Q4 2015 Earnings Call

Company Participants

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

Other Participants

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

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to Hypermarcas' Fourth Quarter of 2015 Results Conference Call. Today with us, we have Mr. Claudio Bergamo, Chief Executive Officer; and Mr. Martim Mattos, Chief Financial Officer.

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 and further instructions will be given.

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

We also would 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 all for participating. In fiscal year 2015, Hypermarcas continues its strategy of profitable growth in both business units of the Pharma and the Consumer, both divisions posted sell-out demand growth above their market growth which resulted in market share gain in the year.

During the year, the company also started a strategic plan for restructuring its portfolio, aiming at concentrating its business in the pharmaceutical sector, in which it holds strong, superior, competitive advantage and in which it's supposed to benefit from the secular trend of aging of the Brazilian population.

Since November, the company has announced the sale of its Beauty Business to COTY for R$3.8 billion and Condom Business to Reckitt Benckiser for R$675 million. We also announced that it has set its Disposable Products for sale.

We believe that, with this strategy, we will maximize the value of our business, selling a portion of our units to companies that have high synergies to take them to new level. We also believe this strategy to be very attractive in terms of shareholder creation as it allow us to focus on our resources in the pharmaceutical market, which has very favorable mid-to-long term growth prospects.

After the close of such transactions, under a capital structure point of view, the company will have fully eliminated its net debt, start to hold a net cash position. Under strategic point of view, it will become a pure-play pharma company, number one in the market, with very strong presence in many segments and an outstanding overall market position. This same transformation, the company will start reporting its numbers based on continuing operations, which will include our Pharma division and Sweeteners and discontinued operations.

For the year – for the full year, considering both businesses, the company net revenues reached R$5.2 billion, which represent a 12.7% growth for the year. Also for the year, the company ended with an EBITDA of R$1.153 billion in line with our guidance, which was around R$1.2 billion for the fiscal year.

I pass to Martim to talk about more in details about the numbers. Thank you very much.

Martim Prado Mattos {BIO 16015889 <GO>}

Good morning, everyone, Martim speaking. As we said in our Hyper Day last December, because of the transactions we announced in our Pharma Consumer Division portfolio, we would start reporting our results segregating continuing operations from discontinued operations.

You may have noticed that both our financial statements and our earnings release, mainly presented the sales performance of our continuing operations and we will report the coming quarters that way as well.

Perhaps you may have also noticed that we included on table 19 and table 23 of our earnings release, the historical figures quarter-by-quarter of results and financial cycle of our continuing operations during 2014 and 2015.

We also included on table 9 of the earnings release, a reconciliation of the company's total operating results, including continue and discontinued operations.

But before talking about the continuing operations results, we will like to start on page four of the presentation, which shows the results under the old view and without segregating continuing from discontinued operations.

Net revenue in 2015 reached R$5.235 billion, posting good organic growth of 12.7%, mostly under influence of the Disposable products results, which grew 34% in the year, as the price increases carry out to offset the depreciation of the Brazilian real.

The gross margin was reduced by 3 percentage points during the year to 59.4%, net of expenses related to product launch. This happened because in spite of the price increases carried out during the year, the FX depreciation increase costs by 3.9 percentage point.

In addition, the steep growth in Disposable products caused a negative mix effect of 1.2 percentage points on the margin. Operating expenses were reduced from 43.2% to 42.3%, a 0.9 percentage point gain as a function of operating leverage on fixed expenses, as well as on the reduction of the company's marketing expenses.

Due to the partial closing of the sale of the Beauty Business on December 28 last year, we had capital gain of R$330 million, gross expenses. The final closing of the transaction took place on February 1 and with it we will book the remaining capital gain related of this transaction.

After depreciation and amortization, as well – no recurring expenses, the adjusted EBITDA was R$1.153 billion in 2015, still within the guidance for the year of around R$1.2 billion. The financial results virtually not yet impacted by the transactions we announced increased 30.5% in the year, amid an environment of higher interest rates and inflation in the country. Given so the net income increased 39% to R$560 million.

On the following page, we present the continuing operations results in the year of 2015. To make it clear this result reflect the complete results of our Pharma division, including the Sweetener segment. Moreover, these results reflect the company's profitability profile even after the closing of the transactions announced for Beauty, Condoms, and even Diapers.

Regarding third-party product sales, the net revenue grew 8.1% organically last year, even after 2014 which was a good growth year. The gross margins have 0.8 percentage point contraction to 74.8%, which is already net of expenses related to product losses, mostly because of the 1.6 percentage point impact caused by the increase of dollar-related input costs.

