Puerto Rico Banking Industry Report

ISSUE XLI • January to June 2019

INSIDE THIS ISSUE:

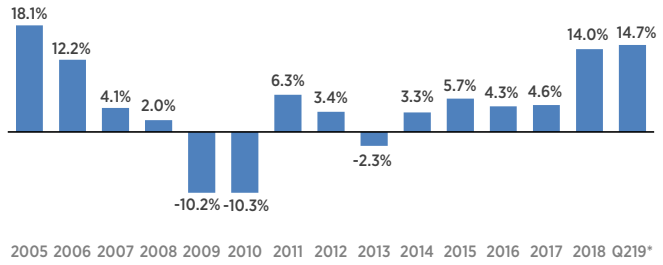
The local banking industry showed strong profitability in Q2 2019, closing the first half of the year with an annualized Pre-Tax ROE of 14.7%. The second quarter of 2019 is the fifth consecutive quarter that local banks report double digit profitability levels on a consolidated basis. This level of profitability had not been seen since prior to the onset of the 2006 economic downturn. Local banks have been reporting robust earnings growth despite operating in a challenging market. Notwithstanding year-over-year improvements in some economic indicators, others remain weak. The Economic Activity Index increased by 5.8% in FY 2019 after six consecutive years of decline, but as of June 2019 it remained below pre-hurricane (August 2017) levels. In this issue we examine total deposits trends and banks' branch footprint. Total industrywide deposits reached $60.0 billion in 2009, falling by $14.9 billion or 25% to $45.1 billion by 2016. However, 2016 marks a reversal of this downward trend, with total deposits reaching $57.7 billion by the end of Q2 2019, an increase of $12.6 billion or 28%. On the other hand, the number of branches has declined steadily from 493 in 2009 to 296 at the end of Q2 2019, a decrease of 40% or 197 in the 10-year period. As a result, average deposits of branches have increased significantly in the past three years, from $141.0 million in 2016 to $194.9 million in YTD 2019. Given that physical coverage still plays a strategic role, banks will need to continue identifying opportunities to increase coverage and/or further reduce their footprint.

PROFITABILITY > "Local banks on a consolidated basis posted an annualized Pre-Tax ROE of 14.7%, the highest level of profitability since 2005" The local banking industry closed the first half of 2019 on a strong footing, posting an annualized Pre-Tax ROE of 14.7%. Additionally, Q2 2019 marks the fifth consecutive quarter that local banks, on a consolidated basis, report double digit profitability levels. These levels of profitability had not been seen since prior to the onset of the economic downturn of 2006.

This marked improvement in banking profitability has occurred despite the historically challenging operating market conditions in Puerto Rico. While some economic and fiscal indicators have been showing some modest improvement, many remain weak.

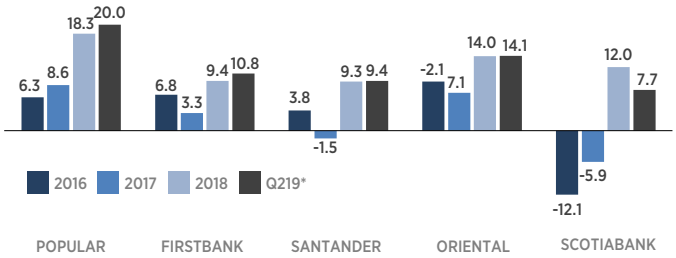
The Puerto Rico Economic Activity Index (EAI) increased by 5.8% in FY 2019, after six years of decline, but has yet to surpass pre-hurricane levels. The June 2019 EAI reached 120.3, still 0.8% below August 2017, month prior to the devastating impact of Maria. The short- and medium-term growth will largely depend on the amount and rate at which federal disaster dollars are disbursed, including upcoming Community Development Block Grant – Disaster Recovery (CDBG-DR) funds. Unfortunately, disaster federal funds have been disbursed at a slow rate, reflected in the lackluster performance of the economy. When it comes to the fiscal health of Puerto Rico, General Fund net revenues reached $11.4 billion in FY2019, an increase of $2.1 billion or 22% with respect to FY 2018. Furthermore, total retail sales reached $30.5 billion in the first eleven months of FY2019 (Jul. 2018 - May 2019), an increase of close to $1.8 billion or 6.1% when compared to the same time period in FY2018 ($28.7 billion). Auto sales totaled 110,131 in FY2019, an increase of 17,943 auto units or 19.5% with respect to FY2018. While the unemployment rate dropped down to a historic low of 8.1% in July 2019, the labor force participation remains chronically low at 41.7%.

FIGURE 1: Industry Pre-Tax ROE Trend (2005 – Q2 2019)[1]



* Annualized Jan. – June 2019 Pre-Tax ROE.

