

Company Name: Banorte
Company Ticker: GFNORTEO M
Date: 2018-07-27
Event Description: Q2 2018 Earnings Call

Market Cap: 374,330.34
Current PX: 129.82
YTD Change(\$): +21.99
YTD Change(%): +20.393

Bloomberg Estimates - EPS
Current Quarter: 2.552
Current Year: 10.252
Bloomberg Estimates - Sales
Current Quarter: 22878.333
Current Year: 82444.300

Q2 2018 Earnings Call

Company Participants

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

Other Participants

- Jason Mollin
- Philip Finch
- Jorge Kuri
- Rafael Frade
- Thiago Bovolenta Batista
- Carlos G Macedo
- Claudia Benavente
- Arturo Langa
- Marcelo Telles
- Jörg Friedemann
- Carlos Gomez-Lopez

MANAGEMENT DISCUSSION SECTION

Operator

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

Ursula Margarete Wilhelm Nieto

Thank you. Good morning, and welcome to Grupo Financiero Banorte's second quarter results. My name is Ursula Wilhelm, Head of Investor Relations. Presenting to you this morning is Marcos Ramírez, Chief Executive Officer; and Rafael Arana, Chief Operating Officer. Following our comments, we will be glad to take your questions.

Before we start, I will refer you to slide 2 of the presentation which contains Banorte discussions regarding forward-looking statements. Thank you. Marcos, please go ahead.

Jose Marcos Ramírez Miguel

Thank you, Ursula. Good morning, everyone. This has been quite a dynamic quarter. On the one hand, Mexico experienced its largest election ever and, on the other hand, Grupo Financiero Banorte merged with Grupo Financiero

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Interacciones not only to [ph] found (00:01:09) the second largest financial group in the country, but one to serve in the best interest of our shareholders.

In this context, let me revise today's conference call into three. First, I will address our very strong quarterly results. Then I will comment about the Mexican election outcome. And finally, Rafael Arana will assess the merger and provide you with updated year-end estimates which will include Interaccion (sic) [Interacciones] (00:01:38).

I will start on slide 3. As you can see, we were able to gather good asset growth, margin expansion and a stable credit quality during the second quarter. Grupo Financiero Norte delivered MXN 7.2 billion of earnings, up 27% compared to last year and 6% above the first quarter. Earnings per share were MXN 2.59.

Accumulated net income for the first half of the year was MXN 13.9 billion, growing 25% above the same period last year. As usual, let me highlight some key performance indicators. We managed to obtain a strong return on equity for the quarter of 19.1%, moving up 97 basis points in the period. Similarly, ROE for the first semester was also a strong 18.8%, improving 265 basis points year-over-year. The annual ordinary dividend of MXN 9.5 billion was paid to shareholders on June 11.

On slide 4, revenues grew 2% in the quarter to total MXN 22.7 billion on a strong growth in net interest income, fees and good results in trading and treasury. Accumulated revenue for the first half of the year was MXN 45.1 billion, increasing a strong 18% as all revenue lines achieved good growth.

Net interest income from the banking operations posted good sequential growth of 6%, reaching MXN 16.1 billion, while consolidated NII incorporating Insurance and Annuities declined a modest 2% in the quarter to amount MXN 17.8 billion. This decline is entirely explained by the seasonality of the insurance results compared to the first quarter. The evolution of the net interest margin in the quarter was positive. The margin of the banking business expanded 20 basis points to reach 5.6%. Year-over-year, it grew 30 basis points.

Also, the NIM of the loan portfolio was up 10% – 10 basis points to reach 8.6%. The net interest margin of the consolidated group declined 20 basis points to 5.7%. Again, this decline is entirely explained by the seasonality of the insurance results. Year-over-year, the NIM increased 30 basis points. The good evolution of the margin reflects a positive mix of assets towards interest rates and tight control over the funding costs. Net fees from services was MXN 3.2 billion, increasing 25% sequentially and 11% annually, driven by good growth in all fee categories.

On slide 5, the total expenses of MXN 8.9 billion declined 2% in the period as we line up our annual expense growth to the guidance. Here, it's worth noting that we reached another record quarter of positive operating leverage and efficiency ratio achieved the lowest historical level of 39.5% in the quarter.

Moving to the loan growth and asset quality on slide 6. The loan book totaled MXN 640 billion, up 3% in the period and 8% yearly, in line with our guidance. All loan segments of the book are growing as expected, yet loan demand in government has been soft, and we also booked some prepayments, reason why this portfolio declined 3% up to June.

If we exclude the government book, the loan portfolio was up 10%. As I said, we have been able to deliver these strong results at stable asset quality. The NPL ratio deteriorated 5 basis points in the quarter and now it stands at 2% due to the usual seasonal behavior of the credit card and payroll books during the second quarter.

Loan loss provisions were MXN 3.8 billion, 10% lower than the prior quarter. As you will recall that in the first quarter we booked some specific provisions for our commercial credit exposure. As a result, the cost of risk declined to 2.4%.

Now, moving to the relevant subsidiaries on page 8. The bank posted record results with net income of MXN 5.2 billion, 29% ahead of last year and posting a return on equity of 23.3%. The NIM reached 6.4% expanding 40 basis points. Results reflect good growth in the loan portfolio and the deposit base. Seguros Banorte booked earnings of MXN 751 million in the quarter, 11% ahead the same period last year. Accumulated earnings were MXN 2.1 billion, up 35% annually. Afore Banorte added MXN 363 million in earnings to the group, which were up 10% in the period.

On slide 9, we provide the evolution of the capital ratios of the bank which remain very strong. The capital adequacy ratio was 17.8% while the Common Equity Tier 1 ratio was 12.7%. Both indicators increased 10 basis points in the

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quarter while risk-weighted assets grew a modest 7%.

Now, let me shift gears to part two. I want to take a moment to highlight some of the recent developments and our outlook for the second half of the year. Elections are over and to no one's surprise, Andrés Manuel López Obrador will take office on December 1. The surprise [ph] I think (00:07:12) however that AMLO's MORENA party [ph] won simply (00:07:14) majority representations in both the lower and upper houses of Congress, giving him ample capacity to make changes to laws although not at the constitutional level.

While AMLO has favored a change in the economic model with more state intervention to reactivate the economy to tackle inequality and poverty, the message of the elected government so far has remained moderate towards maintaining macroeconomic stability and fiscal discipline, as well as maintaining the independence of the Central Bank and a flexible exchange rate regime. The new government has communicated that it will increase minimum wages. It will introduce scholarships for the youth and we have raised universal pensions for the elderly, along with investments in infrastructure. We should expect to see these measures as soon as next year.

Nevertheless, we do not expect a higher budget deficit as the newly elected government has reiterated that the above-mentioned programs will be financed via an optimization of the government spending and not by increasing the country's indebtedness level. We remain optimistic of the economic developments for the remainder of the year and we are hopeful of a smooth government transition in the year 2019. We are positive that the group will deliver another set of strong results for the second half of the year as we continue to execute on our strategic plan and also to work on the integration of Grupo Financiero Interacciones. In this context, let me be very clear again, our 2020 goals remain intact and we are fully committed to achieve them.

Let's move to that part three. I will ask Rafael Arana to give you an update of the acquisition of Grupo Financiero Interacciones as well as to comment on our expected results for the end of the year as we incorporate the acquisition. Rafa, please go ahead.

