Q1 2015 Earnings Call

Company Participants

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

Other Participants

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

MANAGEMENT DISCUSSION SECTION

Operator

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

We would like to inform you that this event is being recorded and all participants will be in a listen-only mode during the company's presentation. After Hypermarcas' remarks, there will be a question-and-answer session for investors and analysts, when further instructions will be given.

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

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

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

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much. Thank you very much, all, for participating. In the first quarter of 2015, Hypermarcas achieved results, which are consistent with its profitable growth strategy, with value creation to its shareholders. The company has started to harvest the fruit of the restructuring plan carried out during 2011 through 2014, a period when the company invested more than R$1 billion in the consolidation of the 23 companies acquired during 2007 through 2010. These investments had the focus on to create an operating platform with superior competitive advantage and to strength our business and our brands.

We invested in the demand generation with strong investments in mass media, medical visits and promotional activities in the points of sale. We also invested heavily in innovation with several launches of new successful products. We modernized our brands, plants and logistics, always aiming at high-capillarity distribution and low-cost operations.

As a result of all this effort, in spite of the economic crisis, our sell-out demand proved to be robust in the beginning of the year growing around 20% in both business divisions, leading to an acceleration of market share gains. In Pharma, the demand grew 19% and in Consumer 20.6%.

We gained 1.1 percentage point market share in Pharma reaching 11.1% the highest historical level. The division climbed in March to the first position of the market according to IMS Health's PPP ranking. We consolidated the second position in generics and grew 27.5% in prescription business.

In Consumer, we gained 1 percentage point of share, climbing to 8.6% of the market. Several relaunches of 2014 had very positive effects, with market share gains in many of our business and brands. In infant diapers, for example, we gained 2.8% market share, tied to the second position in volume in the market.

During the quarter, the company's net revenue reached R$1.2 billion, a 12.2% growth compared to the first quarter of 2014. On a comparable basis, we grew 15.7% excluding third-parties business. This expansion was consistent in both business divisions, which posted double-digit selling growth, 15% in Consumer and 16.2% in Pharma, excluding third-parties.

In terms of operating results, the company's adjusted EBITDA was R$286.9 million, 10.8% above first quarter 2014 or 17.1% higher, excluding third-parties. We highlight that in spite of the reduction of our gross margin in the quarter, our selling, marketing and administrative expenses were diluted resulted in adjusted EBITDA margin of 24.2%, stable compared to first quarter 2014.

The reduction of gross margin in the period was mainly resulted from the depreciation of the real against the dollar, greater than 20% in the period, impacting our EBITDA by R$13 million. To offset this impact and other cost increases, the company has launched since April a new price list with average adjustment of 8%.

In terms of net income, the company reached R$90.7 million in the quarter, slightly above first quarter 2014. This result was not only higher because of the increase of the IPCA inflation, which raised our financial expenses by approximately R$14 million in the quarter. Without the impact of both the dollar appreciation and the inflation, our net income would have been R$18 million higher or 20% above first quarter 2014.

We believe that we have done much, but there is still much to be done. We continue to believe in Brazil in spite of the crisis we are going through and will continue to invest in our business and our brands. We believe that in moments of crisis such as the one we are dealing now that a competitive platform such as the one we created opens new opportunities for the company to accelerate its growth.

Market share gains during these moments, when we witness an increase in risk aversion, prove to be even more attractive and profitable and value generation for our shareholders.

Thank you very much. I'll pass on to Martim, who will discuss a little more in detail the numbers.

Martim Prado Mattos {BIO 16015889 <GO>}

Good afternoon, everyone. Martim speaking. I'd like to go quickly through the main financial results of this quarter.

Starting on page three, we had organic growth of 15.7%, 15% in the Consumer division and 16.2% in Pharma. As a result of consistent market share gains in both divisions, our organic growth over the past 12 months was 13%, being 15.4% in Pharma and 10.2% in Consumer.

On the next page, we see that gross margin decreased 2.4 percentage points, also because of the gross margin drop in Consumer division, a division in which we have adopted a more promotional strategy in selected high volume categories. At the same time, as we had an important mismatch between cost increases as assumptions mostly of FX variation and price increases, implemented only in April.

On the other hand, we had both the new dilution of SG&A expenses ex-marketing, which are operating expenses of fixed character and a reduction of marketing expenses following this year's budget of marketing growth below net revenue growth.

