answer session from investors and analysts. Our first question comes from Alexandre Spada, Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, gentlemen. Good morning. First of all, congratulations on the solid results this quarter. I have two questions. First one is, can you comment on the schedule for the delivery of new products and services for this second half of 2018. And also, among these new services or products you may introduce, which ones do you think could be the most promising from a revenue generation perspective? And then, I'll come back with a second subject. Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Spada. We are currently working both internally and with market participants on aligning exactly the priorities that you mentioned. As you know, we spent most of our time last year and early this year making sure that we executed on the merger combination, doing some internal changes to some of our key areas.

And among them, two very important areas where we, I think, made relevant changes that are going in the right direction in our view are exactly the client coverage/relationship management area, and also the project management and sort of execution of new products area.

So we are now, in the second half of this year, actually articulating with the market what the priorities will be. And in terms of the – sort of the scope of what we want to address is additional ideas in futures and in equities and also in fixed income registration. So unfortunately, I'm not in a position right now to give you a lot more information and to answer your question better, but I think we'll be able to do that by the end of the year.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you, Sonder. And if you allow me, another subject. You commented in the initial statements – actually Rogério did about the ongoing changes in the registration of contracts. But the concerned Rule Number 689 also introduces certain changes that may have implications to the liens registration service as well.

So can you share with us if you expect any changes in the economics of debt (00:19:34) service as well on the back of these regulations, or if you think the changes in economics should be restrained to the contract registration service?

A - Daniel Sonder {BIO 18250247 <GO>}

Yes. Thank you for the questions. That's quite important. So we – at this point, we believe that most of the changes are going to be in contract registration rather than lien. We have obviously been in close contact with the regulators as well with the banks. And it seems to us at this point that there's not, let's say, a very fast-moving agenda in any respect to change the Liens business. So if we hear differently, we'll obviously be transparent with the market about that. But at this point, it seems to us that, that has been, let's say, set aside for now at least in terms of any major changes in the Liens segment. So we feel that's pretty stable for now and most of the changes are actually taking place in the contract registration, but excellent opportunity for us to make that clear. Thank you.

Q - Alexandre Spada {BIO 16687974 <GO>}

Thank you for the very clear reply.

Operator

The next question comes from Neha Agarwala.

Q - Neha Agarwala {BIO 17722501 <GO>}

Thank you (00:21:10). First question is on the Liens and Loans segment. You present in the slides what is your market share in the different states in Brazil. How could this market share change? Could you increase your market share in some of these states? And what are the other regulatory headwinds that you could see in this segment particularly? And then, I'll ask my second question.

A - Daniel Sonder {BIO 18250247 <GO>}

Great, Neha. Thank you for asking this. So we don't provide services now in about 37% of the number of contracts that are registered in Brazil divided by state, because this is a state-by-state business, in the sense that we must have a relationship or be plugged, our commercial relationship with (00:22:07) but we must be plugged to the local RMV (00:22:11). So this is a state-by-state activity. So when we are in a state, we basically show that we have the entire market share that, that state represents in the pool of total contracts registered in Brazil.

When we're not in those states we counted out. So we are now very focused on the states that we already have a presence due to the fact that they are going through this regulatory transformation, and we are trying to ensure always, in connection with the banks, that they end up in the best place possible from a regulatory choice.

Now, it is not to be ruled out completely, the possibility that some of the states where we currently do not have a presence could potentially in the future switch to a model similar to São Paulo for instance, where we do have a role to play.

So, I think your question is very relevant in the sense that, it's not only a – necessarily a scenario of loss of revenues or earnings in this business. We could, due to the new regulatory model, also have an opportunity in the future to gain market share in places where we're not. But it is very important to say that, that's not a priority for us at this point.

Q - Neha Agarwala {BIO 17722501 <GO>}

Very clear. Thank you so much, Daniel. Another question is on the Securities segment. Yeah, we heard in about May that the ABBC (00:23:57) was starting to launch a fixed income registration unit. Any development on that? And also on the new exchange which is trying to set up business, ATS (00:24:08), any update on that? Thank you so much.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Neha. So those two aspects are obviously areas that we are covering very closely. On the ABBC (00:24:25) effort, we have sought to interact with them, and we have had several conversations with them about strengthening the relationship between our company and the banks that basically are around this Banker Association and supporting this project of trying to open an alternative registration platform.

We have discussed with them ways in which we can better service them and think about future developments of products and also the relationship going forward. Now, at this point, the information that we have is that their initiative is indeed going forward to try to set up an alternative registration platform for some of the bank-funding securities, and we are following that very closely. We highly respect these banks as clients, and so forth.

We do however, feel it's important to point out that this is a challenging business to go into, and we know that firsthand, because as you might have followed at the time, BM&F, the former BM&FBOVESPA (00:25:48) prior to the merger did try to compete with the former Cetip, exactly in this business which is the registration of banking securities.

And the fact that Cetip, and now B3 does in our view, a very, very solid job in covering the clients and delivering for them resilient systems with very, very good customer service. It makes it quite difficult to answer that business and have clients switch over to a new platform.

So while on one hand, again we are staying close to these clients and trying to make sure that they are happy with what they're doing and they will look forward that we have a productive dialog. We also see with some care, the ability of new entrants to actually compete very successfully with what we do so. So, I think that those are my thoughts on this initiative, and we are following it quite closely.

On competition in equities trading and the potential entrants there, the current state of this is that, as you know, we have signed up a commitment with our regulators, and that basically made it formal what was already the position of B3 and BM&FBOVESPA before that regarding the ability of potential new entrants to connect to our platforms.

So given current Brazilian regulation in equities, it is already possible for someone to set up an alternative trading or clearing company, and connect to our clearing house or depositary if they wish to do so. We are firmly again committed to these possibilities in front of – vis-à-vis, our regulators and the market if the market should think that this is something valuable.

We obviously work very hard to meet the needs of our clients and brokers in trading and post-trading. And we think that the challenges are not small to set up on alternative platform; but if that's what the market at some point desires, we will be ready to also do our part. And hopefully, this will be an exciting moment of the Brazilian capital markets with growth, and with additional revenue opportunities that should more than compensate for any loss of market share in that regard.

So we have just one more point, which is we have an arbitration procedure that is ongoing, and that has to do with the prices that would be charged to investors who use our depository services if they connect through a different platform, and that is something that is still happening as we speak. And we don't expect an outcome in the near future, but probably something in the next few months.

Q - Neha Agarwala {BIO 17722501 <GO>}

Okay. Very clear. So if I understand this right, ABBC (00:29:32) is going ahead as your competition in securities. It might be challenging for them, but they are going ahead with setting up a platform. And you are in arbitration process with ATS (00:29:42) on the equities trading side. So there's still no clarity on when they can start operations?

A - Daniel Sonder {BIO 18250247 <GO>}

I wish I had spoken as precisely as you just have.

Q - Neha Agarwala {BIO 17722501 <GO>}

Thank you so much, Daniel. Again, this is Neha Agarwala from HSBC. I think they didn't get the name right.

A - Daniel Sonder {BIO 18250247 <GO>}

Yes. Yes. Thank you so much.

Q - Neha Agarwala {BIO 17722501 <GO>}

Thank you.

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>}

Once again, I'd just like to thank everyone for joining the call and also for following B3 very closely and for lending us your support. And to the team that's sitting next to me, again, thanks for putting all this together and please feel free to – anyone that wants to call us later, please feel free to do so. Have a good day.

Operator

That does conclude the B3 audio conference for today. Thank you very much for your participation. Have a good afternoon and thank you for using Chorus Call Brazil.