Q3 2013 Earnings Call

Company Participants

- Eugenio De Zagottis, IR & Corporate Planning Director
- Marcilio Pousada, CEO

Other Participants

- Guilherme Assis, Analyst
- Javier Martinez, Analyst
- Richard Cathcart, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time we would like to welcome everyone to Raia Drogasil conference call to discuss its results for the Third Quarter of 2013.

The audio for this conference is being broadcast simultaneously through the Internet in the website www.raiadrogasil.com.br/ir. In that address, you can also find the slideshow presentation available for download.

(Operator Instructions)

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

Today with us are Mr. Marcilio Pousada, CEO; Mr. Eugenio De Zagottis, Investor Relations and Corporate Planning Vice President; and Gabriel Rozenberg, IR and Corporate Planning Director.

Now I'll turn the conference over to Mr. Marcilio Pousada. Sir, you may begin your conference.

Marcilio Pousada {BIO 16117399 <GO>}

Thank you. Good morning. Welcome to the Raia Drogasil earnings presentation. As usual, Eugenio will detail the numbers of our last quarter. Just after the presentation, I'd like to stress the main points that we are working in the moment and that we believe can generate a huge value for the Company in the future. Eugenio, please.

Eugenio De Zagottis {BIO 7193695 <GO>}

Well. Good morning or good afternoon, everyone depending on where you are. Welcome to our Third Quarter conference call for 2013.

We ended the quarter with 931 stores in operation. We opened 29 stores in the quarter and closed 6 stores as part of a program that we have been developing this year. We reached gross revenues of BRL1.7 billion in the quarter, 16% of growth versus the Third Quarter of last year. We reached also 9.9% of same-store sales growth in the quarter.

Our gross margin total is 26.8% and this represented a 0.6percentage point increase versus the previous year.

We recorded adjusted EBITDA of BRL90.8 million, which represented an EBITDA margin of 5.4% of gross revenues.

Our net income amounted to BRL42.6 million, a margin of 2.5%. And finally, we recorded in the current quarter a positive free cash flow of BRL57.7 million. The total cash flow after the dividend payments, after interest, and after the tax shield from (those two lines) amounted to BRL57.9 million positive in the quarter.

On page 4, I would like to talk about our growth in the year. As I mentioned before, we have reached 931 stores in operation. We opened in the quarter 29 stores, closed 6 stores and we also have 3 suspended stores. We generally suspend stores when we are rebranding those stores, so most of the suspended stores have started transitioning from either Raia or Drogasil to Farmasil or to change from the Raia and Drogasil to each other.

We have added already in the year 67 net stores and a total of 90 store openings, not discounting the closings.

In the quarter, 35% of our total store base was still undergoing maturity, and 65% were full matures.

On page 5, as we can see, we're progressing pretty well in our store opening program. We opened to date 90 stores versus less than 60 stores in the same period of the previous year. And we are fully on track to meet our guidance of 130 new store openings.

Yesterday we also updated our guidance for 2014 and we will keep growing at this same pace of 130 stores a year. We have already accumulated a lot of contracts already signed for next year, and Marcilio will detail that after the presentation.

On page 6, as we can see, out of the 931 stores that we have in operation, 463 are Raia and 468 are Drogasil, which includes Farmasil. Farmasil is a sub-brand of Drogasil. We have now 11 Farmasil stores. We are reaching something like 20 stores in the beginning of next year, so the pilot is already reaching quite a robust stage.

We are very happy with Farmasil, but we're still not in a position to have a growth program for the brand. We still have to feel more comfortable to give more plan, but everything that we have observed so far has been very, very favorable.

We're operating in 12 states that account for 83% of the Brazilian pharmaceutical market. And according to IMS, we have a national market share that declined 0.3percentage points this quarter over the same period in the previous quarter. However, it is important to note that IMS has significantly increased the number of informants in its panel. And this has distorted not only market growth, but also market share figures.

So according to IMS, the market will be growing 16%, but the reality is that there is a significant portion of this number that is a new informant added to the panel. So I would assume the market's growing something like 10% to 12%, which is a robust network, but not the 16% that IMS has reported.

We also asked the IMS to do a separate analysis, excluding new informants that have entered the panel for us to have a comparable informational market share. We only have the data on a national basis, but the reality is that when you take out these distortions, our national market share should increase 0.2percentage points as opposed to decreasing 0.3percentage points.

We also rely on Abafarma data, and Abafarma is a very accurate data produced by our association in which everybody reports to Abafarma. And our national market share within Abafarma, including only the large and middle sized chains in Brazil, it's also increasing by 0.2percentage points.