Thus, as we can see on page five, adjusted EBITDA implied a slight margin reduction to 24.2%, but overall growth 10.8%. In comparable basis, as a function of sales of third-party products, adjusted EBITDA growth was up 17.1%.

Moving onto the next page, we see that net income reached R$91 million in the quarter, same amount as in the same quarter of last year. In spite of operating results growth, there was a strong increase of financial expense. Even though our debt is fully hedged in terms of FX variation, about 28% of it is exposed to IPCA inflation, which had sharp oscillation in the first quarter of this year.

Free cash flow was R$35 million in the quarter. CapEx was R$42 million in line with the budget for the year. On the other hand, cash flow from operations was up R$63 million, influenced mainly by an inventory building of about R$95 million, which was composed of packaging and raw materials for the Consumer division product. Given the great volume increase observed in the division, about half of this increase, however, was financed by supplier terms.

Thanks for the attendance. And we may now move to the Q&A session.

Q&A

Operator

Thank you. The floor is now open for questions from investors and analysts. Our first question is from Robert Ford, Merrill Lynch. Please go ahead.

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

Thank you and good day everybody and guys, congratulations on the strong sales growth and market share improvements in the quarter. Can you discuss the innovation, the go-to-market improvements, the price positioning and maybe some other things, which are accelerating the growth across your major categories of business? And how sustainable do you think those trends will prove to be?

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

Hi, Bob. Here is Claudio. I think as I said in the introduction that I believe that a big part of our results in terms of demand this quarter has been resulted from things that we have been doing in the last year, something that we have been interacting in the many fronts, which had helping us across the board, basically. And that is a small piece of innovation, a small piece of productivity. So there is much – lots of building blocks for that.

In the official front as you act, I think the growth in the quarter, for example, in the prescription business, we grew 27.5% against around 7% to 8% of the market. The decrease of that result was because of the launching of our Addera D vitamin D brand in pills which were the first to launch in the market, and we were able to do a good standing at the doctors in a very short timeframe. That enabled us to have the biggest and the most successful launch in the total pharmaceutical market in Brazil for 2014.

Similar to that, we have launched new versions of Risqué with new product formulation and product attributes, the diapers and men's grooming. So as you know, in our Consumer division, we've reached around 85% innovation index by the end of 2014. Most of the investments in product launched were able to leverage former brands with strong brand equity and then – but we were able to upgrade the product concept, product attributes and positioning properly in a way that really to increase the propensity of our consumers to take our brand and to continue doing more repurchase. So I can tell many stories, but innovation play a major role in this growth, as well as the improvement in our go-to-market capability.

When I say go-to-market, I say most of our sales and trade marketing capabilities. As you know, we have been consolidating many of our sales force since 2011. 2014 was the first year that we could have only one sales force for Consumer and one for Pharma, bundled together and we're able, given that we didn't need to make major restructuring, to focus more on productivity, they develop the adequate systems, practice, people development and all other things and to work more with the clients to see what are the opportunities. That effort also is paying back now. We are seeing many, many gains and fulfilling of our work. White space is something we have been talking a lot for very long and also has been helping us a lot.

All the work we have been doing as well in category management for OTCs now are starting showing their results.

In summary, I think the results of the quarter is more than just one point specifically, but is more a result of an effort of things that we have been doing in the mid-term. And I expect that given that now we've reached this performance level that as I said , doing a lot, but we still have a lot to do, companies that we have exhausted of our opportunities but on the contrary.

For example, when you look that we have only 51% coverage of all the molecules in the market shows the huge potential now we have to continue to grow and more important that now we can get a good product, we are more excited now that we are able to have a good growth market execution level for that product in a way that the investments of the launches, we have much bigger pace, faster pace than in the past. I'm actually sorry for it's longer than a little bit, but it's a very, let's say, big question, so.

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

That's very helpful, Claudio. And with respect to pricing, there have been a few multinationals that have already announced price increases in Brazil, ahead of yours, right? And I was hoping you could touch on maybe the behavior of your major competitors across the more important segments like Pharma, OTC, diapers, maybe some of the Health & Beauty items, in terms of what they're doing and the reception of your price hikes within that context and the magnitude of your hikes within that context please?

