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Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the Banorte Third 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, madam.

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

Thank you, Christian, and good morning, everybody. We're here for the Banorte's third quarter results. I'm Ursula Wilhelm, Head of Investor Relations. And our CEO, Marcos Ramirez, will provide us with some remarks about the results and some longer-term [stuff]. As usual, we will hold a Q&A session after his comments. So Marcos, please. Thank you.

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

Thank you, Ursula. Good morning, everyone. Thanks for attending our earnings call. The market has been discussing and writing about the environment in Mexico, economic activity, and therefore, how it can impact our business going forward. Well, we continued to see good consumer activity, which is becoming the main driver of growth for us and for the economy, although at a slower pace. Also corporates and companies remain prudent and vigilant of the decisions that the government is taking and their impact going forward. So capital expenditure is still low.

Competition is strong and we see some pricing pressure in segments like government and corporate financing. The Mexican Central Bank initiated the easing cycle, which we welcome, as we believe it will stimulate loan demand growing forward. In this environment, Banorte reported a good set of numbers, with strong earnings growth and healthy asset quality.

Beginning with the quarterly results, please go to the Page 3 of the conference call deck. I am sure you have taken this into account, but let me stress that this is the first quarter that shows the full absorption of the Interacciones merger, which happened on July 13 of year 2018. The group reported MXN 8.8 billion after-tax net income. This translates into earnings per share of MXN 3.07, both increasing 1% in the quarter and 13% in the year. In fact, net income was MXN 27.5 billion year-to-date, getting us closer to our annual goal.

Nine-month earnings are up 26% annually or 21% if adjusted by the one-offs disclosed early in the year. It is worth noting that almost all subsidiaries have their net profits growing firmly up 20%. [On] insurance, it's tracking lower at 40% annual growth. It, nevertheless, is quite good. Return on equity was strong at 19.6%, adding 15 basis points to this period. We are just a few basis points up from our 2020 planned target of 20%. The bank posted ROE of 23.6%.

In terms of return of assets, we're already slightly up above our 2020 target of 2.2% as it expanded 4 basis points in the quarter to 2.24% and adding 27 basis points in the year.

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

Moving to Page 4 and 5, let me give you the highlights of the results. Net interest income grew 3% in the quarter and 9% in the year, mainly driven by declining interest expense. This was possible in part due to a substantial decline in interest-bearing liabilities at the bank, which reduced the released funding cost by 10 basis points in the third quarter alone. The cost of core deposits declined 14 basis points in the period, as client loans were priced lower. This reflects the ongoing effort placed on managing down the funding cost of the assets acquired last year.

In this respect, year-to-date, we have obtained a benefit of 90 basis points in the funding cost of the Interacciones assets. And as we continue to work on optimizing the funding [months] and its pricing, we anticipate an additional 10 basis points to sink in over the next coming months. We believe it's too early to see the impact of the 50 basis points rate cut on the bank's net interest income as deposits are just starting to reprice downwards. And as per their duration, we expect the positive change on repricing to be more evident in the fourth quarter, both on the net interest income as well as on the net interest margins of the bank and group.

In the quarter, the net interest margin of the group grew 25 basis points to 5.7%. Along with it, the NIM of the bank was up to 23 basis points to 6.5%, while the NIM of the loan book grew 38 basis points to 8.3%. These positive trends in margins reflect the progress achieved in managing correctly the funding cost and mix. I am confident to tell you that we expect at least an additional 10 basis points growth in margin to take place between now and December.

Moving to fee income. Net fees declined 12%, mainly affected by a MXN 283 million charge related to the acquisition cost [from] insurance on new premium underwriting. The decline is also explained by the MXN 207 million revenue of the second quarter, which is not repeated this quarter as it was related to the sale of some real estate assets. Client-related fees are tracking as scheduled, and gross banking fees improved 3% in the quarter and 11% in the year on higher transactional volume from customers. The highlight of the quarter came from some market-related income. We managed very conservatively the balance sheet, always without taking unnecessary risk. And over the past 5 years, trading income has not represented more than 3% of consolidated revenues and the gross profit results from growing customer interaction.

The quarter -- this quarter, we obtained record trading revenue of MXN 2.3 billion. A good portion of it is related to clients. While market-related revenue we booked MXN 400 million gains on the current positioning in fixed income, given the volatile market conditions observed in the period, and MXN 155 million gain on the sale of available for-sale securities. The remainder result of around MXN 760 million is related to treasury operations concerning bonds and FX derivatives. Other income was up by 10% on higher revenues on the sale of reclaimed assets.

