Q2 2018 Earnings Call

Company Participants

- Bernardo Rothe, Chief Financial Officer
- Daniel Maria, General Manager of IR

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Other Participants

- Carlos Macedo, Analyst
- Jason Mollin, Analyst
- Thiago Batista, Analyst
- Unidentified Participant

Presentation

Operator

Good morning, everyone, and thank you for waiting. Welcome to Banco do Brasil Second Quarter 2018 Earnings Conference Call. This event is being recorded and all participants will be in a listen-only mode during the conference presentation. (Operator Instructions). This conference call is also being broadcast live via webcast and through Banco do Brasil website at www.bb.com.br/ir where the presentation is also available. The replay of the conference call will be available through the phone number 55 11 2188 0400 until August 17, 2018, in English and Portuguese. To access the replay, please ask the operator to listen to BB's conference call. In that, identification will be required. Participants may view the slides in any order they wish.

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With us today, we have Mr. Bernardo Rothe, CFO; and Mr. Daniel Maria, Head of Investor Relations. Mr. Daniel Maria, you may now begin.

Daniel Maria {BIO 17030121 <GO>}

Good morning, everyone. Welcome to the earnings release teleconference for the second quarter 2018. Let's just start the presentation on page 4, with some earnings highlights. The adjusted net income in the second quarter '18 reached BRL3.2 billion. This is a change of 7.1% in relation to the first quarter '18 and 22.3% in relation to the last year --

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to the same period last year. In the first half 2018, the adjusted net income reached BRL6.3 billion. This is an increase of 21.4% in relation to the first quarter -- first half of 2017.

The fee income grew 5.5% in relation to the first half of '17, reaching BRL13.3 billion. The NII increased quarter-on-quarter 5.3% and reached 24.6% [ph] in the first half 2018. That implies a decrease of 8.1% in relation to the first quarter '17. The administrative expenses reached BRL15.8 billion in the first half 2018. This is an increase of 1.2% in relation to the same period last year and it grew below inflation. We highlight that we revised the credit provisions expenses guidance due to the outstanding improvements in the credit quality in the period. The new guidance -- the revised guidance for the period is BRL16 billion to BRL14 billion [ph].

Moving to the next page, we bring some market ratios. The adjusted earnings per share is BRL1.16 in this second quarter '18. That means a dividend yield of 3.65%. The price/earnings ratio reached 6.74% in the second quarter '18 and the ratio of price/book value is 0.78%.

On the next page, we bring the net income and profitability in two perspectives. Looking at the second quarter '18 and the first half 2018. It's important to highlight that the fee income covered 83.3% of the administrative expenses. This is the highest level since 2014. We bring also here the return on assets according -- using the marked standards. The ROE reached 13.3%.

On the next page, page 7, we bring the earnings breakdown. NII increased 5.3% comparing quarter on quarter. It's interesting to highlight the movements of the Treasury or the contribution of Treasury for the NII and also how the loan operations grew in the period. The NII for the first half reached 36.8 billion. This implies a reduction of 8.1% when compared to the same period last year. The fee income grew 5.5% in the first half 2018 when compared to the same period last year. This growth was driven by the checking accounts that grew 7.2% and the asset management that grew 13.2% in the same period.

The administrative expenses grew 1.2%, reaching 15.8 billion in the first half 2018. This growth below inflation shows a solid cost control and the cost to income ratio reached 38.9%. The credit provisions expenses decreased 29% in the first half 2018 when compared to the first half 2017. We want to highlight the improvement of the asset quality of the portfolio and mainly the contribution of the company's portfolio to that movement.

On the next page, we bring the loan portfolio on an expanded view. The loan portfolio increased 1.5% when compared quarter-on-quarter. The NPL ratio above 90 days decreased 31 basis points reaching 3.34%. This number includes the specific case and we want to inform that this case has already been solved in July and considering this case solved, the NPL ratio is 2.92% using the data for June. The NPL formation below -- is below the previous quarters and reached 0.55%. The coverage ratio increased to 166.18. Cost of risk decreased for the third quarter in a row, reaching 3.57%.

