Q2 2015 Earnings Call

Company Participants

- Claudio Bergamo dos Santos, Chief Executive Officer & Director
- Martim Prado Mattos, Chief Financial Officer & Controller

Other Participants

- Alexander Robarts, Analyst
- Robert E. Ford, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon. Welcome to Hypermarcas' Second Quarter of 2015 Results Conference Call. Today with us, we have Mr. Claudio Bergamo, CEO; and Mr. Martim Mattos, CFO.

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 Hypermarcas' remarks, there will be a question-and-answer session for any investor – for investors and analysts, when further instructions will be given.

We would like to inform the questions can only be asked by telephone, so if you are connected through the webcast, you should e-mail your questions directly to the IR team at ir@hypermarcas.com.br. Today's live webcast may be accessed through the company's Investor Relations website at www.hypermarcas.com.br/ir.

We would also like to inform that statements during this conference may constitute forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those set forward in the forward-looking statements.

Now, I'll turn the floor to Mr. Claudio Bergamo, who will begin the presentation. Mr. Bergamo, you may begin your conference.

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you, very much all. Thank you very much for attending the call. In the second quarter of 2015, Hypermarcas continued to benefit from its growth plan started back in 2012. The sell-out demand for our products and brands in the quarter accelerated with proposed double digit sell-out growth in both business divisions. In Pharma, our sell-out grew 16.5% in the first half of the year, and in consumer 23.6%. In both divisions, we continued to gain market share. The Consumer division, we advanced many market ranks, becoming number one in shaving foam with our brand Bozzano; number two, in infant diapers, with our brands Pom Pom, Cremer Disney, and Sapeka; number three, in the large deodorant market, with our brands Bozzano, Monange and Très Marchand; and also number three in sunscreen protection with our brand Cenoura & Bronze.

In the markets where we are already market leaders such as nail polish, moisturizers, condoms, and incontinence diapers, our market share has - our relative market share has increased also in the quarter compared to the second place. In Pharma division we advanced 0.8% in our total market share in the market, reaching 10.6% of the total market. We had produced a lot of growth in all markets we compete, especially in dermocosmetics, in which we grew 36%, in prescription products, in which we grew 27%, and in generics, in which we grew 43%.

In terms of selling, our net revenue amounted to BRL1.256 billion, representing a 10.8% growth in the quarter, accumulating a 13.1% growth in the first half of the year on the same comparable basis. The success of our growth has been originated by new product launches, combined with strong marketing investments, increased distributions, and improve few things (10:02) execution supported by our low-cost production capacity.

Our adjusted EBITDA for the quarter was BRL297 million. This result was negatively impacted by the devaluation of the real against the dollar in an amount of BRL36 million. It represented a negative effect of 2.9 percentage points on our gross margin. Our net income reached R$111 million in the second quarter, also impacted by the effect of the foreign exchange rate depreciation by about BRL24 million. The company is confident about the mid to long-run growth of our businesses in the Brazilian market, and we believe we are well-positioned to face the challenges of the current macroeconomic environment.

I'll pass over to Martim to talk in more details about our financial results.

Martim Prado Mattos {BIO 16015889 <GO>}

Good afternoon, everyone. Martim speaking. Starting on Page 3 of the presentation we have available on our website, we see that growth was 10.8% in the quarter. In Pharma, growth was 7.7%, with a BRL27 million or 4.2 percentage point impact of a backlog of non-fulfilled orders by the end of June, because of temporary effects on the production of certain pharmaceutical drugs. In Consumer, growth was 15%, same level as two prior quarters, due as a consequence of the smart choice strategy, which had been adopted thus far.

On the next page of the presentation, we can see that the gross margin reduction was 3.3 percentage points. In Pharma, the margin remained virtually in the same level as in the prior year. In Consumer, the highlight was a 5.1 percentage point margin reduction effect, as a function of the impact of the FX depreciation over costs.

In addition, mix in the quarter was less favorable compared to second quarter 2014. But, on the other hand, it was compensated by price increases compared to the same quarter of the prior year. Compared to Q1 2015, there was a 1.2 percentage point (13:13-13:20).

Operator

Pardon the interruption, everybody. It looks like we have lost the line. I've joined in the backup line.

Martim Prado Mattos {BIO 16015889 <GO>}

Continuing marketing. I'll read again the SG&A part until we have any questions indeed in the explanation. SG&A, ex marketing expenses, which are essentially composed of expenses of fixed nature, grew normally close to wage inflation, but were diluted by 0.3 percentage points, as proportion of the net revenue as a result of operating leverage. Marketing expenses were also reduced as proportion of the net revenue, according to this year's strategy of less aggressiveness in marketing.

