Itaú Unibanco

International Conference Call - First Quarter 2017 Earnings Results

May 4th, 2017

Operator: Good morning ladies and gentlemen, welcome to Itaú Unibanco Holding conference call to discuss 2017 First Quarter Result.

At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session and instructions will be given at that time. If you should require assistance during the call, please press the star key followed by zero.

As a reminder, this conference is being recorded and broadcasted live on the investor relations website at: www.itau.com.br/investor-relations. The audio webcast works with Internet Explorer 9 or above and Chrome, Firefox and mobile devices (iOS 8 or above and Android 3.0 or above). A slide presentation is also available on this site. The replay of this conference call will be available until May 10th by phone, on +55 11 3193-1012 or 2820-4012 – access code **1775156 #**

Before proceeding, let me mention that forward-looking statements are being made under the safe harbor of the Securities Litigation Reform Act of 1996. Actual performance could differ materially from that anticipated in any forward-looking comments as a result of macroeconomic conditions, market risks and other factors.

With us today in this conference call in São Paulo are **Mr. Candido Bracher**, Executive President and CEO (Chief Executive Officer); **Mr. Caio Ibrahim David**, Executive Vice President, CFO (Chief Financial Officer) and CRO (Chief Risk Officer), and **Mr. Marcelo Kopel**, Investor Relations Officer.

First, **Mr. Candido Bracher** will comment on 2017 first quarter result. Afterwards, management will be available for a question and answer session. It is now my pleasure to turn the call over to **Mr. Candido Bracher**.

Candido Bracher: Good morning everybody, it's a pleasure to be with you to talk about our first quarter results.

I would like to begin in **page 3**, before going to the results actually, to talk about an important evolution in our governance. It is related to our risk appetite. This is a framework we've been using since 2009 and which had an important evolution now. One which has been prepared for more than one year, it's approved by the Board of Directors, it is based on our Statements, which includes, I mean, being an ethical institution aiming at having high and growing results with low volatility by means of a long-lasting relationship with clients and with a well distributed funding.

From this statement, we derive our principles of risk management, which are based on sustainability of results and customer satisfaction, on a broad risk culture internally, pricing adequately our risks, an adequate diversification of our risks, looking to have operational excellence, and an asset behavior in all parts of our operations.

From there we come to 5 dimensions of risk which we measure: capitalization risk, liquidity risk, composition of results, operational risks and reputation. These risks are distributed in 43 metrics, which we follow permanently. All of these metrics have limits or warning levels, which are followed monthly by the Board of Management of the bank and daily by the executives of the bank.

Going now to **page 4**, first quarter results. In the recurring net income reached R$ 6.2 billion in this quarter, increasing 6.2% when compared to the last quarter, and 19.6% when compared to the same period of the previous year.

Recurring net income from Brazilian operations was 6 billion in the quarter, 7.3% higher than the previous quarter and the same 19.6 higher than the previous year. So, the annualized return on equity was 22% in the first quarter for the consolidated figures and 23.5 for Brazil alone.

Regarding credit quality, we observed stability on the 90-day NPL ratio for both consolidated and Brazil operations when compared with the previous quarters, and both indicators improved when compared to the same period of the previous year.

On **page 5** we demonstrate the evolution of our returns on the shareholders' equity and return on assets. We can observe relative stability in the last quarters, consolidated ROE increasing from 20.7% to 22% in the first quarter, in the consolidated, and in Brazil from 21.7% to 23.5% ROE.

On **page 6** we see our results in more detail and we highlight here on a quarter on quarter variation, first: 5.8% reduction in operating revenues, which is mainly explained by an 8% reduction in the financial margin with clients. I will get into details in this reduction later; B) a favorable variation in the results for loan losses and impairment, down 17.9% in the quarter and; C) a significant decrease in non-interest expenses, mainly explained by the typical seasonality of the period.

So, if we compare now with the first quarter of 2016, we have a 2.7% decrease in the financial margin with clients; a solid growth of 7% in commissions and fees, plus results from insurance; a significant reduction of 28.5% in the result for loan losses and impairment; and an increase of 0.8% in non-interest expenses. This 0.8%, if we adjust the exchange rate impacts, would be 4%... would have been 4%, still below the inflation in Brazil for the period. As a result of all this, recurring net income grew almost 20%, 19.6% year over year.

