# Script for Grupo Security's Earnings Conference Call for 2Q 2020

**Marcela Villafaña (Head of Investor Relations, Grupo Security)**

Good afternoon and thank you for joining us. First, Felipe Jaque, the Chief Economist for Grupo Security, will give us a brief summary of outlooks for the local and international macroeconomic environment.

**Felipe Jaque (Chief Economist, Grupo Security)**

## Macroeconomic Recap 2020 (Page 2)

The second quarter saw record-low activity levels with a drop of 14.1% YoY, impacted by strict quarantine periods in Chile's main cities. The hardest hit sectors were those related to retail and services, where lockdown restrictions began to be gradually eased only recently in August. Reopening should lead to positive figures in the fourth quarter of the year. Sectors tied to electricity generation, mining and manufacturing showed somewhat more limited downturns. However, June was an improvement over May, considered the trough of the cycle. Amidst the boost from income support measures, 10% withdrawals from pension funds and the momentum of global reactivation, we forecast a 5% YoY contraction in 2020 and a 6% YoY recovery in 2021.

## Macroeconomic Recap 2020 (Page 3)

The pandemic's greatest impact has been on the labor market, which lost close to 1.8 million jobs LTM as of July, with not only salaried but also independent or self-employment seeing sharp declines. Quarantines have led to a workforce reduction of around 16% YoY, with a major adjustment to the labor force participation rate that has helped curb rising unemployment, which hit 13.1% in July. However, unemployment would be well above these figures if they considered potentially active workers that would return once lockdown is eased. This is in addition to nearly 700 thousand workers under the employment protection program. Thus, the outlook for private consumption is one of gradual recovery, definitely mitigated by household income support measures, while waiting for measures designed to reactivate public and private investment to generate a sharp recovery in employment over the next few quarters.

## Macroeconomic Recap 2020 (Page 4)

In terms of inflation, larger output gaps have driven non-tradable inflation to levels around 1.5% for the year, helping offset tradable inflation above 3% as of July. Even so, short- and medium-term inflation expectations have tended to stabilize at around 2-2.5% per year, leaving behind potential negative inflation scenarios, albeit with very contained figures, in the midst of low margins for different economic sectors. In the medium term, the reopening process, recovering raw materials prices in a setting of a weaker global dollar and more volatile prices should drive inflation to 2.4% as of year-end 2020 and closer to 3% towards the end of 2021.

## Macroeconomic Recap 2020 (Page 5)

As for monetary policy, we do not anticipate significant changes in direction or message, with a highly expansionary stance sticking around until 2022. This is in addition to new tools available to counteract the crisis like recently approved purchases of public securities on the secondary market, which complement diverse liquidity measures implemented by the Chilean Central Bank. These measures still have room for action, so monetary authorities have the capacity to react to potential additional shocks that might arise during the economic recovery process in the midst of the pandemic.

**Fernando Salinas (Planning and Development Manager at Grupo Security):**

## Grupo Security Results (Page 6)

Grupo Security posted profit of MCH$ 17,328 for the six months ended June 2020, 59.5% less than the prior year, due to lower profit from the Group's business areas, down 47.6% over last year. It also saw an increase in corporate and support company expenses due to larger expenditures on termination benefits. These effects were partially offset by positive tax effects.

For the quarter, this figure was MCH $10,761, 63.9% above the prior quarter. The reduced profit from business areas was more than offset by a smaller loss on indexed assets and liabilities, due to lower inflation during the period, and positive tax effects recognized during the quarter.

In terms of business areas, for the six months ended June 2020, the lending area reported profit of MCH $32,367, 20.8% less than the year before because of a 26.4% drop in profit from the standalone bank to MCH $26,807. The decline can be explained by greater provision expenses mainly in the commercial banking division due to the public health crisis and a low basis of comparison.

In the asset management business area, profit totaled MCH $2,035, less than the same period in 2019, due to lower returns on proprietary trading positions at AGF and Valores and operating income in line with the prior year.

On the other hand, the insurance area reported a loss of -MCH $1,584 as a result of lower returns on financial investments at Vida Security. It is important to mention that insurance is operating in line with projections for the year.

The other services business area recorded a loss of -MCH $2,084 as a result of the impact of the current public health crisis on Travel Security and the lag in legal titles transfered by the real estate company. There is a lag between a sale and revenue recognition. Under IFRS, revenue is recognized once legal title to the property has been transferred. The company expects this effect to be reversed during the year as it transfers ownership on units that have already been sold.

