

Q2 2014 Earnings Call

Company Participants

- Jose Roberto Lettiere, Chief Financial Officer and Investor Relations Director

Other Participants

- Dean Newman, Analyst

Presentation

Operator

Good morning and good afternoon, ladies and gentlemen. Welcome to Alpargatas Second Quarter 2014 Results Conference Call. Thank you for standing by. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions to participate will be given at that time. (Operator Instructions) To follow this conference call, please access its presentation at Alpargatas Investor Relations website at ri.alpargatas.com.br.

Before proceeding, it's important to mention that any forward-looking statements provided in this conference call depends on domestic and international macroeconomic scenario, the footwear markets in Brazil and abroad and other operating factors that could affect the future results of Alpargatas.

The participants of this conference call are Mr. Jose Roberto Lettiere, CFO and Investor Relations Director; Mr. Jose Salvio Moraes, Investor Relations Manager; and Mariane Weger, Investor Relations Analyst.

I would now like to turn the conference over to Mr. Jose Roberto Lettiere. Please go ahead, sir.

Jose Roberto Lettiere {BIO 16358413 <GO>}

Good morning to all of you. We are here in Sao Paulo this morning to talk about our release of our second quarter. Starting to the page number two, where we have the summary. And first of all, I would like to emphasize that we had a very tough second quarter.

As planned, it is right to mention that it's according to our plan. When we did our operating plan end of last year, we planned a very tough second quarter, mainly due to the World Cup events. Last working day and with all the difficulties really are already over. Of course, we did not plan all the ITs in line, which we reported, especially the volatility of

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the exchange rates. And also we had other ITs, which we included or we decided to take actions during this quarter as the restructuring in Argentina and this one specifically was not included in our operating plan.

But all-in-all, I think that we had a good recurrent results with the exceptions I already mentioned, which I will talk about the details in the coming slides. Talking about our international operations, just a few comments about that. We had a great second quarter. We continue growing strongly in all our international business specifically in Argentina, which it's the current autumn not usual results considering the situation of that country.

But following our restructuring process in that country, we could deliver another good quarter. Europe and USA also had a greater performance. We continue growing, expand our retail stores, so business is really getting clear and improving profitability.

So, the internationalization strategy was a good achievement in our second quarter. Its proven that internationalization, which the company had started few years ago is now bringing all the benefits.

We had a higher marketing spend planned particularly with our brand exposure during the quarter, taking it out of the World Cup. So, we decided to make more marketing to support our brands specifically more -- in a more -- and invest more money behind the Havaianas brand with all the games during the World Cup. And our Topper brand, which is a brand which are more focused on the Soccer segment.

As I mentioned before, we had a very high volatility in our exchange rate. I will mention in more detail or talk in more detail in the current line. So, all-in-all, we continue growing the business. So, our net revenues grew by 5% during the quarter and we -- year-to-date is already 9.5%. Our EBITDA dropped significantly, mainly because of the non-recurring items, so now our net income also decreased considering all the non-recurring items as well.

So, talking about our domestic operations and going to page number three. In Sandals, we had a great event with the launch of our apparel business, which was in May. It was a very important event here in Brazil and now we are operating there with three exclusive stores.

The stores are bigger. Our Oscar Freire store is a 300 square meter store and Shopping Iguatemi in Sao Paulo, it's 150 square meters, and one we opened in Rio de Janeiro, the Leblon shopping mall, it's also about 150 square meters. So, it is a very important initiative for us to launch and to enter into the apparel business with our main brand Havaianas.

We have some information already after two months operating and in July, the brand extension products corresponded on average to 40% of sales in the Havaianas stores, which -- in which they are being commercialized.

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It has a good rate, remembering that our target for the brand expansion is to get, to reach 14% of our total Havaianas sales in five years. So, we had a good start and of course, we are talking about a few stores only, but it is a very important initial -- initiation.

So, then talking about volume, we -- during the World Cup, we anticipated the change of the collection due to the World Cup and this make -- and this made some changes in our business going forward. What happened was normally we change the collections in June and this year we anticipated and launched the new collection end of April and this caused a kind of start of declines in terms of orders. We had to, to sell the old collection and we spotted acquiring or buying our product and till date, they had all the old collections dispatched or sold. So, this delayed a little bit our sales, but in June with the new collection in place in -- with the supply already achieving all the clients, we had a very good June.

