# Q4 2017 Earnings Call

## Company Participants

- Eugênio De Zagottis, Corporate Planning & Investor Relations Officer
- Marcílio D'Amico Pousada, Chief Executive Officer
- Unverified Participant



## Other Participants

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

## MANAGEMENT DISCUSSION SECTION

### Operator

Good morning, ladies and gentleman. At this time, we would like to welcome everyone to RD – People, Health and Well-being Conference Call to discuss fourth quarter of 2017. The audio for this conference is being broadcast simultaneously through the Internet on the website, www.rd.com.br. In that address, you can also find a slide show presentation available for the download.

We inform that all participants will be only able to listen to the conference during the company's presentation. After the company's remarks are over, there will be a question-and-answer 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 Securities Litigation Reform Act of 1996. Forward-looking statements are based on the belief and assumptions of RD management and on information currently available to the company. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to the future events and, therefore, depend on certain 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 will turn the conference over to Marcílio Pousada. Sir, you may begin your conference.

## Marcílio D'Amico Pousada

Okay. Thank you. Good morning, everyone. Welcome to the presentation of results of the fourth quarter 2017 earnings. As always, Eugênio will present the slides for the results. And before the Q&A, I would like to stress some points. So, Eugênio, please.

## Eugênio De Zagottis

Okay. Hello, everybody. Thank you all for attending our conference call. So just to start with company perspective, we believe 2017 was a very good year for the company. We were able to grow top line in a very consistent way. So, we gained market share. We had a very accelerated and high quality expansion. And as you all know, we've seen tremendous gross margin pressure from the huge inflationary gains of 2016, but we were able to gain productivity and achieve expense dilution in 2017 so as to mitigate (00:03:09). So in the end, I'd say, we were successful in doing that.

We have the highlights here. We ended the period with 1,610 stores in operation. We opened just in this year 210 new stores and closed 20. So we exceeded the guidance of 200 store openings for 2017. We reached a gross revenue of BRL 13.9 billion, 17% top line growth with 7.2% same-store sales for retail. Our gross margin was 28.8%. So, as I just mentioned, we had an 80 bps pressure because of the huge inflationary gains of 2016, but we were able to offset (00:03:57) that pressure through a very meaningful expense dilution. So in the end, we reached an EBITDA of BRL 1.1 billion, 8.2% of margin, so only 20 bps of consolidated margin pressure.

If we look at only our retail margin, on a cost basis without the Net Present Value adjustment, we're using gains and bps (00:04:20) in our retail operation. Our net income totaled slightly more than BRL 0.5 billion, 3.7%, and we had a negative free cash flow of about BRL 50 million, with a total negative cash flow of BRL 211 billion.

Okay. So next page, page 4, we have here our historic numbers to put the year into perspective. I think what this chart shows is a very consistent progression, very big top line growth, very big – then increasing number of stores, and also, obviously, huge margin gain on top of that.

So since 2011, when we merged, we multiplied revenues by 2 times – sorry, multiplied the business (00:05:17) times, we multiplied revenues by roughly 3 times, and our EBITDA was multiplied by roughly 4 times. The only reason that makes this possible is that the second half of stores where we have had it ever since. So half of the stores preexisted like 2011, so this second half of the total store base is just as good as the legacy stores. So they allowed us to gain scale, to gain – to increase productivity, and to boost our margins and returns. We are the only drugstore chain in Brazil who had been able to grow at a fast pace on a national basis, while maintaining revenues per store on a constant basis, ex-inflation, so as to gain productivity. Nobody else has been able to do that, nobody. And when we talk about expansion, I can highlight probably the main element on why that's the case and why we believe that to continue to repeat.

On page 5, we also – we can also putting in perspective as far as market share. We had a market share of 11.8% for the average of last year. In the end of the year, we were right at 12%. So we see here a very meaningful and consistent market share gain since 2007. When you look at the next three segments, which are other chains either part of Abrafarma or not part of Abrafarma and supermarket, we have seen that these segments have not been able to grow market share in recent years.

When we look independent, then we see a slight share gain, but in reality, this figure divides into two. We have cooperatives (00:07:03), which are more chains, which are independent with a common brand, mostly popular who have been relatively well. Then, we have few independents who are doing really poorly right now. But we see that our market share gain, it's different from the rest of the market.

And finally, here on the right of the chart, we see from a revenues per store, (00:07:27) and it's obvious that we have been able to increase at a very meaningful pace our revenues per store, and we've built a huge gap over anybody else. So in an industry that's driven by a fixed cost structure, this means that we achieve a much bigger expense dilution at the stores, even though we offer more service than our competitors. This is a very important and such a (00:07:52) competitive advantage. And when we put this three together, which are the scale we have and the efficiency we have, I mean, this is completely different from the rest of the market, and this is what will keep us supporting (00:08:08).

On page 6, we ended the year with 1,610 stores by opening 210 stores than more than our guidance and closing 20 stores. Out of the 20 closures, seven stores relate to the correction of expansion mistakes (00:08:30) while the rest is portfolio optimization. It's either relocating stores or closing stores and transferring revenues from the surviving store, which creates value for the company. We also see here on the right that 35.6% of our stores, they are still under great (00:08:52) maturation, so we have been earning a margin of 8.2% on a consolidated basis and our margin will be much bigger in the longer term when average store becomes much less (00:09:04).

