Q2 2013 Earnings Call

Company Participants

- Eugenio de Zagottis, VP
- Marcilio Pousada, CEO

Other Participants

- Guilherme Assis, Analyst
- Irma Sgarz, Analyst
- Matthew Pasteau, 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 Second 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 will also find the slideshow presentation available for download.

We inform that all participants will only be able to listen to the conference during the Company's presentation. After the Company's remarks are over, there will be a Q&A period. At that time, further instructions will be given. (Operator Instructions)

Before proceeding, let us 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, and 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. Eugenio de Zagottis. Sir, you may begin your conference.

Eugenio de Zagottis {BIO 7193695 <GO>}

Hello everyone. Welcome to the Second Quarter earnings call of Raia Drogasil. We ended the quarter with 906 stores in operation. In this quarter, we opened 25 new stores and we also closed 10 stores. We achieved a gross revenue of BRL1.6 billion in the quarter, 16.6% of growth over the same period in the previous year and a same-store sales growth of 10.2%.

Our gross margin corresponded to 27% of gross revenues, a 1.1percentage margin decrease over the previous year.

We reached an EBITDA of BRL103.5 million. Our EBITDA grew 3.2% over the previous year and it corresponded to a margin of 6.5%, a 0.8percentage point margin contraction over the previous year.

And finally, we posted net income of BRL58.6 million which corresponded to 3.7% of net margin, in line with the previous year.

On page 4, I would like to talk about our store development program. We opened in the quarter a total of 25 stores and we closed 10 stores. We are in the middle of a portfolio optimization program in which we have already closed 14 stores in the year and we expect that by year-end we will probably have closed something like 20 to 25 stores.

This is a specific program aimed at eliminating redundant stores and increasing our productivity, and this is not a store closure pace that is likely to go forward beyond this year. Our historic closure rate has been five stores a year, so I would say in the future you will probably see five, six, eight, 10 stores at most being closed per year. But this year, this is a deliberate program and it's something of our search for efficiency.

In addition to the 10 stores closed we have also suspended five stores that are being prepared for rebranding. So they are temporarily closed and they will reopen relatively soon.

When you look at our store portfolio, 35.9% of our stores are still undergoing maturity. So this is slightly less green than we had in the previous quarter, but still one of the greenest quarters in terms of store portfolio that we have seen in the Company.

So this is great news as far as momentum for future growth, but certainly this increase pressures on our results. Because the stores, they start with a lot of preoperation expenses, then they operate for a couple months losing money, and after they break even then they start contributing to the total Company profitability.

So I think looking forward, this is great, but when you look in our current numbers, this is certainly a source of pressure.

On page 5, we can see that we have opened so far 61 new stores in the year versus only 35 in the same period of the previous year. So we are taking this year's program much faster than we did last year. Over the last 12 months, we have already opened 127 stores so we are fully on pace for the 130 stores that is the guidance that we have for this year.

We have already all the contracts already signed for this year, so our start-out program is absolutely on track. And again, when you compare 61 recently opened stores to 35 of the same period of last year, this is a source of pressure that I was referring to in our numbers.

On page 6, we ended the quarter with 906 stores in operation not considering the suspended ones. Out of these stores, 456 are Raia stores, 450 are Drogasil. So it's almost even right now.

And within Drogasil we have six stores of that are under the Farmacia brand. Farmacia is a sub-brand of Drogasil, so we count as part of Drogasil, but it's a different format.

It's a pilot format. This is something that we are still testing but something that looks very promising and that we are excited with and maybe as we reach next year this can turn from a pilot into a new strategy.

Talking about market shares, I think the main highlights of the quarter have been Goias. We have gained 2percentage points of market share in Goias by acquiring 26 stores from Santa Marta. These stores are already up and going and they have already increased share by 2percentage points.

Another highlight of the quarter has been Rio de Janeiro where we increased our share from 4.8% to 5.6%. Then the new markets, we reached Santa Catarina already 4% of market share, we reached in Mato Grosso in pretty much a year 3.4% of market share. We reached in Bahia 2%, we reached in Mato Grosso do Sul 6.3%.

So I think it's a great performance in new markets but of course we have had pressures in a couple markets, Sao Paulo specifically. We lost 1percentage point of share in Sao Paulo after a long period of growth.

Currently, one of our brand is performing very well. The other brand has proven weaker this year. We are working; we identified what are the factors that may underline a weaker performance than what we expected and we are acting upon it. So this is something, a very important message.

I think we are in a difficult year for the economy, for the country. I think retailers have felt the pressure. We may have felt some of the pressure but we are not getting comfortable with that. We are trying to exhaust any possible internal bottlenecks to unlock before we can think of what the crisis can or not do to our business.