So, we grew by 8.3%, even during the World Cup. So, what, what -- another element important to mention is that normally for the last two years, our clients knowing that we were -- we had limitation with our capacity, they were carrying higher stocks, higher inventories. This year with the new plants already operating, so they are reducing their stock levels and they are putting their orders later.

Nearly now in the third -- for the third and the fourth quarter, which are the main quarters. So, this together with the World Cup impacted our second quarter sales. But another important information, so not only June was a good year, good month in terms of growing, we grew 8.3%, but July we had already this number got calculated.

So, July volume grew 29% over July 2013. So, this means that our way into the second semester is really starting in a good -- with a good performance. So, we do expect a good performance in the second semester as the collection is really performing well and as we have all the supply chain already aligned to support our clients and grow it.

Sporting Goods, demand for soccer products were boosted by Topper apparel and ball volumes by 13% due to the World Cup. And regarding other sides, the running shoes and Timberland, they did not perform well as consumers they were much more focused to buy the articles related to the World Cup.

On the retail stores, on the Retail segment, where we do operate direct, we serve exclusive stores. We had a great quarter, not only the quarter, but the year. We -- there were 467 stores in operation, of which 356 were Havaianas. We opened 76 new stores of which 68 are Havaianas and the same-store sales were very good.

We grew only in Havaianas 44%, Osklen also with a premium price, we grew 7%, Timberland 14%, and Meggashop, which is our outlet store grew 9%. Why we have these differences between our direct channels with the indirect channels. In our direct channel of course, our supply chain and the inventories are managed direct by Alparagas.

So, there is no, there is no floating in, on the inventories. So, we have a supply chain almost we could say they are just in time. So, which of course helped a lot. So, our same-

store sales for all of our brands in our exclusive stores, in all the exclusive channels had a great performance.

Osklen, just to mention we concluded the acquisition of 30% two weeks ago. We paid for this 30%, which already was in the form communicated last year. We paid R\$159 million for this 30%, which was from 67.5, which was anticipated last year, okay.

The terms are more favorable than projected in the original business case. So, now we are entering in the period to negotiate and to conclude the acquisition of the next 30%. Changes we'll take in about 60 days, in the coming 60 days.

Moving to page number four, a summary of the international operations, starting from Argentina as I already mentioned, the increase in volumes in sportswear, Topper is performing better its recovery, the volume as you know we do produce Topper in Argentina and as a consequence of the devaluation in the country. We are -- taken a better value proposition to our consumers compared to our competitors, which do report their products.

Another element is the reduction in the cost. We continue and taken a lot of efforts to reduce and to decrease cost in diluted and the fixed cost as we are increasing in recovery volume. So, our margins went up significantly, and the results of the restructuring we performed early in the year is now paying back. So, we -- the reduction we did in reducing headcount labor and also administrative positions is now being generating the benefit and improving our EBITDA.

If you look the slide, the graph on the right side of this page, you can see the improvement we could reach during the second quarter and also year-to-date our EBITDA is really better -- much better than one year ago. In local currency the results were even better, but as we consolidated in Reais, with devaluation of the pesos compared to the Real decreased this improvement.

But looking at the figures, we can -- I can say that our region is now in a -- in another, in a new shape, much more lean, the products also were reformulated and the consumers are now better -- with better -- they have a better choice as the inflation and devaluation of the country is put into the competitor's products in the different price position. So, our products is being -- is at least accepted -- well accepted by all consumers. And we continue leading the Sporting Goods segment in that country with close to 20% volume share.

Moving to page number five, talking about the USA, Europe and exports, we had another great quarter with expanding volumes, opening new stores and controlling SG&A, so the operations are getting more scale in maturity. So, it's really paid back all the investments we started doing a few weeks ago. So, margins are performing very well. EBITDA margin reached 30% in the first half of the year. Remember that we are at the high season in the North Hemisphere, we have the first semester, as the main semester of the year.

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The coming semester is normally weak, but we can see a very good performance in our international Havaianas markets. Exchange rate also helped and consolidated better results from international, as Real depreciated against the dollar and against the EUR.

