Q1 2014 Earnings Call

Company Participants

- Augusto Ribeiro Jr., CFO & IR
- Christiane Assis, IR Director
- Claudio Galeazzi, CEO

Other Participants

- Alexandre Amson, Analyst
- Giovana Araujo, Analyst
- Tim Tiberio, Analyst

Presentation

Operator

Good morning. Welcome to BRF SA First Quarter 2014 conference call. This conference call is being transmitted via webcast in our website www.brf-br.com/ir. At this time, all participants are in a listen-only mode and after the presentation we will conduct a question-and-answer session. Instructions will be given at that time. We would appreciate if each participant made only one question. (Operator Instructions)

Forward-looking statements related to the Company's businesses, prospectives, projections, results. And the Company's growth potential are provisions based on expectations of the management as to the future of the Company. These expectations are highly dependent on market change, economic conditions of the country and the sector. And international markets. Those are subject to changes.

As a reminder, this conference is being recorded. At this conference are Mr. Claudio Galeazzi, Chief Executive Officer, Global; Mr. Augusto Ribeiro Jr., Chief Financial and Investor Relations Officer; and Christiane Assis, Investor Relations Director.

I would now like to turn the call over to the management.

Christiane Assis {BIO 16226621 <GO>}

Good morning, ladies and gentlemen. I would like to thank you for attending this conference call. It's very important for BRF that you follow our activities. During this moment of change inside our Company, Investor Relations department would like to encourage you to follow our Company even closer. The IR team is available for you. Thank you very much.

I would now like to turn over our call to our Global CEO Mr. Claudio Galeazzi.

Claudio Galeazzi {BIO 20826837 <GO>}

Good morning. We are very glad to be here and having the opportunity to speak a little bit about our First Quarter results. I would like to review that in the last quarter we explained in detail our strategy and the projects which we were implementing.

And fortunately we observed the positive signs of gains this First Quarter which indicates that the implementation of the different project, reorganization and transformation of the Company is having this positive effect so much so that we reach an EBITDA BRL861 million, a 7.1% growth over the First Quarter of 2013. And our EBITDA margin of 11.7% against the First Quarter 2013 of 11.1%.

During the month of February, we implemented a very profound and deep change in all of our industrial area fueling and pursuing agility. We reviewed all functional scopes of the industrial sector.

We made redundant (AVT). We also closed five regional offices reducing from five to three levels from the president all the way down to the unit. We implemented 300 redundancies in this process.

We have not as yet begun the industrial footprint which we hope to begin within the next 60 days to 90 days and should be a process that takes at least six to eight months.

In our international market under the leadership of Pedro Faria, we implemented and underwent also some profound changes in the structure and mainly in the strategy. We made a reduction of the six regional offices down to four regional offices.

We reduced production to adequate offer to market demand. We obtained better prices and we also redirected our exports to more profitable markets. There was a rationalization of logistics, renegotiations of freight charges. We reduced SKUs and we established adequate levels of inventories.

All these actions actually reduced significantly the historical volatility that we always faced, seasonal and otherwise. We were able to maintain higher prices and we exported 535,000 metric tons generating revenues of BRL3.1 billion and an operating profit margin of BRL183 million as against BRL35 million in the First Quarter of 2013.

In our internal market, under the leadership of Sergio Fonseca, we implemented a pilot project GTM, go-to-market. It was launched in January in the state of Minas Gerais where sales force was restructured and sales route reorganized.

As initial result, extremely positive. We had an increase of approximately 25% of our client-base in that region. Based on the results we obtained, we made a rollout initially in February of the GTM project in the state of Sao Paulo and we are now currently concluding in the rest of Brazil this implementation of the new GTM policy for the right region, which we call the right region, where we were not present other than through wholesales and distributes.

We promoted cost and expense reductions and we concentrated efforts in logistic efficiency and we are also undergoing a 40% reduction in SKUs.

In food service under the leadership of Ely Mizrahi, we had a growth of nearly 10% over and above the First Quarter 2013.

In the marketing area and innovation, under the leadership of Sylvia Leao, we are launching many new products. We are investing heavily in publicity. We are integrating market intelligence. We are concentrated in brands, categories. And we are also endeavoring an effort in research and development.

As far as our dairy business is concerned, we are presently analyzing the different alternatives which we may have which does not exclude partial or total sales of our dairy business. We do have already over 10 (MDAs) signed and we have many of these companies going to the second phase, searching for more details and information.

