# Q4 2013 Earnings Call

## Company Participants

- Eugenio De Zagottis, VP IR, Corporate Planning
- Marcilio Pousada, CEO

## Other Participants

- Guilherme Assis, 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 2013 results.

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

Be informed that all participants will only be able to listen to the conference during the conference presentation. After the conference remarks are over, there will be a question and answer period. At that time, further instructions will be given. (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 will turn the conference over to Mr. Marcilio Pousada. Sir, you may begin your conference.

## Marcilio Pousada {BIO 16117399 <GO>}

Good morning, everyone. Welcome to the Raia Drogasil results presentation for the Fourth Quarter of 2013.

As always, Eugenio will present the highlights of the year. And just before the Q&A, I would like to stress a few points about 2013 and our challenges for 2014. Eugenio, please?

## Eugenio De Zagottis {BIO 7193695 <GO>}

Hello, everybody. Thank you for attending our conference call.

To start with, I'd like to give an overview for the year. We believe 2013 was a year full of contrasts. It was a very disappointing year in terms of financial results. It's a year we were definitely not happy about.

But at the same time, it was a year of significant breakthroughs that was building the vision that we had at the time of the merger for the Company, as we have significantly advanced in our integration as we are preparing the Company for a leap in execution, for a leap in servicing our consumers, and for a leap in creating value for our shareholders.

We opened in the year 967 stores -- sorry, we ended the year with 967 stores. We opened a total of 131 stores, which is an actual record not only for the Company but for the Brazilian drugstore sector and maybe for the Brazilian retail sector at large. We are not sure about that, but at least I haven't seen any reference for an opening base like this.

We have also closed 24 stores as part of the closure program that has already been concluded. And it's of course the program that we had intended to do and have communicated ever since Raia and Drogasil came together.

We did BRL6.5 billion in revenues last year. We grew 15.6% with 9.3% of same store sales.

It's very important to highlight that we have added in the year BRL0.9 billion even considering the store closures. So we added fully organically a mass of revenues equivalent to the eighth largest drugstore player in Brazil. So it's very significant.

With EBITDA, we developed BRL357 million, a margin of 5.5%, an increase of 9.6%. So as I mentioned, we lost 0.2percentage points in EBITDA margin versus the previous year as a result of mature stores not growing in line with inflation and as a result of the loss of operating leverage that we had at those stores.

Net income on an adjusted basis was BRL176 million with a net margin of 2.7%. And one of the highlights of the year was the fact that we generated positive free cash flow of BRL45 million in spite of the weaker results in the year and in spite of a very strong investment program we undertook last year.

And even when you consider interest, interest on owned capital, we still posted a positive BRL22 million in total cash flow generation. So our cash self-sustainability is something very important for us, and it's something that we believe to keep posting from now on.

On page four, talking about our growth, as we mentioned we opened 131 stores. We closed 24 stores. And we suspended four stores during the year, suspensions meaning stores that are temporarily closed for rebranding, generally from Raia or Drogasil to Farmasil, but sometimes even from Raia to Drogasil or vice versa.

The 24 closures that we had, they have been part of a synergy program announced since the time of the merger. If we consider the last two years, we closed a total of 37 stores in the program.

But it's important to highlight that a very small number of stores that we have closed, and still it is related to store development mistakes in the recent years, only 12 stores of the 37 have been open since 2010.

So we are talking that, on average, we had 6 stores per year that we can consider mistakes in our investment program. And that's at a reasonable pace, closing 5, 6 stores per year. And this is what we expect for 2014.

But the other 25 stores have been legacy stores that have been closed due to the performance optimization that we did. So we had very often two stores that were subpar stores, even if positive, that were side by side. So we had a significant opportunity to close one store, to migrate revenues from the surviving store, and to end up with one good store instead of two bad stores.

The program has been concluded now. And from now on, we still will close stores, but that's part of the normal life. And we expect a rate of 5, 6, 7 per year, not more than that.

By year-end, the age structure of our portfolio includes 33% stores still undergoing maturity. So these are stores that are not generating their full potential. And as the stores mature, they will become a significant lever of profitability for the Company.

On page five, we didn't enter in any new markets last year. So we stayed in the same 12 markets that we had before that account for nearly 83% of the Brazilian pharmaceutical market. So it's a very broad geographic presence.

Out of the 967 stores we had by year-end, 495 were Drogasil or Farmasil. Farmasil is a sub-brand of Drogasil, so we have classified as Drogasil. When we achieve our rapid scale, we can start separating Farmasil. But as of now we don't think it's worth. For Raia, 472 stores in total.

We are accomplishing comparable market shares. This is the market share excluding new informants added to the IMS panel during the year. So we had a comparable market share growth of 0.3percentage points, from 9.4% to 9.7% at a national level.

