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# EDITED TRANSCRIPT

Q2 2018 Grupo Financiero Banorte SAB de CV Earnings Call

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## PRESENTATION

### Operator

Good day, and welcome to the Banorte Second Quarter 2018 Earnings Conference Call. Today's conference is being recorded. And at this time, I would like to turn the call over to Ursula Wilhelm. Please go ahead.

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### Ursula Wilhelm *Grupo Financiero Banorte, S.A.B. de C.V. - Head of IR and Financial Intelligence*

Thank you. Good morning, and welcome to Grupo Financiero Banorte Second Quarter Results. My name is Ursula Wilhelm, Head of Investor Relations. Presenting to you this morning is Marcos Ramirez, Chief Executive Officer; and Rafael Arana, Chief Operating Officer. Following our comments, we will be glad to take your questions. Before we start, I will refer you to Slide 2 of the presentation, which contains Banorte's cautions regarding forward-looking statements.

Thank you. Marcos, please go ahead.

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### José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Thank you, Ursula. Good morning, everyone. This has been quite a dynamic quarter. On the one hand, Mexico experienced its largest election ever. And on the other hand, Grupo Financiero Banorte merged with Grupo Financiero Interacciones not only to form the second largest financial group in the country but one to serve in the best interest of our shareholders.

In this context, let me divide today's conference call into 3. First, I will address our very strong quarterly results. Then I will comment about the Mexican election outcome. And finally, Rafael Arana will assess the merger and provide you with updated year-end estimates, which will include Interacciones.

I will start on Slide 3. As you can see, we were able to gather good asset growth, margin expansion and stable credit quality during the second quarter. Grupo Financiero Banorte delivered MXN 7.2 billion of earnings, up 27% compared to last year and 6% above the first quarter. Earnings per share were MXN 2.59. Accumulated net income for the first half of the year was MXN 13.9 billion, growing 25% above the same period last year.

As usual, let me highlight some key performance indicators. We managed to obtain a stronger return on equity for the quarter of 19.1%, moving up 97 basis points in the previous. Similarly, ROE for the first semester was also a strong 18.8%, improving 265 basis points



year-over-year. The annual ordinary dividend of MXN 9.5 billion was paid to shareholders on June 11.

On Slide 4. Revenues grew 2% in the quarter to total MXN 22.7 billion on a strong growth in net interest income, fees and good results in trading and treasury. Accumulated revenue for the first half of the year was MXN 45.1 billion, increasing a strong 18%, as all revenue lines achieved good growth. Net interest income from the banking operations posted good sequential growth of 6%, reaching MXN 16.1 billion, while consolidated NII incorporating insurance and annuities, declined a modest 2% in the quarter to amount MXN 17.8 billion. This decline is entirely explained by the seasonality of the insurance results compared to the first quarter.

The evolution of the net interest margin in the quarter was positive. The margin of the banking business expanded 20 basis points to reach 5.6%. Year-over-year, it grew 30 basis points. Also, the NIM of the loan portfolio was up 10% -- 10 basis points to reach 8.6%. The net interest margin of the consolidated group declined 20 basis points to 5.7%. Again, this decline is entirely explained by the seasonality of the insurance results. Year-over-year, the NIM increased 30 basis points. The good evolution of the margin reflects a positive mix of assets towards interest rates and tight control over the funding costs. Net fees from services were MXN 3.2 billion, increasing 25% sequentially and 11% annually, driven by good growth in all fee categories.

On Slide 5. The total expenses of MXN 8.9 billion declined 2% in the period, as we line up our annual expense growth to the guidance. Here, it's worth noting that we reached another record quarter of positive operating leverage, and the efficiency ratio achieved the lowest historical level of 39.5% in the quarter.

Moving to the loan growth and asset quality on Slide 6. The loan book totaled MXN 640 billion, up 3% in the period and 8% yearly, in line with our guidance. All loan segments of the book are growing as expected, yet loan demand in government has been soft, and we also booked some prepayments, reason why this portfolio declined 3% up to June. If we exclude the government book, the loan portfolio was up 10%.

As I said, we have been able to deliver these strong results at stable asset quality. Net NPL ratio deteriorated 5 basis points in the quarter, and now it stands at 2% due to the usual seasonal behavior of that credit card and payroll books during the second quarter. Loan loss provisions were MXN 3.8 billion, 10% lower than the prior quarter. As you will recall that in the first quarter we booked some specific provisions for our commercial-grade exposure. As a result, the cost of risk declined to 2.4%.

Now moving to the relevant subsidiaries on Page 8. The bank posted record results with net income of MXN 5.2 billion, 29% ahead of last year and posting a return on equity of 23.3%. The NIM reached 6.4%, expanding 40 basis points. Results reflect good growth in the loan portfolio and the deposit base. Seguros Banorte booked earnings of MXN 751 million in the quarter, 11% ahead the same period last year. Accumulated earnings were MXN 2.1 billion, up 35% annually. Afore Banorte added MXN 363 million in earnings to the group, which were up 10% in the period.

On Slide 9, we provide evolution of the capital ratios of the bank, which remain very strong. The capital adequacy ratio was 17.8%, while the Common Equity Tier 1 ratio was 12.7%. Both indicators increased 10 basis points in the quarter, while risk-weighted assets grew a modest 7%.

Now let me shift gears to part 2. I want to take a moment to highlight some of the recent developments and our outlook for the second half of the year. Elections are over, and to no one's surprise, Andrés Manuel López Obrador will take office on December 1. The surprise, I think, however, that AMLO's MORENA party won simple majority representations in both the lower and upper houses of Congress, giving him ample capacity to make changes to laws, although not at the constitutional level. While AMLO has favored a change in the economic model with modest state intervention to reactivate the economy to tackle inequality and poverty, the message of the elected government -- the government so far has remained moderate towards maintaining macroeconomic stability and fiscal discipline as well as maintaining the independence of the central bank and a flexible exchange rate regime.

The new government has communicated that it will increase minimum wages. It will introduce scholarships for the youth and will raise universal pensions for the elderly. Along with investments in infrastructure, we should expect to see these measures as soon as next year.

Nevertheless, we do not expect a higher budget deficit, as the newly elected government has reiterated that the above-mentioned programs will be financed via an optimization of the government spending and not by increasing the country's indebtedness level. We remain optimistic of the economic developments for the remainder of the year, and we are hopeful of a smooth government transition in the year 2019. We are positive that the group will deliver another set of strong results for the second half of the year, as we continue to execute on our strategic plan and also to work on the integration of Grupo Financiero Interacciones. In this context, let me be very clear again. Our 2020 goals remain intact, and we are fully committed to achieve them.

