

Company Name: Banorte
Company Ticker: GFNORTEO M
Date: 2019-07-26
Event Description: Q2 2019 Earnings Call

Market Cap: 274101.383826
Current PX: 95.06
YTD Change(\$): -0.72
YTD Change(%): -0.752

Bloomberg Estimates - EPS
Current Quarter: 3.07
Current Year: 12.633
Bloomberg Estimates - Sales
Current Quarter: 26672.667
Current Year: 98746.182

Q2 2019 Earnings Call

Company Participants

- Ursula Wilhelm, Head of Investor Relations
- Marcos Ramirez, Chief Executive Officer
- Unidentified Speaker
- Rafael Victorio Arana de la Garza, Director General of Finance & Operations
- Gabriel Casillas, Deputy Director General of Economic Analysis
- Rene Gerardo Pimentel Ibarrola, Deputy Managing Director of Corporate Banking

Other Participants

- Jason Mollin, Analyst
- Jorg Friedeman, Analyst
- Marcelo Telles, Analyst
- Claudia Benavente, Analyst
- Ernesto Gabilondo, Analyst
- Carlos Gomez, Analyst
- Jorge A Kuri, Analyst

Presentation

Operator

Good day and welcome to the Banorte's Second Quarter 2019 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Ursula Wilhelm. Please go ahead.

Ursula Wilhelm, Head of Investor Relations

Thank you, Christian. Hello and welcome to Grupo Financiero Banorte second quarter 2019 results. This morning, Marcos Ramirez, Chief Executive Officer will lead the presentation. Then Rafael Arana, COO, will take you through some details of the quarter. And at the end of his comments, we will take your questions. Before we get started, I'd like to remind you that today's presentation may contain forward-looking statements based on management's current expectations and are subject to uncertainty and change in circumstances. Actual results might differ materially from these statements due to a variety of factors.

With that said, let me turn it over to Marcos Ramirez.

Marcos Ramirez, Chief Executive Officer

Thank you, Ursula. Good morning to everyone. Thank you for joining us in the earnings presentation. We had a strong quarter on first half of 2019. Reported earnings for the second quarter reached MXN8.7 billion. Our earnings per share were MXN3.03, in line with the prior quarter and delivering a strong return on equity of 19.5%. For the first semester, earnings per share reached MXN6.47, increasing 29% over a year ago, resulting in a return on equity of 21.1% or if

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adjusted for one-offs 19.9%.

So, we are getting very close to the 20% return on equity laid out in our 2020 strategic plan and this one year earlier than projected. Therefore, we will share with you our next medium-term strategic plan during the first quarter of next year. In the meantime, we continue to see good momentum within our diversified businesses. While trade volumes are moderating along with the economic activity, customer deposit volumes continued to grow nicely, as well as the transactional business, including general banking transactions and merchant processing. Our clients continue to embrace our multichannel offers and are increasingly using our retail solutions. Outside of banking, insurance volumes remain adequate.

During this time, we have been executing and making progress in our top priorities for the year. First and foremost is a great focus placed on enhanced customer experience, as we continue to advance in automating and streamlining customer processes and services. We are also making investments to expand our digital capabilities to boost customer interaction with the bank. Improving cross-sell remains at the heart of our contact with customers. And already the cross-sell ratio is reaching two products per customer in contrast with the 1.8 ratio of two years ago.

From the financial standpoint, profitability and manageable risks are the main drivers of business decisions. All these efforts together are converging in the good performance achieved this first quarter -- this quarter and half of the year. We have been very active in enhancing our digital payments business for that matter. In mid-June, we announced a minority investment in Clip, a Mexican fintech aggregator that provides users with card readers and enables them to accept card payments through smartphones and tablets.

It is growing its affiliate base at a faster pace than banks. With this alliance, we are aimed to take advantage of the massive market opportunity to become the leading supplier of payment solutions in Mexico. This alliance complements our acquiring business, which as you know is underpinned on digital and e-commerce, as opposed to the more traditional bricks-and-mortars merchant businesses. We also launched Banorte Go, an extension of our mobile solutions to allow customers to make transactions such as payments, transfers or cashless withdrawals on social media apps such as WhatsApp or Facebook, all this without leaving the app.

As it is shown in the conference call deck, the results for the second quarter and the first semester speak for themselves. Let me walk you through the most relevant elements, so let's turn to slide six please.

Revenues totaling MXN24.7 billion slipped 3% against the recurring number of the prior quarter, entirely explained by the seasonality of the insurance at the beginning of every year.

Working down by components, net interest income excluding insurance and annuities grew 2%, net fees increased 22%, while other income grew 31% on a recurring basis. Only trading income declined 16% in the quarter.

We acknowledge that the softer growth in the net interest income is partly driven by slower growth in the loan portfolio, which was 1% in the quarter, but also by higher cost of funds as we have increased the share of wholesale money to fund the assets acquired last year. However, an improved funding structure of the transaction already slashed 70 basis points of interest costs, allowing the NIM to absorb and revert the 20 basis point impact produced by the consolidation of Interacciones. To sum up, the overall equation is moving according to our projections and is generating positive results, as the net interest margin of the banking business improved by all metrics during this quarter.

