Q1 2017 Earnings Call

Company Participants

- Eugênio de Zagottis, Head-Corporate Planning & IR Officer
- Marcílio D'Amico Pousada, Chief Executive Officer

Other Participants

- Joseph Giordano, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to RD – People, Health and Well-being Conference Call to discuss its First Quarter 2017 results. The audio for this conference is being broadcast simultaneously through the Internet in the website, www.rd.com.br/ir. In that address, you can also find the slide show presentation available for download.

We inform 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 Q&A period. At this time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of RD management and any 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 RD and could cause results to differ materially from those expressed in such forward-looking statements.

Today with us are 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

Thank you. Good morning, everyone. Welcome to presentation of the first quarter 2017 of RD. As always, Eugênio will present the slides and results and before the Q&A, I would like to stress some points about our future and about the results also. Eugênio, please.

Eugênio de Zagottis

Hello, everybody. Thank you all for attending our first conference call. This is the first earnings release we do as RD – People, Health and Well-being. And we're very proud to present a strong set of numbers. This was a quarter of very good growth coupled with very tight expense management, which translated in good margin improvement.

So, we ended the quarter with 1,457 stores. We opened 42 stores and closed 5 stores in the quarter. Our revenues reached BRL 3.2 billion, 21.6% of growth with same-store sales growth of 10.5%. Our margin reached 28.7%, which was flat versus the 1Q 2016. And we reached an adjusted EBITDA of BRL 244 million, 7.6% of EBITDA margin, 30 BPS margin expansion.

Our adjusted net income reached BRL 105 million, 3.3%, and the cash flow was BRL 173 million negative free cash flow and BRL 163 million negative total cash flow. And finally, we issued in April, (03:49) quarter BRL 300 million in debentures. The close was on April 12, our company was rated our company was rated AAA by Fitch, and the debenture has terms of five years with an interest rate of 104.75% of the interbank exchange rate.

And finally, we announced also on April 12, the change of our new corporate name. So, we are named RD – People, Health and Well-being reflecting the identity that emerged since our merger.

On page 4, we can talk more about our special program. We opened 42 stores in the quarter, and this is very good number, slightly higher than the last quarter. The first quarter 2016 is, when we opened 39 stores. So, we keep on opening stores in a very paved way through the year, and we also closed five stores in the quarter. These were all mature stores that have been relocated with positive retail expectation associated to them. When we look our store portfolio, 35.4% of the stores are still under maturation. This is the greenest portfolio since the second quarter 2013.

On page 5, we talk about our geographic positioning. Of the 1,457 stores, 760 was Drogasil, 694 were Raia. We reached a total of 830 stores in the State of São Paulo alone, more than 100 stores in Rio and more than 100 stores in the Northeast, a market we have been developing in the last four years, five years – last four years, actually. Our market share growth was relevant. We reached 12.6% national comparable market share with growth in every market where we compete. In São Paulo, we reached 24.9% of market Share. And in the Northeast, we reached 5.7% of market share. So, this is another strong performance here.

Page 6. Of our consolidated growth of 21.6% in the quarter, 20.4% happened in our retail business, and 66.6% happened in 4Bio. So, very strong growth again. In terms of our product mix, I think there is a big highlight here of pharmaceuticals, everything (06:31) pharmaceuticals and the expanse of hygiene and personal care. Generics was the key category here for us, growing 25.4%; branded, 24%; OTC, 21%; and the most challenging category here was hygiene and personal care in which we grew only 12%.

I think we have here a combination (06:55) of factors. First is, we have in the first quarter of last year a huge peak of HPC driven by the Zika virus. So, we have here a very strong comp for HPC. This is one of the factors, but not the only one. The reality is that we haven't done well in entry-level categories beyond (07:18) HPC in basic categories. The good news is in our core categories like skin care, like makeup, like hair care, we have done really well. But in entry level categories like, for example, feminine hygiene, like soap and things like that, we are affected by the market, which is not performing well, and also by supermarkets who have been very aggressive on prices.

