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PRESENTATION

Operator

Good day, and welcome to the Banorte Third Quarter 2017 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, ma'am.

Ursula Margarete Wilhelm Nieto

Thank you. Hello, everyone, and welcome to Grupo Financiero Banorte's third quarter earnings call. I'm Ursula Wilhelm, Head of Investor Relations. And this morning, Marcos Ramírez, our Chief Executive Officer, will give you details into this quarter results. With him are senior executive officers of the group, who will also support us in the Q&A sessions.

Marcos, good morning. Please go ahead.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Ursula, and good morning to all of you. I'm pleased to report to shareholder that, again, the group delivered solid operating and financial results. The quarterly dynamics of all the operating frames continue moving in the right directions to where our targets for the year.

On Slide 2, earnings per share grew 24% yearly, while in the quarter, earnings per share reached MXN 2.24, increasing 9%. Profits for the 9 months was MXN 17.4 billion, delivering an all times high ROE of 16.6% in the first 9 months and 18% in the quarter, moving ahead towards our 2020 objectives. The bank posted a return on equity of 19.7% in the period.

On Slide 3, total quarterly revenues of MXN 20.4 billion for the group grew 15% year-over-year with a strong contribution and double-digit growth from net interest income, fees and trading income.

The net interest margin for the quarter on Slide 4 reached 5.5%, expanding 9 basis points from the second quarter on the continuation of the positive repricing of the balance sheet and improved loan mix. The net interest margin, excluding insurance and annuities, stood at 5.4%, expanding 11 basis points from the prior quarter.

Total expenses in Slide 5 were down 1% during the quarter, as we align expense management to achieve our annual growth target. The efficiency ratio strengthened at 40.5%, declining 166 basis points from the prior quarter on wider positive operating leverage.



Continuing on loan growth on Slide 6. The credit book expanded 13% annually with larger growth in the consumer books. Activity was mild in the government sector, while there were a few prepayments on the corporate book. We expect to maintain momentum towards the end of the year with a pickup in the activity in the non-consumer segments. Loan demand continues to be active in spite of the earthquake.

Growth in the consumer portfolios continues to be largely driven by penetration with our existing customer base. And in September, the cross-sell ratio stands at 1.835 products per customer, higher than 1.830 ratio of June.

Asset quality metrics, shown in Slide 7, remain stable with the overall delinquency ratio unchanged at 1.8%. While the typical seasonal behavior in the asset quality should point to stable to improving consumers NPL ratio towards the fourth quarter, because of the earthquake, our expectation is to see higher NPL formation, mainly in credit cards in the next several months.

To tackle and contain potential asset quality problems, we have several initiatives underway. So let me brief you on them. Around 12% of the loan portfolio is located in the affected areas. However, the book we considered (inaudible) is lower, around 8%, which encompasses consumer and SME loans. The bank has worked together with the banking authorities to put in place a better relief program for customers affected by the earthquake, targeting consumer loans and SMEs.

In the case of the consumer loans, the general guidelines of the program are to provide a grace period of 3 months on installment payments, provided that the client was current on debt payments. Customers have to come forward to request support. It will not be granted automatically.

In the case of SMEs, Banorte will use the program sponsored by the development banks, by which loans could be restructured to longer tenures. These loans will have full guarantee from Nacional Financiera. The banking regulator will allow banks to forego regulatory requirements on these debts, meaning that there won't be additional loan loss provisions for the restructured portfolio.

At this moment, we do not have yet an estimation of the amount on the book that could fall into these programs, so we will report to you as we progress on implementation.

In the quarter, the cost of risk show improvement, moving down 20 basis points sequentially on lower and new NPL formation in the consumer credit portfolios. Going forward, we expect the cost of risk to be within the guidance range, 2.3% to 2.6%.

Moving to capital, Slide 8. The capital adequacy ratio of the bank was 17.63% in September, up from 15.05 -- 15.08% in the prior quarter. The capital ratio was bolstered by the AT1 capital note that the bank issue just recently.

Moving to the relevant nonbank subsidiaries. Quarterly earnings of Seguros Banorte stood at MXN 609 million, excluding the profit from the investment in the pension fund manager Afore, and were 10% lower than the prior quarter on larger-than-anticipated claims. The decline in revenue corresponds to the earthquake impact. Estimated claims stand at around MXN 1.1 billion, but most of the cat risk is [sequential]. Therefore, the impact to protect profit in the property and casualty segment was only MXN 52 million registered in September. Also, the floods had an impact of MXN 11.5 million in the auto segment.

The annuities company posted profits of MXN 178 million, which were 6% lower sequentially, mainly driven by the lower subscription in the quarter. For the 9 months, profits are up by 33%.

Lastly, we are looking forward to the next quarter. It usually is the strongest quarter of the year, and we expect to reach the annual targets we committed to. In the meantime, we expect furthersome support from the population to the victims of the earthquake in Mexico moving forward to reconstruction. At Banorte, we are committed to continue supporting our clients and our communities in the reconstruction effort.

Looking even further, many are already thinking about the 2018, and it has been customary we will give you the outlook in January.

With this, I conclude my comments, and we are ready to take your questions. Thank you very much.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we will take our first question from Ernesto Gabilondo with Bank of America.