As such, on slide six, the net interest margin of the bank increased 10 basis points to 6.3%, while the net interest margin of the group excluding the insurance and annuities expanded 20 basis points to reach 5.5%. The consolidated net interest margin of the group level declined 20 basis points as was expected. Note that the insurance renewals affect the group's NIM by exactly 20 basis points between the first and second quarters every year. To conclude, the NIM is performing according to our forecast and should result in an improvement in the overall consolidated group's net interest margin of 20 basis points going forward.

Moving on to expenses on slide seven, they were lower MXN479 million than the first quarter on general and administrative expenses. While total expenses grew 8% for the year in line with our forecast, they include MXN770

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million related to running the Interacciones operation and also rents on corporate offices, remember the sale and leaseback, which are expenses that Banorte didn't have prior to this year. Excluding these new items, expenses at Banorte are growing at a controlled 3%. We delivered positive operational leverage again and improved our efficiency, which stands at a healthy 38.9% (sic 38.5%) as we roll out our yearly investment plan. The cost of credit remained stable in the quarter as provisions were in line with those of the first quarter mainly because of three factors. First, softer loan growth. Second, provisions reversals related to loan payments in the government book and third, normalization of the NPL formation in some of the consumer books.

Compared to last year, the 60 basis points improvement in cost of credit relates to provision reversals on payments within the state government loan book and also from the lower provision requirements of MXN275 million, as we have started to use our internal models to calculate LLPs, the loan loss provisions. Our effective tax rate for the quarter was 25.9%, slightly better than our outlook.

Now turning to slide eight, overall credit quality is stable. In the quarter, the group's NPL ratio deteriorated 12 basis points to 1.9%, driven by a seasonal deterioration in payroll loans of MXN420 million, slightly higher delinquencies in SMEs of MXN153 million and two commercial exposures worth MXN270 million, in which we are already acting on, anticipating them back to performing status in the second quarter -- semester. The quarterly increase in the loss ratio of the group, as well as in the payroll and SME portfolios is exacerbated by the global growth in the balance of performing loans.

Compared to last year, the group's NPL ratio of 1.9%, improved 11 basis points related to lower delinquencies in the credit card book, auto and commercial portfolios. We anticipate a stable asset quality performance going forward as credit underwriting remains tightly controlled in all segments. In the Consumer business, we are prioritizing workflow within existing customers, as new origination is based on credit pre-approvals. We think that the current environment still remains fairly supportive to our consumer businesses, particularly as salaries in the country are growing high in real terms and inflation continues falling.

Now let's turn to slide nine, to review the performance of the nonbank subsidiaries. Accumulated net profit for Seguros Banorte, excluding the investments in the Forex were MXN2.4 billion, increasing 16% annually. Retained premiums grew 6%, while claims were down 4%, as it is explained by seasonality, profits in the second quarter were MXN824 million. Pensiones Banorte posted accumulated net income of MXN495 million, which increased 24% annually. In the quarter, net income was MXN223 million, 18% lower on higher operation expenses. Afore reported MXN1.6 million in accumulated earnings, 20% higher than a year ago on higher financial income on its invested capital, while in the quarter, profits increased 4%.

Turning to the solvency of the bank, this is slide 10. The capital adequacy ratio of the quarter was 20% partly boosted by the AT1 bond placement. I want to highlight that the core equity tier 1 ratio was 13.1%, which is lower by 7 basis points from the previous period, as the bank made a dividend to the holding company of MXN9.9 billion to complement the group's dividend to shareholders, which was also paid in June.

Switching gears to the economy and the marketplace, page 11. Throughout the year, Mexico has experienced slower growth, downward inflation and a stable exchange rate. On the one hand, slower growth is explained mainly by the fact, but there is always a slowdown during the first year of every administration. As it is shown in slide 11, for example the growth rate during the first year of former President Fox' administration was minus 0.4%. And the first year of government of former President Nieto was 1.4%. As in every political cycle, we are pretty sure that confidence will be restored and we will get back to growth rates closer to 2% later on. It is also worth noting that private consumption has proven to be quite resilient. In our view, this has been mainly explained by solid formalist employment dynamics and wages that have continued to increase in real terms, currently growing above 2%.

In fact, on the slide 12, you can see that inflation has been trending downwards toward the Central Bank 3 percentage target. On the other hand, the exchange rate has remained fairly stable. In our view, this has been mainly due to the wide interest rate differential between the US Fed funds and Mexico monetary policy rates. The fact that the Mexican government sped up the Senate ratification of the new trade agreement, the USMCA, as well as the Mexican government's prudent fiscal stance. In this context, the government has pledged to keep the debt unchanged at the

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current levels, around 45% of GDP, which by the way includes PEMEX debt, as it is shown in the upper right corner on this slide.

In terms of interest rates, the downward inflation path and this lower growth environment may open up space for rate cuts as we move closer to the end of the year. In this context, we have rebalanced our asset portfolio towards fixed rates, allowing for a less sensitive balance sheet to integrate dynamics going forward. All in all, the one thing I want to stress here is that rain or shine, regardless of booms and busts, credit penetration in Mexico has increased around 4 percentage points in each administration, as it is shown in the chart below in the slide 12.

Moreover, in the past cycles Mexico did not have the solid formal employment structure that the country is based upon these days. We do not see why we cannot observe at least a 22% grade to GDP ratio by year 2024, more so that the new administration has the goal to boost electronic payments of government services, as well as implementing CoDi, increasing financial inclusion, which in turn will evolve and foster other financial needs and yes, Banorte will be there too.

