

Q1 2017 Earnings Call

Company Participants

- Breno Toledo Pires de Oliveira, Chief Financial Officer & Investor Relations Officer
- Claudio Bergamo dos Santos, Chief Executive Officer & Director

Other Participants

- Guilherme Assis, Analyst
- Joseph Giordano, Analyst
- Robert E. Ford Aguilar, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to Hypermarcas First Quarter of 2017 Results Conference Call. Today with us, we have Mr. Claudio Bergamo, CEO; and Mr. Breno Oliveira, CFO and Investor Relations Officer.

We would like to inform you that this event is being recorded and all participants will be in a listen-only mode during the company's presentation. After Hypermarcas' remarks, there will be a question-and-answer session for investors and analysts when further instructions will be given.

We would like to inform that questions can only be asked by telephone. So if you are connected through the webcast, you should e-mail your question directly to the IR team at the following address: ir@hypermarcas.com.br.

Today's live webcast may be accessed through the company's Investor Relations website at www.hypermarcas.com.br/ir.

We also would like to inform that statements during this conference may 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 forward in the forward-looking statements.

Now, I'll turn the floor to Mr. Claudio Bergamo who will begin the presentation. Mr. Bergamo, you may begin your conference.

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much all for participating in the teleconference of Hypermarcas first quarter results.

In this first quarter 2017, Hypermarcas completed the divestment cycle of its diaper business, becoming a few pharmaceutical company with more than 10% market share and solid presence in most relevant pharmaceutical markets in Brazil. The improvement of its execution combined with the new organizational model and many successful product launches contributed to the company's good performance in the quarter. Net revenues advanced 12.2% compared to the same period of last year, combining both growth in prices and volume.

In the quarter, the company reached record EBITDA of BRL 350 million, representing 37.7% of net sales. Net income reached BRL 252 million, more than double of last year's quarter. The company approved a distribution of BRL 410 million in dividends to its shareholders, equivalent to BRL 0.65 per share, of which BRL 0.60 per share already paid during the first quarter. Another BRL 32 million or BRL 0.05 per share will be paid today, May 2.

Additionally, on April 19, the Shareholder's Meeting approved a reduction of company's capital stock in the amount of BRL 822 million to its shareholders, equivalent of BRL 1.30 per share, which is expected to be paid by the beginning of July. Considering sum of all the payment of dividends, capital reductions and share buybacks, the company will return more than BRL 1.4 billion to its shareholders in the fiscal year of 2017 alone.

I would like to remind that in regard to media news articles about the company published last week, as we have already said in notice to the market, there is no talks of our controlling shareholders relative to the sale of the stake in the company and the company is not negotiating mergers and has not hired banks or financial advisors to help in any transaction of this nature.

Thank you very much. I would pass over to Breno who will explain in more details the results.

Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Thanks, Claudio. Good morning, everyone.

Before we go over the highlights of the quarter, I would like to mention that we've revised the breakdown of our sales and financial expenses to better reflect the current moments of the company. We are now showing our research and development expenses and we bundled together freight and logistics expenses, among other changes. At the end of our earnings release, you can find the last three years of historical data under this new breakdown.

Now, going to page 3, our continuing operations net revenues growth was up 12.2% in the quarter with highlight of the Branded Prescription business unit. To a greater extent,

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growth was a function of price increases associated also with volume growth in the quarter.

Gross margin was 74.7%, a 1.4 percentage point growth, mostly as a function of better sales leads in the quarter. Marketing expenses increased 21% due to the creation of new medical reps teams during the year of 2016 and higher media expenses compared to the first quarter of 2016. Last year, advertisement and consumer promotion expenses were largely concentrated in the second half of the year. This year, we expect these expenses to be better distributed throughout the year.

Sales expenses grew 12.9%, mainly as a result of 54% increase in R&D expenses, given the company's greater focus on innovation and development of new products. Therefore, the company's EBITDA reached BRL 349 million, a 12.6% growth with margin of 37.7%.