We posted a slight margin loss in Sao Paulo, 0.1percentage points, a slight margin gain in the southeast, which does not include Sao Paulo -- so the southeast is basically Minas Gerais, Espirito Santo, and Rio de Janeiro -- and then strong gains in the Midwest, in the south, and the northeast.

If you consider the new stores open -- not open, but new informants added to the base during the year to store comparability, we ended last year with 9.4% of share. But we cannot compare that figure with the previous year because it's two different base of informants. The comparable number is a 0.3% national growth.

On page six, we discuss our revenue growth for the year. Last year was a challenging year in terms of sales by any means. We grew 15% over the whole year.

And it's important to mention that the closing and suspension of stores impacted our numbers by 1.2percentage points. So we would have 16.8% not considering the stores that were closed or suspended.

We ended the Fourth Quarter already at a much better pace with 17.5% growth. Same store sales grew 9.3% for the year, but in the Fourth Quarter they were already 11.9%, which is a good number. And for mature stores, 4.7% for the whole year versus 6% for the Fourth Quarter.

So we ended the year with our stores in line with inflation. And this was very, very important for us. And this is something that happened that helped a lot in the Fourth Quarter numbers. And that sets a positive trend for mature store growth above inflation for 2014, and probably started in the First Quarter already.

Talking about our product mix, the highlight of the year was OTC. We benefitted from shifting OTC product exposure from behind the counter to the front store at Raia. And as the Brazilian stores were progressively renovated, we have also brought OTC to the front store. So this has helped.

Other categories within OTC like vitamins, this is a very important category that had not been well developed by our suppliers. But last year we had a great year in vitamins as the market grew there.

We did several -- launched several new items. We improved its execution. Our private label also helped. And the two brands, they pushed the whole category. So what you see was a very good number.

Generics have been challenging, and we don't deny that. Over the full year, we lost 0.2percentage points. And the Fourth Quarter was particularly very challenging with only 11.2% of penetration for generics.

What happened here is that we are swimming upstream. So what happened here is that we haven't had any new major generics launched. So our whole improvement now depends on our execution.

We want to at least maintain generic cost, which is not growing, based on improvements in execution with generics. I think the new system at Drogasil will be instrumental to push generics' penetration. And even under (inaudible) we have things that we can do to deliver better generics penetration.

On page eight, I'd like to discuss our gross margins for the year and our cash cycle. We increased gross margin 0.1%, so pretty much in line with the previous year.

But when we look at the Fourth Quarter, we see a 0.4percentage point gross margin contraction. There is nothing wrong with the Fourth Quarter of this year. What happened is that the Fourth Quarter of last year was very, very high. It was, by any means, a big number.

Both numbers are fully comparable because the tax impacts that we had due to the new tax regime that we adopted during the whole 2013, it happened before that. So in both quarters, both Fourth Quarter 2012 and 2013, we have a fully comparable base.

But the Fourth Quarter 2012 came after a very weak 2012 where we had grown only -- when we had a gross margin of only 26.2%. So probably we had the high concentration of trade allowances in the Fourth Quarter as opposed to the Third Quarter of last year.

When we consider 26.7%, this is absolutely in line with the performance that we had in every non-seasonal quarter last year. So we had 26.8% in the Third Quarter. We had 26.6% in the First Quarter.

The Second Quarter was slightly higher, but this is a seasonal quarter in which -- followed by inflationary gains or events generally produces very high margin numbers. But still we did not save that way, as we do not do any forward buying. And as we had a change in purchasing model, that ate the benefit from the inflationary gain or events. But when you compare the Fourth Quarter with every non-seasonal quarter last year, it was pretty much in line. So there is nothing wrong here.

And we are now -- in December we left the previous tax regime and we are back to the tax substitution regime. This will help our model by approximately 0.4percentage points.

And we believe we'll see the whole margin improvement booking already in the Second Quarter of the year after the whole inventory has been rotated.

Another important thing to explain here is that, as we got back to the tax substitution, which is a much better regime in terms of gross margin, we had a penalty in cash cycle because, under the tax substitution regime, we buy all of the merchandise with taxes already pre-collected by our suppliers, while in the regime that we just opted out from we used to pay taxes only when we transferred items from the DCs to the stores.

So to enter the new tax regime, we had to pay taxes on inventory. So we basically do an inventory count and we pay the taxes to the state on those inventories. These taxes in inventories represented 4.1 days of cash cycle that we booked already in the Fourth Quarter of the year.

So when you look at the cash cycle, even though it looks like we only improved 1.1 days, the reality is that, on a comparable base taking out the tax effect, we would have a cash cycle improvement of 5.9 days.

This is very, very significant. And this has been boosted by a very important inventory level reduction that has been pursued over the whole of 2013. In the Fourth Quarter, we ended with 84.8 days of inventory, an improvement of 1.5 days of inventory even considering that our cash cycle increased by 4.1 days as a consequence of the adoption of the tax substitution.

