Q2 2014 Earnings Call

Company Participants

- Eugênio de Zagottis, Director-Investor Relations & Corporate Planning
- Marcílio D'Amico Pousada, Chief Executive Officer

Other Participants

- Guilherme Assis, Analyst
- Joseph Giordano, Analyst
- Luciano Campos, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Raia Drogasil's Conference Call to discuss second quarter 2014 results. The audio for this conference is being broadcast simultaneously through the Internet in the website www.raiadrogasil.com.br/ir. In that address, you can also find the slide show presentation available for download.

I inform (00:31) that all participants will only be able to listen to the conference during the company's presentation. After the company's remarks are over, there will be a QA period. At that time, further instructions will be given.

Before proceeding let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Raia Drogasil management and all information currently available to the company.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of Raia Drogasil and could cause results to differ materially from those expressed in such forward-looking statements.

Today with us, we have Mr. Marcílio Pousada, CEO; Mr. Eugênio de Zagottis, Investor Relations and Corporate Planning Vice President; and Gabriel Rozenberg, IR and Corporate Planning Director. Now I'll turn the conference over to Mr. Marcílio Pousada. Sir, you may begin your conference.

Marcílio D'Amico Pousada

Okay. Thank you very much. Good morning, everyone. Welcome to the Raia Drogasil results presentation for the second quarter of 2014. As always, Eugênio will present the highlights of the results. And just before the Q&A, I'd like to stress a few points about the quarter and about the future for the company also. Eugênio, please?

Eugênio de Zagottis

Hello, everybody. Welcome, everybody, to our conference call for the second quarter 2014. We are very happy to present another great quarter. And I think this quarter in this course (02:22), this new phase of higher diversity have been reached, the integration is everyday more in our rear mirror, and we can get back to servicing better our consumers. We can get better, we can focus better in terms of improving the quality of operations. So as a result of this, I think the numbers that are presented here, they are good and they are sustainable, and they have continued from the good trend we saw in the first quarter.

We ended the quarter with more than 1,000 stores in operation, 1,015 stores. We opened 29 stores in the quarter alone and closed another two stores. We reached gross revenues of R$1.9 billion, 15.7% of growth. And for the same-store sales, the growth was 8.9%. We reached a gross margin in the quarter of 28.1%, a 1.1% (sic) [percentage point] (03:21) margin increase. As a result of this, our EBITDA reached R$131.3 million in the quarter, a margin of 7.1%, an increase of 26.9% over the previous year.

The net income on an adjusted basis increased to R$73.8 million, a net margin of 4%. and an increase of 26% over the previous year. And finally, we generated in the quarter both positive free cash flow of R$51.5 million and total cash flow of R$19.5 million. It's important to highlight that every year, the second quarter is the strongest quarter on an absolute basis. What happens is that the price increase set by the government, they happen in the very end of March.

So we entered this quarter selling for increased prices, products that were purchased too (04:18) at another cost of goods sold. Progressively as we replenish our inventories through the quarter, and replenish at a higher price, the margins get back to normal. But this quarter is always a very high margin quarter. So this quarter can only be compared to the second quarter of any other year. You cannot compare it to any other quarter. Just as the first quarter is the weakest quarter of all, due to the fact that January is a vacation month, February is a short month and it's Carnival as well.

On page four, we would like to highlight our organic growth. As I mentioned, we reached 1,015 stores in the quarter. When we consider the whole semester, we have opened 47 new stores. We have closed three stores and we have re-opened four stores that have been temporarily suspended for branding (sic) [rebranding] (05:12). It's important to highlight that we achieved the milestone of 1,000 stores. And in our case, it's 1,000 fully operated stores. There's no franchising in the model. So we have only a very small number of retailers that really operate north of 1,000 stores in Brazil, that I know for sure, besides us, there is also Grupo Pão de Açúcar, I don't know of any other, but there may be one or two. So we are part of a very small group of companies that operate more than 1,000 stores.

We also reiterate for the year our guidance of 130 new stores. This means that we have a high concentration of openings in the second semester of the year. And this was already planned because the World Cup has delayed mobilization (06:00) and opening of new stores. So as our engineering team has a lot of work to do into the end of the year, in contrast, our prospection team is already in 2015. We have already signed each and every store for the year, and we're already working on the stores to be opened next year. And this is happening quite ahead of time. We generally expect to be over with the current year in August, and we're already (06:30) early August and over (06:32) and we're working on 2015 plan.