Next page, we then discuss our national presence. And the main reason that (00:09:12) from our expansion and nobody else has been able to manage. We are now presently in 20 Brazilian states that account for 94% of the Brazilian pharmaceutical market. All Brazil, (00:09:28) two of these places are very recent: Ceará, where we opened seven stores; in Piaui, where we opened three stores last year. But all the others – so these stores have still improvement. We see great initial numbers. So, it's encouraging, but it's still too early to tell what we can achieve there. But if we forget those two, we're still talking about 18 states that account for more than 90% of the Brazilian pharmaceutical market where we have all of our brands already established. We have very constant revenue per mature stores across all different (00:10:02) markets. We have the capacity to grow in every single market here with consistent marginal returns. We're not the only chain in Brazil to have a national footprint or to have a fully covered map or almost fully covered map, there are others. But we are the only chain in Brazil who makes money on a consistent basis all across this market. (00:10:26).

So if we define a national chain as one, who is able to grow nationally and make money nationally, we are the only national chain in Brazil. So when we grow – and we open 200-plus stores every year, we are swimming in a blue ocean because the pain from fixing the brand from getting to the – know by the consumer for one and the bad (00:10:54) initial results, they happen in several markets, but they are far away the best. Now, it's a consistent story.

Meanwhile our competitors are trying to swim on a red ocean because for them to be able to grow 100 stores or more, they have to enter many new markets in which they arrive at a very late stage and they will face tremendous breathing because the new stores, they don't perform in the beginning, huge barriers of entry, gross margin will be lower. So (00:11:25) when you look around with our competitors, it's easy to see this picture on their results. I mean, one by one you can see the frequency in growing with consistent productivity and this is something we have by any means achieved.

Here on the right, we discuss our progression as far as the market share. We've reached at the end of the period 12% of national market share by maintaining organic share in that single market here. So, in São Paulo, our market evolves from 22.5% to 22.9%, still lower than we believe we can achieve. In the Southeast, where we came from 7.7% to 8%.

In the Midwest, it was constant at 13.1%. And you may remember that in previous quarters, we had lost some share here because Brasil Pharma, who (00:12:17) for two, three years and helped us a lot in growing revenues per store here. Their local (00:12:21) operation was sold. (00:12:25) obviously went when (00:12:29) we gave back some of the revenues. But now we have stabilized that and we are much better today than we were when this process started.

So, we have a very profitable operation there with very high revenues per store, so the whole meltdown of Brasil Pharma was very positive to us. But whatever loss we had initially when the operations started – when the stores were sold and started the refurbishment and then started receiving (00:12:56), and we have already consolidated and already maintained the share. In the South, we also gained share of 5.9% to 6.6%. In the Northeast, 100 bps gain from 4.7% to 5.7%.

Retail, I'll talk about the growth here. So in 2017, our consolidated revenues grew 17.1%. I think this is a very consistent figure. In the fourth quarter, we grew 14.2%, but we had a negative calendar effect of 80 bps. So, we'll be talking on a neutral calendar basis at a 15% top line growth. This is kind of where we stand by now. When we break down by business, in the drugstore business, we grew 16% in the year and 13.1% in the quarter, which corrected by the calendar, we'll be talking around 14% in the quarter, while 4Bio grew (00:13:57) 53% in the year and 49% in the quarter.

When we look our mix from 2016 to 2017, the main highlight has been OTC, they grew from 17.6% to 18% at the expense of HPC, which contracted from 26.7% to 25.9%. I think for the first semester, the contraction of HPC was – thoroughly (00:14:24) it was related to a cross-channel competition, but we believe we have been able to stabilize that.

When we look at the quarter, we still see a contraction in HPC. Well what happened here is much more seasonal than structural. We had a colder and rainy (00:14:38) summer, and obviously, especially the holiday period is very important for HPC. People buy a lot of sunscreen and other products, and it was not a very good period because of the climate. And you can also see that by looking at OTC that increased 17.1% fourth last year to 17.9% this year. So we have kind of an opposite dynamics here, but right now it's more seasonality than it is structural.

On the next chart, revenues (00:15:06), we can see our comps in further detail. So as I mentioned, we grew in the year 17.1% on a consolidated basis and 3.1% for mature stores. So mature stores grew in line with inflation last year. When we break down by quarter, we see a stable (00:15:25) fourth quarter with 14.2% total growth, which would have been 15% on a neutral calendar basis. With mature stores growth of 0.8% which would be 1.6% on a neutral calendar basis. So we can talk where we are now and this is where we end the year and where we start this year is we are 1% to 2% below inflation at our mature stores.

Obviously, this is not the first time it happened. Life is not a straight line. The only place you can find the straight life is in the models you all develop. But in reality we have period slightly better, slightly different (00:16:03) and we're facing a period slightly below inflation. This has also to do with cannibalization, I mean, if you have a stronger weightage (00:16:12) you slightly would have – cannibalize slightly more and less (00:16:16) was the strongest (00:16:16) in 2012.

There is some more competition. This year we saw a lot of new store openings when compared to especially in the fourth quarter and as (00:16:26) as we may be on the future of those growth trees that we don't see as sustainable, obviously, it affects to some extent our comps. So we are 1% to 2% below inflation. We have a lot of initiatives in the way. And what we would like to see happening is a (00:16:44) inflation. We will see the (00:16:48) or not, time will tell. But we have a – we are not just looking, we're doing a lot of things for that to be possible.