On **page 7** we separate our results in Brazil and in Latin America. So, as you may notice, our results composition is still heavily concentrated in the Brazilian operation, and Latin America net income was approximately 3% to 4% of our total net income in the past quarters, as has been stated.

Page 8. In page 8 we show our business model. Here, as you know, we divide our results in those deriving from credit and from trading, from insurance and services, and the last, fourth column, the results of our excess capital.

Here some important points to observe. First, that a large portion of our results are related to insurance and services, we have 53% of our total net income in the first quarter 17 from these two activities. In credit results, we have stated our goal of delivering a return equal or higher than our cost of capital. In 2000… in the fourth quarter of 16, this figure was… the ROE was 8.2% for credit, now it has evolved to 13.2%, so we are already getting closer to our goal of having this figure equal or higher to the cost of capital.

It's worth mentioning that we have observed in this first quarter a reduction in the financial margin, in the insurance and service products, when compared to the fourth quarter of 16. This reduction is mainly related to lower activity in the acquiring business, which is seasonally very strong in the fourth quarter, and the lower SELIC rate that impacted mainly our margins in liabilities.

Going to **page 9**, our credit portfolio, we see that we are not yet observing growth in our credit portfolio, but we can mention that we have observed an acceleration in origination concentrated in our retail operation in this month of March and April, for individuals and for SMEs, not for the wholesale part.

Page 10, here we see our financial margin with clients. We see on the gray line on the top the SELIC rate, and then the green line is our financial margin, which decreased from 10.8% to 10.3%, and in the blue line we have our expended financial margin to include the FX of loan losses, which has improved from 6.6% to 6.7%.

The compression in the margin was mainly related to the reduction of the SELIC rate in the period. This SELIC reduction impacted mainly our liabilities margin, but also impacted the remuneration of our working capital. We were also impacted here by a seasonal effect related to a lower number of calendar days, this impact was approximately 311 million. And there was an increase in our risk-adjusted financial market with clients, from 6.7% to 6.6%, mainly explained by the provision for loan losses, which improved in this quarter. We expect this trend of improvement in the risk-adjusted financial margin to continue in the following quarters.

Page 11, we show our financial margins with the market. This was another good quarter in the financial margins with markets, and, as you can notice, the one year moving average has been quite stable in the past few quarters, improving slightly.

Moving now to credit quality, in **page 12**, we see that the 90-day nonperforming loan ratios were stable, for both consolidated and Brazil figures, for Latin America there was a 10 bps increase in the quarter.

Regarding our Brazilian operations, we observed again reductions in the 90-day nonperforming loan ratios for individuals and SMEs. We are expecting individual NPLs to slowly improve until the end of the year. For SMEs, we expect to finish 2017 in a similar level as that of the fourth quarter of last year, but with some volatility during the year. Regarding large corporate 90-day NPLs, we expect to continue to observe volatility here related to economic groups that could get overdue for more than 90 days.

On **page 13**, moving to the 15 to 90 day NPL ratio, this one increased to 3.2% from 2.5% in the quarter with increases in both, Brazil and Latin America operations. Here we must separate the corporate side from SMEs and individuals.

In SMEs and individuals, as you can see in the lower chart, this is seasonal move, I mean, always in the first quarter we have this increase in the 15 to 90 day NPL ratio, which is due to the accumulation of taxes and the credit card bills of the purchases of the last quarter of the year.

In the corporate segment, we had an increase of 1.3% in the quarter, mainly due to two corporate clients from the construction sector. Both these cases were already mapped and adequately provisioned.

In the scenario of crisis migrating to 90-day nonperforming loss, we should transfer provisions for potential losses to our provisions for overdue loans, which went in a reduction of our coverage ratio.

On **page 14**, NPL creation, we see, I mean, this figure continues to reduce, it has reduced to 4.9 billion from 5.3 in the quarter, reaching the lowest level since the first quarter of 15. This was mainly driven by a consistent improvement in retail banking NPL creation.