Proceeding now to Page 5, we see that as of that consequence of what has already been discussed, that is a gross margin decrease partially offset by operating leverage on fixed expenses and marketing expenses dilution, the adjusted EBITDA grew 3.3% to BRL297 million. Net income achieved the mark off BRL111 million, a 9.3% drop compared to Q2 2014 given the combination of a lower EBIT in the period and a BRL9.6 million increase of financial expenses. Primary, as a consequence of increase that costs linked to CDI interest rates and IPCA inflation, but also as a result of higher average net debt compared to the prior year. The net debt rose in its current result, but mostly from the working capital investments over the last quarters, mainly on the form of higher inventories in Beauty and the Consumer division, in correlation to the strong volume growth we have experienced.

Thanks everyone for the attendance, and we may now proceed to the Q&A session.

Q&A

Operator

Thank you. Our first question comes from Robert Ford of Bank of America Merrill Lynch. Please go ahead.

Q - Robert E. Ford {BIO 1499021 <GO>}

Thank you. Good day everybody, and thank you for taking my question. There were quite a few calls - or issues already addressed on the Portuguese call. So, I'd like to switch gears if that's okay, Claudio. There is a massive deal that's being announced today with respect to generics - Teva is buying out Allergan's generics business for $40 billion, making it the biggest generics producer in the world. And when you think about the Brazilian marketplace, right, there's Sanofi acquired Medley several years ago, there was a small Pfizer Kyoto (16:41) deal. But for the most part, you really haven't seen multinationals do much. And I was wondering if there's a reason that you see why consolidation in the Brazilian market is taking so long or if there may be some structural differences in your opinion that might make Brazil more or less attractive from a strategic perspective when it comes to consolidation and the participation of multinationals in Brazil.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi, Bob, and thank you. Well, I don't see any lack of attractiveness of Brazilian in contrary. The Brazilian market is expected to become the fourth largest market in the world in the coming years. And also, in Brazilian market, we have many products, opportunities to be launched. However, it's a tough market, it's a market that – it's very difficult to compete organically. My view is that, for the time being there are other opportunities outside Brazil, but once probably the whole macro environment gets more stabilized, probably people start looking more into Brazil again. For the time being, (18:24) somewhat with me because we can't continue pursuing our strategy of growing market share.

You have been following us for many years, and you know that when we started generics, many people were skeptical about our capability of growing in this market. And we ended this quarter with close to 14% market share from a – since we acquired Neo Química, showing that our strategy was in the right direction. Neo Química now it's one of our leading brands, we have revenue rounded above BRL1 billion, more than four times than what we – when we acquired Neo Química, and then, the market continues to growing very aggressively. And we have been able to reach that level of our market share. We still, which many important products not being part of our product portfolio, which we have been working on. So I believe that once we get new products in our pipeline, we should have a new wave of growth. Maybe that's how I can position from the time being.

Q - Robert E. Ford {BIO 1499021 <GO>}

No, it's very helpful. And then, just a follow-up, right. You've got phenomenonal pricing right now, and – I'm sorry, you've phenomenal volume growth, share growth. You talked a little bit about maybe balancing profitability and working capital considerations with market share and trying to compensate for some of the FX pressure. Can you give us a sense of what that might mean in terms of averages? And I know it's very specific to individual categories that may be more discretionary, less discretionary, more exposed to FX, less exposed to FX, particular dynamics within each individual item, right, or segment.

But just in general terms, can you give us a sense of where you think you can take pricing in this environment, and maybe what kind of margins we should be looking for going forward, maybe where you may be able to release some working capital and over – that might lead to (21:00) magnitude in the times? And I think in the last call too, you were saying that the working capital cycle is 100 days; you start making changes today, it takes three months before it kind of begins to show evidence. But if you could just maybe address the magnitude of opportunity you see given how healthy your brands, volumes, and your shares would indicate the business appears to be, that would be very helpful.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

I mean, you know that we have been pursuing our growth strategy for already quite some time. And we have been going after new product launches, improved distribution, improved execution, a capital (21:55) reduction in capital expenditures in order to increase our capacity, sometimes very high levels of launching these innovations. So, there was a series of actions that we have conducted in the last two years really, in order to change the level of our demand in the marketplace. And then I believe that this – by the end of this half year, let's put it this way, we have achieved many of our targets very successfully.