On the next page, let me talk about the gross margin. We saw in the year a gross margin pressure of 80 bps. This was widely anticipated, as you know, it started in 2016 (00:17:05) with a 12% price increase, we had huge inflationary gains. So we lost 60 bps only in terms of inflationary gains because this year (00:17:15) price increase was 3%.

The other extra here (00:17:18) here is that interest rates are now lower than they were in 2016. So the Net Present Value adjustment, which is a non-cash effect, it's a non-economical effect, but it's part of the accounting here, this is another 20 bps of pressure. So if we took away the NPV adjustment, we'll be talking only the price increase effect of 60 bps.

When we're looking the quarter and here, the pressure on gains (00:17:46) is no longer in the picture. We see a 20 bps gross margin contraction. This is exactly due to the Net Present Value adjustment, which represents 20 bps.

On top of that, 4Bio, who has lower (00:18:05), it has a negative mix effect here, but the market was also lower than the previous year, pressure gross margins by 30 bps. But we posted other gross margin gains of 30 bps that allowed us to maintain the cost on cash margin, which means beyond - not counted in NPV adjustment or (00:18:24) with the NPV adjustment.

We also had a very - we had a relatively high cash cycle in the fourth quarter, 49.1 days versus 44.7 days last year. I think we have two calendar effects here, one is the end of period date, it's not a good one. So accounts receivables go up and the other factor is that because of lower sales from 80 bps of calendar for the quarter also (00:18:58). We expect overall to navigate this year with a cash cycle slightly better than what we saw last year, especially the end of the year.

On page 11, certainly (00:19:14), we can discuss here the highlight of the period, which was expense dilution. So, we achieved both in the year and the quarter 70 bps of expense dilution. In the quarter, 30 bps came from G&A dilution, obviously we had a very heavy G&A in the fourth quarter 2016, but then we also gained 10 bps on labor, 10 bps on markets, and 10 bps on logistics and 10 bps of dilution from 4Bio.

We had 10 bps of other gains, we had a 10 bps pressure from Electricity. But what we can see is that, these efficiency gain has been widespread through a multitude of different lines. Is not once you (00:19:57), is not one drastic action, I mean, we're talking about several different and sustainable actions. Our expectation is to maintain this level of expense control as we enter 2018.

And finally, we posted an EBITDA margin pressure of 20 bps in the year. If you take out the NPV adjustment, there is no cash, we'll be talking a flat margin on a consolidated basis. And for the retail business, in which - which posted an 8.4% EBITDA margin, not counting (00:20:33) 4Bbio here. If we take out the NPV effect, we'll be talking about a 10 bps margin gain in the year. So in spite of huge gross margin pressure, we were able to maintain constant EBITDA margin at our retail prices 00:20:48. The difference is that, that EBITDA, which before was inflation boosted, now it's a full structural one, so I think this is a much more consistent number than the one we saw last year. And then in the quarter, our adjusted EBITDA increased by 50 bps, coming (00:21:06) from expense dilution as I previously mentioned.

Next page, our net margin was 3.7% for the year, 3.6% for the quarter, so we see on the fourth quarter 70 bps extraction versus last year. We posted in the year BRL 0.2 million of non-recurring gain, which was BRL 2.4 million gain in the quarter, which is tax credits from previous years. We have also in the first quarter, BRL 2.2 million non-recurring expense, so the net effect for the year is BRL 200,000 positive, it's (00:21:47).

Page 14. We had a negative free cash flow in the year around BRL 50 million, which is, I'd say a good number for a company growing as much as we are, it's almost unusual cash flow generation. So we generated BRL 860 million resources from operations, after this cash cycle and other assets and liabilities. The operating cash flow was BRL 590 million, which almost funded BRL 640 million in investments. And in the end, after interest on capital and taxes paid, we're talking about a BRL 211 million negative total cash flow.

On page 15, you can see our share gain. We had - our share performed very well at 51% appreciation versus 23% for BOVESPA. BOVESPA had a good year, but our shares did better. But for me what matters is the longer - long-term feature here. When - for those investors who entered our new IPO, they have seen total shareholder return of 33% per year. Those who invest in the RADL3 has seen 36% total shareholder return per year here. So - and believe it or not, we have a bunch of shareholders who are around, who maintain or increased their holdings (00:23:13) versus the Raia IPO.

I'll now pass to Marcílio for him to talk about scalability and put the year and our future prospective in perspective.

## Marcílio D'Amico Pousada

Okay. Thank you, Eugênio. Before to go to the - about the 2017-2018, I will talk about, a little bit about sustainability, okay. We closed last year (00:23:39) we also stood better, how the company can help the society can help it, all the place that we make business in this (00:23:51) three pillars, three different pillars, and I will briefly - a little bit about each pillar.

The first pillar, to take care of people's health. This is like our accessory - we take care of the people, we love that. We don't talk, just take care of our employees, and as part of life, our employees, but look for more health, and the treatment for our customers also. And this help was also to make our guidance to value investor, social initiatives in the future. This is the first pillar.

The second pillar to take care of the business' health. We know how important it is to keep the company with good profitability results (00:24:36), also to encourage our dialog with the stakeholders, not only financial, but also with the vendors, with the government, and to develop the employees for the new phase that we're looking for our company.