On the next page, we bring the loans to individuals that increased 2.2% quarter-on-quarter. We would like to highlight the diversification efforts in this portfolio. For instance,

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the credit card portfolio, salary loan and consumer finance showed some growth in the period. The NPL ratio above 90 days decreased 16 basis points, reaching 3.33%. The NPL formation is below the previous quarters, reaching 0.8%. The coverage ratio increased, reaching 175.75. The provision [ph] expenses was BRL1.8 billion in the period for this portfolio.

On page 10, we bring the loans to companies on an expanded view. The portfolio is almost flat compared to the previous quarter. We highlight that the middle market, corporates and governments portfolio increased in a way that compensated the reductions in the very small and in small companies portfolio. The NPL ratio above 90 days for this portfolio decreased to 5.2%, the fourth decrease in a row. The NPL formation for the period is below the average of the last quarters, reaching 0.54%. The coverage ratio increased to 151.46%. The credit provisions expenses decreased to 2 billion, being the lower volume since 2014.

On slide 11, we bring the agribusiness portfolio. Agribusiness portfolio grew 2.1% quarter-on-quarter. The NPL ratio above 90 days decreased 24 basis points, reaching 1.61%. The NPL formation is below the previous quarters, reaching 0.3%. Coverage ratio increased to 184.93%. The credit expenses, credit provision expenses was BRL1.2 billion. For the harvest 2018-2019, Banco Do Brasil made available BRL103 billion to finance. This implies an increase of 21% when comparing to the disbursements for the previous harvest.

On page 12, we bring the net interest margin. NIM increased 14 basis points in relation to the previous quarter, reaching 3.98%. When we analyze NIM considering the recovery, the increase was 25 basis points, attaining 4.48%.

On the next slide, we bring the spread by portfolio. The spread for the credit portfolio is stable when compared to the previous quarter and the spread for individuals portfolio is 16.45%, agribusiness 4.7%, and companies portfolio 4.62%.

On the next slide, we bring the BIS ratio. In June 2018, we reached 9.61% of CET1. This number includes the effects from the Resolution CMN 4680. We reinforced our targets to reach the minimum amount of CET1 of 11% in January 2022.

On the slide 15, we bring the changes in the CET1 comparing June numbers to March 2018. We highlight here that the decrease in the capital is mainly due to the mark to market of the security portfolio. The number of 9.61 includes the decision resolution CMN 4680 that allows the bank to add back to the capital, the tax credits generated with losses in the hedge up investments outside Brazil.

On the next page, we bring the guidance and the follow-up. The adjusted net income of 6.3 billion analyzed is in accordance with the guidance. The NII is minus 8.1% below the guidance, but much better compared to the last quarter. We see ahead, the NII heading towards the guidance. The organic domestic loan portfolio decreased 1% and mainly due to the behavior of the company's portfolio that decreased 7%.

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Individuals and rural loans and agribusiness loans is growing according to our forecast. The provision expenses, net of recoveries of write-offs, is 7.8 billion and we show here the new revised guidance of 16 billion to 14 billion for the year. Fee income increased 5.5% above inflation and in accordance to our guidance. Administrative expenses grew 1.2% in accordance with our guidance and below inflation.

With that, we end our presentation and we can go to the Q&A session. Thank you.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions). Our first question comes from Carlos Macedo from Goldman Sachs.

Q - Carlos Macedo {BIO 15158925 <GO>}

Hi. Good morning, gentlemen. Thanks for taking questions, Bernardo and Daniel. First question, if you could answer, I'm trying to get an understanding about margins. You said you expect the NII growth to migrate to where -- to your guidance by the end of the year. We're looking at originations and of course the originations are much stronger, particularly on the consumer portfolio, they're up I think 38% year-on-year, a little bit weaker in the second quarter on your corporate portfolio, but still in the consumer portfolio, really strong.

And if you look in your release, you can see that the rates on these origination are lower than they've been in the past. Your credit spreads or your yield on loans on the consumer side remains very strong. It's a matter of phasing that in. Should we expect any pressure on those yields as a result of the phasing in of the new loans that are coming (Technical Difficulty) Should we expect any pressure as a result of the lower spreads that are on the new loans?