Regarding the financial results, we had financial income of BRL 14 million this quarter compared to a financial expense of BRL 149 million in the first quarter of 2016. It is worth noting that in that quarter we had the early payment of BRL 2.8 billion in debt (07:33) with one-off financial costs of BRL 87 million. Thus, our continuing operation net income was BRL 253 million, a 114% increase compared to the first quarter 2016.

Discontinued operations posted net losses of BRL 89 million, mainly as a function of the operating results of that business in the first two months of the year and of no cash expenses with the write-off of assets that were not included in the Disposable Products deal. So, the company's total net income including continuing and discontinued operations was BRL 183.5 million.

On the following page, we see that the cash conversion cycle increased six days, mainly because of receivable days. However, this increase in receivables happened in the second quarter 2016 and have been stable at that level since then, as well as the working capital as a percentage of net revenues metric that has been around 39% since the second quarter 2016.

Cash flow from operations was BRL 243 million, impacted among other factors by the prepayment of an advertisement agreement in the amount of BRL 82 million. CapEx and intangibles investments grew BRL 22 million mostly because of the investments in our new Innovation Center. With the proceeds from the sale of the Disposable business of BRL 837 million, our free cash flow reached BRL 1.013 billion in the quarter.

On page 5, the company's net cash position ended the quarter at BRL 1.263 billion, a BRL 471 million increase compared to the previous quarter, mostly because of the proceeds from the sale of the diaper business even after the payment of BRL 378 million in dividends and BRL 84 million in share buybacks. Consider dividend that are being paid today in the amount of BRL 32 million and the capital reduction estimated to be paid in July, our pro forma net cash position is about BRL 410 million.

That's it on my end. Thanks, everyone, for the attendance. We now open the floor for the Q&A session.

Q&A

Operator

Thank you. Okay. Our first question comes from Robert Ford of Merrill Lynch. Please go ahead.

Q - Robert E. Ford Aguilar {BIO 1499021 <GO>}

Hey, Claudio. Hey, Breno. Congratulations on the quarter. I had a question with respect to the Branded Rx business. Breno, I think you highlighted it as one of the best performing businesses in the first quarter and I was curious when you look forward, can you touch on maybe your plans in Branded Rx in terms of innovation as well as any channel or regional strategies to maintain or even improve momentum in the segment, please?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi, Bob. Thanks for the question. Just to recall, when we say Branded Prescription that it's really included in that business unit, not only Rx's, but as well all our business of dermocosmetics as well our OTX product. So that, I mean, that is about – just also to recall that out of that unit, around 40% are OTX and dermocosmetics, which are by nature also Consumer Health type of markets but which generate demand at the physician community, all right.

So let me – I'm going to expand your question for the whole division, not only for Rx, and basically as we have already highlighted, when we look our market position in these markets, we do have a very material and substantial room for growth in this market, given that we are the number fifth player in this market and we are not present in many therapeutical areas and in many product – certain product specifications.

We have a very strong presence in cardiology, in orthopedic and pediatrician where we still have a very large room for growth in many other therapeutic areas such as, for example, ophthalmology, neurology, also the – and some other one – and cardiology as well. So, basically what we have been able to do, we have been able to launch new products in these other therapeutical areas, which have been enabling us to grow of both the market – in many of these – in these markets.

Ophthalmology is an area that we have just launched (13:55) last year a new sales force based on a couple of products that we've been able to launch and we expect to complement that in a couple of years from now, as well as cardiology and the other ones as well.

Also, the dermocosmetics is doing very well. We had been very close to become the number one brand in the market, very close to the (14:22) when you look to L'Oréal that has three major brands in the marketplace, in total the (14:34) L'Oréal is still the number one. But when you look on a brand by brand basis, Mantecorp Skincare has tied with (14:45) in this quarter. And we expect to continuous growing and hopefully to become the

number one definitely as a brand. So it's a business that has been growing more than 20% for many quarters and we still have many potential for it to grow.