The third pillar is to take care of people's health. We know that we don't have a lot of technicalities about our business. We know that we don't change a lot about the current health, but it's important to view for us when an open store, work with you, all of our contractual effected the environment and reduced our rates and to reduce our environmental impact in distribution process. Also we draw correct for these things. We know this is good for us to follow this every year. We made a report, we call the sustainability report, we're planning to do this every year, and you guys can follow our next steps in (00:25:38) pillars for the future.

Let's move to the business in page 17. Here, as Eugênio told you, we are - we believe we have the best year for Raia in 2017. We knew the best, so I would say we are challenged, not only because of the price increase, but also if you look in 2016, we have the price increase and we have also a very rich comparison in same state in Brazil, when you talk about Bahia for example, compete against Santo or maybe (00:26:12) figure out in Brazil, (00:26:16) 2016, 2017 and you do get advantage of all this competition against (00:26:25). We know that in 2017, all the competitors are much more strong and we know we don't have the advantage of the tax increase. Then, we're starting to work - in the end of 2015 (00:26:39) level to reduce all the expense in the line, it's not only in people, but using - reduce (00:26:48) lines in the P&L, we did very, very good job indeed and we really believe that the number of expense that we have right now is (00:26:59) for the future years.

The best thing at this point that we do not - all these challenges which were best number in NPS, Net Promoter Score. This is - we are proud about that. We achieved a lot of milestones, good milestones. We opened 210 stores, not only 210 local stores, 15 to 20 stores every month with good quality, backed in our legacy, okay, we tend to (00:27:27) which is good because we needed (00:27:31) much better towards the experience for the customers. We (00:27:37) and if you can visit a store that is in tiny area, here you can visit a store much better than the past and they are ready for the future of the stores. We re-launched Raia and re-launched the Drogasil program, loyalty program. (00:27:55) technology, we will be using all the data to using the customer behavior to make the relationship with the customer. It will be good for your future.

And we closed the implementation to a new pricing platform, we are making rollout right now in this quarter. This will help us to price better in the front end of the stores. We're also working on our core enabler. We achieved a record low level of the store count and not only this, we achieved the record also in how to (00:28:39) as I told you, which we are working very, very closely how you can assess the customer in a store, how you can serve the customer in the counter when the stock (00:28:50) for us, how you can give the customers the best deal for their (00:28:56) close the cultural transformation that I told you during the year. We closed all the communication of this new culture for the company and this help us for the future.

Then let's go for the next page, what we are working right now for the future. Not all for 2018, but also for the next year. For the expansion plan, we are planning to increase a little bit. Right now, we are guiding 240 stores for 2018-2019. We will create a platform to do this, we know how difficult is in Brazil to opening a company that you can grow organically in all the states (00:29:44) Northeast and the South, we know how to do that, we have people, process and system and not only to find the right location, but how to handle the stock, then increase the number we know that you can use this numbers for the future also.

We hired (00:30:06) bank to help us to write a new strategic plan for the future, (00:30:16) work strongly how to deliver for a customer at digital speed, we know in the future the customer uses the cellular to make his decision. We needed to use all of the devices that you have (00:30:31) our stores to use the digital speeds the customers together for us in the future. We (00:30:40) is difficult to do that and you start very strong this year, so you can see all the changes that we're doing for this year.

The other (00:30:50) is how to use our healthcare (00:30:53) 4Bio, you know 4Bio is a new business for us, we're now – entering a new market for us (00:31:02) 4Bio in two different ways, how to extend better the health business and then how you can – integration better the 4Bio business in our 600 store that we have. Then, we are very optimistic about our business, we really believe that the results will be much better in the future, because we've had a very consistent business in a very consistent market also.

Thank you. (00:31:31) after that we'll be here for the questions. Thank you very much.

## Unverified Participant

Okay. So we have here our earnings calendar for the year and also we have highlighted some of the conferences we have already scheduled for the upcoming months. So we will announce the first quarter on the 2nd of May 2018. We generally do it inside the month, the exception this time because of calendar issues, we are doing in the beginning of May. We will publish the second quarter July 30th, and the third quarter on October 30. We have many upcoming investor conferences that we will attend, so March 12 and 13, (00:32:19) will be at Itaú BBA LatAm Consumer Event in London; April 3 and 4 in Brazil over the Bradesco Conference; April 10 and 11, I will be at the Latam Investor Forum in Asia, Hong Kong and Singapore with Bradesco; May 16 and 17, we will also be – Marcílio and myself in New York at the Itaú Conference; and finally June 5 to 7, I'll be at the CalGEMs Conference, of Merrill Lynch in California.

So we will now open for your questions. Thank you very much.

# Q&A

## Operator

Mr. Joseph Giordano from JPMorgan would like make a question.

## Q - Joseph Giordano {BIO 17751061 <GO>}

Hi. Good morning everyone, and thanks for taking my question. I'd like to continue exploring two topics. We discussed in the (00:33:33) conference call concerning the mature stores, same-store sales. So I'd like to understand a little bit better how the new pricing may help to bring back the growth to close to inflation levels? Thank you.

