Q3 2018 Earnings Call

Company Participants

- Breno Oliveira, Chief Executive Officer
- Vivian Angiolucci, Chief Financial Officer

Other Participants

- Gustavo Oliveira, Analyst
- Maria Paula, Analyst
- Olivia Petronilho, Analyst
- Robert Ford, Analyst
- Thiago Macruz, Analyst
- Tobias Stingelin, Analyst

Presentation

Operator

Today with us, we have Mr. Breno Oliveira, CEO; Ms. Vivian Angiolucci, CFO; and Mr. Adalmario Couto, IRO. We would like to inform you that this event is being recorded and all participants will be in listen only mode to join the company's presentation. After the company's remarks, we will start the Q&A session for investors and analysts alone, and further instructions will be provided. (Operator Instructions) Also like to inform you that questions can only be asked by telephone, by which you are connected to the webcast, you should email your questions directly to the IR team at ir@hypera.com.br. Today's live webcast may be accessed through the company's IR website at www.hypera.com.br/ir. We would also like to inform that statements made during this conference call might constitute forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those set forth in the forward-looking statements.

Now, I'll turn the floor over to Mr. Oliveira, who will begin the presentation. Mr. Oliveira, you have the floor.

Breno Oliveira {BIO 17215392 <GO>}

Good morning, everyone, and welcome to our audio conference to discuss the results relative to the third quarter 2018. Before moving on to our main highlights of the quarter, I would like to update you on the works conducted by the independent committee. As I mentioned in the last call, we hired (Technical Difficulty), and we have been conducting the works according to plan. But as of now, we do not have a definition as to the completion of the works conducted by such committee.

So now moving on to the company's operating performance. Net revenue grew by 8.4% in the quarter. As a comparison, the growth in the pharma market in the quarter came out at 8.3%, according to IQVIA data. It's worth mentioning that the comparison basis for this quarter was stronger because of a change in the recognition criteria for the revenue realized in the fourth quarter 2017, which led the year's revenues to be concentrated on the second half of last year. For the coming quarters, the next quarter, the comparison basis will be even more challenging because according to the new recognition criteria (Technical Difficulty) was using the rule, final quarter 2017, the growth of 18% in net revenues and 27% in EBITDA, because of that the growth rate in the fourth quarter should slow down as expected, due only and exclusively, because of this change in the comparison ratio.

As for the operating results, EBITDA grew by 5% in the quarter, and 14% in year-to-date numbers. Net income grew by 18% in the quarter, and 27% year-to-date. Other highlight was our operating cash flow, which grew by 73% in the quarter, and 24% in the (Technical Difficulty) after the effects of the change in accounting practices, which happened at the end of last year. In fact, it also exemplifies that we are quite satisfied with the company's performance in the quarter and especially with the execution of our launching pipeline. We continue to grow in a sustainable, profitable way, generating cash and Vivian, will have a chance to detail, as we move forward with the presentation.

Talking about our business units. Our Similars and Generics products unit was benefited by reduction of discounts (Technical Difficulty) in the molecules, which are relevant for the company and by other initiatives to increase our capacity, and our productivity in our plant, with a significant reduction in the lack of products because of production capacity problem. The leading brands and similar products Neosoro, Flavonid, Doralgina were positive highlights in the quarter, as well as the performance of our generic line. We have a relevant transaction in Similars and Generics products, which strengthened our growth strategy through investments at the point-of-sale, gains in distribution channels and the development of new molecules of higher complexity, where there is lesser competition and consequently more profitability. As for Branded Prescription products, growth happened mainly in -- around leading brands, such Mioflex-A, Alivium and Rinosoro. And also because of the performance of products from our dermacosmetics line Mantecorp Skincare and also because of the recent launches we conducted.

In Consumer Health, despite the flu season having proven to be less intense than it was last year, which impacted our performance in that particular area. We had a relevant contribution from recent launches, extensions of lines of traditional brands such as Maracugina, Tamarine and Biotonico Fontoura. Of course, besides the success in repositioning the Miorrelax brand. Recently, we announced the renovation of our sponsorship for the soccer broadcast for the TV Globo for 2019. The objective is to strengthen our leading brands even further under the Consumer Health brand, not only to mention our Neo Quimica Generic products. The Globo's soccer package for next year will be even more interesting than it was this year. We'll have a higher level of exposition of our brands because on top of the Brazilian League and the state leagues, we're also showing our brand during the Copa America and we'll have more flexibility in showing our brands during the games and also during the news programs of the network.