So we are always focusing internally. I think we lost some momentum in Sao Paulo in the beginning of the year and I think we are on our pace to recover.

Then in Brasilia, the federal district, we lost 1.2percentage points of share. But here, it's exactly the fact that we haven't opened any stores for the last two years so of course that if you don't grow, you get diluted. So I think this is part of life and as we resume growing in Distrito Federal probably next year I think we will see Distrito Federal growing once again.

Then when you look for the whole country, we remain in line with last year with 9% market share. This is IMS data. IMS data, when you look one year versus another it's good data. When you look short-term trends, it's then not useful because this is not exactly demand, this is more selling from wholesalers to direct stores.

This is not selling price. This is factory price, so there are a lot of limitations on the data. When you look to ABRAFARMA information that we don't publish but we have, we gained market share in ABRAFARMA.

ABRAFARMA grew 12% in the first semester of the year and we grow something like 14% in the first semester. So we are gaining share in ABRAFARMA; in IMS we are stable. In both we see that we lost some share in Sao Paulo and we are on our way to recover that.

On page 7, breaking down our growth, we enjoyed 16.6% of total revenue growth. It's important to mention here that as we have closed and suspended a lot of stores, if you exclude from the basis the closed or suspended stores, we would have grown 18.1%.

The reason I refer to this number is to show that there is a significant gap between same-store sales growth, which was 10.2%, and what would be comparable total sales growth, 18.1% not considering (stores). So this is to show that this gap is exactly the new stores and we are very happy with how our expansion program is showing up.

If you only consider a gap from 16.6% to 10.2%, you can get the wrong impression that the new stores are not doing well. Well the fact is that as we are closing so many stores, this is something that limits our growth but this is not -- our new stores are not to blame for and the closures are. And I think it's good because we are losing on revenues but we're improving our bottom line.

Finally, a mature store can grow 5.7%. We have seen in this quarter a favorable calendar effect of 0.7percentage points versus last year. So if you take out the positive calendar effect, we will have seen mature stores growing by 5%.

This is not the level we are used to. This is not a level we want to see, but when you look around at what other retailers are posting, we cannot say that this is not a reasonable number.

I think it is a reasonable number even though it's below our expectations and it's below what we have done historically. And we are acting a lot internally to do everything we can to get back on track as fast as possible with our growth program.

As we entered the Third Quarter, we saw a weak July especially because of the weather. We have seen the coldest weather of the last 50 years in the second half of July. But then August, we are seeing an amazing beginning of the month. So it's too early to call. It's one week, but if this week proves to be the level for August, that will be a number we will be very happy about.

So overall, I would expect for the Third Quarter a more similar trend from the previous quarter. Then as you reach the Fourth Quarter, then we have a much weaker comp base and then I think we will see our figures getting back on track, not necessarily because they are improving, but because last year's comp base is weaker. But when we talk about revenue growth, we have always to look at what comp base we are talking about.

On page 8, we are discussing our sales mix. The highlight of the quarter was OTC. We saw almost 20% of growth in over-the-counter medicines. They grew 40 basis points as the participation in our sales mix so this is a very good performance.

We have cold weather in the late fall in Brazil and this is something I think helped us in the quarter. Hygiene/personal care has also proved solid with 17.3% of growth gaining 0.2percentage points of share of our product mix versus the same period of the previous year. And generics has been almost constant, a slight improvement over the previous year.

Then since the total cannot go beyond 100, if something is growing something has to go down, and branded is going down. It was the weakest category of the quarter for us.

On page nine we talk about gross margins. We experienced in this quarter a gross margin loss of 1.1percentage points when compared to the previous years. The first thing to consider here is that the figure of the Second Quarter 2012 was inflated by late negotiations, meaning that we concluded our merger in November 2011.

Already in the beginning of last year, we started negotiating with suppliers and these supplier negotiations they were only concluded in the Second Quarter. So we booked in the Second Quarter of last year trade allowances that were related to the First Quarter but they hadn't been negotiated on time to be booked in the First Quarter.

So the 28.1% comp base of the Second Quarter of last year should have been 0.3% lower than that. So this is an effect from the comp base.

Then on this quarter, we have two impacts here, 0.4percentage points from our tax situation. We have an increased tax burden and this is something that we will solve still within the year so that we can start next year with our margin back on track as far as the ICMS -- the sales tax pressure is concerned.

And finally, we implemented in this quarter a change in purchasing strategy especially on generics, on which a huge load of trading allowances that came off invoice was incorporated to the invoice price.

So economically, nothing happens because the replenishment cost is the same that we had before. But under the average cost method what happens is that when we stop buying with trade allowances, the trade allowances cease to exist immediately; and even though we have now a lower replenishment cost, that replenishment cost is yet to be incorporated to the average cost of goods.