We have experienced different cycles throughout the years and we have upsides. We plan to continue doing so. The financial group and its subsidiaries enjoy a strong franchise and business capabilities, a robust financial standing and exceptional solvency. Therefore, we are positioned very strongly to navigate through a more challenging environment and deliver strong performance.

Now Rafael is going to give you some details on the results and the guidance. And then we can move back and be happy to take your questions.

Questions And Answers

Operator

(Operator Instructions) We'll take our first question at this time and it comes from Jason Mollin from Scotiabank. Please go ahead. Your line is open.

Jason Mollin, Analyst

Hello. This is Jason Mollin. My question is on credit quality and the credit cycle. The cost of risk has been stable at Banorte and we're seeing very muted economic growth. We're seeing Banorte and the sector slow loan growth. How do you view where Banorte and the banking system are in the credit cycle? And you did mention and show how strong employment and wages continue to be. How long can that last? And should we expect a turn in this cycle in the next 12 to 18 months? Thanks.

Operator

Ladies and gentlemen, please stand by, as we're experiencing a temporary interruption in today's conference. Please -- thank you for your patience and please remain on the line. Apologies. The line is now reconnected. Please go ahead.

Marcos Ramirez, Chief Executive Officer

Yes, since I don't know exactly where we lose connection, I will -- sorry, but I will repeat. Basically, what we are discussing at this point in time is how we're going to comply with the guidance. We are in line to achieve the results that we promised the market. Obviously, as a financial group, we have different levers that allow us to have flexibility in the way we generate the revenue. And the revenue in many of the businesses have been strong, in others it has been slow. But overall, we are on line to deliver the results promised to you.

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Let me start with the lending business. The lending business, the consumer portfolios continues to be quite strong and healthy, mortgage book is growing around 12%. The car loans are growing 15%. Credit card is also reaching close to 10%. The payroll loans are the ones that are lagging behind, mainly because every change in the administration. We basically stopped the lending process a year before the change in the administration. Now we're going to start again to start giving and growing on the payroll loans. So overall, what you can see on the consumer book is will be around 11% to 12% growth.

On the corporate and the commercial books, there's another story. We see single-digit growth 6% to 7% basically on the corporate and commercials. Credit demand for investment has moderately [ph] , but we still see strong corporate demand for working capital and also a lot of initiatives to increase the debt profiles. In the government segment, as we anticipate when the balance of loans in the second semester are basically stable or negative, as we anticipate to you and there were some concerns also by some of the investors community, that our concentration with the book on the government book was too high.

We explained then that, that concentration is going to go and reduce through the years because the rate of growth of the other -- of the parts of the book, the consumer and the corporate and commercial and SMEs. So we are very pleased with how the government book is performing. As you have seen, a declining in the overall market of 4% in the government book. Loan demand is mainly related to refinancing existing credit and competition is intense, basically leading to margin pressures. Since we have the largest credit portfolio in this segment, we are the target of competition and competition has been extremely aggressive to go for the government loan. But not everything is negative. This juncture is giving us the opportunity to reduce risk that we don't want to have to strengthen the relationship where appropriate. And our goal is to maintain the profitability of the book. And therefore we are letting go those exposures that we believe the spread is not where we want it to be or the relationship is not exactly what we want to have. If you were to recall that these assets provide us with a strong return on equity and very healthy risk as we expected since the acquisition.

The concentration of the government book within the total loan book has declined to 25% from 28% as we announced you since the beginning of the acquisition. This number should continue to trend to 23% to 22% and stays on 22% based upon the rate of growth of the other portfolios. In sum, we continue to see private sector loan growth exactly as we mentioned to you at the beginning from 7% to 9% with the government book mostly flat.

Turning to the net interest margin. We are more optimistic than earlier and as Marcos mentioned, since the beginning of the acquisition of Interacciones, we basically were funding assets as the reference rate was 20 basis points, now we are 70 basis points below that, that cost of funds. And we continue an acceleration of the improvement on the cost of funds that will allow us to continue to expand the profitability of the portfolio acquired from Interacciones. A very good work from the treasury has allowed us to see by end of the year numbers basically at least 40 basis points more on the margin side for the book of Interacciones. This will improve our margin for at least 20 basis points more, as we also mentioned at the beginning of the year, maybe 20 basis points is the lower end of the market.

Unidentified Speaker

(Foreign Language)

Unidentified Speaker

Yes. Excuse me, can -- do you -- can you listen to us?

Operator

Yes, sir. We can hear you loud and clear. We can hear you.

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Unidentified Speaker

Sorry, we thought we were cut from the line. So overall, what we see is a good improvement on the net interest margin by the efficient work of the treasury and from the 70 basis points reduction of since the acquisition of Interacciones, now we anticipate 40 basis points more to the end of the year. So the 20 basis points that we see I think is on the lower end of the potential growth and improvement.

In the interest rates, there have been some concern about the sensitivity of the book. As you have seen, we have been working aggressively in reducing the sensitivity of the book. Now we are coming to a number that 100 basis points has a sensitivity of around MXN380 million to MXN400 million, that is sensibly lower than the MXN1.2 billion that was two years ago. Another interest -- another element that will support the expansion in the net interest margin and the accelerator on a better funding cost is the additional Tier 1 capital ratio that we just issued a month ago equivalent to MXN20.9 billion at a blended coupon of 7.9% [ph], which is quite favorable compared to the 7.33% coupon of the AT1 that we issued back in 2017.