As a recognition of our marketing networks, we won two awards from Premio Lupa de Ouro Sindusfarma, the main award granted in the pharma sector. They were given to the following products; Benegrip, Benegrip Multi, Ofolato and Peridal. Besides the investment in marketing, we continue to invest, in developing our innovation pipeline and also investing in new partnerships and acquisition of products. In the third quarter of '18, our innovation index reached 30%. In the last 12 months, we have invested over BRL170 million in research and development. In the last quarter, our investment exceeded 5% of our net revenues, a record for us and above the level realized by other companies of the same size. Our efforts in that area has been recognized with award innovation highlight granted by a local newspaper.

In this quarter, we launched 11 products, in Branded Prescription and the Consumer Health and Prescription -- Branded Prescription. It's worth mentioning Rinosoro Jet Infantil, besides the expansion on the dermacosmetics brands under Episol and Urby. We also relaunched Lubrinat, which was acquired by the company in the second quarter, and which was licensed by -- to Merck previously. Lubrinat is the first feminine hydrating gel, based on hyaluronic acid in Brazil, and it complements our portfolio for gynaecological product in Consumer Health. We launched Atrofem for menstrual cramps, and also have a new presentation for Estomazil antacid. Again, it's worth mentioning, the hiring of Helio Segouras, as our new Head of Consumer Health. He is quite experienced in the pharma market and also consumer group. And he now complements our executive team.

And now I'll give the floor over to Vivian, who will go deeper into some of the points, which I have listed in terms of results.

Vivian Angiolucci {BIO 19917048 <GO>}

Good morning. Thank you, Breno. We'll start on Slide 5, where I'll be talking about gross margin. Our gross margin was of 70.7%, 3.9% down from what we posted in the third quarter of 2017. Most of that variation was driven by the mix effect, because we had a higher stake from Similars & Generics products when compared to the previous year. It's worth mentioning that Similars & Generics products have been impacted by restriction of capacity in the third quarter of last year. In a smaller proportion, margin was also impacted by a raise in costs, which was also affected by the depreciation of the real, Brazilian real against the dollar.

Marketing expenses grew 0.7%, as a percentage of the net revenue, which reflects our continuous search for demand generation. Among the main investments made with company in marketing, in the period, we have an increase of over 100 associates in our medical visitation team with objective of increased flow -- outflow for our recent launches. Along with that, we had an increased distribution of three samples. Launches also led to a higher number of marketing actions at the point-of-sale. It's worth mentioning that year-to-date, marketing expenses as a percentage of net revenue have maintained relatively stable, when compared to the previous year.

In terms of admin expenses, they have decreased in relevance, both in nominal terms and in relative terms, which driven mainly by the optimization of expenses with important gain and infrastructure expansion. In the others, we have a positive result of BRL7 million, when compared to a negative result last year. It's important to mention that the result in the third quarter was quite close of the recurring revenues we have from rents, which will continue to impact our results positively in the coming quarters. In short, the reduction of gross margin and increase in marketing expenses, offset by a lower admin expenses led to a reduction in 1% in our EBITDA margin for the period. It's worth mentioning that in the year-to-date, EBITDA for continuing operation is 0.8% above what we had in the same period of last year.

In closing, our company's net income for continuing operations grew by 17.6% year-on-year, despite the lower financial revenue that was because of a drop in interest rates. That growth comes from a reduction in the IR effective rate, resulting in an interest on capital in the amount of BRL126.2 million, so now maybe talking about cash flow and debt. Operating cash generation was BRL301 million in the quarter, which helped lead to a growth of 24.2% in the operating cash flow in the period. Year-to-date, operating cash flow represented 91% of the EBITDA for continuing operations. Free cash flow, in it's turn was BRL276 million this year, which led us to a net cash position of BRL991 million, the equivalent of 0.7 times EBITDA for continuing operations in the past 12 month. Our return on equity continues to grow and reached 16.2% in the quarter, 5.6 percentage points above what we posted in the third quarter of 2017.

Now I give the floor back to Breno for his final comments.

Breno Oliveira {BIO 17215392 <GO>}

I would just like to wrap up. I think that we remain very excited and optimistic with the opportunities presented by the Brazilian pharma market. It has been quite resilient this market for the past years, and it continues to show a very good growth potential for the mid and long-run. And for us to capture those opportunities, investment in innovation, which we're doing right now are essential and we expect them to mature in the coming years.

We see a cumulative result up until September, and our perspective for the fourth quarter '18, we are on the right path to deliver our guidances, both for EBITDA and net income for 2018. For the fourth quarter 2018, we have a significant number of launches in different therapeutic classes, in different business units. Now, we're talking about more innovation, launches and our strategy of doing our Hype Day on December 3rd. We expect to see you all there.

We will now have our Q&A. Thank you.