So we expect that already on the next quarter we should see our margin get back on track and these onetime effects cease to exist. It's important to explain the reasons that led us to implement this change.

The first thing is that this kind of purchasing, which allows you to have a lot of trade allowances in generics, it brings tremendous volatility to our gross margins because in months when you buy more you usually generate more trade allowances. When we reduced the inventories, we generated less trade allowances.

So this volatility is something that will cease to exist because we are incorporating the trade allowances in the cost of goods sold. So it will no longer be related to our purchasing volume.

So the benefits are margin stability. This is very important.

The second thing is that collecting these trade allowances is never as easy as it looks like; unfortunately our suppliers they don't pay our trade allowances on a timely basis as we do with our invoices to them. So this is always a big effort collecting this money. The money is never on risk but we have always delay that pressure our cash situation. So by incorporating the invoice, the collection delays will no longer exist.

And finally, what will happen is that we will be able to reduce inventories without punishment to our margin. That is something very important, not only to work with lower cash cycles, but also to gain leverage on our suppliers because our suppliers learn the tricks.

So they know that we must buy every quarter to maintain trade allowances constant. And now, we can see if you have a lot of inventories, we can stop buying for one, two, three months, as much as we can and this will put tremendous pressures on them. And if they have sales targets to meet, this means that they will have to sell cheaper for us to buy.

So this restores our purchasing leverage that we kind of lost because of this dependence on trade allowance. So I think it's a price to be paid, but it will make for a much healthier Company going forward.

The reality is that we don't disregard the short-term, but our variable for optimization is not the quarter. It's one year, two years, three years, five years, and I think we are doing whatever it takes to get the Company where we want and to have a stronger company for the next years to come. So I think this adjustment is part of that transition.

In terms of cash cycle, we recorded a 6-day cash cycle reduction over the previous year. This was all driven by inventory reductions and we will keep reducing inventories through this year. And another thing is that as our generic inventories are getting down and generics have higher payment terms than the rest of the merchandise, we are no longer generating accounts payable for generics for the time being.

So our base of supply is kind of pressured. When our inventories get where we want and we resume buying generics on a normalized basis, we expect the base of supplies to get up and our cash cycle to reduce further.

So this is a big focus for us this year in the second semester is getting cash cycle down and generating cash this year. This is what we want to do and we are doing all it takes.

On page 10, talking about operating expenses, overall we reached an expense dilution of 30 basis points when you compare to last year. So 20.6% total expenses versus 20.9%

Of the biggest reduction was in general and administrative expenses. We achieved the reduction of 0.8percentage points.

An important part of this reduction, 0.4% to 0.5% was in variable compensation allowance. As our numbers this year in terms of profitability are lower than we expected and they are lower than the compensation targets we established, we are adjusting accordingly our compensation allowance. So this is a kind of an offset for the weaker numbers that we are posting.

In sales expenses, even though we increased 50 basis points when you compare to the Second Quarter of last year, if you compare to the peak of the Fourth Quarter of last year, we are already getting down and this is very good.

Comparing to the Second Quarter of last year, we had part of the expense pressure is structural, especially 0.2percentage point of rental increase. Then there are more transitory factors like 0.2percentage points in new store pressure. We opened 61 stores in this first semester versus something like half that in the beginning of the same period of last year. So of course, we have higher pressure from new stores.

Then as you also open a new DC in the Fourth Quarter of last year, that DC pressured 0.2% in the Fourth Quarter. But now as we are growing and we have started dilution, this is

0.1percentage point of pressure over the previous year.

So our expenses are getting down from the Fourth Quarter of last year but they are still higher, and our sales expenses are still higher than what we had at the same period of the previous year.

So our EBITDA represented 6.5% of gross revenue. A margin pressure of 0.8%. This margin pressure happened especially in our gross margin that got down by 1.1% and then was partially offset by expense improvements in 0.3%.

Another important thing to mention here is that the government introduced a provisional measure in the end of last year that reduced our social charges starting on April. The problem is that that provisional measure failed to be voted on time and expired. So we got the benefit of lower social charges on labor in April and May; but then in June, our social charges got back to normal.

Where we are now is that we are negotiating with authorities, especially representatives to get our -- not only this Company is -- as a factor our trade associations are negotiating with authorities to try to get us back on the reduction of trade allowances. We are doing our part.

Certainly there are chances for that to happen, but it is absolutely uncertain at this point in time. So we are not counting with that for the second semester. This is a 0.5percentage point expense pressure, an improvement we would have had and now it looks uncertain. So we are not counting with that.

We are looking internally wherever we can to try to reduce expenses and try to offset that pressure partially or totally. So as of now, it's difficult to predict what is the trend for the second semester.

Of course, this is looking to be a pressured year without the reduction on social charge. If we get the reduction back, then I think the outlook certainly will be much better. But again, it all depends on how much expense we can control and we are working internally pretty much as we speak.

