Q1 2018 Earnings Call

Company Participants

- Bernardo Pinto Paiva, Chief Executive Officer
- Ricardo Rittes, Chief Financial and Investor Relations Officer

Other Participants

- Alexander Robarts, Analyst
- Antonio Barreto, Analyst
- Isabella Simonato, Analyst
- João Pedro Soares, Analyst
- Lauren Torres, Analyst
- Luca Cipiccia, Analyst
- Mohammed Ahmad, Analyst
- Thiago Duarte, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and thank you for waiting. We would like to welcome everyone to Ambev's First Quarter 2018 Results Conference Call. Today with us, we have Mr. Bernardo Paiva, CEO for Ambev; and Mr. Ricardo Rittes, CFO and Investor Relations Officer. We would like to inform you that this event is being recorded and all participants will be in listen-only mode during the company's presentation. After Ambev's remarks are completed, there will be a question-and-answer section. At that time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996 (sic) [Private Securities Litigation Reform Act of 1995]. Forward-looking statements are based on the beliefs and assumptions of Ambev's management and on information currently available to the company. They involve risks, uncertainties, and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Ambev and could cause results to differ materially from those expressed in such forward-looking statements.

I would also like to remind everyone that, as usual, the percentage changes that will be discussed during today's call are both organic and normalized in nature. And, unless otherwise stated, percentage changes refer to comparisons with first quarter 2017 results. Normalized figures refer to performance measures before exceptional items which are either income or expenses that do not occur regularly as part of Ambev's normal activities. As normalized figures are non-GAAP measures, the company discloses consolidated profit, EPS, EBIT, and EBITDA on a fully reported basis in the earnings release.

Now I'll turn the conference over to Mr. Ricardo Rittes, CFO and Investor Relations Officer. Mr. Rittes, you may begin your conference.

Ricardo Rittes {BIO 15184017 <GO>}

Thank you. Hello, everyone. Thank you for joining our 2018 first quarter earnings call. I will guide you through our financial highlights of Brazil, Central America and the Caribbean, Latin America South, and Canada, including our below the line items and cash flow. After that, Bernardo will give more details about our performance in Brazil, evolution of our growth platforms as well as our outlook for the remainder of the year.

Beginning with the main highlights of our consolidated results, we started the year with growth in CAC, LAS, and Brazil. On a consolidated basis, top line was up 5.9% in the quarter with volume going down 5.8% mainly due to a shortfall in Brazil. Volume decline was more than offset by a healthy net revenue per hectoliter increase of 12.4%. EBITDA was up 10.1% in the quarter reaching BRL 4.6 billion with margin expansion of 160 basis points to 39.9%. Normalized net profit was BRL 2.6 billion, 12.7% higher than that of the first quarter of 2017 as EBITDA organic growth and lower interest expenses were partially impacted by a higher tax rate.

Moving now to our divisional results, and starting with Brazil. Brazil EBITDA was up 5.3% with margin expansion of 280 basis points to 41.8%. In Beer Brazil, top line was down 1% as anticipated. We started the year facing challenging volume that declined by 8.1% mainly driven by the combination of a weak industry and a tough comparable in the first quarter of 2017. On the other hand, net revenue per hectoliter remained strong and grew by 7.7% benefiting from the carryover of the price adjustment implemented in the third quarter of 2017 and from our continued revenue management initiatives. Despite volume not being supportive, we still managed to grow Beer Brazil EBITDA by 5.2% and expand margin by 260 basis points to 43.8%. Cash COGS per hectoliter in Beer Brazil was down 4.8% driven by favorable FX partially affected by inflation and higher commodity prices. And cash SG&A was up 3.1% as higher logistic costs impacted by operation deleverage were partially offset by below inflation sales and marketing and administrative expenses.

In Non-Alcoholic Beverage Brazil, NAB as we call it, EBITDA was up 6.1% with margin expansion of 350 basis points to 29.5%. Despite posting solid net revenue per hectoliter growth of 16.2% which benefited from the annualization of our revenue management initiatives implemented in the second half of 2017, top line was down 6.4% impacted by a volume decline of 19.4%. Similarly to Beer, NAB's weak volume was driven by mainly two factors. One, a still declining industry; and second, a hard comparable in the first quarter of 2017. Bernardo will expand on this topic. In terms of costs and expenses, cash costs per hectoliter in NAB was up 4.9% as favorable FX was adversely impacted by higher raw materials, including sugar, coupled with volume decline effect in fixed cost dilution. Cash SG&A on the other hand grew below inflation at 1% as high logistic costs affected by operational deleverage were partially offset by lower sales and marketing expense.

Moving now to our international operations. In Central America and the Caribbean, we continue to experience a positive momentum. In the first quarter of 2018 EBITDA in CAC reached BRL 445 million, increasing organically 18.7% with margin expansion of 330 basis points to 38.7%. In U.S. dollars, reported EBITDA grew close to 16%. Net revenue increased by 8.7% and on a per hectoliter basis by 4.2%. Volume was up 4.3% with Dominican Republic and Panama, the two largest countries in the region for us, delivering strong growth. In the Dominican Republic our performance was supported by a continued investment in the Presidente brand that in the first quarter promoted a notable Carnival along with a strong 360 Holy Week activation. And in Panama, this quarter we continue to witness the success of our portfolio of brands led by Atlas Golden Light which delivered the consumer great experience during two major events, Carnival and the Atlas Golden festival. Cash COGS per hectoliter in CAC was slightly positive, growing 0.2% benefiting from the tight cost management and further cost savings in our non-working money as well as efficiency gains in our working money. This translates into decline in cash SG&A by 0.3%.