Finally, in the international business area, Protecta Security reported profit of MS./ 4.7, with premium volumes and investment income similar to last year. Therefore, the reduced profit for the six-month period can be explained by fewer reserves released for claims incurred but not reported.

## Banco Security (Standalone) (Page 7)

The Bank's standalone profit was MCH $26,807 for the first half of 2020, or 26.4% less than the first half of 2019.

In particular, the commercial banking division recorded profits of MCH $21,703 for 1H20, 26.1% below the previous year. This smaller profit can be explained by increased provision expenses due to shifting customer risk ratings because of the public health crisis, combined with a low basis of comparison because of provisions reversed during the first quarter of last year. This was only partially offset by the net interest margin, which was 7.8% higher, in line with 16.1% growth in loans.

Commercial loans have grown 13.3% YoY, exceeding initial expectations, driven by customer preference for liquidity. We believe this growth will normalize during the second half of the year. Of this growth, state-backed (FOGAPE) loans account for only 5%. In contrast, at industry level commercial loans grew 19.1%, with 33% of this growth explained by FOGAPE loans.

In the retail banking division, loans to individuals were up only 3.2% YoY, driven by 9.6% growth in mortgage loans, offset by a 4.5% decrease in consumer loans attributable to the public health crisis's effect on the economy.

The division reported a loss of MCH $551 for the first half of the year, versus profit of MCH $3,147 last year. The net interest margin was down 5.8% YoY due to MPR cuts, while net fees fell 23.7% due to decreased sales of supplementary loan insurance products. In addition, provision expenses reached MCH $14,546, up 24.2% from last year, because of an increase in the portfolio's NPL ratio, consistent with an economy impacted by the public health crisis.

The treasury division reported profit of MCH $10,839, reflecting an increase of 35.0% over the first half of 2019, due to MPR cuts and growth of the proprietary trading portfolio, in line with a new investment strategy to take advantage of funding lines offered by the Chilean Central Bank.

## Banco Security Consolidated Indicators *(Page 8)*

Banco Security had total loans of BCH $6,225 as of June 2020, representing YoY growth of 13.3%, driven by 16.1% growth in commercial loans. As we mentioned before, at industry level commercial loans grew 19.1%. One-third of this growth was explained by FOGAPE loans. In contrast, these loans only represent 5% of Banco Security's growth.

As we mentioned, loans to individuals were up 3.2% YoY, due to a 4.5% fall in consumer loans attributable to the pandemic's impact on the economy. The net interest margin has remained stable over time at around 3.3% of loans.

Banco Security's consolidated efficiency ratio was 50.3% for the first half of the year, due to lower gross operating income and a 1.4% YoY increase in operating expenses primarily because of increased personnel expenses for commercial bonuses for good results in 2019.

In 1H20, the ratio of loan loss provisions to total loans was 0.89%, compared to 0.54% for 1H19, reflecting the low basis of comparison in the commercial banking division.

In addition, the pandemic has put a damper on the economy, causing several customers in the commercial banking division's individual portfolio to be reclassified and driving the retail banking division's NPL ratio upward.

Return on average equity was 10.8%, compared to 12.3% for our peer banks and 6.9% for the industry.

## Factoring Security (Page 9)

At Factoring Security, factored receivables totaled BCH $321 for the six months ended June 2020, reflecting a drop of 9.7% YoY due to economic slowdown and assistance programs such as state-backed FOGAPE loans and loan renegotiations.

Profit for the first half of 2020 was MCH $5,568, up 25.2% from the same period last year because of greater operating income, where lower volumes of factored receivables were more than offset by a larger spread, since the company managed to transfer the higher economic risk to its prices.

Efficiency was 39.8% versus 42.2% in 1H19, while the risk index, calculated as provisions over total loans, was 2.33%, up 29 basis points from 1H19, also impacted by the effects of the crisis on its customers.

**Marcela Villafaña**

## Vida Security (Page 10)

The insurance area recorded a loss of -MCH $1,584 in 1H20 and Vida Security recorded a loss of -MCH $1,992, which compares negatively to the profit of MCH $11,428 for 1H19. The decrease is attributable to the public health crisis's impact on financial markets, thus affecting the company's investment income.

In aggregate, gross written premiums totaled MCH $113,690, 14.2% below the previous year as a result of lower annuity and group insurance sales.

The individual insurance product line had a contribution margin of MCH $5,695, with growth of 25.5% in direct premiums written and lower investment income from the CUI and APV portfolio. In addition, claims paid were up 29.6%, explained by increased surrenders and transfers from CUI and APV policies.

