

Q2 2018 Earnings Call

Company Participants

- Breno Toledo Pires de Oliveira, Chief Executive Officer
- Vivian Angiolucci, Chief Financial Officer

Other Participants

- Guilherme Assis, Analyst
- Joseph Giordano, Analyst
- Luciano Campos, Analyst
- Luiz Guanais, Analyst
- Marco Calvi, Analyst
- Maria Paula Cantusio, Analyst
- Robert E. Ford Aguilar, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to Hypera Pharma's Second Quarter of 2018 Earnings Result Conference Call. Today, we have Mr. Breno Oliveira, CEO; Ms. Vivian Angiolucci, CFO; and Mr. Adalmario Couto, IRO. We would like to inform you that this event is being recorded, and all participants will be on listen-only mode during the company's presentation. Subsequently, we will have a Q&A session only for analysts and investors, where further instructions will be provided.

We would like to inform that questions can only be post through the telephone. So, if you are connected through webcast, you should email your question directly to the IR team at ir@hypera.com.br. Today's live webcast may be accessed through the company's Investor Relations website at www.hypera.com.br/ir. We would like to inform that the information within this call reflects forward-looking statements regarding the company's future projections. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those said originally.

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

Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Good morning to everyone. Welcome to our earnings results conference call of the second quarter of 2018. Before talking about the main highlights of the quarter, I would

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like to update you about the independent committee. On May 23, our board approved the appointment of independent committee in order to carry out internal investigations for facts that were reported in April. The committee started its duties after they were appointed, and they have already hired their advisors, (00:02:36), that is a law firm, and Deloitte. And they have already initiated their activities. Currently, we do not know what the deadline it will be to finish the investigation.

Now, starting with the main highlights of the quarter, the financial side, and net revenue grew 12.6% with a highlight to Prescription product unit (00:03:03), Similar & Generic (sic) [Generics & Similar] (00:03:04). As a comparison, the growth of the pharma market of the quarter was 11.5% according to the data that we received. The truck drivers' struck (sic) [strike] (00:03:18) did not impact relevantly our sales. The inventories of raw material were okay and shipment from our distribution center, and mainly because of a great effort of the company in order to recover the shipment of finished product that weren't able to be delivered during the strike, but we were able to deliver them during the quarter.

The operational results, the EBITDA was €340 million, a growth of 12.1%, with a margin of 36.9%. The net income of continuing operations grew 23.3% and we totaled BRL 279 million. Other highlights were operating cash flow that reached its high – it's a high record, BRL 345 million. During this quarter, we ended the hiring of the new team of physicians visits (00:04:21) and focusing on gynecology, gastro, pediatrics and GP. Now we have four sales force working for established product, as well for the new launchings.

We also strongly invested in media and marketing and the point of sales during this quarter, and a growth of 32% vis-à-vis the last year, supporting our OTC brands that are part of Consumer Health. The Consumer Health portfolio, during the second quarter, we launched 14 new products. We would like to highlight: Maracugina, Zero Cal Sabores, Adocyl, Consumer Health products; and Branded Prescription, Colflex, Ofolato, Gestamax and Bifilac, that is very important for our portfolio. We also concluded the replenishing of analgesics and Miorrelax that was (00:05:27) promoted in the media and now is part of the portfolio of Consumer.

For brands in Generics, we would like to highlight the launching of parasite (sic) [antiparasitic] (00:05:36) Nitazoxanida after the molecule patent ended, which was BRL 200 million in value. Our research and development center completed one year in June during the quarter. Our investment in research and development were 4.6% of our net revenue. These investments are very important for our launching pipeline and it continues growing quarter-on-quarter.

The last 12 months, we invested strongly on the organizational structure of our production, and we have had great (00:06:18) gains of productivity and also more capacity on bottlenecks. And with this, we're able to reduce restrictions of production capacity, and we're postponing and reducing investments in CapEx. We are growing sustainably, profitably, and with cash generation. Our return over equity continues improving, totaling 15.8% during this quarter, 4.8 percentage points above what we observed during the second quarter of 2017. Now, the results of this quarter have already totaled 52% of our guidance for the year in terms of EBITDA and 53% in terms of net income. So, we're on the right pathway to deliver the guidance of the year.