Moving away from revenue, please turn to Slide 6, where you can see that expenses increased 11%. They include personnel-related cost of MXN 691 million related to salary increases and provisions. Also there were MXN 145 million in advisory fees, MXN 105 million in operating expenses related to the current businesses and MXN 74 million in rates. For the 9 months, expense growth is at 9% as anticipated by the normalized expense growth rate [of minority alone] was 4% in the quarter.

The efficiency ratio was 40.2%. Deterioration slightly on lower operating leverage, but at a level that we feel comfortable with according to our 2020 plan. The efficiency ratio for the 9 months stands at 38.5%, 50 basis points lower than the prior year. Efficiency improved again for the fifth consecutive year. During all this time, we have been able to achieve positive operating leverage successfully despite the change in environment, the change in interest rates and the change in economic growth. These have been possible thanks to a strong expense discipline at the core of the organization and operational efficiencies, and we will remain concentrated on running an efficient operation.

Moving on to the business, go to Slide 7. You saw in the earnings report that the loan book declined 5% in the quarter. Without any doubt, part of this decline is explained by the less loan demand, which has been sluggish through the year, but also our lending decisions have been centered on prudent and selected growth, fostering strategic commercial relationships and prioritizing risk-adjusted profitability, as is evidenced in the risk-adjusted margin of 5%, which is at historical record high. We are convinced that it doesn't add value to grow without focus. Therefore, it is our priority to remain selective and rigorous in our credit and lending decisions.

In the corporate and midsized company market, we are partnering with our clients supplying them or financing mainly to cover working

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

capital needs, keeping the loan book safely secured with adequate levels of high-quality collateral. We also saw this quarter that many companies took the opportunity to refinance and improve financing costs. Several of our clients went to the international bond markets to refinance existing bond debt. And so the balance of our corporate loan book declined 6% in the quarter on loan prepayments. Therefore, we expect the loan book would only grow between 4% to 5%, excluding government loans, and not 7% to 9% as we have told you before. So consider it official that we are revising down the loan growth guidance for the year.

On the other side of the spectrum, we will remain very selective on SME risk. We don't see a lot of appetite from small companies to take an additional debt, and we remain selective, only lending to companies that maintain a strong liquidity position or have high-quality supplier receivables. Therefore, the bank SME book has been flattish.

Moving to the government lending market. As we anticipated, the balance of government loans declined 16% in the quarter, as we released some client exposures to the competition who was willing to take them at an unreasonable risk-adjusted return.

In the consumer segment, we still see a growth story. We believe that there are good opportunities to grow without [indiscernible] [measurable] risks. And for these reasons, our consumer book went up 2% in the quarter with higher cash balances across all products, like mortgage, auto and cards. In payroll loans, we have resumed growth. Although not so evident in numbers yet, improved growth rates will be obvious in the fourth quarter. We are lending again this product on the premise that the government employee segment has stabilized from the heights of lower rates of the first half of the year, while in the private sector we are taking advantage of the salary increases. From the asset quality standpoint, we feel confident that the quality of the credit book, is sound and healthy.

Please turn to Slide 8, where the main indicators are explained. Let's review them one by one. NPL formation was low in the quarter, particularly in the consumer portfolios as the loan being purchased of the different products are performing better, reflecting the positive impact from the stricter underwriting standards in place. The write-off rate was 0.62%, increasing around 18 basis points and includes MXN 463 million write-off from the residual balance from the homebuilder legacy assets. Adjusting for this amount, the normalized number was 0.56%, in line with prior periods. The NPL ratio was stable at 1.9%.

By segment, there was a slight deterioration in the NPL ratio of the current mortgage and commercial books, but reflecting slower growth in the denominator as the balance of delinquent loans was down 1%. The cost of risk for the quarter was 2.15%, and it includes MXN 224 million in provisions for the homebuilder exposure that was charged off in the quarter. The cost of risk for the year stands at 2%, in line with the low-end range that we provided to you. The reserve coverage ratio declined slightly to 126%, yet remains strong and adequate for the risk in the credit portfolio.