Let's move to the part 3. I will ask Rafael Arana to give you an update of the acquisition of Grupo Financiero Interacciones as well as to comment on our expected results for the end of the year as we incorporate the acquisition. Rafa, please go ahead.

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**Rafael Víctorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance***

Thank you, Marcos, and good morning to all of you. As we informed weeks -- a few weeks ago, we concluded the Interacciones transaction on July 13. The price, as you know, was paid at MXN 26.5 billion; 50% was paid in cash through a capital reduction from Banco Interacciones and the remainder with 109.7 million newly issued shares from Grupo Financiero Banorte, which were determined upon a fixed exchange rate factor of 0.4065.

The legal merger between the companies happened at the same date, and therefore, Grupo Financiero Interacciones and subsidiaries cease to exist as of that date. We will report consolidated financial information as of that date.

The integration process kicked off as soon as regulatory approvals were granted. IT integration and migration is completed, and operations are already under Banorte without causing disruptions to customers.

On the business side, the infrastructure group of Grupo Financiero Interacciones will become a product unit within Banorte wholesale banking division. It will be headed by Carlos Rojo from Grupo Financiero Interacciones. Banorte's business teams will retain customer relationship responsibility. The remaining business areas such as mutual funds and a small wealth management group will be absorbed by Banorte counterparts. Risk management and treasury also now are running on the Banorte team. Our target is to conclude the integration at the most by the end of September.

Now turning to Slide 10 to give you some color on the financial consolidation of Grupo Financiero Interacciones. On a pro forma basis, the most relevant changes to reported Q2 information by Banorte are total consolidated assets of the group will increase by around 13%.

The loan portfolio of the bank will go up by around 15%. The consolidated government exposure will represent close to 28% of total loans from the 20% reported at the end of the second quarter. And as we mentioned to the market, that number will trend down to 26% in the coming years based upon the dynamic growth of the other parts of the loan book.

Total deposit balances will increase by around 14%. Banorte capital would increase around 3% post transaction. Therefore, its regulatory capital ratio CET1 and accumulated capital will decline by an estimated 100 basis points temporarily. We expect this to restore the bank capital ratio within 2 quarters upon earnings growth. These numbers should be at the -- on the consolidation basis at the beginning around 11.6%. And as we mentioned to the market, we hope at by the end of the year to be above 12.2% in core Tier 1.

Regarding the financial commitments of the transaction, we confirm them as follows. As we mentioned to the market, we are very confident to achieve 65% of cost synergies from Grupo Financiero cost base, which based on our estimate for the second semester of 2018 they should be close to MXN 1 billion.

On funding the compromises to achieve 46 basis points improvement in the funding cost of Grupo Financiero Interacciones, of this we estimate to generate between MXN 150 million to MXN 200 million from July until year-end. This is important to remember that 46 basis points is just for the remainder of the year. Our commitment for the full year basis of '19 is well above that number.

We will register extraordinary expenses as follows: MXN 500 million related to integration cost, mostly severance payments; and MXN

400 million in legal and advisory fees on the transaction. Therefore, the estimated earnings contribution of Interacciones to GFNorte in the second semester is estimated between MXN 1.7 billion and MXN 1.9 billion, resulting in an accretion to earnings per share between 3% and 4% for '18.

Now I want to take a few moments to walk you through some revisions that we are doing to the guidance of '18 to incorporate better-than-anticipated results of GFNorte and the addition of Interacciones in the second half of the year. For this, could you please turn to Slide 11? We confirm our loan growth target for Banorte between 8% to 10% for this year. Including Grupo Financiero Interacciones, it will go up by around 28%.

As you remember, we commit to be very clear about Grupo Financiero Banorte and the integration of the new business unit to present to you exactly the dynamics of each. You should expect higher loan growth in the consumer of around 14%. Nevertheless, as you've seen, we have been moderating the rate of growth of the consumer to a very reasonable 14%. And for the Interacciones loan book, the short-term goal is to improve profitability while to scale up the infrastructure financing business.

We improve our expectation that the full year net interest margin of GFNorte will expand between 25 to 30 basis points. With the incorporation of Grupo Financiero Interacciones in the second semester, the full year consolidated net interest margin of GFNorte, as we mentioned before to the market, could decline 10 basis points or show a marginal increase of 10 basis points versus the reported net interest margin of 17%. This is dependent of how fast can we change the funding base of Interacciones that we are achieving extremely positive advances in this area.

Based upon this speed, we are confident of a better-than-expected reduction in the funding cost of Interacciones because we will be hitting also the best part of the year for -- the second part of the year is the best one for the demand deposits. And a very efficient campaign of the time deposits that has been running on the Banorte side for the last 3 months has been more than beneficial for this reduction in the funding cost. Expense growth for Banorte alone should be better, between 7% to 8%. But on a consolidated basis, expenses will grow double digit, as we include exclude expenses on -- for Grupo Financiero Interacciones, basically the extraordinary items mentioned earlier. The consolidated cost-to-income ratio should still be between 39% to 40%. Cost of risk at Banorte should be around 30 basis points greater than initially anticipated. Consolidated cost of risk will range between 2.2% and 2.4%.

Finally, we expect incremental net profits both because of better-than-anticipated performance of GFNorte and also the integration of Grupo Financiero Interacciones. The new estimated net profit range is between MXN 30 billion and MXN 31 billion and does not take into consideration MXN 1.3 billion of net profit generated by Interacciones during the first half of the year, which are consolidated in the capital.

On this note, I conclude my comments, and we are ready to take questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And we do have a question first from Jason Mollin of Scotiabank.

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**Jason Barrett Mollin** *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

We saw solid results, especially in terms of the profitability at above 19%. I just wanted to know if you could comment a bit on how you saw the quality of the earnings this quarter, particularly because we saw very strong trading at about MXN 1.2 billion above what you had been running at for some quarters. And secondly, we saw a small impact on the equity. So should we really be looking at this 19% as kind of the core earnings or core return on equity that you're posting that you're running at now?

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**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Thank you, Jason. I will ask Rafa to go over that.

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**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Yes, Jason. As you know, we have always been guiding around MXN 700 million to MXN 800 million for the quarter on net trading gains. Yes, we had a very good quarter this last one and basically because we have been extremely conservative on the position on the balance sheet on this part. So compared to our peers, you saw that last year, and also in the first quarter, they were more profitable than us on that line. For this quarter, it was unexceptional achievement, as you mentioned. But I think the quality is not coming because we [are] taking any direction or position or anything like that but the quality of the funding and how we are really taking care of the balance sheet. Is that repeatable? No, I don't think that, but we expect the next quarter also to be a little bit above the MXN 700 million to MXN 800 million on that part.