So if we don't consider that, then we have a very strong inventory reduction. So on a comparable basis, inventory went down significantly. The cash cycle went down significantly, in such a way that it absorbed the tax penalty to get back to the new tax regime, and still allowed a small 1.8 day gain to exist.

Another important thing to highlight here is that, as we had decreased our purchasing especially in generics over the whole year -- over most of the year, after we paid the last outstanding invoices in the second and Third Quarters specifically, our cash cycle number there was penalized by very low days of accounts payable.

Now, as we are now -- after reducing the inventories that we are now replenishing normally, our accounts payable have got back to where they should be. So this helps show the effect of the inventory reduction that was previously offset by a transitory penalty in accounts payable.

On page nine talking about sales expenses, our sales expenses increased 0.7percentage points in the year. So out of this increase, 0.3% was payroll increases, 0.2% was rental, and 0.2% was marketing.

And something that is important to mention here, I mean, in a year in which margins went down by 0.3%, 0.2% was a choice that we made, was the market investment that we made.

The point here is that our management horizon is not the quarter and it's not the year. We do whatever it takes to be successful in the middle term, in longer term.

This market investment certainly did not pay off last year, but it's very important and it pays off over a longer term. So whenever we have to take a choice of posting beautiful numbers or doing what's right, we do what's right. And this is, I think, a very, very good example of that.

When you look at the Fourth Quarter, we had a flat sales expenses performance, which we take as a victory. Maintaining sales performance, sales expenses, flat in an inflationary environment, we think it's a very good number.

And the main reasons on why we have been able to do that in the Fourth Quarter is, first, various cost control. Second, the store closures are helping because we took off the less productive stores. And third, we are seeing a better sales environment. And as a result, we are achieving a better evolution.

People think of sales expenses as variable, but they are not variable. Payroll and rentals are fixed. When revenues are good, dilution is good. When revenues are poor, dilution doesn't happen. So the sales performance is a determinant in sales expense dilution.

The next page, G&A, we have been very successful in diluting G&A. Ever since the merger of Raia and Drogasil, we have maintained the corporate G&A constant in inflation and inflation adjusted terms.

So the total number of G&A has increased only by inflation ever since our merger, while the number of stores that we have supervised increased by 20%. As a result of this dilution, we saw last year a 0.3percentage point dilution in G&A pool in the year and in the Fourth Quarter. And we expect to keep diluting G&A in 2014 and maybe 2015.

As a result, we had a 0.3percentage point pressure in the annual EBITDA due, as I mentioned previously, to a tough sales scenario within which mature stores grew below inflation and lost operating leverage. And we also saw a recovery in the Fourth Quarter by maintaining, for the first time in the year, the same margins of the previous year.

Something that we highlight here is the impact of the stores opened in the calendar year over the Fourth Quarter performance. So we started -- we had in the Fourth Quarter of the year 836 stores that were already in operation in December 2012.

So in 2012, by year-end we had even a higher number of stores, but then we closed some. So 836 are the existing stores that were in operation ever since the end of the Fourth Quarter.

So these stores alone, not considering the new stores that have been added through the year, they posted in the quarter BRL1.6 billion gross revenue, BRL104 million of EBITDA, fully absorbing corporate G&A and logistics, and then they posted 6.4% of EBITDA in the Fourth Quarter over a higher -- over, sorry, a slightly lower revenue base.

So this highlights the impact of the new stores on our profitability. Whenever you look at valuation, and if you forget that we have opened a lot of recent stores that are still generating negative productivity but will create value over their maturation term, I think it's important to consider that to see the whole picture.

Page 12, depreciation increased 0.3percentage points in the year due to the acceleration in our investment program, and increased 0.2percentage points in the Fourth Quarter.

Financial expenses also increased 0.2% in the year as we maintained an average net debt higher than the previous year. But as the net debt improved significantly in the Fourth Quarter, we maintained constant net financial expenses of 0.1percentage points.

Then, taxes improved significantly as we have goodwill amortization. So 0.7percentage point improvement over the previous year.

When we compare the Fourth Quarter, we are comparing a quarter in which we had goodwill -- taxes from goodwill over the whole quarter this year versus a quarter in 2012 in which I think only December we had booked goodwill -- a deduction on goodwill.

So it's not fully comparable, but it helped increase adjusted profitability by 0.6percentage points in the Fourth Quarter. As a result, we had a slight net income increase of 0.1percentage points on an adjusted basis, and a 0.4percentage point increase in the Fourth Quarter.

On page 14 I would like to give a lot of emphasis on nonrecurring expenses. We are in the middle of a significant change program due to the integration of Raia and Drogasil.

We have had significant advances in the end of 2013 and in the beginning of 2014. We have finished the corporate integration, and we are clearing the way now for unifying checkout systems in the stores. Marcilio will go over that to a higher level of detail.