Unfortunately, we don't have the breakdown by market either for Abafarma or for the adjusted IMS figures. So we still report the normal IMS figures.

This shows a share loss in Sao Paulo and the share loss is really -- it really happened; probably not at this magnitude, but it really happened. There is not a new competition in Sao Paulo, but I think we had some pains related to the integration process and I think there is a lot of internal bottlenecks that we are unlocking to resume share growth in Sao Paulo. This share decrease has happened many years of very consistent share increase. So I think it's also normal, there's nothing unusual happening in that market.

We also point to the strong market share growth that we have achieved in our more recent markets. So we are very happy with our store development program and as a result, the new, the share in those new markets they show that as well.

On page 7, we have grown in total 15.9% in the quarter. But it's important to mention that if we take out the stores that have been closed from last year's base, our total growth would have been 18.1%. So the store closed, they are penalizing revenue by something like 2%.

And on the one hand you have some revenue loss, but the whole reason we're doing the store closing program is to improve efficiency and it's a certainty that we will improve our numbers in terms of bottom line coming forward. We recorded same-store sales growth of 9.9% and mature store sales growth was 4.9%.

It's important to mention that our mature stores this year, they are growing below inflation and this is not good. And this has resulted in loss of operating leverage at the store level. Our store expenses they are mostly fixed, something like 90% of the store expenses are fixed.

So this is both a blessing and a curse. When we grow ahead of inflation, we have (inaudible) operating leverage. When we're growing behind inflation, we have operating deleveraging. And this is what we are seeing now.

We are working very diligently in terms of improving our execution. There are a lot of actions being undertaken. Marcilio will detail that as well. And we have all that it takes to get our mature stores back to inflation or beyond. This is not something that will happen from one quarter to the next, but I think over the second half of next year we have to see a much better picture for mature store growth.

On page 8, talking about our sales mix. The OTC was the highlight of the quarter and, to be frank, of the year. We increased OTC nearly 20%. The participation in the sales mix has gone up by 50 basis points. And I think this is quite significant.

Hygiene and personal care, I think after (a total) (inaudible) in the Second Quarter of this year, we are yet to good levels. We are maintaining the share of HPC in the sales mix. We can probably do better. A lot of the actions that we are doing, especially in Drogasil, have to do with front-store sales, which is something that we are looking at. But it's not a bad figure.

And I think the problem, the main issue of the quarter in terms of category was generics. If you compare to the same period in the previous year, we lost 0.3percentage points of participation in the sales mix. And if you compare to the Second Quarter, we lost 0.6%.

It's important to mention that the Second Quarter was probably a peak, just as the Third Quarter is probably a valley. What happened is that we faced in the quarter logistics problems with one of our main generics suppliers. This is already normalizing and we should see generics in the next quarter or so coming back to something like 11.2%, 11.3%.

But when you look beyond the quarter, when you look structurally, it's not (inaudible) to explain generics because the pipeline for new generic launches has been kind of dry, recent. So as we don't have many new generics being launched, it has been tougher on a structural basis to expand generics penetration.

Another thing is that if you look at IMS, you'll see a huge generics growth taking place. And what happened is that most of the new informants are smaller chains in less affluent regions with higher share of generics. So IMS is providing a lot of distortion in their figures right now and we have to look at IMS with a certain grain of salt and try to understand what's really happening.

So the generics market as a whole I think is not explained here (as straight) as it was. But when you look -- because of the new informants being more generic (slanted), it looks as such.

Page 9. We saw in the quarter a gross margin improvement of 0.6percentage points over the previous quarter. I think the margin of the quarter is a good margin; it's a margin that has been in line with the previous period. And I think the increase is mostly attributable to the weak comp base of the Third Quarter of 2012.

One important thing is that we have not a lack of (inaudible) because in the Third Quarter we already had that effect, but we still have the ICMS tax issue affect to our margins. And we are already solving the problem. Marcilio will also elaborate on that.

Talking about cash cycle, the cash cycle it's good if you look the recent quarters, but it has increased over the same period of last year by five days. And we see a very different picture when analyzing inventories versus accounts payable. We have probably the lowest level of inventories recorded in the last couple years. We've reached 73.5 days, significant reduction over the most recent quarters. And this is something very good and something that we have been very focused at.