Over the last 20 years, I think we gained share of supermarkets pretty much every single year, but this year because of the crisis, they're very aggressive and we have to make our – to choose our battles here. So, we focus on our core categories and it can be at the expense of other categories that are not as important for us.

Page 7, of the 21.6% of total growth, 10.5% was due to same store sales growth and 6.1% was due to mature store sales growth. Our gross margin remained flat versus first Q 2016. We gained 20 bps based on the net present value adjustment. Last year, in the first quarter, we had started our forward buying much earlier. Because of a 12% price increase, we were concerned about our ability to buy. This year, with 3% price increase, that's not an issue. So, we built up the inventories in the end of the quarter.

So, this means that we have longer accounts payable now than we had in the first quarter last year. So, we were lower – so, this generated a gain in NPV adjustment. Our retail margin also grew 10 bps. But we lost 30 bps at 4Bio, due first of all with the negative margin mix. 4Bio's (9:21) lower gross margin, and in this quarter, the gross margin was not particularly good. In terms of cash cycle, we maintained exactly the same number as last year.

Expenses, as I mentioned in the opening, this was really the highlight of the quarter. We achieved 30 bps of total expense dilution. G&A remained flat. But sales expenses, which is traditionally our toughest line, was the highlight of the quarter. So, we got 30 bps of dilution. In personnel, we achieved 10 bps dilution. In electricity, which is another 10 bps dilution. We are no longer in high tariff levels than we were last year. 4Bio helped, also 10 bps.

Pre-operational expenses, we have 20 bps dilution. And this is really a good performance here, because we opened similar number of stores for 1Q this year versus 1Q last year. So, this is efficiency, but rentals pressure 20 bps. And what's happening here is that, over the last 12 months, the IGPM has grown 150 bps ahead of the CPI, and most of our contracts are IGPM-linked.

So, now, the IGPM is on a much lower level, but we need several months of adjustment for these new levels to make a difference in our base. So, we believe the 20 bps pressure is the worst we'll see over the year, and there's a chance that in the second quarter, we could even be flat. But right now, it's a pressure, and most likely, it will remain a pressure in the second quarter. But all the other expenses, they have helped.

As a consequence, our EBITDA increased by 30 bps, which was all due to selling expense dilution. If we consider the 1,415 stores, the highest levels you had by the end of December, and we fully attribute to these stores all the G&A and all the logistic expenses. We're talking of BRL 3.2 billion in gross revenues from these stores, but BRL 244 million in EBITDA. So, we have – our EBITDA margin would have been 8% if we ignore the stores opened during the year. (11:57) EBITDA margin in the retail side of 7.8% and 4Bio has (12:02) an EBITDA margin of 2%.

Adjusted net income went down by 10 bps. So, what happened is that out of the EBITDA margin gain, we had 20 bps of net present value adjustment. In the end, this adjustment helps on the margin, but then it's subtracted again at the interest level. So, that's why we don't see the EBITDA margin reflected in the net income margin. We also booked BRL 2 million in non-recurring expenses. This is actually the net effect of many different components here. We had adjustment in labor contingencies.

We changed our loss estimates related to pre-existing claims following recent negative trends. So, this is BRL 12 million. And all these claims were pre-2017. We also had a gain of BRL 13.1 million related to the timing of booking trade allowances. We have specific allowances that we used to book with a one-month delay. And due to improved controls, now we can launch during the same month. So, there's this one-time gain by changing the regime here (13:24). And finally, we have a retirement compensation of a C-level executive that retired in the first quarter.

In terms of free cash flow, we had a free cash flow of negative BRL 173 million, and total cash flow, negative BRL 163 million, both similar to last year. Obviously, when we are comparing any quarter to the fourth quarter last year, it's always a disadvantageous comparison, because the fourth quarter is the best seasonal quarter in terms of cash cycle. So, any other quarter compared to that will suffer next year.