Now, I would like to give the floor to Vivian that will deep dive in some points of our results.

Vivian Angiolucci {BIO 19917048 <GO>}

Thank you very much, Breno. Good morning to everyone. We're going to start with start (sic) [slide] (00:07:24) 7, talking about net income. We ended the quarter with a growth of 12.6%. Here, we have Branded Prescription and Generics & Similar. The first half of the year, we had robust and consistent growth in all the business units of the company. In Branded Prescription, we highlighted [ph] chronic (00:07:47) dermal cosmetics. We had Predsim, Alivium, and Mioflex-A. And Generics & Similar, the growth was driven by [ph] Similar (00:07:58), and we are focused on products of greater added value, Torsilax, Doralgina, Histamin, and Neosoro, that is a great product in the pharma market. In Consumer Health, we highlighted traditional brands like Tamarine and Biotônico Fontoura, in addition to Gelol, Estomazil and Epocler.

Now, going to the gross margin on slide number 8. Our revenue growth comes with an expansion of 0.5 percentage point in the gross margin. This gain of margin is because of the elevation of price higher than that of cost. We've seen that in all business units. We would like to highlight that gross margin was not affected by the exchange rate because the stock was - stock that was accumulated was before the rise of the exchange.

Now, marketing expenses grew 1.8 percentage points as a percentage of net revenue. Here, we have more expenses in propaganda, and this greater investment is due to the expenses of last year that were phased off and we had to sometimes postpone some things regarding propaganda.

Now, we - the propaganda with Consumer has grown with the greater amount of launchings. We would like to remind you that during the semester, the marketing expenses maintained themselves at the same level of last year.

Now, sales expenses had a growth below revenue. We reduced expenses of BRL 2.8 million during the quarter. Now, the sales expenses are also aligned with last year.

Now, administrative expenses. We can say that they're dropping regarding 2017, then we will have better results. During the second quarter, we had a non-recurring expense regarding that's - with (00:10:21).. In 2017, we had non-recurring expenses in the line others. This way, if we exclude these impacts that are not majority impacts from the other line, we would have a 3% higher EBITDA than last year.

In the summary, the gross result with lower sales expenses and lower administrative expenses give us a good EBITDA that was BRL 340 million. In the semester, we grew 6.4% regarding the net revenue and this represented 52% of the guidance for the year, which shows us that we're on the right path to fulfill our targets. At last, the net profit of continuous operations grew year-on-year, although the result is below 2017 and because the new level of cash flow, the growth of net income was driven by the income tax and the value of BRL 129.8 million.

Now, when we go to indebtedness on slide 9. Cash flow, we had operating cash flow of BRL 345.9 million, record 12.5% above the second quarter of 2017, and 0.4 percentage points the growth of the EBITDA during the past period. Now, the free cash flow grew 31.3%, and was impacted by investment and divestment in 2017. We're maintaining our working capital as a percentage of net revenue. Since the third quarter of 2016, we've strengthened our inventories and practically, we continue growing. We have improved our flow of cash generation, and we had a net cash of BRL 733 million, 6.6 times the EBITDA of the last 12 months.

Now, we're at your disposal to answer questions.

Q&A

Operator

Thank you very much. We will initiate our Q&A session for investors and for analysts. Our first question from Mr. Luciano Campos from Bradesco.

Q - Luciano Campos {BIO 16181710 <GO>}

Good morning, Breno, and everyone. My first question would be the effect of (00:13:18), I would like to know if it's recurring, if it's proportional to any level of research and development, or this may not happen during the next quarter?

And my second question, Breno, regarding guidance. We have observed the market expectation that is an increase of revenue that is slightly above what we see in the market and perhaps you're sacrificing margin. And because of this law, you would be able to expand this margin in order to - I would like you to tell us what can we expect during the second semester. Because if you are - you think you will fulfill your guidance, is there something regarding marketing that will bring you to what you have in your guidance?

A - Operator

Good morning, Luciano. No, regarding the (00:14:43), this law is an incentive that will be felt throughout the year. It is not a clock, so we will not have the value every quarter because all of this depends on our profit after taxes. This is something that we should also see on semester end. It is proportional to our investments and our movement.