Moving out to Latin America South. In LAS we started the year maintaining the good trend of 2017. EBITDA was up 25.2% organically, reaching BRL 1.3 billion with margin expansion of 30 basis points to 43.1%. Net revenue grew by 24.6% explained by a combination of, number one, strong volume that grew 5.7% with all the countries performing well, enabling us to reach record beer volume in the first quarter in the region; and second, net revenue per hectoliter increase of 17.8% which were a consequence of the high inflation in those countries plus revenue management initiatives and a favorable brand mix. In Argentina in particular, beer volumes grew by high single digits fueled by Brahma coupled with the successful launch of Quilmes Clásica. Our premium portfolio in the country also led the way with Stella Artois, Corona, and local craft brand Patagonia presenting strong growth and driving a positive mix. Cash COGS per hectoliter in LAS went up by 13.5% benefited by FX. While cash SG&A increased by 28%, mostly impacted by sales and marketing expenses.

Turning now to Canada. We delivered in the first quarter BRL 275 million of EBITDA which is 20.4% lower than that in the first quarter of 2017. Top line grew by 0.5% and net revenue per hectoliter rose by 1% as a favorable brand mix was negatively impacted by excise tax increase. Volumes were marginally down, declining 0.4% predominantly driven by a soft industry. On the other hand, our strong portfolio helped us retain our leading position in the Canadian market with, number one, Bud Light, Corona, Stella Artois, and Michelob Ultra outperforming the industry; and number two, our craft portfolio comprised of Mill Street and Archibald among other brands growing double-digits year-over-year. Cash COGS per hectoliter however was up 26% in Canada due to a hard comparable in the first quarter of 2017 and the impact of imports. On the other hand, cash SG&A was down 2.9% benefiting from cost savings in our non-working money as well as phasing and efficiency gains in our working money.

Still in our international operations and before going back to consolidated figures, I would like to highlight that we are enthusiastic with the evolution of our business in LAS and CAC, reinforcing our positive outlook for both regions. Especially in LAS, we're also pleased that we closed the transaction in Argentina that resulted in a perpetual license of Budweiser brand. Such transaction brings us a unique opportunity to further develop Budweiser which is a very strong global brand with great potential for growth going forward. Finally, in Canada while we're not satisfied with our performance this quarter, as we cycle COGS, hard comparable we're confident that we will be able to deliver improved results supported by our strong portfolio of brands.

Now back to consolidated figures. Other operating expense totaled BRL 258 million in the first quarter mainly explained by government grants related to state VAT long-term tax incentives that were down year-over-year. Lower revenue and the revenue geographic mix explain this reduction. Finally, moving below EBITDA. In the first quarter our net financial results totaled an expense of BRL 544 million, declining 37.6% when compared to the first quarter of 2017. Going to more details, main items in the financial expense of the quarter were, first, interest income of BRL 103 million driven by our cash balance, mainly Brazilian reais, U.S. dollars, and Canadian dollars. Second, interest expenses of BRL 348 million that include, among other items, interest incurred in connection with the Brazilian Tax Regularization Program, as well as a non-cash accrual of approximately BRL 65 million related to the put option associated with our investment in the Dominican Republic business. Such non-cash accrual declined more than 50% year-over-year as a result of the partial exercise of the put option in January 2018 which resulted in the decrease from 45% to 15% of ELJ ownership in the business.

Third, a BRL 183 million of losses on derivative instruments mainly driven by the carry cost of our FX hedges primarily linked to our COGS exposure in Brazil and Argentina. Losses on derivate instruments declined by 26% year-over-year benefiting from positive results of equity swaps coupled with low interest rates in Brazil that contributed for the reduction of carry costs. Fourth, gains on non-derivative instruments of BRL 92 million that comprises a gain related to the adjustment in the fair value of the put option in the Dominican Republic that, as I just mentioned, was partially exercised at the beginning of the year. And finally, number five, fifth, BRL 119 million of other financial expenses mainly driven by interest in contingencies.

The effective tax rate in the quarter was 19.3% versus 12.9% last year mainly explained by the negative impact of foreign exchange variation on intercompany transactions due to the depreciation of the Brazilian real. From a cash flow perspective, cash flow from operating activities before changes in working capital was BRL 4.7 billion versus BRL 4.6 billion in 2017. Starting from the higher cash flow generation before working capital, during this quarter we had a negative cash impact from working capital due to volume decline in both Beer and NAB business in Brazil. Given that we have a negative working capital position, every time we grow our business there is a positive impact on working capital as cash generated by Ambev (00:14:46) is significantly higher than the cash tied up in receivables and inventories.

The opposite is also true. Every time we face volume deceleration there is a negative effect on working capital. As a result, the first quarter of 2018 cash generated from operations was BRL 2.5 billion versus BRL 3.1 billion during the same period of 2017. This quarter we also had a higher cash tax payment when compared to the same period of 2017 mostly due to FX negative impact from tax paid abroad and phasing as this figure is expected to be partially diluted over the year. Similarly, we also completed a transaction that I alluded to whereby we increased the ownership in the Dominican Republic business from 55% to 85%, leading to a cash outflow of roughly BRL 3 billion. Finally, in the first quarter, we paid out BRL 1.1 billion in dividends to shareholders.

Thank you very much. I will now move to Bernardo before going to Q&A.

Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thank you, Ricardo. Hello, everyone. As mentioned by Ricardo, we started the year delivering EBITDA growth and margin expansion for Beer Brazil despite volume decline of 8.1%. When we announced 2017 full-year results, we mentioned that we expected a challenged volume for Beer Brazil in the first quarter, but that we have a positive outlook for the remainder of the year. In this context, I believe it's worth sharing with you our view on two questions. One, what are the main drivers that led to such volume decline? And second, is there any change in our outlook going forward?

So what happened? There are a few factors that explain beer volume decline in Q1. First, earlier Carnival. The earlier the Carnival, vacations got short. And as a consequence, beer consumption levels tend to suffer. Second, poor weather. Especially in January and February, we had more rain and lower temperatures across the country when compared to the first quarter 2017, particularly in the Southeast region where we have a stronghold. And third, macro. The consumer environment in Brazil remains volatile. It is a reality that unemployment rate is still very high and the real disposable is recovering at a slow pace. These three drivers together led to a weak beer industry that, according to our estimates, declined between low and mid-single digits in the quarter. In addition, we also faced the hard comparable in Q1 2017 when we substantially outperformed the industry.