Moving forward, I think that's what I said in the Portuguese call, that we can be a little more selective at this point given that we have accumulated many of these actions up to now. So, if you – and have a stronger focus on cash flow especially, given that the macroenvironment we are in now. So, that will – I mean, we can think in many, many levers. CapEx for example I think, for now, we have invested a lot in consolidating our plants to improve our capacity. I think if I need to make a decision how to increase market tactic (23:33) probably we're going to postpone for some and be able to take advantage of the profitability of some markets that has been too strong a demand.

In terms of consolidation, mostly we have finalized our consolidation. So, our CapEx needs will be smaller, probably we would – we still have a method (24:08) to transfer, but it's only for alliance. So, it's a decision we can still wait for. In terms of working capital, when you pursue a strong growth strategy as we pursue, you're growing very high, you need to invest a lot in working capital. So we are at a point now that we believe we can benefit a little more on the other working capital needs in some of the markets.

The diapers market for example, is the market that the demand has been quite strong, as it consumes quite a good amount of working capital. So I believe we can benefit a little bit more on that front, and on that bigger source of a short-term opportunity. And then we have to continue to increase in price. I mean, just right now, I was coming back from before the column moved to the dollar level, now it's BRL3.35. So we have to see now a price increase to grow to BRL3.10 and probably, we will need to do again in the fourth quarter another price increase to keep that level of exchange rates we maintain to higher level.

Once – when you do the process of increasing price, naturally clients tend to reduce their stocks at the chain. (25:53) suggested price to speculate on your stock. And so, as you go through this process of improving prices until you end it, there is naturally a reduction of the inventory level across the chain, which you come towards probably, and so that's what why we believe that probably and I can say that we might have some realization of a working capital, as we go through this process which I cannot measure them out now, but likely, that may happen in the next coming years. As well, we are also considering seriously to conduct some cost cutting initiatives, that we would be announcing as we go through the second half of the year, already with the objective to Q2 to start 2016 which have these cost savings already analyzed on our results. So there are many changes we are going after now.

Q - Robert E. Ford {BIO 1499021 <GO>}

That's very helpful, Claudio. Thank you very much.

Operator

And our next question comes from Alex Robarts of Citi. Please go ahead.

Q - Alexander Robarts {BIO 1499637 <GO>}

Hi. Thanks and hello everybody. I want to go back to a topic that we were discussing in the morning. I mean, on the Portuguese call, which is the outlook for free cash flow. And frankly, when we think about how it has turned in this quarter to be negative and there is several factors involved, and as you rightly point out, some are more temporary than others. But just trying to understand the business strategy of the diaper division, over then kind of shorter term like kind of three year end, I mean I appreciate this, the idea that a couple of price increases are going to be necessary to offset the FX here in the second half and folks might – or your clients might think about reducing their inventories, but at the same time, the trend that you're posting in your numbers as far as the inventories kind of go on the other way. They're increasing and there's probably a driver behind this market share gain and growth that you're getting in diapers. In other words, as a smart choice item, you're getting the volume growth there, you're ramping up the production, which at the same time, right, has these working capital needs.

So how do you kind of think about balancing this goal of trying to have clients or kind of pushing through this price increase, while at the same time trying to keep your inventory level growth under control, and kind of specifically, if you could answer that around your diaper division. And who do you think you're gaining market share from, the 4.5 points, I mean is it fair to say that it's mostly the multinationals or have you been seeing some gains at the – with the regional players?

And the final bit on diapers, is – if perhaps there is not the kind of price and interest level, you're seeing among the potential buyers, I mean I'm thinking about your public statement that there's M&A opportunities with the diapers. But if you're – I mean, is one of your options to keep the diaper division and try to work at it, making it more profitable? So, several parts around the diaper division? Thanks very much.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Okay, Alex. So many questions you want. So, I'm going to try to see if I can answer at least one or two of them. One I think the cash flow. Again, I think, the company has been showing a strong cash flow generation in the last quarters. And in this specific quarter, we had a very large growth and as a consequence of that, we needed to invest in the working capital. That's it. Working capital is something that you recover, it's not something you lose it. So, we have to wait and see the full cash flow along the year and then we have a better measure on that.

We – any time that you follow our growth that we have been growing very high, we'll have to invest in working capital as a consequence. Given that now, we have to – we want to balance more working capital and cash flow, especially given the high levels of interest rates in Brazil, we had many ways to go about it and realizing our working capital and we have to balance the growth on the working capital. And then especially because the view (32:05) nowadays it's a high interest rate. I myself say, if you're in an environment, where interest rates more or like close to zero or at least very low as it is in more mature economies, probably we had continued our growth strategy as fast as we could because we have been very successful, and we believe there's still lots of room to grow. But we need to balance in large but in our given an environment we are now, but it's not a – it's a question basically that we need to balance the situation in we are. But even when we do that, when you decide to do that, not necessarily that might change given that the wait (33:15) goes for everyone, not only for us.