Also (15:07) our Vitamin D market with Addera D3, which is continuously growing a lot, we basically have developed this market in Brazil from scratch. Now this market's grown in BRL 500 million in Brazil when we have more than 50% market share of this market. We have just recently launched a new concept of gel caps for vitamin Ds, which we expect very nice growth coming from this market.

It's also to highlight our launch of Alivium. Alivium is an ibuprofen brand, which competes against Advil in the consumer market and we had been able also to launch gel caps for Alivium and we will be also rolling out our growth strategy for them.

So, we have kind of many stories like that and then this story (16:05) that's what is behind the successful growth of this division.

Q - Robert E. Ford Aguilar {BIO 1499021 <GO>}

And, Claudio, how much of the growth in the quarter came from Branded Prescription and OTX and dermocosmetics? And when you look at the innovation that you have as well as some of maybe the channel strategies that you mentioned earlier, do you think you can maintain or improve momentum in these categories?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, I think our target is to improve the momentum of new products and innovation moving forward. All right? I think we have been able to have this innovation despite some of the infrastructure that we didn't have sufficient, adequate. Our Innovation Center is expected to be fully operational by the second quarter. And we have already a very mature and substantial pipeline of new projects to be executed by our new R&D capabilities. So, we have more than a hundred projects in our pipeline that more than actually - more than our capabilities and our capacity to do it. So, we have the option to choose the best projects, the ones that we're going to roll out in our development labs that we have been creating. As well, we have been much more active in business development as in the past. We have lots of opportunities now and the negotiation for many new products and new categories and new product concepts that we can bring into Brazil into the marketplace.

So, in the short term, we do have a very healthy portfolio of new launches for the second half of this year and for this first half of last year. So I see our target is actually to gain more momentum than we have been. And that's pretty much - our effort is going into that direction. The first signs that are good that we are in a good track for that. But we need good dedication in order really to make them not only makes really them (19:00) viable and bring value for the shareholders.

And that's why also we have created the business units because we believe that by giving more focus, we will be able also to improve further our execution capability moving forward. So we are pretty much working on that direction. And then I invite everyone to

visit our new Innovation Center, from May on will be fully operational. Please, when you come down to Brazil, you will be our guest, to know in (19:42) what we are talking about.

Q - Robert E. Ford Aguilar {BIO 1499021 <GO>}

That's helpful. And one other question, Claudio. In the past, you've mentioned joint ventures as an opportunity to grow. Can you touch a little bit on how that's developing? And as you contact potential partners which control intellectual property, do you see a willingness to fairly share economics in terms of - do they perceive the importance of stewarding something (20:09) and the speed to market that you can enable versus an alternative?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, you are right. In the past, we have gone through some initiatives and then it didn't work out the way we would like for it. And now recently, we have changed our approach for business development and giving more dynamics on that piece. And I'm being quite surprised by the amount of - in a very short period of time the multiple opportunities that we had now on the table. I don't have any concrete thing to be announced that we have there.

And the opportunity is very vast (20:58), as you know, from in-licensing types, from co-development, supply agreements, even acquisitions of small brands and products, as well the (21:14) that we can develop here in the marketplace. So they're very diverse and they're very complementary. What's the - the good news is that the industry, once we became a pure pharma player and people start realizing the strength of Hypermarchas in the marketplace, people start being very keen to do business with us. I think in the past given that we have both the consumer and the pharma altogether, I think Hypermarchas was not perceived as strong as it is in the pharma side as we have been perceived now, given that we became a pure pharma player. And we are also the only pharmaceutical company in Brazil, we are public and we have a corporate governance, company is managed by professionals, and these things slowly, slowly people start favoring and start understanding our model and start understanding that we are a very - we are the partner - probably a very good partner of choice. But that thing that we have been exercising, not very long, so we have still some time to go. But the first indications are pretty good.

Q - Robert E. Ford Aguilar {BIO 1499021 <GO>}

No, that's great news. Good to hear. Thank you and, again, congratulations.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thanks, Robert. Thanks for all the questions.