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

On my first question, I will appreciate your view, what are your expectation for what could happen with NAFTA? I would like to know what could be the consequences for the banking sector, if we don't have the NAFTA next year, in terms of loan growth or asset quality. On my second question is competition. We're seeing that all banks are repricing loans, so I just want to think about, which could be the one that could be the most aggressive one at the moment. On the other hand, how you're willing to differentiate from other banks in terms of the retail banking? We're seeing other peers investing in their platforms and catching up to what BBVA Bancomer is doing. So any comments on what are you implementing will be much appreciated.

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

Thank you, Ernesto. Maybe we can start with the NAFTA and the implications in the banking sector. I will ask Gabriel to go and to go and tell us (inaudible).

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

Thanks, Marcos. This is Gabriel Casillas, Chief Economist. Thanks for the question, Ernesto. Going real quick, I think I would like to elaborate on 3 aspects. The first one is with respect to the negotiating team. We have a Mexican negotiating team. I think it's actually the best of this -- out of the 3 teams. They are negotiating NAFTA, with the most experienced and so on and so forth. So in this context, the technical arguments that have been used actually are quite good in every negotiation. But I must say that unfortunately, the Mexican negotiating team is using economic arguments, while the U.S. team is actually using political argument, so it's kind of hard to reach an agreement soon. Now having said this, the first 3 rounds were pretty good because there was a lot of -- there were a lot of low-hanging fruits, so it was pretty easy to reach common ground. However, one thing -- once you reach the thorny issues in this fourth round, well, this kind of impasse is usual in trade negotiations. So we are not as negative as some other market participants and analysts in this context. The second thing is that you remember what happened in the U.S. with the border adjusted tax. It was an issue that was all over the place. Congressmen were on board to that. Even President Trump was on board to that. I mean, at the end, he said he didn't. But the private sector did a great lobby on that. And the border adjusted tax actually was completely eliminated off the discussions. So in this context now, we are seeing the private sector, not only in the U.S., but also in Canada and Mexico. I mean, a big lobbying team in U.S., Congress and the Senate. So we do think that this could progress actually on a more positive way. It will not take away the uncertainty that we might experience from now, at least till the end of the first quarter of next year. But I mean, that's also on the positive side. And a third aspect that, I think, is important to highlight it's -- if we go to the worst-case scenario, we think that the probability continues to be low. But let's say the U.S. leaves NAFTA because we do not think that either Canada or Mexico will actually stand up from the negotiating table or will leave it. However, in this context. if the U.S. exits NAFTA, we don't think it will be catastrophic. Let me tell you just a couple of numbers. Right now, as you know, Mexican -- or a company that is based in Mexican territory, the ones who export goods to the U.S. or Canada, they can do it either via the NAFTA window or the WTO window. So if they use the NAFTA window, of course, it's duty-free. You pay no tariffs. But if you go via the WTO, you pay the most favored nation tariff. And as you know, it's around 3.5% on average. So having said this, actually, right now, as we speak, around 42% of Mexican goods that are exported to the U.S. actually cross via the WTO window. They don't use the NAFTA window. This could be because they don't fulfill certain requisites and so on and so forth. So it's not -- they -- I mean, even though the majority of exports go through NAFTA, a big chunk goes already via WTO. Now let's say U.S. exits NAFTA, what will happen is actually that the tariff to Mexican goods will pay in the U.S. is very low. There will be some exemptions because, I mean, the average is 3.5%. But there would be some exemptions, for example, in terms of pickup trucks. That is 25% tariff. And -- but there are very few -- actually, if you want to take into account all the goods that will face high tariffs, it will be -- it will account for around 2.8% to 3% of Mexican export. So it will not be catastrophic at all. Of course, not having this branding of NAFTA goods have some medium-term impact on investment and so on and so forth. But this is difficult to take into account. And we don't think it will be actually material, honestly. So having said all this, just to round up, in respect to the Mexican financial sector, on the one hand, I mean, impacts for next year, we see no impact at all because after all, these discussions will continue so on and so forth, at least till the first quarter of next year. If it goes more than the first quarter, it will probably take maybe more



than 1 year because, as you know, we have several political events, like the Mexican presidential elections in 2018, then the U.S. midterm elections in November. So if negotiations are not done by the first quarter, it's going to be very hard for negotiations to really be fast. So in this context, we don't -- I mean, we were very concerned when the U.S. election took place because of the outcome. And we thought a lot of Mexican business names will actually put a lot of projects on hold this year. And actually, we're -- on our first estimations, we were thinking that from January 20 when President Trump took up office, all the way up to the -- to April 30, the first 100 days, what we saw there is that we took away all the new investments, and that's how we came up with a very low GDP estimate for this year. I mean, fortunately, talking to businessmen, it didn't take that long. I mean, at the end, by mid-February, businessmen were already reactivating projects. And they really shrugged off all the threats from President Trump. So in this context, we don't foresee that this will have any impact on next year, honestly. I mean, it will, for sure, have some short-term impact on the markets. But we don't -- I mean, as soon as market participants have to digest that this will not be catastrophic, then I -- we do think that markets could get back to normal real quick. And it will not distort economic activity and, of course, issues in the banking sector.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you. Ernesto, regarding the platforms, we feel very comfortable with our platform. As you may know, we have been working for years in the multichannel architecture. And we hope we will have, as soon as April 2018, the best mobile technology in the country. Let's see, but we are aiming for that. And now, Rafa, can you give us more color on the repricing, please?