But what happens here is that we don't effect the level of change we are effecting without nonrecurring expenses. And we do a full disclosure of nonrecurring expenses so that any investor can understand it and consider it in any way it sees fit.

So we did, over the full year, BRL48.5 million in nonrecurring expenses. It's a high number. We know it, but it's the cost of doing the integration, of building the company that we are building. In the Fourth Quarter alone, it was BRL14.5 million.

The point I'd like to stress here is that already from the First Quarter of 2014 we see a radical reduction in nonrecurring expenses, and for very clear reasons. Last year we spent

BRL15.5 million in store closures. This is basically non-cash asset write-offs that goes to expenses.

Now store closures will be zero, because even though we'll be closing a couple of stores, maybe 5, 6 stores, they'll be part of the recurring profitability of the Company. The program is over. The closures have been successfully concluded. So already in January, when you look at our nonrecurring expenses, you see zero in store closures.

Farmacia Popular, same story. We had BRL13.3 million in the year. We subsidized the stores that lost their license in the cooperation. Over the year, we recovered the licenses.

Those expenses started last year with BRL5.5 million in the First Quarter and dropped significantly to BRL1.8 million in the last quarter. And now we have zero for the First Quarter 2014 as every single regional store is already fully relicensed, up and running in the program.

Severance expenses, we had BRL9.1 million severance expenses. We had changes in the management structure of the Company. We had restructurings and people leaving the Company. And in the Fourth Quarter, you can see an increasing severance of BRL4.4 million.

What happens here is that we have -- we still have some severance expenses for next year, but we have provisioned those expenses in the Fourth Quarter. So as we are using the provision for next year, we will also book zero nonrecurring expenses as part of severance expenses.

And finally, we booked last year BRL7.1 million in consulting expenses. We will still have consulting expenses, but to a lesser degree. So nonrecurring expenses will not be zero, especially in the First Quarter consulting expenses.

They existed because we had the support of consultants to conclude the corporate integration. We will have some level of consulting taking place to support us in the integration, but at a much lower expense volume. So I think nonrecurring expenses for next year will be a very, very low number.

On page 15, I would like to give more color on our free cash flow, which I think was one of the highlights of the year. We generated an operating cash flow of BRL282 million in the year, already considering working capital.

We invested a significant amount, BRL236.8 million, in the year. Not only we opened 131 stores, but we have also accelerated renovation of new stores -- of existing stores, especially Drogasil.

So we had a free cash flow of BRL45 million. I mean, I think this is significant. You take a year in which we invested BRL236 million, a year in which our performance was deteriorated and we lost operating margin, still BRL45 million of free cash flow. I think this is an achievement.

Then, this amount was even sufficient to pay interest on owned equity on a cash basis of BRL29 million, to pay net financial expense, net of the respective taxes, and to post a total cash flow of BRL22 million in the year.

On page 16, this is something we don't talk much, but I think it's important to highlight. I mean, we've always had, even before the merger with Raia and Drogasil, a very significant commitment to sustainability, to the bottom line.

I think we have had very strong social inclusion programs and social mobilization programs, and even environmental initiatives. I think we have not shed enough light on them in the past, and I think it's important to disclose the stuff that we are doing.

We have a model social inclusion project in Brazil. We employ more than 900 handicapped employees as part of the Side by Side project. And they are fully located, fully deployed through our stores.

We are not the only company in Brazil to hire handicapped people. This is even a legal requirement. The difference is that we are not hiding our people in distribution centers, in call centers.

We are putting them in stores where the social inclusion is full, in which the clients see what we are doing and appreciate what we are doing. So this is something -- we believe a lot in that.

Another thing is that we had very little donations to social enterprises that come from our profitability. But we use our critical mass to mobilize suppliers, to mobilize consumers, and to generate resources to causes that we believe in, that we think are worthwhile.

So last year we collected BRL3.3 million that were used to fund selected NGOs. So Raia has a social magazine named Sorria which revenues are fully -- net of taxes are fully channeled to NGOs.

So last year we donated as a result of Sorria BRL1.7 million, mostly to -- this amounted was donated both to GRACC, which is a reference youth center for cancer in Brazil, and for the Instituto Senna. This is a foundation that manages education in underprivileged areas.

And if you look, since 2008 we have collected and donated more than BRL12 million. And the bulk of that has been to GRACC to fund their new hospital in Sao Paulo. So it's something that I think is very much useful.

Leveraging the learning of the Raia social magazine and leveraging our capacity to multiply this initiative, we launched the Bem Life magazine at Drogasil. So already in the first year we collected and donated BRL0.9 million to Obra do Berco. This is an NGO that assists needy families.

And Drogasil has also had another program that we call Solidary Change, in which we invite clients to round up their purchases, and then we collect this extra amount. I mean, it's generally cents for each consumer, but BRL0.7 million in total for the year. And we are donating the amount to AACD, which is an NGO specializing in assisting disabled children.