Rafael Victorio Arana de la Garza

Thank you. Thank you, Marcos, and good morning to all of you. As we informed a few weeks ago, we conclude the Interacciones transaction on July 13. [indiscernible] (00:09:28) as you know, was paid out MXN 26.5 billion, 50% was paid in cash through a capital reduction from Banco Interacciones and the remainder with 109.7 million newly issued shares from Grupo Financiero Banorte, which was determined [ph] by – upon (00:09:47) a fixed exchange rate factor of 0.4065. The legal merger between the companies happened at the same date, and therefore, Grupo Financiero Interacciones and subsidiaries ceased to exist as of that date. We will report consolidated financial information as of that date.

The integration process kicked off as soon as regulatory approvals were granted. IT integration and migration is complete and operations are already running on the Banorte without causing disruptions to customers. On the business side, the infrastructure group of Grupo Financiero Interacciones will become a product unit within Banorte wholesale banking division. It will be headed by Carlos Rojo from Grupo Financiero Interacciones.

Banorte's business teams will retain customer relationship responsibility. The remainder business areas such as mutual funds and a small wealth management group will be absorbed by Banorte counterparts. Risk management and treasury also now are running on the Banorte team. Our target is to conclude the integration at the most by the end of September.

Now, turning to slide 10 to give you some color on the financial consolidation of Grupo Financiero Interacciones on a pro forma basis, the most relevant changes to reported Q3 information by Banorte are, total consolidated assets of the group will increase by around 13%. The loan portfolio of the bank will go up by around 15%. The consolidated government exposure will represent close to 28% of total loans, from the 20% reported at the end of the second quarter. And as we mentioned to the market, that number will trend down to 26% in the coming years based upon the dynamic growth of the other parts of the loan book.

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Total deposit balances will increase by around 14%, minority capital will increase around 3% post transaction. Therefore, its regulatory capital ratio CET1 and accumulated capital will decline by an estimated 100 basis points temporarily. We expect this to restore the bank capital ratio within two quarters upon earnings growth. These numbers should be on the consolidation basis at the beginning around 11.6%, and as we mentioned to the market, we hope by the end of the year to be about 12.2% in core Tier 1.

Regarding the financial commitments of the transaction, we confirm them as follows. As we mentioned to the market, we are very confident to achieve 65% of cost synergies from Grupo Financiero cost base, which based on our estimate for the second semester of 2018, they should be close to MXN 1 billion.

On funding the compromises to achieve 46 basis points improvement in the funding cost of Grupo Financiero Interacciones of fees we estimate to generate between MXN 150 million to MXN 200 million from July until year end. This is important to remember that 46 basis points is just for the remainder of the year. Our commitment for the full-year basis of 2019 is well above that number.

We will register extraordinary expenses as follows. MXN 500 million related to integration cost, mostly severance payments, and MXN 400 million in legal and advisory fees on the transaction. Therefore, the estimated earnings contribution of Interacciones to GFNorte in the second semester is estimated between MXN 1.7 billion and MXN 1.9 billion, resulting in an accretion to earnings per share between 3% and 4% for 2018.

Now, I want to take a few moments to walk you through some revisions that we are doing to the guidance of 2018. To incorporate better than anticipated results of GFNorte and the addition of Interacciones in the second half of the year. For this, could you please turn to slide 11. We confirm our loan growth target for Banorte between 8% to 10% for this year. Including Grupo Financiero Interacciones, it will go up by around 28%. As you remember, we commit to be very clear about Grupo Financiero Banorte and the integration of the new business unit to present to you exactly the dynamics of each.

You should expect higher loan growth in the consumer of around 14%. Nevertheless, as you have seen, we have been moderating the rate of growth of the consumer to a very reasonable 14%. And for the Interacciones loan book, the short-term goal is to improve profitability quite to scale up infrastructure financing business.

We improve our expectation that the full-year net interest margin of GFNorte will expand between 25 basis points to 30 basis points. With the incorporation of Grupo Financiero Interacciones in the second semester, the full-year consolidated net interest margin of GFNorte, as we mentioned before to the market, could decline 10 basis points or show a marginal increase of 10 basis points versus the reported net interest margin of 17 basis points. This is dependent of how fast can we change the funding base of Interacciones that we are achieving extremely positive advances in this area.

Basis upon the speed at – we are confident of a better than expected reduction in the funding cost of Interacciones because we will be hitting also the best part of the year – for the second part of the year is the best one for the demand deposits and a very efficient campaign of the time deposits that has been running on the Banorte side, for the last three months has been more than beneficial for this reduction in the funding cost.

Expense growth for Banorte alone should be better – between 7% to 8%, but on a consolidated basis, expenses will grow double-digit as we include expenses on – for Grupo Financiero Interacciones, basically the extraordinary items mentioned earlier. The consolidated cost-to-income ratio should still be between 39% to 40%. Cost of risk at Banorte should be around 30 basis points better than initially anticipated. Consolidated cost of risk will range between 2.2% and 2.4%.

Finally, we expect incremental net profits both because of better than anticipated performance of GFNorte and also the integration of Grupo Financiero Interacciones. The new estimated net profit range is between MXN 30 billion and MXN 31 billion and does not take into consideration MXN 1.3 billion of net profit generated by Interacciones during the first half of the year, which are consolidated in the capital.

On this note, I conclude my comments and we are ready to take questions. Thank you.

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Q&A

Operator

Thank you. [Operator Instructions] And we do have a question first from Jason Mollin of Scotiabank.

<Q - Jason Mollin>: Hello. Thank you for the opportunity to ask a question. We saw solid results, especially in terms of your profitability at above 19%. I just wanted to know if you could comment a bit on how you saw the quality of the earnings this quarter, particularly because we saw very strong trading at about MXN 1.2 billion above what you had been running at for some quarters. And secondly, we saw a small impact on the equity. So, should we really be looking at this 19% as kind of the core earnings or core return on equity that you're posting that you're running at now? Thanks.

<A - Jose Marcos Ramírez Miguel>: Thank you, Jason. I will ask Rafa to go with that.

<A - Rafael Victorio Arana de la Garza>: Yeah. Jason, as you know, we have always been guiding around MXN 700 million to MXN 800 million for the quarter on net trading gains. Yes, we had a very good quarter this last one, and basically because we have been extremely conservative on the position of the balance sheet on this part. So compared to our peers, you saw that last year and also in the first quarter, they were more profitable than us on that line. For this quarter, it was an exceptional, as you mentioned, but I think the quality is not coming because we are taking any directional positions or anything like that, but the quality of the funding and how we are really taking care of the balance sheet. Is that's repeatable? No, I don't think that, but we expect the next quarter also to be a little bit above the MXN 700 million to MXN 800 million on that part.

<A - Ursula Margarete Wilhelm Nieto>: If I may add, Jason – this is Ursula – that on the trading-related income, a larger portion of what we had this quarter is related to operation with customers and not necessarily to risk positions because we had larger than usual operations on the derivatives because of some hedging instruments that we sold to customers, and that is why the result is also larger than in the previous quarter. But it's not – it's coming from customer activity and not from risk position.