Now, regarding the question regarding margin and guidance, I believe that the margin is highly aligned with the past quarter. During this quarter, we had some non-recurring revenues in others, and we had non-recurring revenues in the second quarter. So, I believe that the margin is highly comparable.

Now, regarding our guidance, I remember that we said 52%, 53% in terms of net income, but we have to remember that last year's fourth quarter was a challenging moment. Because we changed the accounting operation, the fourth quarter was very strong. So we believe that we're on the right path to fulfill our guidance. But I believe that there is no space to review our guidance currently at least.

Q - Luciano Campos {BIO 16181710 <GO>}

Just a follow-up in the first part of my question regarding the law that was approved. This doesn't depend on the level of search and amount that you have to invest 4% of your revenue to attain this benefit. So any investment will receive benefits, which provides us this variation. This would be the level of income of revenues taxed?

A - Operator

Well, yes, it depends on the number of pre-requirements, but these pre-requirements are not connected to investments. And research and development, yes, there are some rules.

Q - Luciano Campos {BIO 16181710 <GO>}

There are number of Ph.Ds, there are technical rules, what can be allocated to obtain this incentive?

A - Operator

Yes, what impacts our quarters, what we can – as a matter of fact, are income that will be taxed.

Our next question from Robert Ford from Bank of America.

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

I am impressed with what you have. Can you tell us about the level of inventories in your channel?

A - Operator

Okay. In terms of sellout, if we see our markets, in brands, for example, Prescription brands, Consumer Health were growing 11% of sellout during the quarter, highly aligned with the total growth, practically the same level in Generics & Similar. So, I believe the sell-in and the sellout are highly balanced. And we do not see any type of variation in our customers' inventory.

Yes, we have a level of inventory that is good within our customers that is part of a strategy. These are products of higher margins to avoid stock outs and moments of problem within our factory, or like what we had with the truck drivers' strike. So, this doesn't impact the sellout that is very important for us because we have products that have a gross margin that is around 75% on average.

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

I know that everybody expected something with the contract of football (00:19:29) and more growth, but the level of growth in the industry seems to show us the increase of prices. Can you tell us what is happening in terms of competition? Your opinion also what is behind strong growth in the rates for everybody?

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A - Operator

No, the growth of the second quarter in the market also surprised us positively. This accelerated a bit regarding the first quarter. And if we see the first semester, it is slightly above what the market expected, that was around 9% of growth for the market. So it's slightly above mainly in terms of volumes. So, the growth is in volume. The increase of price, as you said, was slightly below last year. But we have been positively surprised in terms of market growth - in terms of margin, okay, we expected less. Let's see what happens now during the second semester.

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

But aren't you observing an increase of marketing for the entire industry or do you have any concerns regarding your competition?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Well, it's not clearly visible. The level of marketing from the commercial point of view, we have not seen more aggressiveness from our competition in terms of price. Now, in terms of marketing, if they're investing more in marketing, well, we really can - we're not totally clear, but in promotional terms, we have not seen an increase in competition. What I mean is the competition being more aggressive in terms of discounts and marketing.

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

So, thank you very much, Breno, for your quarter, and thank you for answering my questions.

Operator

Next question from Mr. Thiago Macruz, Itaú BBA.

Q - Marco Calvi {BIO 19854632 <GO>}

Okay. Good morning. This is Marco speaking. Two questions on our side. The first one would be the launching pipeline because of the greater amount of investment in R&D. Could you update us and tell us what can we expect in terms of launchings of new products this year? This is my first question. And the second one, the accounts receivable, we saw a slight increase year-on-year in terms of days. I would like to know, what is this increase of years associated to year-on-year?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Oh. Hi, Marco. This is Breno. I'm going to answer the first question. Regarding the new launchings, we have invested in R&D mainly since last year when Inova (00:22:57) started to operate our R&D center. We do not disclose future launchings, but the trend is that the launchings will impact our results. But mainly as of 2019, you do know that the cycle of maturity of investment on R&D is long because both internal R&D and then when the Anvisa has to approve our research and development. I believe that these investments will mature more to the future. But we believe that during every quarter, we will see more

importance of our products. We will see more and more launchings. Now, I will give the floor to Vivian so she can answer the second question.