And finally here, to illustrate the impact of new stores on our profitability, if you consider the 845 stores that have been under operation since the end of December of last year, and these are the 164 stores that we had in December less 19 stores that have been closed or suspended, these 845 stores, they have posted an EBITDA margin of 7.4% instead of the 6.5% for the total portfolio.

So it's very easy -- that we are not talking mature stores. We are talking mature stores plus mature stores opened until the end of last year. So it gets very clear the kind of pressure that we get from the new stores.

As we keep growing at least 130 stores per year, we probably don't see our portfolio of stores maturing and then we don't see the maturation potential back. We estimate that if we stop opening stores our EBITDA margin would improve by 1.5percentage points. Something like 0.5% from tearing out pre-operation expenses and then 1% of operating leverage from maturation of stores.

The day we stop opening stores we will see that whole benefit back. If our store opening decreases, progressively we see that back. If we keep growing at the same pace, that improvement gets postponed for the future, but at some point, it will have to happen. This is a future value of an asset that is already fully invested for. So it's important in understanding and considering that.

Page 12, our depreciation expenses went up by 0.2percentage points and this is very simple. More investment means more expenses.

Net financial expenses went up by 0.1%. We had less cash in the Second Quarter than we had in the previous year. But we got a big benefit from the tax shield from goodwill amortization, so we paid 0.2% over gross revenues in income taxes versus 1.3%.

So there's a 1.1% improvement which in the end means our adjusted net income stayed constant over last year at 3.7% as we show on page 13.

Talking about nonrecurring expenses, I know some investors and analysts take issue with nonrecurring expenses. We are very transparent and detailed in terms of opening what those expenses are and we understand that you don't make an omelet without breaking eggs and this is the breaking egg part.

So consulting and legal expenses from closings and store closures, for example, things absolutely related to our integration and the main line of pressure has been the Farmacia Popular program. Every Raia store got out of the program when we did the incorporation and progressively we are getting those licenses back.

In order to minimize the interruptions to our clients, we decided to subsidize the program ourselves. We know it's an important amount. It's BRL3.7 million in this quarter. Last quarter was BRl5.7 million. So this account is going down as the stores are getting relicensed; but this is something that we believe we have to do because in order to maintain our customers.

Again, this is when we refer to our long-term focus. We are willing to take short-term sacrifices like this to have a better company in the middle and on the longer term. But as the stores are getting relicensed, this number is getting down.

On page 15, we are talking about our cash generation. We had a total cash flow of negative BRL31 million in the quarter versus negative BRL39 million in the previous year. So BRL10 million better -- even considering that we have BRL10 million more in CapEx being done so as we are opening more stores we are investing more. So BRL10 million more in investments.

When you look at our results from operations, we had BRL99.6 million versus BRL95.2 million. So this led to a BRL10 million improvement in cash or less cash consumption, BRL10 million even though we absorbed BRL10 million more in investments in this period.

On page 16, our stock is down 15.3% over the end of last year. This is certainly lower than what the IBOVESPA is dropping. IBOVESPA has fallen by 22.2% in the same period.

And even with this drop in our stock price for whoever invested at the Drogasil IPO, we have posted an average annual return of 20.6%; and for whoever invested in the Raia IPO in the end of 2010, 26.6% of annual return. And this is only stock price return. We are not considering here dividends and interest on loan capital we've paid along the way.

I will now pass to Marcilio for him to discuss the progress of our integration.

Marcilio Pousada {BIO 16117399 <GO>}

Hello, everyone. I think we have only two slides for you but it's very important to highlight some points here.

I believe it is managing (events) and important points that can help us in (launching) our next year results. One of these points in integration. We had a very important date for integration in the Company, which would be September 1st. In this day we start to roll out the new system in Drogasil stores. This is very important because start to work with just one (campaign) in entire company.

We also put together warehouse and stores on the same system. This is just the beginning of rollout and for sure will transform the whole Company.

It will help reducing costs and the -- because we have a lot of departments today which work with two systems but you can be more (flexible) in prices and customers (off advertising). We are planning to (do this) in the next six months, this transition, and we know that indeed the future for this broad new construction can deliver for us a completely new company after this six months.

The next slide I will highlight some points that is doing with us right now. The store development. All the new store opening program is running as expected with the most -- we will be most opening 130 stores this year. This is very important for the future growth and you keep the same numbers the next year.

We are preparing a buffer of contracts to help us maintain the same multi-number in the beginning of 2012. Why? Because in the beginning of the years always we have a problem with the opening store in January, February, March. But this year (inaudible) for the market new stores also can do right now.