We expect that this process would take anywhere between 60 days to 120 days to be concluded.

We on our capture of opportunities as stated previously, we are in line with the ramp which we mentioned previously and we've included this captures already in our budget. We are in line and of course the ramp increases from here on. And by the second semester, we should be obtaining these captures translated into results.

We just finished the (OBC) program, which is the Zero-Based Budget, which we should start implementing in May, June which results of redefining the Company's structure with reduction of expenses, significant we hope. And a redesign of our process through the Zero-Based Budget program.

We expect that the results will be obtained within -- after implementation between 12 months and 18 months. We have not. And I would like to repeat, as yet started the industrial footprint rethink which we'll be starting possibly in June and should promote many, many changes in the industrial footprint.

As you all know and recall, we have approximately 35% idle capacity. So reviewing this footprint is extremely necessary and one of our objectives for the transformation and reorganization of the Company.

I would like to emphasize that we had a very, very significant free cash flow of BRL1.1 billion due to much more efficient structuring of our working capital and optimization of our investments. We are also being very conservative financially and we also agree with a (inaudible) mentioning previously that Brazil will probably avoid a crisis.

We are renegotiating our revolver, anticipating the negotiation. It was due in 2015. We anticipated to present negotiations increasing the revolver from BRL500 million to BRL800 million, renegotiating the profile as a whole.

The idea is to be very conservative and if the unprobable or probable crisis may occur, we would be very well structured to face it. We will have cash. We have different go-to-market. In other words, should that happen, we would be in very good condition to face any eventual and unprobable or improbable crisis.

Finally, BRF will continue investing in efficiency, quality, development, innovation, (inaudible) logistic (NTE) while viewing also bettering the level of services to our clients where we believe we are still fragilized.

I'd like to mention the fact that one quarter does not necessarily establish a reversal of tendency. But all the indications which we have point to very good results of the transformation being implemented. And I'd like to mention once again that we expect the real results of all the transformation implementations for the Second Quarter of this year.

Thank you. And I will transfer to Augusto Ribeiro, our CFO, that will expose all the numbers.

Augusto Ribeiro Jr. {BIO 18485971 <GO>}

Good morning, to everyone. The First Quarter of 2014 was marked by significant organization advances of key areas of the Company coupled with the launch of high impact actions aimed at increasing the leadership of our brands in Brazil. And replicate our performance and competitiveness in the international market.

The net revenue of BRF amounted to BRL7.3 billion in the First Quarter 2014 with growth of 1.8% compared to the First Quarter 2013 in a domestically more challenging consumer environment and smaller volumes in the foreign market following our strategy to maximize profitability.

The total sales volume in the period reached 1.3 million tons, 7.4% less than the same period last year driven mainly by the external market. Compared to the First Quarter 2013, cost of sales decreased 1.2% with a volume decrease of 7.4% in the same period.

The costs with labor and milk collection suffered significant increases compared to the First Quarter of last year, of the First Quarter 2013, as well as increase in freight and packaging influenced by devaluation of the period.

The feed in the same period was driven mainly by soy meal increase and -- while compared to the Fourth Quarter of 2013, feed cost increased driven by corn.

Even with the cost increase, our gross profit amounted to BRL1.9 billion, 11.5% higher than the First Quarter 2013 which resulted from higher price in the period leading to a gain of

2.3percentage points in gross margin and increasing the same from 23.5% to 25.8% margin.

In the First Quarter of 2014, we had an increase of 9.9% in operating expenses if compared to the First Quarter of last year totaling 16.5% of net operating revenue compared to 15.3% of the last year.

Selling expenses increased 11% primarily due to increased expense in marketing and trade marketing due to alignment with the Company's strategy to have a greater focus on the consumer and commercial part of the business. To just give you an idea about value, we invested in marketing and trade marketing approximately BRL80 million in this First Quarter than the First Quarter of last year.

Administrative expenses decreased 1% compared to the First Quarter of 2013 with reductions in several lines.

In the First Quarter of this year, we presented a total of BRL128.5 million in other operating expenses, higher than the BRL68.3 million in the First Quarter of last year.

Within this number, there are nonrecurring events. For instance we had a negative net impact in our result of BRL24 million. From the negative side, we booked BRL46 million as restructuring costs plus BRL5 million in claims due to a fire incident we had in one of our factories.

Those impacts were partially offset by asset sales, specifically farms. And the lawsuit won by BRF totaling a positive impact of BRL27 million. Therefore we had those BRL24 million that I mentioned before.