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

Yes. Hello, Ernesto. Good morning to everyone there. The issue about competition and the fact of the repricing, I think you have to tie to 2 things. First that, as Marcos says, we have been working a lot in really target the clients on a one-to-one basis to see the price that this client deserves and looking up a lot in the expected loss that we could really tag to each of the clients. So if you go on the NPLs for each of the products, overall, you will see that the only one that is compared to last year, instead of being 5.7 is 6.2 is the credit cards. If you go to the payroll, we are below the -- at the same level that the last year. Car loans are better than the last year. Mortgages are better than the last year. Commercial is also better than the last year. And corporate is the same. And that's really reflects that the adjustment that we have been doing is more than the -- and the repricing is adjusting the type of clients that we would like to give them the loans or not. So you will never see Banorte advertising anything about prices or anything because we really go by client. We don't go on the overall products. We saw some vintages that were not performing in the right direction in the credit cards. We adjust that around June. So we expect those numbers to be much better by the end of the quarter and continuing to the next quarter. But on the repricing, I would say that it's based upon the client. We don't do repricing on an overall portfolio, as it was in the past. And it has been playing pretty well because if you look at the risk-adjusted margin for most of the products, the risk-adjusted margin has been continually improving, even though you don't see any aggressive repricing on the consumer.

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

Are you seeing other banks being aggressive in the repricing or, in the contrary, offering lower spreads to gain market share?

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

I would say that if you look at the graph that are provided by the CNBV, you will see that on the car loans, I would say, is a reasonable market. You see some disproportions in the credit card market. In the -- everything else, I would say, everybody has been very rational about this. I mean, it's difficult to try to gain market share at the expense of provision. So no, I think everybody has been quite rational in the market.

Operator

we will take our next question from Carlos Macedo with Goldman Sachs.

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

Two questions. One, going back to the asset quality figures you were just disclosing. We did see on the credit card side that you didn't have the typical seasonal improvement you have in the third quarter and that NPL ratio for SMEs bumped up. Is that something that you can attribute to the earthquake? Or is it part of a broader cyclical trend? Or is it just a one-off that we're probably going to see revert back in

upcoming quarters? Second question on margins. I know you've been repricing and talking -- you've mentioned in the past that your portfolio will reprice with time. We did -- you did report this quarter the loan margins being flat quarter-on-quarter. Is there still more -- are you still going to reprice your portfolio over the next couple of quarters? Is that process fully done and we should expect, if the benchmark stays now at 7, that your loan book will -- that your margins will more or less flatten out from current levels?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Regarding the first one, yes. It didn't go down as quarterly, used to be, limit, but -- and it is because of the earthquake. So we hope, in the next 3 or 4 months, to recover the pattern, and that's it. And going to the second question, Rafa, please?

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

Yes. No, I think what you will see is that on the expansion on the margin, we can -- we will continue to see expansion on the margins. And there's 2 things that usually happen on the third quarter that, if you look at the way the mix of the funding came because of -- we had a much better growth that we anticipated, the cost of funds from the time deposits went up a little bit. We are growing very nicely on the time deposits. But you will see, for this quarter, an expansion also on the margins based of 2 things. Some parts of the repricing, but mainly because the cost of funds overall for the bank will also -- will go down nicely because you get the seasons -- the seasonality part that you get all the demand deposits flowing very nicely up to the end of December. And also you will see that the time deposit cost also is now leveling off and going down. So you will see a lot of positives on the margin side by the end of the quarter. Part of the repricing, part of the cost of funds and on the -- and what you mentioned about an uptick on the SMEs, and I think on the SMEs, we are very confident about what's going on, on the -- from the loan portfolio, where specific parts on the -- on 2 regions of the country that were addressed immediately. On the credit cards that I mentioned before, we already adjust some of the origination lines that we were not performing the way we want it. So you will continue to see an improvement in the SMEs. And also the credit card will be leveling off and start to going down in the first quarter next year.

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

Okay. Just Fernando, just one follow-up then. The -- so the improvements that you're going to get now, from what I understood, on your loan margin that was flat quarter-on-quarter, 8.5%, will come more for -- from funding than necessarily from higher loan yields or maybe change in mix, even though the change in mix will probably continue to happen given the pace of expansion.

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

Exactly right. You're right. And the fact was that we've funded some of the high growth of the consumer with the -- with time deposits, instead of the usual demand deposit. Demand deposits -- I mean, the growth outpaced the rate of growth over demand. So that's the reason mainly.

Operator

And we will take our next question from Tito Labarta with Deutsche Bank.

Daer Labarta *Deutsche Bank AG, Research Division - Senior Analyst*

Couple of questions also. I guess, first on your loan growth, we continue to see very good consumer loan growth. Just want to get a sense of your outlook for that. As Carlos mentioned before, the NPL is kind of remained a bit high there, but you think -- you mentioned that could be really due to the earthquake. So how sustainable is this strong consumer loan growth that we're seeing? And also following up a little bit on the margin, like, how much -- excluding changes in rates and better funding, how much does -- can the change in mix continue to benefit margin? And then my second question in terms of your guidance, Marcos, as you mentioned, the fourth quarter tends to be the strongest quarter. So a stronger fourth quarter would imply that you would probably surpass your net income guidance for the year. So is that reasonable to assume that there's some upside risk there?

