4Q20 Earnings Call Transcript

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Operator: Good morning and welcome everyone to Crédito Real's Fourth Quarter 2020 Earnings Conference Call. Crédito Real issued its quarterly report on Wednesday, February 24, 2021. If you did not receive a copy via e-mail, please do not hesitate to contact us in Mexico City at +52-55-52-28-97-53. It is important to note that the presentation and MP3 recording referred to this call will be available at www.creal.mx. Before we begin the call today, I would like to remind you that information discussed in today's call may include forward-looking statements on Crédito Real's future financial performance and prospects, which are subject to risks and uncertainties. Actual results may differ materially, and the company cautions not to rely unduly on these forward-looking statements. The company undertakes no obligation to publicly update or revise any forward-looking statements. With us this morning from Crédito Real, we have Mr. Angel Romanos, Executive Chairman and CEO, and Mr. Carlos Ochoa, Deputy CEO. They will discuss on the more important strategic financial and operating aspects of the fourth quarter 2020. I will now turn the call over to Mr. Romanos. Please proceed, sir.

Angel Romanos: Thank you, operator. Good morning, everyone, and thanks for joining us today. I would like to start by saying that all of us at Crédito Real hope that you, your families, and dear ones are all in good health and safe. In the face of the prevailing COVID-19 headwinds, Crédito Real delivered resilient quarterly and full year financial results while maintaining its asset quality on the back of a cost-efficient structure and proactive initiatives to preserve the well-being of its people and ensuring its financial stability. As you will remember, these initiatives encompassed, firstly, the adoption of preventing protocols to protect our people against COVID-19, following all recommendations from health authorities and setting a high resilience on remote work... reliance on remote work. Second, the implementation of relief programs to support the company's client base, mostly on the SME space, initiative that besides of succeeding in the retention of valuable customers, also contributed to preserve collection, thus preventing any major deterioration in the overall loan portfolio quality. Third, the identification and effective realization of cost-saving initiatives to maintain profitability. Fourth, the adoption of a comprehensive capital management to have an adequate liquidity to comfortably meet our short- and medium-term financial obligations and seize opportunities from the economic reactivation expected for the second half of the year. And last but not least, the implementation of our credit origination policy oriented to have long-standing clients that allow us to anchor our best-in-class non-performing loan ratio. In line with these initiatives, Crédito Real also devoted considerable resources to recalibrate its business practices to adapt them to the changes brought by the new normal, as it is a wider automation of processes. Amongst the outstanding developments in the funding front outstands the launching of our medium-term securities facility for up to 1.5 billion dollars conducted in April 2020 that provided the company with a higher flexibility of financing at an attractive cost. Under this program, at the beginning of 2021, we already carried out the issuance of senior notes due 2028 for 500 million dollars, the first debt placement from a Latin America non-bank financial institution since February 2020 with an appealing interest rate of 8% as we tapped into a continued accommodative monetary policy worldwide while boosted the diversification of our company's investor base. Furthermore, this transaction was accompanied by the successful renewal and arrangement of several credit lines for approximately 330 million dollars with existing and new lending institutions, both domestic and foreign, that despite the backdrop showed a rock-solid confidence in the company. Similarly, in the developments of year 2020, we find a partnership closed with Famsa, which is oriented to expand our market outreach along the vibrant market of North Mexico, where we expect an annual origination of about 3.5 billion Mexican pesos drawing from the combination of the retail network of Famsa and our solid underwriting and origination capabilities. In this regard, it is worth noting that Crédito Real's role in this commercial agreement lies in the screening analysis and funding of loans by the development of its usual business standards. Another development I would like to highlight is the acquisition of a payroll loan portfolio from Banco Ahorro Famsa carried at the beginning of this year. This transaction is particularly relevant before our strategy of long-term value creation as it propels the company's flagship business segment by providing attractive yields at relatively low risks. On the ESG side, outstood the company inclusion in the new ESG index launched by the S&P Dow Jones and the Mexican Stock Exchange. And a 100 million dollars credit facility subscribed with the United States International Development Finance Corporation, oriented to improve women entrepreneurs' access to formal finance. Thus, we are affirming our commitment of serving the unattended segments and further broadening the participation of development banks in our funding. Now turning to the business segments analysis. Over the quarter, as it happened most of 2020, overall origination continued to be largely dictated by COVID-related effects and implementation of precatory and provisional measures to face it. In this way, hand-in-hand with the enhancement of collection, we were able to maintain a delinquency level way below the average of the industry and reporting net earnings across all business segments. In Payroll, loan originations slowed down on a sequential basis due to the new COVID-19 lockdowns imposed on major urban zones in Mexico but remained above the levels reported in the second quarter, thanks to the growing contribution from our business partnership with Grupo Famsa, which is currently close to Credifiel's numbers. Non-performing loan ratio in Payroll remained stable, and it is worth noting to tell that over the pandemic and to the present day, no block of governmental employees has defaulted on any payments. For 2021, we expect that payroll origination lies above the levels seen in 2020 on the back of a normalized economy backdrop resulting from a widespread vaccination. On Used Cars, loan origination remained in a positive trend, primarily supported by the surging demand for used cars, especially in the United States, that maintained the second-best delinquency rate company-wide. Breakdown by market, Used Cars Mexico achieved the record collection levels at quarter end, while origination continued to be favored by a greater preference for the use of private transportation. Meanwhile, Used Cars USA origination continued to improve, already nearing pre-pandemic levels, thanks to the changes in transportation patterns and new federal unemployment benefits. On the other hand, small- and medium-sized enterprise continue to show slow dynamics, particularly in Mexico, as the implementation of the new COVID-19 lockdowns and the high uncertainty have weighed on the business metrics. In this sense, Crédito Real continues striving to help its distressed clients against the unprecedented COVID-19 crisis. Momentarily and most probably just for 2021, we plan to undertake a soft landing in the participation of SMEs in Mexico, pursuing to reduce our exposure to the assets most exposed to COVID-related developments. Separately, the SMEs origination activity in the U.S.A. outperformed that of Mexico, supported by our calibration of credit profiling, which also contributed to a stable delinquency. As for Instacredit, a better-than-expected performance was recorded in asset quality that remained stable, coupled with a strong collection following the introduction of flexible payment options and broader coverage of collection points. Especially noteworthy was the above-average return on assets achieved for the full year in this segment, even at the face of the lockdowns imposed to contain COVID-19 contagions, particularly in Costa Rica, and the grace periods for loan payments enforced in Panama by the government. This remarkable result was largely attributed to improvements in the cost structure, the closing of different business partnerships and strengthening of key management functions. At this point, I want to state that looking ahead, we will remain committed on the well-being of all our stakeholders. And to weather the challenges, we will continue building on the strategic initiatives already undertaken, drawing for this purpose on the competitive strengths that have already enabled Crédito Real to overcome several crises over the last 25 years. Similarly, to help us navigate along choppy waters, we count on a solid financial position and diversified sources of funding that are reflected in the credit ratings assigned to our debt securities. All in all, we remain confident in our strength to drive long-term value creation, drawing for this end into the effective use of all of our resources alongside a solid approach on sustainable growth. Therefore, for 2021, we expect the growth rate for the total portfolio between 8% and 12% and a non-performing loan ratio in a range of 2% to 3%. And before closing, I would like to express my gratitude to all our investors, associates, partners and distributors. It is through your hard work and confidence that we have been able to successfully walk into the paramount challenges of 2020 while poised to phase the year 2021 with greater clarity of the road ahead. At this point, I hand the call over to Carlos Ochoa who will discuss in greater detail our financial performance over the last quarter and the whole year. Thank you very much.