With that, I would like to highlight that even though we underperformed the industry this first quarter, we don't see any structural change in our market position. One of the reasons for that is that when we mention industry figures, we are referring to sell-out and not selling data. And based on inventory levels at the retail channel and pace of destocking, there may be significant difference between the two of them. As such, in fourth quarter 2017, our volume was up 5.1% while the industry was flattish. It is fair to say that at that time retail was expecting a strong summer season.

Regarding first quarter 2018, summer was actually impacted by poor weather, and as a consequence the sell-out was lower than expected leading to a slower destocking. If you analyze our performance during fourth quarter 2017 and first quarter 2018 combined, volume was down approximately 1%, in line with the industry.

Having said that, I will now move to the second question, if there is any change in our outlook for the balance of the year. And the answer is no, our positive outlook remains unchanged as, one, since the close of the quarter the trends are positive. We have seen an improved performance in April and our beer volume is back to positive territory. Second, we have the World Cup, a major event with a strong execution approach. And third, we remain consistent on our commercial strategy, leveraging our growth platforms. And despite the challenged quarter, we still manage to make a good progress in each of them.

It starts with Elevate the Core. Skol, our easy-drinking lager, closed the summer season with a strong Carnival. The brand promoted the most important street parties in Brazil, providing breakthrough experience to more than 40 million consumers in more than 40 cities. Also during the quarter, Skol maintained its position of being the most innovative brand in the market and launched a new package, Skol Long Neck Flint, with a pull off on its crown helping consumers open the bottle more easily.

Now, talking about Brahma, our classic lager. In Q1, Brahma maintained a good trend of 2017, strongly outperforming the industry. Looking forward, Brahma is building momentum as the World Cup approaches. The brand has been part of the Brazilian's consumer life since the first edition of the World Cup in 1930. For the 2018 edition, we will keep the tradition alive, executing strong (00:20:48) activation that we evoke all with heritage.

Brahma's most recent action was the reprinting of historic labels that adorn its bottles during the years in which Brazil won the World Cup – 1958, 1962, 1970, 1994, and 2002. The new labels were distributed across the whole country with an incredible positive response from consumers. Still on Brahma's family, Brahma Extra with its three variants – Lager, Red Lager, and Weiss – delivered strong performance in Q1 with volume growing almost 100% and reaching more than 1% of our beer volume in Brazil. Going forward, we see that Brahma Extra has a great potential to continue to grow, provide its consumers the first (00:21:41) alternative and driving positive mix.

Finally, Antarctica. Antarctica also delivered a memorable Carnival in Rio de Janeiro and in Brasilia, reaching more than 20 million people. Along with that, as I mentioned in our last call, Antarctica launched its new Visual Brand Identity during the quarter. Early results indicate that the new VBI will be a major success.

Now, moving to premium. Our global portfolio of premium brands comprised of Budweiser, Stella Artois, and Corona grew double-digits in Q1 2018, meeting the raising awareness of Brazilians for premium brands while delivering memorable experiences such as the Lollapalooza. Budweiser sponsored the first edition of the festival in U.S. back in 1991. And inspired by this inheritance, in March the brand sponsored the Lollapalooza in Brazil featuring several iconic singers. As we move to Q2, Budweiser also executed a remarkable acquisition during the World Cup, increasing its awareness and further consolidates its strong position in the premium segment. Still in premium, Stella Artois is also doing well for the second consecutive year in a row. The brand launched a global campaign Buy a Lady a Drink in partnership with Water.org to help raise awareness of the global water crisis, inviting its consumers to leave a legacy.

Going forward, we are excited that our premium brands are well-positioned to keep delivering strong results not only in the short-term but also in the long-term. It's fair to say that even though we have substantially improved our premium volume performance in the last five years, there is still much more to be done, especially considering that premium volume remain underpenetrated in Brazil as compared to the other markets.

Now talking about smart affordability. We have been developing several initiatives related to package and route-to-market which tackle the affordability issue in Brazil without impact on profitability. We believe that to foster beer consumption in the country, especially in the underdeveloped regions, we have to steadily evolve with these type of initiatives. And given the importance of affordability, we incorporated this as one of our growth platforms. Having said that, our returnable glass bottle strategy in off-trade remains high in our agenda with the 300 ml returnable glass bottles, or our minis, delivering more competitive consumer price.

Finally, moving to different locations, in home and out of home. As we started the year we continue to accelerate our trade programs, putting great efforts to assure a high service level everywhere. We are confident that a consistent execution in the on-trade and in the off-trade enables us to step up consumers' experience in both channels while building strong brands.

Before closing, a quick run through our Non-Alcoholic business in Brazil. NAB had a very challenging quarter in terms of volume. It was down 19.4%. There are mainly two drivers that explain such performance. One, a hard comparable in first quarter 2017 when the soft drink industry declined by high single digits and our volume was flattish. And second, an industry that's still being impacted by low discretionary spending, falling by mid-single digits in first quarter 2018. However, as mentioned by Ricardo, despite facing weak volume we still managed to increase EBITDA and expand margins. While we are not satisfied of our net volume result this quarter, we are confident that we're implementing the right initiatives needed to strengthen our foundation and which will enable us to deliver improved volume, build a more profitable business and, as a consequence, deliver a stronger EBITDA growth.

