Q2 2019 Earnings Call

Company Participants

- Daniel Sonder, Chief Financial Officer
- Rogerio de Araujo Santana, Managing Director Investor Relations

Other Participants

- Domingos Falavina, Analyst
- Felipe Salomao, Analyst
- Pedro, Analyst
- Thomas Peredo, Analyst
- Tito Labarta, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call about the earnings results of B3 for the second quarter of 2019. [Operator Instructions]

I would now like to turn the conference over to Mr. Daniel Sonder, Chief Financial Officer of B3.

Daniel Sonder {BIO 18250247 <GO>}

Hello, everyone. I'd like to welcome you to B3's Second Quarter 2019 Earnings Call. I'm here with Rogerio Santana, Head of Investor Relations as well as the finance and Investor Relations team, and I'd like to thank all of them for preparing the document you have in front of you. Additionally, on behalf of the entire executive team, I would like to thank you for your continued trust and support.

starting the presentation Slide 3, I'd like to highlight some important achievements and figures of the second quarter of 2019. Once again, the quarter was marked by the expansion of the business opportunities for our clients and by high activity in the financial markets in Brazil. In this context, we saw strong numbers in the listed market. ADTV in cash equities of BRL14.7 billion and ADV of fixed income currencies and commodities of 3.9 million contracts. There are two other aspects that deserve mentioned. First, the incentive programs in the equity markets and in Treasury Direct aiming to expand individual investor base. The rebates and discounts related to these programs totaled BRL57.8 million in the quarter, and will discuss this topic in more depth later in the presentation.

Second, the revision of our guidance for adjusted expenses as a consequence of the inclusion of expenses from BLK Sistemas Financeiros and Portal de Documentos, two companies recently acquired by B3. As you know, we do not have revenue guidance out of the market, but the acquisition of these two operational companies will have a positive impact on revenues as well. Regarding our financial performance in the quarter, the diversification of our business across different markets again demonstrated its strength and our revenues reached BRL1.6 billion, an increase of 14% when compared to the second quarter of '18.

Our adjusted expenses reached BRL250 million in the quarter, 5.3% higher than in the second quarter of '18, which we will explain in more details later in the presentation. EBITDA, adjusted for non-recurring items reached BRL999 million, an increase of 3% over the previous year with an EBITDA margin of 70.3%. Recurring net income reached BRL785 million, a reduction of 8%. This decrease is mainly explained by higher income tax with no cash impact in the second quarter of '19 and the increase in non-cash expenses connected to our own share price.

We move now to Slide 4, we think it's important to highlight the level of activity of the local capital markets. We are seeing an unprecedented positive scenario for the development of the capital markets in Brazil with important factors contributing to the structural change. First, the current level and a consistent outlook for low interest rates, which creates demand for diversification and more risk appetite from investors. Second, there is a significant and hopefully permanent change in the policy adopted by the Brazilian state-owned banks regarding lending for corporates. This creates an opportunity for the capital markets to become the main source of funding for these issuers, which is leading companies to alternative capital and ownership structures. The result of these changes can be seen on the chart, which shows that we already reached more than BRL200 billion in equity and fixed income offerings, an impressive amount when compared with previous years.

Now, Rogerio will give some more details about our performance by segment.

Rogerio de Araujo Santana {BIO 20317880 <GO>}

Thank you, Daniel. Hello, everyone. I would like to ask you to move forward to Slide 5, where you will see the performance of the listed equity-markets. Revenue in this segment grew 26% year-over-year mainly driven by growth in revenues from trade in post-trading services, in cash equity and equity derivatives markets. ADTV in the cash equity market grew 22% from BRL12 billion in the second quarter 2018 to almost BRL15 billion in the second quarter of 2019.

This performance reflects the increase in the turnover velocity from 89% one year ago to more than 95% in the second quarter '19, coupled with the increase of almost 16% in the average market capitalization of listed companies in the same period. Still, we are seeing the trade in post-trading revenue. The ADV of stocking in the future contracts increased by almost 110%, reflecting the growth in trading of many contracts, notably by individual investors and high frequency traders. It's worth mentioning that revenues from our equity depository were impacted by incentive programs as Daniel mentioned, offsetting the increase in the number of accounts in the quarter. I will go in more details on that later in the presentation.