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

On the net income, as you -- and you nicely called risk, yes, we see that we are now comfortably aiming for the high end of the guidance. We still have to see how the effects of the earthquake really are -- pass it to the customer base. But we are confident that we will be reaching the

high end of the guidance. Yes, on that part. I would say that the -- related to credit quality, I mean, you have to really see the rate of growth on the credit card that was very high. And as you know, the provisioning lines, just for the fact that you are bringing up the credit card book, you have to reserve on day 1 8% of the -- on the provisioning piece. But I think we are now confident that the vintages after the adjustment that we did, they were performed pretty nicely. And we don't see it, to be honest, on other parts of the portfolio, anything unreasonable about the behavior of the vintages of the -- or the origination processes. We knew exactly what happened on SME. It was exactly in 2 parts of the country that was adjusted immediately, as I was -- mentioned before. And we continue to -- and we are very confident that we will continue to see margin expansion up to May, June, July next year.

Daer Labarta Deutsche Bank AG, Research Division - Senior Analyst

Okay. That's helpful. So I guess, following up on the first question, do you still think of consumer loan growth can remain above 20%? For how long could that sustainable for?

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

No, no. I think what you will see is consumer -- the consumer book will be rounding around 16%. That will be the numbers that you will see.

Operator

And we will take our next question from Jorge Kuri with Morgan Stanley.

Jorge Kuri Morgan Stanley, Research Division - MD

Two questions, if I may. The first one on expenses, you did really well this quarter with expenses down 1% sequentially. You're probably going to end up within the guidance, maybe -- hopefully at the low end. How do you think about 2018 in the context of lower inflation? To what extent you can deliver better numbers than 2017 there? And then my second question is on NIM just to -- I guess, there's been a lot of different questions regarding this. And just to try to synthesize it, Rafa, you said that you can continue to see NIMs expand until June, July of next year. How much more do you think that is? So if NIMs are now at 5.5% or 5.4%, depending on if you look at what the insurance -- or the pensions or not, the peak in June, July is 10 basis points more, 20 basis points more? How much more do you think there is? And then if we assume that rates end up at, say, 5% in 2019, hopefully, there is no rate cut next year, and if rates end up at 5% in 2019 or 4.5%, where do you think your margins will be then? I'm just trying to figure out what's the sustainable margin. I know you've been saying that the mix shift has done enough to the underlying profitability of the assets, that maybe we don't get a lot of margin pressure, but just wanted to see if you can quantify that a little bit more.

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

Yes, on the expense line, you will continue to see the expense line going down by the end of the year. As you remember, we front-load a reasonable size of expenses for locking the software cost on that was mainly in U.S. dollars when the -- everybody was really worry about the peso. So you will continue to see expenses go down for the fourth quarter. And as we have been guided in the past, we see that a reasonable number to see on the expense line is expenses plus -- as inflation, plus 125 basis points. That's really where we've been addressing the 2020 goals that we set for the organization. On the NIM side, I would say that you have really look -- have to look at -- as you say, we increased and improved a lot of the mix. And I think we had a pretty good run on the -- on growing the consumer books, in the mortgage book, in the car loans, in the payrolls and in the credit cards nicely. So now the weight of the consumer book is where we -- close to where we really want it to be. So I would say that now, we are going to work a lot more on the funding side in order to be able to -- as you mentioned, when the interest rates start to go down, we have to continue to be pretty solid on the cost of funds and on the mix. We have a pretty good mix right now, 69%, but I think we could still accelerate a little bit on the demand deposit side. And that's what will continue to expand the margin, even if the interest rate starts to going down. We have been living in the past when interest rates went around 3.25. If you remember, it was -- the margins that we were obtaining at that point in time was 4.25, 4.30. So we can really think that the expansion on the next year, you will see at 18, 20 basis points more. Yes, we can really achieve that. And overall on the next years, I would say that the margin will be steady around 5.7, 5.8.

Operator

We will take our next question from Carlos Rivera with Citigroup.

Carlos Rivera Citigroup Inc, Research Division - Senior Associate

My first question is regarding the efficiency ratio. I mean, we saw a big improvement in this quarter, a combination of expenses coming down, but also strong revenue growth. So now the efficiency ratio is around 40%. How low do you think this could go? Actually, I'm thinking more long term. I know the guidance for this year. But what is implied in terms of efficiency ratio for your 2020 plan? And my second question will be related to the Afore business. Earnings are basically flat year-to-date. So just wondering a little bit if you could give us a little bit of color about the outlook for this business. What has been some of the challenges there and what you see going forward? Also if you see any chances for goodwill impairments that would, of course, reduce the equity and would be negative, but also would improve the ROE there.

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

(inaudible) No. The efficiency ratio, yes, it's [in place]. And for the 2020 plan, we plan to continue that way. So the challenge is to keep it in place around (inaudible) and that's our goal for the 2020. And now we're moving to the Afore. Fernando Solís is going to answer.

