

Company Name: Banorte  
Company Ticker: GFNORTEO M  
Date: 2018-11-01  
Event Description: Business Update Call

Market Cap: 342,237.46  
Current PX: 118.69  
YTD Change(\$): +10.86  
YTD Change(%): +10.071

Bloomberg Estimates - EPS  
Current Quarter: 3.016  
Current Year: 10.738  
Bloomberg Estimates - Sales  
Current Quarter: 25429.667  
Current Year: 89861.556

## Business Update Call

### Company Participants

- Jose Luis Muñoz
- Jose Marcos Ramírez Miguel
- Rafael Victorio Arana de la Garza
- Gabriel Casillas Olvera
- René Gerardo Pimentel Ibarrola
- Felipe Duarte Olvera

### Other Participants

- Philip Finch
- Arturo Langa
- Jason Mollin
- Marcelo Telles
- Claudia Benavente
- Siva Natarajan

## MANAGEMENT DISCUSSION SECTION

### Operator

Good day, and welcome to the Banorte hosted Extraordinary Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Jose Luis Muñoz.

### Jose Luis Muñoz

Thank you. Good morning, and welcome to Grupo Financiero Banorte's conference call. I am Jose Luis Muñoz, Director of Investor Relations. And this morning, Marcos Ramírez, Chief Executive Officer will present the message. And at the end, we will address your questions.

Marcos, please go ahead.

### Jose Marcos Ramírez Miguel

Hello. Good morning, everybody. Thank you for joining us today. In light of the recent announcement in Mexico regarding the proposed consolidation of the new airports in the Stockholm, we wanted to take this time to provide clarity on what this means for Banorte. In the past couple of days, we have got several calls from analysts and investors, and we wanted to share it with all of you the same information that we provided so far.

I will ask Rafael Arana to continue with the presentation if he has more clarity on what we want to say. Rafa, please.

### Rafael Victorio Arana de la Garza

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Thank you, Marcos. Just for the sake of clarity, some of you may have missed [indiscernible] (01:22) vacations, so there is no need to worry. Anyway I will continue to go through the presentation, and let me begin by saying that Banorte, those net hold device exposure to the airport project. Our exposure is through the new suite of standby letter of credit in favor of the new airport managed by Grupo Aeroportuario de la Ciudad de México. We have issued six letter of credits with our current exposure of approximately MXN 6 billion on behalf of five different construction companies, one of which is a consortium formed by certain contractors.

These line of credits are contingent liabilities and as of today, none of them have been drawn. The main purpose of this line of credits is to guarantee that construction companies will make proper use of the advance payments received from the airport. This means that construction companies must use its funds exclusively towards the construction of the airport project and not towards any other project that they may have.

In this regard, we have been vigilant of the proper deployment of these trends. Therefore, in our view, there is a low probability that these letters will be executed. If there were a breach in the use of these funds, the airport might execute this line of credit and Banorte would have to pay either the full amount or a partial amount of these letters, depending on specific circumstances of each contractor. At that point in time, Banorte would have to claim the payment directly with each contractor.

It is important to mention that we have confidence in the strength of our risk assessment of this company. We run through a diligent risk analysis before granting this letter of credit, and they will issue to well-known and experienced construction companies in Mexico. Depending on the current awareness of each company, we require a certain level of grant from these contractors. For some of them, we require 100% of the amount of letter of credit as collateral, in other cases this percentage was lower depending on the financial strength of the company. The moment these letter of credits are drawn, they will be registered and treated as performing loans in our balance sheet.

In addition to this information, we would like to mention that in accordance with our risk policy, we will not provide corporate loans for construction companies. Loans to these types of companies are specifically directed to individual projects whose cash flows become the main source of repayment of the loan.

The recent announcements made by the Mexican President, Mr. Peña Nieto, confirmed that the airport construction will continue without change whatsoever until November 30 which is the last day of his administration. Mr. López Obrador created a task force led by Alfonso Romo, the appointed Chief of Staff, who will be taking the different business leaders in the country to plan how the new airport contracts will be honored and how the negotiation process with each contractor will be conducted. Mr. López Obrador met with two of the main contractors yesterday and after the meeting they mentioned it was a good conversation. We left the meeting confident that the new government will act according to the law, and this is a quote coming from [indiscernible] (04:53).

Primary concern that has been brought to our attention is whether our exposure to government lending could be put at risk by action from the next administration. In this regard, we can confirm that upon the measure, all government loans have fully adopted Banorte risk policy. And we're confident of the result of extensive due diligence performed on each and every loan from this portfolio.

These loans are guarantee by federal transfers which are collected in a trust. We have thoroughly reviewed this trust and feel confident with their structure. If there were any future changes to it, they would not be retractive and would not affect the performance of these loans.

I want to take this opportunity to confirm that we are on track to meet the guidance numbers that we have previously announced. And we have been working on the budget for 2019 which will be timely communicated within the first month of the year as we usually do.

Banorte as a well-diversified financial group has several levers which can be pulled in order to continue delivering recurring solid result. Thank you once again for your time today. At this time, we will be happy to take any questions and I would like also to let you know who are here at the table with us. We have our Chief Economist with us, we have the Head of Wholesale Banking, the Head of – Chief Risk Officer, the Head of Corporate Business, and also the head of all investment and structuring deals. So we would be very happy to go you need any concerns that you have with us.

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## Q&A

### Operator

Thank you. [Operator Instructions] We'll take our first question from Philip Finch with UBS.