Questions And Answers

Operator

Thank you. The floor is now open for questions for investors and analysts. (Operator Instructions) Mr. Robert Ford from Bank of America would like to ask a question.

Q - Robert Ford {BIO 1499021 <GO>}

Good morning, everyone, and thank you for taking my question. Breno, how do you see the way to recover margins in the future? Mix would be important, or are you seeing some other way to recover those margins going forward?

A - Breno Oliveira {BIO 17215392 <GO>}

Hi, Bob. In the quarter, specifically we're talking about the mix. Half of the effect came from our mix of products, and a quarter gain from the foreign exchange effect. The foreign exchange effect, of course, it will depend on where the US dollar will stabilize, as compared to the BRLs, but in the short-run, it will continue to have an effect for the full fourth quarter. For example, we are still going to continue on foreign exchange effect. If it continues at the same level BRL3.6, BRL3.7, for the dollar, then we expect to have that same level going forward. Now we will expect that to remain at that level. In the fourth quarter 2017, that number was quite lower BRL3.2, BRL3.3. So yes, the answer is, yes, we expect to have an impact coming from foreign exchange in the short-run. As for the mix effect, I think, it does have a gradual effect as the markets for Similars and Generics products grows slightly higher than the other markets. But it's a very, very slight difference. It will happen gradually to long time. Apart from those two effects mix and foreign exchange impact, there is nothing else impacting our margins. No other effects on our margins now.

Q - Robert Ford {BIO 1499021 <GO>}

Thank you, Breno. One follow-up question, if I may. What you have to say about working capital going forward?

A - Breno Oliveira {BIO 17215392 <GO>}

That's something we would like to address. In the mid-run, we have been increasing our working capital, especially in the accounts receivable line. The intention going forward is to stabilize that, or even reduce stock using investment in working capital, especially under accounts receivable. Under the inventory line, the tendency is, for us to maintain or even increase slightly the investment in inventory. In the past, we did have some issues. In terms of capacity, as it was mentioned. So we should have a slightly higher inventory level. And again, we have the foreign exchange as half of our inventory composed of raw materials, which is imported to a large extent. So whenever we have a foreign exchange issue that will reflect on inventory as well.

Q - Robert Ford {BIO 1499021 <GO>}

Thank you, Breno.

Operator

Mr. Tobias Stingelin from Citi has a question.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Good morning, Breno. Early on, you briefly mentioned that there is no deadlines for independent committee. Isn't there general mandates for that, for that internal investigation? So I don't want to reside on that, but could you perhaps give us some more color, in terms of price and volume as well?

A - Breno Oliveira {BIO 17215392 <GO>}

Okay, Tobias, I'll take the first part, about the independent committee, and then Vivian will address the second half on price and volumes. As for a deadline for the independent committee, I have the following to say. It is an independent committee. They need to work in their own pace, in their own time. So ideally, things would be wrapped up as soon as possible, but that's something we have no control over. They have already concluded their collection of information. They are now analyzing all the information they have collected. It's difficult to establish a deadline. But we do believe that in the coming few months -- I'd say the coming few months, we will have a completion of that work. And I'll give the floor over to Vivian to address the second question.

A - Vivian Angiolucci {BIO 19917048 <GO>}

In terms of price and volume as you asked, for Generics and Similars product, basically, one-third of the impact was price and two-thirds coming from volume. But as I said early on, our Similars and Generics products business unit had been impacted by a reduction in capacity before. As you recovered capacity to produce, volume gained a more relevance in terms of impact. But the price for that business unit is way higher than the market. Under Consumer Health and Branded Prescription, the increase in volume was halted because of the growth in price.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Okay. And for Branded Prescription?

A - Vivian Angiolucci {BIO 19917048 <GO>}

What I called brand -- since what I called brand, it's Branded Prescription and Consumer Health. It has the same dynamics. Basically, it was slightly negative before, but we had some growth because of price, both product-by-product and because of the mix.

Q - Tobias Stingelin {BIO 18290133 <GO>}

And following up on Bob's question and for gross margin, Breno, what do you expect to see in terms of mix? When you talk about the impact of the currency exchange rates? Do you expect that impact to be lesser going forward?

A - Breno Oliveira {BIO 17215392 <GO>}

No. I thought about the foreign exchange rate. We do not -- what I did say was that the Similars and Generics products market is growing and it continues to grow above the market in general. So there is a slight effect coming from that growth in Generics and Similars products, which have a lower margin.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Okay. Now, I get it. Okay.

Operator

Mr. Thiago Macruz from Itau has a question.