Coming to specifics around – on the diapers, I think it's very important we keep our perspective the same. We consolidated diapers markets in the view, acquiring three very good Brazilian companies – the Sapeka, which is the leader in the North East of Brazil, the Pom Pom which is a leader brand in São Paulo, a Chilean state and which is the leader in the adult diapers, BigFral brand, and Cremer Disney, which used to belong to Mabesa and it's a leader – it's a very strong brand in and in the Rio de Janeiro, Minas Gerais and in the south region. So, all these brands complements to each other in terms regionally speaking.

We have been pursuing and positioning of these brands not only regionally, but as well in between the price deck (34:16). And we have been conducting a series of change in the product specifications, which are projected to have very good cost benefit options for our consumers, positioning the Pom Pom as the premium brand, Cremer Disney as the intermediate brand, and the Sapeka for the high-low end brand. That's not only regionally, but from the nationwide.

So we have been going after these changes in our products specifications. And we have actually been able to change the products in a such way that they become even with superior quality, with comparable products in the same segment. That process we have basically gone through the last year and the beginning of the year; we had just finalized this process by the end of first quarter when we launched the Pom Pom quality management. (35:35) So that change was quite well-received by the consumers, because we're able to offer excellent quality for a fair price. So the whole industry has been going through an issue of the dollar devaluation, not only us. It's us and as well our competitors, which are mostly multinationals, and it is a challenge both for everyone, because when you get through this high level of exchange devaluation, I mean we're having 55% exchange devaluation in the last one year for a product which is around 70% dollar denominated; it's a challenge for everyone.

So, what happens is that everyone is slowly increasing prices during this process; some companies are faster, some are not faster and there is situational activity in the market, and sometimes, our – the demand has been too high. So, we had to go through this process. I think we are still in good shape, in terms of our product specifications. And then, actually some of the multinationals now are following us. We have lots of new product specs, for example, we produced (37:32) the 14 hours duration for Pom Pom and 12 hours duration for Cremer Disney, which was 10 hours and 12 hours; it's become a huge success. Consumers love it because they've been serviced the (37:53) consumers and giving good options with good quality for a good price. So, and yeah, so but the absolute level of pricing from an exchange, given exchange rate and they have been in the mid of this quarter. After that, everything will get normalized and but most important, that we have the reengineering of the whole product line, and it could be shaken out to meet the long along the line competition in this business.

Q - Alexander Robarts {BIO 1499637 <GO>}

So, sorry on the market share then do you think you were more successful against the multinationals, or did you source that share from the regionals or it's kind of more of a case-by-case in the quarter?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

I think the regionals now are very small in busniess. So there are basically three major players now, which is Procter, Kimberly and ourselves. And pretty much we're splitting the cake into three, both depending how we see the figures and there are no – they had same numbers don't capture very well our revenue in Sapeka in the northeast. So when you look to the missing numbers, now we are the second player tied – in volume level tied which Procter and Kimberly, the leader abroad.

But if you I mean take into account that division don't measure it very well, the Sapeka as well the Cremer Disney, you could wonder who is really the little one now. So at the end you could argue that all few companies are tied now in the marketplace. And the regional players they basically exit in the market because of not be able to get a good go-to-market so that's it and it's a quite initiatives from multinationals.

Q - Alexander Robarts {BIO 1499637 <GO>}

Got it. Got it. And the last part of the question was just that, so it is possible or it is one option that you keep the diaper division for the rest of the year,I mean, that's a possible scenario, correct?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Again, we have like I said, Martim said during the Portuguese call, we have hired advisors to evaluate what are our options and we are evaluating results. So, at this point, I cannot say anything else than that on that specific initiative. But we conducted doing our business on the merry course as we all have been doing.

Q - Alexander Robarts {BIO 1499637 <GO>}

Thanks a lot. That's very helpful. Thank you again.

Operator

Thank you. The question-and-answer session is now closed. I would like to turn the conference back over to Mr. Claudio Bergamo for any final remarks.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you all for participating on our call and our IR department is available for any of you to discuss any further clarifications that you might have. Thank you very much and have a nice day.

Operator

And thank you for your time, sir. Today's Hypermarcas conference has now concluded. And we thank you all for your participation. Have a great day.