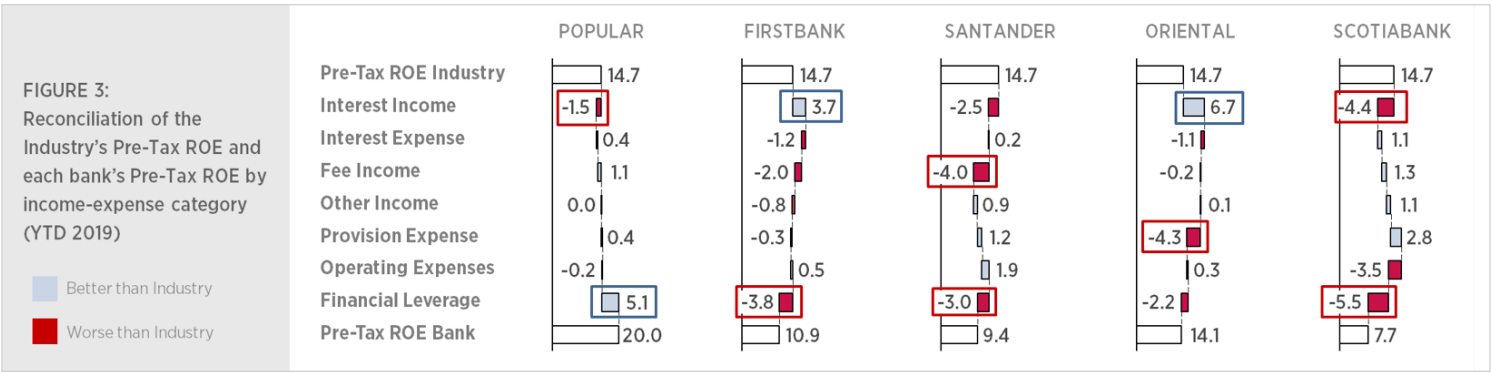
FIGURE 2: Pre-Tax ROE (%) Trend by Bank (2016 – Q2 2019)



* Annualized Jan. – June 2019 Pre-Tax ROE.

When analyzing profitability by bank, Banco Popular posted a Pre-Tax ROE of 20%. Popular's higher profitability vis-à-vis the industry is largely driven by a higher financial leverage, with an assets-to-equity ratio of 10.0 compared to 5.5 for the industry when excluding Popular. Additionally, as of the end of Q2 2019, Popular's total assets have slightly surpassed the $40 billion mark, of an industry total of $69.2 billion, representing 59%. Oriental, which recently announced the purchase of Scotia, registered the second highest profitability, with a Pre-Tax ROE of 14.1%, followed by FirstBank (10.9%), Santander (9.4%), and Scotia (7.7%). Oriental's acquisition and merger of Scotia will solidify its local market position, significantly growing its mortgage portfolio share, its auto loan industry share, and its mortgage servicing business.

FIGURE 3: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (YTD 2019)



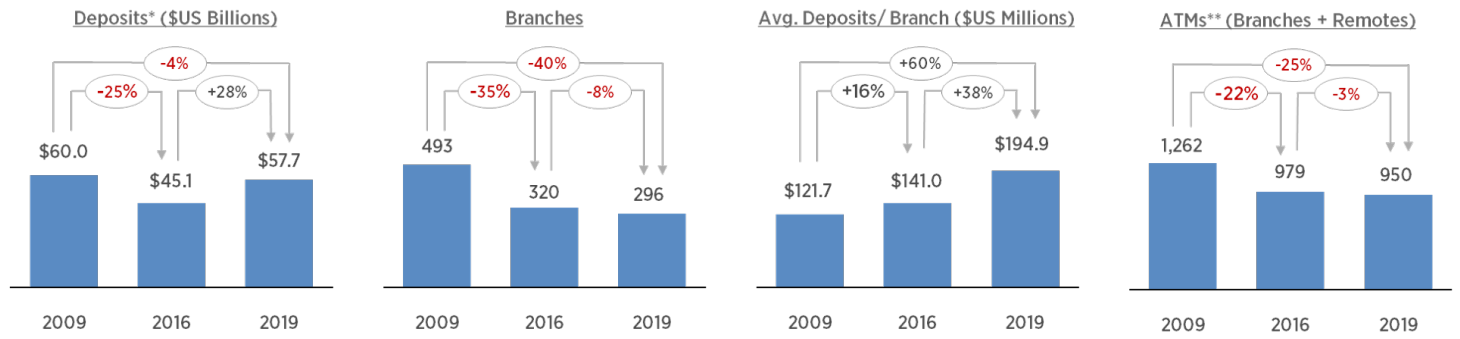
DEPOSITS AND BRANCH FOOTPRINT TRENDS > "While the downward trend of deposits has changed direction since 2016, increasing from $45.1 billion to $57.7 billion (+$14.9 billion or +28%) as of the end of Q2 2019, local banks' branch footprint has continued to decrease, dropping from 320 branches to 296 (-24 or -8%). Consequently, during the same time period, average deposits per branch have increased from $141.0 million to $194.9 million (+$54.0 million or +38%)"

Puerto Rico's economic, fiscal, and demographic crises have fundamentally changed the island's banking and financial landscape. While trends regarding banking assets, deposits, loans, and profitability are often at the forefront of discussions regarding the reshaping of the banking sector, less frequently are changes in banks' branch footprint examined. To address this gap, this issue will be devoted to analyzing the brick and mortar presence of local banks, historical and forward-looking trends, and branch network optimization, among other related topics.

The protracted economic downturn that has wiped out more than 20% of Puerto Rico's Gross National Product (GNP) and close to 280,000 jobs since 2006, has also impacted the Puerto Rico financial industry and changed the local banking sector landscape. However, as will be expounded on later, 2016 marks the reversal of the downward trend in assets and deposits. Moreover, profitability levels have also recovered and have become comparable with US banking industry profitability levels for the first time in ten years.

