Intergroup Financial Services
2Q11 Conference Call
08/03/2011
9:00 AM

Operator: Good morning, and welcome to the Intergroup Financial Services second quarter 2011 conference call. All lines have been placed on mute to prevent any background noise. After the presentation, we will open the floor for questions. And, at that time, instructions will be given as to the procedure to follow if you would like to ask a question. It is now my pleasure to turn the call over to Peter Majeski of I-Advize Corporate Communications. Sir, you may begin.

Peter Majeski: Thank you, Kallie, and good morning, everyone. Welcome to Intergroup Financial Services second quarter 2011 earnings conference call on this, the third of August 2011. We are pleased to have with us from Intergroup, Mr. José Antonio Rosas, Intergroup's Chief Financial Officer, and Mr. Enrique Espinosa, Portfolio Manager, from Interseguro. They will be discussing Intergroup's results per the press release distributed yesterday. If you have not yet received a copy of the presentation or earnings release, please visit www.ifs.com.pe to download a copy, or call us in New York at 212.406.3695. It is now my pleasure to turn the call over to Mr. José Antonio Rosas, Chief Financial Officer. Mr. Rosas, you may begin.

José Antonio Rosas: Thank you, Pete. Good morning, and welcome to Intergroup's second quarter 2011 conference call. We will start with a brief discussion of the highlights of Intergroup's performance. Net earnings at Intergroup increased 12% year on year, driven by growing loan volume and fee income at Interbank, and higher investment income at Interseguro.

Earnings, however, fell 9% quarter over quarter, as a result of lower investment income at Interseguro, and increasing provisions and financial expenses at Interbank. Looking at the performance of Intergroup's subsidiaries, Interbank's net earnings rose 22% year on year, driven by growth in gross financial margins and fee income. Administrative expenses remained stable, year on year.

Net earnings remained stable quarter on quarter. Gross financial margin grew 7%, but was offset by a 29% increase in provisions. Loans grew 4.3% quarter on quarter and 22.4% year on year, as a result of continuing strong demand across most segments. Recurring net interest margin decreased 30 basis points quarter on quarter, mainly due to a decline in loan yields and a net increase in deposit costs. Asset quality remained stable year on year, with a past due loan ratio at 1.6%. The ratio of operational expenses to average loans decreased from 3.6% in the second quarter of 2010 to 3.1% in the second quarter of 2011. Administrative expenses at Interbank remained stable, quarter on quarter and year on year, despite an increasing volume of business, leading to improvements in the efficiency ratio.

At Interseguro, earnings rose 30% year on year, due to a 26% increase in investment income, but decreased 34% quarter on quarter, from a record level reached in the first quarter of 2011, as a result of lower realized gains in the investment portfolio. Annuity sales nearly doubled year on year, driven by Interseguro's leading position in the expanding early retirement segment.

Please turn to the following page for a brief overview of the net earnings of Intergroup and its two subsidiaries. On page 4, we can see a summary of the quarterly earnings of Intergroup and its two subsidiaries. Operating performance was strong, driving both subsidiaries to a positive year-on-year performance. Interbank's net earnings remained stable quarter on quarter, but Interseguro's earnings declined, as mentioned, due to lower investment income. On the following pages, we will go through detailed discussions of each of the companies' quarterly performance.

Now, please turn to page 5 for a discussion of Interseguro's net earnings. Looking at Interseguro's performance, first on a quarter-on-quarter basis, we can see that net earnings decreased 8.9% quarter on quarter, driven by lower investment income at Interseguro, and higher provisions and financial expenses at Interbank. Gross financial margin grew 2.9%, as a 4.9% increase in financial income, was partially offset by an 11.4% increase in financial expense. Provision expenses increased as a result of unusually low provisioning requirements in the first quarter of 2011, which have now returned to a more normal level. Interseguro's loss from insurance underwriting decreased 12.7%, due to lower reserves, linked to a quarterly decline in annuity sales. Administrative expenses remained stable, while the business continued to expand. This was due to technology improved investments at Interbank, which have allowed the Bank to conduct a larger number of transactions without increasing headcount or external services. Net operating margin decreased 3.9% as a result of the above-mentioned factors, but net earnings declined at the higher rate of 8.9%, due to higher income taxes on dividends paid out by our subsidiaries and on increasing earnings at Interbank.