Another point that I'd like to highlight is that apparently, we're doing the same number of stores as last year. Last year, we opened 131 stores. This year, we're guiding to 130 stores. But when we really think on organic growth, on organic prospection, there's an important difference. We had 25 acquired stores last year in Goiânia. So out of the 131 stores, only 106 stores were truly prospected from the ground up. And this year, we have upgraded that to 130 contracts signed. So it's an improvement in the pace of prospections that we have made. When we analyze our store portfolio, still 33% of our stores are undergoing maturity and they are nowhere near their potential in terms of revenues, especially in terms of profitability.

On page five, I want to highlight our national presence here. We have 1,015 stores in 13 states of Brazil. Out of these stores, Raia has 46 stores, Drogasil has 529 stores, including purchase of the (07:44) Farmasil stores. We have already reached a percent of 42% of our stores, they are located in new markets, while 58% of the stores are located in São Paulo, our major market. This is a number that was built over the last 10 or so years. And I think that it's quite an achievement. When you look at most of our competitors, I mean, a lot of our competitors still rely heavily on an aged (08:17) market. And I think this number shows our capacity to successfully reproduce the model at a very fast pace with a very, very high level of quality as expressed in our numbers.

So we have already exceeded (08:32) our brand in the chief states of Brazil. In many of those states, we can say we have a mature brand, like in São Paulo, like in Goiás, like in Paraná like in some parts of Minas Gerais and so on, and Rio de Janeiro. While in other stores, we are in different stages of brand maturation.

One of the highlights of the year is our growth in the Northeast region. Not only we have entered in Pernambuco, we now have three stores in operation. By the end of the quarter, we had two stores. We are very happy with the initial results that those stores are showing. So it's a very promising market, very similar to what we saw in Bahia. And we are also entering Alagoas and Sergipe. Our first store in Alagoas will be open next week in Maceió, and then in a couple weeks' time, we'll also be opening our first stores in Aracaju in the state of Sergipe. And the Northeast, counting also Bahia, will be an important part of our growth this year.

Talking about market share, we present here our comparable market share growth. We say comparable market share because this figure is an IMS adjusted figure to take out from the base, new informants that are added to the base this year, but were not in the panel last year. So when we do that exclusion, (09:55) we see a 0.6 percentage point market share increase on a national level.

In São Paulo, we came from 20.5% all the way to 21.3%. So it's a strong figure, 0.8 percentage point in our most mature market. In the Southeast region, besides São Paulo, 0.4 percentage point of increase. In the Midwest, 0.7 percentage point; In the South, 0.9 percentage point; and in the Northeast, 0.4 percentage point. So we have gained market share in each and every region. When we consider the reported market share, with the increased panel without any adjustments, our national market share was 9.3%. So in one way or the other, we're increasing market share at a very robust level.

On page six, we highlight our revenue growth in the quarter. Our total revenues have grown by 15.7%, with same store sales growth of 8.9%, and with mature store growth of 4.2%. It's important to mention here that in the second quarter, we had a negative calendar effect of 0.8% because Easter was shifted from the first quarter, where it usually belongs, to the second quarter. So we have less working days and an unfavorable calendar effect of 0.8%.

On the other hand, we had public demonstrations last year that affected our revenue growth by 0.8%. So our comp base is penalized by 0.8%. So the demonstrations and the calendar effect we net out (11:33), in general, we have is a World Cup effect of 1.3 percentage points. Marcílio will talk more about the World Cup, but I think that the results of the World Cup had a bigger effect on our soccer team than they had in our revenues.

On page seven, we highlighted the main category in the product mix once again was Hygiene/Personal Care. The participation in the mix increased by 40 basis points to 25.4%, a revenue growth for the category of 17.5%. OTC also performed well with a 10 basis point increase in the product mix. When we compare Generics with same quarter of last year, we lost 30 basis points of market share but we have a significant improvement versus recent quarters. And finally, Branded has remained pretty much in line.

Now talking about gross margins, this was really the highlight of the quarter as we came from 27% of gross margin all the way to 28.1%. So 110 basis points improvement in this quarter, and a couple elements that explain that increase. First of all, we have fully normalized tax situation. So we were harmed pretty much for a year and a half by a tax penalty of 40 basis points. Last quarter, half of this tax penalty has already been reverted and now tax is no longer an issue. We only talk about taxes in the comp base. Our margins are now normalized.