Q - Thiago Macruz {BIO 16404924 <GO>}

Good morning, everyone. Thank you for taking my question. I have a question about medical visitations. We see a significant increase in that expense. Should we expect that level to be maintained for medical visits? And a question about revenue growth. Generally, there was a breakdown in terms of new products and legacy products for that growth in margin -- revenues?

A - Breno Oliveira {BIO 17215392 <GO>}

From your second question, what we can tell you is about innovation index. We did mentioned that, that index for the quarter was 30%, that means products which were launched in the past five years. That's what we can breakdown. As for the medical visits, we mentioned in the previous call for the second quarter of 2018, we mentioned that we have increased our team. We now have 100 extra associates doing medical business that started in July, so that's the new level we should be working around going forward. Yes, we maintain a level of expense.

Q - Thiago Macruz {BIO 16404924 <GO>}

Okay, thank you.

Operator

Mrs. Olivia Petronilho from JP Morgan has a question.

Q - Olivia Petronilho {BIO 19090195 <GO>}

Good morning, Vivian and Breno. Thank you for taking my questions. Little around innovation. I'd like to hear from you about the pipeline for the fourth quarter or for next year. Would you envision a double-digit growth going forward because of this pipeline? And the second question, if we could talk about different size clients? Do you see a different make up of sales as you deal with different sized clients? Is there any kind of impact does that have on working capital?

A - Breno Oliveira {BIO 17215392 <GO>}

Olivia, as for innovation, we have been investing for some time now in innovation, and this will mature through our time. So we're talking about several projects. There is no major blockbuster in the pipeline, at least in the short run. We talked about smaller projects, which will gradually contribute to revenue growth, So in the long run, that revenue is coming from the innovation index gain from less than 20% to the current 30% level. And we expect this level to gradually grow. But in the very short run, there is no major impact coming from innovation onto the revenue. As I mentioned, for the fourth quarter, that number should even slow down when we compare to the third quarter, actually because we have a different basis for comparison, as I mentioned. And for next year, we expect innovation to gradually contribute to revenue growth. But as I said, again, there is no major blockbuster coming up that will make a huge difference, no.

As for growth in the different market segments, that does not really affect our working capital. The effect is more from the standpoint of products. Similars and Generics products have a slightly shorter run when compared to branded products. So as they grow, they will have a positive effect on working capital. It's not also -- it's not immediate either because our average term is high. We're talking about 120 days, 120 days that's more than a quarter. So what we do in a quarter will reflect two quarters or three quarters later in the cash flow. So for us, the market segment, which is growing more, is not really important because we have a very, very diversified portfolio where we can service the different market channels quite well, a great chain, midsize chain and also the independent stores, which are served through distributing channels. So we are present and operating in several channels, so a specific variation and specific segment will not really have a high impact on the business as a whole.

Q - Olivia Petronilho {BIO 19090195 <GO>}

Okay, thank you.

Operator

Ms. Maria Paula from BB Investments has a question.

Q - Maria Paula {BIO 19356895 <GO>}

Good morning, Breno, and good morning, Vivian. Thank you for taking my question. I would like to explore the issue of mix. What is it going forward? Do you see that the focus on Generics will stay, or when we have a more normal economic situation with branded products, we have more room? And how are you working around with new products? You have been focusing on innovation or innovating Generics and Similars, how does that look going forward? And when you talk about other expenses, I'd like you to give us some more color on the other expenses line? I didn't really understand that.

A - Breno Oliveira {BIO 17215392 <GO>}

I'll talk about innovation a little bit for Similars and Generics product, and then Vivian will address your second question. As for innovation, we are investing heavily on branded products, human health and Branded Prescription products. Those are the market segments which have higher margins and that makes more sense for us to invest on. In the short run, Similars and Generics business units has benefited in terms of growth, because as Vivian said, we managed to address productivity issues, capacity issues at the plants, and that line was the one which was most benefited. Because if you have lower margins, when we had capacity restrictions in the past, those were the first products to suffer the impact. As we improved our capacities, they are now also the first to benefit. But there is no change in strategy on their part of the company when we look at different market segments. As for innovation, of course, we favor branded products which, of course, have higher margins. I'll give the floor over to Vivian.

A - Vivian Angiolucci {BIO 19917048 <GO>}

Hi, Maria Paula. Speaking about others line, you might remember from previous calls, we mentioned that we have a distribution center, which is rented for the former owners of the discontinued operation. We have rented that distribution center. So the new proprietors now pays us monthly rent to use that distribution center, and we expect to continue to receive that rent money for the coming quarters. So we expect to have a positive result on that -- under that line going forward, which is not a nonrecurring effect, it is a recurring effect. You will see, if you're looking today, that we have a recurring revenue. That revenue line is coming from the rent.