Now, looking at the year-on-year performance of Intergroup, we can see that net earnings increased 11.8% year on year, driven by growth in loan volume and fee income at Interbank, and by higher investment income at Interseguro, partially offset by a rising cost of funds. Gross financial margin grew 8.9%, as a result of a 16.4% increase in financial income, which was partially offset by a 45.7% increase in financial expense. Financial income growth was driven by a 26% increase in loan volume at Interbank, and a 26% increase in investment income in Interseguro. Financial expenses rose almost 46%, due to higher funding costs on deposits, and the interest of a $400 million senior bond issue carried out at Interbank. Fee income grew 8.5% year on year, mainly as a result of increasing business activity in credit and debit cards. Interseguro's loss from insurance underwriting grew 31%, due to an increase in reserves linked to significant year-on-year growth in annuity sales. Administrative expenses remained stable, year on year, as a result of efficiency gains at Interbank. As a result of the strong operating trends discussed above, income before taxes rose 17.4%; however, this was partially offset by an increase in Intergroup's effective tax rate, from 24.8% in the second quarter of 2010 to 28.4% in the second quarter of 2011. This increasing rate was a result of lower tax-exempt income at Interbank.

Now, please turn page 7 for a discussion of Interbank's performance. Interbank's net earnings rose 22% year on year and remained stable quarter on quarter. The year-on-year increase was due to growth rates of 8.5% in gross financial margin, and 8.4% in fee income. Administrative expenses remained stable. Earnings also remained stable quarter on quarter, as gross financial margin grew 6.9%, but was offset by a 28.6% increase in provisions. Interbank's return on equity was 31.8% in the second quarter of 2011, above the 31.5% reported in the first quarter, and 30.1% reported in the same quarter of last year.

Please turn to the following page for a brief discussion of Interbank's loan portfolio. The loan portfolio grew 4.3% quarter on quarter, and 22.4% year on year, as a result of strong growth in the retail and commercial segments. Retail loans grew 3.9% quarter on quarter, mainly driven by increases of 5.7% in mortgages and 4.6% in credit cards. The rate of growth in mortgages was strong, but slightly lower than in previous quarters. Mortgages had expanded by 7.5% in the first quarter of 2011, and 9.7% in the fourth quarter of last year, driven by very strong demand for new housing. This growth rate moderated slightly in the second quarter of 2011. The quarter-on-quarter growth rate in credit cards was one of the highest in recent quarters, driven by continuing strong consumer demand. These significant growth rates in mortgages and credit cards have led retail loans to expand by 19.3% year on year. The commercial loan portfolio grew 4.2% quarter on quarter, and 23.2% year on year, as demand for loans among mid-size businesses remains strong.

Please turn to the following page. Interbank financed its quarterly growth with an increase of S/. 377 million in deposits, partially offset by a decrease of S/. 131 million in bonds. Commercial deposits grew 8%, and retail deposits expanded 5.8% quarter on quarter, as strong demand among retail and commercial clients allowed Interbank to replace a portion of its institutional deposits with more stable and lower cost sources of funding. This is very positive in terms of our stability and cost structure of our deposit base. The decrease in bonds was due to the impact of the appreciation of Nuevo Sol on Interbank's U.S. dollar dominated bonds, which accounts for 88% of our dollar bonds outstanding. Also, $10 million in subordinated bonds matured during the quarter. The Bank's total funding base grew by almost S/. 2 billion year on year, due to increases of S/. 1 billion in bonds, S/. 600 million in bank loans, and S/.360 million in deposits. Deposits grew only 2.8% year on year. However, the composition of the bank's deposit mix changed significantly, as growth rates of 19% in retail deposits and 14.5% in commercial deposits were offset by a 24% decrease in institutional deposits. As a result of increasing demand for transactional deposits among retail and commercial clients, Interbank reduced the proportion of higher cost and less stable institutional deposits from 34% of our total deposit base in the second quarter of 2010, to 25% in the second quarter of 2011.