A - Vivian Angiolucci {BIO 19917048 <GO>}

I would just like to say the accounts receivable was already at this level since the first quarter in terms of days. Why? I don't know if you remember that at the end of the last year, the fourth quarter, we had a rupture because of production bottlenecks. And as we stabilized this, we - the channel had the ideal level of inventory. If it weren't for this inventory, we would have been affected by the truck drivers' strike. This is our conservative strategy for stocks, be it accounts receivable, because any lost sale can affect our margins.

Q - Marco Calvi {BIO 19854632 <GO>}

Okay. Thank you very much, very clear.

Operator

Next question from Joseph Giordano, JPMorgan.

Q - Joseph Giordano {BIO 17751061 <GO>}

Good morning to everyone, Breno, (00:25:00) the question here. Question is CapEx, if you already have a budget to share with us regarding all your production. I would like to know what would be your investment timeframe, and if we should think in the medium term about a new factory to have more capacity. My second point would be more specific regarding the gross margin. You said that you still haven't seen the exchange rate effect on cost. I would like to know if you could tell us what this effect could be like during the second semester.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

I'm going to talk about CapEx. Then maybe - regarding CapEx, during the last call, we said that we had improvement and we saw a significant improvement in our factory. And with this, we're able to postpone investment and CapEx without affecting the production of our products. So, we don't have a formal guidance of CapEx.

But this will not be a relevant growth like it was last year when we add here. It's important to talk about CapEx, intangible CapEx. And I believe that the analysts say BRL 300 million for the lines. I believe we won't have major variations regarding these figures that are very close to what we had last year.

Now, in the future, of course, we have to invest in growth, more middle, long-term, and we will have to carry out relevant investments to expand our industrial unit. But we still do not have any details of when and how much will be invested in expansion. But this is not something that we'll do in the short-term.

When we talk about margin and the impact of the exchange rate, the impact of the exchange rate is not immediate. We have to consider there's an interval between the raw materials come in and the - we have inventory coming in and out. There's a period here. We have to highlight here that the percentage that is in dollar is one-third and represents one-fourth of our revenue, and we also impact - the exchange rate of the dollar during the second semester will not be very significant. We believe that our margin will deteriorate a little bit, but the impact won't be as strong.

Q - Joseph Giordano {BIO 17751061 <GO>}

Okay. Thank you very much.

Operator

Next question from Mr. Luiz Felipe from BTG Pactual.

Q - Luiz Guanais

Good morning to everyone. My question is regarding Inova (00:28:18), if you could comment on the recent initiatives that have been developed or the evolution of a partnership with European universities for research, and if you already see an effect in the approval process of new medication. I believe that when you open the Inova (00:28:38), one of the points was to be more assertive in the process of R&D, and this would also help you in the approval process.

A - Operator

Luiz Felipe, as I mentioned, the cycle of R&D is along the initiatives that we started. Here, we have products here and mainly non-medications. We're talking about product that have a shorter cycles of approval. But when we start producing - when we start launching products, we want them to be robust so that the approval in Anvisa is quicker, but we still do not have many cases because of the time of operation of Inova (00:29:35) and also the time that it takes in order to approve medication. But we believe that this will positively impact the approval deadline.

Q - Luiz Guanais

Thank you very much.

Operator

Next question from Mr. Guilherme Assis, Brasil Plural.

Q - Guilherme Assis {BIO 16143141 <GO>}

Good morning, Breno, Vivian. I have two questions in reality, and I would like to elaborate on matters that were explained here. Now, regarding the Lei do Bem, I would like to know what impact this had on the quarter. Vivian said that the expenses dropped - no, they increased instead of dropping. Can we see what the impact of this quarter and also with the investment plan? There was a plan to build a model plant and that would perhaps -

perhaps that would absorb part of the production from Inova (00:31:03) and from Goiás. What is happening? Are you investing on this? So, what is the situation right now?