Before moving to the Q&A, I would like to close with a final message. As I just mentioned, as we turn the page on Q1 the trend is positive. In this context and also supported by a strong execution during the World Cup, we expect beer volume to resume growth in Q2 2018. The World Cup will also bring a great opportunity for NAB with Guaraná Antarctica as the official sponsor of the Brazilian team. With that in mind, we are optimistic about our business in Brazil and we are committed to keep consistency in executing the initiatives implemented under the growth platforms, remaining confident that we have a strong plan and great portfolio to further accelerate EBITDA growth versus 2017. Finally, we are also excited that all the important countries in which we operate, Argentina, Uruguay, and Panama, will participate in the World Cup. We also have a great plan to execute a strong (00:26:57) activation in all these countries, further enhancing the equity of our brands.

We can now move to the Q&A. Thank you.

Q&A

Operator

We will now begin the question and answer session. The first question comes from Luca Cipiccia with Goldman Sachs. Please go ahead.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Hi. Good afternoon, Bernardo, Ricardo. Thanks for taking my question. I wanted to ask two very briefly. The first on the beer volumes outlook. Appreciate the details that you gave in the second quarter, but maybe if you can add – if we look at the industry overall as we size the type of catalyst or contribution that the World Cup may have and the sequential improvement that it seems you are expecting, do you think the industry will be able to show positive growth in volumes overall this year? Do you have any visibility on that and maybe if you have any comment. That will be the first one.

And then secondly, on the Non-Alcoholic Beverages. It seems that the debate on affordability in that category has also been quite relevant, and the Coca-Cola system seems to have moved more focus on that. I'm just wondering the relative underperformance of your portfolio, does it have to do more with the type of, let's say, price positioning that you have or mix positioning that you have or rather as the biggest player in the market pushes a little more on affordability maybe you don't have as many tools as they have given the difference in scale and brand portfolio? If you have any additional qualifier there as well, it would be useful. Thank you.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thanks, Luca. Thanks for the question. First, linked to the industry and the outlook, I think we not comment for the full year. But as I comment in my speech, we really expect for the second quarter for the volume to resume to grow, so our performance will be better in the second quarter. I mean, we have the visibility of April and the initial numbers of May. So we are positive about our volumes in terms of the second quarter.

For the affordability issue, I think that – we have been implementing initiatives in this front at the last meeting. So we acknowledge that we need to keep developing affordability initiatives to boost the beer volume and expand the beer cabinet especially in the underdeveloped regions like the northeast for instance where the disposable income is low. So what could be done? For instance, one, what we have been doing to the packaging such as the returnable glass bottles in the off-trade which we are now expanding even more in sub-segments of the off-trade. That takes time because you have to go there to visit, I mean, to put a crate and so on. But we're doing this in mom-and-pops and pit stops and among others sub-segments of the off-trade.

And second, the route-to-market. That's very, very important. If you're serving better and it's enabling more point of sales, enable us to deliver our products direct and able to manage the right price across the whole country. So doing that and increasing the number of point of sales that we're selling with the right price, a consumer price and doing this in a profitable way helps a lot to bring more affordable SKUs and brands overall in many regions in Brazil. The third thing is the innovation pipeline. So we have been studying that and working on that to really bring to the market innovation like we've done on the 300ml. But not only package, in other fronts as well but we could not and we will not comment, I mean, for competitive reasons.

The only thing that we not do is to play in the value segment with no margins; that we don't do. So we have a strong growth in our core. Our premium is evolving, the portfolio is doing very, very well. But really to bring volumes with no margin, selling one-way cans with zero margin or negative margin is not our game. So having said that, for the business key, that's why we put in our platform, I mean, and obviously even more clear, and then we rolled that, driving smart affordability that it's a profitable one, the kind of affordability that you are searching for.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Bernardo, just quickly if you – sorry.

A - Ricardo Rittes {BIO 15184017 <GO>}

Going to the question that you asked about Non-Alcoholic Beverages specifically, just to highlight that our pricing strategy is to increase price level inflation. So when you look at – when price was taken the second half of 2017, Q4 2017 after price increase net revenue per hectoliter grew by 9.6%. And then Q4 versus Q1 2018, net revenue per hectoliter was actually down 11.2% as a result of the catch up of the state taxes. So again, I think the Non-Alcoholic business is the more elastic one and all the issues that Bernardo discussed get a little bit amplified in the very short-term that were discussed. But we are very confident in the strength of our brands in that portfolio, Guaraná Antarctica and Pepsi specifically.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Just quickly. The premium segment of the Non-Alcoholic business, is that showing a similar resilience or relative outperformance as what you commented about in Beer? Or what you would call premium within Non-Alcoholic? Is that also doing better even though it's much, much smaller? Appreciate that.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Yes, Luca. It's doing better. So the portfolio of premium, the juices, and the Fusion energy drinks are doing very, very well. So that's one of the best for the future.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Thank you. Thanks.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thank you, Luca.

Operator

The next question comes from Isabella Simonato with Bank of America. Please go ahead.

Q - Isabella Simonato {BIO 16693071 <GO>}

Thank you. Good afternoon, Bernardo, Rittes. My first question is on Beer, more in line with what Luca asked. I mean, looking for Q2 or maybe beyond aside from maybe a better weather in April or the positive impact from the World Cup, are you seeing real signs of consumer consumption recovering on beer? And also thinking about affordability, do you think consumers are ready to take more significant price increases going forward without affecting a lot of volumes at this point? That's my first question on Beer. And second, regarding SG&A. This has been a line that has been very under control with selling below inflation. What sort of impact should we see from Q2 on that line because of the World Cup? Thank you.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thanks, Isabella. Thanks for the question. I think for the same question that Luca asked, we would just add in terms of, I mean, kind of a feel of the industry for the future. First, we have to have knowledge about the consumer environment. Brazil is too soft, disposable income is growing at a slow pace, and unemployment is still high. In any case, a gradual improvement of macro indicators should be supported for the beer industry as the year progresses. We should also keep in mind that the beer industry is one of the last to get in to the crisis and one of the last to be described as well. But all in all, leaving the first quarter behind, we are optimistic about our business in Brazil and confident that we'll be on the right track. So we really expect going, I mean, for the future, yes, (00:35:49) industries given that, again, Brazil disposable income one day will be better, and will, and then with the impact in the industry. And the industry again is one of the last ones to enter in a crisis and one of the last one to leave the crisis as well. So SG&A, I think Ricardo can answer.