The number of banks, through several waves of consolidation, has declined significantly in the last decade, decreasing from 10 in 2009 to 4 in 2019. A major wave of consolidation occurred in April 2010, with the Federal Deposit Insurance Corp. (FDIC)-assisted transactions involving Westernbank, Eurobank and R-G Premier Bank. Subsequently, Oriental acquired and merged Banco Bilbao Vizcaya Argentaria (BBVA) in 2012, while Popular and FirstBank, in 2015, purchased certain assets and most deposits of failed Doral bank. Most recently, on June 26, 2019, Oriental announced the acquisition of Scotiabank for $550 million.

FIGURE 4: Selected Banking Indicators, trend 2009 – 2016 – 2019



Source: Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico
Notes: *Total deposits in Puerto Rico branches of all private commercial banks. Data from the OCFI of Puerto Rico was used to only include deposits held in Puerto Rico. FDIC data, used throughout the remaining of this report, includes deposits in U.S. mainland branches. **ATM data as of March 2019.

Local banks on a consolidated basis held $60.0 billion in total deposits in 2009, decreasing to $45.1 billion in 2016, a decline of $14.9 billion or 25%. (see Figure 4: Deposits). As aforementioned, in 2016 there was a reversal of the downward trend of deposits. Total deposits rose to $57.7 billion as of the end of Q2 2019, an increase of $12.6 billion or 28%. Post-disaster federal funds and other recovery and reconstruction funds flowing into the island following Hurricanes Irma and Maria further spurred the growth in deposits.

When analyzing banks' branch footprint, we see a continued drop from 2009 to the present, unlike deposits which began to recover in 2016. There were 493 bank branch offices in 2009, dropping to 320 in 2016, representing a decrease of 173 branches or 35% (see Figure 4: Branches). While deposits began increasing from 2016 onward, branch offices have continued their decline, reaching 296 in YTD 2019. This points to greater efficiency on the part of local banks as they hold and manage more assets and deposits with a smaller branch footprint. It should be noted that banks have not increased automated teller machines (ATMs) to compensate for branch consolidation. The number of banks' ATMs decreased from 1,262 in 2009 to 950 in YTD 2019 (see Figure 4: ATMs). Given the increase in deposits and continued decrease in branches, we see, accordingly, an increase in the average deposits per branch. At the end of 2016, branches in Puerto Rico held on average $141.0 million, compared to $194.9 million as of June 30, 2019, an increase of $43 million or 34% (see Figure 4: Avg. Deposits/ Branch). From 2016 to YTD 2019 Popular and Oriental have experienced the largest increases in their branches' average deposits, with 49% and 38%, respectively. On the other hand, Scotia saw a decrease of 4%. It is important to note that efficiency improvements have also been driven by the greater use of digital and automated processes, and the push to online acquisition and transaction processing channels by most banks.

Given these trends, several questions arise: Are there still opportunities to further reduce the branch footprint or has a low point been reached when it comes to the brick and mortar presence of local banks? Finally, are there discrepancies around the regions of Puerto Rico in terms of the concentration of branches, with some regions having an excess and others needing more? These questions will be explored in the following section.

Branch footprint reduction is likely to continue after the announced acquisition of Scotia by Oriental since there are 3 Scotia branches at less than 200 meters distance from an Oriental branch (Los Colobos, San Patricio and Plaza del Sol) and 3 more at less than 400 meters distance (Plaza las Américas, Plaza del Caribe in Ponce and Caguas). Despite the continued shrinkage of branch networks, banks are still highly dependent on customer segments that rely on the physical presence of banks, look forward to branch interaction, and/or are not comfortable with digital and online banking. One third of Puerto Rico adults are more than 60 years old and cash is still an important transaction method used by local businesses and individuals, particularly outside the metro area. As a result, branch footprint optimization will continue to play an important role for banks to gain market share and improve efficiency levels.

BRANCH FOOTPRINT OPTIMIZATION > **"Given recent deposits trends, it is important that banks identify opportunities to increase coverage as well as areas where further consolidation is required"** In Figure 5 we can see the percentage change in deposits and in the number of branches between 2014 and 2018 of Non-Metro municipalities[2] of Puerto Rico with more than one bank branch, as well as the estimated deposits per branch. Among these municipalities, all either maintained the number of branches or experienced a reduction during the 2014-18 period. Most of these municipalities saw their total banking deposits increase during this time period, with the exceptions of Arecibo (-2%), Juana Díaz (-4%), Isabela (-18%), Toa Baja (-29%) and, particularly, Las Piedras (-52%). As a result of this surge in deposits, a total of 6 municipalities have seen their average deposits per branch surpass the $100 million threshold. For example, San Sebastián's average deposits per branch increased from ~$60 million in 2014 to ~$101 million in 2018.

If the upward trend of deposits continues going forward, there may be opportunities for some banks to open new branches for the first time in many years and gain market share in specific areas of the Island. On the other hand, the fact that some municipalities with average deposits per branch below $60 million have experienced a total deposits reduction (i.e. Toa Baja and Juana Díaz) indicates that there may be further consolidation or branch elimination opportunities in certain parts of Puerto Rico.