These proceeds, including the cost of foreign exchange risk coverage will allow us to manage further down the cost to fund these assets purchased last year. So a good expansion on the profitability of the book from Interacciones will continue to provide a sustained and recurring earnings to our net income. Our liquidity position also becomes more supportive of NIM because the perpetual correct feature of the bond does not have LCR requirements. Continuing on revenues, we confirm our estimate to achieve a fee growth of 12% on higher volume of transactions. As Marcos mentioned, we continue to be very aggressively in managing electronic transactions and the acquisition of electronic payments.

Now on expenses, we estimate that expense growth will remain in the target range of 7% to 9% for the year, therefore bringing the cost-income ratio below the 38.5%. It's worth to mention what Marcos referred to us at the beginning of the presentation that if you divide the different components of the expense ratio, Banorte is growing at a rate of 3%, that is right below inflation and right in line what we based upon -- want to achieve based upon the automation and all the investment that we have been doing in technology.

Switching to the cost of risk that there were also some comments on one report, let me go through these numbers and also refer to specific pages on our report that allow us to you to go deep into what I'm going to describe. The cost of risk we maintained a range of 2% to 2.3% and it's quite important to remember that this cost of risk was given to you at the beginning of the year. Even though the cost of risk at this point in time is of 1.9%, many of you have seen and heard us to say that is mainly too low compared to the usual cyclical performance of the book. So what I think for the year, what we will see is a range of -- we keep the 2.3% range, but we will be on the lower end of the range.

On this, there has also -- and you can see in page seven on the quarterly report, a very detailed explanation of the loan loss provisions that because there's some concern that there was some deterioration of the book. As you have seen, the credit card book continues to be better than last year, an improvement. The mortgage book is at 1% NPL, the car loans 1% NPLs, there was some deterioration as Marcos says on the payroll loans, but this is mainly explained by the change in the labor numbers from basically the government administration, most of it now has been passed through to the vintages.

Another reflection that I would like to stress is that there were some comments regarding that the coverage ratio reduces 14 basis points on the first half. This has a very clear explanation for that and it doesn't have to -- anything to do to manage the balance sheet to privilege the income statement. What it has to do is basically of this 14 basis points, 10 of those are coming for the right reasons, for the better performance of the models that now we use the internal models, prepayments on some of the loans and also a relief from the provisions that we build up at the end of the last year because a very high number of short-term loans from the government book came at the end of December.

On the 14% impact on the coverage ratio, only 4% -- only 4 basis points come from deterioration that has mainly the payroll book, some commercial loans and some of the -- on the SMEs. So the coverage ratio by the end of the year will jump again to the usual 130%, 131% as we have seen in the past years. But this doesn't have to do anything to privilege the net income by playing with the reserves or with the coverage ratio, it's a very clear explanation on page seven on

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the quarterly report.

If I move now to the tax rate, that there was also some comments about the tax rate. Let me also give you and guide you through the tax rate to explanation about why the number is below what we guided to the market. As you know, we have been in the past year and years mainly trying to create all the provisions and -- for the homebuilders' process. Since those provisions were difficult to guarantee that there was going to be a recovery of those, those provisions were never deducted or going to deferred taxes. So there was really reducing the financial number and created an additional weight on the income. Since those are now gone, we have not to provide anymore for those, so that benefit our -- and reduce our tax rate. And the other issue is related to the integration and acquisition of Interacciones of the MXN110 billion, then when you basically apply the inflation rate based upon the rules of the tax authorities, you get also a reduction in the tax rate related to the impact of inflation.

So the number that you should see on a recurring basis going forward is 27%. So this is related to the relief that we now have from the homebuilders issues and related mainly to also the integration of Interacciones and the inflation impact that we have with it.

Now moving to the net income, why do we move the net income from MXN36 billion to MXN36.8 billion and we reduced the range. Basically, we continue to see a very strong numbers in some of the business and very healthy trend on the cost of funds. When the cost of funds were affected by the integration of Interacciones, we jumped the cost of funds overall to 53% of reference rate. Now we are aiming to end the year around 48% and trend by the next year close to the 44% that was before the integration of Interacciones. That trend is sustainable and we see a very positive acceleration to achieve that trend.

So that is basically another push that we will have in -- that will benefit all of the business that we got, it benefit the balance sheet overall for the group. On the -- another issue that is also coming to many of the questions and interactions with the investors community and the analyst is what is happening with the capital ratio? The capital ratio, as Marcos mentioned, now exceeding at 13.1%, the core Tier 1. The additional Tier 1 that we put on the book allow us to jump that to -- on Tier -- the core Tier 1 plus AT1 to 18.5%. And you see another piece of basically Basel II non-efficient capital that is sitting on top of the capital ratio, that you will see those prepayments happen in the next year to reduce that 2% to stay around the overall capital ratio of 18%. The core Tier 1 as we have always mentioned to the market is our commitment is to stay from 12% to 12.5%, now we are above that. And that also, the question was what's going to be the process to managing the capital?