Moving to Slide 9, on the nonbank subsidiary. Let me start off with the insurance company. Seguros Banorte posted MXN 807 million in quarterly net earnings, up 14% annually. Written premiums grew 8%. Lower claims, control expenses and strong financial results resulted in pretax profit growth of 15.5%. Afore posted net income of MXN 845 million, 2% percent lower in the quarter but up 21% in the year. The Annuities company continues to post good results. For the 9 months, net profits stand at MXN 758 million, up 20% versus the prior year.

Let me talk about the capital position of the bank on Slide 10. As shown in the earnings report, the capital ratio of the bank are strong at 20.3% and will remain strong with improving quality as we intend to reduce the proportion of Tier 2 capital. In fact, we have already called in approximately MXN 205 million of Tier 2 subordinated debt, and next year, we intend to pay at maturity 2 bonds for a total amount of \$173 million.

One last comment on the 2020 key point indicators on the Slide 11. I want to emphasize that we just crossed the 2 products per client indiscernible ratio. It's a milestone for us, and one of the important metrics that has shaped our strategy and allow us to reach the profitability that we committed with our shareholders.

With this, I close the first part of my message and let me switch gears to the macro picture. The Mexican economy has been slowing down much more than we want to -- that we expected early in the year, even though we depicted the less optimistic outlook among analysts. It is usual for Mexico to experience a slowdown every first year of government, but this time, it is taking longer for clients to

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

reactivate their investment projects. As a result, GDP is growing at rates close to 0%. However, we have begun to see positive change in sentiment of local business community and global investors.

Both manufacturing and nonmanufacturing PMAs in Mexico showed an important improvement in September, and the Mexican stock market index shows a clear inflection point in the central bank cut, the reference rates for the first time in August 15. Business community and investors have realized the government has kept its promises of keeping healthy fiscal accounts and improving PEMEX's financial situation and to focus on increasing crude oil production. The 2020 budget is a fiscally responsible proposal and the latest liability management operations conducted by the state-owned company have enhanced its debt maturity profile. Along with the government capital injection, it's clear that [governments] will be able to keep its debt prepayments in good shape.

Turning to monetary policy. Consumer price increases have remained at a moderate level, lowering 12-month inflation to the central bank target of 3%. Moreover, it seems likely to see inflation between 3% and 3.5% next year. So with low inflation levels and a relatively stable exchange rate, the central bank will likely continue with its easing cycle. We expect traditional rate cuts of 25 basis points each before year-end, leaving the reference rate at 7.25% this year. The easing cycle should continue in 2020 to lower the rate and leverage between 6% and 6.5%. We expect GDP to grow at least 1.4% next year.

On improving business sentiment, lower rates and a significant base effect, particularly because it will no longer be a first year of a new administration so there is a less steep learning curve to execute government spending. We estimate a base effect of nearly 1% and a leap year effect of nearly 0.3 percentage points. Moreover, even though the U.S.-China trade war is having a negative effect globally, Mexico is benefiting from the positive substitution effect, receiving foreign direct investment in the manufacturing sector, particularly from Asian companies that are finding it hard to support their production to the U.S. from their geographies.

We acknowledge that challenges remain ahead, but we are quite confident that we will provide the numbers we promised in our guidance, passing the 2020 plan with flying colors. And we will provide a new medium-term goals in the first quarter of next year.

With this, I conclude my comments, and now, let's move to Q&A. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Jorg Friedemann from Citi.

Jorg Friedemann *Citigroup Inc, Research Division - Director*

I have 2 questions, please. The first one, you had impacts on specific cases this quarter. Just wondering if there is anything else in the spotlight that might be a concern for the coming quarters.

And the second question, related to treasury results. We observed that in the MD&A, you mentioned that activity with clients increased substantially. But also you had stronger results with the market. So just wondering what level of recurrence we could expect in the coming quarters as well.

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

I will start, Jorg, with the second one. We expect them to normalize, let's use that word, and the treasury results are 2.2 each quarter, around that one -- sorry, 1.2, sorry, is the normalized standard and we will go to that direction and we expect that. And regarding the first one, anything else in the spotlight in the coming quarters, not as we anticipated. Everything that we know with just -- you said it, and there is nothing that we foresee right now that we should tell you. I don't know.

Jorg Friedemann *Citigroup Inc, Research Division - Director*

Yes. Perfect. Just a quick follow-up there. Are there any specific factors that might be at stronger risk in the ongoing slowdown that we should be monitoring? Or do you think that the slight tick up that we saw in terms of [bill creation] can also be related to the stronger growth in riskier lines, especially retail?