On **page 15** we see the amount of our provisions for loan losses. This provision for loan losses reached 5.4 billion in the quarter. It is important to tell you that we don't think this figure should be annualized and compared with our guidance because it has a nonlinear distribution among quarters. We expect this figure to remain more or less in the same magnitude next quarter, but reducing significantly in the second half of the year.

So, we reiterate our guidance for provision expenses, which implies that we expect reductions in our provision expenses for the following quarters. And regarding cost of credit, which is in the lower chart of the slide, we expect the improving trend to continue in the following quarters.

Page 16, total provisions by type of risk, consolidated, we see that we had a slight increase in total allowance to 37.6 billion from 37.4, and this includes 1.9 billion of provisions related to financial guarantees provided, which are allocated in provisions for potential losses. This provision for potential losses has, as its main component, provisions in the wholesale segment, as you can see in the breakdown which is provided.

In **page 17**, this appears again, when you see that the coverage ratio for this large corporate is at 553%, for retail 165%, the combined coverage ratio at 231%. This is the highest coverage ratio since the merger with Unibanco and, when analyzing the expended coverage, we have enough allowance to cover all 90-day nonperforming loan and all of the negotiated portfolio.

It is important to point, once again, that this very high coverage level is due to the anticipation of provisioning we have been doing recently, especially in the wholesale segment. And when these credits, when the these credits become overdue, the consumption of this coverage is expected to happen.

On **page 18** we see our commissions & fees and results from insurance. We observe the reduction compared to the fourth quarter 16, which is due to typical seasonality related to credit cards, and when compared to the first quarter 16 we see a significant increase of 6.3%.

Page 19, we see the noninterest expenses. We see, as I mentioned, an increase of 0.8% when compared to first quarter 16, which, excluding the effect of foreign exchange of our operations abroad, the increase would have been around 4%, which is a level still below the Brazilian inflation.

We see that the number of employees increasesd this quarter, but this was mainly due to a larger number of the replacements of available positions. And in terms of branches we've had a net reduction of 100 branches in Brazil, as part of the permanent process of reviewing our branch network. We expect this reduction to reach approximately 180 branches this year, so we have concentrated disclosures in the first quarter. In parallel, we have opened in the quarter nine digital branches and we expect to open 20, a little over 20 digital branches in the whole year.

Going now to our core capital ratio on **page 20**, we had a reduction in our Basil ratio in the quarter mainly due to higher deductions related to the phase-in schedule of the Basil 3, and also by the additional payment of interest on noncapital. Each of this phenomenon impacted our capital in 0.7%.

If we consider full application of the Basil 3 rules and the impacts of the consolidation of the operations of Citibank in Brazil and the payout, which we have increased from 25% to 40%, our common equity Tier 1 would have reached 13.8 in the quarter, as it is highlighted in this slide.

So, coming to our guidance now, on **page 21**. We reiterated the guidance for the year, but going item by item, the total credit portfolio we expect to end the year around the middle of the guidance we have provided. Financial margin with clients, ex-impairment, here we think that we will be within the guidance, but in the lower part of the range. Results from loan losses and impairment, we reaffirm the guidance and our expectation is to be in the middle of the range. In commission & fees and results from insurance operations, we also reaffirm the guidance and expect to be in the upper side of the range. And non-interest expenses, we also reaffirm the guidance and our expectation is to be in the middle of the range by the end of the year.

Here, in **page 22**, it is just to present the new model, which we announced last week, regarding changes in the disclosures of discounts granted, which was… these changes were previously classified as a component of our financial margins with clients and will now be classified as a component of the cost of credit in the managerial income statement. This change is in line with our management information regarding discounts granted.

Page 23, just to show the performance of our stock, stock market performance, and to highlight the increase in the dividend yield observed in 2016 and 2017.

With this I close the presentation and we open now for your questions.

Q&A Session

Operator: Ladies and gentlemen, we will now begin the question-and-answer session. If you have a question, please, press the star key followed by the one key on your touchtone phone now. If at any time you would like to remove yourself from the questioning queue, press star two.