Now, please turn to page 10 for a discussion of our financial margin. First, looking at our quarter-on-quarter performance, gross financial margin increased 6.9% quarter on quarter as a result of growth in income from loans and investments, partially offset by a rise in the cost deposits. Financial income increased 7.7%, driven by growth rates of 50% in exchange gains, 67% in investment income and 2% in interest on loans. The increase on interest on loans was attributable to a 4.3% growth in the average volume, partially offset by a 50 basis decline in the average yield. This decrease in yields took place both in the retail and commercial loan portfolios, mainly due, in the case of the retail book, to a shift in mix between mortgage and consumer loans, and in the case of the commercial portfolio, due to competitive pressures from rates. Investment income increased 67% quarter on quarter, mainly as a result of dividend receive and non-recurring gains on the sale of investments, a total of S/. 50 million. Excluding non-recurring factors, investment income would have grown 10% quarter on quarter. The increase in exchange gains was a result of higher income from trading activity with clients and gains in Interbank's own exchange position. The return on interest earning assets 10.3% in the second quarter of 2011, 30 basis points higher than reported in the first quarter, mainly as a result of increase in investment income. Financial expenses grew 10.3% quarter on quarter, due to increases of 22% in interest on deposits and 4% in interest on bank loans. The increase in interest on deposits was driven by an 8% growth in the average volume, and a 20 basis point increase in the average cost. This increase in the average cost was a result of a 60 basis point increase in the cost of institutional deposits, which was due to two factors. The first was a 50 basis point increase in the Central Bank's reference rate during the quarter, from 3.75% to 4.25%, and the second factor was an increase in the proportion of institutional deposits denominated in Sols, which have a higher cost than dollar deposits. The average cost of retail and commercial deposits remained stable quarter on quarter. The average cost of funds was 3% in the second quarter of 2011, a 20 basis point increase quarter on quarter, as a result of the higher of institutional deposits and growth in medium-term financing.

Now, looking at our year-on-year performance in terms of financial margin, we can see that gross financial margin increased 8.5% year on year, driven by growth in the average loan volume and exchange gains, and partially offset by higher financial expense. Financial income grew 15%, driven by an increase of 13% in interest on loans, and 54% in exchange and derivative gains. The increase in interest on loans was attributable to a 26% growth in the average volume, and partially offset by a 150 basis point decline in the average yield, which took place both in the commercial and retail portfolios. The yield of the retail portfolio fell as a result of lower average rates of credit cards, and an increase in the proportion of mortgages within the total retail book, from 29% in the second quarter of 2010, to 33% in the second quarter of 2011. The decrease in commercial loan yields was a result of competitive pressure. Financial expenses increased 39% year on year, mainly due to growth rates of 66% in the deposit costs, 109% in interest on bonds, and 19% in the cost of funds. The increase in interest on bonds was due to significant growth in the average volume, as a result of the $400 million senior bond issue carried out in October of last year. The increase in interest on deposits was attributable to 8.6% growth in the average volume, and an increase of 50 basis points interest on bank loans increased as a result of 19% growth in the average volume, with a stable average cost. The average cost of funding rose 70 basis points year on year, mainly due to an impact of the reference rate increase and the cost of the bond issue.

Please turn to page 11 now for a chart showing our net interest margin. Net interest margin increased ten basis points quarter on quarter, from 7.3% to 7.4%, mainly due to non-recurring gains reported in the second quarter of 2011. Excluding non-recurring factors, net interest margin would have decreased 38 basis points quarter on quarter, as a result of the lower yield in the loan portfolio, and the higher average cost of funds.

