Q3 2018 Earnings Call

Company Participants

- Ursula Margarete Wilhelm Nieto
- Jose Marcos Ramírez Miguel
- Rafael Victorio Arana de la Garza
- Manuel Antonio Romo Villafuerte
- Gabriel Casillas Olvera
- Carlos Eduardo Martinez Gonzalez

Other Participants

- Carlos G Macedo
- Jason Mollin
- Claudia Benavente
- Mario Pierry
- Arturo Langa
- Marcelo Telles
- Gilberto García
- Carlos Gomez-Lopez

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Banorte hosted Third Quarter 2018 Earnings Conference Call. Today's call is being recorded. And at this time, I would like to turn the conference over to Ursula Wilhelm. Please go ahead.

Ursula Margarete Wilhelm Nieto

Thank you, Vicky. Good morning, and welcome to Grupo Financiero Banorte's third quarter results. I'm Ursula Wilhelm, Head of Investor Relations. And this morning, Marcos Ramírez, our Chief Executive Officer will lead the presentation. And at the end of his comments, we will address your questions. Thank you. Marcos, thank you.

Jose Marcos Ramírez Miguel

Thank you, Ursula. Thank you, everyone. Good morning. Thank you for joining us today. I'm very pleased to tell you that we have achieved again another set of good results. The quarter evolved with good dynamics in our core businesses and solid performance across all subsidiaries. It is worth noting that the financial information and results represented today are fully consolidated with Grupo Financiero Interacciones.

As we mentioned in our last conference call, the merger took place in mid-July. In this context, let me tell you that we have made significant progress in the integration, particularly related to three key aspects: one, the structural business; second, IT migration; and third, OpEx reduction.

Bloomberg

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Please now turn to slide 3 of the presentation. Here, you will see that the consolidated net income reached MXN 7.8 billion, which is 26% above last year and up 9% in the quarter. In this sense, earnings per share reached MXN 2.71, growing 21% and 5% respectively, as it includes the new shares that we issued upon the merger.

In the two charts below, you can see how well we are doing towards our 2020 goals. On the one hand, the return on assets stood firm at 2.1% while on the other hand, the return on equity for the quarter reached 19.7%, 54 basis points higher than the previous quarter.

Moving to slide 4, you will see that revenues grew 5% on a quarterly basis, [ph] was up to (00:02:15) MXN 23.8 billion. This was on the back of the strong 7% growth in net interest income, as well as good growth in net fees of 6% and adequate results in trading income.

The net interest margin stood firm at 5.7%, offsetting the impact of the integration of Interacciones. In fact, the post-merger consolidated NIM was only affected by a modest decline of 5 basis points, much lower than our originally projected 40 basis points reduction. This moderated impact is the result of the active management that our treasury was able to do on the funding cost of the acquired assets. Once again, let me underscore that good progress has been accomplished, and we estimate that overall reduction in funding cost achieved in the September to be equivalent to 56 basis points.

Getting back to the table in the lower-left corner on slide 4, net services fees grew 6% versus the previous quarter, adding up to MXN 3.4 billion. The business continues to produce good levels of fees from consumer [ph] credit loans, (00:03:24) as well as transactional activity in the electronic and digital channels. It's worth noting that part of this good result had to do with the strong growth in the Mutual Fund businesses where fees have grown 26% this year.

Trading income posted a good MXN 877 million in the quarter, even though these meant a quarterly decline. This was mainly due to non-recurring client transactions present in the previous quarter absent in the Q3. On slide 5, expenses increased 5% in the quarter and 10% in the year. They include around MXN 400 million on merger-related OpEx, but these are being compensated with cost management at Banorte.

Let me elaborate a little bit more about this. The reason why we were able to offset part of the severance payments related to the integration is because we implemented a 3% reduction in personnel expenses at Banorte. Moreover, even though the staff reduction at Banorte took place back in May, we had already provisioned for these expenses in the prior months. This is why we observed an overall reduction in personnel expenses in the third quarter.

Now, during the integration, overall expenses at Banorte grew at an [ph] annual (00:04:39) rate of 8%. In fact, given the efficiency ratio slightly deteriorated 70 basis points to 39.7%, this was entirely explained by the merger, and it is still within our guidance interval for this year.

Moving to the slide 6, the loan book posted 17% growth in the quarter. It is worth noting that adjusting for the merger, the loan book remained flat. The corporate and commercial portfolios increased 1%, while consumer loans expanded 3%. However, the government book declines around 6% in the quarter. The infrastructure book was MXN 44.5 million and grew 4% in the quarter.

In terms of asset quality, moving to slide 7, the non-performing loan ratio in the quarter reached 1.8%. Excluding the government book, the NPL ratio of the rest of the portfolio was 2.4%. Moreover, the cost of risk in the quarter reached 2.3%. It's worth noting that included MXN 250 million of specific provisions for the corporate exposure mentioned earlier.

In this context, we are satisfied with the performance of the portfolios. The only red spot is in the payroll loan portfolio. That has generated higher-than-normal delinquencies, yet the operation of the vintages shows that it's already reaching an inflection point, and we expect the duration to ease towards the fourth quarter.

In this context, please recall that we have already taken preventive measures on creditor emission in this this book since the end of last year. In fact, this is why we have observed a lower rate of or re-emission in payroll loans this year. In the corporate portfolio, a loan exposure of MXN 412 million was moved to a nonperforming status as the client is moving towards restructuring.