Operator

Okay. Our next question comes from Guilherme Assis from Brasil Plural. Please go ahead.

Q - Guilherme Assis {BIO 16143141 <GO>}

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Hey, guys. Thanks for taking my follow-up question. I was wondering after the Portuguese call and now, we haven't talked too much about competition. Can you guys talk a little bit about how you're seeing the competitors in terms of commercial aggressiveness and general pricing for the three segments that you operate on? And also, one of the things that you've done over the past year seems (23:33) you've disposed off the non-core assets. You have beefed up your executive team and also your operations team. Right? You've been investing in new medical (23:46) team and so on. So can you talk a little bit whether you think you already have the complete execution team or should we expect any more hires or any more people being hired to complete the team? That's my question. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Guilherme, I think the first part of your question about competition, we have to separate. Like, one side, the Consumer Health and the Branded Prescription products and on the other side, the Similar and the Generics, right?

On the Branded side, which is the Consumer Health and the Branded Prescription, I think the competition is not on price. Okay? Very clear. The competition is on innovation and marketing and execution. That's where the key is. Some companies are less favorable, not really more - investing so much. I mean, in general, Brazilian companies are gaining market share in this market vis-à-vis the multinationals. Because multinationals has been somewhat affected by the Brazilian prices (25:24) and somewhat slowed down their investments in Brazil, which for us that are only Brazilian, which somewhat is a good deal because we have been continually investing and because of that we have been also able to gain market share in this market in a persistent way over time.

On the other spectrum, you have the Similar and the Generics. And on that spectrum, there is more competition on pricing and commercial aggressiveness, especially starting from some low-end players in the market, also treated by a new way of buying from some retail chains that they don't buy, they buy by product now, they don't buy by company. So, they have changed in the way they do business with the industry. And in a way, that's becoming more competitive. In that case, it's very important our cost structure that we believe we have the lowest cost structure in this market coming from our live (26:41) manufacturing side, our very (26:44) mentality against low cost that we have in the company. So, it is very important that our low cost position in that respect. Okay?

Regarding the second part of your question, which is if I understood is that we have fulfilled our spaces for new people for the different organizations that we have created, the answer is yes. On the business unit, we have finalized the process and then we have the full teams in places from this quarter, second quarter on. So, it's something that is the benefits of that will take some time to come because it's just a new team that we have just finalized (27:43). On the other side, on our R&D capability, we have to wait for about one quarter, the beginning of the operation, so in a way that one is a little delayed, but we will from second one moving on, we will be fully operational, so we are handing out the fulfillment of the empty spaces that we've got.

Q - Guilherme Assis {BIO 16143141 <GO>}

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Okay. That's clear, Claudio. That's helpful. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much.

Operator

Okay. Our next question comes from Joseph Giordano from JPMorgan. Please go ahead.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hi. Good morning, everyone. Thanks for taking my question. Good morning, Claudio and Breno. My question goes on the growth trends going forward. So, Claudio, you mentioned a lot about potential launches, accelerating volumes. So I'd really like to understand what should be the average price increase for the company this year when we look at the average of 3.1% for the industry? So how should we see that? And then, like, on the volume side, we saw - like, you mentioned in the Portuguese call about 4% volume growth. And I would like to understand if we should take that as a relative proxy for the year. So that's the first question.

The second one goes on the gross margin side, right? So we have lower cost pressure this year, so the FX is - you mentioned you have tailwinds in the first half of the year versus a headwind last year. So I'd like to understand how this plays out with price increase, mix and lower cost pressures. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, Joseph, I'm going to take first part. Breno will answer the second one about the gross margin. Basically, as I've said in the previous Portuguese call, we have price increase this year. On average, our price will be 3.5% after the weighted average of the different sectors that we are present. It's much lower than the 12.5% of last year.