<A - Rafael Victorio Arana de la Garza>: On a capital base, Jason, as you know, on available for sale, as you know, there have been movements based upon mainly on the valuation of those positions but I think honestly that we [ph] can't (00:20:47) really because if you look at the trend for the last 2 to 3 years based upon the movement on the currency and the valuations of those positions, we don't see that that is a critical point based upon how we are achieving our 19.1% return on equity. So, I think it's very solid numbers as you see the fee growth. You see we continue to keep a very good cost of funds, risk is contained, and also, the subsidiaries also are delivering pretty good results.

So, we don't anticipate that based upon valuations or anything like that, it's really helping the return on equity on a specific basis. But also, if you look also at the leverage ratio of – that we are running, that is instead of taking more leverage of that, we are reducing the leverage of the group and of the bank. So, I would say that there's no specific movements that we are really trying to play the capital base based upon the movements on the positions that we have on available for sale. Now, it's basically on what we have on the valuation pieces, and everything else is really solid results coming from the operation of the group.

<Q - Jason Mollin>: Very helpful, Rafa, Ursula. And maybe just a follow-up comment, I mean, I'm looking at the accretion in ROE – well, EPS but also in ROE that you're looking for with the merger with Interacciones. That seems very positive. And I noted your highlight that the cost of funding may even be able to be brought down more into – in, I guess, in 2019. What's driving that expectation? Is it what you're seeing now that you could even have further gains in the cost of funds?

<A - Rafael Victorio Arana de la Garza>: Yeah, yeah. The treasury team and the network of Banorte and the product guys from the deposit base initiated a very active process to really completely change the cost of funds that Interacciones was holding off. And also, we launched very successful campaigns on a time deposit basis that the network has been extremely efficient to achieve rate of growth on some regions, about 20% to 24%. But at the same

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time, demand deposits has having a very good year also not only on the mix but also on the rate of growth . The commercial and the corporate also has been more than ahead of the – of what we expected from them.

So overall, what we have is a combination of extremely good change of funding that we went into the market and achieve very good rates for the positioning of the – for the replacement of the already existing funding of Interacciones, that instead of the 46 basis points, now, we are close to reach those numbers to 70 basis points on the funding side. And it's a combination of very good activity from the network, from the commercial, from the corporate, and the product people have been extremely efficient to target the right clients with the right products to have a very good mix.

Our cost of funds from that right now is running at around 42.9%. We are well below what we anticipated to have. We were running expectations around 44% and we are at 42.9% and that's because the mix that's much – has been a much better mix that we anticipated. So, the network and the commercial and the corporate side are doing an extremely good job, plus the treasury has [ph] slacking (00:25:03) a lot of good funding at a very good rate for replace the Interacciones fund.

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

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

Operator

And moving on, we have a question from Philip Finch of UBS.

<Q - Philip Finch>: Hi, Marcos. Hi, Rafa. Thanks for the presentation. First question is also related to the merger with Interacciones. So, very detailed information, so thanks for that. For the second half, you're saying the earnings accretion is 2% to 4% given of the – a lot of upfront expenses being bought. Now, when you first announced this merger last year. You were talking about potential accretion of 10% to 12% in 2019, assuming a full year – on a full year basis, so that's including, obviously, all the benefits from cost but also funding. So, can you reaffirm that that 10% to 12% earnings accretion for next year is still achievable. And secondly, going back to more of the underlying performance that we saw in the second quarter, your efficiency ratio just continues to improve beyond certainly our expectations. How much more upside is there from here? Is that 39% or something? It seems as though you may have peaked.

<A - Jose Marcos Ramírez Miguel>: Thank you, Philip. Yes, it's achievable. Rafael is going to give us more color. And talking – how far we can go with the efficiency, we're expecting to be below 40s and stay that way, but Rafael can give us more color about that.

<A - Rafael Victorio Arana de la Garza>: Yeah. Thank you, Marcos. Yes, Philip, and thank you for the remain – remind us of those numbers, yeah. We are fully confident that we could achieve EPS from 2019 from 10% to 12% based upon the, as you mentioned, the funding cost, plus also the expansion on the business. As you know, we never considered any cross-sell potential when we did the numbers. So, we now see that there's room there for have an increase in the cross-sell ratio. And so, we are very confident that we can deliver the 10% to 12% accretion for full year of 2019.

On the efficiency ratio, I think all what we have been doing in automation and on a technology base and a very disciplined cost base, I honestly think that based upon the dynamics on the revenue side and that we have been very stable on the cost base because there were some concern about some notes that the personal expenses on a quarter basis grew like 17%, but you have to consider that we already booked MXN 200 million, not of the Interacciones merger but MXN 200 million of severances. That is because as you know, every year, based upon the meritocracy of our employee base. We run every year of who should be doing or giving more productivity, who should improve the performance, and the ones that they've not achieved their goals, we have a continue revamping of the base. So, on a – I would say on a normal basis, we always book around MXN 200 million that has been booked in this quarter of severance. And also, we also anticipate MXN 90 million of frontloading the bonuses for the end of the year. So, we still see room to keep reducing the cost-to-income ratio to numbers around 39% on a steady basis and a little below that on an extraordinary

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basis.

<Q - Philip Finch>: Wow. Thank you. Just quickly – a quick follow-up, Rafa, a minor point maybe, you said just now the thought that you're looking for 10% to 12% EPS accretion next year. That EPS, that includes the additional number of shares for the process of this transaction. Is that correct?

<A - Jose Marcos Ramírez Miguel>: Yes, Philip, that's correct.

<A - Rafael Victorio Arana de la Garza>: It's correct. Yes, it's fully loaded.

<Q - Philip Finch>: Perfect. Thank you very much indeed.

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

Operator

And our next question comes from Jorge Kuri of Morgan Stanley. Please go ahead, sir. Your line is open.

<Q - Jorge Kuri>: Hi. Good morning, everyone. Congrats on the numbers. I have one question on your government business. You provided a pretty good overview of your expectations for the new government in terms of what you think they're going to focus. How do you think your government business is going to evolve in the new administration? What are the challenges and opportunities that you see as we transition? Thank you.

<A - Jose Marcos Ramírez Miguel>: Mr. Carlos Rojo, the new guy in the team, is going to answer. Thank you, Jorge. Thank you.

<A - Carlos Alberto Rojo Macedo>: Hi, Jorge. Good morning.

<Q - Jorge Kuri>: Hi.

<A - Carlos Alberto Rojo Macedo>: Listen, I believe that at this point in time what we're going to see is the same seasonality that we've been observing for the last years. As you know, states and municipalities have greater liquidity during the first half of the year and that has been shown, as we have seen prepayments at this point in time. However, the lack of liquidity that usually happens during the second half of the year should accelerate the deployment of launch for that part of the year.

<A - Jose Marcos Ramírez Miguel>: You want to add something?

Operator

Mr. Kuri, did you have anything else?

<Q - Jorge Kuri>: No. I mean, I guess I was looking for a little bit of more detail, but that's fine. I understand there's still a lot unknowns here. But thanks anyway.

<A - Rafael Victorio Arana de la Garza>: But of course, we're happy to go deeper. Please feel free to ask. We have here Carlos Martinez who runs the state on municipalities, and we have also Armando Rodal who runs the federal piece. So, we can give you a detailed information as you need.

<A - Jose Marcos Ramírez Miguel>: What's your specific concern?

<Q - Jorge Kuri>: No, no. I don't have a specific concern. My question was about challenges and opportunities. I mean, it is a new government with some particular focus on development with more government spending intervention. And so, just wondering given that you are a big provider of credit to the government, and that's a really big part of your business. If you just walk us through what do you think the challenges and opportunities are of these new government. I mean, MORENA has never managed the country, and just wondering how you think that's going to play out for you in

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terms of your government business.