Moving to Slide 6, you will find details on the performance of the listed fixed income, currencies and commodity derivatives, which grew 7.6% in revenues. The main factors behind this performance were the high-single digit growth in the average volume in this segment coupled with the appreciation of the US dollar against the real in the period, which had a positive effect on the RPC of US dollar linked contracts.

Next on Slide 7, we present the performance of the OTC segments. In the fixed-income revenue line, the increase in volumes of bank and the instruments mainly certificate of deposit was offset by two things. First, the decrease in the Treasury Direct revenue due to the enhanced programs implemented in January 2019 to foster growth of this product and we will go in more details later. Second, the redemption of debentures issued by leasing companies following regulatory change that offset the growth seen in the local corporate backed markets as mentioned by Daniel earlier in this presentation. This is not a new aspect to do something that is impacting our business for the last few quarters. In derivatives, higher revenue were a product by the increase in volumes of FX-linked swap agreements and by the appreciation of the US dollar against the real in the periods, which impacted FX-related derivatives.

In Slide 8, we show revenues for the infrastructure for financing segment, which grew 36% over the second quarter 2018. Reflecting the effect of change in the business model off the contract system adopted in some states of Brazil during 2018 and early 2019. To clarify, the impact of these new models in the contract system, we show in the chart the breakdown of revenues as well as the breakdown of revenue-linked expense, among these services in this segment. As you see the growth in contract systems revenue has been more than offset by higher revenue-linked expense resulting in a small compression of our gains in these services.

Besides that, the National Liens System or SNG was positively impacted by the 7.2% increase in the number of the vehicle finances. Additionally, there was the annual price adjustment by inflation appliance on our fees that also had a positive impact on revenues. It's also worth mentioning that we completed the acquisition of Portal de Documentos as Daniel mentioned in the first slides, which we trust will have a positive impact on revenues from this segment going forward.

Moving to Slide 9, we can see the performance of the technology, data and services segment, which grew 8.7% in revenues. The growth seen in the technology and access line is related to the entry of new clients in the OTC markets, which pay monthly fee to access our platforms. In the case of the data and analytics line, the solid performance reflects the appreciation of the US dollar against the real given that almost 58% the revenue line is US dollar denominated.

On Slide 10, we give more details on the incentive programs to expand individual investor base in B3, like Daniel mentioned before, the lower interest rate environment is shifting investments from more conventional fixed income products to more sophisticated ones.

In this context and aiming to fulfill our essential role in the development of the capital markets in Brazil and supports the outstanding work done by brokerage firms. We have two incentive programs to expand the individual investor base in Brazil, one in equity -- in the equity depository and the other in the Treasury Direct, a platform that allows individual investors to buy government bonds directly. This is consistent with B3's stated objective of sharing with market participants and the clients in our ecosystem, part of the economic opportunity that we can from the growth in volumes in our markets. And here we are combining these objective with clear growth targets for (inaudible) and client. Both programs reward brokerage firms based on similar goals, growth in number of investors and growth in outstanding positions, where the hire, the target acheived, the higher the reward.

In the case of the equity depository brokerage firms, we see discounts while in the case of the Treasury Direct we receive rebates. The amount returned to these market participants totaled BRL57.8 million in the second quarter 2019 and BRL80 million if we consider the first half of the year. These are good examples of price incentives we can introduce to foster market development. We consider that expansion of individual investor base in our markets and products, we will be extremely positive for the market and for B3 in the medium to long term.

Examples of potential benefits from a larger individual investor base are positive impact over the last of the cash equity markets and increased liquidity, single stock derivatives, and small companies. We will continuously use these products and also seek new ways to further develop our markets in close partnership with our clients and intermediaries.

In the next slide, number 11, we show the Company's adjusted expense, which reached BRL249.9 million, a 5% increase year-over-year. The main factors were the increase in adjusted personnel expenses as a consequence of annual collective bargain agreement in August 2018 and in third-party services mainly related to advisory services in connection with product development.

Now, I will hand over the presentation back to Daniel who will show other financial highlights of the B3.