Now moving to page number six. We have the consolidated net revenue. As I mentioned before, in the first semester, we are growing 9.5%, may impact this revenue. I would highlight that this operation or the recovery in the Argentinian business is plus 5.6% volume growth, 12.5% in sandals in the overseas market, another strong growth.

And in the local domestic market is where we had more difficulties as explained before, mainly caused by the World Cup and for the reasons that we post or we anticipated the launch of the new collection. But conversely the exclusive store, exclusive stores we performed a very strong same-store sales.

Prices in general, we increased price, but another important element is that the mix, the changing mix. You can see on the table you have (inaudible). In the second quarter 2013, the higher added-value products represented 38% while in the second quarter 2014, we increased to 54% of the real depreciation of the high added value products.

Sandas overseas market increased price by 11% in USA and foreign exchange is helped with all the foreign operations. With the exception for Argentina, which were negative as the peso and depreciated in comparison to the Real.

Moving to page number seven, here we have the net revenue breakdown. We increased the participation of Sandals from 48% to 54%, which is mainly due to the improvement in the mix of the higher added value products.

Looking by region, it's very important to mention that all the international operations represented 37% of our total revenues in the second quarter. So, meaning that our internationalization process is really progressing and bringing real benefit.

Moving to page number eight, talking about the EBITDA. Here I will explain in more detail of the non-recurring impact. Talking about EBITDA, last year second quarter 2013 was 130.7, 15.7% margin. Then we increased the gross profit, some operating and strategic expenses, the normal inflation, it's on expenses, launch of products, et cetera. It's below inflation and we were very focused or continue being very focused on cost control, expense control as we will use a zero based budget methodology.

So here no problem, it's all we really improved our recurring EBITDA or recurring margin went up to reach 17.9%. And then we here as demonstrated the amount of money we invest, the incremental of our amount of money we put behind our brand to market our brands during the World Cup.

So R\$25 million is the incremental marketing expense we allocated to our brand during the World Cup. So, it's not recurring because presently we are not going to have another World Cup in Brazil in the coming years.

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Then we had the major impact, we have the Forex impact and commodities. And here we have an important impact, remember that we had -- we started to hedge last year, it's about 18 months with the hedge. And last year of the second quarter, we consolidated a very positive hedging result, it was R\$29 million positive. And this year as the dollar is being controlled by the government, so the fundamentals of the exchange rates are being monitored and controlled by the government.

We had this start of the year, the exchange rate is started reaching 2.40, 2.45 and at that time is where we contract our protection for the coming 12 months. So, at that time the future dollar was around 2.40, 2.40 plus.

And what happened after March, the government or the Central Bank of Brazil is starting controlling and managing in a band of 2.20, 2.25 and this is making an accounting impact, bringing an accounting impact in our results, which is negative -- was negative in the second quarter in around R\$13 million.

So, as we are comparing, we have a swing of R\$42 million coming from the accounting, in the hedge accounting. But talking about cash, it's important to mention that since we started our hedge accounting process, we're generating cash, so we increased our cash in R\$23.5 million coming from the hedge gain.

This year, we have reported in accounting this R\$13 million in the second quarter, but in cash we used only R\$2.4 million as we are -- paid all the contracts, which was expired during the quarter.

It's important to mention that in the hedge accounting process, you need to have the -- to calculate the present value for all your future positions and bring it to the present value and in accounting, in your balance sheet, in your P&L, you need to calculate this present value comparing the spotted value against the dollar field to recover, the non-deliverable forwards currency.

So, as we are moving forward and the dollar is already changing the level, we do expect a lower impact in the hedging in our P&L, okay. So, hedge is very important for operations as we are -- we have a lot of dollar index raw materials like the rubber, as we do import goods like Mizuno. So, the hedging is very important to protect or to reduce volatility in our cash flow management and we are going to continue managing our hedge policy.

And this specific quarter, we had to report a negative impact, but the cash again it's still positive, where we are -- we had a positive cash flow result from our hedge operations.

Going to the next page number nine, net income, Talking about net income and in this slide the intention here was again to isolate the non-recurring item you can see on the right side of the graph, where you can see the non-recurring items impacted net income.

Of course, the main impact came from the lower EBITDA which I already explained in the previous slide, but also we had here impacting the non-recurring items or the elements

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like the restructuring in Argentina, okay and the start up of the Montes Claros plant. So, we had our net income also reducing due to the non-recurring items.