**<Q - Philip Finch>**: Thank you, Marcos. Thank you, Rafael. So can you just confirm that you have no debt exposure and your exposure is only through letters of credit amounting to MXN 6 billion?

**<A>**: Philip, in addition to the letter of credit, we have MXN 300 million of an outstanding loan, that is working capital mainly.

**<Q - Philip Finch>**: Okay. Thank you. And so given these two exposures, have you, first of all, made any provision for them? And secondly, how much collateral do you have for these two exposures?

**<A>**: For the MXN 300 million?

**<Q - Philip Finch>**: MXN 300 million and also the MXN 6 billion.

**<A>**: So, yeah, no – for the MXN 6 billion, we have different level of collateral. Some of them as full cash, in other side guarantees from the companies and other personal guarantees. So, I would say that it covers a wide range of different collaterals that we have. We haven't done any provisions at this point in time. This is letter of credit are treated by risk-weighted assets. So they consume MXN 269 million of capital currently and – but basically, we don't have any immediate provisions because as we take these letter of credits are fully performing, and we don't have that.

**<Q - Philip Finch>**: Thank you so much.

**<A>**: So I would say that in a general number, 95% of the letter of credit have a collateral in different ways or form.

**<Q - Philip Finch>**: Okay. Thank you very much.

**<A>**: Thank you, Philip.

### Operator

Thank you. [Operator Instructions] We'll take our next question from Arturo Langa with Itaú BBA.

**<Q - Arturo Langa>**: Yes, hi. Good morning, gentlemen. I was just wondering if you could remind us – I understand that it's possible one of these letters of credit could be granted to a related party, a construction company that is related to Banorte chairman. And I was just wondering if you could remind us what the TMB regulation phase regarding the maximum exposure to related party? And how this relates to? And if any possible loan granted to this construction company?

That will be my first question. And then my second question maybe, just more on the macroeconomic side. But does this decision by the government change your forecast for interest rate levels in Mexico? And how do you relate that to credit demand going forward next year? Thank you.

**<A - Rafael Victorio Arana de la Garza>**: Let me first go to the first one. Our first part of the conversation we have fixed letter of credit outstanding. One of this letter of credit is basically given to seven different companies. I cannot name the companies of those but what I can tell you is that [indiscernible] (11:05) of the letter of credit goes to each of the company. So it's around MXN 750 million that is holding for each of these seven companies.

So, that's – and which fully comply on any related product regulation step that contain. So there is no breach in any of those pieces.

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What is key to understand is that this letter of credit that is given to our consortium is divided by seven parties, each of the parties have sustained amount of money given to them so it's not that different from the – on the – on how the letter of credit is being constructed.

Do you ever think it's about the interest rate? And I will ask, Gabriel, our Chief Economist, to go in his perspective about this?

<A - **Gabriel Casillas Olvera**>: Thank you, Rafa. Thanks for the question, Arturo. This is Gabriel Casillas, Chief Economist. Well, important here to highlight, on the one hand, before the airport decision, we have already called for a 25-basis-point hike for Banco de México for this year, but more in terms of inflation.

Having said that, we are forecasting the interest rate of the Central Bank to remain around at this level for a long period of time. In fact, even though we foresee some conditions to cut rate in year 2019, we never called for that. This is very different from the market view. Actually in our view rates will remain high at this level at around 8% for a long period of time. This is number one thing, and it's because of inflation and because of the U.S. rate hiking.

Now, the Central Bank should hike more because of what happened with the addition of the airport, we don't think so honestly. In our view, when you take these kinds of decisions what you do is the Central Bank is usually you allow a real exchange rate depreciation and you have to act more on the side of inflationary pressures. And in this context, for example, gasoline price in Mexico, the Mexican government, the actual government has decided to increase the excise tax that has been able to charge the consumers; it's not an increase of the total tax. For example, let me give you example, this is very important, if a regular gasoline the excise tax before gasoline is MXN 4.69, so in this context this will not increase. The thing is throughout the year the government has not -- they have decided not to have the full charge-off of this excise tax.

So if you go all the way up to MXN 4.69, then, well, these costs come in pressures on inflation. And this is why [indiscernible] (14:02) we'll end this year around 4.8% of that with Central Bank forecast and this is why think the Central Bank will hike once more and [indiscernible] (14:09) rates will remain at this level for a long period of time.

Now in terms of credit, in our sensitivity analysis of how, at which level interest rates start to have some, which will have to, will have, start to increase, sorry, the non-performing loans, usually, these levels in the past have been around [ph] MXN 8.25 or MXN 8.50 (14:32). But I mean is that when they start to increase, but it's not that it's exponential and [indiscernible] (14:39).

Now in terms of credit growth, that was the final part of your question. In terms of credit growth, what we have said in the past, these were high probably in the past more than 14 years, credit initiative has been growing at a pace of a 2 times nominal GDP growth.

So, what we're expecting next year and we have had these forecasts for more than a year, we're expecting a real relative growth of 1.8%, and we're expecting actually lower inflation vis-à-vis this year. So probably, a nominal GDP next year will be around 5%. So in this context, you see the confidence interval that technically speaking, we could be thinking of credit growth of between 8% and 10%, now that's what we are thinking at the moment, Arturo.

<Q - **Arturo Langa**>: Thank you, Gabriel. Thank you, Rafa for the answers, very clear.

<Q - **Arturo Langa**>: Thank you. Thank you for your question.