Another important effect here, you might remember that, is that last year, exactly in this quarter, we undertook a change in purchasing strategy. Our Generics purchasing were being – relied (13:30) very heavily on trade allowances. And trade allowance is something very complex to deal with because, first of all, the payment of the trade allowances is not very control. (13:43) I mean our suppliers sometimes they pay faster, sometimes they take months to pay. So first of all, there is a working capital problem. And second, trade allowances bring huge volatility to margins. So we decided to renegotiate our purchasing contract, eliminate as much as possible trade allowances, and include them in the final purchasing price in our invoices. And this was successfully done.

The problem is that in the first month you do it, you are no longer booking trade allowances but your cost of goods sold is still very high. Then as we replenish, cost of goods sold get down, and the margins got back on sync. So our margins were penalized last quarter by – in the same quarter last year, exactly by 40 basis points because of this purchasing strategy change, that was very important but it had a cost in the second quarter.

And finally, the remaining view (14:42) 0.3 percentage point improvement, it's really operational. It's due to better pricing. It's due to better purchasing. It's due to very good terms in the forward buying. So we believe part of this improvement, we will be able to sustain; we'll see. But 0.3% was certainly better execution on our side. When we talk about cash cycle, we had a three-day cash cycle improvement. There's a couple effects here (15:15). First of all, except the fourth (15:18) quarter, taxes on inventories have increased our inventory days by 4.5 days. So we're comparing a period with taxes on inventories with a period without tax on inventories. So tax on inventories, 4.5 days.

Another thing is that in the second quarter next year, we discounted 0.6 days on receivables. I mean, this result is an (15:41) off-balance sheet financing, this is not operational. So to understand working capital, we have to plug (15:48) it back as well. So when you put everything in place, our cash cycle improved not by three days but by eight days. We have also to admit that as we were transitioning to a new purchasing model, days of accounts payable were also repressed. So this eight-day improvement has to do (16:08) to some level, something like four days to five days, with the cost of transitioning during next year. But still, we are – when you look (16:19) inventories on a cyclical level, not on a financial level, when you take out tax effects, I mean we get more efficient. We are reducing inventory days there, day after day, without sacrificing service levels, without sacrificing our operation. And this is very important.

On page nine, sales expenses were pretty much in line with same quarter of last year. They only increased by 0.1 percentage point and we all know this is the most challenging line for us to manage. We face here a steep inflation in general both on labor and on rentals. On the rental side, there was a 20 basis points pressure. However, on the labor side, for various reasons that I'll detail, we are able to reduce 10 base points. So the net effect was only 0.1 percentage point pressure on the sales expenses. What happened with customer (17:13) expenses is that first of all, at the same point last year, I think we were kind of slightly over-staffed in the stores. So part of the reduction we did was good.

There's a lot of factors to take into account here, and this is a process gap on our side. I mean our people replenishment has been slower than we need it to be. So part of the staff reduction we had is not sustainable and it's not good for the business. So we will normalize through this year, and maybe there's just an effect on the next quarter, we'll see, but this is not something good. Because this means that we have less people servicing our consumers, so this can affect also perception and other things like that. So we will get – we're focusing a lot on the people replenishment process. We're getting that back to normal. So that was quite or kind of artificial relief on the labor side that should not be sustainable. And it's good that it be reverted as we soon can.

Another factor here to take into account is that last year at this point in time, we had the reduction in social charges. That only lasted for two months. The total effect on the last quarter was 30 basis points. Out of this 30 basis points, 20 basis points was the sales expenses, 10 basis points in corporate G&A. And this 20 basis points in higher social charges this year were fully offset by the fact that the new stores had provided a lower level pressure. First of all, because we were opening more stores at this point in time last year. So part of this will show up in the second semester. But then there is the fact that we are seeing a very high level of revenues per store and profitability – unusual profitability in the new store. So part of the gain is performance, is due to the quality of our expansion. But it's timing only and we revert it in the second semester of the year, but it helped in the quarter.

G&A increased by 30 basis points, page 10. In a way, this is a good increase. What happens is that as we are seeing numbers that are better than what we had originally budgeted, we are increasing our variable compensation allowance. And in contrast to what happened exactly this quarter last year, we were exactly watching our numbers deteriorate, and as a result, we were reverting our provision. So it's a big delta between hedging provision this year and reverting provision last year. So it's a 50 basis points pressure. That comes basically out of a better (20:04) performance.