## A - Marcílio D'Amico Pousada

Joseph, thanks for the question. I mean, as I mentioned, although last year we grew overall matures stores in line with inflation, towards the end of the year the number was below inflation. Already in the third quarter, even though we published a number ahead of inflation, if you consider (00:34:09-00:34:17) in the previous year, I mean discounting that effect, we already (00:34:22) in the third quarter. So we ended the year with (00:34:26) 2% below inflation and that's the trend we have as we start 2018.

We have several initiatives lined up to try to convert that. I mean we're not repeating that that because our competitors do also listen to our conference call. But I think the pricing platform is one of the initiatives that can help us, especially in the front store. We believe we have much lower price granularity than we should have had. If you came to Sao Paulo and compared prices (00:34:59) in other places, I would say that the traction (00:35:05) and that's wrong, I mean you have to be more competitive where you have more price elasticity, where you have (00:35:11) environment and you can make more money where you have less competition. So the price – the pricing platform will allow us to do that, to have much granularity. So it's one of the elements, but it's not the only element. There are other things in store that we are preparing for the next months.

## Q - Joseph Giordano {BIO 17751061 <GO>}

Okay, thank you.

## Operator

Mr. Guilherme Assis of Brasil Plural would like to make a question.

## Q - Guilherme Assis {BIO 16143141 <GO>}

Hello, everyone. Thanks for taking the question. I'd like to follow-up on the subject of same-store sales for mature store, can you guys comment a little bit on the revamping plan for Drogasil stores and if you foresee any potential positive impact on the same-store sales growth base for the mature stores?

## A - Marcílio D'Amico Pousada

Guilherme, can repeat the question. I couldn't read that. I'm sorry.

## Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. Can you hear me better now?

## A - Marcílio D'Amico Pousada

Yeah, better.

## Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. So, can you comment a little bit on the revamping plan for Drogasil stores and whether if you think that it could have to lever up the same-store sales for mature stores?

## A - Marcílio D'Amico Pousada

Okay. Yes. I think the revamping of Drogasil is very important initiative. In the stores where we do it, we generally see an impact, I think it's a much more upgraded stock lined up with the brand positioning, better customer experience, so I think it's a step ahead. I think Drogasil (00:36:50). But having said that, it's not a – I mean, it's something that takes couple of years to have that. I mean, we are accelerating that, so we validated (00:37:02) end of the year. So, we have relatively small number of stores refurbished or already opened in the new form. I think this year will be a big step ahead, several of our main stores already being renovated as we speak. And I think this can help, but it's not realistic to imagine that we have restored them in the year. So it's a more progressive effect (00:37:29).

## A - Eugênio De Zagottis

Guilherme, it's much more difficult to remodeling a store than to open a store sometime, then it's a journey. We did right now on only 81 stores, but third is new stores (00:37:40). We are doing this every year. I don't know how many store we can do, and it's very difficult to figure out how this increase will help us in the same stores. We are sure that if we don't do this, we will have problem in the future. This is the point we do remodel the stores, okay.

## Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. That's clear. Thank you. And if I may just follow-up, IMS released drugstore data for January in Brazil and we saw a pick up. I know there was a negative calendar impact on the fourth quarter. But it seems that sales are actually rebounding a little bit. Do you think – do you take that as a potential upside to your same-store sales for the first quarter of the year?

## A - Marcílio D'Amico Pousada

Guilherme, this is a figure that is difficult to take into account on a month-to-month basis. There is a lot of noise in the number. So for example, IMS may – it collects data from large chains and it collects data from wholesalers – for wholesalers selling to small chains. In numbers, anything that you see, for example, it's a small chain, it's anywhere for the price increase, they are boosting metrics. That will show up as a market increase. So if you look at it year-on-year, it's okay, but the noise moves out; but month-to-month, this is not the data that we take into account.



## Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. That's fair, that's clear. Thank you.

## A - Marcílio D'Amico Pousada

Thank you.

## Operator

Mr. Luciano from Bradesco BBA would like to make a question.

## Q - Luciano Campos {BIO 16181710 <GO>}

Good morning, Marcílio. Good morning, Eugênio. I'm sorry, good afternoon actually. As your comment Eugênio, life is not a (00:39:34) straight line and for the questions that you're having on same-store sales, life is much - much, much easier, same store sales of mature stores (00:39:42) inflation and it gets treated when it's not, so that's again, my question is also there, it's very clear to me that you have the execution and the balance sheet and the excess returns to generate - continue to generate value even if same-store sales of mature stores remains below inflation for some time, right. But again, it gets trickier because it depends offsetting factors like the SG&A right now, the intense of competition, and (00:40:13) to keep accelerating openings.

In that sense, could you in the best of your possibility, I don't - I'm not asking for numbers, I'm asking for conceptual guidance or conceptual directions here to understand better how to interpret your results along 2018 and 2019, for example, should we find normal to see the same-store sales of mature stores below the inflation for many quarters of 2018 or this is just a separate event that happened in the fourth quarter of 2017?

Another example would be acceptable in your plans to see if these same-store sales of mature stores level remains low to see at some point some margin compression, and it would be okay to your plans of expansion to see that kind of thing? And in that case, what kind of level should we find normal? What kind of level should we raise a yellow flag that perhaps your store opening - your expansion plan should change because of the conditions of the market, competition and what not reflecting on the same store sales of mature stores? Sorry for the long question, but it's a conceptual one, please help the best way you can? Thank you.