As of this quarter -- I mentioned that in our last call at the end of last year. But as of this quarter we will no longer disclose adjusted EBITDA. So the First Quarter EBITDA reached BRL860.8 million, 7.1% above the First Quarter of 2013, representing an EBITDA margin of 11.7% compared to 11.1% in that same period in the last -- in the First Quarter of last year.

Now if you exclude the non-recurrent effect of BRL24 million, our EBITDA margin would be 12%.

The net profit was BRL315 million compared with a net income of BRL358 million (sic; see slide 11, "BRL359 million") achieved in the First Quarter 2013 impacted mainly by the other operation results as I just mentioned to you. But also by our financial results.

The latest, the financial results increased from First Quarter of last year due to interest payments over loans, exchange rate variation on investments in subsidiaries abroad. But also -- and also appreciation on cost of grains acquired based on price to set basis.

Now if we -- I will move on, talk a little bit regarding our performance, give you some numbers from our business, BRF businesses.

So internal market, in the First Quarter 2014, revenues in the domestic market reached BRL3.2 billion, 3.6% greater than the First Quarter of 2013 with volumes 2.7% lower mainly due to the other sales line which volume decreased 16.3% due to the sale of the Doux plant in May 2013.

We will continue to have this distortion on a comparative basis until the Second Quarter 2014. If we just consider the other sales on the consolidated results, the analyses better reflect the scenario of domestic market with net sales of BRL3 billion, 4.8% above the same period last year, an increase of 0.7% in volumes and an increase of 4.1% in average prices.

Operating income reached BRL352 million in the internal market, 15.4% lower than the First Quarter 2013, registering an operating margin of 11% compared to 13.4% last year, a decrease of 2.4percentage points when compared to the same quarter last year.

This difference in performance was largely due to nonrecurring expenses related with restructuring incurred in the period, by increased expense and marketing trade following the Company's strategy and also by a difficult basis of comparison being EBIT of the domestic market in the First Quarter last year, one of the greatest of the Company for that period. So a little bit of (inaudible).

Moving forward, in the external market, BRF achieved good results in the First Quarter 2014. During the period, the Company exported 435,000 tons and revenue reached BRL3.1 billion.

The foreign market has benefited from the devaluation of the real against the dollar an average 18.5% compared to the First Quarter 2013, which raised the average price in reais by 11.5% compared to same period last year which ends up offsetting the volume decrease following our strategy again of withdrawing volumes from regions below margins and contributed to keeping the revenue nearly flat on an year-on-year basis.

The operating profit of the Company had a significant improvement reaching BRL183.8 million in the quarter compared to BRL34.5 million recorded in the same period last year.

Operating margins, therefore, also show an increase of 4.9percentage points from 1.1% in the First Quarter of last year to 6% in the last quarter -- in the First Quarter 2014.

I will give you some more messages regarding the performance in each one of our markets outside of Brazil. So I would start for Menasa; Middle East, North Africa. And South East Asia. The volume in that specific market was above expected totaling 270,000 tons and revenue reached BRL1.3 billion.

In this period, the Company took two big steps for consolidation in the region by acquiring 100% of the economic rights of our distributor in the Emirates, Federal Foods. And announcing a bidding offer of 40% of Al Khan Foods, our current distributor in Oman which is the leading distributor of frozen foods to retail customers and wholesale food services. Both actions are in line with the plan of strengthening of our brand, distribution. And portfolio expansion in the region.

For the Far East, in Japan for instance, the First Quarter 2014 was marked by a balance between supply and demand. And good conditions for negotiations. In the Far East, the period of Chinese New Year recorded strong demand and even without the break of bird flu in China and South Korea, the Company had great results in the region. The export volume was 122,000 tons with revenues of approximately BRL700 million.

It is important to inform that China has recently announced the qualification of five poultry production units in Brazil, one of them from BRF, which now counts to be seven units licensed to export to that country.

Europe, Eurasia; Eurasia market is at a positive moment, although exports to Ukraine are suspended and the region faced serious political conflicts. Shortage of pork and turkey, the latest specifically for Europe, offer for this year -- the shortage of those, pork and turkey, also for this year has set good opportunities for BRF.

In volume terms, the region recorded 858,000 tons exported which resulted in a revenue of BRL700 million, 4.8% greater than the same period last year.

Americas; during the period, this market sold volumes of 669,000 tons in revenues of BRL419 million. It is noteworthy that after most of uncertainties, the US finally opened its market to Brazilian export of pork in natura. Initially, of course, the export volume will be small. But the endorsement of the country has great weight to the Brazilian pork industry.

