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Grupo Aval Acciones y Valores S.A. (NYSE:AVAL) Q2 2023 Earnings Call Transcript

Published on August 18, 2023 at 10:41 am by INSIDER MONKEY TRANSCRIPTS in News, Transcripts

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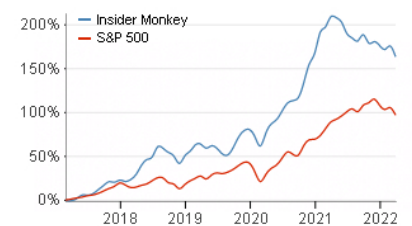
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Grupo Aval Acciones y Valores S.A. (NYSE:AVAL) Q2 2023 Earnings Call Transcript August 17, 2023

Operator: Welcome to Grupo Aval's Second Quarter 2023 Consolidated Results Conference Call. My name is Regina, and I will be your operator for today's call. Grupo Aval Acciones y Valores S.A., Grupo Aval is an issuer of securities in Colombia and in the United States SEC. As such, it is subject to compliance with securities regulation in Colombia and applicable US securities regulation. Grupo Aval is also subject to the inspection and supervision of the superintendency of finance as holding company of the Aval financial conglomerate. The consolidated financial information included in this document is presented in accordance with IFRS as currently issued by the IASB. Details of the calculations of non-IFRS measures such as ROAA and ROAE, among others, are explained when required in this report.

Banco de Bogota executed a spin-off of the 75% equity stake in BAC Holding International Corp. BHI, to its shareholders and Grupo Aval subsequently spun off its equity interest to its shareholders on March 29, 2022. On December 19, 2022, Banco de Bogota sold 20.89% of the outstanding investment of BHI through a tender offer. As of December 31, 2022, Banco de Bogota held 4.11% of BHI. This investment is reflected as an investment at fair value through other comprehensive income. Following the sale, the equity method recognized under the share of profit of equity accounted investees, net of tax equity method between April and November was reclassified to discontinued operations. For comparability purposes of this presentation, we have reclassified BHI's equity method for the second and third quarter of 2022 to net income from discontinued operations.

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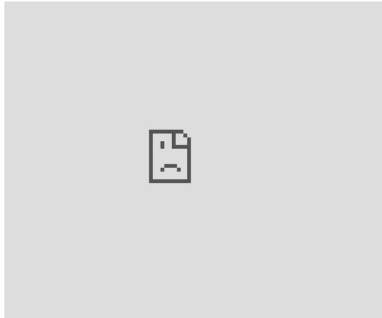
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Banco de Bogota's remaining 4.11% interest in BHI was disposed of in March 2023. This report includes forward-looking statements. In some cases, you can identify these forward-looking statements by words such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, potential or continue or the negative of these and other comparable words. Actual results and events may differ materially from those anticipated herein as a consequence of changes in general, economic and business conditions, changes in interest and currency rates and other risks described from time to time in our filings with the Registro Nacional de Valores y Emisores and the SEC. Recipients of this document are responsible for the assessment and use of the information provided herein.



Matters described in this presentation and our knowledge of them may change extensively and materially over time. We expressly disclaim any obligation to review, update or correct the information provided in this report, including any forward-looking statements, and do not intend to provide any update for such material developments prior to our next earnings report. The content of this document

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and the figures included herein are intended to provide a summary of the subjects discussed rather than a comprehensive description. When applicable in this document, we refer to billions as thousands of millions. At this time, all participants are in a listen only mode. Later we will conduct a question-and-answer session. I will now turn the call over to Mr. Luis Carlos Sarmiento Gutierrez, Chief Executive Officer.

Mr. Luis Carlos Sarmiento Gutierrez, you may begin.


Luis Carlos Sarmiento Gutierrez: Good morning. And thank you all for joining our second quarter 2023 conference call. On today's call, I will limit my intervention to three main points; an outlook of the economy, a summary of COP45 trillion approximately remains frozen in the Central Bank, thus causing a liquidity crunch in the financial system. Logically, this crunch resulted in a new surge of cost of funds, especially when comparing average funding rates versus sovereign debt yields. In sharp contrast, the global economy has continued to exceed expectations. Despite tight global monetary policy, economies around the world are trending upward. Additionally, a soft landing of the U.S. economy appears now to be the likelier scenario as market participants have revised downward the probability of a recession occurring in the coming months.