Carlos Ochoa: Thank you, Angel. Good morning and thank you all for being part of our quarterly earnings conference call. During the fourth quarter of 2020, total income reached 2.9 billion pesos, down 14.8% when compared to the same period last year in a pro forma basis. This variation is largely attributed to a weaken economic environment brought forth by the pandemic, saying that has also taken a toll on Payroll's canvassing activity as this has been limited by the implementation of lockdown measures, coupled with a slowed-down growth in the SMEs interest income and deployment of the strategic relief program for most troubled clients. In this sense, the headwinds of the economic challenges were partially offset through the incremental contribution from our commercial agreement with Grupo Famsa. For the full year 2020, interest income decreased 14.5%, reaching 10.2 billion pesos due to the same factors that affected the quarterly performance. Comparable interest income was down 15.4% in the fourth quarter 2020 against the 3.1 billion pesos recorded in the same period last year. For the full year 2020 it was recorded an 11.8% decrease in this metric. Interest expense posted 1.2 billion pesos, an annual decrease of 7.9%, mainly derived from the lower average cost of funds that more than offset the company's larger investments. For full year 2020, interest expense amounted 4.6 billion pesos, down 2% on an annual basis. The foregoing, together with improvements achieved in different credit facilities given the current environment of low rates, has estimulated an annual decrease of 380 basis points in the average cost of funds that stood at 9.4% in the fourth quarter 2020. While during 2020, the average cost of fund was 8.9%, 390 basis points below the 12.8% recorded in 2019. Consequently, the financial margin was about 1.4 billion pesos for the fourth quarter of 2020, down 30.2% when compared to that of last year. Accumulated financial margin during 2020 totaled 5.6 billion pesos, down 22.5% against 2019. Comparable fourth quarter 2020 and full year 2020, financial margin contracted 25.1% and 18.6%, respectively. Provision for loan losses was 558 million pesos, increasing 10.6% from 58.9% in a sequential and annual basis, reflecting the additional generation of incremental reserves to further strengthen our position amid the challenging landscape. For the full year 2020, this item amounted to 1.9 billion pesos, increasing 47.5% versus that of 2019. Following the build-up of incremental provisions over the year, the cost of risk posted an annual growth of 1.7% and 1.3 percentage points for the fourth quarter and full year 2020, respectively, reaching rates of 4.7% and 4%. The coverage ratio stood at 225.3% compared to the 217.3% and the 219.7% posted in the previous quarter and the same period last year as a result of higher provisions, a tighter control over delinquent accounts and more efficient collection. Administrative and promotion expenses summed up 860 million pesos, down 11.4% against the figure recorded in the same period last year, mainly in connection with the softer origination activity and, to a lesser extent, to the cancellation of discretionary expenses. For the full year 2020, administrative and promotion expenses decreased 10.9%, totaling MXN 3.2 billion pesos following the same quarterly dynamics. 4Q20 and 2020 comparable administrative and promotion expenses decreased 15.3% and 13.8% versus fourth quarter 2019 and 2019 full year, respectively. It should be noted that following the consolidation of Crédito Real Arrendamiento, further depreciation expenses were recorded, same that amounted to 192 million pesos for the fourth quarter 2020 and 527 million pesos for the full year 2020. Consequently, net income amounted to 115 million pesos, down 73% and 42% versus 4Q19 and 3Q20, respectively. As a result of the effects of the pandemic, full year 2020 net income decreased 62.1%, totaling 751 million pesos. Return on average equity decreased 780 basis points on an annual basis to 2.7% in the fourth quarter 2020. During full year 2020, return on average equity stood at 4.2%, declining 800 basis points when compared to the same period last year. Excluding the perpetual notes effect, these metrics stood at 3.6% and 5.5% in the fourth quarter and full year, respectively. On the other end, return on average assets contracted 230 basis points to reach 0.6% in the fourth quarter 2020. And during 2020, return on average assets decreased 250 basis points to 1% when compared to 2019. The capitalization ratio contracted by 250 basis points year-over-year, standing at 31.6% as of December 31, 2020. Turning to the loan portfolio performance. Consolidated loan portfolio totaled 51.3 billion pesos as of quarter end, recording an annual growth of 9% despite of the implementation of more selective standards that led to distributed risk-adjusted return on asset quality. Likewise, consolidated non-performing loan ratio was 1.8% as of year-end 2020, standing at the same level recorded last year, supported by the implementation of a comprehensive strategy focused on the incorporation of low-risk and high-quality assets alongside the enhancement of collections. Breaking the analysis by business segments, the Payroll portfolio amounted to 29.4 billion pesos, up 4.1% when compared to the MXN 28.2 billion recorded in 2019. And its delinquency remains unchanged in a sequential basis. The small- and medium-sized enterprise portfolio reached 12.1 billion pesos, increasing 27% year-over-year. The softened rate of growth compared to the previous year stems for the from the overall weakness in the business activity that follows the COVID-19 and the adoption of a segmented origination policy focused on clients with limited exposure to COVID-related risk. The non-performing loan ratio for SMEs stood at 0.8% as of quarter end, 40 basis points above the figure posted in 2019. In this regard, we are pursuing a recalibration in the origination standard, which, in combination to relief program, has certainly contributed to certain impacts on asset quality. In this context, SMEs Mexico portfolio growth was 47.3% on an annual basis, totaling 10.9 billion pesos, coupled with a non-performing loan ratio of 0.7%. While SMEs USA portfolio amounted to 1.2 billion pesos, a 44% annual decrease, explained by the restricted origination over the year, mainly in the second half, alongside with a non-performing loan ratio of 1.1%. Separately, the Used Cars portfolio totaled 3.9 billion pesos or 10.5% versus year-end of 2019 given the surge in demand for non-public affordable transportation, while delinquency in this segment remains at a very low level of 0.9%, 40 basis points below than the number registered in 2019. In Mexico, the Used Cars portfolio posted a slight annual decrease of 1.4%, amounting to 1.4 billion pesos given a tighter origination policy, whereas the nonperforming loan ratio stood at 1%, remaining at the same level of last year. As for Used Cars USA, NPL continued below the 1% mark, combined with an 18.3% annual growth in loan portfolio that was supported by the expansion of unemployment benefits. Separately, Instacredit portfolio reached almost 5 billion pesos, representing an annual growth of 1.6% on the back of a more stable business environment. In terms of portfolio quality, Instacredit recorded a better-than-expected performance as the non-performing loan ratio increased only 30 basis points to reach 5.1% at the end of the period. Now turning to the balance sheet. As of December 31, 2020, total assets increased 14.5% when compared to that of the same period of 2019 to reach 70.5 billion pesos driven by the consolidated total portfolio growth and a high cash and investment in securities balance that amounted approximately 2.3 billion pesos, in line with that of 2.5 billion pesos recorded as of year-end 2019. The outstanding total debt totaled 49.9 billion pesos, up 20.1% compared to last year, is primarily attributed to arrangements of different credit facilities. And last but not least, as of year-end, the stockholders' equity totaled 16.2 billion pesos, an annual increase of 0.9% following the already discussed factors. With this, I conclude my remarks and now let me turn back the call to the operator to open the line for Q&A.