## A - Marcílio D'Amico Pousada

Okay. Luciano, thanks for the question. I'll start with the long-term view and then I'll try to bring it to more immediate concerns. I mean, we have - the whole focus is on the company's long-term, I mean, we are driving in the interest of consolidation in Brazil as a factor that expands (00:41:55) because of the age of population, in factor in which we have only 12% of market share, but we're dealing more and more and the opportunities (00:42:05).

So our view is structural. We are not here to optimize the year or to optimize the quarter. We're here to create long-term value. If we can do that along with short-term margin expansion, we have nothing against it. But the quarter margin doesn't drive our decision. What drives our decision is the long-term value creation. So this is the backdrop for everything here. I mean, if you look at mature stores, I mean, it's not easy in general for the mature stores to maintain productivity, because we're opening more stores and this cannibalization, we manage cannibalization, we make sure new stores (00:42:43) enough to pay the cost of capital, but still cannibalization been like in a mature store.

In a certain way, the more successful we are in the expansion, the (00:42:56) existing stores, because they will donate customers, but historically will add enough marginal revenues to make economic facts. But in spite of that, because of the market growth, because we have been gaining competition, we have in general seen way more performance in line with inflation than below inflation, but this is not the first - if you look back, this is not the first quarter below inflation that we have.

It doesn't mean that we'll stay always below inflation, but also I don't have a clue that we always will be able to grow mature stores in line with inflation and that 200 plus stores. So finally, we have been able to do, we will (00:43:37) we hope it will, but I can't swear about that and even if it isn't, it doesn't mean that we lose margins, because revenues are shrinking from one store to the other. But the new stores are adding more to the pipe than they were adding before.

So we believe even with one quarter, two quarters, couple of quarters or even if we had a year below inflation, but at this kind of pace, obviously, it will have zero, it will have negative effect, but at this kind of magnitude, which is a slight different, we're talking 1% to 2%, I don't think it should get in the way of maintaining our margins, (00:44:19) pressure margins. I think we have other levers, we have (00:44:21), we have G&A dilution. It could be the case that we can have a gross margin increase. So you have to look at the whole picture.

And if you're profitable with the margins we are, we believe we'll be around the same margin, around - could be flat, could be 10 bps low, could be 10 bps up, it doesn't really matter, but I don't think we are contracting margin, we should be in this kind of level, but we should be creating a (00:44:49) value with this kind of expansion.

Another thing here is that competition has also been cyclical. We have been in the past cycles of a lot of new store openings, but if you look at history, we have been the only company who has been able to grow sustainably and create (00:45:08) is that you can't make - well that could be, regional changes have only grown in their markets. I mean I think we made - we were able to raise that (00:45:18) as well, but you can't pick a single company over the last 10 or 15 years, who tried to grow on a large scale on a multi-market basis besides us who has created value.

What happened is that, those companies face entry barriers in a lot of new markets, the store selection which is not the best because of lack of analytics, lack of expansion, too much hurry (00:45:41). And what happens is that, the additional stores, they deliver revenue per store below the legacy stores, the market contracts, at some point they have to reduce growth, they have to clean up. So it is the famous chicken fry with Marcílio, the term that Marcílio has coined. I mean, you grow and you stop, you grow and you stop, everybody has (00:46:05).

We saw now an acceleration again, yeah. I really believe it's another chicken fry because when we look the stores competitors are opening, (00:46:14) to markets that are very difficult right now. I mean what can the 5th brand in São Paulo add to the table, they certainly they can't find the best location, compete in São Paulo (00:46:26) is no walk in the park. When we enter difficult market like (00:46:36) we face a ton of pain in the beginning, that we faced at a much earlier stage, it was only us and the incumbent. Here we're talking São Paulo for establishing and good players and any new entrant has to add something new to the table on top of the (00:46:51) can they add better location, can they add a better operation, can they create a brand out of nowhere, (00:46:58) that.

And it's not only São Paulo, if you go to (00:47:01) we entered (00:47:03) as the first – the first new challenges to compete in (00:47:10) who is the leader there. It's four years ago, it's different now. Today whoever enters (00:47:15) is the fourth or fifth chain entering the market, competing against (00:47:21), competing against (00:47:22) competing against (00:47:25) São Paulo who came before. So can't they add something new to the table and create value? I mean, based on my experience, based on what I have done, I doubt.

And by the way when you look at the profitability, when you look at the growth, when you look at the margins, I mean, you see that the company is weaker and not stronger. So regardless if the company has deep pockets (00:47:46) or if they don't, (00:47:48) have to fix it. Generally, the biggest company, the more structured, the best to manage (00:47:53) in what discipline they have to be.

So (00:47:57) opened, they don't create value, it's a matter of time for them to be helped and corrected. So it's another way, but I don't think it's a structural addition that represents what we will see in the next one, two, three, four years. I think we'll see, back then we'll see correction of that. History is very clear on that regard. But, yes, even though we maintain, even if we operate the full year at this kind of level 1% or 2% below inflation, which is (00:48:24) because we're trying – we're doing a lot of things that could help us, I still think we can defend our margins.

## Q - Luciano Campos {BIO 16181710 <GO>}

Thank you, Eugênio. Just another question then and a simple one. You have this new strategic plan process that you're starting this year. The first pillar, if I understand, is to look at potential ways to accelerating (00:48:49) store openings. Did I get it right? I mean, you would be looking then at the possibility of expand – of opening more than 240 in future years, that's the – is that the right interpretation? Thank you.