However, as most of the reduction is in generics, and we have ceased for quite a long time to refill our generics sales because we had a lot of inventories at hand, what happened is that we no longer are generating invoices, and as a result the days of accounts payable has dropped significantly. We believe that from now onwards we will see accounts payable progressively normalizing. So this is a trend that should increase and this should be good for us in terms of cash cycle.

Most importantly is that as we are in the middle of the integration, and integration affects a lot of logistics, we are completely rebalancing our logistics. I mean until recently we had separate distribution networks for both Raia SA and Drogasil. We are now starting to mix it up and to have a single distribution network shared by both brands.

A couple -- two DCs have already shared DCs, Rio de Janeiro and of lately Ribeirao Preto. We still have our many DCs. To be sure, they're still separate DCs.

And what happens is that I believe we will still see improvement in inventories, but I think it will get worse before it gets better, because well, in a huge rebalancing like this, what happens is that you have to increase the inventories in the (inaudible) receiving stores. And you will see a compensation in the decrease in the district that is giving up stock, but this takes longer.

So as an example, last month we integrated the Ribeirao Preto (inaudible) Sao Paulo DC. What happened is that for that DC to service higher stores, we had to increase inventories. And those stores will improve the service of all the DCs.

So with time the inventory level of the DCs that currently serve those stores will go down. But in a snapshot, what happens is that the new DC has increased inventories and the older DCs, they are still at the same level. So I think we'll see probably some level of inventory pace in the next quarter and maybe next two quarters. And after that I think we should go back to this level or even better.

On page 12, I mean expenses have again been the main challenge for the Company. Our sales expenses increased 0.2percentage points from the Third Quarter of this -- or compared to the Third Quarter of 2012. Some of those drivers have been structural, like payroll expenses have been up by 0.2percentage points. And rental expenses in this quarter also went up by 0.1percentage point.

In addition to that, we had (in general) more transitory pressures, especially in logistics. Logistics went up by 0.1percentage point; it's the fact that we opened in the Fourth Quarter of last year a new and big DC. And when you compare now with the Third Quarter, we have one DC more in the base now. And as we are not opening new DCs this year or next year, what will happen is that already in the beginning of next year we should see some dilution in terms of logistics expenses.

Another thing is that we have increased marketing expenses by 0.2percentage points. We have been accelerating our marketing program for recent markets where we have a lot of stores maturing. We believe this (inaudible) is already accelerating maturation.

I mean this is the season. When you had the seasons that is (inaudible) will not be a tradeoff. Increasing expenses like 0.2percentage points means that we're pressuring this year's results, but our management horizon is not the quarter or the month or the year. Although we don't disregard either of those, our horizon on management is when you look one, two, three years ahead of us. So this is something that will help us ahead, but it's something that penalizes right now; and as such, our duty as management of the Company is to do what generates value on the longer-term.

Another important issue here to mention is that we, as you know, we entered the Second Quarter of this year with the benefit of the social charges reduction. However, the provisional measure that generated that failed to be voted on time and we have been trying to reinstate the reduction in social charges ever since without success.

So now is reality check time and basically what we did now was we had to reinstate our allowances for social charges. So in the First Quarter of the year, what we have done, we had reduced social charges by something like BRL6 million that referred to previous years. So we booked as a non-recurring gain and just as such we're reverting back and we're booking that as a non-recurring loss. So the two offset each other.

But we had a portion that we booked at current results in the First Quarter and now we are reverting that. That accounts for 0.2percentage points of revenues. So we are booking in the quarter 0.2% of increase in allowances; that, of course, it's operational so it's in operational results. It of course relates to the year, but it doesn't belong in this quarter. It's something that should have affected the First Quarter.

So 0.2% of the pressure came from restating the full allowances as we are not counting with any social charges reduction right now.

Talking about administrative expenses, I mean administrative expenses, they have remained flat. In the Third Quarter last year, we had to do a major reversion in variable compensation allowance. And even as we are (not allowed), we are also doing small provisions in variable compensation this year, but the fact that the reversion that we did last year ended up pressuring the quarter by 0.1percentage points in comparison. That was diluted by other positive effects.

As a result of all of that, we have posted an EBITDA margin compression of 0.2percentage points and the reason is pretty straightforward. I mean with mature stores growing below inflation, and with our costs growing ahead of inflation, especially labor and rentals, we are facing operational deleveraging. Fixed expenses in our sector, they represent like 90% of total expenses of a store.

This is both a blessing or a curse depending on when you are (worth) of labor. Because when you see mature stores growing, we have huge operating leverage. When you see mature stores coming short of the inflation, we have operating deleveraging. What we're doing is we're working very intensively in all the variables of our execution in our stores, in mix, in service levels, with layout. So there are a lot of (overhauls) being done.