Daniel Sonder {BIO 18250247 <GO>}

Thank you Rogerio. In Slide 12, we demonstrate our financial robustness with a solid position in cash and a very healthy balance sheet, which is an important part of the business of being incredible counter-party in the financial market. On the left side, we show total cash amounted to BRL10.9 billion at the end of the quarter, composed by B3 on cash as well as third-party cash, mainly related to collateral pledged in cash by clients. In the light blue bars on this chart, you will find B3's own cash position amounting to BRL7.6 billion in the second quarter of '19, which includes BRL601 million of interest on capital and dividends already paid out in early July 2019.

On the right side, you see the Company's debt profile and amortization schedule. As previously announced, our guidance for financial leverage for 2019 is 1.5 times total debt to last 12 months recurring EBITDA. In line with this guidance this quarter, we concluded the issuance of three year debentures amounting to BRL 1.2 billion paying an interest of 102.8% of CDI. Finally, we reaffirm our payout ratio guidance between 120% and 150% of IFRS net income.

With this, I'd like to conclude the presentation here and open our Q&A session. Thank you.

Questions And Answers

Operator

Ladies and gentlemen. As we will now begin the question and answer questions from investors and analysts. [Operator Instructions] Our first question comes from (inaudible), Goldman Sachs.

Q - Tito Labarta {BIO 20837559 <GO>}

Hi, Daniel and Rogerio good to speak with you again. Thanks for the call. Couple of questions, I guess, first if you could maybe give some more color on the potential positive impacts from the acquisitions that you did. You mentioned they should contribute positively to revenue. So just wanted to get a sense of how you see the benefit of business in general and any color you can give on the potential impact? And I guess second question just in terms of margins, right. I mean we saw expenses rise, although partially due to some revenue linked expenses and stock options. So margins fell a bit in the quarter. So how should we think about your EBITDA margin because you do have operating leverage, but given some of these expenses are tied to some things I guess outside of your control in a sense. Yeah. Is it reasonable to assume that margins can increase as volumes continue to go up or is this 70% EBITDA margin sort of the peak? So I just want to get a sense and your thoughts on that? Thank you.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Tito, this is Daniel. So on the acquisitions, we are not providing details and guidance on the revenue side. Again, these are very small businesses compared to the total revenues of the Company. We find that they are long-term opportunities for us to strengthen our relationship with key clients in the case of BLK as you saw by the numbers in the transaction. This is quite a small company, but which we think provides a pretty nice service through the brokerage as well as the buy side [ph] asset management community. We don't expect meaningful financial impact from this in the near term. Portal de Documentos has a slightly bigger size, still very small compared to overall revenues to us. So, which again should we make a big impact on anything going forward in terms of projections in the near future, but it does again speed up our deployment of real estate related products in the finance unit and brings us closer the retail side of these large financial conglomerates, which we already serve under the auto (inaudible) loan platform, but which traditionally the historically has been a smaller client of ours. So we want -- we typically serve the wholesale side of financial institutions with the treasury and brokerage areas and trading areas and so forth.

So that's what we can, we can say for now about these transactions that cannot-- again very, very meaningful. We did, however, want to disclose the expense impact, because as you know, we have established a pretty tight budget policy internally for us as well as disclosing that to the the market in terms of our adjusted expenses. So we wanted to ensure that everybody understood that any changes in the expenses for the year were to these acquisitions rather than to any sort of more flexible position with respect to expense management in B3.

Q - Tito Labarta {BIO 20837559 <GO>}

Okay.

A - Daniel Sonder {BIO 18250247 <GO>}

With respect to the margin, again it's -- as you mentioned, the impact in margins was mostly due to these expenses that are linked to our stock price, these are non-cash expenses, provisions and adjustments in our -- in terms of the value of our stock-based compensation programs. So this is what happened this quarter. It's very hard for us to give any sort of guidance on margin. That's not how we think about the business in terms of our margin objective. We, as you know we have operating leverage. We have systems and platforms and personnel that can deal with much larger volumes and what you see is that we are implementing new programs, new projects as well as partnerships in coordination with the brokerage industry to push our volumes higher and their volumes higher if possible. One thing to note is that going forward, you should see less volatility on these expenses linked through stock compensation because as of the beginning of this year we've implemented a hedging onto those expenses by signing swap agreements with financial institutions, where we basically have the negative position vis-a-vis those banks with regard to our stock price. So that should be a more stable and you can take the second quarter expenses as a reference, a better reference going forward because you should see less change in that line.