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

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

Thank you, Jorg. I will pass this to our Chief Risk Officer, Carlos de la Isla. He will answer to you.

Carlos de la Isla Corry *Grupo Financiero Banorte, S.A.B. de C.V. - Chief Credit & Risk Officer*

We don't see any sectors at this stage that could affect our portfolio. Slowdowns are not evident so far. So as Marcos said, we don't have any particular concerns, at least for the moment.

Operator

Our next question will come from the Thiago Batista from UBS.

Thiago Bovolenta Batista *UBS Investment Bank, Research Division - Analyst*

I have 2 questions, the first one about the bank's capital position. Looking to the Banorte's position, we see that Tier 1 ratio now is 18.5; in the last quarter was high teens. So is this the comfortable level that the bank will probably work in the future? And when you look to your capital targets, you focus more on the Tier 1 or in the core capital Tier 1?

And my second question is about the subsidies. So even adjusted by the real estate gains that the bank booked into the second Q, does this decline materially in this quarter? So it's not around 7% Q-on-Q. But we also saw an increase in the number of products per client, so cross-selling is increasing. How do we consolidate these viewpoints? And how -- what the bank is expecting for the fees in the future?

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

Rafa go ahead.

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

Thanks, Thiago, for the questions. The first one, I think, what you mentioned about -- let me go first to the capital target. I think that the capital target, as we have mentioned to the market, we'll feel comfortable when we are around the 12.5% core Tier 1. You have seen an increase on the total cap ratio basically because we have been very successful in the market, issuing additional Tier 1 capital in order to really eliminate Tier 2 capital that is becoming non-efficient from a capital point of view.

So -- but you will see a decline in the coming months of Tier 2 and you should be looking at a core tier -- at a total cap around 18% and core Tier 1 should remain around the 12.5% to 13%, depending on the time of the year before we issue -- give the dividend out to the market. That's related to the capital ratio. I don't know if it was clear, the explanation. Do you want me to go further into more details?

Thiago Bovolenta Batista *UBS Investment Bank, Research Division - Analyst*

No, perfect.

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

Thiago, it's Ursula. Can you please repeat again your second question? Because it was not very clear.

Thiago Bovolenta Batista *UBS Investment Bank, Research Division - Analyst*

No, on the fees, the fees of the bank have posted a material decline in the second -- in the third Q. Part of that was [counted] by the sales of real estate assets that the bank booked in the second Q. But even adjusting for these, the fees dropped materially Q-over-Q. So my point is, when we look to the cross-selling, you showed that the number of products per client increased further. So I want to consolidate it, we are selling more products to the client, but the total fees is not expanding. So I want to see how we can -- how can we -- what will be the main trend of fees in the near future?

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

These are the fees for the -- you have to look at 2 reasons on 2 issues. Net fees in the quarter were down, but it was not related to lower fees, but it was related to a specific charge that came from the insurance company and Fernando can elaborate on that, so you can understand why this happened. But if you look at gross fees, gross fees are up around 7% in the year, and even if you would break it down further, if you look at what we call basic banking fees, the one that are generated upon transactionality with customers, those are up

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

almost 10% in the year -- 11%, to be precise. What is lagging down, I would say, is the fees that are related to consumer credit are growing at a lower pace because the consumer portfolio, although it's still growing, as you saw, it is growing at a lower pace than what it was growing in 2018 and in 2017. But other than that, fees from client activity and customer activity are as we expect it.

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

And just the second one, you want to elaborate, Fernando, to the total fees?

Fernando Solís Soberón *Grupo Financiero Banorte, S.A.B. de C.V. - MD of Long Term Savings & General Director of Long Term Savings*

Yes, yes. Thanks. Well, let me explain what happened to the income statement of the [indiscernible] company, particularly at the high end that is the acquisition cost. What happened is that we increased position of a very large policy that we handled, which is the large insurance policy for all the federal government workers. And what happened is that we experienced during a few months, an increase in the loss ratio. And therefore, we decided on a probational basis and accordingly to change our methodology for ourself, which is called the (inaudible) of the reserve.

Therefore, to be -- to not be showing some results that might not be observed in the future, we decided to increase their reserve at a indiscernible rate on a very conservative basis. That's the plan. And according to the -- I mean this account has some insurance, and according to the statutory accounting of the insurance commission, we have to put that reserve in the acquisition cost, which is where we handle all the commissions that we receive or that we have to give to our reinsurers. So that's because of the statutory accounting and because we changed the methodology.