And then what we see is a dilution in personnel at the corporate level of 20 basis points. So when you look at the structural piece of the G&A, we have diluted that very effectively. We diluted personnel expenses, 20 basis points. And here we have another 10 basis points of other improvements that are paying for the higher social charges that we have this year when compared to the previous year. So structurally, G&A is great and this will show up certainly (20:42) in the second semester. But in this quarter, the decrease of the allowance – of the bonus allowance has penalized the figures here.

All in all, we increased our EBITDA by 27% in the quarter as we reached R$131 million. Our margin went up 0.6 basis points to 7.1% of EBITDA. When we put together the first semester of the year, we did a very good 6.1% of EBITDA margin. This is a margin that makes us very happy. We will be delighted if you can sustain it on the second semester, but even if not, it shouldn't be very far from that. So I think we are heading to a very robust year. In comparison to last year, in which in the first quarter, we did 5.6%. So in the first semester, we improved our profitability by 50 basis points. This is certainly on the higher end of the expectations that we had for the year.

Another interesting thing here to understand is when we compound the results of the stores that were fully operational by the end of the year, meaning we're taking out from the base every store we opened this year and the pre-operational expenses that they generated. So the pre-existing stores when absorbing full logistics expenses, when absorbing full G&A, we'll have an EBITDA margin over the revenue of new (22:16) stores of 7.6%.

So it's very easy to understand that the initial loss of new stores, plus the pre-operational expense even before opening those stores halved (22:26) our EBITDA by 50 basis points. I'm not talking (22:29) maturation. Maturation would add another 100 basis points or so. Only the cost of the magnitude for (22:35) initial results is 50 basis points. So this effect shows in our – the cost of opening stores shows in our EBITDA, shows in our net income, shows in our P/E (22:46), shows in our consolidated (22:49), shows pretty much in every financial figure. So to understand the business, it's important to understand the impact of maturation.

Depreciation remained flat versus last year at 2.4%. We diluted net finances expenses by 10 basis points. We have a better cash position, so we're paying less interest. And finally, as a consequence of better operational results and lower financial expenses, we'll have an increasing taxes accrued by 40 basis points.

And this resulted in a net income – an adjusted net income of R$73.8 million in the second quarter. This means 4% of adjusted net margin, 30 basis points better than at the same point of last year and a 26 so percent increase. Non-recurring expenses remained at a very low level of R$1.5 million, pretty much in line with the previous quarter, and much lower than what we saw last year when we give R$8 million in the second quarter, R$20 million in the third quarter, and R$14.5 million in the fourth quarter.

So this is another testament to the fact – to the progress of our integrations. There is still some loose ends that has to be sewed (24:03) and integrated but we think in the cost of integration that the bulk is already done. For those who care about the reported net income, without adjusting for non-recurring expenses, then our reported net income increased by 54 basis point. I don't take this figure very seriously because I think the right way to look at the results is on an adjusted basis. It is where we see where the performance is trending (24:35). This is the best way to go into a problem (24:37).

Cash flows, page 14. We generated in the quarter a positive free cash flow of R$51 million and total – positive total cash flow of R$19.5 million. And this includes R$21 million in disbursement for a share buyback. As you may recall, we repurchase shares in order to finance our variable compensation program based on restricted shares. So these shares that we bought, they should be enough for, I don't know, two years, three years, four years depending where our performance goes. But we spent R$21 million and we purchased these shares and still had a positive total cash flow in the quarter.

When we compare this year-to-date, pretty much everywhere that you compare year-to-date to be negative. For the simple fact that December is the best seasonality for working capital. So when we compare the June versus – the six months ended in June with December, we have consumed a total free cash flow of R$67 million versus R$94 million at same point last year, and a total cash flow of R$98 million, negative, versus R$105 million (sic) [negative R$105 million] (25:59) at the same point last year. Resources from operations in the semester increased by R$45 million.

Cash cycle. The cash cycle investment was R$143 million versus R$152 million at same point last year, and the main difference here is in other non-current assets and liabilities.