Q - Maria Paula {BIO 19356895 <GO>}

Okay, Vivian. Thank you have a nice day everyone.

Operator

Mr. Gustavo Oliveira from UBS has a question.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Good morning, Vivian and Breno. In terms of growth in Generics, you saw some improvement in production capacity, as you mentioned, which had been a problem before -- last year. We have been hearing from drugstores, that they are focusing more on Generics. So you have benefited as you improved your production capacity, but you have also benefited because there is a higher demand from drugstores. Do you see that happening? Could that have a positive effect for you in the mid-run? And you also mentioned a reduction in discount for Generics, where you said that one-third of the growth came from price. If you could update us on how you see that trend going forward, now and going forward for the coming quarters?

A - Breno Oliveira {BIO 17215392 <GO>}

Thank you, Gustavo. When we say that -- we are talking about the business unit, which is Similars & Generics product, two-thirds of revenues come from Similars products and one-third comes from Generics. So Generics represent 10% to 12% of revenue. So the impact is important, but not that big. When we talk about the business unit, we are talking about Similar products more than we are talking about Generics product. Generics have been growing above market, and continues to grow. But for the year, we expect a growth of 10%, and that Generics, we're talking about 14% growth. But that has always been the case. From the last year, generics have always grown above the market growth and has increased its penetration gradually in the market. But in our case, there is no big change. An important reason, in fact, was the effect of the ForEx. As we have a higher foreign exchange rate, raw material have a higher stake in the production cost. So as costs go up and company's pass on that increase, we have a trend of seeing a higher growth in the short term because of the foreign exchange issue. You had a second question, Gustavo?

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Yes, about the growth trend, pricing will have a higher demand from drugstores, not really sure how do you see that going forward? You're saying that you are more sensitive to foreign exchange. I don't know what kind of price drivers we can expect. But the question is, if you -- since you have removed some bottlenecks in production that you had in the past, do you also see higher demand for Generics? And from what I hear from you now, that's not the case, right, the demand remains the same.

A - Breno Oliveira {BIO 17215392 <GO>}

Yes, we do not see a big growth in demand. The demand has been growing as it has always growing. And what we see is that industry is passing on that increase in cost to the consumers. That happens more so in Generics than in other categories.

Operator

Mr. Robert Ford from Bank of America, would like to have to ask a question.

Q - Robert Ford {BIO 1499021 <GO>}

Hi, Breno, Vivian. Thank you for taking another question. On top of the faster growth for Generics and Similars products, can we also say that there was also an impact coming from a weaker flu season, if I may?

A - Breno Oliveira {BIO 17215392 <GO>}

Yes, Bob. Yes, as I mentioned earlier -- earlier on in the presentation, and we did see an impact coming from that. We had a higher growth in Generics and Similars products, and we also saw a weaker flu season, but very big growth in 2017, but not this year. Here, growth was smaller, and it of course contributed to the mix. For next year, we don't expect such a large variation for the flu product.

Q - Robert Ford {BIO 1499021 <GO>}

Breno, how many points in margin came from this weaker flu season?

A - Breno Oliveira {BIO 17215392 <GO>}

In the gross margin, I wouldn't have that number now in hand. In terms of total mix, the specific effect for flu product, it's not 100% that's two percentage points, but we had other effects. For Branded Prescriptions, we saw higher selling of derma products. We don't have that number. I think, we can give that number later. That's part of those two percentage points. The antiflu products represent a small fraction.

Q - Robert Ford {BIO 1499021 <GO>}

Okay, thank you.

Operator

Mr. Tobias Stingelin from Citi has a question.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Thank you. Breno, let me talk about Generics and Similars product. You said one-third was volume and two-third price. And for the other segment, it was price that top line. What is your market share, like, now, or it has changed throughout the period?

A - Breno Oliveira {BIO 17215392 <GO>}

We think, in the current market, we grew on average in line with the market, around 8%, slightly less for Branded Products; around one point below in terms of branded products; and one point above when we talk about Generics and Similars product. It's more or less the breakdown for those numbers.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Okay, thanks.

Operator

Thank you. The Q&A session is now over. We'd like to give the conference over to Mr. Oliveira for his final remarks.

A - Breno Oliveira {BIO 17215392 <GO>}

I'd like to thank you all for participating in our audio conference. As usual, our IR team remains available for follow ups or doubts you may have, and I'd like to reinforce our invitation for our Hype Day on December 3rd, here in Sao Paulo. We hope to see you all there. Have a nice day, everyone.

Operator

The conference call for Hypera Pharma is now over. Thank you all for participating. Have a nice day everyone.