Another thing is in terms of environmental endeavors. I think the main program that we have, and it's still a program concentrated higher, is a Conscient Waste Program, in which -- this is not something mandatory by law. It's something that we do because we believe in it.

So we have 231 Raia stores that are fully equipped to receive returns of medicines from consumers. These are used medicines. They are medicines that won't be used anymore, medicines that have expired or whatever.

So we take these -- we collect these medicines. We have collected 22 tons of residuals last year, and then we dispose of this waste correctly, considering the best environmental practice possible. And our estimate is that we are preserving up to 9,000 liters of water that could have been contaminated by such waste.

And finally, before passing to Marcilio, I think we had a very low share price by year-end. Our share price -- we had a share price reduction last year of nearly 36%, even below the IBOVESPA, as a consequence, I think, of our disappointing results and also as a function, I think, of the whole investment environment in Brazil.

But already in the beginning of this year our share price is now at something like BRL16.4. So we have a share increase year-to-date of 11%. And I think this is just the beginning to put the Company back where it should be.

I'm now passing to Marcilio to comment on our challenges for next year.

## Marcilio Pousada {BIO 16117399 <GO>}

Okay. Well let's go to the -- before proceeding to our main challenges for 2014, I wish to highlight two very important achievements in 2013, okay, with the results of 2013.

The first one is we have concluded the unification of our corporate systems. As we announced, we finalized the conversion of all Drogasil stores which were migrated to our retail platform.

We started the rollout last September, and the final stores were converted on February 28th during the Carnival. We now have 970 high end Drogasil stores fully connected to our 7 DCs under the very same retail platform and the very same financial and accounting systems all together.

This integration will help us inside our corporate structure and process and allow us to achieve a leap in execution, in customer service, and in value creation.

The second achievement for this year, in my point of view, is that we opened 131 new stores. Even with our key focus on the system integration in 2013, we opened these new stores during the year, a hybrid approach for Raia Drogasil and for the Brazilian drugstore industry.

The expansion plan has allowed us to extend our presence in the markets in which we are the leaders, like Sao Paulo and (Portuguese spoken), and also to increase our presence in recent markets Mato Grosso, Mato Grosso do Sul, and Bahia.

The team and the intentions that we had for store development are unique in the industry, and represent a huge competitive advantage in relation to our competitors. This has allowed us to lead the consolidation of our industry not only in terms of the number of the stores, but also regarding property quality and expected returns.

Please now go to slide 18, and we will try to stress the challenges for 2014, okay? And it's four main challenges this year. The number one challenge is to sustainable growth and financial discipline.

We intend to open 130 stores per year in the coming years with great financial discipline. We expect high marginal returns and positive free cash flow generation just like 2013.

As productivity in mature markets has increased year after year, we are balancing stores in these markets with entering new states, especially in the northeast. That should grow with more stores this year.

We also focus on new formats, not only Farmasil, which is still in the pilot stage, but also with a different execution for Raia and Drogasil, including both compact stores or large formats in small markets, or in big markets also.

The second challenge will be the productivity gains. With the end of the integration of the corporate systems and the beginning of the unification of the checkout systems, we will review our store processes to simplify our activities and to increase the opportunities and the service standards to our customers.

The strength in margin expansion we expect depends on our controlling selling expenses in the scenario of inflation. Our focus will be on initiatives that promote full store growth above inflation and reduce selling expense without jeopardizing the service to our customers.

At the corporate level, we intend to intensify the control of administrative expense and to increasing gross margin through category management and increasing penetration of the private label and generics.

Our third challenge for 2014 will be increasing the Omni channel position. We are one of the leaders in Brazil in telesales and e-commerce, but we are still operate standalone. We know the importance of the integrating of this channel platform to enhance the shopping experience of our customers.

Such learning is in the medium term, but we are already moving in that direction. In 2013, we will unified telesales and e-commerce with Droga Raia as a single service under the brand Drogaraia.com, and in December we launched the Drogasil.com.br website.

Furthermore, we unified the fulfillment strategy for both brands into a single site. And we will integrate the IT infrastructure in 2014, creating the basis for our vision and the basis for the growth for the next years.

And the important next challenge will be aligning pensions. We implemented in 2013 a compensation program that is based on overall goals for the Company and for each individual executive. We intend to improve this model through variable compensation program based on fixed shares that was approved by our Board for (inaudible), but to the General Assembly.

We want to reform our main executives like the CEO, VPs and Directors into shareholders to align long-term interests and establish active mechanisms to retain our key talent.

Now we can move to the questions. Thank you very much.

## Questions And Answers

### Operator

(Operator instructions.)