Operating expenses, much like in the total results, contributed 1.2 percentage points margin expansion, because of dilution or reduction of fixed expenses, especially G&A

expenses, as well as reduction of marketing expenses just as stated in the budget for the year.

Therefore, the continuing operations adjusted EBITDA was R$982.3 million, an 8% growth compared to 2014. As you may have noticed, continuing operations account for 85% of the company's total adjusted EBITDA, in spite of accounting for only 56% of the revenues. But we've adjusted EBITDA margin of 33.2%.

The net income of continuing operations only increased 2% compared to 2014 and reached R$345.5 million, even though the continued operations inherited most of the – almost the full financial expenses for the year.

Lastly on page six, we see that the gross debt ended the year at R$4.958 billion. The cash position on the other hand already adding up non-realized hedge gains was R$3.262 billion. Also given that, we received R$1.7 billion on December 28th as the first installment for the sale of Beauty business. Thus, the net debt after hedge was R$1.696 billion down from $2.930 million by the end of 2014.

If we also consider the amount received as the second installment for the sale of the Beauty business. And also, the amount should be received for the sale of the Condoms business, the pro forma net cash would be R$1.69 billion by the end of the year or 1.9 times the continuing operations adjusted EBITDA.

As explained during our Hyper Day, our liquidity strategy after the transactions will be pre-payng as early and as much gross debt as possible aiming at optimizing the company's financial results.

As a first move in this direction, we announced last week a tender offer to repurchase the totality of our bond outstanding in the market. We believe that with this transaction, we will be very close to our strategic goal of being acknowledged as the pharmaceutical company that we already are. If their market is emerging from this transition phase with a much more robust balance sheet, with fiscal and financial optimization, and high profitability level. We are ready to face the year of 2016.

Thanks, everyone, for the attention and support. We will move now to the Q&A session.

Q&A

Operator

Thank you. The floor is now open for questions from investors and analysts. And our first question will come from Bob Ford from Merrill Lynch. Please go ahead.

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

Thank you and good day everybody. I had a question, just to sort of to compare, and that is, when you look at last year in the fourth quarter, sales were up 19.5% excluding some of the contract manufacturing that occurred. Now, can you discuss the innovation from last year as well as the difference that you made in terms of direct selling efforts, category management efforts and other things that drove that compare. And as you cycled against that this year, how did you try to negotiate or improve upon that prior year success?

A - Martim Prado Mattos {BIO 16015889 <GO>}

Hi, Paul. This is Martim.

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

Hey, Paul.

A - Martim Prado Mattos {BIO 16015889 <GO>}

Well, 2014 was a year of – as you said, the fourth quarter of 2014 was a year of very good growth. So, I think 2015 also had a lot of initiatives on the innovation side to also support our growth levels. I think what differentiates 2015, which was very positive is that, we had a lot of initiatives on the OTC side as well, on the branded prescription side that were – that improved a lot performance of those segments in 2015.

In previous years, most parts of the highlights of the growth would come from the dealer size or on the generic side. But, we took the decision a few quarters ago to incentivize more initiatives more on the OTC and the branded prescription side, which started to mature in the year of 2015.

So, we were able to finally do some launches there on the OTC side, branded expansions on our existing brands that were – that had a very good reception out in the market as well as some launches in the branded prescription side and of which the products Addera D3 was for sure, the one that presented the highest growth of the company. And by the way, with that very good performance of that product, it became our most important product on the pharmaceutical side of the business, higher, even higher than Benegrip that used to be our business products in terms of sales.

So, in general, I think it was a very positive year for innovation as a whole. And as we've been saying, including the highest base, it's certainly an area that will continue supporting, because that's the way that we are aiming for the future to maintain our growth levels without innovation, certainty or with innovation certainty, we can do much better than in previous years.

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

Now, that's helpful. And then, I think the press release, you touch on bringing in client terms a little bit, right, bringing in those days receivable. Can you touch a little bit on what you're able to achieve and maybe how the market reacted to that?

A - Martim Prado Mattos {BIO 16015889 <GO>}

Yes. Sure. What we've been doing or what we've done in 2015 was to be very strict in terms of the terms that we do to our clients in this macroeconomic scenario with lower liquidity in the market and financial costs increasing, there is always more pressure for more terms to be given to our clients. So, I think a good achievement on our side was to be able to maintain the levels of the terms where they were. And even with that maintaining additional growth for the year, especially if you compare the growth that we have with other segments and other sectors of the economy.