And we see R$30 million positive last year versus almost neutral this year. What happens here is that last year at this same point in time, we were recovering taxes on inventories. And what happens now is that we are repaying those taxes on inventories as we changed our tax situation. So both situations are not recurring. It was a one-off benefit last year. It's a one-off penalty this year. So this is a difference in R$29 million over R$27 million just because of that.

And to conclude, before passing to Marcílio, we see that our share price at the end of the semester was R$18.24, a 23.4% share price increase versus an IBOVESPA increase of only 3% in the first semester. Over here, I mean, as we saw last year, a 30 basis point profitability deterioration (27:29). I think that was an overreaction and our price fell very sharply. So it was a maybe once in a lifetime opportunity for those who bought the shares at R$13. And as a result, we're seeing – as the results have normalized, we see a big escalation in our share price that is very good.

So I will now pass it to Marcílio for his comments (27:53) about the quarter and about our perspectives coming forward.

Marcílio D'Amico Pousada

Okay. Again, our results show a great improvement. I have three points I would like to stress with you about this, why we have a good improvement in this quarter, okay? The first is revenues. Despite all the pessimism (28:11) about the World Cup in Brazil, we only saw moderate impact, like if the World Cup has happened in other countries (28:17). We only saw disruptions when Brazil played as there were no holidays in the Brazil during other games. But another thing that helped us in the revenue results is the new stores. We are slightly behind schedule, but we are already signed all contracts to open 130 new stores for this year. It has been an amazing semester in terms of the quality of the stores already opened, with higher projected revenues than the preexisting (28:43) stores in the same market. This shows the quality of our expansion plan and the growth opportunity ahead of us.

If you look at the gross margins our margins increased by 1.1%. We solved the tax government (28:57) benefits from the changes in purchasing strategies we did last year, and especially is equipped (29:03) much better than last year. We had upgraded the cushion (29:07) in the forward buying and negotiate a very good term. Certainly it was much easier to plan (29:14) had just one system and with sharing this (29:17) connecting the same system.

Additionally, we had a comfortable cash position and if we make a great (29:24) working capital that gave us confidence to increase inventories (29:27) knowing they would normalize after that. Another factor that contributed to the margin increase was better price management taking. (29:37) Smart price decision for both brands, Raia and Drogasil, market by market, store by store, and product by product, by leveraging our capital management structure and retailer better front (29:46). I think this margin increase, associated with the expenses (29:52) that Eugênio presented helped the company to close the quarter with R$131 million EBITDA, 27% better than last year and a margin with 7.1%.

I believe we that can keep this good performance the next quarter because in my understand, the main drive that we have right now in the company is keep these good results for the future. I will stress that they are our drivers right now for you. I think the future (30:26) integration, we now have more than 1,000 stores in selling to distribution centers, connect to the same retailer fee and (30:27) financial systems help us to improve our situation (30:35) and realizing results (30:37) for the future.

The second point that I think is very good for us right now is the management model. We have clear performance you target for the company and in each executive and their variable compensation model based in restricted shares to align sales. (30:52) We have all the executives working separately not targeting their goals (30:56). This is very important for the company.

We start also probably with category measures. (31:01) We have invested and appropriated cat measure structure (31:04). And we are sharing our expertise across both brands to leverage their valuable position (31:10). This leads to much better commercial decisions, and (31:15). But the most important point that we are working right now, is a focus in execution. Execution which is consistent on a day-by-day basis is very important for our business. And we're working hard every day to be ready when the customers search to us (31:33).

Finally, we believe that these drivers are bringing our execution to a new a level and still have many opportunities ahead that should bring continued margin improvements in the coming quarters.

Now we can move to the questions.

Q&A

Operator

Thank you. Mr. Joseph Giordano from JPMorgan would like to make a question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hi. Good morning, everyone. Thanks for taking my question. First of all, I'd like to congratulate you all for the 1,000 store milestone. That's such a great achievement here. So I'll pick up with a question on the systems integration. We're seeing some gross margin improvement stemming (32:33) from such integration, particularly on the commercial front. So I believe that during the quarter, you enjoyed some procurement gains with some better pricing strategy. So I'd like to understand how this new pricing strategy should be aligned with the refurbishments of the new Drogasil stores. And so that's my first question here.

A - Eugênio de Zagottis

Joseph, thanks for the question. I think we did a significant improvement in pricing. As we integrated our retalia B (33:09) and as Raia Drogasil have now applied to (33:13) all the stores applied (33:15) to the same system, we have way more flexibility to price.