Group challenging and sales in the second semester we believe that we will close the year with the same, similar revenues scenario as revenue in first and Second Quarter also. The reduction in social charges that expired in May that Eugenio talked for us right now may be a real challenge in expense for us. But we are negotiating with the government right now how to keep these values again.

But you can increase the price in some specific markets, if your working price opportunities improve your gross margin. Finally markets where we (inaudible) these are shipment (inaudible).

We put all the management and focus on execution improvements in the stores, try to reduce the (all) in the stores, try to reduce the people in the stores, also try to save some monies for us right now.

We are working very, very close also in the inventory opportunities. Try to reduce the inventory and try to keep the number better as possible for the next year.

We really believe all these initiatives together will bring us a 2014 more profitable and ready to grow (technical difficulty), but our number one goal is finish the integration.

Eugenio de Zagottis {BIO 7193695 <GO>}

Great. So before going to Q&A, something that I would like to stress. I think on the last call we mentioned that there was so much work being done for the integration that it was still below the waterline and that was not visible.

So the analogy that I used was of an iceberg. To illustrate that further, on page 17 we put an iceberg in place to discuss and explain all the effort that it takes for the system integration to go forward as Marcilio mentioned.

There's a lot of work that goes before the results are actually collected. So we start with files unification; this is something that is absolutely crucial, like tax files, product files, and so on. Mix alignment across distribution centers. We upgraded and adequated our purchasing and logistics systems. We continually rewrote our cost management system, improving that tremendously. We have already worked on pricing and sales system.

And we are now finalizing the interfaces for the iceberg to emerge in the surface and we will really start seeing things to happen. First you will see the distribution system, the distribution centers getting implemented. Then you will see the stores being connected to the distribution center and being served by that distribution center.

And finally, next year we will change our point of sales system. The first store that will be rolled out, to roll out on September 1, this is a Drogasil store that will be served by a Raia distribution center. So at that point in time, we don't need the DC working.

But then already the next wave to happen still this year will be a full regional distribution center. Then there will be absolutely -- I will say the big proof for our systems then to roll out, roll out, roll out until we conclude the integration at the end of First Quarter and latest end of Second Quarter the next year.

So this is a crucial moment for us. We believe that this will bring so many benefits to the Company, economic benefits. This will restart the whole focus on productivity improvement and serving our consumers better. So this is something absolutely that we must do. And our number one, number two, and number three priorities, they are all the same -- completing the integration.

So with that, we go now to the Q&A.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Guilherme Assis of Plural. Please go ahead.

Q - Guilherme Assis {BIO 16143141 <GO>}

Hi. Good afternoon, everyone. Eugenio, I have actually two questions for you. I think regarding your footprint, you mentioned in your presentation that you are gaining market share in some of your markets; and you had flat or you lost a little bit in some other ones. I would like to understand your strategy for the growth from here to the future.

And regarding the mix that you have in terms of Drogasil and Raia, I would like to understand how do you see the market share, if you see an opportunity of gaining more market share by introducing new brands to regions where you basically have only Raia or only Drogasil.

It's my understanding that you are already trying to do that. I would like to understand that strategy.

And the second thing about the closing of stores that you mentioned, of closing between 20 to 25 stores, I would like to understand where do you think that you have more opportunity to close stores and how much gain would you get from closing these stores. Those are my questions. Thank you.

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

Guilherme, thanks for the questions. When you look at our growth program this is a year that we focused on existing markets. So at the end of last year we has Bahia, Mato Grosso, Mato Grosso do Sul. One year before, we entered Santa Catalina. And this year, we are keeping to existing markets and of course we are further developing the recent markets.

Next year, I think for sure we will start advancing to new markets. But then it's important to clarify that not every new market is alike. The best example that I give you is the South of Brazil. Our entry into the South of Brazil is much, much, much tougher than it is in the Northeast or in the Midwest.

Santa Catarina -- and our entry certainly being successful both in Santa Catarina, in Parana and do Sul. We already see our stores in Santa Catarina growing a lot. We will now give a lot of -- we'll increase advertising and focus a lot on new markets to further accelerate them.

But we already see Santa Catarina stores trending to a very good revenue level. The problem is that in a very competitive market, we have invested so much in gross margins ever since we entered that space.

Parana is a step ahead of Santa Catarina. The stores are already very good in revenues. The margin is already one notch upward at Santa Catarina; but that's also a market that we heavily invest on prices and we are progressively increasing our margins there.

If you compare what happened to those markets to the Midwest and to the Northeast, it's a completely different scenario. The competition is much, much softer on the Northeast and the Midwest. The tax burden within the states is much softer.

So if you look by year, Mato Grosso, Mato Grosso do Sul are starting to progress very, very well. We already have meaningful levels of revenues. The revenues point in a very interesting direction for when the maturation is complete and our gross margin is already very reasonable.