So on the balance sheet, we see that and on the financial cycle, we see that on the fourth quarter, we were able to cut a little bit the average terms to our clients. And the good sight of it was that the continuing operations for the cash requirement they tend should be lower than on the discontinued operations and that was also geared towards by the end of 2015.

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

Makes perfect sense. And then, in December, there was some press reports that suggested competitor price increases were going to be moving early, right. Some reports indicate prices were being raised by 10% or 20%, primarily because of the reductions in some of the discounts. Can you talk about what you're seeing in terms of competitor pricing and dynamics? Where there happened late in the fourth quarter, what you're seeing so far this year?

A - Martim Prado Mattos {BIO 16015889 <GO>}

For some time (19:39) they've been complaining about the impacts of the dollar denominated input costs on the total cost for the industry. So, not only for Hypermarcas, but for the industry, that's a reality. And because of that some of them or a lot of them were also being renegotiating with their clients, some price increases either in the form of a new prices or in the form of reduction of discounts to try to offset that. It's aligned with the strategy we are at Hypermarcas are trying to do. And certainly, the price increase authorized by government for April this year of roughly 10% will also help the industry in recovering parts of the margin that is lost because of FX depreciation.

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

And Martim, do you – are you seeing good industry discipline or do you think this could breakdown and we could see a little bit more aggression given perhaps some greater price sensitivity in downturn?

A - Martim Prado Mattos {BIO 16015889 <GO>}

No, it's been a good performance. We don't have any clear in the market that being overly aggressive in terms of their prices or using a profitability to gain more market share. Here and there, sometimes, it occurs in some specific markets, but it's not like an overall behavior, either from local players or multinational. So, it's being a healthy competitive environment.

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

Now, that's very encouraging. Thank you. And then one last question if I might and the diapers were very impressive, your comments were focused on the year as a whole. And I was just curious if there has been any competitive response to what you've done in terms of price and innovation? And what you're doing subsequently to the cost structure to enable an ability to continue offering a very differentiated value proposition while sustaining higher levels of profitability?

A - Martim Prado Mattos {BIO 16015889 <GO>}

It was for discontinued diapers specialty, right.

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

Yes.

A - Martim Prado Mattos {BIO 16015889 <GO>}

So for diapers, 2015 was a very good year. It was a transitional year as well, it's – if I may say so. Because the FX effects lost the profitability of the segment. So I think bringing forth an initiative on our side, the courageous one, I would say that we were very aggressive on price increases during the year to help us offset that pressure.

And then meet that or even doing that our market share in that specific segment responded pretty well, it's without any significant elasticity. So it was a very good behavior for the segment and with that we were able to transition it to another level of sales that as usually (23:08) that now after those price increases, we have a different business in terms of nominal amount of (23:16) with much better profitability than at the beginning of 2015 or at the end of 2014.

So I think that was really positive to us. And we are not seeing any major counter initiatives from the competitors. They also suffered the same as we do in terms of the FX exposure. Eventually, in different times, some of them will increases prices earlier or later or will be fully hedged or not, but increase and structurally speaking, we are all invested. And so far, it's been a good behavior on the industry as a whole.

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

And then with respect to your cost structure in that business specifically, my understanding is that you've made some strategic changes in terms of how you're going to go market and the support you're going to put behind that. Can you talk about that with respect to the profitability of that business in addition to the price increases?

A - Martim Prado Mattos {BIO 16015889 <GO>}

You mean in what sense, Bob, when you say – when you refer to structural changes to the business?

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

My sense is that maybe there is just going to be a little bit leaner of the business, more of a – I think in a strong value proposition business, you got to be really tight on the SG&A, right, tight on manufacturing as well, so you can have the leanest manufacturing operations, but also very much leaner administrative structure as well. And that was my perception with what's being done with this business as you continue with the sale process?

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

Just to help that, Martim, on that Bob, it's Claudio. You're right. When the diapers was bundled with cosmetics, we ended up having SG&A more organized by or to serve more the cosmetics business, which is structurally larger SG&A. Now that we are a pharma diapers only division, we have during the carve out adjusted to our structure in order to serve the diapers, which is a more volume-oriented business as opposed to when you look to cosmetics which is more value-oriented business.

So I think and coming just to comment one on the things that Martim was saying, we were able to increase the prices, but at the same time, to maintain our market share. And also part of that is because, I believe our brands are quite well positioned in terms of the cost benefit equation. As you know, we have released our Cremer Disney and Pom Pom brands to a level of quality and the price position that we roll up in the market at align with somewhat a trade down, a trend that is happening in this segment.