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Let's move to slide 8 in order to elaborate on the performance of the relevant subsidiaries. First of all, the bank posted a net profit of MXN 6 billion, growing 12% in the quarter, reaching a return on equity of 24.3%. This is 105 basis points above last quarter, while return on assets is 109 basis points to 2.2%. The net interest margin expanded 3 basis points to 6.5% despite the impact of the merger, providing evidence of the satisfactory evolution of the funding cost and deposit growth at Banorte.

Moving to insurance company, it reported a profit of MXN 1 billion in the quarter. This was 8% lower compared to the previous quarter, but was mainly explained by seasonal dynamics. This result include MXN 348 million net income from the Afore.

The annuities company achieved a net income of MXN 230 million or 22% higher on good underwriting activities. In July, the company acquired and consolidated an annuities portfolio worth MXN 15.5 billion for which it paid MXN 239 million.

On slide 9, we provide the evolution of the capital ratios of the bank, which remain very strong. The capital adequacy ratio was 16.57%, 123 basis points lower than the ratio that's reported the previous quarter. The decline is mainly explained by the merger.

The Common Equity Tier 1 ratio was 12.13% at the end of the quarter, 54 basis points lower than the previous quarter. We were able to mitigate the impact from the merger on this indicator as a result of strong internal capital generation. Risk-weighted assets grew 19% annually.

With this, I conclude my comments on the quarterly report. For the remainder of the year, we are expecting results to come in line with the revised guidance numbers that we discussed with you in July, which you can review in the slide 10 of the presentation.

Now, I would like to briefly comment on two recent developments at the macro levels in Mexico. On the one hand, we believe that the announcement of the new agreement with USMCA is a quite positive development. Among the most important changes, there are stricter rules of regional content for cargo production, but they are not expected to enter into full force until year 2023, and there are new elements and revised chapter of the current agreement, which overall modernized the trade agreement.

Even though, there are still legislative approval processes pending in each member country. The conclusion of the renegotiation process has already reduced a great deal of uncertainty over the outlook of the Mexican economy.

On the other hand, I want to highlight the President-elect nomination of Jonathan Heath to become the Vice Governor of the Central Bank in Mexico. In our view, he has the academic credential that quite reaches Spain in both the public and private sector, and the market recognition to add value to the monetary policy debate at Banco de México. In this context, we see this as a clear signal of López Obrador respect of the autonomy of the Central Bank, one of Mexico's pillars of microeconomic stability.

And now, a final thought. As you all know, we are now entering into the last quarter of the year. This is a period of quite relevant commercial and transactional activity. So we expect Banorte to post another strong quarter.

With this, I conclude my comments, and now, we're ready for taking your questions. Thank you very much.

Q&A

Operator

Thank you. [Operator Instructions] And we will take our first question today from Carlos Macedo with Goldman Sachs. Please go ahead.

<Q - Carlos G Macedo>: Yeah. Hi. Good morning, gentlemen. Thanks for taking questions. First question, could you talk a little bit more about the synergies and integration that you've been going through? How far along are you? How

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much more do you have to go? Also trying to get a feel – you talked about some integration expenses this quarter that you were able to offset with lower personnel expenses. What should be the baseline for the non-interest expense in the fourth quarter? MXN 9.5 billion, it was in the third quarter and the second quarter was eight point – essentially MXN 9 billion. Where should we start that number in the fourth quarter? Should we start at MXN 9 billion, so – because some of the integration expenses won't be there? I mean what – how should we think about that number?

Second, capital levels are still really high or somewhat high even after the merger with Interacciones being concluded. And with loan growth not being particularly strong and profitability approaching 20%, you're going to continue to accumulate capital. Is the plan still to distribute a large amount of dividends? What's the thinking behind the distribution of income? Thank you.

<A>: Thank you, Carlos. I will start with the second one. Yes, you are right, and we are planning to increase our dividends up to 50% which is good for everybody I think. And related to the first question, Rafa Arana will elaborate on that. Please.

<A - Rafael Victorio Arana de la Garza>: Yes. Thank you. Thank you, Carlos. On how are we are at the synergies and what we expect from the coming – for the fourth quarter. On the cost line, let me just give you the general numbers and we can elaborate from that. The total running cost of running the Interacciones business was MXN 3.2 billion. That number right now is down to MXN 1.2 billion, and we need to strip MXN 100 million more from that cost. So the running cost on a monthly basis for the integration of Interacciones should add MXN 100 million more to the cost line of Banorte. So going and adding all that up you should be looking at a number around MXN 9 billion for the fourth quarter as a baseline number still to come our MXN 300 million more of integration costs that should have happened on the fourth quarter.

But you should be looking at around MXN 9 billion cost line. That should be the cost line. And in a very, I would say, consolidated way, you should be looking at reduction of cost for Interacciones to MXN 3.2 billion to MXN 1.1 billion. And we are very close to achieve the MXN 1.1 billion. We are MXN 1 million away from that number, so we are very, very on line what we expect to have on the cost line.

On the funding cost, that is the other big number in order to reach the accretion that we promised the market. We already are around – Marcos said the September numbers, but we are very close to the 60 basis points number on the funding cost. So, the overall synergies that we commit to the market are right on track to be achieved. We already are ahead on some of them on the funding cost. And on the cost lines, we will be very, very, very, very close to the number that we promised by the end of November.