## A - Eugênio De Zagottis

Luciano, at this point I cannot confirm that. What we're doing is when you look at our strategy, we have to look at every element that we have. So we have been challenging what we're doing. So then we look on a market-by-market basis, how competition is doing, how much market share we have, how have been the IRs in the recent expansion, and we would be challenge ourselves, can we do more, or even if we do the same, can we do the same, but with a different breakdown of stock for market, can we do – can we have any new format for, let's say, store selling only BRL 500,000 and not having to sell BRL 800,000, what are the next steps from that view (00:49:48), is that the final (00:49:50) market.

So it's way more than just increasing our number. To increasing our number, we don't need this kind of structural revision. We will (00:50:02) to a bigger number, I don't have a clue, what I can tell is that our guidance for 2018 and 2019, it's already laid on the table, it's 240 stores per year. And yes, we believe we can sustain our fast pace of growth way beyond that, but we don't have any numbers right now. The whole strategy review will help us fine tuning that and again it's more about how than it is about how much.

## A - Marcílio D'Amico Pousada

Yeah. And I (00:50:32) there, they consistently help us to write (00:50:34) the agenda for the future. And during the future, we can share the agenda for you also, okay. We now have opportunity that this market has for us and you only – that they consistently (00:50:44) help us to organize this agenda and to (00:50:49) the agenda for the future.

## Q - Luciano Campos {BIO 16181710 <GO>}

Okay, guys. Thank you very much.

## A - Marcílio D'Amico Pousada

Thank you.

## Operator

Mrs. Julie (00:50:59) from Bloomberg Intelligence would like to make a question.

Hello. Thank you for taking my question. I wanted to ask you about e-commerce a bit. When we look at some of the expectations for growth in the Brazil e-commerce market, some of the highest growth areas over the next few years are in personal care and consumer health. And so I wanted to ask you where you stand now there in that channel? And what your plan is over the next year or two? Thanks.

## A - Marcílio D'Amico Pousada

Okay, Julie (00:51:29). Thanks for the question. I think, this is a very important topic. (00:51:33) is certainly a huge priority, but (00:51:37) was way beyond e-commerce. E-commerce generally means moving goods from a DCO (00:51:43), from a store to a customer house. And yes, we do that. It accounts for something like 0.5%, we sold that in this year BRL 90 million in e-commerce for a company with total revenue being around BRL 14 billion, so its (00:51:57).

When you look at the overall market, the e-commerce (00:52:02) and when we look around the world, this industry in the U.S. or Europe, there hasn't been a huge migration towards e-commerce. But having said that, there are customers who want to do e-commerce, want to receive at home and we are progressing towards that, we launched a new website, we launched our apps, we changed our thinking process from a specific DC to a normal DC (00:52:27), so over the next two years we'll be able to have every DC (00:52:30) in every region as an e-commerce platform to serve those regions.

We have advanced on that and we'll keep advancing more. But the most important thing here is digital, it's not only e-commerce. Digital means that a consumer will (00:52:45) will start using direction on a digital basis and that (00:52:50) the store that he's buying for us to deliver to his home. So we believe, digital can remove several of the pain points at our stores. (00:53:00) we've seen (00:53:03) a huge value offering for consumers. A huge adoption for that.

And this is great because (00:53:13) you still want to come to the store, but you don't want to be in the line in the pharmacy counter, you can pre-order, you can have it all fixed (00:53:20), so you just collect your medicine (00:53:22) and you can browse the huge (00:53:25) collection. In the end, we believe that the stores will always remain the cornerstone of the consumer experience here. As long as the store is well located, it offers experience, it offers service, it offers convenience.

This is a (00:53:39) in which our core consumers, they love the stores, seniors and women, generally, especially mothers because of beauty and things like that. But some consumers don't want to come to the stores. So, we'll be able to offer (00:53:52) store experience, which is better than we offer today and use (00:53:57) to enhance the in-store experience. We're removing bottleneck, allowing you, for example, just (00:54:03) product and get more information on the product.

So, part of our – so one of the main factors of this strategic planning, we just started is the digital transformation. So, we believe (00:54:14), but we don't believe in e-commerce disruption in terms of – I too think when you look 5 or 10 years ahead, the biggest portion for sales will be inside the store, but they will be initiated and powered by digital and that I think is (00:54:33).

## Q - Operator

Thank you. I appreciate that perspective, it's really helpful. And if I could ask one more...

## A - Marcílio D'Amico Pousada

Sure.

## Q - Operator

...on the selling expenses, we got some nice dilution in expenses in the fourth quarter and really for all of 2017. I wanted to ask what the couple of main drivers of that were, the better – the lower selling expenses as a percent of revenue and then if you think you can get similar improvement in 2018?

## A - Eugênio De Zagottis

Okay. I think what we did on the expense side is not a silver bullet doing a huge thing on one element. I think it's that we are in a certain way of trying (00:55:15). So we had improvements in labor, we had improvements in G&A, we renegotiated with suppliers and (00:55:29). There's a bunch of different – we have been able to renegotiate with a contract, we have had this initiatives on energy efficiency like putting LEDs in our stores which are more efficient. So a lot of smaller, consistent efforts that we have been doing for quite a while and we were fortunate to mention late last year when mostly needed. I think we went down a fair bit and did well, but I don't see this as a ladder that we can continue to get this kind of dilution year-after-year. I think very likely now we still

(00:56:05) we can really try to gain some more over the ladder, but that's we'll be talking marginal gains and not another - not trying to - not going down another step in the ladder.