So growing into the Northeast and Midwest is not the kind of growth where we press so much our profitability like we did in the South, even though the South is resolving itself and the South is advancing in the direction that we hope.

And in terms of a mix of stores, Raia versus Drogasil, we don't have any internal targets. One good thing about Drogasil, we are completely dispassionate about our brands. Our decisions in terms of branding, when you open a store or when we rebrand a store, it's absolutely technical. It's absolutely based on what is best for us in that scenario.

So our priority for a new market is to enter with Drogasil. We believe Drogasil is a more universal brand than Raia. I think Raia is more upscale and sometimes it carries a favorable pricing perception so the whole priority for new markets is with Drogasil.

But we have a lot of opportunities for both brands in existing markets. This year we have shadowed the brands in Goias as we bought 25 stores. Half of those stores that extended our presence to new neighborhoods, they were opened as Drogasil. And the second half of stores that were located in existing neighborhoods we opened as Raia. And both brands are doing very well.

So if Goias is a pilot for a two brand scenario in the more recent market, it's been a successful pilot. So this may encourage us to shadow brands in most markets whenever we feel that the opportunity is no longer that big with the existing brand.

So we will focus with one brand; and when we believe it's tougher for the brand to grow, from that point onwards we can mirror brand. And that increases our total growth capacity in every market. So this is how we are thinking about.

We are certainly on track for 130 this year. We are starting already on next year's program.

We are putting up 130 stores. We will be in a pipeline for the 130 next year. We already have 21 stores signed for next year. More will come in the next few months.

And we are starting also to understand what to do with Drogasil if we will have a program for the -- for Farmacia, sorry, or not. So I think progressively those things will get clear for us.

We are starting to work on next year's program. We are starting internal discussions to validate the number of stores, to validate what we do or not at this point with Farmacia. So I think over the next months maybe we could have news for the market.

In terms of the closures, I think the main important is whenever we have unproductive Raia or Drogasil stores close to another store. Because in those situations, not only we eliminate stores that are not profitable but we can even allow an existing store to encourage some of the revenue.

So that's always the best (setting). In several instances, that's the case. In other instances we are correcting either mistakes from the past or stores that with time were good at some point in the history but then deteriorated.

A store is a living system, so I remember one or two years ago we closed a Raia store that had been open for almost 60 years. That doesn't mean that that store was a mistake. It means that the reason deteriorated (the status).

So we have no prejudice about closing stores. Sometimes closing stores is just as good as opening stores. You just have to be technical in terms of the criteria for closure just as we are in terms of the criteria for opening.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay, that's great. That's very clear. Thank you, again.

Operator

The next question comes from Richard Cathcart of Espirito Santo. Please go ahead.

Q - Richard Cathcart {BIO 16457807 <GO>}

Hi. Good afternoon, everyone. Just one question on the market share loss in Sao Paulo. Could you just explain in a bit more detail why you think you have lost market share?

Is it the pricing? Is it the promotions? Is it the mix in stores? Just a bit more information on that would be helpful. Thank you.

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

Richard, thanks for the question. We have been gaining share in Sao Paulo for so long, almost quarter after quarter after quarter and in fact, in this First Quarter, we lost share. I mean, IMS shows that and ABRAFARMA also shows.

When you understand now how we are doing one brand is doing much better than the other right now, and we are understanding all the bottlenecks to unlock growth for the brand that's not doing so well this year.

So I think we are basically to blame it. I think in the beginning of the year we had sometimes systems discontinuities at stores. So we are looking at every possible bottleneck to fix the bottleneck and to put stores in place.

If you consider the size of the share in Sao Paulo, we cannot -- losing 1% of share in Sao Paulo is very different from gaining 1% of shares, I don't know in Goias or Rio or whatever.

Sao Paulo is a much bigger market. So as a percentage of the total sales, 1% of Sao Paulo is nothing compared to what it could be in other markets.

So I think there's nothing new in Sao Paulo in terms of competitive scenarios especially in the metropolitan region. The metropolitan region of Sao Paulo is one of the calmer regions in the country. In the countryside there's a sometimes specific cities that may have new competitors entering, but that's part of life.

We manage a portfolio of markets. Sometimes we need to put more effort and sometimes we need to invest more money on margin in some market. But we can always withdraw from another market that is performing well. I don't think Sao Paulo is any critical in terms of competition.

That is certainly not a market where we need to -- we're neither investing nor divesting in margins in Sao Paulo. But sometimes -- Goias is a market we invest in margins and we draw margins from other markets to finance that.

So competition varies by market and varies on the time. Sometimes you have more competition. But the thing is with the portfolio of margins that we have we can generally self-compensate and not necessarily -- defend ourselves when needed and not necessarily pressure margins. So this is one of the biggest assets we have given our size and given the diversity of markets where we operate.