**Ursula Wilhelm** *Grupo Financiero Banorte, S.A.B. de C.V. - Head of IR and Financial Intelligence*

If I may add, Jason, this is Ursula, that on the trading-related income a larger portion of what we've had this quarter is related to operation with customers and not necessarily to risk positions because we've had larger-than-usual operations on the derivatives because of some hedging instruments that we sold to customers. And that is why the result is also larger than in the previous quarter. But it's not -- it's coming from customer activity and not from risk position.

**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

On the capital base, Jason, as you know -- on available for sale, as you know, there have been movements based upon mainly on the valuation of those positions. But I think honestly, that we got really -- because if you look at the trend for the last 2 to 3 years, based upon the movement on the currency and the valuations of those positions, we don't see that, that is a critical point based upon how we are achieving our 19.1% return on equity. So I think it's very solid numbers. As you see the fee growth, you see we continue to keep a very good cost of funds. Risk is contained, and also -- the subsidiaries also are delivering pretty good results. So we don't anticipate that based upon valuations or anything like that is really helping the return on equity on a specific basis. But also, if you look also at the leverage ratio of -- that we are running, that is -- instead of taking more leverage of that, we are reducing the leverage of the group and of the bank. So I would say that there's no specific movements that we are really trying to play the capital base based upon the movements on the positions that we have on available for sales. Now it's basically what we have on the valuation pieces, and everything else is really solid results coming from the operation of the group.

**Jason Barrett Mollin** *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

Very helpful, Rafa, Ursula. And maybe just a follow-up comment. I mean, I'm looking at the accretion in ROE -- well, EPS, but also in ROE that you're looking for with the merger with Interacciones. That seems very positive. And I noted your highlight that the cost of funding may even be able to be brought down more in, I guess, in 2019. What's driving that expectation? Is it what you're seeing now that you could even have further gains in the cost of funds?

**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Yes. Yes, the treasury team and the network of Banorte and the product guys from the deposit base initiated a very active process to really completely change the cost of funds that Interacciones was holding now. And also, we launched very successful campaigns on our time deposit basis that the network has been extremely efficient to achieve. The rate of growth on some regions is about 20% to 24%. But at the same time, demand deposits are having a very good year also, not only the mix but also on the rate of growth. The commercial and the corporate also has been more than ahead of what we expected from them. So overall, what we have is a combination of extremely good change of funding that we went into the market and achieved very good rates for the positioning of the -- for the replacement of the already existing funding of Interacciones. But instead of the 46 basis points, now we are close to reach those numbers to 70 basis points so far of the funding -- on the funding side. And it's a combination of very good activity from the network, from the commercial, from the corporate. And the product people have been extremely efficient to target the right clients and with the right products to have a very good mix. Our cost of funds right now is running at around 42.9%. We are well below what we anticipated to have. We were running expectations around 44%, and we are at 42.9%. And that's because the mix that's much -- has been a much better mix than we anticipated. So the network and the commercial and the corporates are doing an extremely job, plus the treasury has locked in a lot of good funding at a very good rate for replaced Interacciones fund.



**Operator**

And we have a question from Philip Finch of UBS.

**Philip Finch UBS Investment Bank, Research Division - MD, Global Banks Strategist, and Latam Banks Analyst**

First question is also related to the merger with Interacciones. So very detailed information. For the second half, you're saying the earnings accretion is 2% to 4% given all of the -- a lot of upfront expenses being booked. Now when you first announced this merger last year you were talking about potential accretion of 10% to 12% in 2019, assuming a full year -- on a full year basis. So that's including obviously all the benefits from costs but also funding. So can you reaffirm that, that 10% to 12% earnings accretion for next year is still achievable? And secondly, going back to more of the underlying performance that we saw in the second quarter. Your efficiency ratio just continues to improve beyond certainly our expectations. How much more upside is there from here? Is that 39% something -- it seems as though you may have peaked?

**José Marcos Ramirez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member**

Thank you, Philip. Yes, it's achievable. Rafa is going to give us more color and talking how far we can go with the efficiency. We are expecting to be below 40s and stay that way, but Rafa can give us more color about that.

**Rafael Victorio Arana de la Garza Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance**

Yes. Thank you, Marcos. Yes, Philip, and thank you for the reminder of those numbers, yes. We are fully confident that we could achieve EPS from '19 from 10% to 12% based upon the, as you mentioned, the funding cost plus also the expansion on the business. As you know, we never consider any cross-sell potential when we did the numbers, so we now see that there's room there to have an increase in the cross-sell ratio. So we are very confident that we can deliver the 10% to 12% accretion for the full year of '19. On the efficiency ratio, I think all what we have been doing in automation and on our technology base and are very disciplined cost base, I honestly think that -- but based upon the dynamics on the revenue side and that we have been very stable on the cost base -- because there were some concern about some notes that the personal expenses on a quarter-to-quarter basis grew like 17%. But you have to consider that we already booked MXN 200 million -- not of Interacciones merger but of MXN 200 million of severances. That is because, as you know, every year based upon the meritocracy of our employee base, we run a -- every year of school who should be doing or giving more productivity, who should improve their performance. And the ones that they're not achieve their goals, we have a continue revamping of the base of -- on a -- I would say on a normal basis we also -- always book around MXN 200 million that has been booked on this -- in this quarter of severance. And also, we also anticipate MXN 90 million of frontloading the bonuses for the end of the year. So we still see room to keep reducing the cost-to-income ratio to numbers around 39% on a steady basis and a little below that on an extraordinary basis.

**Philip Finch UBS Investment Bank, Research Division - MD, Global Banks Strategist, and Latam Banks Analyst**

Just quickly, a quick follow-up, Rafa, a minor point maybe. You said just now at the start that you're looking for 10% to 12% EPS accretion next year. That EPS, that includes an additional number of shares for the purchase of this transaction, is that correct?

**José Marcos Ramirez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member**

Yes, Philip. That's correct.

**Rafael Victorio Arana de la Garza Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance**

It's correct. Yes, it's fully loaded.

**Operator**

And our next question comes from Jorge Kuri of Morgan Stanley.

**Jorge Kuri Morgan Stanley, Research Division - MD**

I have 1 question on your government business. You provided a pretty good overview of your expectations for the new government in terms of what you think they're going to focus. How do you think your government business is going to evolve in the new administration? What are the challenges and opportunities that you see as we transition?





**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Mr. Carlos Rojo, the new guy on team, is going to answer. Thank you, Jorge. Thank you.