We're always looking for ways to make and return capital to the market in the best efficient way by either tactical dividends or other potential movements that we could have through the process that guarantee that the shareholders get the best return by managing the capital right.

Finally, I also would like -- because some concerns have been addressed to us. I want to comment on the bank exposure of the state-owned companies, and they have these numerous questions about it. Our total exposure to PEMEX stands around MXN40 billion, while our exposure to supplies is MXN10.5 billion. In the case of CFE, the energy company, exposure stand at MXN28 billion and supply is around MXN1.6 billion. Both exposures are small and manageable from a concentration standpoint and from the capital perspective, that said, we remain vigilant on the execution of the recently announced PEMEX program.

With this, I conclude my comment and now we are ready to take your questions.

Marcos Ramirez, Chief Executive Officer

Thank you, Rafael.

Operator

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(Operator Instructions) We will continue with a question from Jason Mollin from Scotiabank. Please go ahead, sir. Your line is now open.

Jason Mollin, Analyst

Hi, thank you very much. Thanks for the presentation and actually addressing a lot of the issues and questions, Rafael, that I had. My more general question on the credit cycle, in particular for consumers, you've seen a stable cost of risk, you've seen NPLs under control. And you -- as you highlighted, you've seen very good employment numbers and wage numbers, positive trends for the consumer. But where do you think we are in this cycle? Is it just one way up or shouldn't we at some point see some kind of downturn on this front? Do you think that the consumer could see some difficulties in the next 12 to 18 months? Thanks.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Jason, thank you. As we mentioned on the call, we are vigilant. And I think we are looking good numbers on employment and good numbers on wages. I think the internal models are providing us with a much better perspective of the credit risk of the portfolio. And also we tightened up the origination process mainly devoted to the clients that we see. We are not confident to say the 1.9% cost of risk that we now currently have and we move to the 2% to 2.3% or 2.4% that we have on the guidance, it's because we -- as you know by the cycle, we expect some deterioration, especially on the payroll loans.

On the overall books, I think we will on a very happy path to continue strong growth and reasonable numbers. The more vigilant that we have as you know every change in administration is the payroll book that is now I think mostly through the cycle and will start to improving. And also the SMEs that usually -- when the lack of funding from the federal government to the state, there's a crunch -- a cash crunch that really affects the SMEs. So that's the other part of the book that we have been vigilant. And you already see some deterioration on the SME, especially and it's very, very precise location of those in three of the regions that we serve.

Marcos Ramirez, Chief Executive Officer

I have something?

Jason Mollin, Analyst

So do you think -- I mean, do you think that on the consumer when could you see a downturn or bigger slowdown in credit cards or car loans or mortgages for that matter or is this kind of double digit, mid-teen growth really sustainable for more than a few quarters?

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

If you look, Jason and I think this is worth mentioning also, we have been in a very aggressive competition with the other banks mainly BBVA, especially on the mortgage book and on the car loan books. And what that is creating is really a very good offering for the market in -- concerning the rates. So I think that will allow the market to continue grow at a pace that we see in the mortgage and the car loans. I honestly think that we will see a pickup on the lending side for the payrolls. And SMEs once the federal budget starts to be released to the entities, we also will see a pickup in that. So we don't see any signs of deterioration on the consumer as long as the labor and wages stays in the way they are.

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Gabriel Casillas, Deputy Director General of Economic Analysis

Jason, this is Gabriel Casillas of General Economy, just to complement a little bit to what Rafael has already mentioned. Your question is very good in terms that you see the convergence of two events, a turning political cycle and also a turn in the credit cycle. So if you take a look to -- that both things are happening pretty much at the same time. And taking a look at what has been happening not only to consumer credit growth, but also to nonperforming loans that are at the very low levels. Then the next question is whether the consumer feels confident to spend, then this will be the beginning of a new credit cycle. But that's the main question and that's why Rafael has been saying that we are very vigilant with respect to what has been happening to nonperforming loans and all that. So once this confidence is restored, as it has always happened in the past political cycles, I think if you see this from a credit cycle standpoint, it will mean the beginning of a new credit cycle, if companies are not restored, we will be the other way around. But in a way, we do not see any deterioration happening or to happen in the -- I mean very soon.

Jason Mollin, Analyst

Thank you.

Marcos Ramirez, Chief Executive Officer

Thank you.

Gabriel Casillas, Deputy Director General of Economic Analysis

Thank you, Jason.

Operator

We will now take our next question from Jorg Friedemann from Citi. Please go ahead. Your line is open.

Jorg Friedeman, Analyst

Sorry, not sure if this is my turn because I got broken down. Can you hear me?

Marcos Ramirez, Chief Executive Officer

Yes, perfect. Yes.

Jorg Friedeman, Analyst

Okay. This is Jorg Friedman from Citigroup. Thank you very much for the opportunity. I have two questions, the first one related to capital. I think much has been said about the potential negative impacts that the bank could have on its balance sheet when PEMEX and CFE were downgraded last month. But I see that securities mark-to-market were actually a positive contributor to capital this quarter, adding about 13 basis points. I don't know if it's probably related to gains on the longer part of the current structure. So, if you could comment about any potential impacts that should follow these downgrades on capital for the next quarter that would be great or not impacts on that, it would be great. And the second question, just wondering on the guidance, you changed it slightly those two line items highlighted by Rafa during the presentation, both in the upside net interest margins and lower taxation. But just wondering, if you

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could comment the reasons for not changing the upper part of the net income and ROE ranges that I know were kept stable, don't you believe that those potential upsides could also bring upside for the overall net income guidance previously established? Thank you very much.