Our first question comes from Philip Finch, UBS.

Philip Finch: ... now given that the SELIC is set to come down further, is there a risk that your current guidance for financial margin or NII growth is too optimistic?

My second question is regarding your capital position, where we are seeing continued improvements of your common equity tier 1 ratio at around 15.4% and, as you just mentioned, your Basil 3 fully loaded core tier 1 at 13.8%. Do you think you have too much capital? And if so, what do you plan to do with the excess capital, especially as you showed just now in your presentation on slide 8 that the ROE on excess capital is only 9.4%? Thank you.

Candido Bracher: Okay, thank you Phillip. I'm not sure I heard all you first question, but if I understood well, you asked whether we are not being too optimistic in our forecast of the financial margin with clients, given that the SELIC rate is bound to fall more in the year. Was that it?

Philip Finch: Yes, exactly. Thank you.

Candido Bracher: Okay. So, here we don't think we are being too optimistic here, it is a fact that we expect the SELIC rate to fall more, but there are other effects which will also happen, I mean, especially, I mean, the question of the working day…of.. the number of days in the quarter, which is not going to be repeated. So, I mean, looking in detail at our forecast, I mean, we came to this figure in the lower part of our expectation.

What changed mainly in relation to when we made our forecast, when we provided the guidance, were two aspects. One was the SELIC rate, as you mentioned, I mean, which is the average rate will be significantly lower than what we had anticipated, and the second one are the changes in credit cards operations in Brazil, regarding the new resolution, the installments and the revolving credit. So, these two effects bring our expectations from the middle of the range to the bottom of the range, but we think, I mean, this is a reasonable expectation now.

On your question concerning capital. Yes, I mean, 13%…to… 0.8% is probably more capital than would be needed, should the situation remain as it says. But there are some changes which are possible and even expected, I mean, we expect the Brazilian economy to recover at some point in time, and this will…, we'll use more capital in this, and there is still some regulatory uncertainty, Basil IV, I mean, it has been postponed, but it has not been forgotten. So, we don't know yet what will come from this, we think it's prudent to have capital to cover for these two potential events.

I should also mention, I mean, that…, the deal with excess capital, I mean, we have also taken two measures: We have elevated the payout ratio and we continue to buy back shares in the market.

Philip Finch: Just a follow-up on that, please, are you considering at all to do a special dividend going forward?

Candido Bracher: No, we are not considering to do a special dividend going forward, I mean, what we consider is to continue our buyback activity.

Philip Finch: Okay, perfect. Thank you very much indeed.

Candido Bracher: Thank you.

Operator: The next question…*Desculpe*… The next question comes from Carlos Macedo, Goldman Sachs.

Carlos Macedo: Thank you. Good morning, good afternoon Candido, gentlemen. I have a couple of questions. First question, you talked about margins, but one of the things that was a little bit higher than the, say, the straight-line guidance for the quarter was your market-related income at R$ 1.8 billion. Your guidance for the year is R$ 6 billion, annualizing this you'll be ahead of that. How should we think about that? Are you positioned with your ALM so that you will be benefited from the decline in rates and as a result that can offset part of the pressure that you are getting on your book otherwise? Should we think that maybe your results on the trading line over the market-related income line will be higher than the guidance that you gave in the fourth quarter?

Second question, when you look at your auto loan book, right, it used to be a very significant part of your overall book, and now it's small slitter. It's something like this is happening in some of your competitors, but there are few competitors - I think Santander here stands out - that has been expanding this book at a meaningful pace and finding demand and being able to lend. Is there something that they are seeing and you're not? I mean, can you talk a little about the dynamics in the auto segment? I think that's the best way to put it. Thank you.

Candido Bracher: Carlos, thank you for your questions. Your first question, regarding market-related income, as you know, I mean, this is possibly the line most difficult to forecast, I mean, is the one with the highest volatility. We have been able to keep a reasonable stability in the results there, but this is not guaranteed. So, the fact that we are slightly above the average expected for the year, which would be 1.5 billion, is a reason for comfort, but does not authorizes us yet, I mean, to forecast a higher margin than the 6 billion which we have, the guidance we have provided.