So we are in the right, right sweet spot at this point because we are in like in the mid-tier price where most of the demand is moved to. And so that's very good news for us. And I think that's part of why we were able to increase price and maintain market share.

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

All right. That's very helpful. Thank you both very much.

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

Thank you a lot.

Operator

Our next question will come from Amit Maskara (27:38), a Private Investor. Please go ahead.

Hi. Sorry, I just have a couple of quick questions. One is regarding the use of cash, just want to get a sense of why wait until the year end to decide when you already have very clear visibility. The second one is on the margin development. Could you just go into little bit more detail on to how much of this margin decline or how should I think about margin progression from here. And partly related to that how much of your cost of goods sold is imported dollar denominated. Thank you.

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

Hi, Amit.

Q - Operator

Hi.

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

Let me address the first one and Martim going to talk about the margin. When we said that we wait until the year-end is more a question of cautious. We have to now to receive all the proceeds from the sale for both the Coty and then the other proceeds from Reckitt will take a while until they approve the transaction in the antitrust authorities.

And at the same time, we are in the process of prepaying many of our debts, in the meantime, and so we – at this point we have to – I mean our view to wait and see and see how our cash flow will move forward. And once we have more visibility on that, we will take to the board and then probably we have the decision. It might happen, the decision before the year end. It's just a question that we don't want to anticipate at this point until we have more visibility on these things.

So, Martim, talk about the margin side.

A - Martim Prado Mattos {BIO 16015889 <GO>}

On the margin side, I'll make a qualitative explanation, which is valid for full year, fourth quarter, and both the total operations and the continuing operations. So, in general, what we had as financial performance in the year was that we had a decrease in gross margin compared to 2014. And the main fact of that is because of FX depreciation. In affects our different businesses but it affect – so it affects all of our different businesses, but in different ways. When we look at total, it is more exposed as on the Diaper side, it is a segment where there is the highest exposure, but on the pharma side as well. So that's why on the continuing operations, we see some decline in the gross margin, both in the year of 2015 as well as on the fourth quarter of 2015. Specifically, for the fourth quarter, that impact was of 2.9 percentage points or R$22 million.

For the other pieces of our P&L, if you divide into two pieces, one is the marketing, which is a more discretionary type of expense and the other one is the more fixed expenses comprised of commercial expense as well as G&A. On that side, we tend to have increases according to salary inflation or a little bit lower than that. So, as for the total company, we had a growth in excess of that of that salary inflation, we were able to dilute those fixed costs.

And on the marketing side, on the marketing expenses, we also reduced a little bit investments in 2015. So, the overall picture is that the gross margin reduced, but it was offset by operating expenses both on the fixed – more fixed size and on the marketing side.

Q - Operator

Okay. So then how much of your, I mean, just to be – how much of your remaining COGS is dollar based?

A - Martim Prado Mattos {BIO 16015889 <GO>}

The remaining COGS 20% is dollar based.

Q - Operator

Great. Okay. And lastly, one more question, if I may. Where are we on the sale of Diapers?

A - Martim Prado Mattos {BIO 16015889 <GO>}

On the Diapers, we announced this December that or the board decided that it's a segment that we don't – we will not maintain in our portfolio. So, we are initiating a process to buyback that. But here internally, we are choosing carefully the best moment to do so.

On the financial side, we are not in a hurry because we have very, very comfortable cash position, so it's not something that we have to do in a fast manner. But on the strategic side, we will not do it as fast as we can. So we are paying very good attention to the performance, to the financial performance of which it decides the best moment to go forward with the transaction. But it's – with the caveat that its M&A, M&A is always volatile and we'll have to just deal with that, I mean, on macroeconomic environment that is also volatile.

Q - Operator

Of course. Okay. Thank you very much. Thank you.

A - Martim Prado Mattos {BIO 16015889 <GO>}

Thank you.

Operator

Our next question will come from Alex Robarts of Sun Citi (sic) [Citi] (34:23). Please go ahead.

Q - Alex Robarts {BIO 1499637 <GO>}

Yes, thanks. Its Citibank and hi everybody. I have just two questions on this and I appreciated the answers to a lot of my questions on earlier Portuguese call. But thinking about the continuing business, I guess 95% pharma as we think and look at the OpEx that we now can see with more clarity, and thanks to the way you've broken that out. One of the things in the fourth quarter that we see is the marketing expense line. And I guess marketing in the continuing business goes up to about 28% of sales when you look at the first half of the year in the pharma/sweetener business that was about 23% of sales. And I guess as we kind of looked at this delta, in other words, the surge in the marketing spend, it seem that the doctor visits were kind of driving that. And could you confirm that that might be a key factor behind explain that in the fourth quarter probably there's some seasonality perhaps there are two. But was it in fact the medical visits marketing, related marketing that drove that marketing overall expense to be higher in the fourth quarter compared to the first half? And how should we think about this going forward just – in 2016 those kind of medical visit related expenses. That's the first question? Thank you.