<A - **Jose Marcos Ramírez Miguel**>: Rafa is going to give you more color...

<A - **Rafael Victorio Arana de la Garza**>: Yeah.

<A - **Jose Marcos Ramírez Miguel**>: ...and also, Gabriel Casillas.

<A - **Rafael Victorio Arana de la Garza**>: Yeah. I will jump immediately on one thing and I think – and thank you for the opportunity, Jorge, to clarify this. More than going to the details on the numbers is that it's quite important to give the message to the market that at this point in time, we're sitting at 28% of the book with a government book, but that number will continue to decrease in the next years because basically, we are switching more and more to a different type of business. As you know, the transparency law and there has been issue in the past years, it has been put a lot of pressure on the margins and things. So, you need deliver a lot more value-added products. But the dynamics that we have on the consumer, the dynamics that we have on the corporate and the commercial, and that will also continue to evolve in a much faster pace.

I think that our goal to have on the book is around [ph] 24 to 26 (00:34:02) on a steady basis on the government book, but we will have, at this point in time, a lot more products to offer to the market that will compensate that strong pressure on the margins on that, that we could deliver a lot of value added based upon the scale and the potential and expertise of Interacciones and the scale of Banorte and the expertise that Banorte also have.

So, it's quite important to note to the market because there has been always concerns about the concentration on the government book, that we have – we will have a relevant position on the government book because it's a extremely profitable business on a return on equity basis and a very strong incentive to have a cross-sell ratio increase in that part of the business. But the dynamic of the book and the dynamic of the group as a whole will continue to expand at a much faster pace.

<A - **Jose Marcos Ramírez Miguel**>: [indiscernible] (00:35:05). And Casillas?

<A - **Gabriel Casillas Olvera**>: Hey, Jorge, it's Gabriel Casillas, Chief Economist. Just one thing I wanted to highlight here from the macro side, honestly, in terms of – I think a lot of these has to do with opportunities. I mean, since the new government won the election, the economic policy team has been quite open, not only to us but even, for example, in the think tank [indiscernible] (00:35:31) where I'm part of it, they have been quite open in explaining what they really want to do, explaining that definitely they're not going to increase the deficit and indebtedness levels, as Marcus mentioned at the beginning of the call, but doing a complete reengineering on the spending side.

One, a very good figure of they do want to do this is that they want to appoint Gerardo Esquivel – he's a Harvard-trained economist – as Undersecretary of Spending. So, I think that's going to be really very good in terms of spending. It's not going to increase by increasing indefinite levels or taxes but that's going to be re-optimized. So in this context, definitely, we see this as an opportunity, more so now with the Interacciones merger, that if you really optimize how government spending is done, definitely, I think there are a lot of opportunities for funding, for helping in [indiscernible] (00:36:34) this area that we have.

And talking about challenges, honestly, the only one challenge that we see in the short run is that usually, in the very first year of government, what we have seen in the past is that there's a slowdown in GDP. It has happened by, of course, [ph] 95 (00:36:53). It's an outlier, but it has happened in every first year because there's a lot of changes in the people managing the country. And you mentioned that the people from MORENA party, they have not managed the country. Well, they have not managed the country under these parties, but a lot of the people that actually won the elections in MORENA actually had been working in the government for a long time. So even though in the first year probably, there's going to be a lot of changes and they probably will not know exactly how to spend the money and that will make or at least foster the slowdown. A lot people have been in the government. And also, as I was saying with the new unit in Interacciones, part of their job is actually to give this like consulting services and to explain them how to spend and how we can help them. So in this context, even though that's going to be a challenge for the country, I think it's also an opportunity for us. Just wanted to highlight that, Jorge.

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 Company Ticker: GFNORTEO M
 Date: 2018-07-27
 Event Description: Q2 2018 Earnings Call

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 YTD Change(\$): +21.99
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Bloomberg Estimates - EPS
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 Current Year: 82444.300

<Q - **Jorge Kuri**>: Thank you. Thanks for the color, guys.

<A - **Jose Marcos Ramírez Miguel**>: Another comment, Jorge. Carlos Martinez.

<A - **Carlos Eduardo Martinez Gonzalez**>: Jorge, how are you? It's Carlos Martinez, Head of State and Municipalities and also Retail Banking. One thing that we see in the future is that a big shift between regular acquisition of loans for the government to more sophisticated infrastructure loans and not directly from the government, but more from the government suppliers of infrastructure. So, this give us a big – with this alliance, with this merger with Interacciones, it give us a big advantage because the Interacciones team have this knowledge and we have the – know the market and the relations in every state and municipality in in Mexico. One good thing also which, in the future, is we see municipalities also getting to the infrastructure development and market in the future. So, that also give us a big advantage in being there in the municipalities with infrastructure credit more than the regular type of credit that we've been doing in the past.

<Q - **Jorge Kuri**>: Great. Thank you very much. Thanks. That was very clear. Thank you.

Operator

And we'll move to a question from Rafael Frade of Bradesco.

<Q - **Rafael Frade**>: Hi. Good morning, all. I would like to just to explore a little more of the details on your estimates for Interacciones in the second half. I would like to understand how much of this MXN 1.8 billion – MXN 1.7 billion to MXN 1.9 billion is impacted by or [ph] read (00:39:31) by the benefits of synergies. It's fully capturing the synergies or not? You mentioned that there are, for example, some severance costs that should we [indiscernible] (00:39:40)...

<A - **Jose Marcos Ramírez Miguel**>: Synergies.

<Q - **Rafael Frade**>: ...second half. So, I would like to understand what this number would be on, let's say, you expect on a recurring base look for 2019 like.

<A - **Jose Marcos Ramírez Miguel**>: Thank you, Rafael. Talking about the synergies, Rafa, you're – Rafael Arana is going to help us.

<A - **Rafael Victorio Arana de la Garza**>: Yeah. The – what you would see on the numbers that we are presented to the estimated earnings, note [audio gap] (00:40:09) fully loaded on the synergies on that part. So, I would say that as you know, we usually give a guidance for the year on January. So, I will like to be – as you know, we are fully integrating now the books and everything to have a very precise number to give to you. But I would say that you should see on without any confirmation, but basically based upon these numbers, these numbers are not including any on the benefits of the synergies, but a very small piece on the funding side. So when – not on the cost side or anything is included on the MXN 1.7 billion to MXN 1.9 billion that we have on estimated earnings.

And on the accretion, the only thing that you get in, it's basically the benefit on the funding side because most of the integration cost and everything are going to be fully loaded into that part. So, we have to claim that of the remaining of the year in order to have a clean view for the next year. But I will not be comfortable at this point in time to commit to give you the numbers, one week lean on the remainder of the year of the process, but they will be much better on the funding side and much better on the cost side.

<A - **Ursula Margarete Wilhelm Nieto**>: Rafael, if I just may add, remember that in the MXN 1.7 billion to MXN 1.9 billion expected net profit from the Interacciones business, we are already including close to MXN 900 million in onetime expenses – integration expenses, if you will. So, those will not be there in 2019. So, those will be revenue, if you will.