As an example, let us look into the case of the municipality of Trujillo Alto to see if there may be potential for market share competition. This municipality experienced an increase of 15% in total deposits between 2014 and 2018, and there are currently four bank branches located in this municipality. Two of the branches are located by PR-181, the Popular one with total deposits of $164 million and the Scotia one with total deposits of ~$102 million (as of June 2018). This is not only a heavy traffic and commercial activity area, but it is also located between two high income "barrios" of Trujillo Alto, barrio Cuevas and barrio St. Just (with $228 million and $201 million total annual income, respectively). An attractive area from where to "steal" deposits share could be along PR-199, closer to barrio Carraízo (with the highest total income in Trujillo Alto) and to Cupey area (West of Trujillo Alto).

In summary, the local banking footprint has reduced significantly in the past 10 years, while deposits have been surging since 2016. Given these trends, local banks should identify opportunities to increase their physical presence where the demand merits it, and/or further consolidate their branch network. Deposits trends together with available census and geographical data can help banks further optimize the bank branch coverage in Puerto Rico.

FIGURE 5: Selected Branch Deposits Metrics by Municipality

Municipality (# of Branches)	Average Deposits per Branch ($'000)	2014-18 % Change Deposits	2014-18 % Change # Branches
Hatillo (2)	157	+85%	-50%
Cabo Rojo (2)	117	+25%	0%
Humacao (6)	110	+35%	-33%
Ponce (16)	107	+14%	-27%
Trujillo Alto (4)	102	+15%	-33%
San Sebastián (3)	101	+26%	-25%
Mayagüez (13)	98	+11%	-28%
Arecibo (5)	87	-2%	-29%
Cayey (5)	87	+31%	-17%
Vega Baja (4)	86	+43%	0%
Dorado (3)	84	+31%	-40%
Aguada (2)	80	+15%	0%
Aguadilla (7)	76	+20%	-13%
Barceloneta (2)	75	+35%	0%
Manatí (6)	74	+44%	-25%
Fajardo (4)	70	+15%	-33%
San Lorenzo (2)	70	+22%	0%
Guayama (4)	67	+1%	-33%
Isabela (2)	66	-18%	-50%
Yauco (4)	65	+9%	-20%
Canóvanas (3)	64	+24%	-25%
Las Piedras (2)	62	-52%	-33%
Aibonito (2)	57	+26%	0%
Yabucoa (2)	57	+23%	0%
Río Grande (2)	56	+33%	0%
Juana Díaz (2)	55	-4%	-33%
Coamo (2)	53	+41%	0%
Toa Alta (2)	50	+47%	0%
Peñuelas (2)	36	+14%	0%
Toa Baja (4)	27	-29%	-20%

Source: FDIC Summary of Deposits (SOD)

FINAL REMARKS > The resilience of the local banking industry has been made manifest when seeing the return to double digit profitability levels and the growth in assets and deposits since 2016, notwithstanding the still challenging operating environment. While there are some positive signs in the local economy, there is still a long way to go before experiencing a full-fledged economic recovery. The slow disbursement of Community Development Block Grant Disaster Recovery (CDBG-DR) funds and other allocated federal funds have hindered the local recovery. Furthermore, downside risks for the global economy are rising given the ongoing trade wars, lingering Brexit worries, and concerns over a US recession in 2020 or 2021. Whatever the future might bring to Puerto Rico, local banks are well equipped to withstand any heightened economic and/or fiscal turbulence given their strong capital levels, their more robust risk management systems, and more diversified credit portfolios.

SOURCES AND ENDNOTES Figures 1–14: Federal Deposit Insurance Corporation (FDIC), Office of the Commissioner of Financial Institutions (OCFI), 10-Q SEC filings, quarterly results calls, analysis by "Financial Institutions Practice" V2A.
(1) Citibank Puerto Rico financial data is not reported separately from Citibank US and, consequently, the bank is not included in the report analyses.
(2) We have excluded San Juan, Bayamón, Guaynabo, Caguas and Carolina given their size and the fact that they contain multiple micro markets, as well as the smaller municipalities that only have one branch, generally from Popular.

VISION TO ACTION

V2A, LLC.
www.v-2-a.com
(787) 919-7303

SAN JUAN
District View Plaza, Suite 401
644 Ave Fernández Juncos
San Juan, PR 00907-3122

MIAMI
1300 Brickell Bay Drive
Suite 500
Miami, FL 33131

SANTO DOMINGO
Capitán Eugenio de Marchena No. 11
Edificio Diego, Apto. 101, Primer Piso Ensanche La Esperilla
Santo Domingo, D.N., República Dominicana

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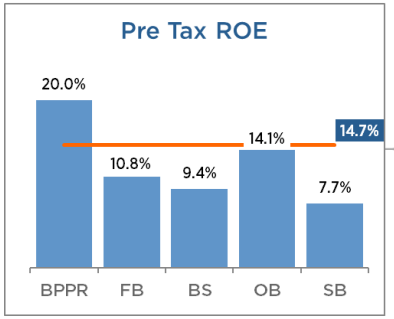
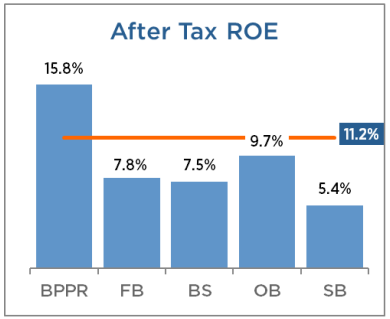
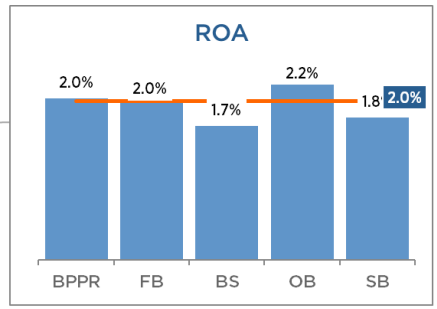
Juan Pablo González
Director, V2A
juangonzalez@v-2-a.com