A - Ricardo Rittes {BIO 15184017 <GO>}

Hi, Isabella. Then again, just highlighting what Bernardo just said, so we are excited about the future and noting what Bernardo also said that we are ready made so we have visibility aside from the World Cup on somehow an improvement because of the reasons that Bernardo explained in his. And regarding SG&A, we recognize that we don't provide any specific guidance in SG&A by quarter but it's fair to assume that there might be some phasing but nothing that will be notable. What we have been doing recently in the last couple of years is always to provide or highlight or provide like specific guidance when we think that that should be notable going forward.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

I think you had a question regarding affordability. Could you repeat, Isabella?

Q - Isabella Simonato {BIO 16693071 <GO>}

Yeah, thank you. Bernardo, it's just in line with the comments for the industry. I mean, if you – given the scenario of a slower consumption recovery, if you think consumers are ready to take more significant price increases without having still a significant impact on volumes.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

I mean, we don't comment in our pricing policy. I mean, the only thing that we comment is our net revenue per – actually it's our, I mean, long-term policy is to grow in line with inflation plus any tax increase over time, so that we need to offset. I think the only thing that it's fair to say is that when you execute better and when you serve the box better, we'd be able to manage the consumer price better. So sometimes the number in terms of the price to a point of sale, and then this number goes to the P&L, is not exactly the same number. Could be higher than the number that goes to, I mean, the final price of beer in the off-trade, in the on-trade. And we think that we're doing pretty well in terms of evolution of our service level, where we're getting much, much better, provide a much better service to the point of sales. And then this has an impact in the way that they price our beers, so which means that you can mitigate any impact including in terms of price PTR (00:38:30) increase for the point of sale level. So excellence in service helps affordability as well. That's one kind of the thing that I try to highlight in the comment that I made to Luca.

Q - Isabella Simonato {BIO 16693071 <GO>}

Great. Thank you.

Operator

The next question comes from Lauren Torres with UBS. Please go ahead.

Q - Lauren Torres {BIO 7323680 <GO>}

Hi, everyone. Earlier today on InBev's call, Brito talked about Brazil being in margin recovery mode. He talked about factors that we've heard from you before, particularly the cost environment being better as the hedges rolled off. But he also spent a little time on positive mix with respect to premium brands and the growth of RGBs. I was hoping you could just talk a little bit more about positive mix for this year because sensing that the volumes are recovering, the cost environment is better, the pricing is in place, something incremental could be more from the mix side. And looking at your historical EBITDA margins, we've been north of 50% in the past; now we're closer to the low-40s. So how should we think about this progression? Is there a lot of upside from mix to consider or should we not get too excited about the lift on the mix side? Thanks.

A - Ricardo Rittes {BIO 15184017 <GO>}

Hi, Lauren. Thank you very much for the question. So a little bit long-term, we're very excited with the evolution of the Brazilian business, if you will, and I think that's what Brito mentioned as a recovery mode. Of course, that part of our business has fixed costs, so every time you grow the business you have evolution in terms of the margins. So as Brazil gets out of the crisis, as GDP starts to go the positive side and et cetera, so there is a top-line benefit when you look ahead and when we look forward. I think that's the first important, if you will, dimension.

The second dimension on the costs side. So if you think very, very long-term, we have managed to over time to have COGS to grow a little bit lower than inflation. But with the size of our COGS linked to FX for example, there is some volatility into this. We use hedges to smooth that volatility for us to be able to react operationally to market risk shocks. And as a result, we have some visibility in a couple of quarters ahead of us in terms of what to expect in terms of, if you will, of the impact of the FX into our COGS going forward. So as we explain in the last quarter's call, the average FX for this year BRL 3.16 and the current FX which closed at BRL 3.5, BRL 3.6 is much higher. And as a result of that, also there's an improvement year over year that flows into the P&L in a way of – that impacts in itself in a way of positive trend towards margins.

In terms of the mix itself, long-term premium has grown from 5% of the total volumes to more than 10% of the total volumes, and that continues to be the case quarter after quarter after quarter. So over time, that also serves as a positive force into our, let's say, margins. So net, if I could like summarize all that, I think Brito also a couple of quarters ago mentioned that the way we see the margins is just like a high watermark and it's not something that we believe was the peak of the margin. It's just a high watermark that we need to run the business, and over time there is no reason for us not to work towards that direction.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

I think, Lauren, link it to the premium segment. I think if you see it globally, I mean, premium average rate is around 20% of the mix of the industry. In Brazil, it's a little bit, I mean, around 10%, a little bit higher than that. If you see some regions of Brazil or even countries like Paraguay, that premium is already 20% of that industry, shows us that we have room to grow for the premium segment in Brazil with good impact in margins as well.

Q - Lauren Torres {BIO 7323680 <GO>}

So I guess with that said, I mean, I quoted that over 50% margin you've given us in the past and I think today you did say there is no structural change as far as your market position. So there's no reason why we shouldn't get back to some of your historical margin levels?

A - Ricardo Rittes {BIO 15184017 <GO>}

Again, it's not a guidance but it's just a high watermark and the 50%-plus margin number is a reference to us. Nothing prevents us from reaching those margins again. The only structural change in our P&L, comparing for instance 2012, 2013, is the other operating income line which has declined. This line used to represent 7% to 8% of net revenue; it now represents around 4%. But besides that, I think the strategy of the company is the same and there is no reason for us not to get there.

Q - Lauren Torres {BIO 7323680 <GO>}

Okay, great. Thank you.

Operator

The next question comes from Thiago Duarte with BTG. Please go ahead.