Next page, page 13, we see that our share has performed very well when you look longer term, not as well recently after the end of the quarter. But when you look longer term, since the IPO of Drogasil, and we're talking a 10-year period, we have seen 950% price appreciation. The average annual shareholder return for those who invested in Drogasil's IPO is 27.2%, and for those who invested in Raia IPO six years ago, 31.5%.

To conclude my part of the presentation, I'd like to discuss some of our capital market highlights. The main highlight is the debentures we have just issued. So, for the first time, we now have a rating from a rating agency, and Fitch rated us AAA due to our strong balance sheet, cash generation and financial discipline. We issued simple, unsecured, non-convertible debentures, which were raised (15:18) through restricted efforts.

And the total issuance was BRL 300 million with the closing on April 12. This is a five-year term debenture. We pay both principal amortization and interest on a bi-annual basis, but we have a one year grace period for the principal. We had a firm commitment by Itaú of 107.5% of the CDI, and we had a very successful bookbuilding, which reduces interest rate to 104.75%. I think we probably have the cheapest corporate debt in Brazil outside of the financial sector. Well, I hope I think I'm not mistaken.

And then we have here the date to our next earnings releases. Second quarter will – the release will happen on July 27; third quarter, October 26. And then, we have a bunch of investor conferences scheduled. Marcílio and I will be in New York at the Itaú conference, May 17 to 18; I'll be at the Merrill Lynch Conference in Los Angeles, the GEMS – CalGEMs, June 6 to June 8; and then we have two conferences in Brazil, Citi, June 28 and 29; Santander, August 15, August 17; and then, finally, September 11, the team will be (16:48) in London for the Morgan Stanley conference.

So with this, I pass to Marcílio so that he can talk about the quarter and a number of (16:58) and brand and identity.

Marcílio D'Amico Pousada

Okay. Thank you, Eugênio. Just before the future, I'd like to talk about the quarter. We talked last year in all the calls that we did with you that maybe 2017 will be a very best (17:12) year, okay. And we know why said to you (17:15) because, last year, we have a very, very strong year for us. Then for (17:20) this first quarter, we are very proud about the business, about the results because we reduced (17:24) the expenses and now, this (17:25) is very important for the future of this year. It's very good to the business (17:29).

Let's go to talk about the future in the next slide, Okay. Before I go to the future, let's talk about our company, okay. We are – remember you (17:40) that you are coming for (17:41) two big companies with (17:43) over a 100 years of history.

The merger, we do (17:46) this merger five years ago, we are the (17:51) all the good things (17:50) of the two original companies. And then we need that – we had the – of balance in certain geographies (17:57) After five years towards integration and trying to do the best, we know what's good for our company and we know what is efficient for our business. Then, we started to understand better what's good to our (18:11) future, what's good for the future for the company, okay. Then, you have the first (18:15) in next slide will be that more (18:17) belief.

Our belief is people taking care of people. In the pharmaceutical industry, (18:25) (18:26) pharmaceutical industry, a quarter (18:27) is very, very important. The (18:29) place (18:30) that we make the business and we (18:32) have to make a relationship with the customers. If you look at (18:38) the other retail business, other – all (18:41) retail business will be self-service, not our business. Then, we know people is important for our business. We love (18:48) people (18:48) if (18:45) we know how people is important for an business, and we have to work to training, (18:52) to prepare the people, then we know how important to take care of the people in our business.

That we've said (19:01) on purpose. Our purpose is taking close care of people's health and well-being during all times of their lives. In this statement, we (19:10) have two important phrases here, taking close care. Taking close care is much more than the only close care. We are – much more than (19:21) take care of the business, because we know how important to understand the customer needs, how important to transmit (19:28) confidence into our customers and put all things together to help and then you use our NPS score, that information (19:38) to understand better the customer and taking close care with (19:43) the customer.

The second point is during all times of our (19:47) lives, okay. We had to take care of people for the worst when they get older, and they (19:53) take care of the business then the customers (19:55) not only to buy simple pharmaceutical items and take care of the customer when they need (20:02) to buy special drugs for them, then we bought 4Bio also.