Marcos Ramirez, Chief Executive Officer

Rafa, please.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Let me go for the first -- for the second one. We have been prudent on the cost of risk, when you put the numbers and you add up everything to the 2.4% or 2.3% of the high end of the -- that will -- can reduce the potential upward trend above what we mentioned on the net income. We are conservative on that point, yes, but we would like to stay in that, as what Gabriel mentioned to see how the cycle goes. And I will also want to add some other questions about Jason. If you just look at the number that were just being published of the retail sales, retail sales continue to be very, very strong, confirming that real wages had a very positive impact already in the economy side and on the sales with the -- of the consumer. So I would say that that's the reason -- that's mainly the reason for that, that we would like to stick with our cost of risk that we guide the market at the beginning. If we see a much better trend and a sustainable trend by the third quarter, we will change our guidance on that upper part of the number. On the other...

Jorg Friedeman, Analyst

Yeah, so just help me to understand here, the 2.3% I know, which is the upper range of the cost of risk, I know you are just one -- working in a conservative manner, I know tracking if this could weight on the net income, if trends continue healthy as they have been so far, probably you are going to revise up the net income guidance for the next quarter. Is that correct?

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

That's correct, that's correct. And regarding the PEMEX securities, as you know, this change on a constant basis, on a -- we mark-to-market that on a daily basis and that would be a positive. It has to do a lot more to do with the exchange rate, that's more about the potential ratings or anything about PEMEX, since the currency has been quite stable, that has been a benefit on this part of the securities. Usually, if you look at the numbers on a quarterly basis that we provide the market, you see these numbers range from MXN1 billion plus to minus MXN1 billion less depending on the currency, on the state of the currency.

Jorg Friedeman, Analyst

Perfect, Rafa, that's very clear. If you could just remind us as a follow-up there, you mentioned about exposures for both PEMEX, CFE and their suppliers. Could you break down those exposures between loans and securities as well? So I think this would facilitate our job in understanding potential impacts going forward. I really appreciate.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Now Ursula has a very detailed because she's a very expert on PEMEX.

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Ursula Wilhelm, Head of Investor Relations

Not quite, but on the MXN40 billion exposure to PEMEX, around MXN14.5 billion are bonds. And on the CFE exposure, around MXN600 million are bonds, the rest is credit.

Jorg Friedeman, Analyst

That's perfect, thank you very much.

Operator

Thank you. We will now take our next question from Marcelo Telles from Credit Suisse. Please go ahead, your line is open.

Marcelo Telles, Analyst

Hi, hello everyone. Thanks for the opportunity and congratulations on the very good call. I got a lot of information, very transparent, appreciate it. I have two questions. The first one regarding the growth of the loan portfolio. It's kind of a follow-up from one of the earlier questions. You kept the guidance for loan growth for this year of 7% to 9%, but we -- if you look at your loan growth to date -- year-to-date, your portfolio is probably down maybe something close to 2%, which would mean you probably have to grow almost like 4% per quarter in the second half of the year to reach the guidance. And we saw one of your peers reducing the guidance from 7% to 9% to 4% to 6%, so what makes you confident that you can still reach the guidance for the year? And my second question is, I know you talk a lot about the margin outlook, but if you can fast forward a little bit and then think about next year, how do you think your NIM should evolve if rates indeed come down a little bit and growth probably not going to change that much? Would it -- and plus with some of the instruments that you've been issuing the longer-term bonds, included this last one that you just did, which definitely improved your LCR in a very big way, which is definitely a positive, but how do you see that play out in the margins down the road? Thank you.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Yeah, thank you, Marcelo. And I think it's very important that we clarify this. The numbers that we mentioned and when we run down the numbers above the 15% growth car loans, 12% on the mortgage book, close to 10% on the credit cards and payrolls and SME lagging, but going to catch up a little bit on the remainder of the year, that's basically -- and in addition with the commercial and corporate growing 6% to 7%, that's basically what we call the banking book, excluding the government book.

The government book as you well mentioned is below the growth of last year, that has been the case for Banorte in the past. And since we anticipated and the acquisition of Interacciones, that book was not going to grow because of the size that we already have on the market. And also that there were some redundancy on the credits that we have and we will like to better let them go and strengthen the relationship that we have with other parts of the book. So the numbers that you see, even if we -- there's always a strong pickup at the end of the year on the government book. The government book will not allow us, if you add the government book, we will not reach the 7% to 9%. The 7% to 9% will be reached basically on the banking book. And the government book -- the benefits on the government book on the margin side, on the net income side will come from the much better funding cost that we are getting from the relief on the funding cost that we have currently by funding on the Interacciones book. But it's quite important that -- and I thank you for clarifying that.

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If we add the government book, that number will not add up to 7% to 9%. (Multiple Speakers) The consumer and the corporate and the commercial that will stick to the 7% to 9%, the government book, as we mentioned at the beginning of the year, will either be flat or growing less -- minus 2%.