Operator: Thank you, at this time will be conducting the Q&A session, if you would like to ask a question please press *1 on your telephone keypad, a confirmation tone will indicate your line is on the question queue. You may press *2 if you like to remove your question from the queue. For participants using speaking equipment it maybe necessary to pick up your handset before pressing the * key. Once again that is *1 to ask your question at this time. One moment while we pull for our first question. Our first question comes from Nicolas Riva with Bank of America, please proceed with the question.

Nicolas Riva: Thank very much Carlos and Angel for the chance to ask questions. I got 3 questions. The first one, so last week the Senate in Mexico approved some changes to the regulation on payroll lending in Mexico, which I understand as positive in general. They are enforcing employers to remit payments to the lenders within 4 days of the payroll. There is no mention of interest rate caps, which is clearly a positive. But I wanted to ask you how positive, how much of a game changer do you think this regulation would be if finally approved in the Lower House and passed into law? That is my first question. My second question, on your capitalization. So, I saw in the earnings report, you mentioned that shareholders approved a dividend payment on 2019 net profit. And considering the liability management that you did in January and this dividend payment, then in my numbers, I calculate that debt-to-equity would increase to 3.5 times, which I believe is the maximum in the covenants of some of your bank debt. I wanted to ask you about the rationale for going ahead and distributing dividends already. I am not aware really of many other Mexican financials that have already decided to pay out dividends. Yeah, so if you can walk us through the rationale for already going ahead with that decision and if you still think you do not need more capital or equity capital this year. And then the third question, which is related to liability management and also your leverage levels. You already took out a portion of the "23s" earlier this year, but you can call them, you can call the remaining balance at the price at about where the bond is trading right now, the "23s". Do you plan to use some of the 500 million dollars you raised with the "28s" to take out the remaining portion of the "23s"? Thanks.

Angel Romanos: Hello Nicolas, how are you? This is Angel. I am going to answer the first question about regulation. We worked very hard with the authorities last year to get to this regulation. We were very involved on how it was developed and how it was done. I think from every angle of it, it is very positive for Crédito Real. And at the end of the day, what this will get us to is much less competition because now companies will have to be either public or regulated or complying with certain standards that were not asked before by the authorities. And this will make us one of the strongest companies in the sector. So we are very pleased with the regulation, and we do expect it to go through the Lower House, and that should be in the coming weeks. And it will be a very big plus for Crédito Real in the future.

Carlos Ochoa: Probably to complement on that one, I think that one of the key aspects about the new regulatory framework is the fact that now the payroll product exists as in legally exists. In the past, it used to be a mix of a credit or something like that. But right now, we have a regulatory framework which is definitely going to be positive altogether, as Angel was mentioning. Another very important aspect of this is that even though we are leaving, you know, there were no discussions in terms of interest rate caps and so on, one of the key aspects that was addressed in the regulation is the fact of preventing the over-leverage in the customers that, as you might know, is probably the riskiest aspect of this business. So as Angel was mentioning, just to wrap this up, we are pleased with the outcome. We were very involved in this, working with the legal teams and so on. And I think it is going to be positive for the industry and definitely positive for Crédito Real. Now turning to your second question in terms of capitalization, let me start by the dividend, by the payout. For starters, as you might recall, those 75 cents per share were determined early last year, it was 1 year, a year ago, and basically, what we are stating at this point is that at some point, we will be paying that dividend that corresponds for 2019, not for 2020. And that is basically where we are standing. When it comes to the capitalization and the way we are seeing the capitalization altogether is that we are going to release a lot of pressure over the capitalization as long as we unwind down the SMEs portfolio. And basically, by doing so, definitely, it is going to release pressure over the capitalization, and probably at some point, we would not be needing more cash, extra cash. I would say that how we are seeing things, you know, with different initiatives from different businesses such as the payroll business in particular, where we are seeing a ramp-up in terms of the origination this year, I think at some point, the high NIM products that we carry are going to grow farther than the other, and the most capital-intensive, as the SMEs, we are going to be unwinding them. So basically, that is where we are standing. And in terms of the liability management as for your third question, well, I mean, we are very pleased with the outcome, I mean, we are very pleased with tender for roughly 200 million dollars, and we, you know, made all the covenants set consistent with all the different facilities that we have outstanding. And I do not know, at this point, we are not thinking in buying back more of those "23s" outstanding until we see the dynamics of the whole business altogether.