And the system implementation is probably the most important of those and we believe we can accelerate mature store sales next year. Of course we won't see a huge improvement from one quarter to the other, but when you look on the fact of the matter of next year, we have to be at a different level and that will occur most for us through (absorb) expenses.

Finally, we also isolate the effect of the stores opened in the year to have a better understanding of what is our economic performance regarding the recent openings. So basically, we have 841 stores that were already operational in the very end of last year. So when we count only the EBITDA generated by these stores, and of course with the full corporate G&A of the full distribution expenses, what happened is that we had BRL1.6 billion revenues coming from those stores. Those stores generated BRL100 million EBITDA and this corresponded to an EBITDA margin of 6.2%.

So if we disregard the stores open only in these years and if we disregard the pre-operation expenses of stores that are yet to be opened, these alone represent 0.8percentage points in pressure from store development.

I'm not talking about mature store margin. I mean we're counting there a lot -- we're counting within the 6.2% a lot of stores that are still undergoing maturity. Stores that we opened in December last year, they are part of this EBITDA. So we believe that if our business was fully mature, we would be 1.5percentage points ahead in terms of EBITDA margin compared to where we are right now. This is important to understand the impact of growth in our profitability.

On page 12, depreciation is 0.2percentage points ahead of last year because we are opening more stores and more CapEx has been booked. Net financial expenses, they increased slightly over last year because we have a slightly lower net cash position. However, with the tax shields from goodwill amortization, we have a lower level of tax accrued. All in all, when you look at net (margin) expenses, we have maintained a very similar margin to last year at 2.5percentage points. 2.5% of gross revenue.

On page 14, we're talking about non-recurring expenses. And non-recurring expenses have been chasing us ever since the merger started. We still have some to happen, but I mean I think this was one of the toughest quarters in non-recurring expenses. And there are very clear reasons for that and most of the facts will not repeat themselves.

So we have BRL4.4 million in charges from store closure. The bulk of these is non-cash asset write-offs, so we have already closed 20 stores and we have only 5 to go until the end of this year. And after that it is normalized. Next year onwards it will, I don't know, 5 stores, 6 stores, 8 stores, and it will be moved as part of the recurring profitability of the Company. This year as we end this period, as we are concentrating on closure as part of our program, the number are the highest. So in this quarter we had BRL4.4 million in store closure expenses.

Another thing is that we have subsidized Farmacia Popular. This level is going down quarter after quarter. We booked in the Third Quarter BRL2.2 million. Already in this month we will be at something like BRL1.5 million per quarter. So as new stores -- again realize that these expenses are going down, but these expenses they won't immediately zero.

Another thing is that we had BRL4.5 million in severance payments. This is from our CEO change, so there are other expenses related to that as well.

And finally, we booked BRL5.9 million in reversion in payroll taxes. This is exactly the opposite of what we did in the First Quarter. So in the First Quarter we booked a non-recurring gain of BRL5.9 million and now we booked a non-recurring loss of BRL5.9 million since the tax -- the social charge reduction is no longer applicable to us.

On page 15, we would like to discuss our cash generation. We have in the nine months of this year generated a negative free cash flow of BRL25 million. This means that our operating cash flow has nearly funded all the investments we have pursued in the year. So we already invested in the year BRL175 million all in CapEx. On top of this, we also have working capital investments and a lot of that related to the new stores being opened.

And even considering the higher cash cycle and the working capital investment for new stores, operating cash flow amounted to BRL150 million. And I'm talking a year in which we have a lot of non-recurring expenses and our (inaudible) grow. So it's pretty obvious here that we're very close to Q2 self sustainability in terms of free cash flow generation.

We also tracked the total cash flow. Basically we considered interest on our equity, financial expenses and the tax effects arising from them out of the free cash flow. But they're still cash outlays from the Company. So when you look at total cash flow, we have in nine months BRL36 million of negative total cash flow. If you compare to the same period of last year, we had more than BRL100 million. So in terms of cash management I think we are getting very close to cash generation.

And finally, our share price is down by 26.7% this year. This is not something we are happy about. We are working on the business, we are working on our execution to have a better future and to have an inflection point and get back to margin expansion, which has been our long-term trend.

Even so, if you invested in Raia Drogasil you have had -- not considering dividends and interest on our capital, only considering the share price -- 17% annual return and for whoever invested in the Raia IPO 18% average annual return.