Cash flow in the slide number 10. Comparing last semester, one year ago through the close of the second semester 2014, we had an operational cash flow generation of R\$150 million. So, we are continuing generating cash. And on the right side of the bridge, you can see how much we already paid to our shareholders, is another important cash outflow. So, ending with a cash balance of R\$670 million, increasing around R\$31 million on our cash position.

Our cash net of debt on the slide number 11 is very balanced, we were sustainable. Our business model is very focused on cash generation. Our cash conversion cycle is being under control below 60 days, around 57 days. And we have cash generation as our key major indicator within the Company.

Talking about shareholders compensation on slide number 12, we already paid interest on equity. The first payment was in April, R\$22.9 million. The second one was in July on the 3rd, we paid 23.5 and we are now planning another payment for August the 10th, will be R\$24 million totaling the three -- these three blocks totaling R\$70.4 million, which is -- which will represent a payout of 50%.

So, this was what I had to talk and explain to you regarding the second quarter, but I also would like to expand or is that few words talking about the second semester. We already reported in our press release some guidance.

We do expect a strong second semester mainly for our Sandals business, which already reported a very strong June and a very strong July in terms of volume growth. And we see the new collections perform well and with the new plants increasing or advancing either ramp up.

We are going to enjoy a very strong second semester for the Sandals business, which we do expect to generate or to reach volume growth by the end of the year, our volume growth around 10%.

Another element -- important element is talking about -- is regarding our Sporting Goods. We do expect the volume growth in the Sporting Goods to accelerate in the second semester, maybe for Mizuno and we do expect an increase of up to 5% in the volume growth for the year. Argentina, we've continued growing our Sporting Goods and our Footwears business and our volume growth is expected to be between 6% and 18% in the year.

So, we really are very optimistic. The market is very challenging in all regions, Brazil, Argentina, US, Europe, so the world is really being, experiencing a very difficult period, but we are very confident with the work we are conducting in our areas. And our brands are very resilient and we are very confident that we're going to improve our performance during the second semester.

So, okay. So, now, Salvio, Mariane and I, we are here and we are ready to answer your questions as you wish. Thank you.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Dean Newman from Invesco.

Q - Dean Newman {BIO 5474727 <GO>}

Hello, there. I just want to check one thing, that the line went bad for me when you were explaining that you expect a strong second half, especially in Sandals and you are talking about very strong June and July volume growth, and then you said that the new product ramp up isn't advanced. When you are just going to go and talk about what volume growth might be in Sandals for the second half and I didn't hear that. Could you just explain that again, please?

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

Yes. Hi, Dean. We -- as explained in June, we already grew 8%, July 29%, and our expectation for the full year is to grow 10%. So, which means that we are going to continue reporting strong double-digit strong sales in the coming months.

Q - Dean Newman {BIO 5474727 <GO>}

Yeah.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

The major growth in fact in the second half will come from Brazil.

Q - Dean Newman {BIO 5474727 <GO>}

Yeah.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

Because, as you know, in the second half of the year, sales volume, they are lower in international operations, mainly in US and Europe, because of the seasonality, right. So, the 10% estimate is for Havaianas as a whole, Brazil and the rest of the world, volume growth, but mainly pushed by Brazil in the second half of the year.

Q - Dean Newman {BIO 5474727 <GO>}

Okay. Thank you very much. That's clear. Thank you.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

All right. Thanks.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I would like to invite Mr. Jose Roberto Lettiere to proceed with his closing statements. Please go ahead, sir.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

Well thank you very much for your participation. Just I would like to highlight that we will continue to focus our business model on cash generation. And our brands are very well supported by important initiatives and the launch of the brand extension for Havaianas is really performing very well.

And as I mentioned before, our second semester for our Sandals business is really, we have a great expectation as the new collections is performing very well and we are entering in the high season for this business.

And our major -- we are very -- our major concern at the beginning of the year was really Argentina, but now with all the restructuring we conducted is really bringing great results and now we are also very confident that our Argentina business will continue to deliver its strong results as we did in the first and second quarter.

Okay. So, thank you.

Operator

That does conclude Alpargatas' audio conference for today. Thank you very much for your participation. Have a good day and thank you for using Chorus Call.

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