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

Sure. What's going on with the Afore, there are 2 things from the expense side. We have been experiencing a lot of competition. So we have been increasing our expenses in the commercial side because, otherwise, we would be losing market share on the one hand. And on the other, you recall that we are making a provision for a fine to the Afore by the trust commission, by the COFECE, in Mexico. It's something that we are, of course, mitigating because we are not agreeing with the amount. But going on the conservative side, we are observing an unexpected hit. It will be of MXN 180 million for the year. So if you take that out, actually, the Afore income has been growing positively, not flat. And actually, the hit -- I mean, the guidance is that without taking into consideration the provision for the fine, the guidance is that the net income will grow somewhere between 5% to 7.2% on an annual basis. But taking into account that we have to make this provision and that we are incurring higher expenses due to this increased competition that Afore is facing, therefore, otherwise, it's going to be somewhere the same level of last year. And with respect to whether we will have some write-downs or with respect to the goodwill, at this point, we do not foresee any.

Carlos Rivera Citigroup Inc, Research Division - Senior Associate

Okay. And just if I may follow up on the efficiency ratio. So just to confirm, you do not need to go below the 40%. You don't need to go to 39%, 38% to achieve the 20% ROE, correct?

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

Correct, that's not our objective. Maybe we can reach it, but we stay at 40%, that's okay for us.

Operator

And we will take our next question from Alonso Garcia with Credit Suisse.

Alonso Garcia

I just wanted to touch base on the strategic partnership with IBM. I mean, could you please provide some details on the profit-sharing scheme? How much have you paid so far to IBM, if that's possible? And how should I account it for? And the metrics you used to determine the remuneration to IBM? Any color would be appreciated.

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

Thank you. Rafa will go into it.

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

Yes, the partnership with IBM, now as we mentioned is entering the second stage of the deal. That is basically moving most of the operating cost and the operational centers of the technology base to the global centers of IBM in order to benefit from the global scale of these centers and also to increase the levels of the cybersecurity piece that everybody is worried about. So that started in last May. And has continued



moving forward in order to be finalized by June next year when we will be moving all the operational IT structure to the IBM centers and we have full redundancy in hotline for the -- for each of the applications in the partnership that we are giving them. Overall, I would say that of close to the \$320 million that we have been paying IBM, they have been getting around \$30 million in the profit gaining share at this point.

Operator

We will take our next question from Jason Mollin with Scotiabank.

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

So I mean, the margin expansion has been impressive and looks to be continuing. And part of that you're describing, of course, is due to the rates. But your balance sheet is shifting and the mix is shifting, and that does require a different provisioning. How should we think about the post-provision margin? And is this a sustainable level? Or with this increased exposure to the consumer growing so quickly, should we expect that to be relatively flat? And maybe an update just on the sensitivity to rates. Is it -- are you changing it either because of the mix in the balance sheet or hedging? Or how do you see this? Particularly if you expect rates -- I don't know, maybe you could give us a view if you expect rates to go down at the end of next year or not. And then, just a very basic question on we saw a very large shift in the -- or gain in the sale of foreclosed assets in the third quarter versus the second. It looked like there was over a MXN 500 million improvement on that line, if you can give us some color there.

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

Thank you, Jason. And we always look at the risk-adjusted margin, as you mentioned. That's the one that we follow very closely. That's why we have been very careful on the repricing part in order to really keep the risk-adjusted margin in the levels that we want. I think it's a reasonable -- I think it's reasonable to think that, that will continue to slowly increase. Why? Because we see the portfolio, as we mentioned, the mortgage growth, the car loans, all portfolios are performing well. The only adjustments were made on the credit card. And in all the -- on the corporate commercial government side, the risk-adjustment margin has been really aggressively growing in the past 2 years. So yes, we will -- we are always looking at that number. That's the number that we really follow on the margin. We continue to see expansion there, yes. I think as we mentioned before, the consumer mix on the book is already reaching the levels that we would like to have. You see more coming on the SME side, on the commercial. But I think that we are reaching now a very balanced book instead of the 11% consumer book that we had 3 years ago. So yes, we'll see risk-adjusted margin continue to expand. And I would say that the sensitivity to rates, we have been doing a lot of exercises about this. I know it continues to be the same. I mean, 100 basis points of margin gives us MXN 1.1 billion of pretax benefit on the margin. What is different now, and I think that that's in a booklet that we distribute to the investors, is that the effects on the rise of the interest rates, it usually takes, on a negative part of the curve, like 6 months, to start leveling off and start gaining. But so the same is going to happen when the interest rates go down. We will have some benefits on the -- around 4 to 5, 6 months on the interest rates going down. And then, we will get the effect of the lowering the interest rates. Because it works going up, the -- all the liabilities side get affected immediately. Going down, also happens the same, but in the good -- for the good reason. So we continue to see expansion on the margin, risk-adjusted margin, we see that a positive expansion also. And the sensitivity, by measuring many, many -- in many ways, continues to be the same.

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

But Rafael, that's a good point. Because if you're measuring the sensitivity of 100 basis points to MXN 1.1 billion in net interest income, given the growth -- the impressive growth we've seen in your NII, that it is a smaller portion.

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

Yes.

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

Is that what you're suggesting? If it's the same impact in interest income, then given the size of the balance sheet and I guess the -- all of the components that it is -- it's less relevant to the size of the income statement today?

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

It's really -- I think it's much more on the -- related to how do we form the balance sheet, Jason, and how fast we can really expand the growth in the cheap funding for the -- for really -- fund the balance sheet. I think we will always look at the way we fund the balance sheet. And we have seen a reduction on -- why? Because the interest rates have been around 150 basis points, on the efficiency on the balance sheet. But it has been in the other way, improved by the better mix. But we now have to work this and have a much more solid funding base for the balance sheet. So that's what we're doing. And we have been doing a lot of scenarios about the sensitivities and looking at many -- every single part of the balance sheet. And we continue to reach to the same numbers.