<Q - Carlos G Macedo>: Okay. Thank you, Rafa. Just to make sure then so the MXN 9 billion number you said that would be the baseline is the number that we should expect. But in the fourth quarter we're still going to get MXN 300 million of integration expenses, correct?

<A - Rafael Victorio Arana de la Garza>: Exactly. But also, you will have some benefits from the already efficiency that happened in May that's still running through. But our original number should be MXN 9 billion.

<Q - Carlos G Macedo>: Okay. Perfect. Thank you so much.

<A - Rafael Victorio Arana de la Garza>: Thank you, Carlos.

<A - Jose Marcos Ramírez Miguel>: Thank you, Carlos.

Operator

And we'll go to Jason Mollin with Scotiabank.

<Q - Jason Mollin>: Hi. Hello, everyone. Yeah. My first question is sort of been discussed or you've given some numbers on the positive trend in funding costs. I just wanted to understand what – how you guys achieve this close to 60 basis point savings. It looks like your money market on a pro forma basis and unsecured debt increased almost 50%,

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48%, I guess, on a quarter-on-quarter basis and you reduced the demand deposits by about 14%. I guess, were those demand deposits that they were expensive demand deposits [indiscernible] (00:15:48) that they were paying up for or can you help us understand a bit of how you manage this? It's very positive.

<A - Jose Marcos Ramírez Miguel>: Thank you, Jason. Effectively, we have a very active [ph] managing (00:16:02) the Treasury Department and Rafa will talk about that.

<A - Rafael Victorio Arana de la Garza>: Yeah. Jason, yes. Thank you. Let me just give you the overall numbers and we can elaborate from that. We substitute MXN 70 billion of funding from Interacciones. That was a high-cost funding. In those funds, what they used to call demand deposits were also very high-cost demand deposits. So, we got rid of those deposits and substitute by debt that we issue into the market, what are much more convenient costs for us. So, it's a replacement of the overall just the market side, on the demand deposit side of Interacciones that now is reaching a reduction of MXN 70 billion has been substituted overall for a much better funding cost that is the one that is giving the 60 basis points. So, when you look at the demand deposits is what's really demand deposit with interest that was also very high, and we already displaced those funds.

<Q - Jason Mollin>: That's helpful. And then just as a second question on payrolls, well, I guess maybe a follow-up there, is there more that can be done or was that MXN 70 billion was kind of the – that's the end of that gain there or is there more to be done? And then the second question would just be on the payroll loan segment. Marcos talked about slowing origination there, some issues. What's generating the issue there? Is that a change – when employees change jobs, is that really where the delinquency happens or these people who are still employed are just not paying?

<A - Jose Marcos Ramírez Miguel>: Thank you, Jason. It's a very good question. It's a little bit of everything. Manuel Romo is in Santa Fe. And he's going to help with that. Can you hear us, Manuel?

<A - Manuel Antonio Romo Villafuerte>: Yes. Loud and clear, Marcos. Thank you very much. Yes, Jason. As Marcos is mentioning the payroll numbers that you see is a consequence of; first, a traditional behavior that we have in our portfolio when on government change in administration. So for the payrolls that we have government, state, municipality or federal, regardless, and it's going to be a change. What we usually do is we are more cautious to slow down the change. If you remember, in the last administration, the last relevant administration change, there was also a little spike on delinquencies. For this year, that's, I would say, one of the first things that happened. We slowed down on origination, became more conservative, so that during the change of administration we wouldn't have that spike or we could lower it down and move it. So you have an impact on personal loans basically from the delinquency coming from that. Even at that – even though it's smaller than in previous changes of administration, there is a denominator effect that because we slow down origination to be more cautious.

The second thing is also that we track the expectations from the private sector specifically SMEs regarding the economy in the future, and what we try to do is to mimic that to their activity in the payroll contract that we have. So basically doing – being more cautious on certain segments, on certain industry where we saw a little of increasing cautiousness regarding the change of administration, and we just slow down a little bit on the profile of payroll and origination.

Right now, what we see on the portfolio is really positive. We see very good trends regarding past due loans. The new vintages are coming really good, really healthy. And I'm sure that you are going to see that the number towards year-end on past due loans is going to plateau and start coming down significantly. And on the second part on origination, we are becoming more comfortable as we have more visibility to start opening up a little bit. That's basically the explanation around it.

<Q - Jason Mollin>: That's helpful.

<A - Rafael Victorio Arana de la Garza>: Jason, the one that you were saying about if there's more coming on the funding side, we still need to replace MXN 20 billion for a much better funding cost in the coming months. And remember that in the fourth quarter, as Marcos mentioned, we will get usually a very large inflow of zero cost deposits that will also help us to achieve the cycles of funds that we would like to have for the full-year next year. But yes, there's a lot more to come on the funding side.

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<Q - Jason Mollin>: Excellent. Thank you very much.

<A - Rafael Victorio Arana de la Garza>: Thank you.

Operator

The next question comes from Claudia Benavente with Santander.

<Q - Claudia Benavente>: Hi. Good morning. So I have a follow-up question, first of all. We don't have like many recent data for Interacciones, but last reported information guided like for about MXN 40 billion on time deposits where you have like a 200 basis points better cost of funds relative to Interacciones. So I guess that should be like pretty straightforward to fit I guess, and still if that would be the case and you've already reached 60 basis points improvement for overall cost of funds versus your guidance of 46 basis points. That means that so far you already have an upside to the provided guidance. It's not that bad if I read correctly.