Nicolas Riva: Okay, thanks Carlos, thank you very much for that.

Carlos Ochoa: Thank you Nicolas.

Operator: Thank you, our next question comes from Gilberto García from Barclays. Please proceed with the question.

Gilberto García: Hi, good morning, thank you for the call, a couple of questions. In your new disclosure by business segment, you show that interest income from the Payroll business, specifically, was down 30% despite positive growth in the portfolio. Could you please explain what drove the significant decline in the yield?

Carlos Ochoa: Sorry Gilberto I did not get the first part, the figure, could you repeat that please?

Gilberto García: Yes, so, in the disclosure by business segments you showed that interest income in the payroll business specifically was down 30% year-on-year despite portfolio growing a little bit in the low single digits. What drove this significant decline in the yield for the business?

Carlos Ochoa: Yeah, I mean there were a number of factors. Some of them, I mean, when it comes to the Payroll business... when it comes to the Payroll business, the fact of having a very soft origination with the teachers, which tend to be the segment with the highest interest rates. And as you can see, with all the challenges that we faced last year, that led to a much softer origination specifically with teachers. On the other hand, we had an effect, you know for the full year, we have an effect of around 400 million pesos or something than that was associated to FX and something like that. What we are seeing at this point altogether, I mean what we are seeing is that we... now that we see a much dynamic origination in the Payroll and in segments such as the teachers and other segments of the business with higher NIM, I think that we should be seeing an improvement. Right now, what I can tell you is the Famsa... they are reaching its full potential. I think that we should be originating a considerable amount with them for they are easily becoming now the (inaudible) distributor. And definitely, that is going to enhance the origination and improvement also in the yield and in the NIM as well. As you can see, and something that we have been very emphatic about it, is that a softer origination, given that we generate an income provision, I mean, tends to affect the yield negatively, and that is basically where we are standing. So it was a combination of factors, but basically, we would expect the (inaudible) to see an improvement there.

Gilberto Garcia: Ok. And secondly, press reports indicated that you extended a loan for more than 10 million dollar that has been overdue. In a statement to the stock exchange, you said that you issued this loan in the ordinary course of business. I understand you might be limited on what you can say about this specific loan, but more generally, can you comment on whether you have any such other jumbo loans outstanding? And if so, what sort of rates do you charge on those loans? And what guarantees do you typically ask for?

Carlos Ochoa: Look, all across the board in the SMEs business, you know the rates that we charge... All across the board, the rates that we charge are something around the 25%. If you think in those terms, typically, and you can see it from... I will answer it on 2 fronts. If you think in terms of the average ticket size, well, it stands something around the 10 million pesos in the case of the leasing business and probably much lower in the case of the factoring and in the case of the credit. That is basically where we are standing. However, yes, we could have some specific operations such as the ones that have been disclosed, and that is basically for those, even though we do that type of facility, those are not, you know... if you look at the average ticket size, they are clearly not the most common thing. Now, what happened with this one? I mean we disclosed this operation. If you remember the time when we disclosed this operation, it was... we released... we disclosed this operation, the press release, because we were on the middle of issuing the "2028s" basically. So normally, what I am trying to say is that from an strategic perspective, the company tends not to get engaged with the press altogether. That is a rule that we have. However, considering that we were in the middle of issuing a facility and for the transparency's sake, that is when we disclosed the press release. But basically, that is where we are standing. When you, answering your question in terms of the collateral or in terms of the guarantees or whatever that we have in the SMEs businesses. Yes, a lot of them involved, I do not know, houses, lands and things like that. But definitely, I mean what I can tell you at this point is the key aspect of our business is to focus not on the guarantees, but to focus on the cash and the cash flows of the business. That is how we grant those loans. And that is basically how the business works. Having said so, if at some point we perceive that there is going to be trouble, you know, for collecting or so on, we try to import different strategies that can be up to repossess assets or whatever. And that is basically where we are standing.

Gilberto Garcia: Ok, thank you. And lastly, do you have any guidance ranges for net income for the year?

Carlos Ochoa: Soon to say. I mean our view is that if you look at the, I mean specifically, if you think in terms of cost of risk it increased dramatically over the year. Yes, and that is probably explained, is mostly explained because of the relief programs. And as you know, I mean, whenever you change the original structure of the facility that you granted, you increase your provision base. So what we are expecting is that in order to start releasing provisions, when we start releasing provision, that is going to happen at some point at the end of this quarter or at some point in the second quarter. If that happens, if that is the case, I think that we will see a much better year than what we experienced last year. Hard to say the figure. It is hard to say a definite figure.

Gilberto Garcia: Understood, thank you.

Operator: Our next question comes from Ernesto Gabilondo with Bank of America. Please proceed.

Ernesto Gabilondo: Hi good morning, Angel and Carlos, thanks for the opportunity. My first question is on your expectation for non-interest expenses. We continue to see that the depreciation of the leasing business continues to put pressure on expenses. So how should we think about OPEX growth this year? Should it be growing above inflation? And then my second question is on your capital ratio. When looking at this in terms of equity to assets, it was reduced to 23% from 26% in 2019. It seems okay, but we have seen other listed Mexican banks with an important excess capital. So how comfortable are you to pay the dividend that was postponed in 2019? And then for my last question, can you share, how are you seeing the ROE for this year? Would it be reasonable to expect low to mid-single digits?