Please turn to page 12, now. Provision expenses increased 29% quarter on quarter, and 4.5% year on year. As a result, the annualized ratio of loan loss provisions to average loans was 3.1% in the second quarter of 2011, above the 2.5% reported in the first quarter, but below the 3.6% reported in the same quarter of last year. Provisional requirements were unusually low n the first quarter of this year and have now returned to a more normal level. In particular, provisions have required banks to align recertification of clients with those of other banks were significantly lower in the first quarter of 2011 than in other quarters. The ratio of past-due loans to total loans increased slightly quarter on quarter, from 1.5% in the first quarter of 2011 to 1.6% in the second quarter, but remains stable when compared to the second quarter of 2010. The coverage ratio increased from 253% in the second quarter of 2010, to 260% in the second quarter of 2011.

Please turn to the following page. Gross fee income rose 3.1% quarter on quarter and 8.4% year on year, driven mainly by increases in credit and debit card fees, as a result of increasing volumes and more activity with credit cards. Administrative expenses remained stable year on year, and increased only 2.8% quarter on quarter, despite increasing business and transaction volumes at Interbank. Technology and processing improvements have allowed the Bank to go to higher volumes, without increasing head count or services received from third parties. As a result, the efficiency ratio declined, from 50.9% in the second quarter of 2010, to 47.2% in the second quarter of 2011.

Please turn to page 14. The ratio of regulatory capital to risk weighted assets was 14.5% in the second quarter of 2011, above the 14.1% reported in the first quarter of 2010, and below the 16% reported in the second quarter of 2010. During the second quarter of 2011, Regulatory capital increased 4.7% quarter on quarter, and risk weighted assets increased 2.2%. The increase in regulatory capital was due to the capitalization S/. 126 million in earnings from the first quarter of 2011. The year-on-year decrease in the regulatory capital ratio was a result of a 16% increase in risk weighted assets, partially offset by a 5% increase in totally regulatory capital, due to the capitalization of earnings. This concludes the portion of the presentation regarding Interbank.

Now, Enrique Espinosa will discuss Interseguro's performance.

Enrique Espinosa: Good morning everyone. Please turn to page 16 of the presentation. The table shows a summary of Interseguro's profit and loss performance where we can see a strong increase on premiums year on year and a slight increase quarter-on-quarter, driven mainly by lower annuity premiums, due to market contraction in the early retirement segment. Technical margin loss was higher year on year, in-line with annuity premiums, since each time an annuity premium is sold, a reserve must be recognized in the financial statements, according to Peruvian regulations. As well, the quarter-on-quarter decrease in Technical margin was sustained by lower sales in annuity premiums. Administrative expenses increased 2.3 million quarter on quarter and 1.8 million year on year. The quarter-on-quarter growth is explained by higher marketing expenses. The year-on-year growth is explained by higher commission sales, in-line with higher premiums. Investment income decreased 17.8% quarter on quarter, and increased 26% year on year. The quarter-on-quarter decrease is explained by a one-time provision made in real estate, and lower fixed income gains. The year-on-year growth is attributable to significant growth in equity and mutual funds.

As a result of the factors explained before, net income for the second quarter 2011 was 24.4 million, a decrease of 33.9% quarter on quarter, and a 30% year on year increase. Please turn to the next page of the presentation. Page 17 shows in detail the performance of Interseguro Premiums. The table shows in detail performance of Interseguro's premiums. Premiums had a significant increase year on year and a slight increase quarter on quarter. The year-on-year increase is a result of higher premiums in all of Interseguro's business lines. The business line that contributed most was annuities, driven by early retirement premiums that reached 27.4 million in the second quarter of 2011, and only 11.4 million in the second quarter of 2010 since the early retirement law was enacted later in the third quarter 2010. As we said before, the decrease quarter on quarter was driven mainly by lower annuity premiums due to a market contraction of 33.6% in the early retirement segment. As of June 2011, Interseguro is a leading provider of annuities in the Peruvian market, with a 24.3% market share.