And my second question is regarding provisions. As an overall – historically Interacciones reported a cost of risks close to 0%. Part of the reason behind that was because of the Interacciones compensated the difference between the CNBV's provisioning methodology and they are all mode of charging temporary fees. What's the provisioning model standard followed by you right now versus Interacciones? Because if I take a quick look to consolidate the costs of risks since that level achieved was only with Banorte's portfolio. So if you can provide us a bit more color there I would appreciate it. Thank you.

<A - Jose Marcos Ramírez Miguel>: Thank you, Claudia. Yes. And talking about the first one, we have at the top room for improvement, you will see a little bit more I guess. Rafael is going to want to talk about that. And the second one about the provisions, and the CNBV methodology also, Rafa, can you help us please?

<A - Rafael Victorio Arana de la Garza>: Claudia, yes. Thank you. And as you said doing a straightforward calculations what you should be looking is on the funding side that we basically move MXN 100 billion of loans to the bulk of Banorte on average. And that will be usually should be measuring against the risk adjusted margin that the overall loop that we have that is around 40 – 4.4% so – 44% so compared to the reference rate. So, yeah, there's a lot of improving also coming to the benefits of the book that we integrated from Interacciones based upon what we're already doing on the base funding cost of Interacciones.

On the other one, as you mentioned, as we advised the market even before the transaction that it was going to be a very difficult for us to continue the practice of charging temporary fees. So that's not happening anymore. And the reason for that is that we can really compete very nicely in the market based upon the funding cost and we don't need to compensate the lack of good funding cost with temporary fees. And that allow us to really move nicely into the infrastructure business that we would like – we have been doing in the past months. And also to improve the cross-sell potential that we have with the relationship that Interacciones was mainly on the credit side.

So, overall, I would say that those fees, you will not be seeing those fees coming to the P&L. And that's part of the advice that we gave the market. We were on the on the road show announcing the transaction. And when we evaluate the company, we reduce the rate of growth of the fees almost to half. So that's what's really compensating for that practice. We will not be using that anymore.

<Q - Claudia Benavente>: In that respect, then I'm wondering, shouldn't we expect then a spike in provisions because at the end, the reason why the cost of risk of Interacciones was close to 0% was because they were compensated with that line. If you take a look to the standards required by the CMB, at the end, they are like harsher relative to the internal model of Interacciones that yielded the temporary fees. So what – how should we see the provisions for Interacciones? What's the methodology that you're using and what implications has in terms of cost of risk? Thank you.

<A - Rafael Victorio Arana de la Garza>: Now, yeah, Claudia, it's very important to say that all the credit policies and credit origination policies and structuring of the loans follow the structure of Banorte. So, you shouldn't see any spike of rates because the loans that were originated from Interacciones were very well the structure under the trust in a

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similar, very similar way that we have at Banorte. And we haven't seen any difference in the way the structuring of the loans, taking aside the parts of the fees that you mentioned. We are very comfortable that we don't see – we will not see any spike at all on the evolution of the integration of Interacciones to the Banorte Group.

The credit risk methodologies are fully in place. The credit risk committees are fully in place. So, no, we don't see any difference on the cost of risk on the integration of Interacciones. We will very thoroughly revise every single loan and every single structure, and we are very comfortable with it.

<Q - Claudia Benavente>: Okay. And the last question would be regarding infrastructure. Should we expect infrastructure to be the one driving the growth for the government book. And should we expect that he will let the government portfolio, the plain vanilla government loans of Interacciones just to expire? Thank you.

<A - Rafael Victorio Arana de la Garza>: I would not say expire, but we have been very selective where we really see a much more beneficial on the cross-sell. We will be staying with those loans. And we will let go some of the loans that we will – much more benefit the infrastructure loans. As we mentioned also on the on the road show, what you should see that right now, the market share that we have with the government book is around 35% in the market. That number based upon the rate of growth of the consumer and the rate of growth on the commercial and corporate should be trending down more to the 26%, 27% in the next four years.

<Q - Claudia Benavente>: Great. Thank you so much, Rafa.

<A - Rafael Victorio Arana de la Garza>: Thank you, Claudia.

Operator

Next is Mario Pierry with Bank of America Merrill Lynch.

<Q - Mario Pierry>: Good morning, everybody. Congratulations on the results. Let me ask you two questions, please. First one, related to this big drop in government loans that we saw this quarter rank, down 6% quarter-on-quarter and government loans now represent 26% of your total loan book. So, I wanted to understand, first, how much of this decline is related just to overlap and how much of this decline is related to a more cautious outlook in the government business? Also related to this, what is the optimal mix that you would like to have by the end of next year?

Second question is related to your net interest margin. We have seen rates have stabilized in Mexico, but we still are running higher than a year ago. I'm just trying to understand for the outlook of your net interest margin then, if you have already repriced your entire existing loan book, or do you think there still is room for repricing and thus we could see margins trending up just on the core Banorte book prior to the acquisition? Thank you.

<A - Jose Marcos Ramírez Miguel>: Thank you, Mario. Talking about the second question, as you remember our raw material is at the rates they want to be. So, I will ask Gabriel also to intervene a little bit to give us a view on the rate. Talking about the first one, we have just a little bit of overlap. Yes, we are more cautious. And where we're heading is we now want to do the cross-selling with this government portfolio. As we said, that's our busiest year. But, Rafa, can you help us a little bit?