In Sao Paulo, it's an outstanding market both for us and to our main competitor there in Sao Paulo. We all have amazing stores, amazing locations, huge revenues per store, very healthy gross margins and nobody plays funny games in Sao Paulo.

Q - Richard Cathcart {BIO 16457807 <GO>}

Great. Thanks very much.

Operator

The next question comes from (Matthew Pasteau) of (ShareLink). Please go ahead

Q - Matthew Pasteau

Hi. On the Portuguese call I think you guys mentioned that it was likely that margins might be flat or even down this year. I know there are some social cost pressures and some pressures on your gross margin. I was hoping that you could speak to that a little bit more. That's my first question, then I had a follow-up.

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

Thanks for the question. We have been working for the whole year under the assumption that we had (technical difficulty) social charges. That's something that was already in a provisional measure, and then for silly political reasons (technical difficulty).

Then I think we probably have a more constant margin scenario for the year. Without that, I think we may have pressures on the second semester especially as we are also increasing our marketing investment.

And again, when you invest marketing you lose money in the beginning and then you make money going forward. Our hope there of optimization is not the quarter of this year but going forward.

So cutting marketing investments because we lost social charge reduction, for us it doesn't make any sense. But what we are looking at is really on operating expense reduction and efficiency that we can gain.

So this is still a question mark because we are still working internally to assess the damage for not having social charge reduction as we expected and what we can do to mitigate or to offset that.

So we are working without social charges. I think the scenario for the second semester is a scenario of pressure but we have to have the Company ready for a strong 2014.

For me, this is much more important than what may or may not happen in the second semester of the year. But again, we don't disregard the quarter and we are doing all we can to live in a different scenario than the one we prepared ourselves for.

Q - Matthew Pasteau

Got it. That makes sense and obviously it's the right decision to invest for the future even if it means the margins will be down this year.

Just turning to the longer-term, I know historically you guys have talked about potentially getting to a margin somewhere between 7% and 8% over the very long-term. Now that there are these additional pressures from social costs and some incremental pressures on gross margin, I think both of those are around 40 or 50 basis points each so that's about 100 basis points.

Is it fair to say that your longer-term target for margin has come down to somewhere closer to 6% or 6.5% versus where you might have thought it would it be a year or two ago?

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

No, Matt. Certainly I don't believe in that. The first thing is that the gross margin, all the factors that we have in gross margin are transitory factors.

Next year, our gross margin will start clean off the ICMS tax issue and this navigation, this purchasing strategy we have implemented this quarter and next quarter will be already done.

So there is no pressure at all when you think longer-term for the gross margin and if you think that our normal gross margin already incorporates a lot of pricing advancement in the South of Brazil as our brands get stronger on those markets and certainly our market investments is part of the strategy, we can even see gross margin going up because those pricing pressures will cease to exist with time and we will not necessarily require them to be reinvested in other regions. So I don't think the outlook in terms of gross margin is any different from what we expected.

Another thing is that margin pressures -- the main driver sometimes of margin pressures is revenues. For example, this year we are growing 2% less, 2% below what we expected. 2% less revenues means 0.5percentage points of less EBITDA margin, just as 2% higher revenue would mean 2% -- 0.5% additional EBITDA margins.

So this has a lot to do with the shorter term revenue navigation. For me, there is nothing here that points to a worse future than of course what we could see.

For sure having the lower social charges on taxes is better than not, so of course if we have that, that's a benefit we can count on, but fundamentally, the main driver that we have going forward is maturation. If we stop growing, this is 50 basis points of immediate improvement just by taking out preoperational expenses out of the system and then 1% operating leverage at mature stores.

I don't think -- the story going forward is nothing different from the one you know.

Q - Matthew Pasteau

Okay. Thanks so much. Congratulations on the quarter.

Operator

Our next question comes from Irma Sgarz of Goldman Sachs. Please go ahead.

Q - Irma Sgarz {BIO 15190838 <GO>}

Good afternoon. This is maybe a little bit more of a housekeeping question, but if we assume now that in the Third Quarter the payroll tax relief is not coming through and you have to make that reversal or you basically have to put through the charges of -- I think you mapped out about BRL9.4 million in payroll related charges, one-off charges for potentially the Third Quarter.

Should we think of this coming through the selling expense line or to the extent that there's been shift between the deductions from gross sales to the selling expense line? I know you make that adjustment in your adjusted P&L, but how should we think about that coming through? And would that becoming through in the Third Quarter?

Then I have a second question. Thank you.

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

Irma, thanks for the question. In April and May when we had lower social charges, our labor provisions were also adjusted down for the fact that within lower social charges regime we will have less future payments. So we reduced that. We completely separated in the Second Quarter as you may recall what was due to provisions accrued in the previous year and what was the part for this year.