So this was all we had in terms of the presentation. I'll now pass to Marcilio for his final consideration before going to Q&A.

Marcilio Pousada {BIO 16117399 <GO>}

Okay. Thank you, Eugenio. I will talk about your point about what's happening right now in the Company and what's my goal (inaudible). Profit and expansion, the new store openings are in line with our expectations. We opened 29 stores in the quarter and we closed the year with 130 stores as (Eugenio) has just covered.

New stores have been performing very well including the recent markets. Yesterday night we published our official new store opening guidance of 130 new stores in 2014. We already have 42 contracts signed. Most of the openings we will have in major markets, but we will also look at new markets.

We monitor our competitors and we continue to lead (inaudible) in terms of new store openings. And with this (inaudible) property tools and know-how that we have in the Company, I really believe the quality of the growth is outstanding. This will give us a huge competitive advantage in the future.

The cycle of closing stores is passing as we have already closed 20 stores at the (end of those years). We will close 5 more (inaudible) for this year, but we anticipate returning to normal levels next year. We will be between 5 to 8 stores per year. These numbers show us how assertive (inaudible).

Talk about the system integration. It's working better than we expected. We converted to date 62 stores and the first DC and we are planning to finish this stage in March 2014.

What we are doing is disconnecting Drogasil stores from their legacy retail system and reconnecting them to the upgraded Raia retail system. In March we will turn off these Drogasil legacy systems and then all stores and DCs will be unified on the Raia retail system and also -- it is very important -- the SAP financial and accounting system. This allows us to unify the logistic network and all corporate processes and systems with synergy gains to be in the future.

We are working very carefully in this process, trying to preserve the best of its true name brand and we believe the relevant synergies will be captured after this process is complete.

The main point that we are observing is the converted stores are improving customer service as the new system (inaudible) operate and help our sales assistants to serve our customers with the best (inaudible) for the customers and for the Company. By distributing product (standardization) across visual and store profile, we (regard) optimization, mainly because the stores which produce more (technical difficulty) and reduction of transportation costs.

At the end of this process, we'll be the only Company, if you compare with our three main competitors who made (recent) M&As in their markets, to work with a single IT platform. And you (inaudible) the best system in the whole industry. This will give us the perfect condition to consolidate the market with a significant improvement in our quality of operation and our profitability.

(inaudible) are working many projects in the next quarter. For example, return to the previous ICMS taxation; this will bring us a gross margin improvement of 0.4% over the coming months. We are doing this change already in December and we will see the improvement in inventory totals.

We are working also in (inaudible) improving net stores. This is a structure to sustain a long-term margin expansion as system integration keeps improving the execution and accelerates growth. After integration, we analyze store profits to bring execution to the next level, not only in customer service, but also in the back office.

Cost managing. Several initiatives are being conducted to minimize the effects of increasing our cost of labor and rentals. Like to manage indirect costs, we just created one specific area in the Company to manage and negotiate with the vendors all the main contracts in the benefit and support areas.

Another important thing that Eugenio already told you is the government is (inaudible) stores for the Farmacia Popular. Today we have 551 stores active in the program. This week the government approved the inclusion of 45 stores. These results are subsidy and (inaudible) and bring more competitiveness in the Raia stores. We are working closely with the government to try approving other stores into next year.

Thank you, all. And right now we are available for questions.

Questions And Answers

Operator

(Operator Instructions) Guilherme Assis, Brasil Plural.

Q - Guilherme Assis {BIO 16143141 <GO>}

I have only one question regarding the expansion plan. So you said that you're keeping the same pace of store openings for next year as this year, 130 stores. Can you give us a little color on potential new markets or how -- the breakdown of the expansion if you think that -- how many markets you expect to tap in the next year? And how much of the 130 stores should be in the existing markets?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

We are looking actively at new markets. We don't want to be too specific here because we're not the only company growing in the market.

And in terms of number of stores, I don't know, maybe like stores in new markets, 15 or something like that. It depends on the timing of entry, it depends on a lot of things. But we keep opening a significant number of stores in mature markets in which we have a very strong brand and in which we have logistics, infrastructure and (interest) people in the field in which we know -- and in the form of competitive dynamics.

So this is not -- this has to be a mixture. If we were only to focus in mature markets, I mean this is the best profitability you can have, but also you exhaust new results growth of the Company much sooner.

If you're overweight on new markets, I mean I think nobody will have the patience with the results of the Company because the pressure will be huge and the execution pressure would be very significant as well. So we're always trying to balance it.