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

Hi, this is actually Guilherme Assis. Thanks for taking the call. My question is I'd like to have some color on the revamping plans for the Drogasil stores. Can you tell us a little bit about how many stores you have already remodeled and how many more you are planning on remodeling this year and about the schedule for the remodeling? That's one question.

I have also a second question, which is regarding the system integration. I'd like to understand -- for the checkout systems that you have already said that you are turning -- finishing this by the end of this year, I'd like to understand a little bit more about what should be the potential gains that you will expect from the integration of the checkout system. Those are my questions. Thank you.

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

Guilherme, thank you for the questions. I don't have here the correct number of stores that we opened last year -- sorry, that we renovated last year.

Since the merger until, let's say, the middle of last year, the focus on renovations was higher. We had several Raia that were rundown stores. We don't have those stores right now.

The kind of intervention that we are doing is functional. We are changing the store layout, and we are pretty much doing let's say a category management shock at the stores.

We are changing layouts. We are bringing products, OTC products from the pharmacy part to the front store. We are organizing better the categories around the stores. And we are moving the checkouts from the front of the store to the side, and this opens more space for selling gondolas and so on.

Every since the second -- whatever we did in the second semester of last year onward was pretty much Drogasil. And we still have a very strong program for this year that will be Raia stores as well, but the focus is Drogasil.

Another thing to mention is that for at least a year we have been opening Drogasil in the correct formats. So probably when we finish this year, I would say that 30% to 40% of the Drogasil stores will have been already fully renovated.

And because we are starting with the main stores, those that have higher potential, this is a parental situation. So 40% of the stores will mean 60% of the potential and something like that.

So this is progressing very well. We've started to see improvement in Drogasil. We are having, as a total for the Company, a better First Quarter in terms of revenues, slight ahead of inflation for mature stores. And in Drogasil we are still below inflation, but we are moving in the right direction.

We have the whole first semester. We are higher. We've been posting very strong numbers, carrying the momentum from last year over a weaker comp base. In the second semester, higher -- we will face a high comp and high -- we'll probably get down a couple basis points in mature store growth.

At that point, we need Drogasil to do the magic, to fill the void of this potential reduction in the high growth, though that's still a year in which we believe Raia will be doing very well over the year. And Drogasil will probably end well the year.

But if Drogasil is at inflation or even slightly above in the second semester, this is a number we can deal with since Raia will be doing well, and then positioning 2015 where both brands should be doing well.

This is an industry in which the cycle is long. I mean, all the mistakes that we do, they don't harm us the next day. They take awhile to show the effects.

And likewise, I mean, when we do things right, when we focus on execution and when we bring the Company to a new momentum in terms of store execution, this takes also a couple quarters to materialize.

But we are comfortable with what we've seen. And also, we are growing in the right direction.

System integration is something also very important. I mean, at the current stage in which all the corporate systems are unified, what happens is that first we can unify the whole corporate structure in the back office and unify the processes in the back office so there is some savings, some increase on productivity in the back office that we achieve.

But much more important than that is that we -- the execution in the stores, especially in Drogasil, starts getting better. For example, the sales terminal that we have at the pharmacy counter, this is almost a satellite of our corporate retail system.

So the sales system at Drogasil in 100% of the retail stores already is a much better sales system, in which our staff has the full information required to make sales. Let's say you ask for a specific product. We know if the product is on pharmacy coverage or not. And if it is, you probably take it for free or very little co-pay.

We know if the product has a generic, how much it costs, and you can choose or not the generic. We know if the product is part of our manufacturer program with this much of discount, if we have a partnership with a health insurance company through which the consumer is affiliated.

So there are a lot of execution things that we are already doing better in the store as a function of this integration. It takes a while to materialize, people getting used to -- with the new systems.

And as I mentioned, that we start to have full flexibility in pricing. At Drogasil, the previous system was very limited in terms of pricing. So we can now work price in a much more effective way.

It doesn't mean that the margins are going up or down because of that. But let's say that the promotional allowance that we currently have will be better distributed across stores and across products.

So this is where we are as we finalize the integration of the checkout systems. Then we start gaining in terms of CRM and more advanced promotional features that we still cannot access at Drogasil.

Just to clarify, Guilherme, we did last year 175 renovations. I think the bulk of these were Drogasil. And this year, we expect to do 215 stores. And there will be a significant number of Raia renovations as well, but the majority will be Drogasil.

## A - Marcilio Pousada {BIO 16117399 <GO>}

And these renovations -- let's back up for a bit, okay? We will have almost this number every year to renovate the stores, not only this year, okay?

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

Okay. And are you concentrating on any specific quarter of the year, or are you going to do the 215 stores throughout the year? How is this currently looking now, Eugenio?

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

Guilherme, we are starting with the renovations with the top stores, and especially the stores in Sao Paulo. So it's a combination of service oriented stores.