<A - Rafael Victorio Arana de la Garza>: Yeah. Mario, I think as you've seen in the Banorte in the past two years, I mean, the government book was almost flat for the past two years. There's also – we had a prepayment of MXN 6 billion on the government book, that that's what you see a decline on that part. You will see also a pickup on the infrastructure. If we could split infrastructure on the state loans, infrastructure also picked up around from 37 to 43. So that was really our expectations to really push that numbers forward, the infrastructure loans. So, what you will continue to see is a much more active dynamism on the infrastructure lending part on a steady state on the state and federal loans.

So it's not surprise us, and we advise that that you will continue to see almost a very small growth or no growth on the state and federal because we are very pleased with the book that we have there and the relationship that we hold there. But the dynamics of the infrastructure loans are completely different. Our short term loans, our small loans that have a

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very high turnover, and that's the type of loans that we would like to have on that part of the book. So you will see a continuous [ph] team (00:31:45) reduction, a small one, to reach numbers, as I mentioned before on the overall book of Banorte around 26% in the next, I would say, four to five years. That will be our desired market. A part of the share that the government lending business has to have on the overall book, because consumers, corporate and SMEs will continue to outpace the rate of growth on this part.

And on the other things that you mentioned about the margins, I think you should expect the margins to continue to evolve, not because of the interest rates because of really the very disciplined cost of funding that we have been having in the Banorte and the rate of growth of demand deposit that we have been achieving on a yearly basis. So, yes, I think to expect on the coming months an additional 10 basis points to 20 basis points increase on the margin is to be expected. That's just some of the book, not taking into account any hike or anything like this, just on the already trend that we have on the book.

<A - Gabriel Casillas Olvera>: And Mario, this is Gabriel. Just to complement the final thing that Rafael was saying on the monetary policy side. On the monetary policy side, I think it's very eloquent to talk about this, because just yesterday, have you noticed these comments by Governor Díaz de León of Central Bank of Mexico, not only his comments but also the minutes of the last monetary policy meeting, is saying that they believe that the market has it wrong, thinking that there's a space for rate cuts or that the interest rate hiking cycle has already come to an end. But in this context, we have called for another 25 basis point hike before year-end.

So we do think that it's highly likely the Central Bank will hike once again to put the Fed rates at 8%. And then, probably what will happen is that we will see now a plateau. Interest rate for the one-time policy to remain at 8% in the foreseeable future, it's going to be very hard for the Central Bank to lower rates. I mean, there could be a reasons for cutting rates next year like some slowdown because of the change in government, not because of López Obrador but just because it will be his first year of government. But honestly, with the U.S. Fed hiking, it's going to be very hard for a country like Mexico, very close, very related to the U.S. to be able to cut rates when the Fed is hiking where, in this context, I think we're different from other emerging countries that have been able to decouple from [indiscernible] (00:34:38). I just wanted to compare that.

<Q - Mario Pierry>: Right. Perfect. So let me just go back then to the net interest margin. So, half of what you mentioned, right, another 10 basis points to 20 basis points improvement, but it's primarily from the funding right? So what I understand then what you're saying is that you have already re-priced your loan book to reflect the higher rates that we have seen over the last year or is that not the case?

<A - Rafael Victorio Arana de la Garza>: No. I think we have been very selective. So talking about a full re-price is not exactly because we have been slower on the mortgage side because of the way the mortgage book is being built. Also, I would say in the car loans, we have also step-by-step raising the price. But what is worth to mention on those two portfolios is that the NPLs are really 1% on those two portfolios. And the rate of growth is pretty high. And the reason for that is that we have been able to be extremely selective on the clients that we would like to do business with. So that will allow us to keep the expected loss pretty low.

And also, there's extremely good opportunities every time we do on the mortgage side and on the car loan side to increase the cross-sell ratio with our clients in a way that – on a customer value, we have been increasing the value of the clients that we do business with, and not just looking just solely at the credit line. So it's coming from the funding side. It's coming from a much better mix. Slowly but sure, repricing of the book, but we have been slow in doing that. And so it's basically the overall mix, the rate of growth of the funding side, and a slow reprice of the book on a very selective basis.

<Q - Mario Pierry>: Okay. And just to be clear, what you said on government loans also, so then roughly – out of your MXN 200 billion government loan portfolio, roughly 20% is related to infrastructure and 80% is states and municipalities?

<A - Jose Marcos Ramírez Miguel>: Yeah. Let me give you exactly the numbers that we acquired from Interacciones, and then you can do – and we can elaborate from that. Let's put MXN 100 billion that we put on the

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book, 65% was federal and state, and the remains were the infrastructure business. So, infrastructure should continue to grow and outpace the rate of growth of the federal and state, but an important numbers. That's what we would like to see. So, overall, what you saw, the 20% is a reasonable number that you should be expect to grow at a much fastest pace at the other part of the book. So the components of that portion should be reaching the 20s – 25% to 30% in the coming months.

<Q - Mario Pierry>: Perfect.

<A - Ursula Margarete Wilhelm Nieto>: Hi, Mario. Ursula.

<A - Jose Marcos Ramírez Miguel>: Yes.