This purpose also help us to define our business strategy. We are only in the business which is health and well-being business, not in the business of selling Coca-Cola and french fries largely. We are looking just for health and well-being items.

Let's go our values. We (20:32) highly different values that is working with this company for 100 years; since the beginning of the – start of this company 100 years ago. The number one value is efficiency, doing well is the most important thing of our business.

Asset growth and (20:51) quality in a simple way with a lot of the discipline. In our retail strategy of the business, if you can stay a good price for this, we know that if you do better, you have better sales, better customer salesman and service, and also have better profits. Ethics. To bring our accounts is very important for us and (21:12). We are always work with the right ethicals (21:16) since the beginning of our company.

Innovations. Always think about how to serve the customer better and more efficiently. Always asking, in every process that you have, is this the best way to do this. We know how efficient and innovation is important for the future to prepare the company for the challenge that you have in the future.

Relationships of trust. Company that likes people, can always trust in people, but we trust more than people. We have the confidence of the other people to take care of our business. We know how important to take – management to take care of (22:00) outside of São Paulo area and we all would (22:05) to take care of the members of the businesses.

We love, in January to celebrate together, when the people grows into (22:14) and manager. And the fifth value is long-term view. We know that it's important to us now to create value for the future, not only for us, but also for everybody.

Then, we (22:32) all the culture with your believes or purpose and values. We know it's important to change your brand, to change our name, brand name. Then, we finally launched the RD-People, Health and Wellbeing. This new brand put together in the next slide, all three different businesses that we have in our company; you have the pharmacies business which brings higher results (22:58) in some of you. We have the service business which (23:03) 4Bio and also have the brand business that's what all (23:08) label brands would need to develop (23:11). All these three different businesses will be the future for us, okay. But the future is not only to design the walls, not only talk about the future; future needs to engage, to prepare the (23:25).

If you go to the next slide, I'll show you how to engage all the team and put the same in the (23:33) which all the process that you have in company with a customer in charge, the customer in the center of the culture. This is very important for us. We are here to serve the customers and we're working very, very close to this with all the team and the last slide will show how this work with the (23:52) with people talking, all the people understand how important is the culture for our business.

Okay. We're ready for the questions. I'm here and we'll get started.

Q&A

Operator

Our first question comes from Mr. Joseph Giordano from JPMorgan.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hi. Thanks for taking my question. I have a couple. The first one is on the expense side, probably the highlight of the quarter. We saw some dilution particularly on some expenses as well a continuous lag. So, when we look over the next few quarters, as we cycle the efficiency initiative that we saw in the second half of last year and the first Q of this year, should we expect a further reduction to those lines? That's my first question.

The second one. It's related to the corporate culture, I recall back at a merger that was a very challenging period for the company. So, you had like to keep on running like a very aggressive expansion plan while changing things and integrating people that in practice (25:20) we compare. So, I would like to understand here, what's the major challenge from now on and why like over the past few months, to generate – to create like a corporate culture and engage all the employees here in the same direction? Thank you.

A - Eugênio de Zagottis

Joseph, thanks for the question. I think, really, the highlight of the quarter was expense management. There were several initiatives that we have been undertaking for 1 year to 1.5 years and, now, we see, we're happy that they're fortifying. I believe – we expect to keep seeing dilution over the year.

In labor, I think we were very, very linear in the quarter. I don't know if we stay in that same level but, still, I think we should be efficient and we think we should see expense dilution going forward. I think expense dilution will be key because we know that the gross margin will go down because of the inflationary (26:21) that we saw last year based on our top percent price increase and, now, we only have 3% price increase.

So, gross margin goes down, especially in the next quarter as well as for the (26:36) of the year. So, the key to closing the gap and to maintaining a good margin is expense dilution. We are very focused on that and, yes, we expect to keep on diluting in the next quarters.