And therefore, I can tell you that the loss ratio since then has been going down, and therefore, in the future, we'll see whether this will be -- I think we will be more than enough, which is what we just have to replace in reserve or even we may observe that it was overestimated, given the recent experience in that account, and perhaps we will show that some part of the reserve will go to results. So that's what happened. And the reason was not to show some results.

The results would have been higher, but we decided to be prudent. That's how we handled the insurance company overall. We are very prudent in the way in which we hold reserves and the way in which we handle the businesses, and that's the reason why we changed this methodology. And that's why you observed this increase in these items on the income statement in the acquisition cost. I hope that...

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

Thank you, Fernando. And related to the cross-sell ratio, I think it's related to what Ursula mentioned, when you look at the cross-sell ratio, you have to look at the way we are really selling more and more at the bank that is basically going to analytics and doing the right offering to the client. So the conversion rate from our contained management processes that we have been managing at the bank has increased substantially in the conversion rate. We started at about 3%, 5%, now we can see some campaigns reaching 18% to 20% conversion rates. So that's the way we will continue to see the evolution to the 2.2%. That is our goal to reach to the 2020.

And going back again, what Ursula mentioned, banking fees, related transactional fees that are related to the activity of the clients all over our channels continue to be strong. But you see -- when you -- you can see some weaknesses and it's because of the sluggish that Marcos referred to the market is basically in the infrastructure business that has been extremely slow in the fee side. But overall, we continue to see good activity in the consumer. And if you look at the results on the corporate business and the commercial business, they were up substantially on the fee side.

So I think that's -- it's a mix and it really reflects the kind of environment that we are managing in the bank. You see some patches of good opportunities, that we [seize] them immediately. And in other ones, you have to go down and reduce your activity on that. But what you have to consider is the overall results are really showing the resiliency of the group by really producing extremely good results from the subsidiaries, the consumer book, and also how efficient we are managing the risk and the risk-adjusted margin for the group.

Operator

Our next question comes from Ernesto Gabilondo from Bank of America.

Ernesto María Gabilondo Márquez BofA Merrill Lynch, Research Division - Associate

How do you see loan growth next year? Your GDP growth is around 1.4% next year. Under this scenario, would it be reasonable to expect a double-digit net income growth next year? And what will be the assumptions behind that growth? I know you will provide more details next quarter, but any trends will be very helpful?

And then in my second question, a couple months ago, I believe Banorte's management met with AMLO. I believe you expressed your intention to participate in the financing of several infrastructure projects. So can you elaborate on what kind of projects are you willing to participate? And also if we can get your point of view in the last update, news on PEMEX will be very helpful.

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

Thank you, Ernesto. Yes, as you were saying, we will release next quarter our forecast for the 2020. But I would like to say that we're on our 2020 plan and everything that is there is going to be there. So far, we think we will be doing it very well. And we see, given that number, that we will again -- we will grow at least 2 digits in the next year. I think that's all I can give you right now because we're working on that, but we feel comfortable, that's for sure, that we will deliver at 2020. And then we will launch, whatever it's called, for the next few years. We are working already on it and it makes a lot of sense to us that we will provide you a very reasonable and very good, I don't know how to call it, plan it -- plan for the future, no? Rafael, do you want to say something?

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

Yes, just additional. What Marcos says, we are confident of what Marcos says, and I think the key element that you have seen in the -- and that has to do with the risk-adjusted margin, and I think it's something that the market is not taking into the full account on these processes that the funding costs that we really incorporated when we acquired Interacciones, it peaked in January around the additional funding cost to 707 -- MXN 700 million on a monthly basis. That's what's in January, what did it peak.

Now that has been going down to MXN 385 million. That same cost because of all the actions that we have been taking in reducing the funding costs and all the actions in the treasury and the balance sheet and also a very well-managed policy on the growth in the time deposits. That MXN 385 million that is currently where we are sitting on, on September, should continue to go down to at least MXN 160 million per month. So that's an additional benefit that you will continue to see flow into the income statement. That's the reason why when people are concerned about the loan growth of Banorte, not on the consumer -- and even in the consumer compared to last year, it's because we have been able to be very selective on the relationships that we want to keep because we have an additional benefit by managing the funding costs in a very active way that is going to continue to release a substantial amount to the net income in the coming 3 months and in the coming year.