As for family protection products, the contribution margin was 62.8% greater due to reduced underwriting expenses and claims paid.

For group policies, the contribution margin grew 33.0% YoY due to a lower claims rate in group health products explained by a drop in elective procedures because of the pandemic.

Meanwhile, the contribution margin for annuities reached -MCH$ 31,846. Over the last 12 months, the annuity sales rate for the entire market has averaged 1.7%, while the calculation rate for scheduled withdrawals has been 2.8%, thus driving industry-wide sales sharply downward. As a result, Vida Security reported direct premiums written of MCH $8,373, down 78.0% from the previous year. This was offset by lower reserve requirements due to lower sales volumes, reflected in a decrease in annuities paid.

The contribution margin for disability and survivor insurance was -MCH $1,515 for the first half of the year, down from last year because of the effects of lower interest rates on technical reserve calculations. This occurred in the first quarter of the year, since the second quarter was positively impacted by rates, resulting in a contribution margin of MCH $894 for the quarter.

These effects resulted in a contribution margin of -MCH $9,317, versus -MCH $40,488 for 1H19.

## Vida Security - Investment Income (Page 11)

Vida Security had investment income of MCH $28,810 for 1H20, down 70.0% from 2019. Investment results for the quarter are attributable to lower returns on equity investments, in both the CUI and APV portfolios as well as the proprietary trading portfolio. This reflects the impact of the current public health crisis on Chilean and international financial markets.

Specifically, the proprietary trading portfolio fell 54.2% YoY, mainly because of lower returns on international equity instruments, alternative assets and real estate funds.

For example, during the first half of the year the S&P 500 recorded losses of -4.0% in dollars, while the IPSA had losses of -15.2%, measured in Chilean pesos.

## Asset Management Area (Page 12)

For the first half of the year, the asset management area, which includes the fund management (Administradora General de Fondos or AGF), brokerage (Valores Security) and securitization (Securitizadora) subsidiaries, reported profit of MCH $2,035, down 32.3% from last year. This weaker performance is explained by a 56.6% drop in non-operating income, which reflects lower returns on the subsidiaries' proprietary trading positions, as a result of a shift in strategy and a higher basis of comparison.

## Asset Management Area (Page 13)

The asset management area had assets under management of BCH $4,149, representing a YoY drop of 14.2%, because of decreases in mutual and investment funds under management and the impact on valuations of weak markets.

As for the mutual fund industry's AUM, money market and balanced funds reported greater growth, while fixed- and variable-income funds decreased. In a YoY comparison, AGF Security reported a decrease in AUM in domestic funds and growth in balanced and international funds.

Operating income held steady from last year, mainly due to a greater ROA, partially offset by falling AUM during the period. Over the past few years, the industry has seen a downward trend in management fees as a result of a declining preference for risk and the industry's pricing structure. Last year customer fund preferences shifted, driving ROA upward. In particular, there was a shift from medium-term fixed-income funds to conservative balanced and money market funds in dollars. Meanwhile, transactional income fell just 0.6%. Despite the drop in trading value, the effect was offset by increased income in the international area.

## International Business Area - Protecta Perú (Page 14)

In the international business area, Protecta Security recorded profit of MS./ 4.6 in the first half of the year, down 47.6% from June 2019. Total premiums written and investment income were in line with last year. However, fewer reserves were released for claims incurred but not reported, leading to reduced profit.

For 1H20, annuity sales were up 7.9% YoY, giving the subsidiary market share of 25.1% and a second place ranking based on sales. The company reported 61.5 million soles in private annuities and market share of 16.5%.

Note that converting results in soles to IFRS in Chile results in a smaller accounting profit.

## Other Services Area (Page 15)

Travel Security, our travel agency, has been profoundly affected by the public health crisis's impact on the travel and tourism industry, reflected in a YoY drop of 66.4% in billing. Consolidated with its similarly impacted subsidiary in Peru, Travel Security reported a loss of -MCH $2,771 for the first half of the year. During the period, Travel Perú posted a loss of -MUS $1.4.

In view of the medium- and long-term impacts on the industry, the company adjusted its structure and reduced its workforce by 32%. The company will also implement a commercial and operations model that is completely integrated between Chile and Peru.

In the real estate subsidiary, quarantines have resulted in delays in municipal approval of projects, thus postponing transfer of ownership.

This subsidiary recorded a loss of -MCH $513 with legal title transfered on 18 units and UF 389,000 in signed purchase promise agreements, down 23.3% from the previous year. On the other hand, real estate assets under management rose 27.8%.