Meanwhile, in Colombia, high interest rates and persistent inflation have affected


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- Warren Buffett**
 Berkshire Hathaway
 \$293,447,417,000



- David Einhorn**
 Greenlight Capital
 \$1,491,303,000



- George Soros**
 Soros Fund





Billionaire Hedge Funds


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- George Soros**
 Soros Fund Management
 \$5,416,602,000


- Jim Simons**
 Renaissance Technologies
 \$77,426,184,000


- Leon Cooperman**
 Omega Advisors
 \$1,886,381,000


- Carl Icahn**
 \$4,198,712,000


- Paul Tudor Jones**
 Tudor Investment Corp
 \$6,160,740,000



downward domestic demand, affecting particularly the purchase of durable goods such as vehicles. In fact, the most dynamic sector during the quarter was government services that grew 4.4% and represented 15.9% of GDP. The least dynamic sectors in the second quarter were commerce and manufacturing, which accounted for 17.5% and 11.6% of GDP and contracted 3.7% and 3.1%, respectively. Gross capital formation decreased 22.2% for the same period, driven by weak investment in machinery and equipment. Based on the aforementioned, we anticipate the GDP growth in 2023 will be in the 1.5% area. As we had anticipated, annual inflation continues to decline. In July, inflation for the last 12 months decreased to 11.78%, down from 12.13% in June.

Notably, food prices, which were a significant driver of consumer price increases in 2022, have now become the main source of this inflation with a monthly variation of 0.22% in July. However, transportation has continued to exert upward pressures on the overall price index, resulting in a monthly reading of 1.07% in July. Going forward, market expectations and our own view indicate that annual inflation will continue to decrease over the next few months, reaching around 9% by year end. Notably, this number will oscillate depending on the government's commitment to increase the price of gasoline and maybe also of diesel, thus, decreasing very popular subsidies, which currently produce a deficit of COP2.5 trillion per month in an effort to reduce its gigantic debt with Ecopetrol.

Notwithstanding the inflation trend, in its meeting at the end of July, the Central Bank maintained the repo rate at 13.25% in a unanimous decision. Analysts and interest rate swap markets now point to the beginning of an easing cycle in September or October. In line with market consensus, we anticipate that the interest rate cuts will start during the fourth quarter eventually reaching a range of 11.5% to 12% by year end. June labor market data published by Dun reported that employees increased to \$23.1 million in June, which implies 1 million more jobs than a year earlier. The stronger than expected job creation pushed the unemployment rate down to 9.3%, which is 2 percentage points lower than the rate reported one year ago, particularly strong in public administration, defense, professional activities, transportation and entertainment.

These sectors combined accounted for 76% of the positions added. Going forward, as business activity decelerates, we expect weaker job numbers. As a result, we expect average annual unemployment in 2023 at a 11.2%, similar to 2022. Regarding the exchange rate on a year-to-date basis, the Colombian peso is the most revalued in the region with a 20% appreciation. A key driving force behind this trend appears to be a sentiment that the government will be unable to get its reform agenda approved through Congress in its current form. This sentiment prompted a reassessment of risk related to Colombian assets during the first half of the year, a correction of the value of the Colombian peso and a rally in the [TEV] market. With material volatility, the peso has recently hovered around COP4,000 per dollar.

We believe that at current exchange rate levels, there is less room for a relevant correction of the Colombian peso. Once this process is over, we foresee the peso to reestablish a depreciation path. Although the depreciation of the peso will reduce pressures on government overall financing needs, Colombia's external financing needs, longer than expected high interest rates in developed economies and decreasing oil exports and persistent inflation will result in a relatively high current account deficit of around 4% of GDP by the end of this year. Finally, on the fiscal front, the deficit of the central government for 2023

was revised to 4.3% of GDP up from the previous estimate of 3.8%. Let's move on to legal matters related to Ruta del Sol.