I think in terms of culture, I mean, we are coming from five years and we're closing a cycle now. I think over this time, especially on the (26:59) two companies coming together. As you know, initially, it was very difficult, completely strong culture, but very different. It took us a while to get the management team to work together well, to find a common ground and to start working as one, to integrate our systems. And I think the bulk both of the integration was completed in 2014, but there were a couple loose ends that have taken even more than that to (27:32).

So, especially since 2015 and 2016, we are in a completely different space. We are effectively one company, and this is what prompted us to investigate internally on the culture, on the identity, on the values. And we believe we have now a culture and an identity that is different either from Raia and/or from Drogasil. This is an identity that emerged naturally over these five years, and we believe this is so important and so defining that we're taking the trouble of changing the corporate name of the company.

So, the challenge now – so, I think this new name, RD – People, Health and Well-being, I think it specifies what we are about. We have now a very inspiring and compelling purpose, which is taking close care of people's health and well-being at all times of their lives. And what we want to do is that every single individual who's working even on the stores or in the back-office or whatever, that they know that everything they do serve a greater purpose, everything they do is a small piece in taking close care of people's lives and well-being over their lives.

So, what we are doing now is we are diffusing this culture internally, and we don't want just only to be a huge logo or a statement in the (29:09). We want people to live by these ideas, live by these values, live by this culture, live by this purpose. And we think we can engage people at a completely different level, and this can be a huge competitive advantage for us. And this is a journey. It's not only (29:29) in the next few months (29:31) for the next few years for us, okay. There has to be a strong future for the next 100 years like the (29:35) our business.

Q - Joseph Giordano {BIO 17751061 <GO>}

Perfect. Thank you, Eugênio.

A - Eugênio de Zagottis

Great. Thanks Joseph.

Operator

It appears to be no further questions. Now, I'll turn the conference back to the company for their final remarks.

A - Eugênio de Zagottis

Well, thank you, all, for attending this conference call. This is the first quarter under the new corporate brand and, if anything, I mean, I think it has brought us luck. This has been a very good quarter for us, very strong and, I think, very solid sales performance, very strong expense control translating both in a market expansion.

We're now entering the toughest part of the first year, which is the second quarter. We have an impossible margin to beat, as you know. So, our goal is to do the best we can here so that, overall in the year, we can be close to last year's margin.

So, expense control, is really the name of the game. I think we have an early signal of what we're doing but, definitely, we expect to keep diluting through the whole year. I think another point I'd like to touch on is the organic growth. We keep growing in a very steady way. We opened slightly more – a slightly bigger number of stores than we had opened second quarter last year. We already opened 215 stores over the last twelve months and this pace is very important to do it well without stretching the organization. And the dilution in pre-operation expenses is a signal of that.

Another thing is that the portfolio of stores we just opened has been remarkable. We – I don't remember if we have any mistakes in these initial stores. It's very, very solid numbers from day one. And this is really the basis for us to keep creating value over the long-term. So, the organic growth is – has been there for us and I think it will be there for us for a very long periods ahead.

We're also working relentlessly on gaining efficiency, not only in expense control but also in better servicing the customer, (32:43) program, new launch programs (32:46) for Raia Drogasil. We're in the verge of rolling out the new Drogasil store identity. We have been improving our platforms and increasing and including new functionalities. So, we are doing what it takes to keep driving this company with value creation for a longer term.

I think culture is now a big agenda for us. As I was mentioning, we have a very strong culture. We now have a very compelling purpose, and our challenge is to contaminate people with this purpose and making – increasing the job significance of our people. I mean, they are not part of doing a clerical job at the back office or just selling across that on the (33:40) store. Be a part of something much bigger, which is taking close care of people's health and well-being, at all times of their lives.

So, I think this is a big agenda for us. This is a journey. But if we are successful, this is another pillar of value creation for the future. Thank you very much.

Operator

Thank you. RD's conference call is finished. You may disconnect your lines at this time and have a nice day.