Carlos Ochoa: Hi Ernesto. I mean, as I mentioned at the beginning, one of the goals that we have for this year is to unwind the SMEs portfolio. I mean it is not so far. I mean if you think the duration of the facilities, in particular, on the leasing side, given the duration it is something around 40 months altogether... on the average, the duration is 40 months. That is probably going to be the one that reduces the least. However, I mean, if you... if we end up, instead of having a concentration above 20% in the SMEs in the consolidated SMEs business, if we end up having something between the 12% and the 15%, that is definitely going to help us in terms of the capitalization and also in terms of the... whatever expense is associated with the business altogether. But that is basically how we are standing. As you know, most of the part last year we were very prudent, we were very selective in terms of originating new loans, and that should continue for the remaining of this year as well and even more because we are going to be unwinding this book. So basically, that would be, I mean, hard to say if this reaches, if the consolidated portfolio in the SMEs business stands at something around the 15%, that should definitely help us a lot with the cash requirements for the company and the capitalization altogether. Going to your second question, the second portion of your question, well, definitely, the dividend is an issue that we are taking, you know we are thinking a lot about that one. I mean you could have on the front of the fixed income side, definitely, there are some consideration. And the most important one in that one is that we are not going to risk our rating. We are convinced that the rating is a key differentiator. We saw that when tapping the dollar market, that was after 12 months closed for us. So definitely, the main aspect behind the decision, the main aspect behind the decision of making the payout is going to lie on the fact of protecting the rating or not risking the ratings. So that is basically where we are standing. In terms of ROEs, I think it should be improving, I mean, if you think materially, if you think in terms of provisions, the amount of money that we have embedded in the provision line, I mean whenever... if we start releasing provisions due to a better performance of the book, I think that the ROE should be trending upward, probably to the, I do not know, probably it is going to be... you know hopefully, to the double digit, but it is definitely going to be between the 5% and 10% at this point. That is what I am thinking.

Ernesto Gabilondo: For 2021?

Carlos Ochoa: Yes.

Ernesto Gabilondo: Ok perfect, thank you.

Carlos Ochoa: Thank you, Ernesto.

Operator: Our next question comes from Matthew Breckenridge with DSC Meridian. Please state your question.

Matthew Breckenridge: Hi, yes thank you. So this is, I guess, a question more about the direction of the business. The debt continues to rise and the loan portfolio was rising at a much lower rate than your debt is rising, and there is not an increase in cash and you are net income positive and yet interest margin continues to drop. So I guess the question is, when do those trends start to reverse? When do you start to see, when do you start to see the balance sheet increase or the assets side of the balance sheet increase faster than the liability side? And when do you expect margins to increase? Because it seems like you are adding debt to put new loans on the balance sheet that are not earning the same cost of capital as prior, and cash is not going up. So how do we reconcile this? And when does that begin to reverse?

Carlos Ochoa: Yes. I mean, definitely, what I can tell you from a net strategic perspective for the company for this year, is that we are focusing on our most efficient use of our equity. Basically, that is the main challenge. That is how we, in terms of direction wise, that is going to be definitely the main driver. Having said so, that is basically the underlying aspect behind the decision of unwinding the SMEs portfolio. It is our most, it is our most capital-intensive product and definitely, we cannot charge the same interest rates, I mean we have different NIMs, if you compare that to the, for example, in the case of the payroll business (inaudible). So what was the attractive part about the SMEs business? What brought us here? And that is what I am trying to explain. What brought us here is that if you think about our business model in the SMEs in which we were relying on a relatively small customer base, every recurring customer. That having a product with a much higher, with a much higher average ticket size, help you in terms of cost of risk, right? If you look at the improvement over the years when the SMEs businesses were the main driver of growth, that led to a decline in the cost of risk. What happened last year and that one, that is been probably the most important aspect about the, you know pressure over the NIM and the pressure over the net income has been the other way around. Higher average ticket sizes led to a much higher cost of risk. So basically, that is where we are standing, and that is the rationale. What I would expect, and especially given that we have a couple of initiatives associated with Famsa that we could ramp up that we could increase the origination in the payroll business for the remaining of the year. And by doing so, what is definitely going to happen is that the concentration that we have in the payroll business, which is going to be, which is one of our high... our product with the highest NIM, definitely is going to help us. So that is basically where we are standing. So in terms of growing the debt, in terms of growing the, yes, you have a point there, but it was basically adjusting to the pandemic during the last year. And definitely, we should turn it around for this year.

Matthew Breckenridge: Okay. I guess a follow-up. You have, in 2021 and 2022, you have a number of bank credit lines and securitizations that need to be rolled. And in 2022 and 2023, you have bonds, how are the discussions with the banks about rolling potentially past the maturities of the bonds? Have the banks asked for additional collateral, have they asked for collateral at all? How are those discussions proceeding?

Carlos Ochoa: I mean, think about last year, I mean, we were able, for the full year, we were able to roll, I do not know if was something around 11 billion pesos or something like that. That was for 2020. So basically, we felt the support from both local and international banks, all the yearlong. So, if you think about 2021, we have something, we have to refinance something around 13 billion or something like that. Some of this has already been paid down, for example, 50 million dollars from a Barclays facility, we pay that down with the issuance of the "2028s" . So basically, I think that we... if the same dynamics that we saw last year continue for this year, we should not have problems rolling those 70% of which amount roughly to 10 billion pesos, we should not have any problems you know rolling those over. I mean most of the... if you think about... if you think in terms of collateral and things like that, what we saw last year, I mean, for starters we rely most of our funding. Given the... clearly, if you think about the senior facilities that we have outstanding, all of them are unsecured. But when it comes to the credit lines, what we saw, we did not see an increase in the collaterals, but what we saw was mostly an increase in the spread that was basically associated with the situation last year. But in any case, we feel comfortable that for 2021 we will be okay refinancing those. And now thinking further into 2022, well, basically, the challenges that you have over there is to refinance 170 million, the CHF, 170 million, and then we have the call of the hybrid at some point. I think it is November or something like that. And definitely, we are looking into it. But basically, we try to address all the amortizations and the refinement for this year first.

Matthew Breckenridge: Thank you.

Carlos Ochoa: Thank you.

Operator: Our next question comes from Lemer Salah with Barings.

Lemer Salah: Hello Carlos, hello (inaudible) thank you very much for taking my questions. I have got 3 questions. So, the first question is with regards to your collections. You have indicated in the past that when your collections are around 80% to 90%, you feel comfortable. At the same token, you have extended facilities to existing clients. I am just wondering, when you adjust the extended facilities for those existing clients, what is the cash collection on your book? If you could elaborate on that. And question number two is with regards to your payroll pension mix. Could you please refresh what the mix is like, the federal pension, state and corporate pension in that book? And the third question is, I think, is probably an easy one for you. So in July 2020, you had this litigation thing with Chiapas, one of these states. I am wondering whether there is any update with regards to that. Thank you.