A - Operator

Regarding this good law or Lei do Bem, we already said it was BRL 8.5 million. This as the effect of this law of the benefit. We would like to strengthen that we used this benefit last year. The only thing is that it changes per quarter, but we cannot consider it non-recurring because we're going to have it every year. Provided we have investments in R&D, we will attain this benefit by quarter-on-quarter. Well, we believe that here, we had a greater impact because during the first quarter, we did not use this benefit.

Q - Guilherme Assis {BIO 16143141 <GO>}

Now regarding - you're talking about the pilot plant, right?

A - Operator

Yes, we still have this plan of a pilot plant, but it will be in Anápolis, in the Anápolis plant. Yes, we first considered to do it in São Paulo, but then we prefer to build the pilot plant in Anápolis because the area is proper for this plant. Yeah, it needs a slight retrofit with very low investment. We believe that the investment will be in equipment that had already been purchased. And I believe it will become operational by the end of the year. This is a pilot plant, and with this, we will attain benefits. We don't want to depend so much on the plant and to have an area that is dedicated to this, so as process make progress. So R&D, there are many processes that have to go through raw material, and the next step would be the pilot batches that I believe will be intensified as of next year. So, we are ready, this location that will become operation by the end of the year in the Anápolis industrial complex.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. Thank you very much. Now, what about the grid (00:33:34) law? There are 18.5 million (00:33:39), I just want to understand better, there are quarters where we see it, quarters where we don't see it. Can you calculate what benefits you can attain?

A - Operator

The expenses that you have of R&D, you said its 4.6% of sales.

Q - Guilherme Assis {BIO 16143141 <GO>}

Do you believe that it's interesting to see last year's value? Can we project this for the future?

A - Operator

Last year's figures, I believe that you can consider growth when we compare it to last year, when you compare year-on-year because this has really been calculated. This year, we want to calculate everything that we have, and last year, we did the same thing. So,

they're comparable. So when you compare year-on-year, I believe that figures are comparable.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. Thank you very much.

Operator

Next question from Maria Paula from BBI Investments.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

Good morning, Breno, Vivian. Thank you for taking my question. I would like to explore the investments in innovation. We can see that your focus has been greater on branded products you talked about ophthalmology, gastro and OB/GYN products. Are you analyzing other sectors? And I would like to see the share of brands, do you believe that this will increase the total sales of the company? How do you see this? You even mentioned that as of the third quarter, the fourth quarter with cosmetic products you will increase your sales. So I would like to know if this line will become more relevant in the expenses of the company with marketing. Then I have another question regarding working capital, but I will leave it for afterwards.

A - Operator

Okay, Maria Paula. The company's focus mainly during a first moment was to focus the R&D resources to branded products that give more returns to the company. So most of our pipeline, I think 80% of our pipeline, is for branded products. So - but as the pipeline and the waiting list shortens, we will also launch more Similar & Generic (sic) [Generics & Similars] (00:36:28) products plus the - but return of our investment, well, these branded products make more sense. Now, we have prescription products, where we have lower presence in markets, and we believe that we should focus on this initially. When we think about R&D resources, I don't know if I answered your question.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

So, it's clear, yes. Now, operating flex (00:37:02), cash flow it increased, it improved, but there is a line here in operational liability that this is the line called the credit to suppliers. Could you explain what does this line or this mean?

A - Operator

Credit to suppliers, I can explain this. This is basically - or these are the suppliers that have receivables for bank. So, we see everything together. When we see a supplier, sometimes we put it in the distribution center here on page 17. When I see cash flow and the cycle of cash conversion here, we put suppliers on the line of suppliers and credit per suppliers. This was a demand of the - there was a new rule that was published, and companies that have suppliers like this have to fulfill these lines. What is important is to see the traditional supplier with the line of suppliers. If you add two in the quarter, you will have an increase of BRL 10 million, BRL 11 million in cash. That is not so relevant.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

Thank you very much.

Operator

Thank you. The Q&A session has come to an end. I would like to hand it over once again for Breno Oliveira for his final remarks.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Thank you once again for participating in today's conference call, and I would like to strengthen that we are at your disposal, our Investor Relations area is at your disposal to clarify any type of questions that you may have. Thank you very much.

Operator

Hypera Pharma's Conference Call has come to an end. We thank you for your participation and have a very good day.

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