# Q1 2017 Earnings Call

## Company Participants

- Elcio Mitsuhiro Ito, Head-Finance
- José Roberto P. Rodrigues, Vice President-Legal & Corporate Affairs
- Pedro de Andrade Faria, Chief Executive Officer Global

## Other Participants

- Alexander Berglund, Analyst
- Alexander Robarts, Analyst
- Gustavo Gregori, Analyst
- Lauren Torres, Analyst
- Pedro Leduc, Analyst
- Ravi Jain, Analyst

## MANAGEMENT DISCUSSION SECTION

### Operator

Good morning, ladies and gentlemen, and welcome to BRF SA Conference Call to Discuss First Quarter 2017 Earnings. 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.

Forward-looking statements related to the company's businesses, perspectives, 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 changes, economic conditions of the country and the sector and international markets, thus are subject to changes. As a reminder, this conference is being recorded.

This conference will be presented by Mr. Pedro Faria, Global Chief Executive Financial and Investor Relations Officer.

We now hand the call over to Mr. Pedro Faria who will begin the conference call. Mr. Pedro, you may begin.

### Pedro de Andrade Faria {BIO 15115819 <GO>}

Good morning, ladies and gentlemen. Thank you all for being with us today. We are here to discuss with you BRF's first quarter results. We are not happy with the results presented today as we think they are still below what is the potential of the company. Since the beginning of the year, we have been working hard to transform our business model into a more integrated and transversal one. As we told you before, we are working with BCG and with the board to implement a new management structure and we have been doing some changes in things since then.

This end of the quarter was especially challenged for the SEC (02:03) and BRF due to all that happened with the Weak Flesh Operation. Despite all the difficulties and challenges created because of that, I think this was also emblematic for BRF. When I look back today, I feel very proud for the fast response that the company gave, and even more than that, for the mobilization created internally.

This mobilization was connecting all layers inside the company, from senior management, field and plant operators. And what made me most happy was the fact that the results that we gave to our consumers came straight from our employees and not from our marketing agency. They have flooded the social media with pictures of their own refrigerators, showing with pride the products that they feed their families that are the same ones they produce with quality and tradition that every BRF consumer deserves.

Besides that, we also have a tremendous support from our chain, from suppliers, retailers and also most specially our out growers. For me, this is priceless and show all the strength and connection the BRF has. Obviously, this episode will leave profound scars. It's worth to mention that for the first quarter we reported the very first and direct impact that we suffered to the tune of BRL 40 million coming from direct expenses incurred to the end of the quarter, such as marketing, communication expenses, lawyers.

Besides that, we lost around 15,000 tons that were not shipped due to that. We are still running a deep analysis to quantify the total impact so we should expect a higher number in Q2. After almost two months, I think we can say we are through the worst moment in a very satisfactory way. I am sure BRF will rise from this event stronger and more united and with much more robust controls and processes to guarantee the quality of products and the respect we have for our consumers.

In Brazil, we are starting to see some signs that consumption might be stabilizing. For the first time since the end of 2015, we reported annual growth in our processed food volumes and at the same time price increase. If we take a close look to our main channels such as key account or the traditional channel, the total volume growth is 7.5% and 6% respectively. The increasing volumes together with our efforts to improve our supply chain planning allowed us to reduce significantly the discount for shelf life or FIFO as we call it. That dropped 26% versus the 2016 average and today we are back to 2014 levels. With all of that, our profitability per kilo started to come back to better levels much more adequately. Despite that, the same integrated plan in Brazil is also bringing a significant reduction in our logistic costs together with our ZBB efforts, allow us to reduce our SG&A in 7.4% year-on-year even with the higher volumes sold.

In that context, Leonardo Byrro assumes newly created Vice Presidency of Supply with the mission of implementing those initiatives in a global and centralized way. He will also be responsible for all the procurement grains purchase strategy. This was one of the most important change that we did in our business model. I would like to take the opportunity also to welcome Alexandre Almeida, who joined us from Itambé, where he was a CEO. He brings a lot of experience to our operation and his mission will be to continue the good work made and developed in our business model as he now leads our Brazil operations.