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

Okay. Maybe just a short comment on the -- what's going on with the sale of the foreclosed assets?

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

Yes, happy to do so. As you know, the foreclosed asset piece has to be adjusted to market value by accounting -- by the accounting rules by the CNBV. So you have assets that they -- what we call they regional anniversary because we haven't sold them. So we have to adjust them at that day. And that was the effect that you saw on the past quarter. And this quarter, it happened the opposite. We have an extremely good quarter for selling assets, foreclosed assets. So what you saw on the pad is, and it was already budget for the year, is that we knew that some of the assets that we hold on the balance sheet were going to reach what we call the anniversary, and we have to adjust the value along with the market. But we have an extremely good -- third quarter on the foreclosed asset sales, and an improvement on that part. So it's, as you will see at the end of the year, it's very reasonable compared year-to-year on the -- on that number. But that's the reason that you saw in the past quarter, Jason.

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

Forward, do we have -- do we have, I mean, looking to forward anniversaries, will there be more gains next year? Or are we done with this?

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

No, it's a permanent adjustment that we have to do. We do it every single year, and we have been doing every single year since then -- since the beginning. So that's why we have an incentive scheme that, for the foreclosed asset unit that have a much more -- to increase the velocity of the way they dispose the assets on a profitable way. So we have been working a lot in the judicial process in the foreclosed assets unit in order to improve how fast we can really put the assets on the market, when we have on the balance sheet. So -- and that's why you have seen a lot of improvement in that number. But every single year, you have to go and look at that number, to see if you haven't sold the assets and you need to adjust those to market. We do every that in every single year. And the numbers that we have seen every single year ranges from MXN 200 million to MXN 300 million.

Operator

We'll take our next question with Eduardo Nishio with Plural.

Eduardo Nishio *Brasil Plural Corretora de Cambio, Titulose Valores Mobiliários S.A., Research Division - Financial Sector Analyst*

I have a question on capital. With your process improving and already is a solid capital base, is that reasonable to assume that your excess cap will start to grow rapidly from now on? And what is the plan to do with these excess capital, for increased payout ratio, buybacks, or perhaps thinking, again, about acquisitions, if especially your efficiency has already reached to an optimum level?

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

The -- as you have seen, and we have also committed to the market that the payout ratio is at 40%. And we do have a process, on a tactical basis, to pay an extraordinary dividend. Yes, we will follow that number very closely. And as we saw in the past, with the -- when we sold the INB, we paid an extraordinary dividend. So we are very vigilant about that. On a tactical basis, that's the way we want to go; stay at the 40% and pay on a tactical basis, extraordinary dividends. Yes.

Eduardo Nishio Brasil Plural Corretora de Cambio, Titulose Valores Mobiliários S.A., Research Division - Financial Sector Analyst

Okay. How about acquisitions and buybacks? Any plans there?

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

I would say that we are always on the look in the market for potential acquisitions that could improve the results for the shareholders. But this is for the shareholders to say yes or no to those acquisitions, as you know, by the bylaws that we have. On the buybacks, I don't think, at this point in time, the buybacks -- we have been discussing that with the shareholders, and they really would like to have a better -- special dividends than the buybacks.

Operator

(Operator Instructions) And we will take our next question from Chelsea Colón with TIAA Investments

Chelsea Colón

Apologies if I missed this at the beginning of the call, as I joined late. But can you discuss your rate expectation for the rest of this year, and more importantly for next year? And then, also, just a quick second question. Is there any update on the investigation we heard about earlier this year into trading of government securities?

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

First, I will go to the second one. We are not in that [party], but we are not hearing anything new. So it seems that everything dissolved, I don't know. I'm going to the first questions about the rates. Gabriel, please.

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

Thanks, Marcos. This is Gabriel Casillas. What about the rate expectation for next year? I mean, honestly, a few weeks ago, market [budget expense] was starting to discount the probability of the Central Bank of Mexico actually reducing rates as soon as this year. This has been a repricing of this. Now actually, some -- I mean if you take a look to the (inaudible) futures, they are now pricing, actually, rate hikes. Now let me tell you, honestly, there are 4 things that are very important to the Central Bank to make their decisions. Number one, you have, of course, inflation. Inflation, I think, we reached the peak at 6.66% back in August. We have the number in September at 6.35%. Probably in October, we might see flat inflation vis-a-vis September, because of some distortions of the earthquake, but it will continue to trend downwards towards 6.4% by year-end. But very importantly, it will step -- it will make a quick -- a big step down in January to around -- something around 5%. This will be reflecting the once and for all big increase in gasoline prices back in January. Now from that point forward, it's going to be very hard for inflation to really reach a -- some levels below 4%. So it's going to be very hard, from an inflation standpoint, for the Central Bank to really be able to lower rates. We don't think they will hike at all. I think definitely the 400 basis points of hiking cycles, that was it. Now for the central bank to be able to lower rates, for inflation-wise speaking, it will have to take place in the second half of 2018, and it cannot be very aggressive. Then, you have other 3 aspects. Number two, very important, you know what the U.S. Feds will do. Now we have seen the Fed -- a more hawkish Fed. And of course, we're still -- we're expecting who's going to replace, or if Janet Yellen will be reappointed. So this is another factor that could be of importance. Number three, have the exchange rate that has been reflecting a more hawkish Fed, has been reflecting the probability of a tax reform in the U.S., and also has been reflecting all the discussions around NAFTA, that even though we are optimistic about it as I mentioned at the beginning of the call, with this -- it's high likely that it will continue to boost the volatility levels. So it's going to be hard also on that standpoint from the exchange rate. And the fourth one is with respect to the election. Usually, election -- presidential election have not been, in the past, a major drawback for the Central Bank to do anything. But that's something also that might be taken into account by board members. So it's going to be very, very hard for the Central Bank to really lower rates in the short term. So probably, if there is a chance to do this, it will take place in the second half of next year. And as I said, it will not be a very harsh easing cycle, such as Brazil for example. Maybe, if things go well, probably, 25 to 50 basis points of cuts in the second half of next year. And if things go well as well in 2019, we might see another 50 basis points, but that would be pretty much it.