Carlos Ochoa: Yes. I mean, the way we see, I mean, probably the rule of thumb that we use when it comes to the collection is that as long as it remains on the 8 billion pesos per quarter range, we are okay, right? If you look at the trend that we saw for the last year, I mean, specifically last year, I mean it stood close to this 8 pesos billion range that I am mentioning you. What happened is that given that most of the facilities that were under a form of relief were on the SMEs front and amounted exclusively for 22% of the book at its peak. That did not affect much, it did not affect that much the collection altogether. It affected the most for the 3Q. So if you look at the figures for the 3Q, it was shy of those 8 billion pesos that I am mentioning. And this is basically because we were at the peak of the relief program for the SMEs. Definitely, I mean, what is something, definitely a competitive advantage of the company is the resiliency that we saw for the payroll business. The resiliency that we saw for the payroll business that is driving that collection figure up quarter-over-quarter. We do not see a reason for that to change. Going further to the second question of the payroll business. I mean, as a rule of thumb, I mean, the concentrations that we have are either with teachers or with pensioners. What has been changing more recently, specifically for the 4Q, is that given the challenges that we are facing with the in particular with the teachers, that shifted a little bit to other government agencies. Right now, the two concentrations that we have our teachers probably 30%, which traditionally is something around 35%. And right now, they amount for roughly 30% and in the case of the pensioners, they amount basically roughly the same, 30%, 32%. What has been more dynamic, where we are increasing the concentration are in what we call the AAA state level agencies. I mean those are government agencies that are reliable in terms of the collections and so on. And that was probably the driver of growth for the 4Q in the payroll business. But that is normally the rule of thumb. What we would expect for this year is to increase origination with the teacher, and that is definitely going to have a positive effect on the yield and on the NIM altogether. And finally, addressing your question on Chiapas, you know basically, we are collecting, I mean, it was a measure taken by the governor of the State of Chiapas. It was a unilateral measure taken by them that could easily, that was easily overturned with a judiciary process. But basically, we are collecting and the effect that it has had all together is that we are not originating anymore in Chiapas and that is basically the sole effect that it has had over the business. Looking forward, what we see, I mean, and definitely is one of the positive aspects about the regulatory framework, the new regulatory framework is that these types of measures are not going to be... are going to be restricted. So that is definitely going to be positive for the business. That is why we feel so optimistic about having a new regulatory framework.

Lemer Salah: So on the Chiapas like, if you assume like you are not originating anymore, what is the quantum of that loan book? And by when is it going to phase out entirely out of your book?

Carlos Ochoa: I mean, basically, if you look at what we had over there in Chiapas, amounted roughly 3% to 5% or something like that. So that is basically is the fraction of the portfolio that we are unwinding, running down that book. Given that we cannot originate anymore and that we are not originating anymore in the State of Chiapas, you know that leads to a softer origination, but that is basically the concentration that we have in that state is roughly 3% to 5%, not more than that.

Lemer Salah: Ok got you. Thank you so much.

Carlos Ochoa: Thank you.

Operator: Our next question comes from Carlos Rivera with DoubleLine. Please procced.

Carlos Rivera: Hi, thank you very much for taking my questions. The first one is regarding the outlook for the NIM. And I have been hearing, of course, the comments and the expected improvement and the reasons for that. But just trying to get any, if you have a numeric target and guidance. I mean, I am looking at the figure that you put in the press release where you show how the NIM declined from 17.5% to 11.5%. Of course, some of these impacts from COVID, FX loss, mixed impact, I would guess those are going to be not repeating anymore, but do you have any target for how fast can the NIM recover and by when? That will be my first question.

Carlos Ochoa: Yes, I would say that if by the end of the year, the NIM stands around the 14%, above the 13% and something close to the 14%, it is going to be okay. How do you reach that? How you manage to accomplish that. On the first hand, thinking exclusively about the product mix. For starters, unwinding the SMEs portfolio, which naturally, given the average ticket size, naturally, tends to have the lowest NIM. And on the other hand, by shifting, by increasing the origination in the payroll business, which we believe is something is very doable, not only with the different initiatives that we have been discussing, such as Famsa deal and so on and so forth. But also on the other lines of business, which tend to behave very well, such as the cars and the products outside Mexico. So I would say that by the end of the year, we see an improvement and leads to the above the 13% or close to the 14% with these several measures, I think we are going to be okay. Just another aspect, important aspect about trying to explain the decline in the 17% to the close to the 12% that you are seeing for the full year. It is the consolidation of the Arrendadora, the leaser, an important fraction of it I think that it is something around the 3% or something like that. It is explained by the consolidation of the Arrendadora. So, going back again to what I was telling you, given that we end up unwinding that book, definitely it is going to have a positive effect on the NIM altogether by the end of the year.

Carlos Rivera: Ok, thank you. And my second question is regarding Famsa, but not the partnership with them by the portfolio that you acquired. How much do you think is that going to be contributing in terms of either net income or interest income? And when will we start to see that contribution?

Carlos Ochoa: That should happen this year.

Angel Romanos: We bought the… hello, how are you, this is Angel. We bought the portfolio at the beginning of the year. So you should start seeing results from that early this year, starting this quarter, we are collecting for it already. We have already received 2 or 3 payments from that portfolio. And we own 33% of the whole portfolio. We bought it at 40 cents to a dollar. So it was at very, very good price that we acquired it. And we have a consortium with Promecap and Credit Suisse, and we divide the deal in thirds, so we own 1/3 of that portfolio. And you should start seeing that coming to the, into our margin, starting this quarter.

Carlos Ochoa: Yes. And probably the way to give you an idea about how we assess, how we normally assess when we buy a portfolio out, what we tend to do is that we assess its profitability based on IRR. So what we would expect at the end of the day, from this acquisition is to have IRR before the full transaction of something around 45, between the 45% and the 50%. So it is definitely something very attractive. And not only that because it gives us the possibility to refinance to that same customer base and to increase the penetration in the northern states and so on. So definitely it is going to be accretive for the company.

Carlos Rivera: Ok, thank you. And the last question that I have is the change in equity, basically a decline of about 900 million pesos. Is that everything related to the appreciation of the peso? Or is there anything else there?

Carlos Ochoa: It is basically, the peso appreciation led to a decline of a 1 billion, roughly, a 1.54 billion or something like that. If the peso depreciates to a 21 pesos range in the range of the 21 pesos, that figure should net out. It is going to become zero. So basically, that happened because if you look at the peso at the end of last year, it stood at 19.90 pesos, if I recall correctly.