Q - Thiago Duarte {BIO 16541921 <GO>}

Hi, good morning. Well, a couple of questions on my side. First, I would cycle to Canada and I would appreciate if you could comment a little bit more on the cost savings (44:05) there. You mentioned of course the tough comps as one reason for the increase in the cost year over year and the increase in the imports. But even if you look in a unitary basis, what we see is the cost are at a much higher level than we saw in the last many quarters. So just wanted to understand whether this import issue is something that we could see in the coming quarters, so that would be like a new normal in terms of a cost magnitude in the operations there or something that we should be seeing as non-recurring going forward. I would appreciate some comments on that.

And second, I would love to hear from you guys a little bit more on the mix in Brazil. You guys commented on further growth in the premium segment. In RGB, we know that they are all accretive on net revenue per hectoliter. So if you could a little bit disclose to us how much this mix has contributed to the increase in the net revenue per hectoliter year over year. And as well, I would love to hear if you could comment on the impact on the net revenue per hectoliter from the exclusion of the ICMS from the fiscal things basis as part of the calculation of the total deduction on gross revenue. I would appreciate that as well. Thank you.

A - Ricardo Rittes {BIO 15184017 <GO>}

Hi, Duarte. It's Ricardo here. So first let me start with Canada. With Canada, if you remember in the first quarter of 2017, EBITDA grew 17.5% at that time and was also impacted by the COGS line, creating a little bit of a reference base. If you look at this full year, and again the shorter period of time you look the more volatility you might have due to specifically the imports that goes to Canada. If you look at the full year, EBITDA of Canada grew 0.9%. So over even just four quarters, and this is an (00:46:05) of the business adjusted because you get a full year, you don't see that type of noise flowing to the P&L. So to answer your question whether this is a new norm, no, this is not a new normal. And again, I think just the same way that last year created a comparable basis. I think you, again, over time you shouldn't see anything different in the Canadian business.

Related specific to the tax issue or meaning you specifically asked how much of the net revenue per hectoliter increase came from the VAT from excise taxes specifically, again it's not that much because if you remember in addition to this we had also the increase in taxes based on the law approved in 2015. So there's a reduction in the reductor of the beer business taxes, and that was the steepest one in 2017 since the law was approved. So again, in 2015 that reduction was 20%, 2016 was 15%, 2017 was 10%, and for 2018 it's 0% in the beer for up to 400ml containers, so it's a big change. So one thing and the other, you have to look at the difference in the net basis which is not that relevant.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

And I think last, you talk about the mix. Thanks for question. And just having to reinforce before we had the tax issue, yeah, also had upside in the VAT but a downside in the federal tax. That was exactly what Ricardo said in this first quarter. So linking to the mix, I mean, clearly difficult for us to really disclose the numbers. But to grow 7.7% year-over-year the net revenue per hectoliter compared this quarter to the other quarter in the last year, for sure you'll have an annualization of the price increase that is done in the third quarter. But you ask mix, and RGBs help us on that because I think that was a good growth in terms of the net revenue. That makes sense in our (00:48:30) that we always say our mantra, that we've increased net revenue in line with inflation plus any tax offset. So that's all we could say to you.

Q - Thiago Duarte {BIO 16541921 <GO>}

Are you trying to say that on a constant mix basis, your net revenue per hectoliter is growing and moving in line with inflation as you just said or should I think in terms of the gross revenue per hectoliter in terms on a constant mix basis?

A - Ricardo Rittes {BIO 15184017 <GO>}

No. If you look at over time, the answer is yes. But if look at a specific quarter or other, no. But if you look, for example, in the last three years or five years, if you do that calculation, you're probably going to get very close to the exact number in terms of net revenue growing exactly in line with inflation.

Q - Thiago Duarte {BIO 16541921 <GO>}

Thank you.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thank you very much.

Operator

The next question comes from Antonio Barreto with Itaú. Please go ahead.

Q - Antonio Barreto {BIO 17449798 <GO>}

Hi. Thanks for the question. My question is going back to the mainstream. When we talk to our channel checks, we believe that you guys are suffering a bit more on Skol than on the other brands. So my question is if you could comment at least on a qualitative basis how the brand preference for Skol has evolved. You mentioned that the Carnival was a very good period in brand activation for Skol in the first quarter of the year, and I would like to see if you guys have seen any kind of uptick in the brand preference for this brand. And looking for the rest of the year, it seems to us that most of the activities are related to Brahma, specially the World Cup. And I was wondering if you guys are seeing anything else relevant to make us think of any kind of recovery or any kind of uptrend on Skol brand preference?

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thank you, Antonio. It's a very good question. First, I mean, we have been studying the rest of the years all the trends that are coming in many markets including here, and we know that one thing that is important in terms of attributes for brands, drinkability is key. But all of this thing about the flavor and so on, this attributable of flavor, both the flavor, it's important as well. So it is beauty that we have on that has a portfolio that we can cover that. So that's why I have been saying to you for two or three years that we have easy drinking lager and a classic lager. And then that's why both brands are very, very important. In terms of the equity, both brands are very, very strong. And then all the indicators that we have from many kind of research company show that Skol is the most powerful brand in Brazil by far. But yes, I mean, this attribute of flavor is growing Brazil.

And the good news is that you have Brahma and Brahma is booming, is growing big, big time. So that's how we'll say to you that it's not a one-brand game; it's a portfolio game and that's why I'm bad at this. So the portfolios on that head is so strong because it can play in the different mid-straight (00:51:56) attributes that consumers get value for a specific occasion for a specific brand. So Skol is doing well in terms of equity. It's even more young. I mean, you're talking about the diversity a lot which Skol connect young people, and just launched the Skol Long Neck Flint that's amazing, all the comments that you see in the social media, is doing pretty well and we have innovation ahead of us.