As to being positioned in our ALM for the reduction of interest rates, yes, we are adequately positioned there. But this is already included in this forecast.

On the auto loan book, yes, your observation is correct, we have been reducing our auto loan book. This reduction is not necessarily that we have been, I mean, we have been making less loans, but we have also been financing a smaller portion of the acquisitions, and so this explains also the reduction of this book.

Another explanation why we are not growing here, especially to compare with other banks, is related to the fact that we have our operational agreements here in Brazil with Fiat, and so the growth, the behavior of our portfolio has close connection with the performance of Fiat sales, which has not been outstanding recently.

Carlos Macedo: Okay, thanks. But you're not seeing… just a follow-up on the second question, you are not… are you seeing increased demand, is the quality of the applications that you receive improving, approval rates are going up, are going down, has there been any change recently?

Candido Bracher: I think that has been no change. I mean, it stopped worsening, but it has not started to improve yet.

Carlos Macedo: Okay, thank you. Just one follow-up question under the first question, Candido, sorry. You mentioned that you are positioned in the ALM, that your guidance for the market-related income considers that. Would that mean that, you know, once your rates are stabilized at a much lower level, we should think about a lower market-related income because you won't be able to benefit from the decline in rates or would that be looking forward too much?

Candido Bracher: I think this would be looking forward too much. It is possible, as I told you, I mean, this is one of the most volatile lines that we have to forecast, but I wouldn't risk making any further forecast there.

Carlos Macedo: Okay, thank you.

Candido Bracher: Thank you.

Operator: The next question comes from Jorge Kuri, Morgan Stanley.

Jorge Kuri: Hi, good morning everyone. Candido, could you expand a little bit on the comment you mentioned about origination in the retail segments starting to pick up? You know, given that unemployment continues to go up and your overall job situation isn't great and consumer leverage is still pretty high, what type of demand are you seeing from what client segment? What type of products? Just some more color on that would be great.

And the second question is just a simple one. What interest rates is embedded in your guidance for financial margin with clients? What SELIC rates are you forecasting for the year? Thank you.

Candido Bracher: Thanks Jorge for the questions. In the…, concerning the demand, I mean, the origination of credit that we have witnessed an increase in individuals and in SMEs in March and April. We were surprised by that, positively surprised, we were not expecting, it's among the first signs of a recovery that we are seeing. They are… I mean, all the lines of products are concentrated in the higher segments of income, in individuals and in the higher segments of companies also, but we have not changed our models, we have not changed our risk appetite yet due to this, we are keeping the same policy we had before.

And what interest rate do we… your second question, we are in line with market expectations in the fall of the SELIC rate, I think that our average rate considered for the year is 10.2%, 10.4%.

Jorge Kuri: All right, thank you very much.

Candido Bracher: You´re welcome.

Operator: The next question comes from Jason Mollin, Scotia Bank.

Jason Mollin: Hello everyone. Thank you for the opportunity to ask a question. Mine is related to the profitability announces that Itaú discloses by businesses as presented in your business model slide, page number 8. Can you talk about this breakdown specifically? How is the credit business segment defined? How are income costs related to credit define are calculated here? For instance, are fees related to credit included in the credit business or in the services segment? What about distribution channel costs, like the branch network, or another way of having this could be, what about transfer pricing in this analysis?

And then, as a corollary, you showed the value creation or destruction based on the capital and the earnings, I guess, in the segment. Can you talk about your cost? I'm imagining you have an implicit cost of capital estimate in that calculation. You talked about that in the past, maybe you can update on your thoughts of the cost of capital given that the 10-year Brazilian sovereign bonds in reais is down, not at historical lows, but pretty close. Thanks.

Candido Bracher: Okay, thanks Jason for your question. I will start by the cost of capital by saying that, I mean, this is a figure we do not disclose even because, I mean, we have different costs of capital for different activities according to their VAR. But what I can tell you is that our average cost of capital is slightly above the cost of capital we have been seeing in buy-side and sell-side houses in general.