<A - **Rafael Victorio Arana de la Garza**>: And the full benefit of the whole reduction of the cost structure and the benefit of the funding. But that will give, in due time, give it to you on the guidance for the next year. At this point in time, what we commit is 3% to 4% accretion on this year. And the cost that Ursula has mentioned has been fully

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revealed, and the earnings, we are very, very comfortable to say MXN 1.7 billion to MXN 1.9 billion, but much better performance for the next year, yes.

<Q - **Rafael Frade**>: Yeah. No, it's perfect. So, I completely understand that I'm not want to get a guidance for 2019 at this point. It's much more just to make clear that so far this number for the second half of 2018. We don't have much of the cost synergies that you are indicating. So, this probably is something more for 2019, right?

<A - **Jose Marcos Ramírez Miguel**>: Yes.

<A - **Rafael Victorio Arana de la Garza**>: Exactly, Rafael, and thank you for the correction. Yes, it's exactly what you say.

<Q - **Rafael Frade**>: Okay. That's perfect. Thank you.

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

Operator

And our next question comes from Thiago Batista of Itaú BBA.

<Q - **Thiago Bovolenta Batista**>: Yeah. Hi, guys, congratulations for the results. I have two questions. The first one is a kind of follow-up on Rafael's questions about the cost synergies. Recently, there is an article in [ph] Reuters (00:43:40) saying that the bank had reduced their workforce by about 50% of Interacciones workforce. How fast do you believe the bank will be able to capture the cost synergies? Is it possible to say that next year, we will have already the full synergies – cost synergies ready or not?

And my second question, about the operation of the bank in the second Q, during the second Q, we saw a very strong service fees expansion, if I'm not wrong, up to 25% Q-over-Q. Probably this is [indiscernible] (00:44:13), but also, 11% year-over-year. Can you comment a bit how do you see this evolution in terms of service fees going forward?

<A - **Jose Marcos Ramírez Miguel**>: The first one, Thiago, is yes, in the remainder of this year 2018 and for the next whole 2019, we expect to have all the cost synergies, and that's it. So, we will end 2019 with that already in the check box.

And talking – and about the second one, Rafael, please.

<A - **Rafael Victorio Arana de la Garza**>: Ursula can.

<A - **Jose Marcos Ramírez Miguel**>: Ursula, sorry, Ursula.

<A - **Ursula Margarete Wilhelm Nieto**>: Yeah. Thiago, on the fee side, if you look at the breakdown of fees, most of the acceleration in growth came from fees that are related to banking services and transactionality. So, these are related to volume. As we mentioned sometime in the conference that we are looking to grow deposits this year faster than the loan portfolio. To the extent that that happens, then we will see fees from transactionality maintaining their growth rate. So, we do expect to continue to post a strong number for the second half of the year, and most likely, for next year, too. As most of these...

<Q - **Thiago Bovolenta Batista**>: Okay.

<A - **Ursula Margarete Wilhelm Nieto**>: ...deposits are – tend to be very sticky.

<Q - **Thiago Bovolenta Batista**>: Okay. Thank you [indiscernible] (00:45:44)...

<A - **Ursula Margarete Wilhelm Nieto**>: And the other piece of the business that is also growing quite nicely is growing at a rate of – at around 20% per year are the fees related to the merchant acquiring business that we're also have been expanding quite fast.

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 Current Year: 10.252
 Bloomberg Estimates - Sales
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 Current Year: 82444.300

<Q - **Thiago Bovolenta Batista**>: Okay. Perfect. Thanks for the answers.

Operator

And we'll move on to a question from Carlos Macedo of Goldman Sachs.

<Q - **Carlos G Macedo**>: Thanks. Good morning, gentlemen. I have a question around what you've talked about and I think Rafa mentioned it a few times on the cross-selling aspect to the transaction. Banorte has been very good over time to cross-selling payrolls into its government clients, and then, in that way, securing cheap deposits and good payroll loans. Could you talk a little bit more about that, give us some color, what do you expect to do in that sense? What's the timetable for you to be able to take that in? Is it within 2019 or is this something that will take maybe a couple of more years? And how much that can add to the general accretion that you mentioned, 10% to 12%, next year? Is that going to add on top of it or it's just already reflected there? Thanks.

<A - **Jose Marcos Ramírez Miguel**>: Thank you, Carlos. As you will recall, the 20/20 Vision is full of 20s and 2s. It's supposed that for the year 2020, we will get to [ph] 2.2 (00:47:12) products per client. That's in our measurement. That's the idea. We are aiming that way. And maybe Rafa can give us more color on that, but the idea is to keep that and rock head on that.

<A - **Rafael Victorio Arana de la Garza**>: Yeah. No, as Marcos said, it's fully embedded on the – on how the business units and the segments improve the cross-sell ratio. So now, we see a pretty fast acquisition of the value proposition that we provide to the federal entities and municipal entities. To be very fast really incorporated into the value proposition that in the past, Interacciones was on the given basically that their consulting services on the infrastructure basis. But they were not able to provide any payroll loans or to be competitive on the funding and on the transactional banking and cash management. So, all these products will be fully into the bags of the Banorte executives that are now we'll be touching a lot more clients with a complete full value proposition that will allow us to pretty fast moving to the same level that the Banorte team has been able to deploy those products into our own client base.

If you say that I saw the accretion that you were thinking about 3% to 4% on the cross-sell ratio for the – I think for 2019, the accretion coming from that part will be more around 2% on accretion basis. And that you provide on your note will be achieved on [ph] 2020. (00:49:18) It's also very important to remember that we are not considering these numbers to help us to reach the 20% return on equity on the Banorte basis. This is always will be fully disclosed of Banorte on its own and the additional product [ph] unit that has been put in how it's (00:49:45) performing. But that unit could be easily be measured how it has been able to provide additional products on a cross-sell basis to the Banorte and to the Interacciones basis.

So, yes, we are very comfortable to continue to deploy a full value proposition to the existing client of Interacciones and to incorporate to the already existing clients of Banorte the products that Interacciones has. So that, all in all, will increase the cross-sell ratio in both sides.

<Q - **Carlos G Macedo**>: Great. Thank you, Rafa.

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

Operator

And our next question comes from Claudia Benavente of Santander.

<Q - **Claudia Benavente**>: Hi. I'm having two questions here. One is with respect to the government book. Is it fair to assume that you're probably going to [ph] leave all (00:50:44) the portion of the government loan book to expire and only grow the infrastructure share? Then what would be a fair growth [ph] base (00:50:52) that we should like assume for the infrastructure book [ph] so far (00:50:57)? They have been posting a five-year CAGR of 33%. Do you feel that growth rate is reasonable or should be slower? How do you see that?

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 Current Year: 10.252
 Bloomberg Estimates - Sales
 Current Quarter: 22878.333
 Current Year: 82444.300

And my second question is regarding lending costs, only taking a look to the gap of the interbank loan rate difference between in Banorte and Interacciones which is [ph] the 170 (00:51:18) basis points, would be fair to assume that you can reach that improvement by 2019? Thank you.

<A - Jose Marcos Ramírez Miguel>: The second one, yes, the [ph] 70 (00:51:33) basis points is fair to say that in the 2019, at the end, we will get there. We are waiting for all the positions to [ph] rent and to start a new rent, (00:51:47) so, yes, it's very fair to say that. And talking about the government book, who can help us on that?

<A - Rafael Victorio Arana de la Garza>: Claudia, could you exactly – because I missed some of the question about the government book – exactly what was the question?