Carlos Rivera: Yes, yes, Ok. That is right. I just want to confirm that was nothing else on that account. Thank you very much for the answers, Carlos and Angel.

Carlos Ochoa: Thank you Carlos.

Angel Romanos: Thank you.

Operator: Our next question comes from Nick Dimitrov with Morgan Stanley. Please proceed.

Nikolai Dimitrov: Hi there. Most of my questions have been answered. I have 2 left, though. I was looking at your NPL guidance of 2% to 3% for 2021. And currently, we are at 1.83%. So I was wondering, it seems like you expect some more asset quality weakness coming from somewhere. And I was wondering where it is going to come from. And whether the deferred loans, which are still at 5.2% of total loans, will probably explain some of this. I was also under the impression that most of the deferred loans would have exited deferral programs by year-end. So just kind of surprised to see that you still have a material exposure to that type of book. So that is going to be my first question in terms of your NPL guidance and then the deferred loan book.

Carlos Ochoa: Yes. Look, the NPL, that is our long-term guidance for NPLs. We have been having that figure for a number of years already, to the 2% to 3% range. And definitely, we do not expect that to change. What happened differently for this year was more on the front of the cost of risk rather than on the NPL front. That is basically, I would say that it is going to be basically the big difference between the 2. You know, what we saw in the past and the NPLs. We would not expect it, we would not expect the NPLs to change much more. But what we will expect is that the coverage ratio should trend downwards. That is what we would be expecting. Yes, 5%, yeah 5% under a form of relief programs, yes. But if you recall correctly, we have lockdown for most part of December. So that is when we needed to start granting a form of relief, especially on the SMEs business. But other than that, I would say that definitely it is going to be declining by the end of this quarter, and we would see a normalization in the coverage ratio, both on the coverage ratio and in the cost of risk by the end of this quarter or probably at some point in the 2Q.

Nikolai Dimitrov: And would you give some guidance then on the cost of risk? You are talking about normalization, possibly releasing reserves. Are we going to see cost of risk (inaudible)? I do not know, Q4 it was like 4.64% as per my calculations.

Carlos Ochoa: Yes, I mean to tell you the truth, I mean considering all the challenges that we faced last year, we feel comfortable with a cost of risk around 4.5%. Definitely we feel comfortable about that one with a cost of risk above the 4.5%. I would expect, hopefully, that to come down, definitely to come down to the previous level probably more close to the 4%, but here you are going to have another difference. I mean, if you see, one of the things as I mentioned at some point. One of the things that drove the cost of risk down was the growth rate that we experienced especially in 2018 to 2019 with the SMEs portfolio. Now that we are unwinding that book, now that we intend to unwind that book, probably it should stay at 4% range, but not at the 3% range that you saw in the 4Q for example.

Nikolai Dimitrov: Makes sense, and the deferred loan book, the 5.2%?

Carlos Ochoa: Yes, I would expect this to be something around the 4%, I mean, it is okay in terms of cost of risk.

Nikolai Dimitrov: Ok, Ok. And my last question is going to be. I noticed that your foreclosed assets jumped to 1.4 billion pesos from 32 million pesos, I think, in Q3. So what explains this increase? Is it the wind down of, I thought it was the wind down of the SME book, but it could also be related to auto loans? What is driving the increase in foreclosed assets?

Carlos Ochoa: In the? No, I mean, basically, as I mentioned at some point, the focus of the company is on the cash. However, by the end of last year, however, by the end of last year and that happened at the end of last year. We perceived that, you know, we could have an increase in the NPL. So we could have an increase in the cost of risk or something. We started negotiating with the customers for whatever we have under, as a guarantee or as a collateral. So how that normally works? Yes, it was on the SME front and a number of loans on the SMEs front. And how that works is that, well, you move it from the portfolio line, you move it on the foreclosed asset line. And for that, you have to, they have to be appraised. And not only that, they are tested for impairment on a regular basis, I think it has to be every quarter or something like that. And if we see a form of impairment, which we would not expect, definitely, you would have to increase the provisions. But we saw that... the decision that we made as the last year was in order to keep the NPLs down. And in order of not increasing further the cost of risk. Basically, we negotiated with our customers and we repossessed the assets. That is basically it.

Nikolai Dimitrov: Ok, that makes sense, thank you.

Carlos Ochoa: Thank you, Nick.

Operator: Our next question comes from John Ho on with Mizuho. Please proceed.

John Ho: Hey good morning Angel, good morning Carlos. I hope you guys are well. Again, lot of questions, a lot of questions answered. I will have two things, and you have touched on them during the call. One was, I know the regulation is expected to be positive for this sector. More transparencies, some caps on to not over leverage the client. Can you maybe speak about what may, you know, what may be the potential negatives in terms of the lenders like yourselves to, you know, with this regulation? Is there a potential for caps anywhere else that they might do to you? And then second was, a gentleman earlier in the call touched on the payroll sector and touched on the origination growth. And then the decline in interest income. I am wondering, you mentioned a few factors. You said there were several factors involved there that we saw the interest income (inaudible). Could you go into that a little more because that is been something that has been a source of confusion over the last quarter, that people have brought up to me over the last quarter. And maybe if you can go into it a little more. Thank you very much.

Carlos Ochoa: Hey, John. Well, I would say, I mean, even though we feel optimistic about the regulation for the payroll business, I mean, I think that there are more positives than negatives. Probably at some point, that could lead to a pressure on the yield. That is probably the only negative aspect that I can think of. But if you think about the experiences in countries such as Colombia or Brazil, prior to the regulation, was due immediately so, was an increase in the penetration. And that is what we would expect at this point. However, if you think at this point, for example, exactly leads to some form of pressure, you know, coming from the pressure on the yield. Definitely, it is going to be compensated because if you recall correctly, with the payroll business, normally what happens is that you could have up to 90 days to collect the first payment. Once that you disburse a loan , if you take up to 90 days to get the first payment. So basically, what we see and one of the aspect that the new, that this piece of regulation is addressing is to limit the times where the government agency pays you back and definitely, it is going to be positive. That is the only thing I would expect as a negative. Especially, if you think about the, how I mentioned, if you think about the experiences in the other countries such as Brazil or Colombia. And now going back to the NIM part, going back to the NIM, yes. I mean, we try to, if you look at the press release, we included a chart trying to explain a little bit the pressure over the NIM and altogether that decline in the yield. Some of it, it was generally associated to payroll business, product mix. And basically, what we tried to do in the press release is to explain, to quantify the different aspects that affected the yield and put pressure over the NIM. They range from the FX losses to the consolidation of the Crédito Real Arrendamiento and pressure of the payroll business, especially because we were not originating for teachers, we were not as dynamic originating for teachers, and we created the concentration in the state level agencies that are not... that in yield wise are not as attractive. But definitely, we believe that we could revert a number of those aspects for this year.