These are the most relevant and, in our opinion, very positive developments. Let's start with the class action suit. As you may recall, in January 2017, La Procuraduría General de la Nación filed a class action suit against Concesionaria Ruta del Sol, CRDS, its shareholders, including Episol and others, for the violation of certain collective rights. No other Grupo Aval companies were mentioned in that lawsuit. The Tribunal Administrativo de Cúcuta, or TAC, a lower judicial instance produced a first ruling in December 2018 in which it found CRDS, its shareholders, including Episol and other individuals and entities not related to Aval or its affiliates, jointly and individually liable in order that the dependents pay damages to the nation for the violation of collective interests in the amount of approximately COP716 billion.

In addition, the TAC moved the department of the defendants from contracting with the Colombian government for a term of 10 years. Episol as well as other dependents appealed the decision to the Consejo de Estado, the highest court in the country that reviews these administrative decisions. On July 27, 2023, the Consejo de Estado issued a final non-appealable ruling, revoking several of the tax rulings, such as the order to pay any amount of damages the department of Episol and others from contracting with the government and the joint and several liability nature of the rulings. It also revoked several injunctions or interim measures and confirmed that certain collective rights were affected. As a result, Episol will not have to pay any damages pursuant to this action and may continue to contract with the government, so we wanted investigations by United States authorities.

On August 10, 2023, Grupo Aval and its subsidiary, Corficolombiana, announced the end after five years of the investigations of the US government through the US Department of Justice, DOJ and the US Securities and Exchange Commission, SEC, regarding Grupo and Porticolombiana related to Ruta del Sol 2. These resolutions are the result of previously and abundantly disclosed investigations by the DOJ and the SEC related to the construction of the Ruta del Sol sector 2 by a joint venture in which Corficolombiana through its subsidiary, Episol, held a minority interest and the resolutions are based on information gathered by US authorities, including testimonial evidence from third parties related to actions taken by a former Corficolombiana executive in connection with an Odebrecht led bribery scheme related to Ruta del Sol 2.

2. These resolutions are the result of previously and abundantly disclosed investigations by the DOJ and the SEC related to the construction of the Ruta del Sol sector 2 by a joint venture in which Corficolombiana through its subsidiary, Episol, held a minority interest and the resolutions are based on information gathered by US authorities, including testimonial evidence from third parties relating to actions taken by a former Corficolombiana executive in connection with an Odebrecht led bribery scheme related to Ruta del Sol 2.

Importantly, as a result of the investigations, the DOJ and SEC resolutions do not contain any findings of wrongdoing by Grupo Aval or its subsidiaries, including Corficolombiana, or any of its shareholders. The resolutions do not bring any enforcement action against Grupo Aval in connection with the RDS2 project. Corficolombiana did enter into a resolution with the DOJ and Grupo Aval and Corficolombiana entered into several administrative resolutions with the SEC. The resolutions with the SEC established an amount of \$40.2

million to be paid to the SEC and the resolution with the DOJ established an amount after credits to be paid to the DOJ of \$20.3 million for a total amount of \$60.5 million, which will be repaid by Corficolombiana and was provisioned on its June 30, 2023 financial statements.

Because of approximately net income



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recognized and accepted the responsibility under US law for the actions of the former Corficolombiana executive. From my point of view, equally noteworthy is the fact that the DOJ and SEC recognized Corficolombiana's and Grupo Aval's extensive cooperation with the investigations and that in the many years since the events occurred, Corficolombiana and Grupo Aval have enhanced their compliance programs and the internal controls. Again, the resolutions with the DOJ and SEC conclude those US agencies investigations into Grupo Aval in Corficolombiana related to Ruta del Sol 2.

Additionally closed. As I will not address any questions regarding



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to Diego, I will briefly address about financial results in the second quarter. I guess I will divide our performance into positives and negatives. Let's start with the negatives. First, the cost of funds continues to be a challenge for the industry and our banks are not the exception, especially those with majority fixed rate consumer loan portfolios. Because of the obligation to comply with NSFR requirements between the third quarter of last year and the first quarter of 2023, the banking system loaded their balance sheets with time deposits at exorbitant costs when compared to the yields of government issued fixed rate debentures.