## Operator

We will take our next question from Jason Mollin with Scotiabank.

<Q - **Jason Mollin**>: Hi everyone. I have two questions, just one on the specifics how these letters of credit work. So I understand what you're saying that the construction companies must use these funds for the construction of the – for the construction of the project. But if they were to draw down the line today and didn't do the work, I mean is it -- as you go, so they could draw down on the line would be my understanding and then let's just say they didn't do the work, then

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what – how does that works for your – for your getting paid or not. I mean then you would have to enter in some kind of proceeding that would be one, just to understand the dynamic of how in fact that you can monitor that the construction companies are using these funds in fact for construction of this project.

And secondly, just in terms of your exposure to infrastructure loans, particularly that you purchased with the Interacciones acquisition, is it possible do you see risk that there could be other projects that the government would just want to cancel and how do you measure those risks if you're building a highway or a school or whatever it is, isn't there some kind of risk that the government could just cancel the project the same way they did here.

<A>: Okay thank you for the question and I would let [indiscernible] in the first one and I will have with me [pg] Vernard (17:32), Head of Corporate, and Felipe, the one who really structured the all of the process of the letter of credit and is fully into restructuring very large deals. So let me pass the word to them and they can guide you exactly how this letter of credits work and what's the potential risk. And then we'll address the second question that is the infrastructure deals and the risk with the infrastructure deals. Please [indiscernible] (18:04).

<A>: Yes. Hi, Jason. Good morning. The standby letters of credit work as a guarantee, and they are guaranteed that the construction companies are applying correctly the advance payments that we're giving to them for working on the project. As you remember, financing for the airport was done through the public markets basically through the bonds and the FIBRA. And these resources have been given to specific construction companies which obtained these contracts through bidding contest. And therefore what we're guaranteeing is that they're applying correctly the funds, so it's not that we have provided credit lines, but we're providing guarantees.

Now these guarantees are governed by or the contracts are governed by the [ph] Leyes de la República (18:55), which is the law that governs the public work contract. If there were to be a cancellation of the project by the government, this will be done through a figure called terminación anticipada or a pre-termination of the contract. Under this figure, the contractors have the right to be reimbursed for all construction already performs, materials, expenses and even severance payments of the work force that currently are at the airport. And so what would happen is there will be a reconciliation of our accounts payable, accounts receivables, the cash that is still in the accounts that was given to them for working on the project.

And at the end of this analysis or this reconciliation, what would happen is if there's an outstanding payment from the government to the contractors, it will be made. But if there's any outstanding payment from the contractors to the government, then the contractors would be liable for this payment. Now if the contractors did not make this payment, that's when they would draw their guarantees and they would draw the letters of credit. At that point in time, if the letters of credit are drawn, they would become a credit line which is what Rafael was explaining at the beginning. So the issue here is there's going to be a process which is the law. And if after this process, there's an outstanding payment from the contractors, and they don't make it, at that point they become credit line.

<Q>: Okay.

<A - René Gerardo Pimentel Ibarrola>: And let me now pass the word to Felipe, [indiscernible] (20:42) the operator of the line of credit. Felipe, please go ahead.

<A - Felipe Duarte Olvera>: Yes. Thank you. Jason, just to add to what René and Rafael has been explaining, I will say that we don't see the event that one of these letter of credits might be drawn. And this is because the payment – the advance payment has been used and this has been violated by federal authorities and even the bank. We have been under surveillance that the proceeds are used or that the payments are used to invest in the new airports and these investments are there. However in the event that one letter of credit may be called, we have the contractual right to collect the – any payment that the government may do to a contractor so we are also covered in that regard.

<A>: Yes.

<A>: I don't know if it's clear, Jason. It's also – I mean...

[indiscernible] (21:53)

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<A>: Yeah. Please go ahead. Go ahead.

<Q - Jason Mollin>: Let me ask one part. So I understand that it's a guarantee, not that they're drawing and that there has to be some, this is a guarantee that the construction was done, not that they can draw the line down, so that makes sense to me. When do these letters of credit expire, so is there an end to when this guarantee of – is there an end to the term of when the guarantee is made?

And then secondly, on the infrastructure, on other infrastructure project, I guess in that case you're actually funding the project so if there was a cancellation how would that work? That would be different. Is that lending through the construction company or is it for the project or how does that work in the infrastructure portfolio prior to Interacciones? Thank you.

<A - Jose Marcos Ramírez Miguel>: Yes. Let's split. We first address the first one, and then we'll move into the second one that's related more to the infrastructure projects, related to Interacciones? I don't know if you...

<A - René Gerardo Pimentel Ibarrola>: Yes. On the expiration of the letters, basically these are issued on a 12-month basis, so 95% of this exposure would expire by June of 2019. And in terms of the infrastructure portfolio, basically as Rafael mentioned at the beginning of the call, we have a policy not to lend directly for working capital purposes of construction companies or corporate loans. So basically what we have is the portfolio, where we have different projects in different industries, different segments obviously, different geographic locations where they are self-contained usually through trust and this trust incorporate the cash flow of the project and also the guarantees.

Now 70% of these projects are ongoing projects which are mature projects not projects under construction, so they can be contract for hospitals, for road, for jails, I mean different type of industries different type of project although most of them are as I mentioned already mature project, so that's the exposure that we have in infrastructure.

<A - Jose Marcos Ramírez Miguel>: Yeah. I don't know if Felipe wants to add something to that.