**Carlos Rojo Macedo**

Listen, I believe that at this point in time what we're going to see is that same seasonality that we've been observing for the last years. As you know, state and municipalities have greater liquidity during the first half of the year. And that has been shown, as we have seen some prepayments at this point in time. However, the lack of liquidity that usually happens during the second half of the year should accelerate the deployment of loans for that part of the year.

**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

So do you want to add something?

**Jorge Kuri** *Morgan Stanley, Research Division - MD*

No, I mean, I guess, I was looking for a little bit of more details, but that's fine. I understand there is still a lot of unknowns here.

**Carlos Rojo Macedo**

Okay. Jorge, happy to go deeper. Please feel free to (inaudible) -- we have here Carlos Martínez who runs the state and municipalities, and we have also Armando Rodal who runs the federal piece. So you -- we can give you as detailed information as you need.

**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

What's your specific concern?

**Jorge Kuri** *Morgan Stanley, Research Division - MD*

No, no. I'm -- I don't have a specific concern. My question was about challenges and opportunities. I mean, it is a new government with some particular focus on development, with more government spending interventions. And so just wondering, given that you are big provider of credit to the government, and that's a really big part of your business, if you just walk us through what do you think the challenges and opportunities are of this new government. I mean, MORENA has never managed the country and just wondering how you think that's going to play out for you in terms of your government business.

**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

It's -- Rafa is going to give you more color and also Gabriel Casillas.

**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Yes, I will jump immediately on one thing. And I think -- and thank you for the opportunity, Jorge, to clarify this. More than going to the details of the numbers is that it's quite important to give the message to the market that at this point in time we are sitting at 28% of the book with the government book. But that number will continue to decrease in the next years because basically we are switching more and more to a different type of business. As you know, the transparency law and -- there has been issue in the past years. It's has been put a lot of pressure on the margins and things, so you need to deliver a lot more value-added products. But the dynamics that we have on the consumer, the dynamics that we have on the corporate and the commercial, and that will also continue to evolve on a much faster pace. And I think that our goal to have on the book is around 24% to 26% on a steady basis on our government book. But we will have at this point in time a lot more products to offer to the market that will compensate that strong pressure on the margins on that, that we could deliver a lot of value added based upon the scale and the potential and the expertise of the Interacciones and the scale of Banorte and the expertise that Banorte also have. So it's quite important to note to the market because there has been always concerns about the concentration on the government book that we have. We will have a relevant position on the government book because it's an extremely profitable business on a return-on-equity basis and a very strong incentive to have a cross-sell ratio increasing that part of business. But the dynamic of the book and the dynamic of the group as a whole will continue to expand at a much faster pace.

**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

That's it. And Casillas?





**Gabriel Casillas Olvera *Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis***

Jorge, this is Gabriel Casillas, Chief Economist. Just one thing I wanted to highlight here from the macro side. Honestly, in terms of -- I think a lot of these has to do with opportunities. I mean, since the new government won the elections, the economic policy team has been quite open, not only to us, but even, for example, in the think tank and elsewhere. I'm part of it. They have been quite open explaining what are they going -- they really want to do; explaining that definitely they're not going to increase the deficit and indebtedness levels, as Marcos mentioned at the beginning of the call, but doing a complete reengineering of -- on the spending side. Now -- and one -- a very good signal that they do want to do this is they want to appoint Gerardo Esquivel, he's a Harvard-trained economist, as undersecretary of spending. So I think that's going to be really very good in terms of spending. It's not going to increase by increasing indebtedness levels or taxes, but it's going to be reoptimized. So in this context, definitely, we see this as an opportunity, more so now with the Interacciones merger that will do really optimize how government spending is done. Definitely, I think there are a lot of opportunities for funding, for helping in the business area that we have. And talking about challenges, honestly the only one challenge that we see in the short run is that usually in the very first year of government, what we have seen in the past is that there's a slowdown in GDP. [Not only] it has happened -- but, of course in '95 it's an outlier. But it has happened in every first year because there's a lot of changes in the people managing the country. And you mentioned that the people from MORENA party they have now managed the country. Well, they have not managed the country under this party, but a lot of the people that actually won the elections in MORENA actually have been working in the government for a long time. So even though in the first year probably there is going to be a lot of changes, and they probably will not know exactly how to spend the money, and that will make a -- at least foster the slowdown. A lot of people have been in the government. And also, as I was saying, within the unit of Interacciones part of their job is actually to give these like consultant services and to explain them how to spend and how we can help them. So in this context, even though that's going to be a challenge for the country, I think it's also an opportunity for us. Just wanted to highlight that, Jorge.

**José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member***

Another comment, Jorge, Carlos Martinez.

**Carlos Eduardo Martínez González *Grupo Financiero Banorte, S.A.B. de C.V. - MD & General Director of Retail Banking***

Jorge, it's Carlos Martinez, Head of State and

Municipalities and also Retail Banking. One thing that we've see in the future is that a big shift between -- in regular acquisition of loans for the government to more sophisticated infrastructure loans and not directly from the government but more from the government suppliers of infrastructure. So this gives us a big -- with this alliance -- with this merger with Interacciones give us a big advantage because the Interacciones team have this knowledge, and we have -- know the market and the relations in every state and municipality in Mexico. One good thing also we see in the future is we see the municipalities also getting into the infrastructure development and market in the future. So that also gives us a big advantage in being there in the municipalities with infrastructure credit, more than the regular type of credits that we've been doing in the past.

**Operator**

And I will move to a question from Rafael Frade of Bradesco.

**Rafael Frade *Bradesco S.A. Corretora de Títulos e Valores Mobiliários, Research Division - Research Analyst***

I'd like to -- just to explore a little more the details of your estimates for Interacciones in the second half. I would like to understand how much of the -- this MXN 1.8 billion -- MXN 1.7 billion to MXN 1.9 billion is impacted by -- already by the benefits of synergies? It's fully capturing the synergies or not? You mentioned that there are, for example, some severance costs that should be integrated in the second half? So I would like to understand what this number would be on a, let's say, you expect on a recurring basis look for 2019, right?

**José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member***

Thank you, Rafael. Talking about these synergies, Rafael, you're -- Rafael Arana is going to help us.



**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Yes. What you would see on the numbers that we have presented today, estimated earnings (inaudible) fully loaded on the synergies on that part. So I would say that, as you know, we usually give a guidance for the year on January. So I would like to be -- as you know, we are fully integrated now with the books and everything to have a very precise number to give to you. But I would say that you should see on a -- without any confirmation but basically based upon these numbers, these numbers are not including any of the benefits of the synergies but a very small piece on the funding side. So not on the cost side or anything is included on the MXN 1.7 billion to MXN 1.9 billion that we have on estimated earnings. And on the accretion, the only thing that you're getting is basically the benefit on the funding side because most of the integration cost and everything are going to be fully loaded into that part. So we have clean that of the remaining of the year in order to have a clean view for the next year. But I will not be comfortable at this point in time to commit to give you the numbers when we clean on the remainder of the year, the process. But then we'll be much better on the funding side and much better on the cost side.