Finally, on page 18, there are some details on Interseguro's investment portfolio and investment income. Interseguro's investment income was 55.4 million in the second quarter of 2011, a 23 million decrease, quarter on quarter and an 11.4 million increase year on year. The quarter-on-quarter decrease is explained by a one-time provision made on real estate and a decline in realized gains in the fixed income book. The year-on-year increase was attributable to increases in equity income and interest earned in fixed income. The investment portfolio increased .8% quarter on quarter and 24.4% year on year, due to higher sales in annuities, as well as the price appreciation of the entire portfolio. Now, we can answer any questions that you may have, please.

Operator: Thank you. At this time, we will open the lines for questions. If you would like to ask a question, please press the star one on your telephone keypad now. Again, that's star one, on your telephone keypad if you would like to ask a question. Our first question will come from Alonso Aramburu with BTG.

Alonso Aramburu: Hi, good morning. A couple of questions Jose Antonio; The first one on the NIM; this quarter the NIM came down about 30 basis points. Can you give us a sense whether you still expect the NIM to remain stable for the rest of the year, or we should expect a little bit more contraction, and my second question is regarding expenses. The bank is obviously doing a very good job controlling expenses. Should we continue to expect these same levels of basically no growth in expenses for the rest of the year?

José Antonio Rosas: Good morning, Alonso. Regarding your first question on the NIM; as you have seen during the presentation that contraction in the NIM is partially explained by the decline in loan deals and partially explained by an increasing cost of funds. The most important component was the increasing cost of funds during the quarter, and in that sense, we feel that we should not expect any more increases in the average cost of funds, going forward; first, because the reference rate, the Central Bank is not increasing the reference rate, so there should be no pressure, at least during this quarter from that factor, and second, because as you have seen, the mix within our deposit book has changed. We have been shifting towards lower cost transactional deposits, and we are likely to see the full impact of that shift during the second half of this year. The other components are declining loan yields, we do not expect any significant declines in the retail loan book, only perhaps if mortgages continue to grow at a significantly faster pace than consumer loans. On the commercial loan book, on the other hand, we might continue to see a reduction in spreads, so there might be some pressure there, but not as strong as we have seen it during the last couple of quarters. Regarding expenses, we do expect expenses to remain stable, although we have to take into account the fact that the last quarter of the year is usually a quarter in which expenses are seasonally higher, so we should see a quarterly increase in expenses towards the end of the year, but nothing too significant when compared with similar quarters of last year.

Alonso Aramburu: Great, Jose Antonio. Thank you. I guess, one more question. Can you give us a sense of how volumes have behaved in the last month, in July? Do you have a sense of how if the growth has remained similar to what you saw in the second quarter?

José Antonio Rosas: Yes, growth has in general remained at similar levels to what we have seen in the second quarter.

Alonso Aramburu: Great, thank you.

José Antonio Rosas: Sure.

Operator: Thank you for your question. Again, if you would like to ask a question, please press star one on your telephone keypad now. Again, that's star one on your telephone keypad, if you would like to ask a question. Please press star one on your telephone keypad if you would like to ask a question. We do have another question from Mr. Aramburu with BTG.

Alonso Aramburu: Hi. Thank you, again, just taking advantage of a few questions, also on the fee side, we saw that expenses on the net fees grew significantly this quarter, from other quarters. Is there something particular there related to this quarter, or is that something we should expect going forward?

José Antonio Rosas: No, there is nothing particular. It's just increasing activity in the credit and debit card business, and most of those expenses were previously not deducted from the fees on line, but were considered as expenses, we shifted that, so now, any increases in volume in credit cards are directly reflected in that line.

Alonso Aramburu: Ok, thanks.

Operator: Thank you for your question. Again, if you would like to ask a question at this time, please press star one on your telephone keypad. Again, that's star one on your telephone keypad, if you would like to ask a question. And, at this time, there are no further questions, Mr. Rosas, I will turn things back to you.

José Antonio Rosas: Thank you, and thank you, everyone for participating in the second quarter conference call, and we expect to have you at our second quarter conference call in early in November. Thank you very much. Bye.

Operator: This concludes today's teleconference. You may now disconnect your lines.