Now I'll move forward to some of our financial figures. In terms of leverage, the Company's net debt stood at BRL6 billion by the end of the First Quarter of 2014, 11.7% below the recorded at the year-end, at the end of 2013, resulting in a net debt per EBITDA of 1.88 times.

Investments; the investments in the quarter amounted to BRL335.8 million, 46.1% below last year. The main disbursements in 2014 were targets for investment to build the processing plant in the Middle East in addition to investments in automation projects, improvement of process and support. All of those investments align with what we've been saying in the last month in terms of strategy, growth strategy and CapEx investment.

In this amount, BRL120.1 million of investments in biologic assets are considered. Now here I would like to make a parenthesis, an emphasis in a specific point; regarding this topic investments it is important to mention that this reduction against the First Quarter of 2013 is due to mainly investment saving only.

For 2014, we sustained a guidance of BRL1.5 billion of CapEx in line with what we did in 2013, okay. So we might have this difference quarter by quarter. But throughout the year, we'll sustain the BRL1.5 billion investment in CapEx.

Regarding our financial cycle, the Company has also been working with the optimization of working capital resulting in the investment of the financial cycle of 58 days in March 2013 to 41.8 days in March 2014. This represents under net operating revenue ratio a reduction from 14.8% in March last year to 11% in March 2014.

And finally we have our free cash flow which has improved a lot if you consider our improvement EBITDA, our improvement of our variation of financial cycle, as well as a better controlled CapEx that in the First Quarter 2014 reached BRL1.1 billion as mentioned previously by Claudio. But I just like to mention one thing, that this BRL1.5 billion, you could compare it with the BRL1.5 billion that we generated throughout the full year of 2013. So 2014 will be a strong year of cash generation for BRF and so far we are in the right track.

So now I'll leave you -- let's move forward to the Q&A. Thank you.

Questions And Answers

Operator

(Operator Instructions) Tim Tiberio, Miller Tabak.

Q - Tim Tiberio {BIO 15194568 <GO>}

I wanted to start off with the MP 627 legislation that we've been reading about. I believe that was approved by the Senate and I did read some comments earlier in the quarter around potentially that impacting your international expansion ambitions.

Can you just give us an update of, one, your take on how this is going to impact potentially your international growth, whether there is any workarounds or amendments that you can push with Congress in Brazil? I guess any additional color that you could provide would be very helpful, particularly for international investors outside of Brazil.

A - Claudio Galeazzi {BIO 20826837 <GO>}

Yes. The 627 MP will of course impact our performance in the countries where there is a very reduced taxation because we will have to pay a complement of reaching 34%. We are working together with congressmen and class entities with the objective of actually having a special clause put into the MP or under a new MP which is being elaborated by government which is the 634 where we will have as food industry exemption.

Of course for instance an example in the Middle East where taxation is below 10% somewhere -- anywhere between 5% and 6% in the Emirates for instance where we are building a plant, if the 627 prevails as such we will have less competitiveness within that specific market.

Anyway it's still premature to say what will happen in the near future. We are following it very closely together with members of the government, with the Ministry of Finance. And we hope to have a specific clause included in -- or an article specifically addressing the food companies of Brazil which are expanding outwards.

Those food companies that eventually have a presence in the United States will definitely not be affected because the taxation there is similar to what we have here which would imply that the measure in itself would not affect them. But those that are present in, let's say, countries that have less taxation will most definitely be affected by having less competitiveness.

As I would like to repeat, it's still premature because the negotiations, the conversations between the different companies that have this worry together with us, we are jointly working with government officials trying to minimize the impact specifically in the food processing companies or the food exporters that do have processing in other countries.

Q - Tim Tiberio {BIO 15194568 <GO>}

Okay. I realize it's premature as you stated. But in the case just theoretically if the exemption does not go through, when we look at your growing free cash flow that you've been talking about on the call, would you be more inclined to shift some of your Group CapEx away from areas like the Middle East to regions you were talking about you guys having a comfortable tax rate, (inaudible) become more attractive or is this a situation where maybe with the increased free cash flow in that scenario that cash returned to shareholders would become a greater priority?

A - Claudio Galeazzi {BIO 20826837 <GO>}

I will repeat that it's still premature. But I can assure you at this stage we have no intention of changing our strategy in these countries. Of course we must think what will be the impact. If we wish to expand in building other or acquiring other industries in other region. But for the time being as far as the Middle East is concerned or specifically the Emirates we will not be changing our present strategy.