Sometimes it's more an art than a science. This has been a year in which we have not entered new into markets. But in general, the one or two years before we entered a lot of stores in new markets. So I think we're getting in that stage in which we can balance very well. I don't know, if I have to give you a number, but that's not something set in stone, maybe there are 20 stores in the new markets. Or let's say 25 if we consider recent markets as well.

Q - Guilherme Assis {BIO 16143141 <GO>}

So you were saying like 20 stores in new markets. Could I say that this could mean one or two markets for next year? Is that what you have in mind? Or you think you could have less stores in more markets -- more new markets?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Well it's possible. I mean one market for sure we will have, two is possible. I don't know if it's more. I mean it depends on how well the markets are doing.

We don't want to be over aggressive here. We want to be measured. We don't take anything for granted. But for sure I think one or two markets is a good assumption.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. Thank you. Then if I may, one last question about competition. There has been a new entrant since we last talked in the last conference call from last quarter. We had the Grupo Ultra actually buying Extra from (Endemarta Publio). I know they don't have any overlap with you at this point, but how do you see the competitive environment going forward?

And how do you see this new player as a competitor to you even that they could have some synergies with the gas station, food that they have? Do you think that they would eventually come to Sao Paulo? I mean how would you view them as a competitor or in the south -- not specifically in Sao Paulo, but in the southeast?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Guilherme, I only have good things to talk about Grupo Ultra. It's a great company, we have a lot of admiration for them. And they basically bought a good and solid company.

So the things that we pay a lot of attention to is net addition of assets. I mean I'm not as concerned about M&A as we are with new store openings.

I mean for me M&A is basically the same asset operated by a different player. It's not something that I think affects too much competition. But what we don't want to see is an over opening of stores in the markets where we are.

Another thing to say is that different from other companies, I mean one of our main strengths is that we were able to succeed in very competitive markets with the best players in the industry. So we will play in Sao Paulo. We are leaders after Drogaria Sao Paulo, which is a very good and very solid operator.

So we have been able to grow our brand and to develop very good operations in new markets competing with local players. So if we are here today and if we are successful, it's not for a lack of competition, but because of our ability to succeed in competition.

I believe that any local player, including us, that has strong brands, strong execution and strong property quality is very well defended. I believe that both -- well, we are growing in other markets and we sometimes find competitors here and there like that. And if the competitor has the three pillars that I just mentioned, I think they are very resilient and they are very successful in absorbing new entrants. Just as where we enter new markets where the players do not have all those three characteristics, our life is generally much easier.

But on the other way, I mean both ourselves and our local (Pague) in Sao Paulo, Drogaria Sao Paulo, we are very good on three dimensions. So if you look in the past, no entrant in Sao Paulo had an easy life. You should think about the (context) of our (early entry) in Sao Paulo. We are hugely profitable in Sao Paulo, but if you think about the companies that enter in Sao Paulo, neither of those were successful. Neither of those are successful because they were competing with very strong brands, executions and asset quality.

So this is the most important thing. In the end, the game is about asset quality and I believe the asset that we have makes us very strong versus any kind of competition that we may have in our market or when we go to other markets.

Q - Guilherme Assis {BIO 16143141 <GO>}

That's very helpful. Thank you, Eugenio.

Operator

Richard Cathcart, Espirito Santo.

Q - Richard Cathcart {BIO 16457807 <GO>}

I just wanted to ask a quick question about costs for next year. Clearly you've spoken about some increasing costs in payroll, rental. I'm just wondering whether you think you will be able to keep SG&A as a percentage of sales flat next year or whether it's likely to increase again and whether you may be able to offset that with better gross margin or better G&A?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

We don't deny that controlling expenses in a high inflation involvement is something very, very challenging. I think when you look at sales expenses, it's very, very tough to maintain sales expenses. So my realistic expectation is that we have pressure in sales expenses.

Our job is to offset those pressures in corporate G&A and gross margin increases. And as a result, being able to expand our margins.

But in the end, it all depends on what kind of growth we have in mature stores. So if you grow in mature stores above inflation or slightly better, I think that's the kind of assumption that I will have. But if all the initiatives that we are unleashing, they translate in strong growth for next year, then you can have a surprise. Then maybe yes you can control or even dilute sales expenses.

An example that I'll give you; given a certain level of revenue that you expect in a certain year, if you have 1% higher revenues, you have 25 basis points of margin improvement versus what you budgeted. If you have 1% less revenues, you have 25% less EBITDA margins than what you budgeted.