<Q - Claudia Benavente>: [ph] They're (00:52:06) kind of two questions. The first [ph] is specific (00:52:09) for the government portion you're going to [ph] let that stick (00:52:12) to expire according to duration? And the second one is about infrastructure. So far, Interacciones has reported a five-year CAGR of 33%. So I was wondering if that rate is reasonable or you feel it should be slower, and if it's [ph] lower, (00:52:29) why?

<A - Rafael Victorio Arana de la Garza>: I can tell you more than on a budget basis than on a market basis. On a budget basis, when we did – and did the numbers, we were very conservative on the growth on the infrastructure basis. As we remember on the presentation, we think that we will more concentrated on make a lot more profitable the relationship that Interacciones used to have with the government and the entities.

And on the infrastructure book, I think you should be looking on a standalone basis the same rate of growth that they have on the past year. That's what we budget. Could we see upside on that? I honestly think so. Once you have the full commercial arm of Banorte moving along with the expertise of Interacciones into the market, yes, but we will – we are kind of conservative on the budget to have the same – basically, the same numbers on – without obviously taking into account the synergies and the costs, the same rate of growth that Interacciones achieved this year.

Is there potential for additional growth? Yes, we honestly think so. But at this point in time, the way we did the budget for the valuation and everything was on a similar basis for this year. Once we have all the information in place and everything on the new budget, Claudia, we will be very happy to provide the exact rate of growth that we could achieve. At this point in time, I think it's fair to say that what's achieved this year could be repeated on next year with a full benefit of the synergies and the full benefit of the cost.

<Q - Claudia Benavente>: Perfect. So just to double-check, 33% year-on-year growth on infrastructure is reasonable and the [ph] 170 (00:54:34) basis points cost improvement, has [ph] this (00:54:36) already incorporated in your – this 10% to 12% accretion estimate that you provided for 2019?

<A - Rafael Victorio Arana de la Garza>: Yeah. The 10% to 12%, yes. The [ph] 37%, (00:54:46) I would say that would be a different mix, but I would say that the overall – at this point in time, you have to be of the overall delivery of – if you look at the level of Interacciones that [indiscernible] (00:54:59) the numbers were around MXN 4 billion of net income. I think you should be looking on a net income basis without all the benefits of the synergies and the funding that you will have to put above those MXN 4 billion all the benefits on the funding and on the cost.

That's the numbers that we are running at this point in time. Once we have all the [ph] grapes (00:55:23) on the budget on a product-by-product piece, we will immediately release to the market exactly what's our commitment to deliver on that number.

<Q - Claudia Benavente>: I'm sorry, the [ph] 170 (00:55:39) basis points are incorporated in your 2019 [indiscernible] (00:55:44)?

<A - Rafael Victorio Arana de la Garza>: Yes. Yes. Yes, yes, yes. Yes.

<Q - Claudia Benavente>: Okay. Thank you.

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Bloomberg Estimates - EPS
 Current Quarter: 2.552
 Current Year: 10.252
 Bloomberg Estimates - Sales
 Current Quarter: 22878.333
 Current Year: 82444.300

And we do have several questions remaining in the queue. Do we have time to take a few more at this time?

<A - Jose Marcos Ramírez Miguel>: Yes, yes, go ahead.

Operator

Well, we'll hear next from Arturo Langa of Itaú BBA.

<Q - Arturo Langa>: Hi, gentlemen, Ursula, thank you for taking my question. In your presentation, you mentioned that there's a strategic [ph] deceleration (00:56:23) in unsecured consumer loans. Is there any – anything that you're seeing there that worries you in terms of asset quality?

<A - Jose Marcos Ramírez Miguel>: Manuel Romo is going to help us with that. Thank you, Arturo.

<A - Manuel Antonio Romo Villafuerte>: Hi, Arturo. Manuel Romo here. I think that, in general, we are not seeing a major shift of the market in credit cards nor in personal or payroll loans. However, in certain segments of certain activities in the economy, we see a little bit more of volatility. So, for example, in payroll, as you know, this election year was the biggest one ever. And so, there are going to be certain changes in administration. And in that from municipality, state, federal, et cetera, that brings a little bit of uncertainty on our scoring models. And so we are reflecting that with regards to the appetite of risk that we are taking.

Also, what we are looking at and working here with the analytic and risk and everybody, teams, we are trying to reevaluate how the market is going to look in 2019 with regards to expense, et cetera, and on a – be very, very clear on which segments we are going to be more aggressive, which we are going to remain as we are and which others are going to be more conservative.

In general, I would say that the growth rate that you're seeing of low double digits is going to remain until we have a little bit more of visibility, that's with regards of payroll loans. I think it's going to be, again, as Rafael was mentioning at the beginning, we are going to be outgrowing the market but around low double digits, [ph] 10%, 11%, (00:58:25) something like that, in payroll loans.

Credit cards is a different story. Credit cards, what we [ph] read (00:58:32) is that the portfolio was managed at a very – really at a very efficient level. So any changes regarding speed of growth, very, very fast reflect an increase in ROE and ROI. We reduced the speed of growth in credit cards in low income and low experience in Credit Bureau customers. We are focusing much more right now on cross-sell opportunities from existing debit cardholder – debit cardholders from the group.

Our expectation on credit cards is that the visibility that we see from our customers and the performance is going to be around probably going to give us a little bit higher than payroll loans around 12%, 13% and keep going until we see 2019 how the spend and the consumer spend is going to look towards year-end, you know that year-end's campaigns – and is always a very good proxy of what is going to happen in 2019, we're going to see that towards the last quarter of this year. And then we can see how faster we can grow, but right now, what we're seeing is around 12%, 13%.

<Q - Arturo Langa>: Okay. Okay. Thank you very much.

<A>: Okay. Thank you.

Operator

[Operator Instructions] At this time, we'll hear from Marcelo Telles of Credit Suisse.

<Q - Marcelo Telles>: Hi. Good morning, everyone, and congratulations on the strong results and strong guidance, very happy to see that. Most of my answers have been answered. So I just want to ask, dig a little bit deeper on your government exposure. It seems that the new administration has taken the decision to centralize how federal funds flow

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 Company Ticker: GFNORTEO M
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 Current Quarter: 2.552
 Current Year: 10.252
 Bloomberg Estimates - Sales
 Current Quarter: 22878.333
 Current Year: 82444.300

to states. So it's my understanding that the new administration has already appointed some individual states coordinators, right, that will dictate how states will receive the federal funds. And to my knowledge, I think 85% of state resources come from the Federal Government.

So, given that a lot of the loans to state and municipalities, they rely on their participaciones federales, right, on the federal participation fund. I was wondering if you see that as a potential risk, now there could be maybe some disruption in the flow of funds from the Federal Government to the states and if that pose a risk for your collection of those loans throughout different states? Thank you.

<A - **Jose Marcos Ramírez Miguel**>: Thank you, Marcelo. Thanks for your comments also. And maybe Gabriel Casillas is the one to – can give us a more light on this.

<A - **Gabriel Casillas Olvera**>: Thanks, Marcos. Hi, Marcelo, Gabriel Casillas, Chief Economist. Hello.

<Q - **Marcelo Telles**>: Hi, Gabriel. How are you?