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

Okay. Regarding your second question. Yes, we have been meeting with Mr. López Obrador and all the people there. And for us, we want to keep everything under our radar. And then we are working with them in order to [bank rates] -- all the projects and to say if you want to do this, we need this; if you want to do that, we need that, in order to make it bank rates suddenly, all the projects that they have. And we feel pretty comfortable that in the future you will see a lot of projects that we will be working with the government, no? I think that's it for now what you will see from us in the next year, a lot, I hope, in infrastructure and all these.

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

One thing, this Gabriel Casillas, Chief Economist. Just want to tell you, Ernesto, just to add off a little bit on the GDP growth assumptions as well as on PEMEX that you asked. So with respect to the GDP growth assumptions, I think Marcos explained pretty well that our 1.4% GDP growth forecast for 2020 has to do a lot with the base effect. Actually, a simple calculation of base effect gives you around 90, 9-0, basis points, and you have to add then the leap year, so that adds around [26] basis points.

And on top of that, now I can combine the PEMEX question with this. In terms of PEMEX, we are optimistic that they are going to be able to increase the oil output, mainly because of one thing. I don't know if you remember, that around [3] years ago, when José Antonio González Anaya was -- took over as CEO of PEMEX, oil prices were below \$30 per barrel. So in this context, prior to changing PEMEX from a production-max company to a profit-max company, he decided to shut down several oilfields, conventional oilfields that were high cost at that time, around \$18 per barrel. So this was around -- it took like 250,000 to 300,000 barrels per day at that time.

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

But nowadays, with oil price above \$50 per barrel, which is very likely that it's -- that PEMEX is going to once again reactivate these [deals], so they're going to be able to move from the 1.7 million barrels per day right now production to 1.9 million barrels next year. So this is another reason why you take into account that since year 2004, oil production has been making a dent on GDP. Now it's not only going to stop subtracting growth, but it's going to actually add. So this is, I think, the main idea of PEMEX.

And just to finish the idea on PEMEX, I think it has been very, very important that -- what PEMEX has been doing in the past few weeks. For example, all the liability management operations that Marcos mentioned, that was very important to improve their profile and also even reduce a little bit the debt with capital injections of [oil]. So I think it's really clear that they're not [really meeting the PEMEX there, and they will always pay the parent. So I think this is a major year.] I just wanted to comment.

Operator

We will now take our next question from Adriana De Lozada from Scotiabank.

Adriana Sanchez De Lozada *Scotiabank Global Banking and Markets, Research Division - Associate*

I have 2 questions. The first one is about a legal case that we read about in the news about a MXN 1.2 billion fine. If you can give more details about that would be great.

And second, if you can give us details about the specific corporate write-offs given the sense of the size and why it resulted in additional provisions and what we can expect going forward?

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

The write-off was an asset that is related to one of the homebuilders where we had exposure. It's not related to [CSV], just to clarify that. And we do not expect any more [guidance] on that going forward.

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

And on the fine?

Unidentified Company Representative

Yes. It's not a fine. It's a legal -- an old legal claim against one of the banks that we acquired in 1994 (inaudible), and we cannot give more information because of the legal transition process. And on the other hand, it's fully covered by the indemnities that we have with IPAP when we acquired this bank.

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

So we don't have any worry about that.

Adriana Sanchez De Lozada *Scotiabank Global Banking and Markets, Research Division - Associate*

Sorry, I couldn't hear the last part of it?

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

The fine is it's a process -- judicial process that is in place, so we cannot give you another information. However, what we can tell you is that it is related to one of the acquisitions that Banorte made in 1994 and it is covered by the insurance, IPAP, so it is not an issue where we are concerned or it's not a contingency for Banorte.

Operator

We will now move on to the next question. It comes from Nicolas Riva from Bank of America.

Nicolas Alejandro Riva *BofA Merrill Lynch, Research Division - Research Analyst*

A couple of questions. The first one, on capital, you explained that the target for the CET1 is around 12.5%, you're a bit over that. But on the additional Tier 1 capital, you have a lot of -- more than 500 basis points of risk-weighted assets in AT1. You have 4 perpetual bonds outstanding. If I look at the minimum levels of capital, the optimal level to have for you will be 150 basis points, 1.5% of risk-weighted

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

assets in AT1 bonds because, of course, they are expensive, you pay higher [coupons]. So my question is, why does it make sense for you to have so much AT1 capital?