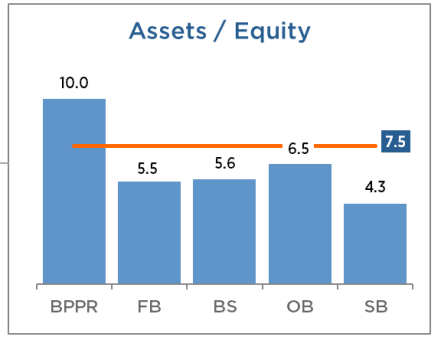
Xavier Diví
Engagement Manager, V2A
xavierdivi@v-2-a.com

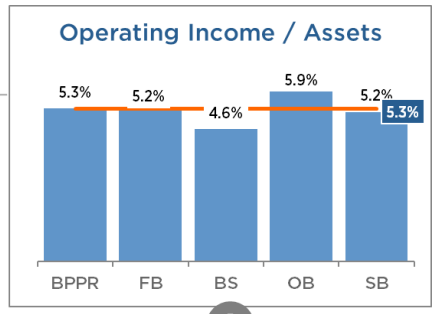
Olivier Perrinjaquet
Analyst, V2A
olivierperrinjaquet@v-2-a.com

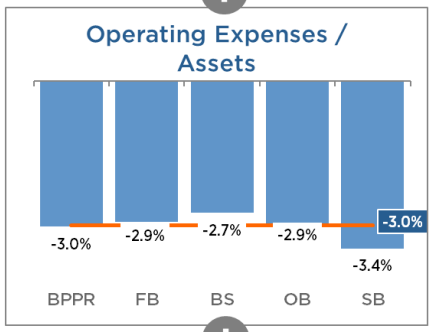


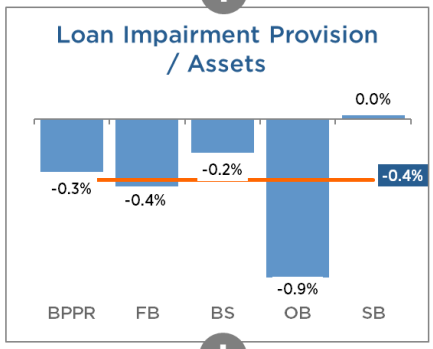


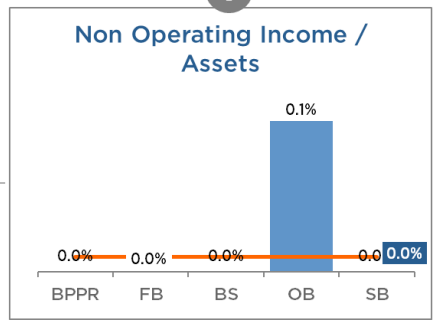


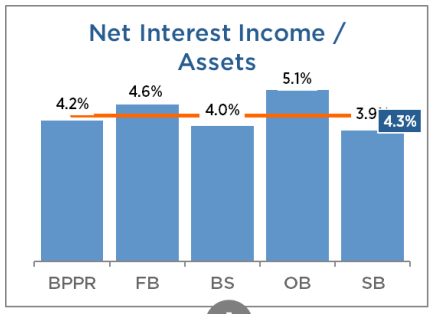


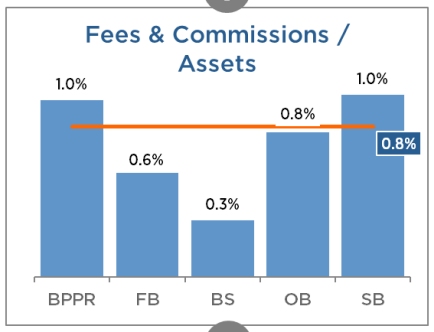


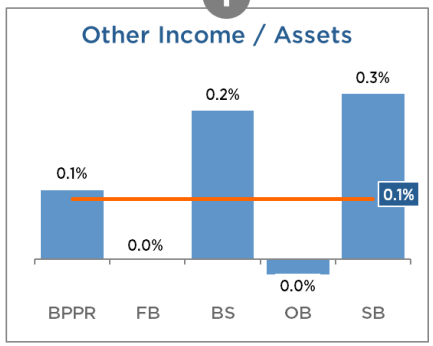










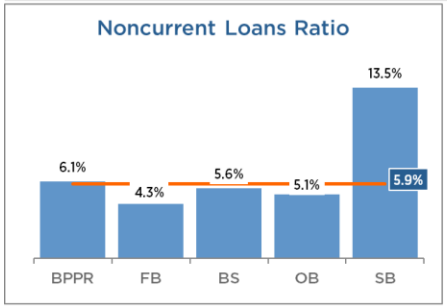


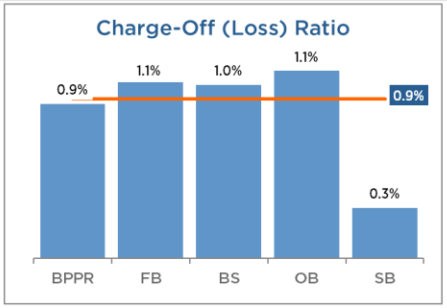
BPPR – Banco Popular de Puerto Rico
FB - FirstBank of Puerto Rico
BS - Banco Santander de Puerto Rico
OB - Oriental Bank and Trust
SB - Scotiabank de Puerto Rico