Consequently between June



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those with new time deposits. As a result, since mid-June, the banking system has experienced a steep increase in spreads between cost of funds and sovereign debt yields, even beyond those seen during the first quarter. This need for funding could not come at a worst moment. Very low public budget execution results in funds that do not circulate in the economy, but rather stay deposited in the Central Bank. As of last week, these deposits amounted to approximately COP45 trillion. Even though the Central Bank makes available a portion of these funds through repo operations, they are short term in nature and do not contribute to the liquidity coverage ratios.

Second, our certain loan



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Third, as a result of the resolutions with the DOJ and SEC, our infrastructure sector results include an extraordinary COP253 billion negative impact, the equivalent of \$60.5 million, which upon consolidation translates into a 1 time negative impact of COP102.5 billion, the equivalent of \$24 million, in Aval's net attributable net income. Fourth, in addition, the contribution of our infrastructure nonfinancial sector investments was lower than in the past, explained by projects starting to move from the construction to the operation phase. There are, however, some positives. First, growth of our loan portfolios during the quarter, excluding the steep [revaluation] of the peso, rose to 1.2%, which compares favorably to

Second, all particularly in consumer loan portfolios, in the last two months, DNI formation



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particularly in consumer loan portfolios, in the last two months, P&L formation has started to stabilize in unsecured consumer loans. Our portfolios are further benefited by our loan mix. We foresee the peak in cost of risk in the third quarter. Third, if our views are correct the cost of funds will begin to subside after the third quarter once the government starts to execute budgets and the Central Bank starts cutting rates. Fourth, during the quarter, we saw a positive performance of NIM on loans from our banking operations as it reverted to the level of last year's last quarter. Furthermore, for the first time in 10 quarters, we saw a slight

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We foresee that our total banking NIM will increase during the last quarter of this year. Fifth, our banks continue to deploy cost control initiatives that enabled OpEx to remain materially flat quarter-over-quarter. And finally, our pension fund administrator had a strong quarter as commissions and contributions evolved favorably and stabilization reserves posted returns in excess of 10%. Going forward, Po

interest rate presentation

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guidance for the remainder of 2023.

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Diego Fernando Solano Saravia: Thank you, Luis Carlos. Beginning on Page 6. Assets decreased 0.3% during the quarter and grew 7.9% over the year. During the quarter, investments loans contr

denominated loans increased 1.2% in the quarter and 12.1% over the year. The 10.1% quarterly appreciation of the Colombian peso led to an 8.5% decrease in the balance of our dollar denominated loans, which grew 1.8% in dollar terms. 12 month depreciation of the Colombian peso was 0.6% and had no material effect on dollar denominated loans growth in peso terms.

Quarterly growth was led by a recovery in demand for commercial loans. On the other hand, high interest rates, slow economic activity and a lower macro outlook drove us after performance of retail loans. Commercial loan growth reached 0.1

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reached 0.4% contracted continue to



total, followed by personal loans and credit cards that account for 23.8% and 12.3% of our consumer portfolio, respectively. Other loans represent 8.8% of our consumer book. Payroll loans fell 1.6% over the quarter and grew 2.5% over 12 months. Personal loans increased 2.2% quarter-on-quarter and 27.8% year-on-year.

Credit cards grew 3% quarter-on-quarter and other loans contracted 2.6%. Other loans have been affected by an increase in car sales. Year-on-year credit card and other loans have increased 18% and 10.5%, respectively. Finally, mortgage has contracted 1.2% quarter-on-quarter and 1.5% year-on-year. We expect loan growth to be in line with the Central Bank's target of 5%.



and 9, we present several loan portfolio quality ratios. The quality of our loan portfolios measured by stages improved at Stage 2 loan growth to Stage 3 and were ultimately charged up, although still high PDL formation and a 30-day horizon decelerated during the quarter. Regarding delinquencies, 30 day PDL increased to 5.1%, a 23 basis points deterioration over three months and 71 basis points over 12 months.

90 day PDLs were 3.6%, a 12 basis point deterioration over three months and a 24 basis point deterioration over 12 months. PDL formation reflects the improvement in our loan portfolio. The 30 day PDL for commercial loans that balance sheet improvement was driven by a decrease in commercial PDLs and a slight increase in consumer PDLs. Cost of risk, net of recoveries, was 2.2%, up from 1.7% a quarter earlier and 1.4% in second quarter 2022. This was mainly driven by personal loans and credit cards. Our loan mix or weighted in payable lending and underweighted in personal loans and credit cards have been protected during this credit cycle. However, even though milder than our peers, we expect pressures on cost of risk to continue into third quarter as consumer PDLs roll forward and require further impairment charges.