Second, could you please just comment a bit on your SME book, both in terms of asset quality and in levels of origination, given that we have only rolled into the whole corporate book. Thank you.

A - Bernardo Rothe {BIO 18059993 <GO>}

Good morning, Macedo. Thank you for your questions. Sorry for the noise in the background. Anyway, going to margins, we've been seeing interest rates going down. That's true. But they are not going down to the same pace as Selic rates and the cost of earnings going down. In fact, with these impacts of the yield curve in Brazil in the second quarter, we start to see high interest rates in longer term duration types of transactions, because we price it, when we do that, we do based on the duration of these loans and looking at the yield curve over time.

So in fact, we had some increasing interest rates, given the change in the yield curve in Brazil in the second quarter. So, you know, margin is in a good pace. We are keeping them at a good level. You can see that the spread is pretty stable in the consumer book and how we calculate that spread, right, just to remind everyone. We look at the spread at the time that we've contracted deal and we kept that stable throughout the life of the transaction.

So although interest rates are coming down, the spreads that we are making in the new loans are at a very good level. So we see margin coming potentially next year, we are supposed to have more compression of spreads this year through competition, but the competition is not that strong out there, only in the lines of credit. We always had strong competition like (inaudible). So margins should behave okay from now on. We may see some compression of margins next year, if competitions start to pickup with a better economic recovery in the country.

In terms of the SME book, we've been growing with certain clients, what the level business we do, we follow our clients in the SME book. Remind you, that's what we released, not SMEs, very small and small companies, right, up to BRL25 million annual income. So -- revenues, so we've been focusing on growing working capital transactions, we are not focused on growing investments in this portfolio of clients. We still have a big portfolio of investments with this group of clients, although it's reducing participation over time, it's still a big portion of it.

As we are not growing this portion of the portfolio that carries a very low interest rate, risk-adjusted returns not that good. We should see the portfolio overall not to grow in this year, but working capital should stabilize and start growing, as we reduce the pace of the cleanup of the portfolio, taking out the old transactions that we have in the book and replacing with the new vintages that are coming at a very good quality and very good risk-adjusted return.

So we may see growth in this portfolio next year, because most of the clean up is going to be done by the end of the year, anyway. But again we are going to grow through working capital, not through investments. So even though we are growing at a very good pace in working capital, investments should keep -- put pressure on growth on the overall portfolio. Okay?

Q - Carlos Macedo {BIO 15158925 <GO>}

All right. Thank you, Bernardo.

Operator

Our next question comes from Thiago Batista from ITAU BBA.

Q - Thiago Batista {BIO 15398695 <GO>}

Hi, guys. Good morning, everyone. I had one question about NPL formation or the new NPL. This quarter, this new NPL was really very low. That's any, let's call it, no recurring event that impacted NPL formation or we can believe that NPL formation will stay around this neighborhood that the bank posted in this quarter.

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A - Bernardo Rothe {BIO 18059993 <GO>}

NPL formation, thank you for your question, Thiago. NPL formation should improve over time gradually. We may have some variation between one quarter to the other, but the trend is to have NPL formation improving quarter after quarter gradually. We may see some seasonality in the first quarter of every year, so we tend to have higher NPL formation in the first quarter every year. But second quarter then comes back to normal and then from there on, we should see NPL formation improving and then increasing a little bit again first quarter next year, given certain seasonality that we have in our portfolio with the consumer book and agribusiness .

We may have a big impact in the third quarter in the NPL formation for our company. It's coming from the final resolution of the one specific case that's pretty big one. Right, so for companies, we see them can be even negative. But that's the one off. The trend is to keep improving NPL formation gradually over time with some variations given some quarters.

Q - Thiago Batista {BIO 15398695 <GO>}

Perfect. Thank you, Bernardo.

Operator

Our next question comes from Jason Mollin from Scotiabank.

Q - Jason Mollin {BIO 1888181 <GO>}

Hi. My question is on your distribution strategy. We did see branches continue, well, I guess year-on-year, they're down 6.8%, very stable traditional branches quarter-on-quarter. But we saw you continue to add on the digital and specialized service points of sale. If you could talk a little bit about the strategy, what that means for headcount and if we could even see more improvement in use of these channels and costs. Thanks.