I mean, no doubts that when you have a format issue, it makes much of a difference with a more sophisticated service oriented consumer than it makes with a more price oriented consumer, with a less HPC driven consumer.

So we are starting mostly but not only in Sao Paulo. And we are starting with the top stores, and then we're moving down the scale. That (multiple speakers) by next year.

## Operator

Richard Cathcart, Espirito Santo.

## Q - Richard Cathcart {BIO 16457807 <GO>}

I've got a couple of questions. The first one is just about the same store sales in mature stores and whether you can give us an idea of what's happening so far in the First Quarter. I mean, we should see an improvement, given the weak comps. So should we be looking at something around 8% or 9%?

Then, the second thing, just in the Fourth Quarter, how did you manage to improve the payroll as a percentage of sales after you agreed such a large wage settlement in Sao Paulo? Thanks.

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

Richard, thank you for the questions. We are seeing a better scenario in mature stores in the First Quarter.

We had a very strong January, but probably a month that is not representative of the full year because the weather was very dry and very hot, and remember that January is rainy. So January will help, but January is not multiplied over the rest of the year.

When we see February and March, we are at a good level. We are happy with what we see, not as high as January but we are above inflation. So we should have a First Quarter mature store number ahead of inflation and better than the Fourth Quarter. So things are happening pretty well.

You also have something correctly, that we were able to have some dilution in payroll expenses in the Fourth Quarter. I think what happened here is a combination of better control, we've been more effective with that, and better revenues.

I mean, people think of sales expenses are variable expenses when indeed they are fixed expenses. Rentals are fixed. You can sell zero or two million in a store, but still pay the same rental agreed by your contract.

And the number of employees, there is very little flexibility, very little latitude in changing that because we have to cover long shifts. A lot of stores are open eight to midnight. A lot of stores are 24/7. So we need to have a pharmacist full-time at the store. We have store managers and also system managers.

And we don't have commissions. We have some variable compensation, but it's not that big at the store level. So in the end, the most important thing is basically to have a good sales performance.

So the combination of a better sales performance with some work in terms of headcount, and the reality is that I think the comp base of 2012 was probably very high in terms of people. So over the year, we were able to improve our control on the payroll.

But having costs in payroll is not something that is sustainable for the longer term. When we look longer term, payroll will be always biting part of our results. Rent is a different story.

We already see an improvement in rent in the Fourth Quarter versus the whole year. And I think this is probably sustainable, because what happened is that the property market has peaked for quite some time. So when we are renewing contracts, of course we are bringing contracts that were below market to the market level.

But each year that we do that, the increase is smaller than it was in the previous year. So I don't know if one quarter is enough to get to that conclusion. But we get the sense that rent expenses, it's still pressuring but the pressure is moving out.

So instead 0.2% that we saw over the year, we saw 0.1% in the Fourth Quarter. Let's see if we maintain that number, but it's a very encouraging number. Then, the whole plan here is tying sales expenses and recurring.

I don't know if we can tie it to expenses next year, but at least we will have total expenses in line or diluted, and then the gross improvement plus whatever stays in terms of sales expense improvement. Sales expense is a challenge, but G&A improves.

The total should be in line or slightly better. So the combination of some sales surplus on the expense side plus gross margin improvements should translate on the profitability next year.

## Q - Richard Cathcart {BIO 16457807 <GO>}

Thanks very much. Can I just have a follow up on the gross margin? First of all, just at the end, you said you're expecting that to improve in 2014. Is that mainly you focusing on generics and trying to improve conversion of that in stores?

Then, just the second thing, the comments that you made about the gross margin for the Fourth Quarter, you said that fell slightly because of the high base from the previous year. But in 2012, I was under the impression that most of the improvement came from synergies. So have you had to reinvest some of that improvement? Just a bit more color about the gross margin for the Fourth Quarter, if you can. Thanks.

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

Great. Thanks, Richard. No. The gross margin synergy, it happened in the beginning of the Fourth Quarter. So the Fourth Quarter -- sorry. Well let me rephrase it.

The purchasing improvement story happened a lot in the beginning of the year. But the Fourth Quarter of 2012, I said even when comparing to other quarters, was a very high quarter.

We had 26.2% in the Third Quarter of the year, and then we had 27.1% in the Fourth Quarter of the year. Both the Third Quarter and the Fourth Quarter were affected by the tax situation. But certainly what happened is that we probably had a higher concentration of trade allowances in the fourth Q 2012 versus the third Q 2012.

Our gross margin is not seasonal. The only seasonal part is the second part. The Second Quarter is not comparable with any other quarter. But the remaining three quarters, they are comparable among themselves.

And we see in the Fourth Quarter a gross margin that is absolutely in line with that of the Third Quarter and that of the First Quarter of the year. So I think that the gross margin of the quarter represents where we are.