**Ursula Wilhelm** *Grupo Financiero Banorte, S.A.B. de C.V. - Head of IR and Financial Intelligence*

Rafael, if I just may add. Remember that in the MXN 1.7 billion to MXN 1.9 billion expected net profit from the Interacciones business, we are already including close to MXN 900 million in onetime expenses, integration expenses, if you will. So those will not be there in 2019. So those will be revenues, if you will.

**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

And the full benefit of the whole reduction of the cost structure and the benefit of the funding, but that will give -- in due time, give it to you on the guidance for the next year. At this point in time, what we committed, 3 to 4 accretion on this year. And the cost that Ursula has mentioned has been fully revealed. And the earnings, we are very, very comfortable to say MXN 1.7 billion to MXN 1.9 billion. But much better performance for the next year, yes.

**Rafael Frade Bradesco S.A. Corretora de Títulos e Valores Mobiliários, Research Division - Research Analyst**

Yes. No, that's perfect. So I completely understand. I'm not want to get a guidance for 2019. It's much more just to make clear that -- so for this number for the second half of '18, we don't have much of the cost synergies that you are indicating. So this probably something more for 2019?

**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Yes, exactly, Rafael, and thank you for the correction. Yes, it's exactly what you said.

**Operator**

And our next question comes from Thiago Batista of Itaú BBA.

**Thiago Bovolenta Batista** *Itaú Corretora de Valores S.A., Research Division - Research Analyst*

I have 2 questions. The first one is a kind of follow up on Rafael's question about the cost synergies. Recently there was an article height is Reuters saying that the bank reduces the workforce by about 50% of Interacciones workforce. How fast you believe the bank will be able to capture the cost synergies? Is it possible to say that next year we will have already the full synergies, cost synergies ready or not? And my second question about the operation of the bank in the second Q. In the second Q, we saw a very strong services fees expansion. If I'm not wrong, up to 25% Q-over-Q, probably due to seasonality, but also 11% year-over-year. Can you comment a bit how do you see this evolution in terms of service fees going forward?

**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

The first one, Thiago is yes. In the remainder of this year 2018 and for the next whole 2019, we expect to have all the cost synergies, and that's it. So it will end 2019 with that already in the check box. And talking about the second one, Rafael, please -- Ursula, sorry. Ursula.

**Ursula Wilhelm** *Grupo Financiero Banorte, S.A.B. de C.V. - Head of IR and Financial Intelligence*

Yes, Thiago, on the fee side, if you look at the breakdown of fee, most of the acceleration and growth came from fees that are related to banking services and transactionality. So these are related to volume. As we mentioned sometime in the conference that we are looking

to grow deposits this year faster than the loan portfolio. To the extent that, that happens, then we will see fees from transactionality maintaining their growth rate. So we do expect to continue posted a strong number for the second half of the year and most likely for next year too, as most of the deposits are -- tend to be very sticky. And the other piece of the business that is also growing quite nicely, is growing at a rate of around 20% per year are the fees related to the merchant acquiring business that we also have been expanding quite fast.

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**Operator**

And we move on to a question from Carlos Macedo of Goldman Sachs.

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**Carlos Grein Macedo *Goldman Sachs Group Inc., Research Division - VP***

I have a question around what you've talked about, and I think Rafa mentioned it a few times, on the cross-selling aspect of the transaction. Banorte has been good over time to cross-selling payrolls into its government clients and then -- and in that way securing cheap deposits and good payroll loans. Could you talk a little bit more about that, give us some color what you expect to do in that sense? And what's the timetable for you to be able to take that in? Is it within 2019? Or is it something that will take maybe a couple of more years? And how much that can add to that general accretion that you mentioned, 10% to 12% next year? Is that going to add on top of it? Or is it just already reflected there?

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**José Marcos Ramirez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member***

Thank you, Carlos. As you will recall, the 2020 vision is full of 20s and 2s. It's supposed that for the year 2020, we will get to 2.2 products per client. That's in our measurements. That's the idea. We are aiming that way. And maybe Rafa can give us more color on that. But the idea is to keep that and to [lock in] on that.

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**Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance***

Yes. Now as much as -- it's fully embedded on the -- on how the business units and the segments improve their cross-sell ratio. Now we see a pretty fast acquisition of the value proposition that we provide to the federal entities and municipal entities to be very fast really incorporating into the value proposition that in the past interaction it was only given basically their consulting services on the infrastructure basis, but they were able to provide any payroll loans or to be competitive on the funding and the transactional banking and cash management. So all this products will be fully into the bags of the Banorte executive that are now would be touching a lot more clients with our complete full value proposition that will allow us to pretty fast moving to the same level that the Banorte team has been able to deploy those products into our own client base. If you say that -- I saw the accretion that you were thinking about, 3% to 4% on the cross-sell ratio for the -- I think for '19, the accretion coming from that part will be more around 2% in the accretion -- on an accretion basis, and that number that you provide on your note will be achieved on '2. It's also very important to remember that we are not considering these numbers to help us to reach the 20% return on equity on the Banorte basis. This is always will be fully disclosed of Banorte on its own and the additional product unit that has been put in how it's performing. But that unit could be easily be a measure of how it has been able to provide additional products on a cross-sell basis to the Banorte and to the Interacciones basis. So yes, we are very comfortable to continue to deploy our value provision to the existing clients of Interacciones and to incorporate to the already existing client of Banorte the product that Interacciones has. So that's all in all will increase the cross-sell ratio in both sides.

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**Operator**

And our next question comes from Claudia Benavente of Santander.

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**Claudia Benavente *Santander Investment Securities Inc., Research Division - Research Analyst***

I'm having 2 questions here. One is with respect to the government book. Is it fair to assume that you probably going to [leave only] a portion of the government loan book to expire and only grow the infrastructure? Then what would be a fair growth rates that we should like assume for the infrastructure book so far? They have been posting a 5-year CAGR of 33%. Do you feel that growth rate is reasonable or should be slower? How do you see that? And my second question is regarding expanding cost, only taking a look to the gap of the interbank loan rate difference between Banorte and Interacciones, which reaches to 170 basis points. Would it be fair to assume that you can reach that improvement by 2019?