On the pharma side, we have already changed the Drogasil pricing. Drogasil has a very flattish pricing program across stores and across SKUs. So we're now playing much more with high-low. So there are products we are more aggressive, there are products we got less aggressive, there are stores we get more aggressive, there are stores that get less aggressive. So I think we had pricing better tailored to the range (33:46) of each market and better tailored to the price elasticity of each item. So this is something very important.

For HPC even though the tool is already there, we are still working on the improvement. It's much more complex with doing HPC. We have to decide the strategy brand by brand, category by category. So the system is already there, but we are still not there. We're getting ready and probably through this year, we can improve our pricing in HPC. I think that the opportunity in HPC it's very interesting because I think Drogasil's pricing was better in pharma than it is in HPC but it was also easier to change pharma than HPC.

Then another thing is that as we finalize the integration and as we change the point of sale system at Drogasil, we get extra flexibility. For example in price coverage, in special Sundays (34:44) promotion and we're still not there. But even if the tool is already implemented, we will not (34:49) be ready to use it. So we're progressing a lot and I think pricing has to do, to some extent, with the margin improvement.

As far as purchasing, the structural purchase integration has happened, much before the system integration. But on a continuous basis, as we get bigger, as we get stronger, we are able to negotiate better and better terms with our suppliers. The renovation is a strategy that you mentioned for our stores, it's progressing very well. We see a big improvement in Drogasil, especially on HPC and OTC as a result of the format change that we have been able to do in the stores that have been already been finished (35:30) by our renovation program.

Q - Joseph Giordano {BIO 17751061 <GO>}

Just a follow up on the HPC side. Now it seems (35:36) that the drugstore segment is gaining share on this market. Is that a true affirmation here?

A - Eugênio de Zagottis

Sorry, can you repeat, Joseph?

Q - Joseph Giordano {BIO 17751061 <GO>}

My question is if the drugstore channel has been gaining market share on the HPC, and if you see that you're gaining share over supermarkets, or over like the direct sales channels. So if you have this type of data.

A - Eugênio de Zagottis

When you look longer-term (36:01), absolutely. I mean there's a huge shift of market share away from supermarkets and into drugstore. I mean I think there's a global trend that small formats grow larger. They grow more. They grow faster than large formats because of convenience and so on. So when you compare what we do, not only us, Raia Drogasil, but us, drug channel, with supermarkets, I think we offer much bigger convenience because our stores are close where people live.

I think we also offer a much nicer shop environment, a much better shop experience, a higher variety of items in the categories we sell. We have people to service the consumers, so consumers see that. And every time, more, the consumers are shifting their primary purchasing from supermarkets to drugstores.

I remember that 10 years, 15 years ago, our HPC offering was very, very – had very little excitement. The purchasing were pretty much on a convenience basis. I mean the consumer was there to buy pharma and remember that if he ran out of deodorant, or shaving, or whatever, and they bought it. Over time, as our mix improved, there's execution improvement, and as the consumer got used to the drug channel, more and more consumers are doing their everyday buying in drugstores. We don't have news and figures, month-over-month or quarter-over-quarter, to be able to say that this year we still expect more than the supermarkets (37:31) but the trend is here. (37:33)

Q - Joseph Giordano {BIO 17751061 <GO>}

Okay. Just my final question here. There's been a lot of rumors in Brazil concerning M&A in the segment, so I'm not sure if you can comment on any of those rumors or if you see like an increased interest for acquisitions in Brazil, particularly from international players?

A - Eugênio de Zagottis

Joseph, we don't comment on any specific rumors but as I've said, it's obviously that Brazil is one of the most interesting markets in the world for the size, for the growth, for the fact that the sector remains fragmented, and you have global players re-examining the market, looking. CVS has already a small presence in the market with Onofre. So the interest of global players is self-evident. And I think it's a matter of time to see global players buying local assets and then become part of the market as well.

In our view, this is not a global market. We have a ton of respect for companies like CVS, like Walgreens and Boots, but I think this is a regional market in which we're very, very well positioned to drive into the redundance of who we're (38:45) competing with. And this is a market in which the formats are local, the brands are local. This is a market which regulation is local. So I think any global players here, the level of competitiveness will depend on the asset they buy. If they have a great asset, congratulations, they'll be a great player here. If they don't have a great asset, they won't be able to be strong here. So the quality of the asset, it's the most paramount thing.