## Q - Operator

Got it. Thank you very much.

## A - Marcílio D'Amico Pousada

Great. Thank you.

## Operator

(00:56:23) from HSBC would like to make a question.

Hello, Eugênio and Marcílio, thanks for taking my question. If I just follow up on the whole digital discussion that we've been having for a while and the benefits that you expect on the consumer experience and also on the pricing, have you noticed any of your competitors doing the same as developed as you are, or do you think that competition is way behind you guys on this? Thank you.

## A - Marcílio D'Amico Pousada

No. I mean, I think everybody has seen it coming, I mean, you have to be deaf and blind (00:56:57) today. So we don't claim the privilege to be the only company trying to work on digital, but one thing is the what, the other thing is the how. So I think the resources we have are different. We have capacity to invest. I think we have the best people in the industry. We have proprietary platforms. The most challenging thing about digital is not having a great website. You can buy a platform in the market to do the best website possible or best app possible. The challenge is really integrating the app and the website to the ERP, to the store pharmacy system to the store checkout system. And because we have all those proprietary platforms, we control every nut and bolt of our execution. And we believe we can move fast on that execution, and we can do more things faster than we believe the others will be able to do.

Another thing is that when you look what these markets will look like in 5 or 10 years, I mean, everybody will have advantage - every large company will have advantage in digital. The only thing about small players (00:58:03) no change, many of them did not have the resources for those kind of things. So I think digital can really separate the men from the boys here. We will be the only chain to have digital solutions. Our main competitors all or most of them will have, then some method of what we do better than them and it's our mission to do something better than them, we believe we will do. But I think we will - the top guys will build a huge gap over the ones behind, and this becomes another driver of consolidation. If digital is imported to the market, this will be another driver of consolidation.

## Q - Operator

Thank you, Marcílio.

## A - Marcílio D'Amico Pousada

Thank you (00:58:41).

## Operator

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

## A - Marcílio D'Amico Pousada

Okay. So, first of all, I would like to thank you all for attending this conference call, and I'd like to quote some of the issues that are discussed with respect to the business. I mean, I think we made clear it that it was a very good year for us with robust top line growth for the average of the year. We (00:59:34) very well the gross margin pressure stemming from the huge inflationary gains 2016, which were enabled to be repeated, but because of (00:59:44) expense dilution of several different lines, we were able to defend our margins.

So, again, if you look just the retail margin, without the NPV adjustment, which is an account adjustment only on a cash basis, we gained 10 bps in a year (01:00:00) because the gross margins was (01:00:02). So, I think we are stronger now than we were before because before we had an EBITDA, which was inflation boosted, now we have an EBITDA which is well structured, and it's a similar EBITDA to the one we had before. And all these initiatives in cost containment and efficiency gain, we were not doing (01:00:25) very closely level of negative evaluation that the customer do in our stores. We have a device in average checkout for that and customer evaluation, negative evaluations went down, positive evaluations went up. So we have slightly less labor inflow, (01:00:41) but we have more profit efficiency and then consumer efficiency there. So this is the best efficiency gain, we believe it's sustainable.

In the year, we grew 17%, 3% of mature store growth, in line with inflation. We opened 210 new stores, 10 more than the guidance. And it was the strongest (01:01:00). So, this is also very encouraging. But as I mentioned, we ended the year with (01:01:08) in terms of sales. We were trailing inflation between 1% and 2% and this is the scenario we carry into the beginning of the year. And from here onwards, it's our job to try to convert back to inflation. We'll be able to do so. It depends on many of the factors. I can't swear that this can happen, but we are working on that. And even if we remain somewhat below inflation at this kind of magnitude with a solid expansion coming to play, I think we can do well in the year, we can defend our margin, and I think we have to do that initially for the company.

I mean, again when you look at our history, we have many years of in line or above inflation, but we have had other years going below inflation and that doesn't necessarily (01:01:54). The only place where straight line exist is in investor models and analyst models, really life is not like that. So the important thing is our long-term focus is the value we can create over the next decade by exploring the structured tailwinds we enjoy like the regional accumulation, like leading the consolidation of fragmented market.

We will start a new cycle of strategic planning, focusing on things like digital, reassessing our expansion, looking at formats and looking at healthcare. We have a very unique platform in the market (01:02:31) and what more can we do, what are the (01:02:36). So, we have a lots on our table. There are practical initiatives to improve execution in term of sales, there are a lot of strategic initiatives that don't stop. But when we look longer term, we will be very optimistic on the company and very optimistic on the business.

Finally, I'd like to thank for the support of all our long-term shareholders. Believe it or not, we have several company - several firms who has been with us since our IPO (01:03:13) and who haven't sold a single share, have actually more - some of them actually more share and went through ups and downs, and so we're really appreciative of their trust.

Thank you very much and hope to catch up with you on our semi conferences and road shows. Bye-bye.

## Operator

Thank you. Raia Drogasil conference call is now finished. Have a nice day. Closing and disconnection.