And then the second question on government lending. I don't remember but in the past you said that we should expect the government loan book to be diluted as a percentage of your loan book. But I thought the idea was more or less for that loan book to remain flat -- for the government loan book to remain flat. However, in this quarter, there's a big contraction in the government lending book, down 15% quarter-on-quarter. So my question is, has your assessment of the risk in this portfolio changed? Or why did you -- why was there such a big contraction in the government loan book this quarter?

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

The first one that you mentioned about AT1, that you see a lot of AT1, you have to see the evolution that we advised the market that we are claiming the -- with the expensive debt that was issued in the past when we did have some acquisitions like the Ixe acquisitions. Some of the Interacciones also that is paper that we have to [recall] from that, basically Tier 2 on that part. So what you will see in the past is not the level that we're concerned because some of that will be used to really reduce the Tier 2. But I think you should be getting used to see some slack on the capital basis and the reason for that is that, when you look at Banorte, you have to look at a company that in comparison with our peers like Santander, CDH, HSBC, we don't have a parent company to support.

So what we have been -- the policy for Banorte for many years is to have a very strong, strong balance sheet that really give all the peace of mind to our investors, not just in the equity side, but also on the AT1 and also on the fixed income side. So that's something that you will see. You will see a very important reduction on the Tier 2s on the coming months. But I think sometimes it might look like that AT1 could be, in a way, in a surplus way. But remember that also that allow us to do and is considered on the amount of money that you can really invest on IT projects and things like that, that allow us to be always on top on that expenses without hurting anything on our capital base. Yes, it looks -- that is a lot, but you have to see the evolution that is coming from the -- in the next months.

And on the government book, I think that this has been -- even a note from the -- on some of the notes that came out yesterday that said that Banorte is losing 60% of the current book that we acquired, and that's really not exactly right at all. If you look at the policy that we advised the market, that we want to have around 22% to 23% of the total book, I think we are on line on that. But the more important piece is that if you look at the profitability of the government book, I will refer just at this point in time just to the state and municipalities, the financial margin for the state and municipalities have grown 94% since we did the acquisitions and integrate it with Banorte. Why? Because we have been very selective on which loans to keep and which loans to release to the market in order to really keep the risk-adjusted margin at the levels that we would like to have in that. Marcos referred to that, that there has been a very, I will call...

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

Unreasonable.

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

Unreasonable fight for the government book, but we have been able to keep really the relationship that we have and the financial margin is at top 94. And what is also very important is that net profit for the state and municipality book is 54% and the return on equity for that book is 53%. So that assumption that we are losing, maybe we will be releasing some loans but we have been increasing the profitability of the book substantially. And the same goes for the commercial book. The commercial book, if you look at the commercial book that has been a sluggish growth maybe on the commercial, you can look at the profit for the book, 26% for the year; financial margins, 16% for the year.

And the same goes for the corporate book. The corporate book is -- the net profit is up 36% with good growth in financial margins. So when you see the risk-adjusted margin that is at record highs at 5%, it's because we have been extremely prudent, but we have also been providing all the services to the companies that we would like to do business with. And all those services and the right approach those companies all over the offering that we do to them allow us to have a very reasonable net adjusted margin and a very rich set of fees and also a good growth on the deposit side. So I think you have to go and look deeper when you look at what is going on with the government book.

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

As Marcos says, immediately when we did the acquisition of Interacciones, a lot of the peers were after the book and they created really a substantial decrease in the profitability of their new offerings pertaining to the market. And we were in a position because we advised to the market that we will be very selective on how we keep the profitability for the book, and we have been extremely successful in doing so.

Operator

Our next question comes from Geoffrey Elliott from Autonomous.

Geoffrey Elliott;Autonomous Research;Partner

The Bank of Mexico's CoDi platform went live over the last few weeks. Can you discuss what you're doing to engage with that? And then give us some thoughts on what you think it is going to mean for you and for the financial sector. I kind of hear conflicting views. On the one hand, it's not going to generate fees directly for the banks; on the other hand, potentially, it's all to drive financial inclusion. So kind of keen to get your take on whether we should be thinking about that as an opportunity or a threat?

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

Thank you, Elliott. [Paco Martha] will help us with that.