Of course you have to reconsider if the impact -- if we grow significantly in the future in different countries that have the benefit of lower taxation, we might have to consider of course the domicile, in other words rethinking the corporate structure to take into consideration the impacts that the 627 may impose on companies like ourselves.

Q - Tim Tiberio {BIO 15194568 <GO>}

Thank you. That's very helpful. I'll leave it there. Just one last question if I may; you mentioned that the rationalization of the global industrial footprint really has not occurred yet. But that could start as early as June. I think investors are extremely encouraged by the efforts behind BRF-17.

But I just had a very technical question as far as the approval process within Brazil; obviously GDP growth has been lagging in the prior years. Is there anything from a government approval milestone that you will have to achieve when you're looking at some of this idle capacity or do you feel confident that you have complete flexibility to take the measures that your financial and strategic teams propose over the next 12 to 18 months?

A - Claudio Galeazzi {BIO 20826837 <GO>}

No. The decision does not involve government participation. In other words, it's restricted to BRF establishing policy. Of course BRF is a conscientious Company. We will be thinking of the social consequences, the regional consequences because we are very relevant in certain cities around the interior of Brazil.

But it has no government necessity to acquire the agreements of there. Of course there would be always government pressure basically based on the social questions involved. But I think we've had experience in the past in this -- what this industrial footprint in other companies and it's a question of how you address the problem and what is the speed with which you address this problem.

Operator

(Operator Instructions) Giovana Araujo, Itau BBA.

Q - Giovana Araujo {BIO 16356713 <GO>}

My question is about working capital. Your guys deliver a substantial improvement in working capital in the First Quarter, particularly in the payables line. And I would like to know if you see room for further improvement going forward and how sustainable are current levels?

A - Augusto Ribeiro Jr. {BIO 18485971 <GO>}

We have to see a continuous improvement. Of course as we tend to say, the improvement from now on tends to be a little bit tougher than what we did in the past. But it's still -- there are lot of rooms -- enough room yet to improve.

For instance we've been proven or has been proven in terms of inventories. But we -- given our strategy regarding recovering our quality of service delivery to get in a better relationship with some key clients, we did not put too much pressure in terms of internal targets for inventory reduction yet.

So there are room for finished goods yet to be tackled by BRF. And so there are still room. But probably with a -- the rate of increase, the rate of improvement should decline from now on when compared from what we did in the past.

Operator

Alexandre Amson, Credit Suisse.

Q - Alexandre Amson {BIO 4119036 <GO>}

Just a question concerning the short-term outlook of the Company, during your presentation of the First Quarter results you mentioned that the strong cash generation in this quarter should help the Company to face tougher times ahead. At least this is my interpretation of your word.

So I just wanted to understand if you could provide more detailed information or more clarity in the sense of if there was any change concerning the outlook that the Company had a few years or a few months ago for the short term, or if this is -- well, anything that you could provide in this sense concerning the evolution of the market, competition. And growth. And ability to pass through the cost increase to prices and so on?

A - Claudio Galeazzi {BIO 20826837 <GO>}

No. In principle we are not changing our outlook for the future be it marketwise, be it participation. What we did mention is that we are just taking precaution should anything do occur which is unlikely I believe. But should it occur we will be in a very good position to face any crisis that should arrive.

Of course you have a reduction in the industrial growth in Brazil; you still have very close to full employment. But if you have, let's say, a slowdown as far as industrial production in Brazil, you might have a increase in unemployment which definitely would affect the market as a whole. We are very much attentive to any changes. But presently as I mentioned we have no intention of changing our expectations for this year or for next year in our planning.

Operator

This concludes today's question-and-answer session. I'd like to pass the floor to Mr. Claudio Galeazzi for his final statement.

A - Claudio Galeazzi {BIO 20826837 <GO>}

Well I would like to thank everybody for listening to us. I thank the questions which were placed. I don't know how successful we were in explaining our tactics, our strategy. And I would like to place that -- reinforce what Chris said that she is also available for any questions, any meetings. And I would like to state that both Augusto and myself will always be here to receive your questions, your worries. And your expectations.

So please feel free to contact us at any time. We will definitely arrange to meet with you. Thank you very much for everything and have a good day.

A - Augusto Ribeiro Jr. {BIO 18485971 <GO>}

Thank you.

Operator

This concludes our BRF SA conference call. Thank you very much for your participation and have a good day.