<A - Ursula Margarete Wilhelm Nieto>: Just one clarification. Not all of the infrastructure book is registered in the government book, okay? So we've provided some disclosure in the quarterly release about the infrastructure book and most of that is booked within the commercial segment, okay? So the government lending is really basically related to pure government risk, whether it's federal or state or so on.

<Q - Mario Pierry>: Okay. Perfect. So that's instead of the MXN 291 billion, so okay.

<A - Ursula Margarete Wilhelm Nieto>: Yes.

<Q - Mario Pierry>: In the commercial book. Okay.

<A - Ursula Margarete Wilhelm Nieto>: Yeah.

<Q - Mario Pierry>: Perfect. Thank you very much.

<A - Jose Marcos Ramírez Miguel>: Thank you.

Operator

And our next question will come from Arturo Langa with Itaú BBA.

<Q - Arturo Langa>: Hi. Good morning, everyone. I have a question just regarding the contribution of Interacciones to the net income. If I take the 18.5% pro forma ROE of last quarter and try to sort of get the implied net income from Interacciones this quarter, it looks like it's quite low compared to the – close to MXN 650 million average that they reported on average during the past four quarters according to the financial, I get a figure closer to something like MXN 400 million to [ph] MXN 450 million (00:39:17). Is that right? Would you be able to share how much Interacciones contributed to the bottom line? And if so, what was the organic net income growth that you saw this quarter just on the legacy Banorte business? That would be helpful. Thank you.

<A - Rafael Victorio Arana de la Garza>: The number that you reach is quite [ph] small (00:39:48). I think you should be adding like a [ph] MXN 100 million – MXN 470 million (00:39:54), but the reason for that is that you are still – a lot of the infrastructure cost of the integration, some of those were already booked at Interacciones. So, the number that you should be looking if you strip those out and it's, as you mentioned, a low number compared to the other things because of all the integration cost, the reduction of the fees, should be a number more in the line of around MXN 1 billion. That is still quite close to what we expect to – that we could sustain on that part. But still, there's benefits on the funding and the cost, so that number should continue to increase.

On the legacy, as you mentioned, at Banorte legacy, you should be looking at net interest income growth of the group around 22% on a yearly basis. So, what we – you should be looking at the evolution of Interacciones is adding 2% of that number to reach the 25%.

<A - Arturo Langa>: Thank you very much, Rafael. That was very clear. Thank you.

<A - Rafael Victorio Arana de la Garza>: Thank you.

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Operator

We'll go to Marcelo Telles with Credit Suisse.

<Q - Marcelo Telles>: Hi. Good morning, everyone, and congratulations on the results. I had two questions. The first one, just trying to depict your recurring ROE once you try to look at the more normalized earnings and adjust for the one-offs, I mean, it looks like in the quarter you had like a 19.7% return on equity. If you consider that, you had this specific corporate provisions at around like MXN 250 million, plus the MXN 300 million to MXN 400 million of integration expenses. It looks like that you'll be running maybe at around like MXN 8.3 billion, MXN 8.4 billion in net profit which would give you a recurring ROE actually closer to 21%. Do you see that as kind of a possible or a normalized recurring level in the quarter, and do you think that can be sustainable in the future, right, given the number was – the [ph] headline was rather very (00:42:42) good, but once you add back these one-offs, it seems your recurring earnings are actually much higher than that, right, and not to mention what you just talked about, the possibility of margins increasing another 10 basis points, 20 basis points. It seems that you could be certainly above 20% or 21% ROE down the road. That's my first question.

And the second question is, you've been performing very well on the consumer book despite this hiccup on the payroll segment, and you've been gaining market share. As you point out, you are at 14.9% market share in the consumer segment, which has risen almost 100 basis points versus a year ago. My question to you is, where do you think you are in terms of your capacity to continue to gain share down the road, right? Because one of the concerns that I have is that we're seeing consumer lending kind of starting to slow down in Mexico. But you have managed to outgrow the market, which is great, right? But at some point, you're going to start to hit, let's say, a higher penetration with your existing client base. So, how sustainable and therefore how long do you think you can continue to outgrow the market in the consumer segment? Thank you.

<A - Jose Marcos Ramírez Miguel>: Thank you, Marcelo. Thank you for your questions and thank you for your comments. The first one, Rafa is going to elaborate, but it's very easy. The ROE is a matter of net income and also a matter of capital, and we're not increasing the capital in the same speed. So that's what the math is there, and it looks so nice because we did it like that, no? We reduced it – we didn't increase the capital of the [ph] whole Interacciones, we took a part (00:44:44) of it. And Rafa will elaborate on that.

And the second one, the quick answer is yes. We are revamping the consumer products that we have because we think that still we have a lot of room for improvement in the near future in Mexico. We need to grow – everybody is talking about the – on the penetration, and now we have 4 million more clients with new in the market. And we think that we are only – and sorry about this – but only scratching the surface. We still have a lot of room for growing there and we need to revamp all the consumer products and the [ph] factories (00:45:32). And that's why we are very optimistic about the future. Maybe Carlos Martinez can help a little bit on that and also Rafa, talking about the first question about the capital.

Carlos Martinez, go ahead.