And on top of that, yes, Brahma is doing pretty well. It's our classic lager that delivers more flavor. Brahma Extra, it's a huge success. So in our core business we are very, very well in terms of the market share, in terms of the equity. If I would say to you the only segment that we really – it's an issue for us is the value segment. But the value segment we don't play because the value segment, it's just volume that goes for one guy from another guy selling brands with no margin; that's not our game. But in terms of the core brands and the core segments, we are very, very strong. Brands are strong. The (00:53:11) strong as well. And in the premium segment, global brands are growing the portfolio and it's becoming even stronger.

A - Ricardo Rittes {BIO 15184017 <GO>}

And just to add something to what Bernardo just said regarding Skol, specifically your concern about the remaining of the year. We have a lot of exciting innovations in the pipeline which we cannot disclose in advance for competitive reasons, but we do have a lot of exciting things for Skol.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

I think that given that all these studies and the deep dive since that we've done in the last years really ensuring that we are building a portfolio to last based in the innovation that we go in the market. Just if you see two years ago, Brahma Extra, that's a variant of our classic lager and more bolder, I mean, it was basically nothing in Brazil and today probably be around 1% of our volume. Core plus, very, very profitable. So we always prefer to look up to the core and up and build the portfolio from there and not look down and go to the value segment.

Q - Antonio Barreto {BIO 17449798 <GO>}

Thank you. Just as more follow-up on that, looking at the VBI changes that you guys have implemented on Skol. Are you satisfied with the results? Anything that you can comment on that front?

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Yes, we are. I think it was very, very important for us and really was part of the change of the VBI and then for this brand to become even more younger because of the arrow saying come back to use the arrow. And then you see after the changes that VBI, all the campaigns, we started to use again in a different way but use again the (00:55:02) and the positive results in terms of equity started to appear. So I think that, yeah, and they must be different, Antonio, because Brahma is, one, is a classic lager, and Skol is an easy drinking lager. But, yes, I mean, for all of the brands including for Skol we always have room to improve in terms of innovation that Ricardo just said and in terms of the VBI as well if we see an opportunity to any kind of adjustment.

Q - Antonio Barreto {BIO 17449798 <GO>}

Thank you.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thank you.

Operator

The next question comes from Alex Robarts with Citi. Please go ahead.

Q - Alexander Robarts {BIO 1499637 <GO>}

Hi, everybody. Thanks for taking the question. So, I mean, I also had a question on portfolio in Brazil and then a second one on Brazil COGS. So one of the trends at least our research has shown is that there is an emerging growth or accelerating growth of this category of pure malt, what you call the puro malte. And you don't really talk about it in your literature and such. I'm wondering if you could comment a little bit about how that segment is doing. I mean, I have the impression that pure malt beer is, as a category, kind of similar in size to the premium space. And how are you thinking about that? Is it in fact the growth there outperforming the industry? What is the competition doing? And are there some strategies around that pure malt category? That's the first question and I'd like to come back with the COGS one.

Thanks, Alex. I mean, if you see the history of beer in more than 11,000 years, it was marked by diversity. So people grew beers 11,000 years ago and then with the ingredients that they had in that specific region. So including malt that's not even an ingredient. I mean, you can malt everything – barley, rice, corn, everything. So the issue is that what you always say but the point is of Ambev as a beer company, you would like to doing that to provide diversity in beer. Which means that we would have beers and for – I mean, classic lager, easy drinking (00:57:50) light. And a few malts, one beer with 100% of malted barley is an option as well, and we have like Brahma Extra. So I think that's the most important thing, again, is that portfolio game. It's very, very important for us to have, yes, for people that also like the pure malt so-called beer. We already have and, yes, we can you prove as well. Yes, we can. I mean, we can reinforce that part of the portfolio.

But the most important thing is diversity in beer and it's another trend because for us we're not here for two years. It's not the trend of the day. We have to see 10, 30, 50 years from now. Just to give an example. We have a brand, that's Colorado; that one. The most important rice in Germany, so-called the land of the pure malt for beer with rapadura (00:58:55). So I think that diversity it's very important value in this society nowadays. And I think that diversity in beer will follow that. And then you see this brand, our craft brand that's growing fast, potential to grow even, even more and mix everything rapadura (00:59:16), graviola, honey. Graviola, I don't know how to translate this to English but I can show to you when you come here in Brazil. So all in all, pure malt is a segment, it's important, but most important than that is diversifying beer. That's why Ambev, a big brewery here in Brazil, is providing choice for everyone. That's basically what I could talk to you about.

Well thanks for that. I'm sorry, go ahead, sorry.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

No. I understood that you have a question on SG&A.

Q - Alexander Robarts {BIO 1499637 <GO>}

I did, it was the COGS. So just to confirm, so this is a segment that's growing faster than the industry, that's equal or bigger than the premium. And it sounds like with the initiatives of Extra Brahma (sic) [Brahma Extra], you might be under-indexed there. Is that fair to say in that category or it's a work in progress?

A - Ricardo Rittes {BIO 15184017 <GO>}

Alex, I think that it's a segment that is growing. It's Ricardo here. So it's a segment that's growing. And as Bernardo said, our strategy, our approach is a portfolio approach. And if there is any segment in the market that we under-index, over time what we tend to do we evolve our portfolio in order to address consumer needs. Again, consumers' needs are first. And if that is the case, again, we have a large operation, a very strong portfolio. So at any given time we could evolve our portfolio to address that. But again, that is the consumer need, long-term, sustainable that is changing; not just a fad, if you will.

Q - Alexander Robarts {BIO 1499637 <GO>}

Got it, got it. Fair enough. And just on COGS, sorry, the 2.5% cash COG decrease in the quarter in Brazil was an interesting one for us. I guess I thought it would fall a little bit more and I appreciate your detail around how the sugar costs with Non-Alcoholic were higher. And then the FX gains and FX dollar COGS hedge helped the beer COGS fall, and net-net you're down just 2.5%. But as we think about going forward, how should we think about aluminum in terms of the commodity hedge? I guess we understand that it only kind of started a bit in the COGS in the first quarter, but it'll probably be more of a factor starting in the second quarter. However, we have the sugar also kind of rolling off and coming back down to the international prices. So as we look maybe in the short-term, the cash COGS in Brazil, would it be fair to say that the FX hedge effect continues to offset the commodity, particularly aluminum? And kind of with that, we've seen a new fresh five-year high with aluminum on the back of several things, including what Trump has done with those tariffs for China. So how should we just kind of think of that commodity hedge for the remaining of the year? Thanks very much.