**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

The second one, yes. [70] basis points, it's hard to say that in 2019. At the end, we will get there, and we're waiting for all the positions to end and start a new one. So yes, it's very fair to say that. And talking about the government book, who can help us on that?

**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Claudia, could you exactly -- because I missed some of the question about the government book. Exactly what was the question?

**Claudia Benavente** *Santander Investment Securities Inc., Research Division - Research Analyst*

They are kind of 2 questions. The first is (inaudible) for the government portion you are going to let that [stake] to expire according to the duration. And the second one is about infrastructure. So far, Interacciones has reported a 5-year CAGR of [50%]. So I was wondering if that rate is reasonable or you feel it should be slower? And if it's lower, why?

**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

I can tell you more than on a project basis than on a market basis. On a budget basis, when we did -- and did the numbers, we were very conservative on the growth on the infrastructure basis. As we remember on the presentation, we think that we will more concentrated on make a lot more profitable the relationship that Interacciones is used to have with the government and the entities. And on the infrastructure -- on the infrastructure book, I think you should be looking on a stand-alone basis the same rate of growth that they have on the past year. That's what we budget. Could we see upside on that? I honestly think so. Once you have the full commercial arm of Banorte moving along with the expertise of Interacciones into the market, yes. But we will -- we are kind of conservative on the budget. You have the same -- basically the same numbers on without obviously taking into account the synergies and the cost. The same rate of growth that Interacciones achieved this year. Is there potential for additional growth? Yes, we honestly think so. But at this point in time, the way we did the budget for the valuation on everything was on a similar basis for this year. Once we have all the information in place and everything and the new budget, Claudia, we will be very happy to provide the exact rate of growth that we could achieve. At this point in time, I think it's fair to say that what's achieved this year could be repeated on next year with a full benefit of the synergies and the full benefit of the cost.

**Claudia Benavente** *Santander Investment Securities Inc., Research Division - Research Analyst*

Perfect. So just to double check. 33% year-on-year growth in infrastructure is reasonable? And the headwind of 70 basis points cost improvements has this already incorporated in your -- this 10% to 12% improvement estimate that you provided for 2019?

**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Yes, the 10% to 12%, yes. The 37% I would say that would be a different mix. But I would say that the overall -- at this point in time, you have to be the overall delivery of -- if you look at that delivery of Interacciones that (inaudible) rounded the numbers were around MXN 4 billion of net income. I think you should be looking on a net income basis without all the benefits of the synergies and the funding that you will have to put above those MXN 4 billion, all the benefits of the funding and on the cost. That's the number that we are running at this point in time. Once we have all the grips on the budget on a product-by-product base, we will immediately release to the market exactly what's our commitment to deliver on that number.

**Claudia Benavente** *Santander Investment Securities Inc., Research Division - Research Analyst*

I'm sorry. The 170 basis points are incorporated in your 2019 accretiveness of (inaudible)?

**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Yes, yes.

**Operator**

And we do have several questions remaining in the queue. Do we have time to take a few more at this time?



**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Yes, go ahead.

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**Operator**

We have next from Arturo Langa of Itaú BBA.

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**Arturo Langa** *Itaú Corretora de Valores S.A., Research Division - Research Analyst*

In your presentation, you mentioned that there is a strategic deceleration in unsecured consumer loans. Is there any tension you're seeing there that worries you in terms about the quality?

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**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Manuel Romo is going to help us with that. Thank you, Arturo.

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**Manuel Antonio Romo Villafuerte** *Grupo Financiero Banorte, S.A.B. de C.V. - MD of Consumer Products*

Arturo, Manuel Romo here. I think that in general we are not seeing a major shift of the market in credit cards nor in personal or payroll loans. However, in certain segments of certain activities in the economy, we see a little bit more of volatility. So for example, in payroll, as you know, this election year was the biggest one ever. And so there are going to be certain changes in administration and in that some municipality state, federal, et cetera. That brings a little bit of uncertainty on our scoring models, and so we are reflecting that with regards to the appetite of risk now that we are taking. Also what we're looking at and working here with the analytic and risk and everybody's teams, we are trying to reevaluate how the market is going to look in 2019 with regards to expense, et cetera, and be very clear on what segments we are going to be more aggressive, which we're going to remain as we are and which others are going to be more conservative. Now in general, I would say that the growth rate that you are seeing of low double digits is going to remain until we have a little bit more of visibility that with regards of payroll loans. Now I think it's going to be again, as Rafael was mentioning, at the beginning we are going to be outgrowing the markets but around low double digits, 10%, 11%, something like that in payroll loans. Credit cards is a different story. Credit cards what we believe that the portfolio was managed at a very really -- at a very efficient level. So any changes regarding it or growth, very, very fast reflect an increase in OEM and ROI. We reduced the speed of growth in credit cards in low income and low experience in [rural] -- in Credit Bureau customers. We are focusing much more right now on cross-selling opportunities from existing debit card holders -- debit card holders from the group. Our expectations on credit cards is that the visibility that we see from our customers and performance is going to be around -- probably going to give us a little bit higher than payroll loans, around 12%, 13%, and keep growing until we see 2019 how the spend and the consumer spend is going to look towards year-end. Year-end campaigns is always a very good proxy of what is going to happen in 2019. We're going to see that towards the last quarter of this year, and then we can see how faster we can grow. But right now, what we're seeing is around 12%, 13%.

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**Operator**

(Operator Instructions) At this time, you will hear from Marcelo Telles of Crédit Suisse.

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**Marcelo Fedato A. Telles** *Crédit Suisse AG, Research Division - MD of the Latin American Equity Research and Head of the Latin American Financials Sector*

Most of my answers have been answered. So I just want to ask -- dig a little bit deeper on the -- on your government exposure. It seems that the new administration has taken the decision to centralize how federal funds flow to states. It's my understanding that the new administration has already appointed some individual states coordinators that will dictate how states will receive the federal funds. To my knowledge, I think 35% of state resources come from the federal government. So given that a lot of the loans through state and municipalities are -- they rely on the participation of (foreign language), right, on the federal participation of fund, I was wondering if you see that as a potential risk? Now that could be maybe some disruption in the flow of funds from the federal government to the states and if that pose a risk for your collection of those loans throughout different states?

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**José Marcos Ramírez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Thank you, Marcello. Thanks for your comments also. And maybe Gabriel Casillas is the one who can give us more light on this.