A - Bernardo Rothe {BIO 18059993 <GO>}

Thank you, Jason for your question. In fact, we're still deploying our digital strategy, so we still have things to be done. That, of course, we are not going to see a big reduction in traditional branches moving forward, right. These -- the change comparing June '18 to June '17 was almost 7% drop in the number of branches. Over time, that reduction should reduce, which is we've been doing pretty much what we have to do, but specialized services should keep growing for a while, as we deploy these strategies and we don't need to replace employees. So the natural attrition should reduce the number of employees moving forward as well.

So we are not -- we don't have any plans to do a big shift like what we did in the end of '16. Right? So, that should be normal business from now on, but the trend is reduction of traditional branches and increasing digital and specialized services over time with the natural reduction of employees coming from retirements and so on. Okay?

Q - Jason Mollin {BIO 1888181 <GO>}

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That's great. And we're seeing -- we've seen that your expense, your admin expense line is growing at least in the first half, grew inline, almost the lowest end of your guidance. So is there a possibility? I mean, is this the trend, you obviously didn't change the guidance, but is there any opportunity to beat that and reduce the expense growth below the 1% to 4%?

A - Bernardo Rothe {BIO 18059993 <GO>}

No, in fact, for this year, we should be close to the middle of the guidance, higher than -- a little bit higher than the middle of the guidance. Given that we have negotiations going on right now with the unions and we should have some increase in salaries happening from September on. So that would put some pressure in expenses, personnel expenses still biggest portion of our expenses. And I don't know, we don't know yet how much is going to be this increase. I can tell you that the unions are asking for inflation plus 5%. We are offering inflation that fits, so we don't have the final figure yet, should be closer to what we are proposing than what they are asking for. But that put some pressure on expenses in the second half among other things. So we should be over the middle of the guidance. Okay?

Q - Jason Mollin {BIO 1888181 <GO>}

Thank you very much.

Operator

(Operator Instructions). Our next question comes from (inaudible) from Citibank.

Q - Unidentified Participant

Hi, everyone. Thank you for the opportunity to ask questions. If we look at the average fee from the clients, we see that Banco do Brasil is actually lagging its private payers. We understand that this should be related to your divestments of some divisions that are used to generate strong fees, such as (inaudible). Do you believe that Banco do Brasil can close this gap through its private peers? Are there any initiatives in place from such? Thank you.

A - Bernardo Rothe {BIO 18059993 <GO>}

Thank you Gabriel for you question. Once you increase revenues made by clients through increase of product consumption by our clients. Right? So we want the clients to consume our products and service at Banco do Brasil. With that, we're going to increase their fees made by clients. And so it's part of our strategy. In fact, as we specialize our service, we are increasing our ability to serve clients on a active basis, meaning that with more relationship managers, we have more people, having points of contact with clients and that can generate more business and that's what we've been doing through technology, digital strategy and so on. So that's something that should keep going through the next year, at least.

So, yeah, we want to increase that, improve that indicator, but of course, we have some gaps here to cover, because we don't consider it part of the business. We do insurance as fees that comes in the equity income. And so part of what we have, we've kept in CLO in

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our case comes as equity income, not the fees. So that in the end creates a -- potentially, we are not going to be in the same level as our peers. That doesn't mean that we are not making the same level of income by clients as our peers. It's just that we report that in different parts of the balance sheet. Right?

So, but the fees part of equity income, but they still are having a good profitability with our clients, although the indicator is not going to show that directly because of the way we report the relationship with the joint ventures and that's the levers that we have. Okay?

Q - Unidentified Participant

Right, right. That's very clear. Thank you.

Operator

(Operator Instructions). This concludes today's question-and-answer session. I would like to invite Mr. Daniel Maria to proceed with his closing statements. Please go ahead, sir.

A - Daniel Maria {BIO 17030121 <GO>}

We appreciate your attendance to the conference call and the questions and we are available for further questions and clarifications. Have a nice day.

Operator

That does concludes Banco do Brasil conference call for today. As a reminder, the material used in this conference call is available on Banco do Brasil Investor Relations website. Thank you very much for your participation and have a nice day. You may now disconnect.

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