A - Rogerio de Araujo Santana {BIO 20317880 <GO>}

Hi, Tito, this is Rogerio, just adding to the comments made by Daniel. Remember that we had two expense line that moves according to the share price, one is related to personnel expense and more specifically a long term (inaudible) for the management and other employees. These revenue line is the one for which we hedged the share price exposure, but the other expense line related to provisions for legal disputes for this one, you will see volatility because we do not have a hedging for that, although --

Q - Tito Labarta {BIO 20837559 <GO>}

Okay. Thank you.

Yeah, it's another -- last important comment is that there are -- as you know, different treatment for shares that we have in treasury and in fact we already have that, but the share price change does not impact our earnings, but at the same time these provisions impact our earnings because in each mark to markets, our exposure to the trading price every single quarter.

All right . Okay. Thank you. That's very helpful. Maybe just want to follow up on the acquisitions, since you do give guidance on the cost side, should we think about that the impact on revenues is marginal, so there is no impact on revenues? Or do we think that there is some offsetting revenue, so the impact on earnings is marginal, just wanted to get a sense given that you did give some guidance on the cost?

A - Daniel Sonder {BIO 18250247 <GO>}

The companies have -- have revenues. They are not just not very big and in terms of both -- their revenues compared to total revenues is not very big and the net impact of revenues minus expenses in the total EBITDA or net income of the Company is very, very small at this point.

Q - Tito Labarta {BIO 20837559 <GO>}

Okay, perfect. Great, thank you for clarifying.

A - Daniel Sonder {BIO 18250247 <GO>}

These are operating companies that have real revenues and clients.

Q - Tito Labarta {BIO 20837559 <GO>}

Okay, that's helpful. Thank you.

Operator

Our next question comes from Domingos Falavina at JPMorgan. Mr Domingos, you may proceed .

Q - Domingos Falavina {BIO 16313407 <GO>}

Thank you Rogerio and Sonder for taking the question. Congrats on the strong quarter. My question is more regarding the vehicle financing unit. We noticed the SNG, the contract registration revenue growing 48% year-on-year and based on the monthly figures this seems volumes of contract and it grew 5% year-on-year. So my question is, if you were to break down the 48% increase in revenues or 40% -- adjusting for the units, 40% price increase, how much of that is driven by new models where you have a cost embedded in the product? How much of that is actually net revenue gains or price increases?

A - Rogerio de Araujo Santana {BIO 20317880 <GO>}

Domingos, this is Rogerio. You mentioned SNG, but just confirm you're talking about the contract season, right?

Q - Domingos Falavina {BIO 16313407 <GO>}

I'm sorry, could you repeat that, the line broke up. I'm sorry.

A - Rogerio de Araujo Santana {BIO 20317880 <GO>}

You mentioned SN, the Liens System, but in fact our question is related to -- mainly to the contract system right?

A - Daniel Sonder {BIO 18250247 <GO>}

Cost, yeah the -- I apologize. Yeah.

A - Rogerio de Araujo Santana {BIO 20317880 <GO>}

Okay. So answering your question. Most of the revenue growth is related to the new business model instead of price adjustments. In fact as we tried to show in the slides, what we are seeing is that, although revenues are growing, expense -- additional expenses related to these new business model are growing faster. So in fact we have a small margin compression in our gains related to these services.

Q - Domingos Falavina {BIO 16313407 <GO>}

Super clear.

A - Rogerio de Araujo Santana {BIO 20317880 <GO>}

The only price adjusted to complement here. They only price adjustments that we had was the traditional annual adjustment by inflation in our contracts, only that.

Q - Domingos Falavina {BIO 16313407 <GO>}

Yeah. But that (inaudible) kicks in the first Q, right?

A - Rogerio de Araujo Santana {BIO 20317880 <GO>}

Yes. It's already reflected in the first Q, you're totally rights.

Q - Domingos Falavina {BIO 16313407 <GO>}

All right. I'm super clear, thank you.