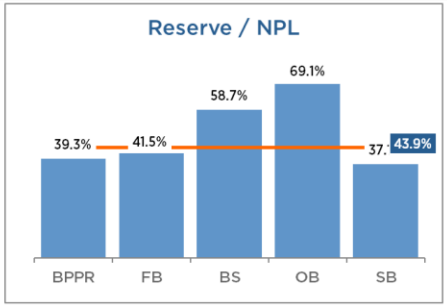
Industry

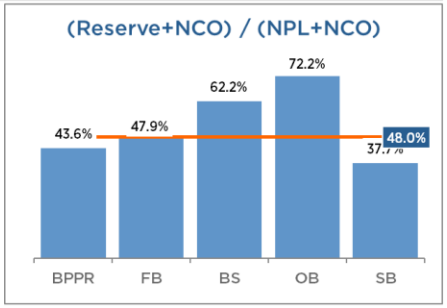
Note 1: Income and expense ratios are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

Asset Quality

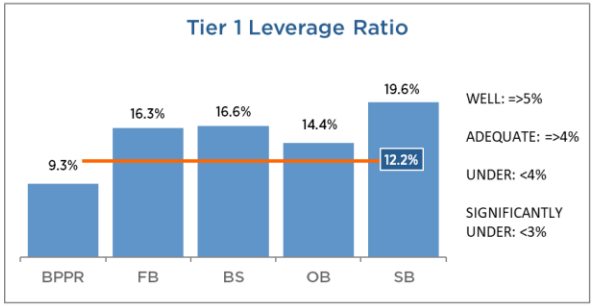


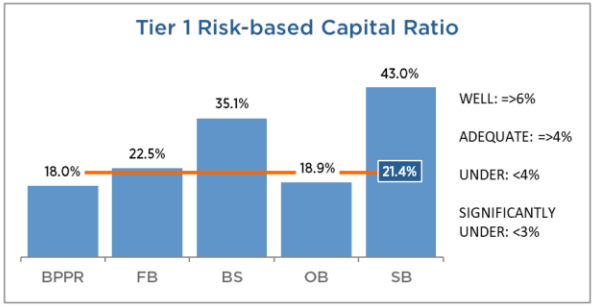


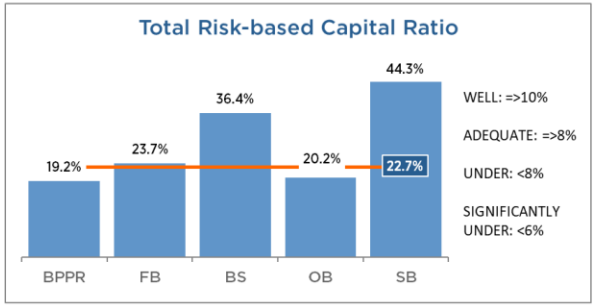




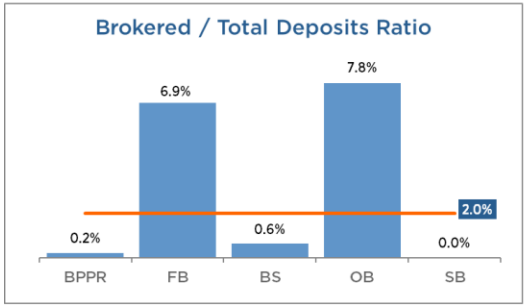
Capital Adequacy

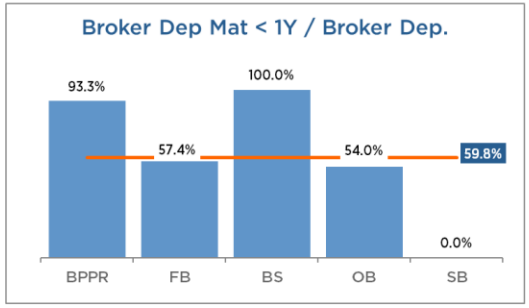




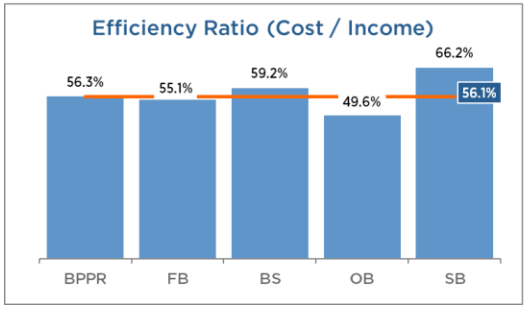


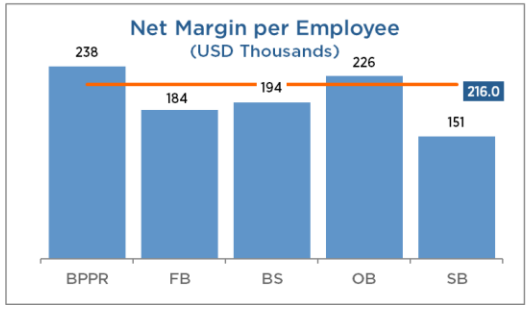
Liquidity





Productivity





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Industry

* Also referred to as Core Capital (leverage) Ratio by the FDIC

Note 1: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios.
Note 2: Income and expense ratios are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