So the part of this year helped a little bit in the current results; and the part related to previous years it was let's say -- it was figures that are nonrecurring revenue so to speak. So if the social charges don't get back to the social charges reduction, we will just undo what we did.

So we will adjust whatever was accrued before this year so the part of last year will be adjusted in nonrecurring and the part related to this year will be as part of the normal recurring profitability.

If I'm not mistaken, I think the main sales line that refers will be sales expenses but probably there is some part of G&A as well. But I prefer -- we probably can talk about this outside the call and then I can confirm the information.

Q - Irma Sgarz {BIO 15190838 <GO>}

Okay, that's helpful. I just wanted to actually confirm whether this is not impacting the sales reductions line. That's correct?

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

Irma, this is a very technical subject. I suggest we talk outside of the call because for me to get messed up in a wrong answer -- it's very easy with a subject like this. I want to avoid that.

Q - Irma Sgarz {BIO 15190838 <GO>}

Okay, no worries. Actually, I have another question more really a big picture and then strategic. Your product on Farmacia, it's interesting, the (interior), that you are already rolling out six stores there.

I would be curious to understand how you think about this growth potential. I know you are still assessing the early feedback or the early results from these stores, but I'd be curious to understand how you are thinking about the store openings.

Would that be incremental if you decide to go out and accelerate the rollout there in 2014? Would this be incremental on top of the 130 store openings that you're talking about? Or is this something that is potentially replacing some of the stores of the other two brands? Thanks.

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

Well let me first go to the longer-term and then we discuss what can or not happen the next year.

If Farmacia -- if our economic hypothesis on the Farmacia is confirmed, then I think we are going in that direction. For me looking longer-term there's a huge potential for Farmacia stores in Brazil. Huge, huge, huge.

Then, what I would expect is that on the shorter term, Raia Drogasil stores will be the bulk of what we do complemented by Farmacia; and then as time goes by, I think Raia Drogasil will probably become progressively lower a portion, Farmacia a higher portion of the total store openings. Because we can still double the number of Raia Drogasil, but beyond that I think Farmacia will have to do the trick.

Concerning next year, we are still discussing internally and understanding where we will go. Farmacia can either be a part of the 130, or if you feel comfortable could come on top of those. I don't have an answer right now but this is something that we are assessing before we put a formal guidance for next year.

What I can tell you is we are not opening anything below 130. So the 130, you can count on that. If Farmacia will be part of that, if Farmacia will be on top of that, time will tell and you will know once (technical difficulty) whenever we have the finish.

Q - Irma Sgarz {BIO 15190838 <GO>}

Thank you. Looking forward to the guidance then.

Operator

There appears to be no further questions. I will now turn the conference back to the Company for their final remarks.

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

Well thank you all for attending our conference call. We are very optimistic of the Company on the longer-term. I think the integration is our number one priority, our number two priority, our number three priority. Nothing is more important than integration.

There is so much value to be unlocked. Part is taking distraction out of the table. Another part is being more efficient in terms of not having duplicity of systems, not having inefficient (file) expenses and things like that.

But then I think the main potential that we will see from the integration is the exact reasons that brought Raia and Drogasil together. When Raia and Drogasil merged, until the very day that we signed the merger agreement, we were competitors who knew each other outside out -- outside in. We didn't have any targets neither for ourselves nor did we give to the market as far as synergies.

What brought us together was the complementarity between Raia and Drogasil on an asset level and on a skill level. The understanding of what we can do by putting together the best of both worlds, and I think we will see the best of both worlds when the system integration is behind us.

The impact I think is great, but I think it's very hard to quantify. We are talking about what better pricing can do. We are talking about what more and more interesting promotional formats can do. We have our own PBM that manages several programs with several companies in Brazil, but these programs are either Raia specific or Drogasil specific

For example, we have huge corporate consumers like General Motors, Fiat, Volkswagen, Ford, Scania, (Matura), Embraer and so on. And these programs are either served by Raia or by Drogasil.

Itau is a good example. We serve all Itau employees in the region where Raia is but we are not serving any employees in Brasilia for example or in Espirito Santo for example.

So whenever our systems are integrated, all of these programs can be shared across both brands. I think this can be an accelerated growth. This can be better margin management. This can be a better shopping experience for the consumer. Then this is huge, maybe, what matters.

As I mentioned, if revenues grow 2% higher than expected, this is 0.5 EBITDA margin gain. If revenues are 2% low, this is 0.5 EBITDA margin loss. So nothing is more important than being productive at the point-of-sale, of delivering a better shopping experience to the consumer; and this is what will allow us to dilute expenses and to bring our margins to the level that we expect for the future.

So thank you for your support and this is a journey, this is a marathon and not 100 meter sprint. Thank you very much.

Operator

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