Operator: Our next question comes from Nicolas Riva with Bank of America. Please proceed.

Nicolas Riva: Yeah, thanks again Angel, a follow-up. There is a concept that Carlos and Angel, that you mentioned many, many times in this call, which is unwinding the SME loan book. And I wanted to ask if you are talking about a specific business within that book, leasing, factoring, working capital or about entire SME loan book? I assume here, you are talking, what you mean is that you plan to grow less in the SME loan book and other parts of the business. Not just letting that SME loan book amortize and just collect on that. I mean, it is over to 20% of the loan, but I wanted to clarify what exactly you mean by unwinding the SME loan book?

Carlos Ochoa: Unwinding, I think, I would say that it is going to be, at the end of day what we would expect is that instead of having a concentration of 23% which currently stands, is to have at the end of the year something around the 12% and the 15%. That definitely leads to a softer origination, as you mentioned, a much softer origination or stopping originating for different products.

Nicolas Riva: Ok, understood. And then related to this, you also said in the call that you expect these let us call it that with reduced exposure to SMEs, to have a positive impact on your capital ratios, right? I mean, if I look at capital ratios, I mean, you gave us guidance for growth in the loan book of 8% to 12% this year, right. And the ROE, the return on equity last year was below 5%. And I admit that you gave guidance to Ernesto previously and I will ask you to repeat, if you can, the guidance for ROE this year. But it seems there is going to be a great challenge for you to have a return on equity which is equal to that 8% to 12% loan growth, in which case your capital ratios would continue worsening. So that is why I was asking if you already have plans to inject more capital into the business this year in order to prevent that deterioration in your capital ratios. Is that clear?

Carlos Ochoa: Look, no, I am not sure. And let me tell you the figures that, you know the calculations that I make. If you think that we could grow the book something around the 5% to 10%, we could grow the book without getting new money, right? As long as we decrease the concentration in the SMEs portfolio, that definitely is going to be mostly debt neutral, right? So it would not have a pressure on the capitalization. On the other hand, if we shift, you know, if we change the concentrations from the product with the lowest NIM, such as leasing or whatever, to the other ones, teachers on the payroll front or used cars or whatever we have in Central America. Definitely, it is not going, it is going to be the other way around. And that is basically what I am... that is basically how we are thinking of it.

Nicolas Riva: Ok, thanks very much Carlos.

Carlos Ochoa: Thank you, Nicolas.

Angel Romanos: Thank you.

Operator: Our next caller is Natalia Corfield from JP Morgan. Please proceed.

Natalia Corfield: Hi Carlos and Angel, thanks for taking my questions. Most of them were already answered, but I have 2 left. One is about our other accounts receivables from subsidiaries. This increased quite a lot relative to last year. So if you could give us a refresher of what these are and why there was such an increase, that would be great. And the other one is a curiosity, related to the new payroll law. And now I understand that is more regulated, it is going to be similar to Brazil and Colombia, of course, without a cap. And you mentioned in the call that you think that this would be good. And one of the reasons was because of competition because many entities are not regulated. But my question is, would not the reason for large financial institutions like Banorte and BBVA to start entering the segment. Now that is more regulated. So those are my two questions.

Carlos Ochoa: When it comes to the other accounts receivable, I would say that the big change that you see is in the income paid in advance to the distributors. And let me explain you that line. If you think that the commissions that are traditionally paid to the sales forces are something around the 12% to 15%. Basically, the distributors need, and those are paid upfront to the sales force, the distributors they need some cash, working capital in order to operate. Otherwise, they would not be able to keep the sales force. What happened during this year, and if you look at the big jump that you see from the 2.4% to the 3.3%. And how do you amortize that? How you amortize that receivable? Basically, when you are collecting, when you are collecting money, instead of paying back 50% of the interest collected, paying it back to the distributors, basically, what you do is that you keep more than 50%.We give a larger amount to ourselves, and that is how we amortize that receivable. Now what happened this year is that remember that for 3 months we did not, we basically did not collect it from the IMSS because of the relief program granted to the pensioners. So basically, what happened is that given that we did not collect, well, we collected, but we lent it back, they, the distributors, they did not get his share of the income and we did not amortize that one. So that is basically the explanation in the most, in the largest fraction of it. Are for the others, there are different numbers of receivables that we give, taxes that are associated, the VAT associated to the leasing business and so on and so forth. But the bulk of it, the largest explanation comes from the, what I am telling you, which is basically the income paid in advance to the distributors and that is basically how it is. And now coming to the competition part of your question, when it comes to the payroll business, coming to the competition part of the question. Yes, potentially that could lead but however, think that the main differentiator, I mean, think that definetely the main aspect that the customers value the most, is the service that we provide them. Is like a lot of our customers they live in places with banking penetratio, with limited banking penetration and so on. And so I would say it is the other way around. I mean, in the history of Crédito Real, we continue to gain market share from the banks. And I do not see a big change immediately. We are more positive, and we are more constructive about the new regulatory framework. Definitely it is going to address many aspects, many challenges of the business. And as I was mentioning, as I mentioned a number of times during the call, we are convinced that this is going to be positive for the company.

Natalia Corfield: Ok, thank you Carlos. Just a follow-up on the other accounts receivables. You explained the income paid in advance to the distributors. But I do not know, could you give a little bit of color on the other accounts receivable.

Carlos Ochoa: You know, I take that offline, and I will give you the specific details with Renata. I will ask Renata to tell you the specific details about the other. Because they are most associated to the distributors in the payroll business. But I will ask Renata to give you a call and try this offline.

Natalia Corfield: All right, thank you very much.

Carlos Ochoa: Thank you Natalia.

Operator: I would like to remind that you press *1 to ask any questions and at this point, we have no questions in the queue, so the question-and-answer session has concluded and thank you all for being in today's conference call, and you may now disconnect your lines.

Carlos Ochoa: Thank you everyone.

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