**Gabriel Casillas Olvera *Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis***

Thanks, Marcos. Marcello, Gabriel Casillas, Chief Economist. Marcello, your question is very good. Let me just give you some details about this issue. Let me separated these individual coordinators that is the new structure that just mentioning from how this flow of funds work. In the second part, how these flows funds -- flow -- how do these funds flow? What are called (foreign language) or participation is not federal money. It's actually the money that each state should collect from taxes. But some years ago, there was an agreement, federal agreement, that they didn't want to do the tax collection because it's not very popular. So they preferred the federal government to do tax collection for them, and then the federal government give their money back, but it's not money from the federal government.

So that structure is so far is -- we don't know that it's going to change. Actually, it should not change. And if they want to change it, it's going to be very hard on it. It's the money from the states. So how do you separate that? As you know, a lot of our (inaudible) is actually structured using those (foreign language) or participation as guarantee. We don't see that changing. Now move to the structure you are mentioning. The thing is -- I mean we have more than 2,000 social programs in Mexico. And unfortunately, CONEVAL, the agency, the government agency in charge of evaluating these social programs, only evaluates around 150. So there's a lot of missed coordination in this part of social programs. So we do see the importance of having these state coordinators to really reassess all these missed coordination of how social programs work. So in this context, I think we see this as a positive thing and have nothing to do with the (foreign language). Now the thing is and the risk that some [newspapers] are highlighting is that these social program coordinators by state could have certain power over the governors. I mean, this will depend a lot of on how these issues are going to be structured. But so far, we see this as a positive development. And we see, honestly, nothing to do with participation. So you don't have to worry about that nothing.

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**Marcelo Fedato A. Telles *Crédit Suisse AG, Research Division - MD of the Latin American Equity Research and Head of the Latin American Financials Sector***

And what about the oil funds, the revenues from oil. Does that go to the federal participation fund as well? How is that shared between the states, if that's the case?

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**Gabriel Casillas Olvera *Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis***

It's a different mechanism on the one hand. And let me tell you 2 things. Unfortunately, these oil monies have been reduced significantly because of the decline in the oil production. So they have not been as significant as they used to be at some point. And there is some mechanism with the oil fund in which if there is money -- part of the oil money goes to the state, but that's a different thing. But the most important one, and the one that has been really relevant, is whenever you have excess revenues from oil, then part of it is actually going back to -- or given to the state -- to the state governments. Honestly, this has not been significant in the last few years, on one hand. And on the other -- I mean the thing is this could be changed because it will depend a lot on what's going to be the assessment on what's going to be the role of PEMEX and so on and so forth. So far, honestly, the economic policy team has been quite moderated, stating that they will continue to work in the country with the energy reforms. Maybe they going to just check around some of the contracts that have been given if they were given in a good way, with no corruption involved. And honestly, they're going to find out that there was no corruption at all. Because I don't know if you have seen these public needs. The public needs have been really, really transparent. And all they have been broadcasted. Each of the participants have turned in 1 single envelope per project. So it's going to be very -- and the contractors are actually [publish] there on the websites. So I don't think the oil parts will be that relevant because it has been decreased. The most important one is participation. So I don't know if you want to add something, Carlos.

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**Carlos Eduardo Martínez González *Grupo Financiero Banorte, S.A.B. de C.V. - MD & General Director of Retail Banking***

Marcello, this is Carlos Martinez here, Head of State and Municipalities and Retail Banking. One thing I think in addition what Gabriel already told you is (inaudible). (inaudible) is what states expenses through the government -- exactly what Gabriel was telling you just a moment ago. We don't see a shift in that. I think it's going to be -- the only difference is before you had 20 or more delegates in the state, and now you're going to have 1 big delegate that is going to address all this. And this is going to give like compensation to in -- to the actual governor. So you can have the governor of the state, and then you have 1 big delegate that is going to make -- be taking these decisions on how this money is going to be spent. But the amount of money that is going to be in each state, we don't see is going to decrease. We see maybe it -- also it can be incremental. And that's one thing that we can see in the future. The other thing that we see as





an advantage is that this can be more orderly used in infrastructure. And the third thing that we see is that this -- you have the check and balance within the governor. And this new figure we think is going to be used more properly than it was used in the past.

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**Gabriel Casillas Olvera** *Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis*

And just to add Marcello, -- this [Ramo] (foreign language) or Fraction 23 don't have to do anything with participation. These are transfers to states. So it has nothing to do with the structure of the credit. And I concur with Carlos that it's not that they going to disappear. This Fraction 23. They are going to do this reoptimization to have a better use.

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**Operator**

And our next question comes from Jorg Friedemann of Citi.

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**Jorg Friedemann** *Citigroup Inc, Research Division - Director*

Lots of clarifications already from the previous questions. But just like to touch 2 points on the operations of the bank. First, I understand that asset quality has been kept stable and you have good prospects on that end, even though you're accelerating retail. But I also noted that over the last few years -- it's not just your case but I have seen some of your peers during the same. Provisions have been a bit volatile. In your case, it's reached almost 150% last year, and it has oscillated between 129% to 130% something in the past few quarters or so. Just wondering, what do you see for this going forward? I know the decline of this quarter was just related to the seasonality that exists in the second quarter, and it just, I know, could go up again. Or if the trend is to go a bit further down given the improvement observed in asset quality so far. And the second question is very quick. One, if you could clarify how much was reversed in terms of the fiscal provision that I know led to a significant decline of the [AT] taxes in this quarter?

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**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

It goes, Rafael Arana.

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**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

Thank you. I was also reading also the note, and thank you for your comments. I think what should be looking at the third quarter of the asset quality, which will be -- we are very, very confident on the car loans, on the mortgage side. But as Manuel was saying, the credit card book is performing nicely on a very steady basis. You usually get a hit on the third quarter, a little bit of seasonality because people go on vacations, and they really load their client card a little bit, but they will clean that by the end of the year. So we don't see any hiccups on the credit card. What you have seen on the payroll loans is much more denominator issue because we have been reducing the rate of growth, as Manuel was saying, because of the change on the government of municipalities and states that usually we are very cautious like 8 month before that to reduced significantly the issuance of the payroll loans on that part. So we don't see anything strange compared to other change of administration. All the measures to contain any disruptions on the quality of the book have been taken so -- but you will see a denominator issue because of the lack of growth on the payroll loans, but usually we grow the book around 16%, 17% that we will be growing around 11% to 12%. So we don't see that. And there was also some concerns that we were reversing the coverage ratio to use that reversal -- a reduction on the coverage ratio and flow that to the net income line. No, that's not the case. Basically, the coverage ratio is a result of all the provisions, methodologies and regulations that we have on the consumer and on any of the books. So no, we -- basically, what we see it has been an improvement of the generation of the provisions. As you know, the first quarter we have an extraordinary item that we disclosed fully on the corporate side. But no, there was no reverse on the -- or reduction on the coverage ratio to use that as a part to release strain on -- at the bottom line. That's not the case. It's exactly as the regulation says and is based upon the provisions, methodology and the rate of growth of the book. On the fiscal provisions, as you know you very well stated on your report, we are always like the highest payers on the tax rate. We are around 29.3%, and the reason for those reductions -- those reversals on the fiscal side was basically that we were over-provisioned in some of the components that we finally get the approval from the authorities to reverse those. That's the case.