A - Martim Prado Mattos {BIO 16015889 <GO>}

Alex, that medical visits is basically salaries, so the salaries of our training force. So strategically what we did was by the beginning of last year 2015, we decided to change a little bit of the profile of the employees we have there and we decided also to change, to increase the number of people on this the training force we have. So both those initiatives increase the overall cost of that initiatives for the company. And it's for sure one of the reasons why our performance for the branded prescription side is being very good, we're gaining market share there, gaining share of prescriptions too. So it was, in our understanding, a very year.

So, if you look on page 21, I believe table 23, you will see that there is some increase on the nominal amount of those expenses and then it stabilizes. But when comparing to fourth quarter of 2015 with fourth quarter of 2014, there is an increase and that increase is due to those factors that I mentioned.

The biggest cause for the increase on the fourth quarter of marketing expenses as a whole was the – were other components of that on the nature side and also the trade yield side. So, those are the ones that affected the most – the strong marketing investments in the quarter.

Q - Alex Robarts {BIO 1499637 <GO>}

Okay. Okay. That's helpful. And do you think Martim that we have a level obviously – you haven't given direct guidance on this, and in the old business we had kind of 18% to 21% of sales were the marketing. But on the continued business, do you think marketing kind of stays in this area, let's say, of the upper 20% level or do you think it's more – that is particular to what's going on right now, given the marketplace and such, and perhaps the fourth quarter level of marketing as a percentage of sales is not something we should use the proxy for this year?

A - Martim Prado Mattos {BIO 16015889 <GO>}

I like to say in 2014, it was – the amount was 26.3% of net revenues and in 2015 it was 25.9%. We had an objective for the year of 2015 to decrease the amount of that that percentage, that object is meant decreasing 40 bps the total amount of (39:39). Hence for the year of 2016, we want to continue in the same direction decreasing the amount of marketing investments that we do for the company. And then on a quarterly basis, sometimes there is changes to lead as the fourth quarter was a good example of it, probably a peak in terms of those expense.

Q - Alex Robarts {BIO 1499637 <GO>}

Very helpful. So fourth quarter I guess we can see as more of a spike it seems to me. Okay, that's clear. Look, the second question is on the guidance and very helpful to see in Hypermarcas Day that you gave us this number R$1.1 billion as the EBITDA guidance number of this year. When we think about that I guess it implies a 12% growth from the continuing business in 2015. And an implicit in that, I guess there is some currency as well as I would assume industry growth estimates and implications for how you build that guidance.

Can you just share with us what the R$1.1 billion? I mean has as far as currency like what is the budget right now, the real dollar currency assumption. And with the industry as we heard earlier, the sell out in pharma decelerating in the fourth quarter to that 7% growth number from 11% in the first time months, when – I mean, what kind of industry range might the R$1.1 billion imply. So those are of the two kind of the implicit assumptions on industry growth sell out of pharma and then currency would be helpful just to understand how that guidance of R$1.1 billion is constructed. Thanks so much.

A - Martim Prado Mattos {BIO 16015889 <GO>}

Well, What it's being said about the marketing 2016 is that the growth should be maintained more or less in level with the growth that we had in previous year. So that's approximately 10% market growth. So that's the market expectations in regards to the market growth.

On the gross profit side or on the gross margin, you're right on one side we have the FX pressure. We are using an FX swap for real to U.S. dollar on our budget approximately. So we already have that cost pressure impact in our budget. But on the other hand we also going to have an authorized price increase of close to 10% beginning April 1. Both those components are included in our estimation for 2016, but obviously also support the guidance that was given.

On the more fixed expense, the expenses should be inflation-related increases. And on the marketing side, as I mentioned, we have – we then should see some opportunities there on the marketing expenses to better select those initiatives that we think that have more impact – more direct impact on the growth.

So with that, we come to with those different components, we come to our guidance of R$1.1 billion.

Q - Alex Robarts {BIO 1499637 <GO>}

Very helpful. Okay. Thank you.

Operator

Thank you. The Q&A session is now closed. 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>}

Thank you. Thank you very much, all for participating. Our