Despite improvement in the Brazilian market, the international market are still in a difficult conjunctural moment. The effect of the real strengthening almost 5%, together with the grain cost still high in a few regions, did not allow Brazil to gain back its competitiveness.

Additionally on OneFoods, we're not able to reduce our inventories yet. We'll be at excess supply of grillers coming from the increasing local production in MENA and from the volumes coming from smaller players in Brazil. That kept directing volumes to market that have a shorter production cycle such as the Middle East trying to mitigate a more restrictive access to credit and working capital. Due to that, our profitability in the region was below what we would like.

We keep focusing in the structural pillars of our operations. Our market share in the region is growing in all Gulf countries and we closed the quarter with an annual growth of 4 percentage points in total share. In Saudi, our main market's annual gain was even more emblematic at 5.4 percentage points. Equally, we grew our share in all categories. For instance, our current share in chicken parts is 64.2%. This represents an annual growth of 6.4%. Looking forward, we expect to see profitability improving from the second half as grain prices keep going at a positive direction and poultry production in Brazil showing signs of contraction.

Moving to the financial side, we ended the quarter with a very solid cash position of BRL 8.1 billion, while managing our cash in a very conservative way. And after Weak Flesh, this was even enhanced. Not only are we strengthening our cash position, but also doing a very restrictive administration of expenses in CapEx during the period.

Our leverage reached 4.2 times EBITDA, which is much too high than we would like. We had a small increase in our net debt but the EBITDA is the main driver of the increase in the leverage ratio. We should see an organic deleverage coming from the improvement of our operational results, especially in the second half of the year moving towards the 2.5 times level in which we'd feel a lot more comfortable. We'll be very restrictive regarding new M&As, dividends, buybacks, we will look very closely on our working capital and our CapEx, it should be way below 2016. The investment grade is very important strategically for BRF. As I told you in the beginning, we're not satisfied with the results presented today, but we keep working very hard to put BRF back on track to regain its profitability and the legal long-term credit that we all believe.

I would now like to open for Q&A. Thank you very much.

# Q&A

## Operator

Excuse me, ladies and gentlemen, we will now begin the question-and-answer session. Each participant may ask only one question. Our first question comes from Lauren Torres, UBS.

## Q - Lauren Torres {BIO 7323680 <GO>}

Yes. Hi. Hi. Good morning. Pedro, I think I've posed this question to you before but with another tough quarter behind you and it seems like directionally a lot of the bigger headwinds that we've seen are dissipating or at least are expected to dissipate in the second half of the year. Could you separate for us a bit those factors of how we should think about the improvements with cost getting better, the Weak Flesh Operation managed well and some other things working, not against you but turning for the better in the second half, how we should think about what that improvement could mean? But I think more importantly I'm just looking at some of the structural changes you've made as a company. Once these headwinds dissipate and these structural changes are put in place, how are you thinking about the longer-term progression here? I know this is a very general question, I'm just trying to get your sense of separating what's tangible now versus what's intangible, and changes that you're making to get you to better numbers going forward?

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Lauren, good morning. And thank you very much for your question. In a way you have encapsulated the three main drivers of how much we've been working and how hard the team has been working because these are effectively three dimensions that are intertwined and this is why I see the first quarter is kind of a transition point then I hope the second will prove even more or so.

From, I'd say, conjunctural cyclical perspective, of course I think everyone kind of agrees, clouds are dissipating. But we have, I would call it, an inventory issue, right? We're still seeing some of the high cost from the past still impacting our cost structure. If we're to start of the company today, then we would be buying grains and raw materials at spot price, and that will make a big difference. So I think there's an inventory issue. I think we need a bit of patience and see those trends that we can basically already identify they start to play out in terms of results. So of course, I think this is kind of more into the second half.

Weak Flesh, of course, came out of nowhere. This was, I think, a quite relevant episode for us as we mentioned. I think as I said in the call in Portuguese, I'm extremely proud to see how the team has handled what could have been a much worse situation, and that I think talks a lot about how we see the world, our transparency to our stakeholders and are willing to improve processes, be it compliance, be it quality. I cannot be so sure that the main thing is behind us because there is a second order, third order impact.