On the other hand, the costs are not running because that we don't have pressure from the exchange rate variations. So, also that what we have been saying that moving forward, our nominal growth will tend to be lower given that the difference of prices on this year, they compress (30:43) compress moving on, second quarter moving on will be tougher than the first quarter. Because of that, probably we should have lower nominal growth, that's not to say that real growth will be the same.

On the other hand, last year, we had some contraction in terms of volumes. People start being more cautious about buying products, especially in the more consumer-related markets, such as the OTCs, because of the increasing prices on one hand and the other hand because the whole atmosphere of no (31:34) expectations, the bad expectations that we have on the macro conditions moving forward as well as inflation affecting the purchasing power of people.

Moving forward, if we continue seeing the same scenario that we have now, which is basically low inflation levels and then a good perspective moving forward in terms of investments, a reduction of interest rates and then a much better atmosphere, and then for the business community, the tendency is that consumer is coming back and recovering part of this volume, they stopped consuming last year, replenish their stocks at (32:30).

Also, it's very important also in that equation of thinking about top line, about the product launch, as product launches do make a difference when you get it right. So that has gone above - top and above the only traditional volume and price indicators.

So, as we move and we can gain more attrition and we increase our innovation index, that shall also (33:06-33:11) will support further growth moving forward. Just to remember, this quarter, our Branded products, which includes both the Branded Prescription and Consumer Health, we were able to grow at 15.9% vis-à-vis the market of 14.9%. So we were able to grow 1% above the market. And at the end, that's what we look for here. All is to say how much can we grow above the market based on all the combination of these variables that I am talking about.

So I'm going to pass it to Breno to talk about the gross margin.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Hi, Joe. On the gross margin, so last year, our average gross margin was 74.3%. Given the positive mix effect that we have in the first quarter, together with the FX depreciation (34:11), right, that we are seeing, even though it's a small effect, but it's a positive effect, we are indeed expecting some slight improvement in gross margin this year.

On the other hand, we are seeing some increases of our investments that we are doing and other expenses that should offset. As we've seen in the first quarter, that should offset this margin expansion - this gross margin expansion throughout the year.

Q - Joseph Giordano {BIO 17751061 <GO>}

Perfect. One extra question, if I may. When I look back last year, we had the 12.5% price increase. So this prompted both retailers and distributors to build up, like, tons of inventories to exploit inflationary gains on their inventories, right? So did you see this effect this year? And, again, trying to strip out to say, okay, maybe last year we had a one-off gain that this wasn't present this year. So I just want to understand this. And also try to bridge with the higher level of discounts that we saw this quarter. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, I'm not sure where you've seen high level of discounts. We can talk about that if you want.

Q - Joseph Giordano {BIO 17751061 <GO>}

The difference between gross sales and net sales.

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A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

That's not - that's what I said in the Portuguese call. That is not increasing in the level of discounts. It's the change in the formats of discounts, right? And I can't - we can talk with you in private if you want (36:02) and explain that. But at the end, what we have been saying in the Portuguese call and we repeat it here that the right metrics to look is the net revenues, not the gross revenues. And don't imply there's a higher discount because that's not really the fact. Okay? So what was the second piece of the question?

Q - Joseph Giordano {BIO 17751061 <GO>}

Related the one-off impact that we had last year, so probably higher growth in Q1, given the higher anticipation of purchases that we saw last year and if you saw, like, a different impact this year?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Yeah. In fact, last year, there was more anticipation than this year because of obvious reasons, right? So, last year, there was much bigger price increase, so people anticipate more than this year. So, this year, there were less anticipating that. In that respect, last year, the comparison was tougher, was a tougher comp vis-à-vis this year.

Q - Joseph Giordano {BIO 17751061 <GO>}

All right. Perfect. Thank you.

Operator

Okay. Thank you. The Q&A session is now closed. I would like to turn the conference back over to Mr. Claudio Bergamo for any closing remarks.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much all for participating. Our IR area (37:56) is available to answer any further questions. Thank you much and have a nice day.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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