Finally, the 10, we present the quarter



0.4% during the quarter and 8.7% over the year. Over the quarter, the balance of our dollar denominated funding decreased 0.3% in dollar terms and 10.3% in peso terms. Deposits account for 73% of our funding, increasing 1.1% quarter-on-quarter and 12.6% year-on-year. Time deposits continue to be the largest component of our funding. Pressure on cost of funds used during the quarter following the steeper effort to adjust for a more demanding net stable funding ratio by the end of March. This allowed spreads for new time deposits relative to a sovereign debt to return close to historical levels.

During the savings account. However, p



system tightened due to lower government budgeted execution and concentration of time deposits that were issued last year to adjust to the new net stable funding ratios coming due. To cope with the pressure derived from the new net stable funding ratio requirements while positioning for the expected interest rate reduction, our banks have increased the average maturity of time deposits, focusing on floating rates. At the end of June, 73% of our time deposits

were due in less than one year and 35% had floating rates.

Our deposit to net loan ratio increased to 101%. On Page 11, we present the evolution of our banks. Both with favorable

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OCI contributing to the growth during the quarter. All of our banks have an adequate Q1 capital. The total solvency ratio of our banks, except Banco Popular, were slightly higher than three months earlier. Banco Popular, the most affected by the contraction, has seen pressure on its separate and consolidated total solvency ratio due to the net losses accumulated over recent quarters. On Page 12, we present our yield on loans, cost of funds, spreads and NIM for our banking operation and for Grupo Aval.

Colombia C in April, ma mentioned

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to comply with more demanding net stable funding ratio requirements built up throughout the banking system up to March 2023. This pressure raised the spread between the time deposits and the Colombian sovereign debt, reaching close to 450 basis points above historical levels. Once banks complied with the new net stable ratio requirements, this level receded to 60 basis points by the beginning of April. This allowed the NIM and loans for our banking operation to improve in second quarter 2023, the first time in more than a year.

In addition, the positive increase of the Central Bank intervention rate allowed the repricing. As a result, of funds in

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segment increased 60 basis points over the quarter. Our NIM on retail loans of our banking segment expanded 21 basis points, the first increase in more than 10 quarters. However, the liquidity in the system tightened again, renewing pressure on cost of funds and spreads of time deposits to sovereign debt. This spread has reached 370 basis points by the end of June and 520 basis points as of last week. We expect this portion to reduce third quarter results.

We expect that the release in cost of funds could come by mid-October as the concentration of time deposit maturities is over, the government budget execution in Central Bank operation

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contracted to 0.8% following a milder downward movement in the yield curve relative to a quarter earlier. Moving to Page 13, we represent net fees and other income. Gross fee income increased 2.2% quarter-on-quarter to 1.5% year-on-year. Net fee income increased 4.9% quarter-on-quarter and 26.8% year-on-year. Pension fees increased over the quarter due to higher mandatory pension fund management fees, driven by wage increases and a resilient labor market.

Trust fees decreased over the quarter explained by lower performance based fees. Income from the nonfinancial sector, specifically, infrastructure, was negatively impacted by the resolution of this was considered as subsequent event that was accounted for as part of our second quarter results. In addition, results for infrastructure fell due to: first, a lower interest income on financial assets due to a lower inflation; second, the negative impact of E2C consolidation and associated equipment costs with

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negative impact of FX appreciation and concession arrangement assets with dollar exposure, which was hedged with a positive effect in other income from FX and derivatives; and third, a slower construction progress in Covioriente due to unfavorable weather conditions.

At the bottom of the page, quarter-on-quarter valuation of other operating

income is related with appreciation



incorporates the positive seasonal effect of dividends received by our subsidiaries. On Page 14, we present some efficiency ratios on a comparable basis. Cost to assets of 2.8% remained flat quarter-on-quarter, incorporating the results of our group wide cost containment efforts. Cost to income increased to 53.7% over the quarter. Close to half of quarterly increase is explained by the impact of the resolutions with the US agencies. Quarterly expenses increased 0.6% quarter-on-quarter and 19.1% year-on-year.