We're seeing that quite vividly in terms of the Minero (12:10) situation, and the inventories we have to process, also some bargaining power that were shifted from sellers to buyers even in the context of markets generally getting better. So I think it's – unfortunately, the year 2017 will be marked by impacts of the Weak Flesh. But I think, longer-term, what you see is a much more unified robust company that has been given the ability to improve the way we operate.

And thirdly, and this is what makes this moment so special, we already signaled into the market the need to change, and we've been quite busy also promoting that change, which I would say goes in the way of creating much, much transversal collaborative way of operating, eliminating unnecessary degrees of decentralization, making our team more robust. I'm extremely pleased to have Alexandre participate in our call having joined a few months back. Also, the strengthening of our supply by spread – we expect to have, Leonardo and the team looking quite carefully into how we think through issues pertaining to the harmony between our value chain and the markets.

So these are the kind of transformation process, I would say. Of course, Weak Flesh did not help in the sense that they kind of diverted the attention, but what I'm seeing going forward is this very important opportunity for convergence. I think it's something I have not stressed in the other call very emblematic to me a few weeks back. We had our shareholders' meeting which we have a record turnout, and all of the matters that were presented by the management got approved by a significant majority, that also talks a lot about this moment and the aim, which all of the stakeholders are giving a big vote of confidence to the company.

So generally speaking, and I know your question was a general one, I believe that if we manage well those three factors, probably we will see the company in much better shape, but I expect this to happen a gradual, robust and consistent manner going forward.

## Q - Lauren Torres {BIO 7323680 <GO>}

Okay. All right. Thank you.

## Operator

The next question comes from Ravi Jain, HSBC.

## Q - Ravi Jain {BIO 16135293 <GO>}

Hi, good morning. I have a quick question on the international markets, specifically for OneFoods, how much of the weakness do you think is in your cyclical and do you see any structural changes in terms of your competitors there? Could you give us some color on the initiatives that you are taking to improve profitability in those markets in a more longer-term horizon in addition to these input costs that we are expecting in the second half of the year? Thank you.

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Well, thank you, Ravi. I think that One Foods' case is an important one. We stress the fact that this were part of the results we're least happy in the first quarter. Of course, the number of conjunctional issues, this is a market that these is conjunctionally oversupplied and that I think talks about not only supply dynamics, and we know that there has been a more aggressive spends from producers both Brazilian and also local, but some weakness in demand, which I think talks about, at the moment. of Saudi Arabia and a few other markets. Of course, it did not help the fact that early in January a big tax increase on imports were passed, and we were not able to pass through those tax increases completely and they also caused some pain for us.

In terms of the competitive situation in Middle East, we see a more serious competition, this is coming, I think, conjunctionally from Brazilian players as they referred part of their production of broilers into grillers, which has a much lower cash cycle. And therefore, it is a good source of funds in a scenario of credit limitations. But also, we've seen local producers also French competition trying to take advantage not only of the Weak Flesh, but a perceived weakness from Brazilian producers. And I think the overall response BRF has given, given how meaningful and how important it is long term our presence in those markets, I think we really pushed into our strength, we gained a lot of market share in the quarter. We made sure that we didn't give any space. And we continued to command a leadership position in all of those markets.

When you think about the initiatives for the long run, they can improve profitability. I think a lot of it is already shown in the first quarter. You see our emphasis in growing our business of poultry parts. We recently had a phenomenal launch of IQF, 8 cuts, 9 cuts, something that we are very excited with, because this is driving the category from whole poultry to poultry parts, where I think we are way ahead in terms of competition. We're also seeing our strengthening position in some of the SPP categories, again supported by successful launches in the fourth quarter and first quarter.

We also see a very important opportunity in terms of GPM efficiencies as we call it, and also even further strengthening our footprint in the region in that we are excited with the coming closing of the above this transaction later this month, which is a platform that will put us on a leadership position, in what I think is the most significant market for halal food. So we continue to be very positive in the long-term with the OneFoods, but the first quarter was marketed by a number of conjunctural fact that as you rightly pointed out, as well as our response in trying not to concede a lot of space that was hardly concrete in the last few years.