You cannot source generics from China or India and bring it to Brazil. You have to have a local manufacturing plant, you have to have local approach to product (39:28) development, local bioequivalence studies based on the local molecule. So I think the scale of any player in Brazil will be the local scale. If a global player buys a big local player, they'll have scale if they have good stores, they will have great stores. But just a passport, I don't think it's enough to win the market.

And what we can do is strengthen our operations, it's strengthen our brands. It's adding great new stores. I think the game in the end it's a game about assets and it's a game about execution, and I think we're very well positioned to play. And again, we respect a lot of global players. I think if they buy the right assets, I think they have a meaningful presence in this business.

Q - Joseph Giordano {BIO 17751061 <GO>}

All right. Thank you very much, Eugênio.

A - Eugênio de Zagottis

Thank you.

Operator

Mr. Luciano Campos from HSBC would like to make a question.

Q - Luciano Campos {BIO 16181710 <GO>}

Hi. Good afternoon, Eugênio and Marcílio. The question is about generics. We noticed that the weight of generics in your mix reduced a little bit and you mention there the reduction of the pace of new launches with new generic molecules coming to the market. My point here is that this is also like giving the chance for other producers to take shop (40:57) in terms of the generic that they can offer to you. Meaning, you now may have over time more producers able to give you the same type of range of products that you need. And I was wondering if that is also reflecting potential like an increase – or potential increase of gross margin for you in the Generic business to compensate this smaller mix or smaller weight in your mix. That's the question. Thank you.

A - Eugênio de Zagottis

Luciano, thanks for the question. There have been a lot of new products. The problem is that most of these products have been redundant products. So the second, third, fourth or fifth generic version of the same molecule. This is good. That's why I think you nailed it. This is great news as far as (41:47) margins, because we have more options where to source from. So margin-wise, I think this is good. But this doesn't necessarily add penetration of generics. Penetration of generics depends a lot on new molecules being launched and I think we are (42:05) that nothing of relevance has come out of (42:11).

2015 should be a better year especially in the end. We expect, for example, CIALIS to get off patent for example. But still when you look longer term, it's not an exciting landscape for new generic launches. When you look at our penetration, you can sell generics here, you can see the glass half empty or half full. I mean if you consider – if you compare to same quarter last year, yes, we are down a couple basis points. But if you compare to previous quarters, I mean we have made a big improvement here. In the second quarter, Generics accounted for 11.3%, it's now 11.9%. So there was an improvement. There's an improvement in execution here.

And there's another factor that even though we still have a small number of Farmasil stores, Farmasil is so reliant on generics that Farmasil kind of moves the needle here. You cannot see Farmasil in any other place doing numbers. But in generics, Farmasil is starting to make a difference in terms of overall generic penetration. So it's still a pilot stage store (43:20). We have done a lot of tweaks that are redistributing (43:25) Farmasil. I don't know how long it will take for Farmasil to be able to be launched, this (43:29) strategy. But even the pilot is starting to help generics penetration.

Q - Luciano Campos {BIO 16181710 <GO>}

Just a follow-up, Eugênio. Is this potential better margins in Generic something that you are – is already materializing with more producers with the same molecules, or this is something for the future that helped or not in the good improvement of gross margins that you had this quarter?

A - Eugênio de Zagottis

Look, I think we already are appointing (44:01) margins. But it's really hard to expect Generics margin to go up. I mean, we have Generic margins somewhere between 55% and 60%. So, yes, we can have a year slightly better than the previous year. For example, this is a year in which we see manufacturers, they were trying to cut down discounts (44:22), get back to aggressive promotional activities. So I think this year, there's a moderate help in Generics margin. But overall structurally, this is not something we expect to see or sustain.

Because when everybody is buying generics cheaper, in the end, the market will price cheaper to the consumer. And we have seen the offers that happened. I mean, last year was a year in which we had increase in generic prices from some suppliers if they can (44:52). In the end, the margin was the same because this price increase was passed to the consumer. So I don't think it's realistic to expect that the gross margins for Generics will grow beyond where they are. Having said that, we expect to improve gross margins in HPC, to improve in OTC and improve in Branded as well. But Generics, I think we are as good as it gets.

Q - Luciano Campos {BIO 16181710 <GO>}

Very clear, Eugênio. Thank you.