So, how is this structured? We have a full product approach here in this chart. So, the commissions, the credit fees, every fee related to credit, comes under the credit column here. You can see here, we have commissions & fees 2.4 billion in this quarter in the credit portfolio and the fees related to credit. We try to separate completely each of these activities. In the trading column, we have…, in the trading column we have exclusively the trading activity with market risk. For instance, in the credit column the interchange in credit cards comes also under this column.

And, I mean, so, insurance & services are the fees we receive which we think are unrelated, have no direct relation with credit. Everything from asset management, for instance, comes here, fees in our funding activity, our liability funding comes here, cash management, private banking, investment banking. This is what comes… all advisory fees come here.

Jason Mollin: And in terms of cost, in terms of transfer of pricing, it must be difficult to allocate. We've seen… had all banks, so it's difficult to allocate cost. But how do you allocate the cost for the branch network? I mean, is this… I mean, I'm imagining this is somewhat of an art rather than just the science. This is an analysis to the best of your ability I guess. Is that an accurate statement or this analysis is very clear-cut?

Candido Bracher: No, this is a very accurate statement in the sense of two things, first, transfer risks, transfer risk is made of market rates. We use market rates for everything, there are no spreads charged, for instance, by our funding activity from the business areas. It all goes and comes at market rates. And the cost allocation, I mean, we have, I mean, extensively invested in having precise cost allocation, but, as you know, there are always many different ways to allocate cost. What we can say is that we have had stable criteria for this for a few years already now, and so this is perfectly comparable quarter after quarter.

Jason Mollin: Very helpful. Thank you.

Operator: The next question comes from Tito Labarta, Deutsche Bank.

Tito Labarta: Hi, good morning. Thanks for the call. A couple of questions also. Sorry to follow-up on your margins, but just, you know, compared to some of your peers, they didn't face as much margin pressure as you did, and you mentioned there was lower interest rates and some seasonality as well. So, given the seasonality, does that mean that your margin can maybe pick up a little bit as that sort of subsides in the next quarters? And are you seeing some more pressure on spreads on loans? I just want to understand, you know, kind of the difference between you and your peers. They are still maybe repricing some of their loans and you don't have loans to reprice. I just want to get a little bit more color on that, I guess why you suffered a bit more on the margins than your peers.

And then the second question, also following up on loan growth, I mean, you talk about origination picking up, but loans are still falling. So, where do you think the inflection point is? When will you start to see loan growth picking up? Could that be in the second quarter, is it still more third quarter? Just want to get a sense of when you see that pickup in origination actually increase your loan book. Thank you.

Candido Bracher: Thanks for your question Tito. Before, I would just like to complement on Jason's question regarding our criteria for cost allocation: The criteria we use in this column is the same criteria which we use for our internal evaluation of all the areas of business, of remuneration and everything. So, it's consistent across the board.

Now coming to your question Tito on our margins. We have not yet started to feel a pressure on spreads. The reduction of margins, because of the SELIC reduction, is especially in our funding activity, it's in the margin of liabilities and not in the margins of assets.

As I said, I mean, we have seen some recovery in the activity of credit in March and April. This is still in the very beginning, we are not expecting anything vibrant for the next quarter, but I think we may start to see some more intense recovery in the second half of the year.

Our guidance here is from 0 to -5%, so I said that we are looking at being closer to the -5% figure, we had in this first quarter a -2.7% compared to the first quarter of last year, so we still see margins going down a little bit during the year. But this is exactly what our guidance reflects.

Tito Labarta: Okay, thank you, it's very helpful.

Candido Bracher: Thank you.

Operator: Ladies and gentlemen, as a reminder, if you would like to pose a question please press the star key followed by the one key on your touchtone phone now.

This concludes today's question and answer session. Mr. Candido Bracher, at this time you may proceed with your closing statements.

Candido Bracher: I would just like to thank everybody for your presence and for your questions. This was the first time I've presented the quarterly results of the bank, I expect to come back in the next quarters also with positive results, as I think has been this one. Thank you very much.

Operator: That does conclude our Itaú Unibanco Holding earnings conference for today. Thank you very much for your participation. You may now disconnect.