And certainly we will now benefit as we get back to the older tax regime and as, in the Second Quarter, we will have a margin improvement coming from a better tax situation. So this is one of the drivers for margin expansion. I think partially it can be another driver.

We will see, but we are not counting with generics because we have stayed away from generics. We are not seeing new generics being launched. We are seeing sometimes similar prescription drugs being launched that compete with the generics, so yes, we can execute better the generics.

But in the current scenario, maintaining generics' penetration, I think it's reasonable. So mix should not be a factor in our margin improvement. Margin improvement will come from certainly the reduction of the tax scenario and possibly some purchase improvements.

## Operator

(Operator instructions.) Richard Cathcart.

## Q - Richard Cathcart {BIO 16457807 <GO>}

Hi, it's Richard again. There's only a few questions, so I will just ask one more if you don't mind. Just again on the gross margin, can you just talk about how you're seeing competition, particularly in Sao Paulo? Are you seeing any change in the competitive environment, anybody being more aggressive on pricing? So like I said, particularly in Sao Paolo, but perhaps also in some other regions as well, so the south and then what kind of experience you're having with the first few stores in the northeast. Thanks.

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

Richard, well, we have to acknowledge that I think we are now in a better market than we were before.

Having said that, we don't have pressure all across the board. We have had localized pressures. For example, Sao Paulo, not exactly in Sao Paulo. Sao Paulo is almost a profit sanctuary. We are both (inaudible) in Sao Paulo, make a ton of money, and nobody plays funny games.

So Sao Paulo is a market that we haven't seen any differences, any changes in commercial policy. And this is a very, very important base for us. Then, I think the main difference in competitive scenario, different from what most people think, is that it's not the entrance of new competitors.

We have seen new entrants in the industry, new entrants from abroad, new entrants from another industry. But these movements have been basically people buying assets. So it's existing assets under new ownership.

Existing assets under new ownership is not added competitive pressure. What is added competitive pressure is when we see competitors opening stores. We are seeing competitors existing stores -- competitors opening more stores.

And so, these openings have brought localized pressures here and there. We have margin pressures in Goiania, whose competitor is (Portuguese spoken). We have margin pressures in Espirito Santo.

But the good thing is that we have such a broad geographic presence that we can redeploy resources from markets where we don't have competitive pressures to other markets where sometimes we need to up the ante in terms of prices.

We haven't seen up until now any disturbances in the south. I think that we pressured other people in the south as we opened stores in Santa Catarina and in the capital of Parana. In the operation, you need to have lowered those margins to build the brand.

And this time, margins are moving up. Already we have a good level of margins in the south, but in Parana and in Santa Catarina. So that's a volume change movement. When you enter a new market, you have to do some additional price investment. And that's part of the calculation towards achieving the returns that we aspire and that we have historically achieved.

So I think we have only had regional pressures, and we have been able to compensate one market with others. And we have been able to maintain gross margins even on a scenario of added tax pressures.

And finally, I think this is not a cutthroat market. This is a competitive market. I think a lot of people overestimate the importance of pricing in the competitive landscape.

I think for the consumers we service in the kind of store that we operate, stores that have prime locations, stores that have easy parking, easy access, great project experience, service and so on, I think that the hierarchy of choice for a consumer is first location. So being the person in the best locations is something that absolutely makes a difference.

The second is brand. We've seen the stores are conveniently located. You choose the brands that you trust. If you are driving in Sao Paulo in the big traffic, in a big jam with security issues, you don't want to be stopping at pharmacy after pharmacy. You pick the pharmacy you trust.

But of course the brand is a promise of execution. If you feel that you were not well services, the prices were not honest or so on, we may move next time to a different player. But as far as we execute well, the consumers don't leave us.

So price is a part of execution. Prices are relevant. But prices are way, way, way less important than most investors think of.

## Operator

It appears there'll be further questions. Now I will turn the conference back to Eugenio De Zagottis for his final remarks.

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

Well thank you all for attending our conference call. We are happy to leave 2013 behind and to build upon the good stuff -- the good things that we were able -- the breakthroughs that we were able to have in the year.

So as we enter 2014, we are leveraging our significant progress in the systems integration. We are leveraging a significant improvement in store execution from the renovations and from other initiatives, and I think we are very positive for the year.

We already see a better First Quarter. It's still early to tell if the First Quarter is better or in line with last year. But we don't expect it to be worst for sure. Maybe it could be better. And I think in the Second Quarter the difference should become self-evident.

So thank you all for your support as shareholders. We know that -- we acknowledge that a lot of you have been through in the good and the bad days. And we are very happy to see that we are starting 2014 in much better shape not only in terms of sales trends but as a Company, in terms of management, in terms of execution focus than we were last year, and certainly this effort will pay out.

So thank you very much. And we are always here for visits, for calls, whatever you need from us. Thanks.

## Operator

Thank you. Raia Drogasil conference call is finished. Have a nice day.