## Q - Ravi Jain {BIO 16135293 <GO>}

Thank you. That's helpful.

## Operator

The next question comes from Alex Robarts, Citibank.

## Q - Alexander Robarts {BIO 1499637 <GO>}

Yeah, hi. Thanks for taking the question. I wanted just to go back to the Middle East again. And saw it's a kind of – talking about the pace of and asking about the pace of traffic. But I mean clearly it's a key point right now in the short-term and I'm wondering what is the role of the macro in your numbers. In other words, can you take a stronger currency – I'm sorry, evolving the FX and lower grain prices are going to play a little role, a meaningful role in this margin recovery? Secondly, who did you get market share from? Local producers, other exporters, if you could kind of give us a breakdown? And thirdly, on the benefit integration, do you think that there could be some meaningful synergies as you think about that integration in the second half? Thanks very much.

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

No, Alex, thank you for your question. I think you are rightly pointing to some very relevant factors here. So basically, when you think about our business in the Middle East, still the majority of this are coming from our presence in great volumetric categories like whole poultry, and this is where I think we've seen most pressure. And more specifically, even in across all the channels, but also in the wholesale. That I think talks a lot about that you can probably look back at the data.

It's a very – I would say, it's a process in which Brazilian, especially small Brazilian producers, they kind of flooded the market I think in search of fastest cash conversion and the ability to generate cash, and that of course create a bit of noise in the market. Weak Flesh doesn't help because it was perceived together with the tax increase in Saudi as an opportunity for local production to strengthen its position, and I think this is more of a structural fact that we have to take into account, how do we effectively respond to local production especially in Saudi and to local players.

I think OneFoods as an investment story is pretty much a good and effective answer of us migrating towards being much more of a local player than just an importer or exporter, so this is important. And you are right about pointing to synergies in boundaries. As we are progressing into the closing of the transaction, one of the areas we are more excited is precisely the opportunity to bring goods from Turkey into the markets in Middle East, especially as you go in more granular into the categories. You see a number of interesting opportunities in poultry parts, calibrated breast, a number of things also on the SPP front, where I think Turkey has already been kind of a long-term supplier into the region. So those opportunities they have I think are a double edge for us. Not only they help to strengthen our position in the Middle East, but they also help us also play the turkey market from a different perspective, having the two hands to play both the exportability or a significantly stronger exportability, as well as the local market which is very interesting.

So I think the first quarter is one that we feel not very satisfied results. I only wonder where all the players are kind of in terms of margins and how sustainable that is. Indeed, we've seen in the last couple of months shipments from Brazil which were way below historical norm, but we need this whole thing to play out so I'm assuming that you'll see a meaningful recovery towards the third quarter or fourth quarter of this year of what I think is strategically a very compelling story, which remains intact in our perspective.

## Operator

The next question comes from Gustavo Gregori from Bradesco (23:07).

## Q - Gustavo Gregori {BIO 16209398 <GO>}

Hi. Good morning. Thanks for the call. My question is regarding dividends and interests on own capital. Considering the leverage there that BRF posted in first q and the negative carry that the last two quarters' weak results are going to have on the leverage ratios. Should we assume that BRF is not going to pay any dividends or interest in own capital this year?

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Well, let me tackle part of the question, I'll also relate to Elcio here, Gustavo. I think, what we are trying to do is to – and I think the first quarter shows that, is to implement even stronger discipline around our uses of cash. So you see the favorable trend in OpEx. CapEx also came in below our original guidance, and we're trying to be very strict even in the advent of Weak Flesh strengthening our position in terms of how we're thinking about expansion in general, and also working capital. As you're implying, dividends and interest on own capital, this is something that is being debated in the board. I don't think your inference is right because we have to manage our expectations from all the stakeholders. However, I think you can assume us to really be very consciencious about the high leverage ratio we find into trying to drive this to much more normalized levels of 2.5 as I think a bit of the operational figures start to improve. Elcio, would like to complement?