So the answer depends a lot on the kind of growth we achieve. People think about sales expenses as variable expenses and they're not. They're fixed expenses. In the existing store base they're fixed expenses. They get variable when you add new stores. So then as you add expenses.

But 90% of those expenses, they're fixed, so if we are able to increase our revenues, we get operating leverage. If we decrease revenue versus inflation, we lose operating leverage.

So our whole challenge is to get as well as possible in the revenue side. And when Raia and Drogasil merged, the whole spirit of the merger was not that we were merging because we can cut costs outside of the system. That's great and we are looking across that actually as well and that's very welcome.

But the whole reason on why the Company was formed is to be able to operate by getting the best of both worlds, the best assets, the best people and the best system and the best skills. And I think we are very close to the point in which we will see that working.

For example, we are exactly in the middle of our systems change. A significant number of Drogasil stores have been already disconnected from the Drogasil legacy system and reconnected in the upgraded Raia legacy system. In March we will be over completely with that, so have 100% of the Drogasil stores in the Raia legacy system. We'll be able to turn off the Drogasil legacy system, the Drogasil finance and accounting system, and have all the Company operating on the same system.

And the systems platform that we have at Raia is a very, very robust and unique systems platform. It's very CRM-driven, it's very execution-driven. And as we are implementing that system in the Drogasil stores, I think we will see the impact of that change.

We are now living in a moment in which Raia is doing very, very well. And Raia is kind of living the best of both worlds. Raia had a very strong system for store operations. We upgraded that system by better controls in the back office and things like cost management and so on. And Raia had a (inaudible) store execution and over the last few years we fixed the gap in store execution and we also had a lot of learning from Drogasil employed at Raia.

So Raia now has kind of the best that we have to offer. It has a very good retail execution, has the full systems platform implemented, has learnings from Drogasil. And we don't publish the figures by brand, but Raia executed (inaudible) ahead of inflation in mature stores.

On the other hand, we have a lot of pains with Drogasil in this integration process that have muted Drogasil growth; it was (executing) significantly below inflation at mature stores. We have Drogasil a very strong execution discipline; and we believe that when we implement the same IT platform, the same retail platform for the Drogasil stores, I think we'll see a significant improvement in Drogasil next year.

And it's not only -- it's not the systems alone. Together with that we're improving, especially at Drogasil, we're improving product mix, we're improving merchandising, category management, improving pricing. We're increasing service levels, we are renovating stores, (inaudible) improving assortment. So we have a huge to-do list. I think that we'll do it to improve our retail execution.

I think ever since we had the change in our management, I think the Company is investing way more of its time thinking about stores, customers, execution. Better thinking about the (costs) and control and things that are important, but they do not add value to the consumer.

Everything that we do here is very focused at the store and the consumer and the execution and I believe that will pay off. I believe that we'll see a very strong good second semester next year.

These improvements, they don't -- you don't feel them from night to day. I don't expect a significantly different Fourth Quarter. Already we are in the Fourth Quarter, or in the middle of the Fourth Quarter, but certainly we don't expect nothing materially different in the Fourth Quarter and the First Quarter of next year. Maybe -- who knows? -- the Second Quarter, but certainly we have to see a very robust growth for mature stores in the second semester of next year and then this should get us back to margin expansion. There has been no secular trend.

Q - Richard Cathcart {BIO 16457807 <GO>}

Okay. Thanks; that's very helpful. Then just one more quick question on the inflation in rental expenses. Is this a trend that's affecting the market as a whole or do you think perhaps that you're seeing slightly higher inflation than your competitors because you do have such strong assets, such strong locations, these stores on the corners? Are they becoming increasingly more expensive versus stores of the competition?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

That's a very good question, Richard. I mean if you think -- I don't think the pressure that we have is any different from the pressure that our competitors have.

Having said that, if you have a competitor who owns their store, the fact is that they can have the owner subsidizing the retailer. So but the reality is that I mean if a competitor owns a significant portion of stores, it's not seeing the depreciation and so on. It's not seeing the rental expenses increase. I mean nobody owns 100%, so it's getting less of an increase.

But then you have the whole investor capital issue and that capital, the (means your worth) more and (inaudible). So you still have an economic problem to solve.

I mean there are slightly different colors market to market. I tell you that (this) is an area insane. So if you have high exposure to Rio, you have a harder time than if you have a higher exposure to let's say a smaller city in the countryside.

So I mean colors could be slightly different, but I think fundamentally the phenomenon affects everybody in a very similar way.