<A - Felipe Duarte Olvera>: Just to add in this regard, well, projects are performing as René was saying. And in the event any project is terminated, it has specific contracted circumstances that must be observed by the termination process and in those events, it might be a case – if it's the case, a credit should be guaranteed as they are linked to projects not to corporate companies.

<A - Jose Marcos Ramírez Miguel>: Yeah. That's quite important because they were a lot of concerns that our exposure to contractors and construction companies and that is – it is very important what Felipe and René were mentioning, we never lend any mezzanine lines of credit to companies, we basically go to a specific project as René mentioned as self-contained, most of them are fully operational, so we have been doing this for many years and we had acquired. So we have been doing this for many years and we are – we have acquired an expertise on this.

Now moving to the second question about the potential risk about the projects of Interacciones and the infrastructure business. It's exactly the same. We basically lend for specific projects, and this specific project needs to be following very specific rules to in order to disperse the money and to use the money. And the team that was working [indiscernible] (26:07) has had very detailed way of following this process. We have been reviewing every single one of these loans and we as mentioned at the beginning, we are confident with that so there is no – there's no way that those credits could be certainly terminated. They are already on the budget. They are already on the [indiscernible] (26:33) transfer profit and they already committed lines for the project. And I also want to abound on this with Gabriel on our economy and expressly any potential risk uncertainty.

<A - Gabriel Casillas Olvera>: Thank you, Rafael. Jason, one thing here, if you read our President-elect [indiscernible] (26:57) book, if you go into the different document that have been published, the famous Economics volume 1 and 2, if you go to the Project 18 website and if you have followed all the press conferences that our President-elect has been giving since he was selected, you can tell that there is a lot of talk about infrastructure, but there is about construction, about building new trains, building new roads, there is only one piece of work that has been again only one and this is the airport. And now so lease context, there is no other mention of canceling any other projects whatsoever in all of these documents and press conference. So I think this is important to highlight because

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what we can see that the President-elect, he wants to fulfill his campaign promises and there is no other project that he has expressed that he's against.

<Q - Jason Mollin>: Great. That's very helpful. Thank you. Thank you for doing the call because I think making sure this information is out there is very hopeful. Thank you.

<A>: Thank you. Thanks for the questions.

## Operator

Thank you. We'll take our next question from Marcelo Telles with Credit Suisse.

<Q - Marcelo Telles>: Hi. Hello. Hello, everyone. Thanks for the initiative to do this call. I have two questions. The first one is still regarding the, you know your infrastructure exposure. Is it possible to quantify what is the amount of projects that you have under construction right now that are directly related with the federal government and our question related to that is when we think about your other projects with state and local governments, right, what is the possibility that the federal government could actually intervene in the transfer of the Participaciones Federales to states and municipalities so that they can honor the payment of their projects. S I think this is an area that was not very clear to me, if there is a risk there or maybe no risk whatsoever. So it'd be interesting to understand that.

And my second and final question is on a bigger picture, we are seeing the upcoming government. I've been into public consultation to decide on a matter that is very technical right, which is the construction of an airport. How do you think of your business going forward? And how are you assessing risk? And what is the impact this is going to have on your risk appetite down the road? And if you anticipate this type of initiative from the upcoming government, how much can that affect business confidence and the outlook for the economic growth, and what you are doing to navigate these waters? Thank you.

<A - Rafael Victorio Arana de la Garza>: Well, thank you, Marcelo. Let me just give you the big numbers about the mix that we have on the stake further and infrastructure that's related. As you know we brought in from Interacciones MXN 210 billion, 35% of those were basically infrastructure projects that are short-term loans, one to two years for specific purposes like schools, hospitals and water treatment plants, so very specific projects with specific purposes. And the money and the federal transfers that go on unfunded are specifically for those purposes. So they are not for general purpose, that's for specific purposes. So, that's the big number.

Once the group – the private sector in different stages of evolution, so ultimately will give you an exact breakdown. We will work on it and we will provide that follow-up with you and with the rest of the table. And but what is important to notice is, short-term loans. But what is important to notice is in short term loans 35% of the total book of Interacciones was what infrastructure loans. But when you add everything up on the state federal loans, this really goes down to around 80% of the total exposure that we have with the government.

That's the first one. What is quite important to notice is that the way the trust have been built and the way this process has been structured are fully complied with the law and are already been fully advised and registered on federal project. So, by law those trusts need to be funded and saved. In the future as I mentioned before there's a change in that...

[Technical Difficulty] (32:30-32:45)

<A - Rafael Victorio Arana de la Garza>: [indiscernible] (32:46) As I mentioned, I mean, if there is any potential risks the potential risk which will come in from any new changes on the law that comes from now on. But it's already been said, and established we are fully guaranteed by the way we have the structure of the loan.

So, we don't see any risk and any potential retroactive process on those. So that's the first. Gabriel will also abound on this but let me just go into the risk appetite. And the risk appetite has to do a lot

with the potential for stability of the loan. As you know the since the transparency level and the discipline level has been in effect, we have seen quite a reduction of the margins that they were used and charged on these processes, so the

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load factoring quite efficient and really beneficial for the state and municipalities by reducing the rates for the state and municipalities needs to pay.

So that has been ongoing for three years. So I would say that, if they – we don't see any need to change anything of that because, they have been quite efficient for the state, so that makes that anyone who goes for the bidding process needs to have a pretty rich funding costs in order to be able to sustain the margins on the new loans that will be contested in this bidding process.