## A - Elcio Mitsuhiro Ito {BIO 21375442 <GO>}

Sure. Thank you, Gustavo, for bringing that up. I think definitely our leverage ratio today we feel very uncomfortable at this levels as our targets is really to work with 2.5 times net debt-to-EBITDA. Very important to understand that this equation is twofold, right? You have the net debt and the EBITDA of the last 12 months. If you look at the net debt over the past three, four quarters, they're looking at BRL 11 billion to BRL 12 billion, which definitely was not the major driver of the increase in net leverage. But the EBITDA accumulating in 12 months, that being the major one. So we called the quarter below BRL 3 billion. And as we have a different scenario and recovery of our margins and profitability over the second half, we have to expect you to have a deleverage – enter into a deleveraging mode pretty – on a solid basis as you're going to be generating more cash or reducing the net debt, and at the same time increasing the denominator which should rise against large 2.5 times.

Just also important to mention that we don't have any financial covenants in any of our debt instruments, so there's no acceleration here. And I guess the last point is, we'll continue a very disciplined management on our cash flow being CapEx, OpEx, working capital, as it's a very critical and important point for us here in our strategy.

## Q - Gustavo Gregori {BIO 16209398 <GO>}

Understood. Is there a level of leverage whereas you're above that you're not going to do any different payments or are you guys going to be just kind of on a forward-looking basis assuming that things are going to improve and then maybe the different payments?

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Yeah. So this is, again, discussions which we are in the moment having with our board. I don't want to imply we have a decision made in one way or the other, but in our projections we believe we have a good job to be done especially in the expenses, as well as other uses of funds.

## Q - Gustavo Gregori {BIO 16209398 <GO>}

All right, understood. Thank you.

## Operator

Our next question comes from Alexander Berglund, Bank of America.

## Q - Alexander Berglund {BIO 19905283 <GO>}

Good morning, everyone.

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Good morning.

## Q - Alexander Berglund {BIO 19905283 <GO>}

My question is also about leverage. It would be helpful if you could provide a timeframe of when you would reach the 2.5% million net debt-to-EBITDA target?

## A - Elcio Mitsuhiro Ito {BIO 21375442 <GO>}

Hi. This is Elcio speaking. I guess it's difficult to measure the exact timing that this is going to happen again. The leverage scenario will start kicking in stronger and over the second half as we start generating cash and increasing EBITDA the past 12 months. So if we're going to go into that direction, there are many other variables that's going to be impacting the operating performance and then the deleveraging mode is going to be consistent with the recovery of the operating margins.

## Q - Alexander Berglund {BIO 19905283 <GO>}

Okay. Thank you. And then I think Pedro mentioned on his presentation that this 2.5 net debt-to-EBITDA target would be achieved in organic fashion. So can we assume that any potential asset sales including OneFoods, would that need to be concluded in order for you to reach this 2.5 target, or does this 2.5 target include assets sales?

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Thank you for your question. This is Pedro back again. I think we are, of course, stating that our goal is to get closer to 2.5 which is where we think structurally we should be. We have not a precise target against time to do so. We think we should see a meaningful progress as our operating margins start to improve in the second half. But if – what I'm implying is we are looking from an organic perspective, you are right, but we're also being very cautious about alternatives that we have and OneFoods' capitalization is something that is not out of the cards, we continue to be contemplating alternatives on that front.

## Q - Alexander Berglund {BIO 19905283 <GO>}

Okay. Thank you, Pedro and Elcio.

## Operator

The next question comes from Pedro Leduc, JPMorgan.

## Q - Pedro Leduc {BIO 16665775 <GO>}

Good morning. Thanks for taking the question. First one more strategic on the Middle East side this quarter. You mentioned that market share gains just appears to have come at the cost of a negative EBIT, however, and maintained the past and there's a lot of focus on reducing volumes, trying to smooth volatility in this quarter similarly there's a bit more focus in market share. Just wondering if it's a change or is it due to the high fixed cost that you have there and just looking forward to see your thoughts here. That'll be the first question. Thank you.