Marcelo Telles, Analyst

Thank you. That's very clear, Rafael.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

And on the margin side, there has been questions. And honestly, before the evolution of the funding side, we were quite happy to have a sustainable net interest margin around 6.2%. Now we see that number that we could potentially even raise it and there's reason for that. The first one is the continuous return to the former funding cost that Banorte used to have, that's a very good trend that is happening.

And the other one is that by doing so currently because in a way to accelerate the funding of the Interacciones book, we've raised the level of price on the time deposits that allow us to grow the book 18% for the year, well above the market, obviously with additional cost. That if you compare the cost of funds of the time deposit book, that is 6.2% compared to the 7.5% that is basically the funding cost in the market -- was very positive for us to allow the -- this growth at a different cost as in the past.

But that also changed the mix. We used to have 65% demand deposits and 35% from time deposits, now the number is 52% to 48%. That -- when the interest rates start to go down, you will get a relief from the 48% also and not on the 65% as we used to do in the past. So that in addition, will boost the margin up. But the main trend, I think now that we see the potential evolution of the overall cost of funds, we are very confident that we will keep sustainable net interest margin even if the interest rates start to drop above the 6.2%, maybe in the range of 6.2% to 6.4%. Thank you, Rafael.
(Foreign Language)

(Foreign Language)

Operator

Thank you. We will now take our next question from Claudia Benavente from Santander. Please go ahead. Your line is open.

Claudia Benavente, Analyst

Hi. Thank you for the opportunity of asking questions. I was wondering about the infrastructure portfolio, it's been three quarters of no growth there, probably something seasonal because it's the first year from new administration. So I was wondering when we should be seeing the portfolio to accelerate, because I understand you can start on the commercial book side, not on government loans. So that's why I was wondering if you see any potential growth there and when.

Marcos Ramirez, Chief Executive Officer

We don't know.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

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Thank you, Claudia and it's quite important to go through this. One of the main reasons for the acquisition of the Interacciones as well the capability that Interacciones has in managing the infrastructure business at a much better and efficient way than anyone in the market. There has been a slowdown, as we mentioned on the beginning on the call. You will see a very big push from -- for Banorte on the infrastructure business in a coming event that is going to happen in less than three weeks, that we would like to present how the infrastructure process in Mexico could accelerate and we could benefit from that based upon the expertise that we now have on the -- at the bank. So you will see in the next in three to four weeks a big announcement of related to the infrastructure where Banorte can play and will lead a key role in developing the infrastructure in Mexico.

Claudia Benavente, Analyst

Perfect. Thank you very much.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Thank you, Claudia.

Operator

We'll now take our next question from Ernesto Gabilondo from Bank of America. Please go ahead. Your line is open.

Ernesto Gabilondo, Analyst

Hi. Good morning Marcos and Rafael and thanks for the opportunity. I think you have answered most of the questions during your presentation, so just a couple of questions. I believe the implementation of biometrics is expected during the first quarter of next year. So, can you please share with us what would be the targets of this new technology? And would this be implemented in branches, ATMs and smartphones? And on my second question, it is related to the government book, given that we have seen downgrades in the credit ratings of PEMEX and the sovereign, just want to know how do you see the asset quality of this segment? We know that by regulation it's not necessary to create additional provisions, what could happen if next year we see a reduction in federal transfers? Just trying to figure out what is the risk on this portfolio. Thank you.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Yeah. Thank you, Ernesto. Biometrics continues to move aggressively in the market. I can tell you now that the numbers that we have is that now we have authenticated 88% of all the transaction that happen at the branch already. We would like to move to 100%, still there's some issues related on the testing and linkages and everything that is ongoing on that part. But we will hope to have a very close 100% in the next months. And we are very pleased of the evolution of that.

Basically, right now, we are doing at the branch level because on the mobile, you can do on -- basic on the -- by using your biometrics on a personal basis. But I think where we would really like to do the big push is on the -- at the branch level that most of the transactions that can have a additional risk happens. So we like biometrics a lot, there's a big push, the branches are already more than using the -- this application and it's helping us to really reduce growth in a nice way. That's concerning the biometrics, so a lot of evolution with that will continue to happen on that. And I would like to -- because there has been concerns on the suppliers of PEMEX, here is Rene Pimentel, that is the Head of the Corporate business, that he will basically manage the -- this relationship. So Rene, if you could.

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Rene Gerardo Pimentel Ibarrola, Deputy Managing Director of Corporate Banking

Yes. Good morning, Ernesto. Basically, what we're seeing on the suppliers of PEMEX and CFE, we've had a very strong relationship with their main suppliers. And certainly, there's been a shift in paradigm and the way they've been operating with PEMEX and CFE. But we have seen some opportunities, specifically for those suppliers that have been working over a long period of time with PEMEX and CFE and our trusted suppliers and deliver especially in those fronts which are crucial for PEMEX' plans of increasing production.

So we have seen some opportunities in that front, probably not the type of opportunities that we expected a couple of years ago in the energy front with the market, but we are certainly seeing some opportunities and we are supporting our clients that have been there present with PEMEX and CFE for a long time. So certainly, there's been a shift, but this is part of the corporate portfolio that has continued to grow and we are being very vigilant and being very careful with what client we work with. But certainly, the top suppliers have been receiving interesting contracts and are looking at interesting projects.