So if we see those loans to be – that we will like to have because there is good profitability on the loans and potential additional businesses, we will continue to do so as we have been doing in the past. As you have seen the numbers of Banorte in the past, the rate of growth of the government has been slowed down quite a bit because under federal government, we go in and out on the big loans with [indiscernible] (35:03) and CFE and this number on the state. With the price that we currently have, we are very comfortable with the size and with the profitability of the book that we have and the municipalities. And the infrastructure deals, we honestly think there are going to be lot of good opportunities coming in to that portion. That is fully the main driver of why we brought the Interacciones capabilities to be brought into Banorte. And let me know – Gabriel will also abound on these law processes.

<A - **Gabriel Casillas Olvera**>: Thank you, Rafael. Hi, Marcelo. Let me assess first -- let me elaborate a little bit on the public consultation on technical matters on how we assess risk in this. I mean Rafael has already talked about the appetite. And then I move to the possibility of intervention on the Participaciones Federales on the participation. So on the first one, I mean, as I said, I'm sorry to insist but I think it's very important, there are no other infrastructure projects [indiscernible] (36:14) we'll have expressed he is against, so this is I think clear.

Second aspect, if he wants to use public consultation for technical decisions, yes, we have already seen that. Now so we think he's going to use them for other infrastructure project in particular, well, maybe because he wants to build a lot of things like these southeast train around the Mayan Ruins or the trans-Isthmus train. But if he decides to do a public consultation on this project, we think he [indiscernible] (36:48) at the beginning of the project because, I mean, these are campaign promises he wants to honor. So we don't think that he is going to use public consultation in the middle of the process so because he wants to deliver these things. So in this context we don't see like any other public consultation in the middle of our process now that he might probably use these consultations, yes, he probably will use them.

Now [indiscernible] (37:11) sentimental growth. Well, the airport decision the affected sentiment in a way because contrary to what AMLO always, people knew at the airport will be cancelled. People believe that airport was not going to be cancelled. But now that we are adjusting for this, I'm sorry to insist, then and all the projects that he has said he will cancel. So I think this is the key aspect once again.

Moving to the federal participation regime, I mean, this is something very important. I mean, as you know, we are a federation and states are sovereign and they can actually do the tax collection of their own taxes. Part of this is the income tax, both corporate and personal income tax. So in a way, that is our constitution was for states to do their own tax collection. However, because this was not very popular to do for governors, they decided to make this federal part and they took this responsibility to the federal level so that the government collects taxes. I know you know the process, but let me elaborate just to finish. So the government collect these taxes on behalf of the state government, and then they give them back their money, of course charging a commission.

So in this context, these monies, these tax collections belongs to the state. So changing the participation scheme would be something really, really major. It would be changing the constitution to change our country from a federal government to a centralized government like Colombia or Chile. This is something super major. I am not sure definitely that even the congressmen and senators of Morena, but now they are going to have probably more governorships. That won't allow that to happen.

Now more importantly, once again if you review all the documents and speeches of [ph] Orlando (39:14) for a long time, not even his latest book – if you go to the book he wrote back in 2012 or in 2006, he has never talked about this. So I don't think he's going to go into this participations thing.



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<A - **Gabriel Casillas Olvera**>: Yeah. He is doing a reengineering of public spending. They are scraping some of the social programs. They are doing a lot of things in terms of public spending engineering in order to be able to accommodate for the new social programs he wants to implement. But in this reassessment or reengineering of public spending, they are not doing anything at all with this public participation scheme. As I said, [indiscernible] (00:39:57) a major change that I'm not really sure even Morena guys would be willing to do and that he has not mentioned at all this issue.

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

<Q - **Marcelo Telles**>: Thanks, Gabriel. Can I just follow up on your answer to my second question, Rafael and Gabriel?

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

<Q - **Marcelo Telles**>: I mean, we have a situation that, I mean, if you look at your 10-year yields in Mexico, they went up by more than 100 basis points, I think it's almost 9% [indiscernible] (00:40:29), which means your cost of equity has increased substantially, right?

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

<Q - **Marcelo Telles**>: Not to mention the higher equities premium that you would expect for [ph] maximum (00:40:41) equities. So how that translates into your business and in terms of your required return for lending, I mean, now you – do you think in this environment requires for you to increase your required credit spreads due to these latest developments or you are still not making any changes to your pricing at this point? And I say that in general, I'm talking about [ph] of course (00:41:11) the corporate, corporate side, but I'm also talking about the consumer side, thinking of your business as a whole.

<A - **Rafael Victorio Arana de la Garza**>: Yes, and thank you, Marcelo. As you know, we are heavily managed and [ph] in this bank by the (00:41:30) risk-adjusted margin and we keep that number very, very closely. As you mentioned the cost of capital, [ph] that's right (00:41:39). That's a reality. But also, since the past, all our strategy has been really to increase the relationship that we have with our clients and the corporate and the commercial and the SMEs and things like that and also on the consumer.

So when you've [ph] driven to the consumer book (00:41:59) and I will give you the same example that I gave you some of your colleagues so that I will use the same example. If we just follow the issuance of a credit or a car loan, we will get roughly MXN 1,000 of potential net income on that loan. But if we also have the possibility to sell the [ph] insurance further (00:42:31) and also the checking account and a very basic savings account, [indiscernible] (00:42:37) of the client rises to close to MXN 2,000.