Administrative expenses grew 0.1% quarter-on-quarter and 24.5% year-on-year.

Administrative increase in increases in



explained 12.4 percentage points and 2.6 percentage points of the administrative expense year-on-year growth. In addition, further pressure on administrative expenses growth came from the 16% minimum wage increase or 13.1% 2022 inflation and the impact on our U.S. denominated expenses of 12.9% year-on-year average depreciation of the Colombian peso for the quarter. Personnel expenses increased 16.2% year-on-year in line with the 16% increase in minimum wage in Colombia.

Over the quarter, personnel expenses grew 11%. Finally, on Page 15, we present

our net income the quarter attributable



explained 12.4 percentage points and 2.6 percentage points of the administrative expense year-on-year growth. In addition, further pressure on administrative expenses growth came from the 16% minimum wage increase or 13.1% 2022 inflation and the impact on our U.S. denominated expenses of 12.9% year-on-year average depreciation of the Colombian peso for the quarter. Personnel expenses increased 16.2% year-on-year in line with the 16% increase in minimum wage in Colombia.

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Consolidated Non-financial activity. This incorporates the interest expenses of our nonfinancial activity. We expect our cost to assets to be in the 2.8% area. We expect our income from the nonfinancial sector to be 60% of that for 2022. We expect our fee income ratio to be in the 20% to 25% range, with a 19% for our banking segment. Finally, we expect our full year reported return on average equity to be in the 6% to 6.5% range or 6.5% to 7% excluding the negative effect of the resolution agreements with the US agencies.



We are now open for questions and answers.

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Q&A Session

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Operator: [Nicolas Riva]

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Nicolas Riva: My first question is on the investigation related to Ruta del Sol. So of course, you did reach the settlement with the US authorities, with the SEC, the Department of Justice to pay in total \$60 million, and that investigation appears to be closed. Now separately, there were comments this week from President Pedro saying that he does want the Colombian authorities to assess any fines that potentially should be paid to the Colombian authorities as well related to this case. My question there is how should we assess the likelihood of Aval having to pay any fines related to this case in Colombia and also potential size of these fines?

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said, the matters in the United States have been settled and in Colombia, that has happened as well. We went to an arbitrage tribunal and it had its own decision and all that was pending was Consejo de Estado appeal. And with that, the bulk of anything pending in Colombia will be and has been resolved. So you ask me what we expect, we expect nothing more.

Nicolas Riva: Yes, if I can just follow up on that. Can you remind us if you had then, if Aval and/or Corficolombiana had paid then any fines related to this investigation in Colombia in the past on the size...

Luis Carlos paid a super

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Luis Carlos paid a super

So that that's been settled as well.

Diego Fernando Solano Saravia: And regarding your second question on loans to related parties, there's a few things to mention. Number one, to do that, the company went through not only its internal consult process but also through controls by regulation. In addition, those bonds were placed at a rate that was above what the capacity of generating revenue for the company was at that point and it

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fund didn't generate any outperformance (i.e. secretly invested like a closet index fund), Warren Buffett would have pocketed a quarter of the 37.4% excess return. That would have been 9.35% in hedge fund "fees".

Actually Warren Buffett failed to beat the S&P 500 Index in 1958, returned only 40.9% and pocketed 8.7 percentage of it as "fees". His investors didn't mind that he underperformed the market in 1958 because he beat the market by a large margin in 1957. That year Buffett's hedge fund returned 10.4% and Buffett took only 1.1 percentage points of that as "fees". S&P 500 Index lost 10.8% in 1957, so Buffett's inv

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in 1957.

Between 1957 and 1966 Warren Buffett's hedge fund returned 23.5% annually after deducting Warren Buffett's 5.5 percentage point annual fees. S&P 500 Index generated an average annual compounded return of only 9.2% during the same 10-year period. An investor who invested \$10,000 in Warren Buffett's hedge fund at the beginning of 1957 saw his capital turn into \$103,000 before



fees and \$64,100 after fees (this means Warren Buffett made more than \$36,000 in fees from this investor).