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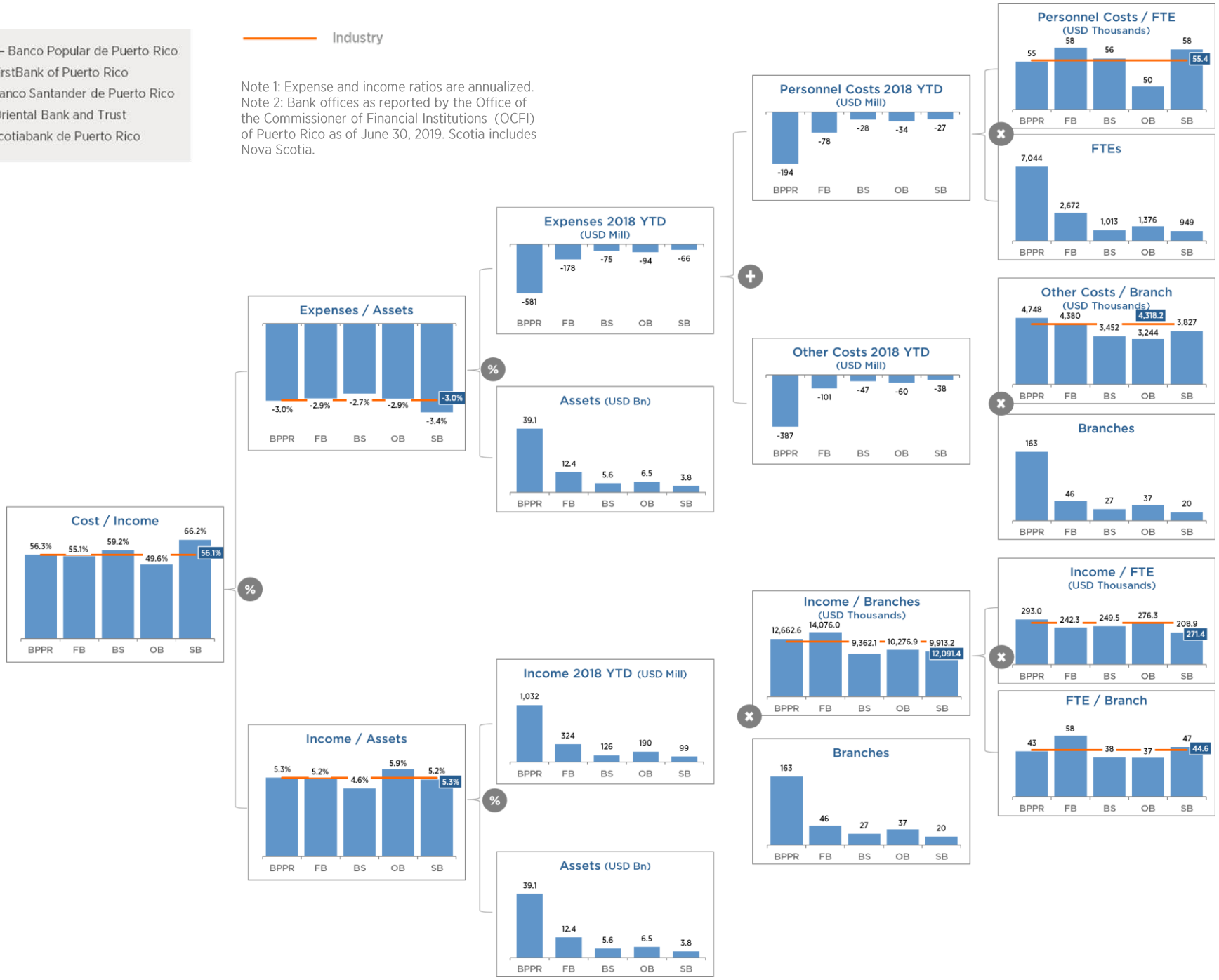
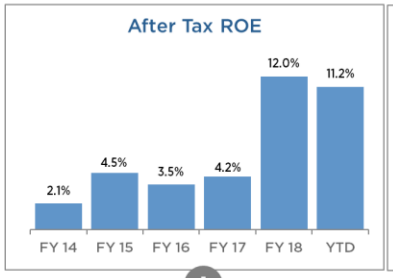
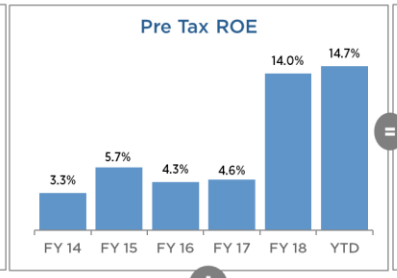
Industry

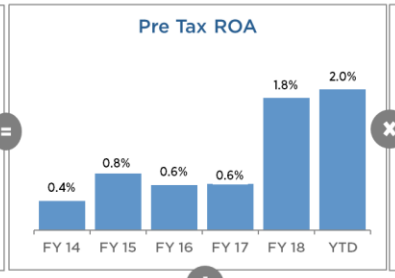
Note 1: Expense and income ratios are annualized.
Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of June 30, 2019. Scotia includes Nova Scotia.