A - Eugênio de Zagottis

Thank you.

Operator

Mr. Ruben Couto from Brasil Plural, would you like to make a question?

Q - Guilherme Assis {BIO 16143141 <GO>}

Hi. This is Guilherme Assis from Plural. Sorry, I joined late in the call, so forgive me if you already answered this question. But my question is, even though there was a good increase year-on-year on health and beauty products, we saw that there was a smaller contribution to the sales mix when compared to the first quarter and fourth quarter from last year. Why was there this drop in the contributions? Is this just a seasonality effects, or is there another reason for that? That's my question. Thank you.

A - Eugênio de Zagottis

Guilherme, thanks for the question. I mean you can compare generics and brands across different quarters, but you cannot compare OTC and HPC. OTC and HPC have a seasonable nature. So for example, HPC will always be very high in summer months. So, for example, 4Q and first Q, HPC moves up, OTC goes down. Then second Q and to some extent third Q, they are more – they're winter months. So this is when you see HPC going down and OTC going up. I think the drugstore, that kind of sustained itself all over the year, but HPC and OTC, they shift a lot from quarter to quarter. So you can only compare versus the previous quarter – or the same quarter previous year.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. And regarding your strategy for HPC, I know that the company is investing a lot in reinventing the store and the product category management. What should expect to see even in the stores when you launch or when you start to implement that more actively, the strategy going forward?

A - Eugênio de Zagottis

I mean we believe the front store and especially HPC have a very important role in improving our – in involving more the consumer with the store and even in terms of the profitability mix. So it's a huge priority for the company to keep pushing the envelope in HPC and in OTC.

The Drogasil renovations are having a huge impact in those categories especially in HPC. So what we're doing in Drogasil is just getting something that was not good back to normality. There's nothing fancy about what we're doing in Drogasil. I think it's necessary to help our figures but there's nothing revolutionary there. But having said that, at some point, I think that the (48:21) next year should be the last year of resetting (48:26) the Drogasil format and getting the stores up to date.

When you look ahead four years, five years, 10 years, I think we can expand our presence in HPC significantly. I think we can move in categories that we're very under-represented right now, like makeup, for example. I think skin care can get stronger. I think we have a lot of categories like vitamins and nutrition can get (48:49) everyday more important. I think the strongest our stores are in HPC and OTC, the higher the consumer is on (48:59) consumer involvement and the brand equity that we build.

Branded and Generics raise our profitability but Generics doesn't bring brand equity to Raia to Drogasil or to any brand that we have. What transforms our execution, what transforms the involvement to the consumer, what helps positioning and strengthening our brand is the work we do in HPC. In fact in categories that bring consumer experience, consumer perception. So this is – we have a lot of strategies being designed and the HPC has a big role in our future.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. Thank you, Eugênio.

Operator

It appears to be no more further questions. Now I will turn the conference back to the company for their final remarks.

A - Eugênio de Zagottis

Well, thank you all, first of all, for attending this conference call. Thank you all for your support, the shareholders, by staying on the tougher days and now being able to reap the benefits of the better days we have seen. And I think this is probably just the beginning of a long cycle of sustainable margin improvement. I think what we have done in the first semester really positions us for a very strong year. We have increased EBITDA margin by 50 basis points. This is on the upper end of any expectations we had. I think we are in a year that, very likely, we should be around 6%, slightly more or slightly less. So this is looking to be a robust year. And I believe the coming years should also be good years.

For me, it's not as critical how fast our margins will grow. The most critical thing is keep our margins going up and up and up on a sustainable basis. And I think we are getting ready to that. I think we have moved 9% of our share of mind from the integration, from the nuts and bolts of putting two companies together, to our execution, to do things better for the consumer, to improve consumer experience, to innovate, to do things that will add to our productivity. So this is what we're – we still have a couple loose ends to tie. But basically, I think we're already at a stage when our efforts, when our minds and our hearts are back to where they have to be, which is operating a better way, servicing the consumer better, building consumer loyalty, differentiating our stores, developing new categories and so on.

I tell you, this is a much more exciting rewarding work. And in the end, this is where the difference will lie for the future we all expect. So thank you very much. And we are always available for any of you for calls, for visits and so on. Thank you. Bye bye.

Operator

Thank you. This concludes today's Raia Drogasil Second Quarter 2014 Results. You may disconnect your lines at this time. Have a nice day.