As previously mentioned, there is a lag between a sale and revenue recognition. Revenue is recognized once legal title to the property has been transferred. As municipal operations and approval processes return to normal, we expect ownership transfers to resume. In addition, the abandonment rate on purchase promise agreements has been well below 10%--our worst-case scenario--so we are optimistic about the results for the second half of the year.

**Fernando Salinas**

## Evolution of Grupo Security - Indicators (Page 16)

Lastly, here we show Group indicators over a longer period of time.

Consolidated profit for 1H20 was MCH $17,328, with return on average equity of 4.6% for the six-month period. The dividend yield was a noteworthy 6.4% and on June 30, 2020, the market to book ratio was 0.69x, among the lowest in the Group’s history.

## Capital Increase (Page 17)

Regarding the capital increase, 415 million shares were issued, reflecting a 11.23% increase. The preferential option period (POP) took place between July 20th and August 19th.

The week of August 3rd, the company held a roadshow for the deal, with 20 one-on-one meetings and 3 larger meetings streamed by more than 300 people.

During the POP, 322 million shares were subscribed, equivalent to 77.64% of the issuance, and MCH $51,555 was raised. This left almost 93 million options, representing MCH $14,845 to be subscribed over the next 18 months.

With the deal, free float rose from 26.8% to 27.7% after a new investor acquired options for over 2% of the company.

## Transformation Underway (Page 18)

The transformation process we are currently undergoing began at Banco Security, but has extended to all Group companies. The focus is on addressing changes in customer expectations while preserving our origins: continuing to be a niche conglomerate focused on service quality that provides a comprehensive offering of financial services across all Security companies.

As for customer interactions, we want to strengthen digital channels, streamline the organization and prepare it for new growth platforms.

In terms of digital transformation, we will leverage analytics and data to harness opportunities and detect risks. We are working on adapting processes and technology to new customer service models.

We must also address regulatory changes coming soon to the industry by optimizing the use of capital and risk models.

In addition, we are implementing efficiency projects organization-wide for the entire Group, aiming to cut administrative expenses by 10%. We are also simplifying and automating processes, reviewing organizational structures using the span & layers methodology, and using zero-based budgeting starting in 2021. Once this process has been completed, an expense control program will be adopted to periodically challenge the company's expenses.

Lastly, we always keep a strong focus on culture, adapting to incorporate changes we want to make, developing new capacities within the organization and bringing new talent on board that will contribute to these new projects.

Once again, thank you for joining our earnings call. Our team is available to answer questions.

## Q&A

**Analyst 1**

First, with respect to the Bank, I would like to understand a bit more about NPL coverage. As of the end of 2Q it is around 90%—already under 100%—and macro and credit risk conditions still represent one of the major threats from this point forward. How do you expect this to evolve?

My second question has to do with Banco Security's LTD (Loan to Deposit) ratio. This also increased sharply with negative annual variations in some types of deposits such as savings accounts. I would like to understand this a little better and know whether you are seeing pressure from the deposit side with low costs.

The third question has to do with the transformation and 10% reduction in administrative expenses. What's your intended timeframe for achieving this? What will the transformation process be like? Could you also comment on whether the new investments in technology might dilute the anticipated expense reduction?

**Marcela Villafaña**

In response to the first question: this year the largest impact on provision expenses from the public health crisis has been in our commercial portfolio, which accounts for 80% of our loans. Our bank focuses on large companies and, therefore, our loans have a larger average ticket size than the industry. These loans have good guarantee coverage. For instance, on average the commercial portfolio has 70% coverage. That is why our provisions may perhaps be lower than what you might see at other banks in a similar portfolio. When one of these loans has a downgrade in rating, we see sudden movements in this coverage ratio.

In addition, we have a low basis of comparison in terms of risk. The year 2019 was a very good year for risk for the commercial banking division, with a provision to loan ratio of 0.6 - 0.7%. Therefore, the rise in loan loss provisions is going to be important this year. According to our estimates, this year we should reach a provision to loan ratio of between 1.2 - 1.25%, versus 0.9% last year. While this is a considerable increase in provision expenses, it is consistent with our portfolio and our efforts to work with customers to get through this crisis.

**Fernando Salinas**

Regarding expenses, I would like to touch on two aspects of the expense optimization work at all companies: the structure and administrative expenses. This process is already underway, with a large portion of expenses already cut during 2020. Furthermore, multiple Group companies have adjusted their structures and are already being capitalized. We hope that the 2021 results (compared to 2020) reflect a 10% YoY reduction in expenses. Some of these effects will be seen this year, although we have implementation costs, particularly from restructuring. On the technology side, we do not envisage any projects offsetting the desired reduction in administrative expenses. So, for 2021 we expect this to be fully reflected in our consolidated expense basis.