Q - Richard Cathcart {BIO 16457807 <GO>}

Great. Thank you, Eugenio; very helpful.

Operator

(Operator Instructions) Javier Martinez, Morgan Stanley.

Q - Javier Martinez {BIO 15226046 <GO>}

I wanted to ask you in these results I see that you are already approaching the end of the integration process or the (inaudible) integration process, no? Two years after the deal was announced. I was wondering if during these two years' learning process that I guess that you also learned a lot of things, the thesis is still the same. So scale adds value, Raia. My question is if this value added via scale gain still applies now that you know not only about the synergies but also the integration pains.

And second, if the thesis is the same when you were moving from BRL2 billion, BRL3 billion to BRL6 billion, or now that you are in BRL6 billion, so the incremental value of a round of consolidation of large chains still makes sense, or now that you are in BRL6 billion it's marginal, the incremental value creation, no?

And if this is the case, what is the role you want to play? Do you expect to be the leaders in this process or you're going to be waiting for people to move or how do you see this evolving in the future?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Very good question. I mean we absolutely see the benefits of scale. And even the benefit of a larger merger like this, for example, what we did wrong at the time of the merger, we saw the huge potential for gross margin improvement but we didn't see the kind of expense pressures we were facing. But still, I tell you that with the strength that we have now, when we negotiate with suppliers, I mean it's completely different.

And even if you had got to the same level of scale organically, I think the transformational issue of a merger is an added value and has had its role in improving our competitiveness. No doubt about that.

Having said that, when you look at the market, and when you look ahead of us, and when you -- and a question about the (inaudible), it's a good question. I mean there are a couple issues to take into consideration.

I mean yes, if you have a larger (maintenance) clearly this is transformational. However, when you look at the assets that have remained in the market, I mean you have the leaders who are large assets, most of them. I don't know if they want to sell or not. I think they are expensive assets.

And when you look at smaller chains, I mean most of the good smaller chains have been already digested by players like us, by players like Brasil Pharma and even by Ultrapar.

So when you look in the middle for smaller chains and middle sized chains, I think the opportunity is very limited right now. And when you look to large deals, it gets very complex in terms of execution, in terms of governance, in terms of price and in terms of distraction from our organic growth.

One thing that you understand very well, I mean, we grow organically by paying 2 times EBITDA. Is it worth it to pay 12 times EBITDA to do a large deal? I don't know, maybe someday yes. Now that we have this huge opportunity for organic growth, actually I probably think it's not worth it. I probably think a transaction will provide a huge distraction from the organic growth.

Then in our case the beauty of this merger is that we didn't sacrifice organic growth. On the opposite, we are able now to grow more than the sum of the parts.

Raia was growing 60 stores a year, Drogasil was growing 40 and we're now growing 130. So we have all the benefits from a merger that I think we will start seeing next year. Plus the fact that we were able to keep our accelerated organic growth. This is not only through -- depending on the level of intervention they will have to do, if you have a company that is very well managed then maybe it's easier. You could not sacrifice organic growth.

But if you have to get an operation that is not integrated, that has a lot of problems, a lot of complexity, I mean even if the underlying asset is good, that can become a toxic asset because of the distraction that it will bring to our organic growth program.

A - Marcilio Pousada {BIO 16117399 <GO>}

Marcilio here. Scale is very important (inaudible) maybe would be good for us. But the most important for this (business process) are the stores. Complicated. It's very complex to serve the customer in this business and you're working with two or three systems it's very, very difficult to manage this.

We had (inaudible) almost go with just one system and this is very good for our business, and I really believe the capability will be -- in the future will be the productivity for the sales team. This will be our goal in the future. Okay?

Q - Javier Martinez {BIO 15226046 <GO>}

Perfectly clear. Thank you very much.

Operator

There appears to be no further questions. Now I'll turn the conference back to the Company for their final remarks.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Well thank you very much for attending our Third Quarter conference call. We will keep focused in this Company in the middle to long range. We are doing a lot of actions that can be transformative in terms of our execution. And in the end, I mean our profitability and our growth will be just as good as our execution is.

The whole energy of this Company is focused at the store, at serving the consumer to a good shopping experience and to execute more efficiently all of that. So this is a journey. We're committed to the journey and I believe the Company that we'll see five years down the road will be a significantly different Company in terms of scale, in terms of efficiency, in terms of quality of the service provided than with the Company that we have now. Thank you very much.

Operator

Thank you for your participation. Have a nice day.