Unidentified Company Representative

Thank you. Yes. Thanks for your questions. We have been working with Banco de Mexico, very aligned with the requirements. As you're aware, we released our mobile banking CoDi released at the end of September. And we also implement CoDi in our paper solution, but it's for the nonbank segment. And we're working on the solution, we have now as much as close to 20,000 people enrolled in the CoDi solution and more than 3,000 people have already sent money using that solution. We -- as I've mentioned, we have the paper solution for the nonbanking segment, and we will work on pushing this solution. We don't know exactly how further it will go now that Banco de Mexico implemented zona CoDi in the main square of the city. And we're working -- we're collaborating, trying to convince all the small- and medium-cost merchants to join the solution.

Geoffrey Elliott;Autonomous Research;Partner

And do you see that as a potential threat to interchange fees you generate from credit cards? Or do you see it as an opportunity? Just trying to understand how you think about it.

Unidentified Company Representative

We -- I prefer to see it [more than] a threat, more of an opportunity. I truly believe that it will be more -- even that the payments trend towards being free, I think it's more -- it's going to be used more like a springboard to enter in another revenue -- another type of revenue pool or another type of revenue model.

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

Let me just add to what [Paco] mentioned, just imagine that if the CoDi continues to evolve and really reach a lot of the nonbank small merchants that we have all over the place, I think the float that we can see getting into the accounts and things will more than compensate for the merchant fees. So as Paco mentioned, we see that as a big opportunity to really [formalize] a lot of economy and really substitute the cash for the small merchants on this.

Operator

(Operator Instructions) We will now take our next question. It comes from Gilberto Garcia from Barclays.

Gilberto Garcia *Barclays Bank PLC, Research Division - Assistant VP & Equity Research Analyst*

My question is on operating expenses. While they were indeed in line with your guidance, we were a little surprised by the sharp increase in personnel expenses. Could you give some color on what drove those expenses?

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

Yes. Those expenses are mainly related to viable compensation that we provisioned for the -- based upon the -- that we see clearly meeting our goal for the net income or maybe a little above the net income. So that's really what was it. We don't see any sharp increase

OCTOBER 25, 2019 / 2:00PM GMT, Q3 2019 Grupo Financiero Banorte SAB de CV Earnings Call

on the coming months at all. So that was basically to normalize the provisions based upon the expectations of the net income related to the viable compensation and to the bonus pool. So that's exactly what it is on that part. But you can -- but you should continue to see that really the expense ratio that we are aiming for compared to the revenue side will continue to be around the 38, 39 that we have guided the market. We don't see any reason why we shouldn't achieve that. It was a sharp increase on this. And also the professionals fees went up because there was some derivatives-related expenses on that, but that's basically it. So I think that you will see a more normal trend in the fourth quarter and continued on the first quarter next year.

Operator

Our next question comes from Mark Lien from Lazard Asset Management.

Mark T. H. Lien *Lazard Asset Management Limited - Portfolio Manager*

Marcos, you mentioned earlier about the trade war substitution effect. How would Banorte specifically benefit from the (inaudible) [Asian] investment? I mean has Mexico captured some of the benefits from -- whether it's Asian or Chinese companies shifting the supply chains to Mexico? Which manufacturing areas are we seeing this in place?

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

Thank you, Mark. Mr. Gabriel Casillas is going to help us with that.

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

Thank you, Marcos. Thanks for your question also Mark. Well, let me tell you, we have had like visits from several manufacturing companies from Asia in the past 3 months, particularly in the automotive sector. These have been the main companies. They are not necessarily automakers, but companies that work for automakers. They have told us that they have had some difficulties to export their stuff to the U.S. from their geography, sometimes not because of tariffs but because of nontariff barriers. So they are seeking to invest in Mexico because of that. So in order to continue to export to the U.S. So yes, for this, it has been primarily in the automotive sector. I hope I answered your question with that, Mark.

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

And Mark -- if I might add to Mark, I think that Gabriel has been also very -- really given a lot of information to the market that if you look at the rate of growth of the center and to the north part of Mexico, that part continues to be extremely active and growing well above the GDP 0.4 or whatever it is. That is where really Banorte is mainly located on the -- through the country. So that activity will continue to benefit us and also the activity of the treaty. But also the already existing high employment, good remuneration, good activity related to the supply chains in the center and to the north, I think, is where really Banorte has most of the geography really covered for that. So we really continue to expect very good numbers coming from those regions.

Operator

We have no further questions over the phone queue at this time, gentlemen.

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

Okay. Well, thank you, and see you next year, at the beginning of next year. Thank you very much.

Operator

Ladies and gentlemen, this will conclude today's conference. We thank you all for your participation. You may now disconnect.

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