So when we look at the risk appetite and especially on the consumer and also on the commercial and corporate, and my colleagues here can [indiscernible] (00:42:51) that we look at the – really at the relationship and sometimes you will see that the re-pricing of the consumer is kind of [ph] a thrill (00:43:02). But the reason for that is that the NPL continues to be very low on the car loans and mortgage side and the risk-adjusted margin, as we have been able to [ph] return (00:43:13) that number because of the trending costs that we have been able to maintain in a very disciplined way, I mean, [ph] the funding lines by growing (00:43:22) around 12% to 13% and the credit lines have grown around 8%. So that give us a bolster on that.

Obviously, on the [ph] new funding (00:43:35) loans, especially on the commercial and the corporate and the government loans, [ph] whatever (00:43:41) we price on a contractual terms, those numbers will immediately rise, and that's not exactly the case on the consumer. And the consumer, you can see which [ph] plans do you (00:43:52) going to serve basically since we do authorize and preauthorize [ph] credits, (00:43:57) we could manage the potential risk and the potential returns on the margins on a one-to-one basis.

On the corporate and the government and I would say a commercial, I will also ask my colleagues here to see the view that [ph] – my thinking (00:44:20) is that they will continue to do exactly how they have been doing that, keeping a very straighter eye to the risk-adjusted margins and adjust to the rate of growth to the market. But we don't see any big

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changes on them because the companies that we would like to have is the companies that we have. Maybe there will be some opportunities because maybe some people would get a little bit tired about the potential risk on the market. We saw that when that happens when Mr. Trump get into power, so we were almost kind of left alone and we were able to really choose and pick the best companies to do business with.

But essentially, as you mentioned, obviously, the cost of capital has gone up, the risk-adjusted margin has to be followed very carefully. The way we apply not just the capital, but also the funding is of critical importance for us. We review that every single week on a meeting to know exactly how we're going to sign, not just the capital, but also the funding in order to keep based upon the risk, the risk-adjusted margins, [ph] where we are. (00:45:40) And I don't know if my colleagues would like to add something and...

<A - René Gerardo Pimentel Ibarrola>: Yes, Rafa. This is René Pimentel from Corporate Banking again. Yeah, we're very much focused on relationship-based banking. And basically, the pricing model that we have is not on a deal-to-deal basis, it's not transaction based, but based on the client relationship. So, we actually – every time we're pricing a deal, we look at the full relationship. Of course, it is very important the cross-selling aspect and trying to increase transactional-based products with the client or other type of products and services that are commission based.

So, definitely, as Rafa was mentioning, we look at the client on a whole relationship basis. In terms of the margin, we're, I mean, constantly re-pricing based on this exercise that I have explained. But as I would like to mention that almost 85% of our portfolio in Corporate Banking is variable rate based and only 15% is fixed rate. So this is how we manage the portfolio.

<A - Rafael Victorio Arana de la Garza>: Hello, Marcelo, if we answer your question, as you mentioned and we understand this, this is a business perspective, but I think we have all the right tools to manage the transition into this high interest rate based upon what we have been building in the past four years, there is really our relationship banking process and value in the whole perspective of the client. And another piece that is critical to Banorte that we have been really outpacing the market is that our Transactional Banking piece has been more and more being able to bring a lot more funds, chit funds to our relationship with the client, and we were lacking that capability four years ago. Now it's a [ph] prime differentiation of work (00:47:38) in the market.

If you look at how the client [ph] related off (00:47:43) and the quality of the client that we serve on the Transactional and Corporate and Commercial Banking allow us to really have this kind of [ph] whole (00:47:50) relationship that René was mentioning. If you're talking about the – if you ask me what's your view about the potential rate of growth, I think, honestly, as Gabriel was mentioning, we will be looking 8% to 10% also for the next year based upon the projection that we have on the GDP. With a different mix? Yes, maybe with a different mix.

And remember that we also have the Apollo business that we are just barely touching the client base now that we are able to really do business with them. [ph] The Annuities – the Pension company show they reached full. (00:48:32) The Annuities business is growing nicely because we have been buying for four years also adding margin to that portfolio based upon the potential lending process on that. The Insurance business is growing at a rate of 20% net income per year.

So we have a [ph] level (00:48:52) of capabilities, and the more we know our client and the more analytics we're putting in place with our clients, the more comfortable we know which clients we can lend to and of what size we should lend to them. So I would say that that – I would love to say that we cannot do a complete change [ph] of course, (00:49:13) but honestly, we will continue to go deep in what we have been doing in the past years.

<Q - Marcelo Telles>: Thanks, everyone, for your answers. Appreciate it.

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

## Operator

Thank you. We'll take our next question from Claudia Benavente with Santander.

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**<Q - Claudia Benavente>**: Hi, good morning. I just have a follow-up question [indiscernible] (00:49:41). I agree with Gabriel about [indiscernible] (00:49:46). However, I'm wondering about [indiscernible] (00:49:49) tax income. And I understand the current – the new administration has already announced that they would like [indiscernible] (00:50:01) revenue, and this represents about 50% of total [indiscernible] (00:50:05) received by the states and municipalities. I understand as well that [indiscernible] (00:50:10) already cover the full outstanding debt, because I was wondering if [ph] this happens, (00:50:21) if it would trigger [ph] that Banorte will be (00:50:21) reducing their position in states and municipalities? Thank you.