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

Well, I mean well, Brazil, it's a country that has been for many years a high inflation country. And then we hope we don't get back to that phase, but the fact that we started the year with increase in the inflation and at the same time, with the big hike in the exchange rate created somewhat an environment that it is company's need to increase prices to offset the margin squeeze that we have seen in the first quarter.

So there is a big momentum for that and in a way that kind of it's a collective behavior given that environment. And it's somewhat, I will not say easier, but it's a more favorable condition than in the past given that the situation we are. So the client as well understood that and understands that it's required to bypass that price increases. That we will bypass to consumers.

On the other hand, the consumers, they have been having for many years and still this year residuals and salary increases that are above the inflation and above productivity gains, but somewhat they are somewhat protected from the increase of the price increase.

And more important for our case that we compete in sample type of products that the available income to consume our products has increased, believe or not, because even that nowadays the durable markets, the discretionary consumer, more seasonal consumer and real estate those becomes very, very difficult for consumers to acquire because of the hikes and the peaks in the interest rates and the lack of availability of new credit terms ended up having more income to our product, maybe that's why one of the reasons that our markets still are so heavy for the year.

So in summary, I think the price will be passed on. Depending on what level the exchange rates stabilize, we might need to have further price increases along the year. I anticipated in the Portuguese call that we might have – we might need given the new price increase in July, but we have to see where the exchange rates stabilize.

Nowadays, the exchange rate is very volatile. As you see today, it is almost R$2.90 and then a few days ago was R$3.10. So it's something that we have to wait and stabilize a little bit to reduce the volatility and to see, but we are prepared to do that. And I think more than never, our products and our brands are in good shape for that, because we have been investing a lot on that. So they're prepared for these things. So products, now brands that haven't invested that much in marketing and innovation in the last years, I think, will suffer more as well as product concepts are too expensive. So I think this year we are quite well positioned to face the crisis.

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

Thanks, Claudio. Just one follow-up on that, when you look at the price hikes relative to the leaders in the categories, are yours above, in line or below those? And then as a follow-up to the reference to marketing spend, you seemed very comfortable on the Portuguese call with the reduction this year in terms of sales, in terms of the marketing spend. What's behind that confidence level?

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

Well, our prices are in line with the market. We are not changed our positioning vis-à-vis what we achieved, because we believe we are now in a quite good balance in terms of benefit and price consumer in a way that we believe we are well-positioned as the superior value proposition if it much drives especially in the consumer market. So we are not – we are just following the market on the price increase not changing our position and we'll not change our position.

We will continue having a strategy of continuous gaining market share, because we believe this is a year that the value investment to gain market share, it's somewhat lower than the previous year and you can conquer even more and leveraging our better execution levels, we believe it's good momentum for that and for the shareholders which we pay back in the mid and long-term.

In terms of the marketing, I feel comfortable that we can reach around 20%. Next year, we reach around 21% and the reason behind that is because the productivity of our investments has increased in the last year. So I can spend a little less in percentage terms, important to understand that also part of that percentage reduction, which if you look it's not – it was about 3% of the total percentage that is one way because of the productivity, in other way because of the dilution of the expenses.

By no means this will not jeopardize our strategy and if we needed to increase, we will do it. And we'll come back to the market and say, we will need to increase, right, because first of all that we need to implement and that's my mandate to implement our strategy.

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

Thank you very much, Claudio, and again, congratulations.

Operator

Our next question is Alex Robarts from Citi. Please go ahead.

Q - Alexander Robarts {BIO 1499637 <GO>}

Thanks and hi, everybody. I wanted just to, first of all, drill into the gross margin at the Consumer division and the evolution. And I appreciated your comments on the earlier Portuguese call, I mean talking to the effects of general cost inflation, as well as mix and as well as the currency for kind of getting us into this margin compression in the Consumer division.

And just wondering, I mean on the FX part, which you've told us is kind of the biggest source of the pressure here. I guess if the real stays where it is today it's kind of R$3-ish R$2.93, you'd get – in our numbers, I mean about twice as much depreciation in the second quarter, almost 40%, than the 20% seen year-on-year in the first quarter.

And if we think about kind of the year-on-year trends, I mean I guess we would seem to – it would seem to suggest that in July, you might have to do a kind of a mid-single, maybe high single-digit price increase. I mean is that the kind of magnitude that perhaps you might be looking for, if we see the FX still stay at these levels? And just kind of the last bit of the first question is, what is the current assumption that you've got in your budget for this year, that would be great. And then I have second question on interest expense, sorry.