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Pedro, thank you for your question. As we're trying to imply we don't see necessarily debt by cost between share gains or margins. But I think since the last quarter of last year, we were trying to show that we were not willing to consider a lot of space for other competitors. We see a more intense competition in the Middle East and I think we have the opportunity to continue to preserve the space that we have conquered in the past. That does not imply that we are doing a conscious effort in terms of pricing. Pricing dynamics in the region, they tend to be a lot more related to supply/demand dynamics in which we see a much more conjunctural imbalance in the market. We think that this, at some point, will start to go away. We're starting to see shipments for the region to come to levels, which are way below historical. We need to also think about how do we best respond to increasing competition coming from local players.

So I think we're trying to adapt to the current scenario but continue to be confident that the position that we've conquered as probably number one leader in the categories, and some other categories number two. This is really a position for us to defend and we believe that later in the second half of the year, probably a lot of the structural competitiveness from Brazilians will come to play in our favor if we manage this in the right way. We also have to think about the context of the tax increase in Saudi Arabia, which create a big dislocation in the market that we are seeing now some normalization.

## Q - Pedro Leduc {BIO 16665775 <GO>}

Okay. Thank you for that. And then a quick follow-up on Brazil – not specifically Brazil, but congrats on well managing the Weak Flesh scam (32:48) investigation, really had small in terms of the volumes than your peers, so well done on that. But also, if you could help us understand (32:56) and how much we can consider from non-recurring costs, is this spillover into procured inventory adding this by marketing or lower the expenses. And from the (33:08) how much should we assume in the second quarter? And then second, has there been any charges or any acquisitions, if you could update on the executive involvement there, the BRL 40 million that you're making, et cetera, that'll be great. Thank you.

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Thank you, Pedro. Let me start with the first question, I have José Roberto here our VP who can answer the second part of your question. So what we already expensed in the first quarter, the BRL 40 million, really talks about out-of-pocket expenses as we're trying to give an adequate response to our stakeholders. And of course, there was a lot of activity around communication, advertising and all other fronts. I think the impacts of Weak Flesh on our operations, they will be mostly felt in the second quarter because, of course, having a plant like Minero (34:04) which is a bit more than 5% of our output. It has created consequence in terms of our value chain, raw material, excess inventories, et cetera, and we are seeing a scenario of stricter controls in most of the markets we operate. And I think, as a second order effect, some bargaining power which has been transferred to buyers which of course will translate into perhaps a more gradual recovery of prices internationally.

So I think, the bulk of impact is coming from Weak Flesh. They have not been felt in the first quarter. I think second quarter should be, I think, the biggest factor that we're going to see, but as you rightly congratulate us, when I looked back at the scenario that could have been precipitated in March 2017, I think we are navigating into, I think, a much better territory than originally anticipated. I will relay to José Roberto so he can give you an update as far as the process and the charges against the BRF or BRF employees?

## A - José Roberto P. Rodrigues

Hi, Pedro, this is Roberto. I think as usual this is one process. We're facing charges against two of our employees. At this moment, they are connected to bribery, things like this – as you probably read on the news. We have very highly skilled specialists who work on this with us, and at this moment we are trying to cooperate and support the authorities the best we could, and hopefully we can clear up and explain everything connected to our operations.

## Q - Pedro Leduc {BIO 16665775 <GO>}

Okay. Thank you both. Very clear. Thank you.

## Operator

This concludes today's question-and-answer session. I would like to pass the floor again to Mr. Pedro Faria.

## A - Pedro de Andrade Faria {BIO 15115819 <GO>}

So thank you very much all of our investors, analysts for your participation in our first quarter results conference call. I would like to emphasize how proud we are. By the way, we have effectively responded to the Weak Flesh Operation. I think the name of the game has been transparency, trying to give an adequate structure and governance, and even operate in a way of strengthening our processes and systems. I believe, as I said, this episode will leave some scars but it will also create the opportunity for us to emerge on a much more robust and as unified way as a team and as an organization. We firmly believe that BRF, as the sector dynamics play out, will be navigating a much more positive territory in the coming quarters, and I'd like to again to thank you for your participation.



## Operator

That does conclude our BRF SA conference call. Thank you very much for your participation. Have a good day.