**<A - Rafael Victorio Arana de la Garza>**: Claudia, I will pass to Gabriel. Let me just – and I think you wrote a very extensive paper about the potential exposure on the way those two [ph] – the 32 and 23 branch (00:50:50) works and how the potential exposure on risk. And honestly, [ph] we were deep (00:50:58) following the rationality of your numbers and we certainly agree with you on that part. I mean, the size of the reductions needed to be extremely [ph] going almost to none (00:51:09) in order to affect the potential capability of the states to serve – our municipalities to serve [ph] the debt. (00:51:18)

The other part, and I will go to Gabriel, but I would just wanted to introduce the process. Yes, as we mentioned since the beginning on the acquisition process of Interacciones, the rate of growth of the other parts of the book will outpace the rate of growth of the government book. And so, we are going to concentrate a lot more in infrastructure [ph] that are short term (00:51:40) loans. The total size of the portfolio will be moving into [ph] downside (00:51:49) compared to the total book. But the profitability of the book will increase because we see more potential on the infrastructure deals [ph] from recurrent (00:51:58) state and federal books. So, yes, you will continue to see a reduction on the percentage of the government book in the total book of Banorte.

And I will ask...

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

**<A - Rafael Victorio Arana de la Garza>**: ...Gabriel to fill in.

**<A - Gabriel Casillas Olvera>**: Thank you. Hi, Claudia. Yeah. As Rafa had mentioned, yeah, we are – we would agree with your assessment that it would have to be a massive reduction of these, let's say, resources that go to state in order to really [ph] put in danger all the credit subject all that and (00:52:38) they'll have these as collateral.

Now, having said that, very important once again to highlight two things. The major source of [ph] values (00:52:47) of a state government, yeah, it's federal money, of course, but remember, this is not in strictly sense federal money, as I mentioned a little bit earlier. This is [ph] – what we call it this (00:53:00) money, a big chunk of it around 80%, 8-0, are part of the money that correspond to [indiscernible] (00:53:07) tax collection that they should be doing.

So, changing that part, I see it as almost being possible because of two things: one, because you'll have to change the Constitution. The government is almost able to do that, but to change the Constitution and changing the regime of the country from federal republic to centralized republic. The second would be to – once you do that – or the second reason why we don't think it's going to happen is because [indiscernible] (00:53:38) has not said this at all. On the contrary, he wants to promote regional and state development, and his home state [indiscernible] (00:53:45) he wants to [indiscernible] (00:53:47) want to give even more sovereignty to the state, so this would be against his own ideology. So I think that that [ph] almost (00:53:56) a very key aspect of this.

Now, having said that, if the government in the spending in reengineering is [ph] to scrapping this branch of fraction 33 – and 33 (00:54:05) as you know that branch [ph] or fraction 23 (00:54:09) is almost the black box of discretionary spending on [indiscernible] (00:54:14) This is something that is really decided by the federal government. And as you know, it has to be approved by the legislators, particularly by Congress. So, yeah, they could change this [ph] fraction 23 (00:54:29) of course. And I do think they're scrapping it at least on paper right now in order to accommodate for the new social programs that the new government wants to implement.

Now, in this context, I mean, they're right now in [ph] fraction 23 (00:54:47) MXN 156 billion, and at the beginning, they were saying they could scrap it all. And now they're saying they are scrapping around MXN 13 billion to MXN 18

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billion out of that. So, they're scrapping things [ph] from many part, (00:55:01) but one thing they cannot touch is participations because of what I mentioned. And in this context, scrapping [ph] the other transfers (00:55:09) really don't put at risk the payment of government.

So, really, I do think that, one, I fully agree with your numbers, it will have to be massive – a massive cut in order to put in danger the credit. And number two, I think it's almost impossible to see that happening because of the [ph] federal pact. (00:55:31) I hope that I answered your question, Claudia.

<Q - **Claudia Benavente**>: Yes. Thanks a lot, Rafa and Gabriel. [ph] It was really helpful. (00:55:38)

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

## Operator

Thank you. [Operator Instructions] We'll take our next question from Siva Natarajan with Trilogy Global Advisors.

<Q - **Siva Natarajan**>: Yeah, hi. Can you hear me? Hello?

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

<Q - **Siva Natarajan**>: Oh, yeah. Thank you. Yeah. Thank you. So my question is also related to the way the state and municipality projects are funded, and thanks for a lot of explanation on that. But if the federal government wants to hypothetically cancel one of these projects, can they specifically cut funding to that particular trust or do they have to pretty much cut tax, I guess, refunds back to the state? Can you explain or any view on that?

<A - **Rafael Victorio Arana de la Garza**>: Yeah. Let me start it. And as you know, once the federal budget is presented and assigned, then that money is committed on the life of the project. In order for this to be canceled, you need to go backwards on the already approved by the lower chamber and the upper chamber on the budget process. So we don't see that as a real possibility.

I don't know, Gabriel, if you want to....

<A - **Gabriel Casillas Olvera**>: Yeah. [ph] And thank you so much. (00:57:08) Just one thing here, I mean, these projects are not the ones that are based upon participations [ph] are not really for that (00:57:19) projects. [ph] Our projects are (00:57:20) decided by state and [ph] use (00:57:23) their own money. So, in this context, even declaration cannot intervene in this. Of course, they can always please cancel that to the governor, but I'm not sure the governor would like to do that. And [indiscernible] (00:57:35) will be extremely costly in many [ph] cases, (00:57:38) particularly what I have been saying that it will be a major blow to the [ph] federal pact. (00:57:44)

So changing – as I said, changing the country regime from federation to a centralized republic is something [indiscernible] (00:57:54) had mentioned, and [ph] and on the contrary, (00:57:57) he has mentioned that he wants to promote development, regional development with sovereignty of the state because this is what he wanted for his home state [indiscernible] (00:58:06). Actually, one of his major comments for a long time [indiscernible] (00:58:11) has written around 18 books, more or less, and in all of them, one of the big issues is that his home state [indiscernible] (00:58:19), they have been extracting a lot of [ph] oil and that the Israel (00:58:23) government has not given back what the state was supposed to get.