Chelsea Colón

Okay. Great. And what's your expectation for growth next year?

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

It's 2.5%.

Operator

We will take our next question from Carlos Gomez with HSBC

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

Two questions, the first one going back to the question of margin and following up on Jason's. You mentioned, again, that your sensitivity is MXN 1.2 billion for 100 basis points. Now is that MXN 1.2 billion only on the asset side? Or you include both the assets and liabilities? Because if you include the whole margin, that would be about a 2% sensitivity, which is extraordinarily low and hard to reconcile with the increase that you have experienced so far. The second, it's a minor thing, but you have had about MXN 126 million in charges for this defined benefit, your pension plans, which has been happening almost every quarter. Is your expectation that this will continue? Or is it just a short-term effect?

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

Carlos, could you please repeat the second one please?

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

Yes. When you look at your changes in shareholders' equity, there is a charge of about MXN 126 million, which is about your defined benefit pension plan -- adjustment to your defined benefit pension plan. I mean, it has been recurrent for the last 7 or 8 quarters. So we wondered where that should go in the future?

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

Yes, that's the -- on the pension plans that -- I will go back to you because we don't have a -- anything that we do is basically on the [actual] tables. So let me -- to be honest, I don't have in my radar that we have to do those charges. So let me go back to you. In the other hand, you will see I'll release more in the coming months in that part. But I will review that very carefully to see that number. Sorry, I don't have that information right now. I follow that number, but it's also on the other positive side. On the sensitivity in the assets and liabilities, I think that if you -- there's a note, and we published that on the booklet as I mentioned, that it's very interesting to see how the curves of each of the hikes that have been happening in the past year, from the 3% to the top of the curve, what has been the effect of each of the curves on the balance sheet and on the margin. And since the amount of the number of hikers that we had, it's very difficult to really see the real effect of each of the hikes. For what we have right now, and we can't really now anticipate the full effect is that, if there have been no more hikes now, and we know exactly the time that it takes for the liabilities side to start being positive after the hike in the interest rates. That's why we have been anticipating and we have been reviewing the sensitivity that we have (inaudible) exactly the same. But we anticipate that because of the liabilities that you mentioned, we will have a much better sensitivity on the liabilities side than in the -- on the assets side in the coming 6 to 7 months. And if you want to discuss that on -- we can really follow that curves that we mentioned on a one-to-one call or whatever you feel like. But I think we need to go and look at those curves to really understand the full effect of how that affects the balance sheet and the time frame for the liabilities side to really kick into the sensitivity piece.

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

I guess -- I mean we understand that and your treasury position is going to determine your impact, very clear. I guess what we all ask and keep asking is what is the effect in the long run? Going 1, 2, 3 years forward, when the full effect of your ALCO has been already absorbed, and one would imagine that then [gives your] liability structure, (inaudible) as you mentioned earlier. And that the impact, one would imagine, should be higher, given that your funding is so good. So I think what I'm expressing is surprise that you don't hinder your sensitivity to rates in the long run from the liabilities if higher than 2%.

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

No it's -- let me give you very simple numbers to see that a lot of benefit will come also from the liabilities side. If you look at the time deposit piece for us, the cost of funds on the time deposit for us, on a year-to-year basis, grew 425 basis points more from year to year. Why? Because we decided to fund the higher rate of growth on the consumer book, especially on credit cards and the remains of the consumer book with the time deposit piece. It was a reasonable bet. It worked pretty well. We funded right. But now we also reached a number on the time deposits, if you see the rate of growth for the time deposit piece that allows us to really manage that cost a lot better. So just for looking at those 425 basis points that grew on a year-to-year basis, that number should be on a reasonable basis, maybe tops 91, 100 basis points on a steady state basis. So you have 300-odd basis points sitting there on the time deposit that should be improved. So there's a lot of moving pieces, but we're really are taking care of each of the ones. But the key effect that you see that there's some, let's say, less positive effect on the margin side, on the third quarter, has to do with the hike that happened on the time deposit cost. That will be leveled off from now until the end of the year.

Operator

And we will take our next question from Claudia Benavente with Santander.