Ernesto Gabilondo, Analyst

if we remove the PEMEX -- if we remove the PEMEX and CFE exposure, and we talk about only on government loans, I just want to figure out if we have lower federal transfers next year, what could be the risk of the government portfolio next year?

Gabriel Casillas, Deputy Director General of Economic Analysis

Ernesto, this is Gabriel Casillas. Well, actually -- remember that the federal transfers are like divided in three, you what we call participations, that is tax collection from each state government that the federal government doesn't -- and then they give the money back. I mean if you take a look to what has happened, I mean this participation has been growing at a very high pace. So, we do not foresee that unless tax collection goes down. But we do not foresee that because of two reasons. Number one, because -- it's highly likely that next year the Mexican economy will grow more, as everything after the political cycle begins. So we're expecting the economy to grow at least 1.4%, so tax collections should go up.

In terms of mechanisms to improve tax collection, the government has been doing a lot of effort to do that as well. So we do not foresee transfers to state government to actually come down, maybe the social transfers could be -- could still be lower and I see it happen this year. But as you know, 90% of the state budgets are -- rely on participations not on social transfers. So, we're definitely not concerned about that at all.

Ursula Wilhelm, Head of Investor Relations

But on the loan book, Ernesto, we don't -- we have an over-collateralization with the tax money that services the loans. So, even if transfers were to be removed, there is a cushion in each of the loans that we have to cover that.

Ernesto Gabilondo, Analyst

Perfect. Thank you very much Gabriel and Ursula.

Operator

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Thank you. We will now take our next question from Arturo Langa from Itau BBA. Please go ahead. Your line is open. Mr. Langa, please your line is open. (Operator Instructions) There seems to be no question from Arturo Langa. At this time, we will move on to our next question, it comes from Carlos Gomez from HSBC. Please go ahead, sir. Your line is open.

Carlos Gomez, Analyst

Hi. This is Carlos Gomez from HSBC. I have two questions. The first refers to capital, you talked about it earlier and I may have missed some details. You are now at CET1 of 13.1%, your loan portfolio is not growing. So therefore, I suspect that you will accumulate more capital, up to what level would you feel comfortable at this point? You have been at 11% in the past. And when would you consider the possibility of giving an extraordinary dividend? And second, we are going to get to 2020 next year, you will achieve your goals presumably on the 2020 plans. What comes next? Do you expect to have another long-term planning exercise, are you comfortable with the ratios that you're going to obtain? Are those sustainable? Have you started to think beyond 2020? Thank you so much.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Carlos, thank you. Talking about the -- what's after 2020 plan? Yes, there is life and we are already working on it. So we are going to let's say, launch it in -- as we said, in the first quarter of next year. We are already working on it because it's not a new plan, it's something that is fade in, fade out. And I think you will be surprised, I hope everybody. And we will show the strength of Banorte in that plan. And as I said, it's going to be released next year in the first quarter next year. And talking about the dividend, yes, there is a lot of -- we can buy shares, we can dividends. But it's too early to predict yet. And we -- as soon as we have more information, we will see what we are going to do with possible excess of capital, but not now yet, okay?

Carlos Gomez, Analyst

Okay. But could you define excess, what is the minimum level you would like to have?

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

No. I think, Carlos, we have been always committed to market from -- as you mentioned, there has been a reduction to 11.4% when we did the acquisition of Interacciones that will revamp that in -- after six months to 12.1%. But our commitment to the market is 12% to 12.5% and that's the number that we see that the tenors of the ATIs and the issuance that we have in addition with the equity holders, I think there's a balance on that. About that, as Marcos mentioned, there is room for additional tactical dividends as we have been doing in the past, plus an additional ways to return value to the shareholders by buybacks and so things like that.

Carlos Gomez, Analyst

That's very clear. Thank you.

Rafael Victorio Arana de la Garza, Director General of Finance & Operations

Thank you.

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Marcos Ramirez, Chief Executive Officer

Thank you, Carlos.

Operator

Thank you. (Operator Instructions) We will now take our next question from Jorge A. Kuri from Morgan Stanley. Please go ahead. Your line is open.

Jorge A Kuri, Analyst

Hi, Rafa. Sorry to ask you this again, could you repeat the exposures you mentioned for PEMEX securities portfolio and also CFE?

Marcos Ramirez, Chief Executive Officer

So, Ursula, you have the names, so...

Ursula Wilhelm, Head of Investor Relations

Yes, the PEMEX -- the overall PEMEX exposure is MXN40 billion, of which MXN14.5 billion are bonds and the rest are loans. The supplier exposures, that is suppliers of PEMEX is MXN10.5 billion. And for the electricity company, the total exposure is MXN28 billion, of which around MXN600 million are bonds and the rest are loans and we have MXN1.6 billion to suppliers.

Jorge A Kuri, Analyst

Perfect. Thank you very much.

Marcos Ramirez, Chief Executive Officer

Do you need anything else?

Jorge A Kuri, Analyst

No, thank you very much.

Marcos Ramirez, Chief Executive Officer

Okay. Thank you, Jorge.

Operator

Thank you. There are no further questions in the phone queue. At this time, I would like to hand the call back over to the speakers for any additional or closing remarks.

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Marcos Ramirez, Chief Executive Officer

No. Thank you everybody. See you next quarter. Thank you.

Operator

This will conclude today's conference. Thank you all for your participation. You may now disconnect.

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