**Manuel Widow**

As for the topic of deposits, the drop is explained by the Bank's decision to take advantage of several financing lines offered by the Chilean Central Bank, which have replaced other funding sources, including time deposits. That is why the loan to deposit ratio has fallen, but it is completely circumstantial and relative, not absolute. This shift is not due to less availability in the market, but is merely a matter of substituting one funding source for another that, at this time, is lower cost.

**Analyst 2**

Could you give us a preview of third quarter results, in metrics such as portfolio growth, net fees and NPL ratio? What are the main challenges? Is the worst behind us?

Secondly, provision expenses continue to increase proportionally. Could you provide us some insight on this trend?

**Marcela Villafaña**

Thank you. On the topic of risk, we think that the worst months of the crisis will be between the second and third quarters. Provision expenses are effectively on the rise and we believe they will remain more or less stable from now until the end of the year. The challenges are obviously to control risk and continue to work on efficiency, not only in the Bank but also in the rest of the companies. Another challenge lies in carrying out this transformation process to produce strong results. We hope these efforts will begin to yield results in 2021.

**Manuel Widow**

Regarding loan growth, we have fallen behind the industry slightly, to a large extent because the industry's growth is from government relief plans, such as state-backed (FOGAPE) loans. We have participated in these programs on a limited basis, in contrast to larger banks in the industry. Isolating that effect, the Bank has marginally surpassed average industry growth and we expect this trend to continue over the next few months.

**Online Questions**

Are you at ease with coverage levels for seemingly higher-risk customers?

When will provision expenses peak? What are your projections for growth and efficiency?

Will you reach 2021 with a clean portfolio?

**Manuel Widow**

Regarding risk, we believe that loan losses from now until year end must more or less keep pace with the past few months. In that sense, we believe that the commercial loan portfolio is well provisioned. However, impairment will probably keep us at levels similar to May, June and July.

As for next year, our customer assistance loan deferral plans will produce a lag in impairment that will probably affect some customers, especially in the retail banking division. These effects should be first seen between August and October, although the impact should be limited, given the characteristics of our portfolio.

Regarding next year’s commercial portfolio, we believe it’s still a little risky to speculate, although with our current provision levels, there should be no major surprises. Clearly, it depends on the country's macroeconomic and political evolution.

**Online Question**

Is there a date for beginning to use the new formula for the asset sufficiency test?

**Rodrigo Guzmán**

This standard will be in place by month-end October. It benefits us because some parameters are more flexible, particularly proportional equity to be considered and asset flows. More assets can be included in flows to offset our annuity liabilities. It is good news for the entire industry, although Vida Security will particularly benefit from the new standard.

**Online Question**

How has business been for Security Factoring in July and August? Is it reasonable to expect the second half of the year to be similar to the first half?

**Marcela Villafaña**

Factored receivables have slowed a bit in recent months. This can obviously be partly attributed to the sluggish economy, which is an important driver of factored receivables. However, it is also because many of its target customers, which are slightly smaller than the Bank's target customers, have accessed Corfo assistance programs and state-backed FOGAPE loans. These loans have very good rates and conditions and, therefore, liquidity supplies have increased.

We expect payments to start up again for companies and for the economy—the most important driver—to revive, which should spur recovery in the factoring business. Clearly, this upturn will depend on how the economy evolves.

**Online Question**

For the Bank, what ratio of net interest margin to loans do you expect to see this year? Do you anticipate recovery in 2021? What is your sensitivity to the UF?

**Manuel Widow**

In terms of the margin, with the facilities made available by the Chilean Central Bank, cost of funds has generally been quite low. It cut the MPR and has made these instruments available to banks, flooding the market with significant liquidity and the resulting downward impact on cost of funds. On the other hand, as a result of higher loan risk, there has also been an increase in customer spreads. Both elements have helped improve the Bank's net interest margin in recent months. We expect this to continue over the next few months as we refinance liabilities at lower costs and assets depreciate at a slower pace.

In recent weeks there has been a certain reaction at financial system level with more aggressive spread levels being offered to customers. However, we believe that for what remains of the year, and probably a good portion of next year, the industry will maintain a higher net interest margin than we were used to seeing pre-crisis. Finally, it will depend a bit on the industry's evolution in terms of aggressiveness and appetite to go out and drum up business.

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