<A - **Gabriel Casillas Olvera**>: Hi, good, thanks, Marcelo. Hey, Marcelo, your question is very good. Let me just give you some details about this issue. I mean, let me separate these individual coordinators, the new structure that you're mentioning from the – how this flow of funds work, I mean, in the second part, how these funds flow.

What I'll call participaciones or participations is not the money, it's actually the money that each state should collect from taxes. But some years ago, there was an agreement, a federal agreement, that they didn't want to do the tax collection because it's not very popular. So they preferred the Federal Government to do the tax collection for them and then the Federal Government gives the money back. But it's not money from the Federal Government.

So, that structure so far, we don't know that it's going to change. Actually, it should not change, and if they were to change, it's going to be very hard [ph] on it. This is (01:02:59) the money from the states. So having separated that, that, as you know, [indiscernible] (01:03:06) actually structured using those participaciones or participations as guarantee. We don't see that change.

Now, moving to a structure you're mentioning, the thing is, A, I mean, we have more than 2,000 social programs in Mexico. And unfortunately, CONEVAL, the agency, the government agency in charge of evaluating these social programs, only evaluates around 150. So, there is a lot of miscoordination in this part of social programs. So we do see the importance of having these state coordinators to really reassess all these miscoordination of how social programs work.

So, in this context, I think that we see this as a positive thing and has nothing to do with the participaciones. Now, the thing is – and the risk that some newspapers are highlighting – is that these social program coordinators by state could have certain power over the governors. I mean, this would depend a lot on how these issues are going to be structured. But so far, we see this as a positive development and we see honestly nothing to do with participations. So you don't have to worry about that, Marcello.

<Q - **Marcelo Telles**>: And what about the [ph] IO (01:04:28) funds, the revenues from [ph] IO, (01:04:31) I mean, does that go to the federal participation fund as well? How is that charged between the states if that's the case?

<A - **Manuel Antonio Romo Villafuerte**>: Yeah, it's a different mechanism on the one hand. And let me tell you two things. Unfortunately, these oil monies have been reduced significantly because of the decline in oil production. So they have not been as significant as they used to be at some point. And there's a mechanism with the oil fund in which, if there's money in – part of [ph] your money, yeah, (01:05:09) goes to the state [ph] staff. (01:05:10) But that's a different thing.

But the most important one and what has been really relevant is whenever you have excess revenues from oil, then part of it is actually given back to or given to the states, to the state governments. Honestly, this has not been significant in the last few years on the one hand. And on the other, I mean, the thing is this could be changed because it will depend a lot on what's going to be the assessment on what's going to be the roll of Pemex and so on so forth.

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 Current Quarter: 2.552
 Current Year: 10.252
 Bloomberg Estimates - Sales
 Current Quarter: 22878.333
 Current Year: 82444.300

I mean, so far, honestly, the economic policy team has been quite moderated stating that we will continue to work in the country with the energy reform. Maybe they're going to just check around some of the contract that have been given if they were given in a good way with no corruption involved. And honestly, they're going to find out that there was no corruption at all because I don't know if you have seen [ph] this public bid, public bid had (01:06:11) been really, really transparent. They have been broadcasted, each one of the participants have turned in one single envelope per project. So it's going to be very – and the contracts are actually public. They are on the website.

So I don't think the oil part would be that relevant because it has been decreased and the most important one is participation, so I don't know if you want to add [indiscernible] (01:06:37).

<A - **Carlos Eduardo Martinez Gonzalez**>: Yeah. Marcelo, this is Carlos Martinez, Head of State, Municipalities and Retail Banking. One thing I think in addition to what Gabriel already told you is [indiscernible] (01:06:49) is what it states [ph] expend (01:06:53) through the government, exactly what Gabriel was telling you just a moment ago. And we don't see a shift in that. [ph] I think there's (01:07:03) going to be – the only differences is, before, you had 20 or more delegates in the state, now you can have one big delegate that is going to address all this, and this is going to give like a compensation to the actual governor.

And so you have the governor of the state and then you have some – one big delegate that's going to be taking these decisions on how this money is going to be spent. But the amount of money that is going to be in each state we don't see is going to decrease. We see it maybe also it can be incremental. And that's one thing that we can say [ph] to see (01:07:40) in the future.

The other thing that we see as an advantage is that this could be more orderly used in infrastructure. And the third thing that we see is that [ph] case, (01:07:50) you have the check and balance within the governor in this new figure we think is going to be used more properly than we used in the past.

<A - **Manuel Antonio Romo Villafuerte**>: And just to add also, Marcello, this [ph] Ramo 23 or Fraction 23 (01:08:05) doesn't have to do anything with participation. These are transfers to states, so have nothing to do with the structure of the credit. And I concur with Carlos that it's not that they're going to disappear this [ph] Fraction 23. (01:08:21) They're going to do this reoptimization to have a better use.

<Q - **Marcelo Telles**>: Great. That was very helpful. Thank you so much.

Operator

And our next question comes from Jörg Friedemann of Citi.

<Q - **Jörg Friedemann**>: Thank you very much for taking my question. Lots of clarifications already from the previous questions, but just like to touch the two points on the operations of the bank. First, I understand that asset quality has been kept stable and you have good prospects on that end even though you're accelerating in retail. But I also noted that, over the last few years, it's not just your case, but I have seen some of your peers doing the same. Provisions have been a bit volatile, in your case, it reached almost 150% last year and it has oscillated between [ph] 129% to 130-something (01:09:33) in the past few quarters. So just wondering what do you see for these going forward, if [ph] I know (01:09:41) the decline of this quarter was just related to the seasonality that exists in the second quarter and to just [ph] I know (01:09:51) could go up again or if the trend is to go a bit further down given the improvement and observed in asset quality so far?

And the second question is a very quick one, if you could clarify how much was reversed in terms of the fiscal provisions that [ph] I know (01:10:14) led to a significant decline of VAT taxes in this quarter. Thank you very much.

<A - **Jose Marcos Ramirez Miguel**>: [ph] Both Rafa Arana (01:10:24). Thank you.

<A - **Rafael Victorio Arana de la Garza**>: Thank you, and thank you. I was reading also at the note, and thank you for your comments. I think what you should be looking at at the third quarter of the asset quality which will be very – we are very, very confident on the car loans on the mortgage side, as Manuel was saying, the credit card book is

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performing nicely on a very steady basis. You usually hit on the third quarter a little bit of seasonality because people goes on vacation and they really load their credit card a little bit. But they will clean that by the end of the year. So we don't see any hiccups on the credit card.

What you have seen on the payroll loans is much more a denominator issue because we have been reducing the rate of growth, as Manuel was saying, because of the change on the government of municipality and states that usually we are very cautious like eight months before that to reduce significantly the issuance of the payroll loans on that part. So we don't see anything strange compared to other change of administration. All the measures to contain any disruptions on the quality of the book has been taken, so – but you will see a denominator issue because of the lack of growth on the payroll loans that usually we grow the book around 16%, 17%, and we will be growing around 11% to 12%.

So we don't see that. And there was also some concerns that if we were reversing the coverage ratio to use that reversal of a reduction on the coverage ratio and float that to the net income line, that's not the case. Basically, the coverage ratio is a result of all the provision methodologies and regulation that we have on the consumer on any of the books. So, no – we basically what we see it has been an improvement of the generation of the provisions. As you know, the first quarter, we have an extraordinary item that we disclosed fully on the corporate side, but no – there was no reverse on the – or reduction on the cover ratio to use that as a part to really strengthen the bottom line. That's not the case. It is exactly as the regulation says and it's based upon the provisions, methodology and the rate of growth of the book.