A - Ricardo Rittes {BIO 15184017 <GO>}

Hi, Alex. So Brazil Beer cash COGS, correct, it was down 2.5% as I said as you continue to cycle favorable FX. Beer Brazil was down 4.8% as higher commodity prices are more than offset by favorable FX. But the Non-Alcoholic business was up 4.9%. So the 2.5% is a combination of both. And despite favorable FX, we're still impacted by higher sugar prices and volume decline effect on fixed cost dilution. Then (01:03:22) COGS will be impacted by higher commodity price, especially aluminum which will be benefited by favorable FX. For reference, our average implied foreign exchange hedge rate for 2018 as we said is going to be BRL 3.16 this year which compares to the BRL 3.59. So again, this is like the highest market risk factor that we have within our P&L. And aluminum is the second one which represents around 30% of the Brazil total COGS.

So again, it's on one hand FX helping us a lot; on the other hand aluminum with positive hedges, but going forward aluminum going up. But overall, for the next couple of quarters, if you will, it's a more favorable environment than what we have had in the last couple of years.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. Thanks.

Operator

The next question comes from João Soares with Bradesco. Please go ahead.

Q - João Pedro Soares {BIO 20904793 <GO>}

Hi. Good morning, everyone. I basically have two questions on outlook. So first one is in Argentina. So has the recent market developments affected your outlook for beer consumption in the country or should we continue to see this trend in seeing the share growth of beer to continue to lead to positive volumes there? And the second is on Canada. So we have been screening out five quarters of flattish to negative volumes on a year-on-year basis. So is it fair to assume that we should expect some sort of volume rebound in the country or do you still see the industry there on a negative trend?

A - Ricardo Rittes {BIO 15184017 <GO>}

Hi, João. So first, in terms of the hedging policy or in terms of Argentina specifically, given our hedging policy, the current movement will impact our COGS just next year, so there is no immediate impact on that for Argentina. Of course, there we continue to monitor the situation in Argentina specifically. And our concerns are much more longer-term in terms of consumption, GDP, and et cetera, and how this translates into the real economy. But we're very excited with the prospects of the Argentina and the LAS region overall, very exciting.

Regarding Canada specifically, Canada is a different culture when you compare to the rest of the portfolio of countries that we have in Latin America, South Latin America, North including Central America and the Caribbean. Here we have essentially three main drivers in terms of volume growth longer-term. Number one is demographics, then number two is the disposable income, and number three is all the innovation we think the industry can do including, for example in Brazil, the 300ml returnable that we over time we contribute to the long-term growth of the overall increase.

In Canada, demographics not necessarily longer-term help us that much but it's a very profitable market. It's a market in which serves also as a laboratory in terms of innovation. It's a market where, for example, craft and some of the premium have a higher weight in comparison to most of our other countries. And again, it's a market that we're excited also for the long-term prospects and our relative and competitive positions there have improved significantly over the last couple of years.

Q - João Pedro Soares {BIO 20904793 <GO>}

Okay. Thanks. Very good.

Operator

The final question comes from Mohammed Ahmad with FGP. Please go ahead.

Q - Mohammed Ahmad {BIO 18064109 <GO>}

Hi. Thank you very much for taking my question. Just a quick one on Canada again. Could you give us a little color from a longer-term perspective when should we expect the profitability to bottom and to what level can you get the improvements? Because if I look at it, say, over a three-year view, volume has essentially been flat, you've had certain degree of net revenue per hectoliter improvement maybe sort of like 1% to 2% a year which in itself – those two combined – is not bad for a mature market, but COGS over three years has gone up a lot. So could you just give us a sense of what we should expect sort of medium-term, two to three years out? And also recent changes in Ontario distribution that I see, does that impact your business in any material way? Thank you very much.

A - Ricardo Rittes {BIO 15184017 <GO>}

Hi, Mohammed. Thank you for your question. So again, we don't provide the specific guidance long-term for Canada, but Canada grew top-line 0.5% year on year in the first quarter, net revenue per hectoliter also healthy. Michelob Ultra specifically had a great start in 2018, finishing Q1 with a 50% brand growth. And if you notice, Canada – one of the things in terms of the trends that we see in Canada, when you look at the craft industry and you compare that to the U.S. or so is relatively underdeveloped but growing a lot. And in the last couple of years, what we have done, so we adjust somehow our portfolio.

If you look at Mill Street for example, the organic beer that we launched there, or Archibald and even like the cider ready-to-drink type of products that we created, that is a moving portfolio that changes (01:08:44) evolving portfolio. And again, there is no reason for us in spite of not giving any guidance. And specifically, again, the shorter the term that you look the hardest for you to see it. There is no reason for us not to have not only profitability that we have in the Canadian business but also to resume growth, if you will, in terms of margin overall. Remember that in 2017, full year, again EBITDA grew by 0.9%.

Q - Mohammed Ahmad {BIO 18064109 <GO>}

Yeah. Thank you very much.

A - Ricardo Rittes {BIO 15184017 <GO>}

Thank you.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Mr. Bernardo Paiva for any closing remarks.

A - Bernardo Pinto Paiva {BIO 7186008 <GO>}

Thanks, Gary. So before I finish our call, just a quick comment regarding Brazil. I'd like to reinforce that the first quarter behind us, we have a positive view about our business in Brazil. We remain very confident in our strong growth platforms. Very confident in a solid innovation pipeline that will help us to resume beer volume growth in the second quarter and further EBITDA growth for the balance of the year. So thank you. Have a great day. Enjoy the rest of your day.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.