So, in this context, definitely, it's completely outside his ideology and intervention would mean very important change [ph] that he has not (00:58:40) mentioned. And honestly, I don't think it will happen. The likelihood I think is very close to zero, honestly.

<Q - **Siva Natarajan**>: Yeah. And one follow-up, what is your exposure to direct federal projects, if any?

<A - **Rafael Victorio Arana de la Garza**>: Excuse me, could you repeat it, because there was some noise on the line?

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<Q - Siva Natarajan>: Yeah. What is your exposure to direct federal project, not the state and municipalities, but direct federal government project? Do you have direct exposure there?

<A - Rafael Victorio Arana de la Garza>: No. I mean, we have – on the federal side, we have mainly to company, to Pemex or CFE, those are the really the recipients of the – they eventually end up in a specific project, but we don't – sometimes we go to a specific project that in generally add to the company, to Pemex or CFE. That's where the money goes.

<Q - Siva Natarajan>: Right. Great. Thank you.

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

## Operator

Thank you.

<A - Felipe Duarte Olivera>: So just – it's Felipe. Just regarding some comments that Gabriel has just mentioned, I just wanted to say regarding project, infrastructure project, you have two layer in the law that actually cover these provisions. The first one is that, at federal level, the government builds the federal budget or the budget for the entire country taking aside all the items that cannot be taken from or that are already used for federal projects or obligations that the government has.

And then there is a second level layer, legal layer, at state level when the states build their own budgets. So you have those two legal layers that go to these projects, and we believe that this will not change in the future.

## Operator

Thank you. We'll take our next question from Scott Kenworthy with Samlyn Capital.

<Q>: Hi, it's [ph] Marshall Porter (01:01:12) for Scott. I just have a question, AMLO has talked – he was against the airport, and these were some of the campaign promises he talked [indiscernible] (01:01:22) he also talked about cracking down on corruption. And I think there's 17 or 18 governors, former and current, that are on trial for some form of corruption. What happens if it's proven that the government that was [ph] in this trust (01:01:39) from the federal level went to the state level, the resources weren't allocated properly and, for whatever reason, whether the project wasn't built or through some sort of actions of corrupt individuals, the money never got to its end destination? Like, is there recourse on the bank or the money going to the state instead of the project? Is there a dangerous [ph] precedent (01:02:04) that could be set if it found out that a school or a bridge or a railway that was supposed to be built with federal, like, transfers never got built? Like, what – he clearly wants to make an impression on some these things, like, how should we think about this?

<A - Rafael Victorio Arana de la Garza>: I think [indiscernible] (01:02:31) one specific way [indiscernible] (01:02:36) as I mentioned, for federal [indiscernible] (01:02:38) lending to the companies and usually are for general purposes or end up in a specific project, some things like that. But you have to be very vigilant. It's exactly what the ratings for the state and what the ratings for the [ph] money (01:02:55) and what's the rating for the companies, in a way, that that's the way you consider to lend or not to lend.

And in a way, that really shows the capability and the cleanliness of the state. Honestly, when there have been these cases that you mentioned, there has been a deep follow-up by the Ministry of Finance and many authorities to immediately go and see exactly what was the performance of the state where the money is. But that's completely different about [indiscernible] (01:03:39) that money is going to be paid or not. That's completely in an – that could end up in a restructuring or refinancing of the process, yes. But the commitments always have been paid in the past.

Maybe there's [ph] a call (01:03:56) for refinancings but always in a way that it is flexible for both parties, for the state and for the bank. So that has happened in the past, yes, and that has been the process. And every time it happens, the

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law becomes stricter and there's a lot more transparency, and that's what [ph] really mainly the (01:04:20) discipline and transparency law what [ph] was the issue for us. (01:04:25)

So we're in a much better state. The reason what you mentioned about the governors is the result of this follow-up process that is more and more [indiscernible] (01:04:35) much more and more discipline.

<Q>: So, if let's just say hypothetically there was an exposure to a state where the governor was – perhaps there was some sort of individual within the state finance position was found to be corrupt and some of the money didn't get to where it was meant to go, would you take a provision for that, like, what...

<A - Rafael Victorio Arana de la Garza>: No. Now, let me just give you a real example of that. There's a state in Mexico that has exactly what you described. That state is Veracruz. There was a full refinancing of the debt. More provisions were needed. There was a full restructuring of that, and that's ongoing and it's been in accordance with the capability of the state. But the process for – the legal process continues in – but the payment for the bank and the need for provision is exactly there was no [ph] affectation announced for that profit (01:05:37).

<Q>: Okay. Thank you.

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

## Operator

Thank you. At this time, we are showing no further questions in the queue. I would like to turn the conference back over to Jose Luis Muñoz for closing remarks.

## Jose Luis Muñoz

Thanks, everyone, for joining. This concludes your call.

## Operator

Thank you. Ladies and gentlemen, you may now disconnect.

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