<A - Carlos Eduardo Martinez Gonzalez>: Sure. Thank you. First, inside the consumer loan book regarding car loans, we've been doing a good work in addressing the market. And we used to do it or we've been doing it very good in agents directly with car loan dealers. But two years ago, we decided to go also into really bigger, more steep relationship with the car manufacturers. So, we were increasing our relation with manufacturers. So we have a new line of business or more into two or three different manufacturers that [indiscernible] (00:46:30-00:46:38) will be Banorte's, we like Honda, would be like another or newer brand, but the credit behind it is Banorte. So we've been addressing that pretty good. We think we can do it better in the next two years.

In the car, that's [indiscernible] (00:46:55). If we go to the mortgages, also we've been revamping our process, as Marcos said. We expect to have a better process in the next year. So we feel very confident to keep our growth above the market.

<Q - Marcelo Telles>: [indiscernible] (00:47:10) this is very reassuring.

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<A - Rafael Victorio Arana de la Garza>: On the return on equity, you should continue to see an evolution of that. And remember the way the transaction was structured, really the amount of capital was put into Banorte was half of the – in the way that we paid for the transaction. And the rate of growth of the net income, as Marcos said, is will outpace that addition of capital. We are not – as we all have already committed to the market, we are not playing any games with the leverage or anything like that, so we are continuing to be very disciplined about the capital base. We commit the market that the capital base will drop below 12% on the Core Tier 1 after the transaction of Interacciones and we will regain that level before year end.

Now, we're already at 12.1% on the Core Equity 1 (sic) [Core Equity Tier 1]. So we already reach also that milestone that we promised to the market. So with a very nice growth on the capital on the Core Tier 1, we don't see any reason why we shouldn't be adding up on a continuous basis on the return on equity as we have been seeing in the past.

Also, if you look at the numbers on tangible, on tangible, we are already above the 25%. So everything is working in the right direction. So we continue to see a very good evolution of the return on equity as we promised the market.

<A - Ursula Margarete Wilhelm Nieto>: And just a last comment on the growth in the portfolio going forward and market share, Marcelo. In credit cards, for example, we still have a long way to go. While we have been increasing market share, and you have seen we've started with a market share of close to 6%, and today we are above 9%. We are still far from the natural market share of the bank which is 15%, so there's still room to grow.

And the other relevant thing is that remember that the growth that we are looking for is more related to increasing customer value than to just gaining share on its own. So we are looking at growing with profitability. And if we do not think that that is going to happen, then we're rather not doing. That is, for example, what you can see in payroll loan. We decided as a conscious decision to reduce the growth of that portfolio because we didn't want to, let's say, increase the credit costs and therefore damage the profitability of the group.

<A - Jose Marcos Ramírez Miguel>: Marcelo, just because I think your question brings a lot that is related to the strategy of the growth of Banorte, let's just – give me just two numbers. If you look at the market share that we have been achieving on the car loans, it's extremely good. I mean, the market share that we already – we are the second in the market, very close to the first one, and a great evolution, NPL's great. But the total number of clients that we have in our client base that have a car loans with us is only 1.7% of the base. So that gives you the size of the opportunity. And that's [ph] just been (00:50:48) happening in the last two years that we have been addressing our client base, the better offers, the better relationship with the dealers.

And if you go to the mortgage book, it happens the same. Only 2.2% of the book have a mortgage loan with us. So the size of the evolution that we could have on our client base and the efficiency that we are now getting in the conversion rates and the campaigns that we manage into the market allow us to have a pretty good view that this expansion will continue on a very efficient basis. Conversions rates on the campaign management team that were around 5%, 6%, 7%, now with the use of a lot of tools with artificial intelligence, a lot of things, we're improving that rates around 14%, 15%, 16%. So, there's a lot of room to grow as we have been doing and in a way that will become a lot more efficient in managing the relationship with the client. And the key word – this is exactly what Ursula mentioned – the value of the client. We are looking at the overall relationship with the client. So, sometimes you will see us with maybe a different price in the market based upon the client that we do serve, but that allows us to really differentiate ourselves with the market and benefit the client in a much better way.

<Q - Marcelo Telles>: It is very helpful. Thank you, and congratulations again.

<A - Jose Marcos Ramírez Miguel>: Thank you, Marcelo.

<A - Rafael Victorio Arana de la Garza>: Thank you, Marcelo.

Operator

And now we'll go to Gilberto García with Barclays.

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\<Q - Gilberto García\>: Hi. Good morning. Thank you for the call. A couple of questions, if I may. On the portfolio growth, you reiterate your guidance for the year. Can you comment about what sort of mix you expect for the growth in the fourth quarter? And secondly, on a different subject, members of the incoming administration have talk about how they intend to try to reduce the amount of cash that is used in the economy. Do you expect this to be a significant driver for you or for the banking system in general in the short to medium term? Thank you.

\<A - Jose Marcos Ramírez Miguel\>: I will start with your question number two with Romo. Can you help us with that, Romo, in Mexico?

\<A - Manuel Antonio Romo Villafuerte\>: Yes, Marcos. Hi, Gilberto. Definitely, we see stars aligning between the bank industry, aggregators, acquirers and with a new government. Definitely, we see a lot of interest in [ph] fighting (00:53:48) cash significantly and with the help of new technologies and new segments, Banorte will definitely benefit from that.

If you see examples from other countries that have this kind of alignment regarding rules, procedures, and really a strong effort into doing that, a significant change has happened, no? So, we are working very closely with the industry. We are leading these efforts with the industry and working with the government entities. And everybody involved is doing a huge effort to have very soon significant changes into that. So, we're looking forward into that.