Operator

[Operator Instructions] Our next question comes from Thomas Peredo, BTG Pactual.

Q - Thomas Peredo {BIO 21712295 <GO>}

Hello. Hi, Daniel and Rogerio and team. Thanks for taking my question. And I would like to ask about two things. The first one is related to the rebates and incentives you've grant since you expanded the retail investor base. Is that something we should expect to see more often from now on eventually expanding to other products? What is a little bit more color on the strategy here? Are you willing to share more -- more of the profitability with the markets and is there a maximum EBITDA margin that you are willing to surpass? And any color on the incentives strategy will be appreciated? My second question is related to competition incentive business, mainly on the security unit, which we're seeing new companies join the markets for instance the CRC is already doing the registration of credit cards receivables end markets -- you're still not involved with as (inaudible) as from the banks are already having some registration for solutions and feedback we have -- is that they planning your expense. Smaller banks are getting together and officially launching a competitor, what is the strategy here? Could you -- should we expect you to lower the prices going forward or mitigate potential share losses with new products, if you could give you more color on this also we appreciate it?

A - Daniel Sonder {BIO 18250247 <GO>}

Excellent. Thank you. Thank you, Tomas. It's great to hear from you and happy to know that you remain diligent on the other side of the table as you were -- when you were on our team. So just to talk about price and competition, I think the two questions are somewhat related. And let me try to address this. So with respect to the incentive programs. This is something that we have used in the past and that we have continued to -- to like as a way to bring more clients into the Company as well as strengthen our relationship with the distribution network of brokers and banks and other potential partners that are out there talking to investors and talking to clients about B3's services.

As a general concept, I would describe our thinking and strategy as follows. The Company has the opportunity to use its operating leverage to let's say create additional results as volumes grow, because our expenses do not grow proportionately in most of the businesses, if not all except with the financing unit, but in most of the businesses in order OTC and listed. We -- as we have additional volumes. We do not have expenses that grow commensurately .

So we see that it's important for us to use this operating leverage to basically do two things, one is to find places in our businesses and services where there is price sensitivity . So if we can, together with our distribution channels, look at pricing as a way to bring on new investors or increased activity of people that already use B3, that is something that we are inclined to do. Obviously, we'll try to measure impact. We will try to do performance related discounts, will try to do volume-related discounts, new client additions all sorts of the classical pricing schemes for the businesses where we see sensitivity to pricing. The second driver will be to look at parts of the business where perhaps the competition might seem easier or the value received by clients is not so high, given the complexity of the products and therefore. So this I think links somewhat to the OTC registration of bank bonds and other areas of the business where we find that over time, we will consider again given volumes and given the strong relationship we have with the clients to review prices gradually as we see opportunities to to do so.

We -- I think that has connection and it's a good way to sort of tied to the second point, which you mentioned, which is competition in the securities unit. We think that we have a very, very strong position in that -- in that business, but nevertheless there will potentially be other platforms that provide some of the services that we provide as well. I think that natural and part of the dynamic of this market as it grows and becomes more sophisticated and we think that there are essentially three ways in which we three will face this environment, right. It's basically to use innovation, service quality and pricing to continue to impress our clients, right. So we have to be flexible and creative and very close to the clients to be able to launch products and features and functionality that they find useful for their development, either new products or by simplifying the internal procedures, trying to lower their cost and therefore -- so that's kind of the innovation part. The other one is quality, we have to remain the most resilient and trusted platform fully complete with all the features, always on and very, very reliable as well as improving our customer service, which is something that we are working on.

And finally, pricing, you know we need to be sensitive to the demands of our clients and their value perception. And if we have this combination, I think we will keep most of the business that we already and seen significant growth as these markets continue to develop and both lending, which means more funding instruments for banks as well as all the other lines of fixed income registration. We see enormous potential for that, but we are aware of the fact that there might be, here and there, some competing firms that we will have to face.

Q - Thomas Peredo {BIO 21712295 <GO>}

Okay, thank you. Pretty clear.

Operator

Our next question comes from Felipe Salmao, Citibank. Mr. Felipe, you may proceed.