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

I'm sorry if the question was already asked. I couldn't join the call earlier. But I was wondering about the insurance revenue. I understand it was relatively weak this quarter due to the earthquake. So I was wondering if for the next quarters, we can see it stabilize to the growth that we saw for the previous quarter? So it's about 20% year-on-year growth?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Claudia. (inaudible)

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

Yes. While we speak to the insurance revenue, I mean, we have the experience in some non-recurring events. First of all, something that everybody is aware of is the earthquake. That's an event that happens in Mexico once every 50 years or so. Depending on the magnitude even, more years than that. Actually, as we mentioned, we expect somewhere between MXN 1.2 billion to MXN 1.6 billion to be paid to our customers. However, since we have a very conservative exposure, we insure most of our catastrophic risks. But however, regardless of that, given our priority that is the amount that we retain, we are going to be hit, as was mentioned by Marcos at the beginning of the discussion, directly, it will -- if hit, our results with somewhere around MXN 54 million directly with respect to the loss ratio. But we also have to pay somewhere around MXN 500 [million] in addition to that, to reinstate our coverage. Because we have our priority. It has to be restated whenever we have an event, and we have 2. We have 2 earthquakes. Because many times, we refer to the one that hit Mexico City, but remember, that we have another one that also hit Puebla and Oaxaca and so on. So we have 2 events, not only one. And therefore, we have to restate the coverage, and that cost us also some money. We have been experiencing a lot of claims. With respect to the earthquakes, the amount is more or less 2,100 claims. But we also have a -- that's I would say on the property and casualty lines. But we were also experiencing some losses or claims, in auto insurance, and in that regard, let me add -- we also have or we also experienced not only claims due to the earthquakes, but also, because of the flooding caused by some hurricanes. So this has been a very unusual year. I would say, not even for Mexico, but also for other regions in the world in terms of catastrophic risks. And therefore, this is something that unfortunately happens, but it's unusual. And therefore, we were hit because of that. In addition to that, we have some other non-recurring items that we have been experiencing, due to some losses that we were recovering from our insurer that has been going into liquidation. And therefore, we have some claims to collect that we are now also making provisions because we are not certain on whether we will collect those claims. The total amount of what we are -- of what these 2 insurers owes us is more or less MXN 280 million. All of this is before taxes, and we have been provisioning that. And actually, we are going to -- they're going to a year. We're (inaudible), at this point, have a hit in our book, more or less of MXN 90 million with respect to a key provision. This fact for more or less MXN 120 million to the end of the year, unless, unless, because we are a -- we are figuring out with our lawyers and with the financial strength, and given that these 2 insurers is going to liquidation, how much we're going to expect to collect. So we may experience an additional one case, if we do not see one off this year, more or less of the complement of MXN 120 million and MXN 280 million. If not, we're going to keep reserving this and see how much we can recover. But that's, at this point, uncertain. So it has been a very unlikely year, I would say, for the insurance company. On the other hand, the



-- even though we have taken measures in the auto insurance, we still experienced a lot of -- following in the auto insurance. That's something that has been going up for all the insurance companies in the country. We also have been experiencing an increase in the loss ratio due in some part of our portfolio due to the Uber cars, of the coverage, because they do not -- they are not disclaiming to us that they are in the public service, and the loss ratio is higher. And this is very difficult for us because they are not -- they have not been -- they don't want to, I should say, they don't want to disclose that they are Uber drivers. And we have to screen them also, some (inaudible) with the loss ratio there. But to answer your question, I mean, our guidance for the insurance company for the end of this year is that net income will grow somewhere, taking into account these non-recurring events, somewhere around 3% to 7%. But if we take out these non-recurring events, plus remember that we also liberated some reserves insolvency last year somewhere around MXN 200 million. We take those non-recurring events, actually, the portfolio has been behaving quite nicely. Because without taking those things, the book -- the net income would have been growing somewhere around 18% to 22%. So this has been a very tough year; unusual. But with respect to the recurring income, with respect to the car business, we are quite pleased with what we have seen.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Fernando, for your short disposition. It seems that (inaudible) was using the 2018 budgets (inaudible).

Operator

And we have a follow-up question from Chelsea Colón with TIAA Investments.

Chelsea Colón

Could you explain or elaborate a little bit more on the relief program for those impacted by the earthquake? You mentioned a grace period of 3 months for installment loans for consumers. Does that mean that those will not go into NPLs? And then, on the SMEs, can you explain how the program works with Nafin exactly?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you. We have a lot of programs. Ursula, go ahead, please.

Ursula Margarete Wilhelm Nieto

Thank you. Chelsea, this is Ursula. On the consumer side, the program basically will be to give some grace period of about 3 months on the loans. The customer has to come forward to request the support. So it will not be done automatically on the entire portfolio, but it will be done on a case-by-case basis. But one of the requirements is that the customer must be on time on its loan. This means that it will not -- this program will not apply for delinquencies. And on the SME side, basically, we will have a guarantee from the development bank, Nacional Financiera, on the loans that are restructured under this relief program.

Chelsea Colón

Okay. So the -- your first comment's related specifically to consumer loans? And your second one, with Nafin, is just for the SMEs?

Ursula Margarete Wilhelm Nieto

That's correct.

Operator

(Operator Instructions) And we have no additional phone questions at this time.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you very much, and I hope to see you in next quarter. Thank you.

Operator

Ladies and gentlemen, once again this concludes today's call, and we thank you for your participation. You may now disconnect.



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