On the fiscal provisions, as you know, and you very well stated on your report, we are always like the highest payers on the tax rate, we are around 29.3%. And the reason for those reduction – those reversals on the fiscal side was basically that we were over-provisioned in some of the components that we finally get the approval from the authorities to reverse those. That's the case.

<Q - **Jörg Friedemann**>: But then do you have any idea about what would be the efficiency ratio if that had not been reversed? Just to understand really what is the recurring efficiency level.

<A - **Rafael Victorio Arana de la Garza**>: No. I think that will not affect at all the efficiency because we usually, as you know, and the 29.3% is more than other provision for the [ph] original (01:14:12) rate. But we will always like to be very conservative on that number. So that number that you see on that is also – if you say that will affect your – any of the numbers that you have on the net income and on the efficiency ratio and anything, no, believe me, it doesn't have to – there's no impact at all in that.

<A - **Ursula Margarete Wilhelm Nieto**>: And if I just may add, Jörg, if you see the guidance that we gave at the beginning of the year and the guidance that we just updated today, we were expecting an efficiency ratio between 39% and 40%. So it's within where we expected even with this reversal. It's just – the reversal is just a reflection of managing the expenses, but nothing more.

<Q - **Jörg Friedemann**>: Yeah.

[indiscernible] (01:15:03)

<A - **Carlos Eduardo Martinez Gonzalez**>: [indiscernible] (01:15:07) Carlos Martinez, Retail Banking. One of the things that you mentioned about the growth in the credit is – it has to be a lot about auto and [ph] grades in (01:15:18) mortgages. We have taken advantage, as you know, two or three years ago [ph] with the full advantage (01:15:24) of the acquisition and the fusion with Ixe Bank. So we've been very good [ph] at attending (01:15:30) the high level, high income [ph] tax (01:15:33) credits in Mexico.

So we've made a lot of alliances with auto builders and also with mortgage brokers. So we've been very good in addressing that kind of market. Our credit mortgage [ph] issue (01:15:48) is about MXN 1.8 billion [ph] or – mortgage in related. (01:15:54) And in the auto industry, [ph] we made alliance risk, risk alliance (01:15:57) with Honda and Mazda and other auto builders that are more related in the high income in Mexico. So that gives us a very good quality of assets and also a very good line of acquiring clients.

<Q - **Jörg Friedemann**>: That's perfect. Thank you for the detailed [ph] information (01:16:12).

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<A - **Rafael Victorio Arana de la Garza**>: Happy to take on – if you want to go deep into the reversals, that happy to have a specific talk and conversation with you to really guide you to exactly what's the numbers. But I would confirm to say that doesn't affect anything related to the efficiency ratio on everything, it's – we are always very conservative on the tax side, and we usually are over-provisioned.

<Q - **Jörg Friedemann**>: Very clear, Rafa. Thank you very much. Okay.

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

Operator

And we will hear next from Carlos Gomez of HSBC.

<Q - **Carlos Gomez-Lopez**>: Hi, good morning. It's late in the call. I just wanted to ask what your expectations for interest rate are and what do you think your sensitivity to a decline of [ph] 100 basis points would be (01:17:09) next year? Thank you.

<A - **Jose Marcos Ramirez Miguel**>: [indiscernible] (01:17:13)

<A - **Gabriel Casillas Olvera**>: Hi, Carlos, this is Gabriel Casillas, Chief Economist. [indiscernible] (01:17:18) In terms our expectations on the reference rate of the Central Bank is that they will leave the rate unchanged at 7.75% at least in the next 18 months. In the past like six months ago, we were thinking that there was opening some space for rate cuts. Nevertheless, as we have seen the evolution of certain variables, more than inflation, honestly, has been the more hawkish U.S. Fed. So that's in our view going to preclude the Central Bank to be able to lower the rates.

Now, having said this, in our view, actually, the bias of the Central Bank is going to be towards hiking rates at some point, maybe not a lot because, as you know, since December 2015, when the Central Bank began its hiking cycles at the same time as the Fed, the Banco de México has done 475 basis points, while the U.S. Fed has done only 175 basis points. So, I think there's some space for the Fed to continue hiking and for México not to follow the Fed.

So, having said that, so no rate cuts at all, maybe some hikes. But honestly, I think the Central Bank, they don't want to hike anymore. And very importantly, and they have highlighted in their communication and in their speeches is that if they see a fiscally responsible government, and that's going to be a very important variable, and if they see that, they're not going to hike. And actually, we have seen the commitment of the newly appointed government to be fiscally responsible. So definitely, I don't think the Central Bank will have to hike rates.

Now, talking about the sensitivity, I don't know if you want, Ursula, to mention that?

<A - **Ursula Margarete Wilhelm Nieto**>: Yeah. Hi, Carlos. On sensitivity, the mix of the banking book has changed over the last three years, and we have a higher proportion of fixed rate assets in the banking book. So this has brought down the sensitivity to rates. Today, a change in 100 basis points in market rates gives us NII of around MXN 960 million, whereas two years ago, the sensitivity was around MXN 1.2 billion.

So, we think that, if rates go down, obviously, irrelevant the velocity and the magnitude of the change. But if rates go down, there is a very good cash cushion within the banking book to support that and the margin will hold.

<A - **Gabriel Casillas Olvera**>: Let me – this is Gabriel again. Just one thing, Carlos, to just add up to what Ursula mentioned. And remember, I mean, at least in the short and medium term, nobody sees interest rate getting back to 3% here in Mexico, in the U.S. getting back to zero. So, in this context, even if the Central Bank finds some space to lower the rate at some point, they're not going to be able to lower the rate that much as of course 3% seems really unthinkable. So we're thinking that, if there's some space that opens up in maybe two years, it's going to go down from the current 7.75% to maybe 6%, that would be one of the lowest point we see.

<A - **Rafael Victorio Arana de la Garza**>: And, Carlos, just an addition that has to do a lot what Ursula was mentioned. We are very comfortable with a reduction in the interest rates because most of the consumer portfolio has

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been very slow to reprice. And the good thing is that we have been able to hold the cost of funds at a very decent level. So, if you start getting the reduction on the interest rates, some people [ph] feel a strength (01:21:24) when we say this, but we are very comfortable with the reduction in the interest rates. We don't see any heat at all in the trend that we are now getting on the net interest margin because of the mix of how we produce that net interest margin.

So we honestly are not dependent on the – or to be very cautious about when the interest rates start to go down. I think the book is very well balanced on the mix and the funding cost continues to be our main, I would say, defensive line for the reduction in the interest rates. As you know, once you get the hike, you penalize the funding side around for six months until the effect on the book starts to happen. So I think we are at a very sweet spot on this on the interest rate cycle.

<Q - Carlos Gomez-Lopez>: Thank you very much.

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

Operator

And with no other questions in the queue at this time, I'll turn the call back to our presenters for any additional or closing remarks.

Jose Marcos Ramírez Miguel

Thank you very much and next – meet next in three months. Thank you very much.

Operator

And, ladies and gentlemen, this concludes our call. We would like to thank you for your participation and you may now disconnect.

Jose Marcos Ramírez Miguel

Thank you.

Ursula Margarete Wilhelm Nieto

Thank you. Bye.

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