Q - Felipe Salomao {BIO 19237023 <GO>}

Okay. Good morning, Sonder, Rogerio and everyone else on the call. Thanks for the opportunity. I have one question regarding technology and excess revenues. So this is a business segment that grew 12% in 2016, 11% in 2017%, 16% in 2018, but it seems that this revenue stream is somehow flattish over the past quarters. I mean, when you look to the second Q '19 revenues when compared to second Q '18, the growth was of 6%. So my question is what -- let's say -- what the Company has been doing to enhance this specific business segment and what can we expect in terms of growth going forward? Should we see the growth down into the level seen in '16, '17 and '18 or better to keep a more cautious expectation for this specific business? Thank you very much.

A - Daniel Sonder {BIO 18250247 <GO>}

Yeah. Thank you, Felipe. We -- I don't have all the numbers for the previous years in front of me, we can get back to you offline. But, if I recall correctly, I think that a significant part of that growth in the previous periods were due to currency elements, because most of this is market data and we charge market data from most of our vendors -- from the vendors, which are our clients in US dollar. So that is, that is one factor that might be, let's say, impacting the comparison that you're noting. Having said that, we do have a number of initiatives in the data and analytics segment. These are not short-term things that you see right away. They depend on the development of the market on the sophistication of our clients and on them also having let's say bigger assets under management that will demand more information, more analysis, more sophistication on their investment strategy and therefore also willingness to buy these new data products. So we are working on pricing of fixed income instruments. We're working on several -- let's say reports and different ways of packaging information that we have within B3 to serve its clients. We're testing some of these ideas with the -- with the client community to evaluate their merits. We are looking at what other international exchanges have done and trying to bring that in. We have recently created sort of a specific department within B3, whether I have new senior leadership to organize internal data and serve the different client areas and product areas that wants to create new things. So we are very, I think positive about the long-term prospect of data analytics. We have to, let's say, put this whole discussion also within the context of the new data regulation that has been implemented in Brazil, which both creates some constraints, but also we find significant opportunities given what we can now do and how people are looking at data going forward. But it's not going to be an immediate result. And as we have these kind of plans and products unfolding, we will discuss that with our shareholders.

Q - Felipe Salomao {BIO 19237023 <GO>}

Okay, thank you. Thank you for the answers Sonder.

Operator

Our next question comes from the webcast, Pedro Gonzaga [ph] (inaudible).

Q - Pedro {BIO 4308147 <GO>}

Good afternoon. Could you comment a little more about the incentive programs to individual investors, specifically if a million more of retail investors were to be added to the Treasury Direct and depository base what would be the impact on revenues?

A - Rogerio de Araujo Santana {BIO 20317880 <GO>}

Thank you. We hold these incentives (inaudible) works, specifically in the case the equity depository and the Treasury Direct. Basically we set targets in terms of growth for a number of clients and growth for the amount deposited or (inaudible) from this clients. So -- and we revise this target every six months. So we have in front of you the impact from the program that was in place in the first half of 2019. We just revise these programs, raising the bar in terms of targets, in terms of flows and now we will follow how the brokerage firms will perform considering this new targets. So this is something that we will review every six months. The idea here as Daniel mentioned during the Q&A is to foster marked developments and to do that we are willing to share part of our financial benefits. And we have total flexibility every time we reviewed this incentive programs to make the targets more aggressive or to adapt to that to the new reality, depending on what is happening in the market.

A - Daniel Sonder {BIO 18250247 <GO>}

Just one more observation these incentive programs are published by us to the entire market. So we can speak offline and sort of help you do the math under the current program, what would be exactly the impact, but we make sure that we disclose this openly to all market participants, because it's obviously something that is available for our brokers, but by consequence also our shareholders have visibility of those -- uphold us programs work currently.

Operator

[Operator Instructions] This concludes today's question-and-answer session. I would like to invite Mr. Daniel Sonder to proceed with his closing statements.

A - Daniel Sonder {BIO 18250247 <GO>}

Well, I'd like to thank everyone for joining the call. Thank you for the excellent questions. Please feel free to call our IR team, if you would like to know anything out or if you have any questions later on. And again, thank you for your continued support of B3 and thanks to all the team for putting together the call on the earnings.

Operator

[Operator Closing Remarks]