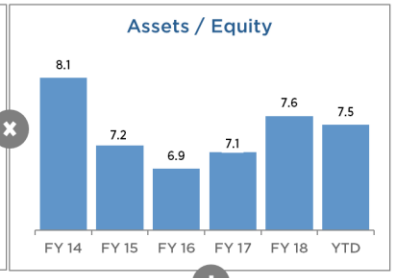


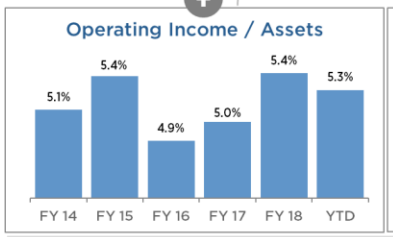
Profitability

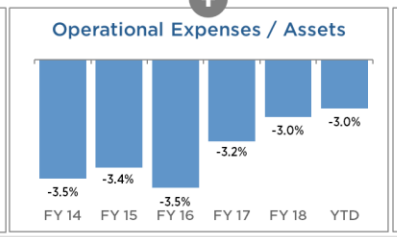


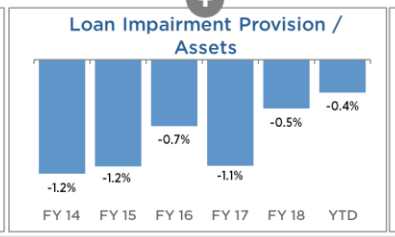


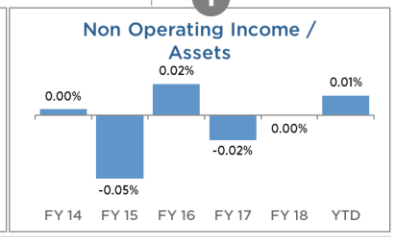




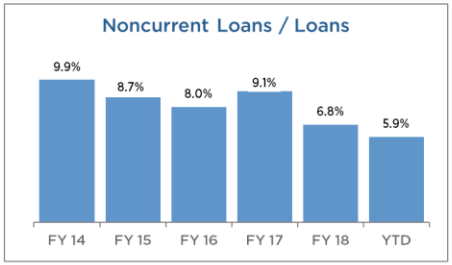


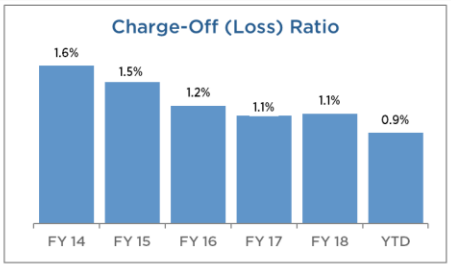


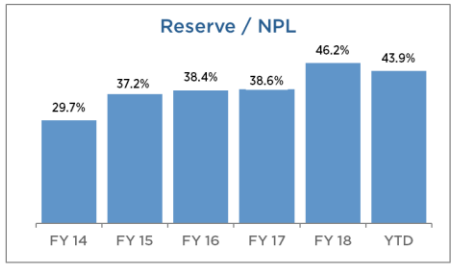


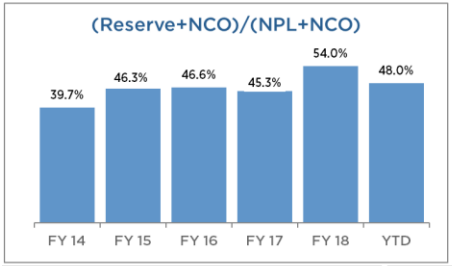


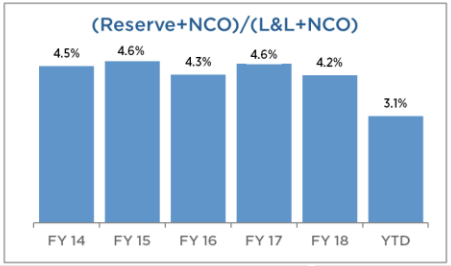
Asset Quality





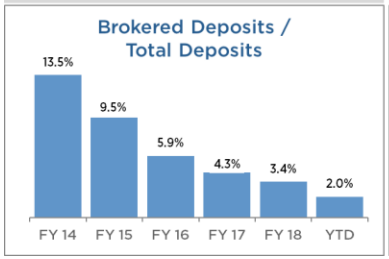




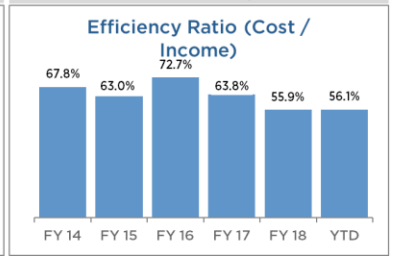


Note 1: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
Note 2: YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

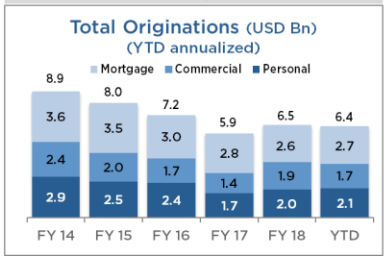
Liquidity



Productivity



Market Originations



Total Assets