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

Well, for the budget, I said in the call in the beginning of the year for 2014, that our original level of dollar was R$2.6. And for that, we would need to give somewhat at a 6% price increase and that was original plan.

Now that the dollar has gone a little over that, now it's R$2.90, let's assume that, we increase between 8% in the Consumer, which is more affected by this – actually our average is more towards 10% than 8%, 8% is on average of the total company. And then I assume that, for example, if we get something around R$2.85 to R$2.82, between R$2.80 and R$2.90, we would be in good shape to restabilize our margin in the levels as was in the second half of last year. If for any reason the dollar spike again, right, and then we need to go and do another price increase and we'll bypass to consumers, you know that. So in a way that we manage that our margins in Consumer not to be lower than the second half of last year.

Q - Alexander Robarts {BIO 1499637 <GO>}

And would you feel that this type of second price increase could be received by the market? I mean are you feeling that let's say today compared to the end of last year, I mean how is your - how is the health of your consumer, is it...?

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

This is - it's a - I mean in Brazil, there's disclosure like I said for Bob of bypassing of price increases, even when it is magnitude. So at the end, the key variable here will be the exchange rate. If exchange rate stabilized around like I said R$2.80, R$2.90, I think we are in good shape. Maybe we don't need the new price increase.

If it comes back and by any reasons those are both R$3.00 again go R$3.10 then we needed, but not only us, the whole economy, all of the players and everyone do it, because that's how I presume all this has happened. But at the end, who is going to suffer like I said? We're going to suffer the consumer. But given in our case that consumers have a bigger income to using our products, to consume our products, I think the elasticity of that will not be that high. Also because of a competition of our sector vis-à-vis other durable and semi-durable sectors, as well our self-service sector vis-à-vis door-to-door, for example, as well in our case that we have as much choice position. So if you look all that variables, probably we are in the last of the curve than many other players ahead of us that will suffer before than us.

Q - Alexander Robarts {BIO 1499637 <GO>}

Thank you. No, we think that's helpful. The second question is just more on the financial expenses. I mean I guess this 25% increase that we see in the financial expenses in the quarter to like the R$178 million level, I mean is this - if we think about, right, the debt profile, I guess 63% of your debt is linked to the CDI or the inflation. I mean these are rates that are trending upward.

I mean where are we in this basic trend? I guess I could say in the sense that is, is R$178 million for quarterly financial expense number? Is that kind of where you'd see plateauing or is there kind of - are we in the process of seeing, as we see these rates increase to perhaps get toward the R$200 million for the quarterly financial expense? So that's the second question. Thank you.

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

I personally think we are in the worse moment now, because first of all, the inflation - IPCA now is trending down. The expectation is still that we will sit down and 2016 should be leveling down back to below the 6%. So when we sit down, that's going to move now. I mean I think there was a spike now I hope, but that's what if you look to the Central Bank's estimates and also that's pretty much what's the vision now.

And on the other side, as I mentioned also in the Portuguese call, we'll have a very major – we have a relevant event in the second quarter next year, which when we're going to be able to buy back our dollar-denominated debt, which is the most expensive one.

So I might be wrong, but I think we are in the worst moment now that we have to carry these expenses back, at the same time we have a spike in IPCA and a spike in CDI. If the government do – Mr. Levy do what is he's promising, and I think it is do, because it is a Chicago mentality, then I had these orthodox view of the economy, and I hope we'll really be able to execute this plan. I think we should see things are reducing volatility, IPCA coming down, exchange rate might come back to R$2.85, R$2.80 that is a little bit when you compare to dollar index, that's what should it be, that should be around R$2.80 when you compare to dollar index. That's already clear you have to overshoot it. And I like that we're able to generate cash to further reduce and at the same time to reduce our average costs. So I might be wrong, but I think we are in the worst moment now.

Q - Alexander Robarts {BIO 1499637 <GO>}

That's helpful. Thank you.

Operator

Having no further questions, this concludes our question-and-answer session. I would like to turn the conference back over to Mr. Claudio Bergamo for any closing remarks.

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

Again thanks very much all for participating in the call. And then from our side, we will continue believing in Brazil. We believe that in spite of the crisis, we're growing. We'll continue to invest in our business, and we believe that in moment of crisis, good companies that are prepared might take advantage of it. So thank you very much all, and have a nice day.

Operator

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