\<A - Jose Marcos Ramírez Miguel\>: And the mix that we expected in the fourth quarter, Gilberto, we are expecting to grow it in all the lines. Remember that the last quarter is usually the best, also because of the government and all these that – they accelerate, you can see that – you will see that in the Interacciones book – well, it's not Interacciones, infrastructure book. But – and we're planning to grow in everything. Aside the infrastructural lease, we are planning to grow around 9%, around that [ph] I think call around the tables (00:55:16).

I don't know if Rafa...

\<A - Rafael Victorio Arana de la Garza\>: No, I think it's exactly as Marcos says. We expect – we've set up the guidance without the infrastructure business at the beginning of the year around, I would say, 8% to 10%. I think we will end the year around – if you strip out the infrastructure business, around 9%, so right on guidance. And with the evolution of the additional business, you will see that I think are good growth in every single one, I think you will see credit card expanding, car loans, the mortgage book. commercial has a very strong pipeline, the same in corporate.

Remember that the time with the elections usually drop demand for credit significantly to two months before that, and usually until the new President comes to office, that's like an impasse that you usually get in the market. We're already seeing additional movement that because the new government has been very actively saying and setting up the guidelines on plans, so that has allow the market to move faster than usually happens in the other administrations.

\<Q - Gilberto García\>: Understood. Thank you very much.

\<A - Jose Marcos Ramírez Miguel\>: Thank you.

Operator

And at this time, there is one name remaining in the roster. [Operator Instructions] And we will now go to Carlos Gomez with HSBC. Please go ahead.

\<Q - Carlos Gomez-Lopez\>: Hello. Good morning. A short-term question, it's just still not clear to me if you expect next year to see more growth than this year as an incoming administration typically slows things down despite, as you say, they're moving fast this time. And we see that most of the trends are still going down. You have good numbers, but overall growth seems to be going down. So I wanted to know what you expect growth in general to be next year for the system and again then the next two or three years?

And secondly, you mentioned that you have now 36% market share in government loans. We know you don't target market share, but where would you expect that to be in two or three year? What will be a number that you will feel

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comfortable having? Thank you.

<A - Rafael Victorio Arana de la Garza>: Talking about the – our guidance is going to be between 9% and 11%. We will see that growing for us at least, no?

<A - Ursula Margarete Wilhelm Nieto>: And in the question about the government book, we don't have a market share target. If you look at the book from the portfolio perspective, today it's just around 28% of the total loan book. And we expect that in a few years as the other books show a faster growth than government, it should come down to a level around 25% to 26%.

<A - Jose Marcos Ramírez Miguel>: Gabriel, please go ahead.

<A - Gabriel Casillas Olvera>: Hi, Carlos. Gabriel Casillas, Chief Economist. I just want to complement about growth. I mean, next year in terms of GDP, we're expecting a growth rate of 1.8%. We have been expecting these – having these forecasts in the past 12 months, has nothing to do with the new administration. I mean, [ph] that is irrelevant (00:58:44), had to do with any new administration. Usually what happens in the first year of government in Mexico is there are a lot of changes in government officials, and they have to learn with a very steep curve how to spend the money. So in this context, if you take a look historically, we have had an important deceleration in the [ph] treasury and foreign (00:59:05). So, that's why – now, it's not a very important deceleration for next year because we're still expecting the U.S. economy to grow a lot.

But very important, and we have discussed [indiscernible] (00:59:18) remember this, Carlos, is that usually what we have observed is if you – the relationship between nominal GDP growth and the growth of, I mean, of overall loan book, not of Banorte, but in general of the Mexican economy, usually grows up two times the nominal GDP growth rate, no? And we continue to believe this will continue to hold. So if next year we're expecting something around 1.8% of real GDP, we could be expecting something around 4.5% or even 5% of nominal GDP growth. So you're multiplying by two, you get something as what Marcos was saying. Thank you.

<Q - Carlos Gomez-Lopez>: Okay. So if I can summarize, essentially you're expecting next year to be more or less like this year. As you mentioned, there is historically a deceleration. In this case, it will be not [ph] naïve one, (01:00:10) but it will be similar to what we have seen in 2018. Do I understand correctly?

<A - Jose Marcos Ramírez Miguel>: Yes.

<A - Rafael Victorio Arana de la Garza>: I think with the change, you will see that payroll regain its growth again because that's a part that you will see. And as Carlos mentioned, we continue to see extremely good growth on the car loans and the mortgage book. So in addition, payroll will regain its good growth. And we are extremely positive in infrastructure business.

<Q - Carlos Gomez-Lopez>: Thank you very much. Again, congratulations, especially on the capital. Thank you.

<A - Jose Marcos Ramírez Miguel>: Thanks, Carlos.

Operator

And there are no other questions, so I would like to turn it back to Ursula for any additional or closing remarks.

Ursula Margarete Wilhelm Nieto

Thank you. At this time, we are concluding the call. Thank you for following Banorte.

Jose Marcos Ramírez Miguel

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Thank you very much, everybody. See you next year. Bye.

Operator

Thank you very much, and that does conclude our conference for today. I would like to thank everyone for your participation, and you may now disconnect.

Ursula Margarete Wilhelm Nieto

Thank you, Vicky.

Operator

Thank you. Have a great day.