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**Jorg Friedemann** *Citigroup Inc, Research Division - Director*

And do you have an idea about what would be the efficiency ratio if final -- that had not been reverse, just to understand really what is the recurring efficiency level?



**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

No, I think that will not affect us at all, the efficiency. Because we usually, as you know -- and the 29.3% is more than every provisions for the original rate, but we will always like to be very conservative on that number. So that number that you see on that is also -- if you said that will affect your -- any of the numbers that you have on the net income or on the efficiency ratio and anything, no, believe me, it doesn't have to -- there is no impact at all in that.

**Ursula Wilhelm** *Grupo Financiero Banorte, S.A.B. de C.V. - Head of IR and Financial Intelligence*

And if I may add, Jorg, if you see the guidance that we gave at the beginning of the year and the guidance that we just updated today, we were expecting an efficiency ratio between 39% and 40%. So it's within what we expected, even with these reversals. No, it's just -- the reversal is just a reflection of managing the expenses but nothing more.

**Rafael Victorio Arana de la Garza** *Grupo Financiero Banorte, S.A.B. de C.V. - COO, CFO and General Director of Operations, Administration & Finance*

(inaudible) Government and Retail Banking. One of the things that you mentioned about the [growth in the credit], it has to be about auto and spreads and mortgages. We have taken advantage -- as you know, 2 or 3 years ago we took full advantage of the acquisition or the fusion with Ixe Bank. So we've been very good at attending to high level, high income type credits in Mexico. So we've made a lot of alliances with auto builders and also with mortgage brokers. So we've been very good in addressing that kind of market. Our credit -- mortgage usually it's about MXN 1.8 billion mortgage-related. And another industry with an alliance -- recent alliance with Honda and Mazda and other auto builders that are more related in the high income in Mexico. So that gives us a very good quality of assets and also a very good line of acquiring clients.

**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Happy to take if you want to go deep into the reverse of that. Happy to have a specific talk and conversation with you to really guide you through exactly what the numbers. But I would confirm to say that doesn't affect anything related to the efficiency ratio on everything. It's -- we are always very conservative on the tax side, and we usually are over-provisioned.

**Operator**

And we will hear next from Carlos Gomez of HSBC.

**Carlos Gomez-Lopez** *HSBC, Research Division - Senior Analyst, Latin America Financials*

I just wanted to ask what your expectations for interest rate are? And what you think your sensitivity to a decline of 100 basis points would be next year?

**José Marcos Ramirez Miguel** *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member*

Interest rate, Gabriel?

**Gabriel Casillas Olvera** *Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis*

Gabriel Casillas, Chief Economist. In terms of our expectations on the reference rate of the central bank is that they will leave the rate on change at 7.75% at least in the next 18 months. In the past, like 6 months ago, we were thinking that there was opening some space for rate cuts. Nevertheless, as we have seen the evolution of certain variables, more than inflation, honestly, has been the more hawkish U.S. Fed. So that's in our view going to preclude the central bank to be able to lower rates. Now having said this, in our view actually the bias of the central bank is going to be towards hiking rates at some point, maybe not a lot. Because as you know, since December 2015, when federal bank begun its hiking cycles at the same time as the Fed, Banco de México has done 475 basis points, while the U.S. Fed has done only 175. So I think there is some space for the Fed to continue hiking and for Banxico not to follow the Fed. So having said that, so no rate cuts at all, maybe some hikes. But honestly, I think central bank they don't want to hike anymore. And very importantly and they have highlighted in their communiques and in their speeches is that if they see fiscal response from the government that's going to be an important variable. And if they see that, they're not going to hike. And actually, we have seen the commitment of the newly appointed government to be fiscal responsible. So definitely, I don't think the federal bank will have to hike rates. Now talking about this sensitivity, I don't know if want Ursula to mention that.



**Ursula Wilhelm *Grupo Financiero Banorte, S.A.B. de C.V. - Head of IR and Financial Intelligence***

Yes. Carlos, on sensitivity, the mix of the banking book has changed over the last 3 years, and we have a higher proportion of fixed-rate assets in the banking book. So this has brought down the sensitivity to rate. Today, a change in 100 basis points in market rates gives us NII of around MXN 960 million, whereas 2 years ago the sensitivity was around MXN 1.2 billion. So we think that if rates go down, obviously is relevant the velocity and the magnitude of the change. But if rates go down, there is a very good cost cushion within the banking book to support that, and the margin will hold.

**Gabriel Casillas Olvera *Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis***

Let me add, again, just one thing, Carlos, to just add up to what Ursula mentioned. And remember, I mean, at least in the short and medium term, nobody sees interest rate getting back to 3% here in Mexico and the U.S. getting back to 0. So in this context, even if the central bank find some space to lower the rate at some point, they're not going to be able to lower the rate that much. Of course, 3% seems really unthinkable. So we're thinking that if there is some space that opens up in maybe 2 years, it's going to go down from the current 7.75% to maybe 6%, and that would be one of the lowest points we see.

**José Marcos Ramirez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member***

And Carlos, just an addition that has to do a lot what Ursula was mentioned. We are very comfortable with a reduction in the interest rates because most of the consumer portfolio has been very slow to reprice, and the good thing is that we have been able to hold the cost of funds at a very decent level. So if you start getting the reduction on the interest rates, some people feel strange when we say this, but we are very comfortable with the reduction in the interest rates. We don't see any hit at all in the trend that we are now getting on the net interest margin because of the mix of how we produce that net interest margin. So we honestly are not dependent on -- or to be very cautious about when the interest rates start to go down. I think the book is very well balanced on the mix, and the funding cost continues to be a main, I would say, defensive line for the reduction in the interest rates. As you know, once you get the hike, you penalize the funding side around for 6 months until the effect on the book starts to happen. So I think we are at a very sweet spot on this on the interest rate cycle.

**Operator**

And with no other questions in the queue at this time, I'll turn the call back to our presenters for any additional or closing remarks.

**José Marcos Ramirez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO & Proprietary Board Member***

Thank you very much and meet next in 3 months. Thank you very much.

**Operator**

So ladies and gentlemen, that does conclude our call. We would like to thank you for your participation, and you may now disconnect.

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