FINAL

Bloomberg Transcript

Q3 2016 Earnings Call

Company Participants

- Eduardo Galanternick, E-Commerce Director
- Fabricio Garcia, Chief Operating Officer
- Frederico Trajano Inacio, Chief Executive Officer
- Roberto Bellissimo Rodrigues, Chief Financial Officer

Other Participants

- Fabio Monteiro, Analyst
- Guilherme Assis, Analyst
- Pedro Fagundes, Analyst
- Unidentified Participant

Presentation

Operator

Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Magazine Luiza's Conference Call referring to the Results of the Third Quarter of 2016. At this moment all participants are connected in listen-only mode. Afterwards, we will have a question-and-answer session when further instructions for you to participate will be given. (Operator Instructions)

Now, we would like to turn the floor over to Mr. Frederico Trajano, CEO of Magazine Luiza. Mr. Trajano, you may proceed.

Frederico Trajano Inacio {BIO 17269235 <GO>}

Good morning, everyone, and thank you very much for participating in our conference call. We have members of our Executive Committee with me today, and they will be available to answer your questions together with myself.

Today we have Roberto Bellissimo, our CFO; Isabel Bonfim, our Administrative Officer and Controller; Fabricio Garcia; our COO for our brick and mortar store stores; and Eduardo Galanternick, E-Commerce Director; Marcelo Ferreira, In charge of LuizaCred -- Office of LuizaCred.

Going straight to our results, undoubtedly we had the best quarter in the year. It was a very well balanced quarter and with a significant improvement in practically all the indicators that are published. And I would like to highlight sales here. We had an additional highlight for our E-commerce, with a 24% growth. In spite of a comparison basis that was higher last year. E-commerce really broke a historical record with about 25% participation in the overall sales of the company. So, this is a record that we have been celebrating it.

But also the brick and mortar stores delivered growth for the first time since the beginning of the crisis. For six quarter, we were not delivering positive same-store sales increases. And I would like to highlight about this increased participation of our Northeast stores. This is an important area for us. We've grew very well there. Also, our virtual stores, which we have in small cities like less than 50,000 inhabitants with a positive performance and recovery of the stores that are in the Greater Sao Paulo area, including Sao Paulo, but also all of these surrounding municipalities. So these were the major highlights.

And I would like to reinforce the fact that all the major categories; telephony, image and white line also had growth in this quarter. And white line, in spite of the fact that we had a cold September, which impacted the comparison basis, because last year it was hot, so in spite of that it grew.

Also an evolution of our gross margin. And I would like to say that the best companies I know do not commit profitability in order to gain market. They have competitive prices, however, the increased loyalty of their clients mainly because of the top level of service and respectful relationship with the clients and Magazine Luiza is and continues to participate in this group of companies. We have very high approval and we have a very sophisticated -- I believe that this is one of the best performances in retail.

About expenses, the indicator after sales that really pleases me the most is the work that we do together with the whole team because it's very difficult to dilute fixed costs. Net expenses in the country such as Brazil that is highly indexed and has high inflation rates, and all our expenses increased 8%, 9% a year, so being able to dilute expenses and keeping them nominally stable requires a very major effort on the part of the team that work on this and we had an extraordinary job done by the team that participated our ZBB and also in our expense management matrix.

These two projects we started last year, at the end of last year, focusing on this difficult scenario and the projects are maturing, our negotiations as well and a very good job done by the teams and because of that we had a 1.4 percentage point dilution of SG&A in the quarter, which is rather significant and Roberto Bellissimo will get into details afterwards.

And improvement in sales, improvement in margin 63.4% to BRL180 million in our EBITDA, 8% increase. And to finalize, I would like to say that very often profitability is not translated into cash and we were able to do this in this quarter. We had a good operating cash generation, with improvement in working capital. And by materializing this result, we were able to reduce our net debt by BRM 465 million and bring our leverage net debt-EBITDA ratio to 1.2 times, which is historically very low and that gives us a favorable condition for our future.

And before giving the floor to Roberto, I would like to say that, in our view, in the company's view, the worst part of the crisis has already been overcome. I'm not saying that the scenario is good, but it is no longer deteriorating and we have the outlook for a recovery. And we know that Magazine Luiza will leave this crisis back in a very strengthened manner to tap into trend of the Brazilian economy and the consumer sector as well.

Very advantageous condition to tap into the benefit of these trends. And in my view, these trends are growth of e-commerce, with increased penetration of broadband and also mobile access in Brazil. Magazine Luiza is probably the best, or one of the best companies to really tap into the growth of e-commerce and this has become evident in the last few quarters. In the last two quarters of last year, we grew more than the market average and with profitability.

And the second one is the recovery of the economy as a whole, most probably if no problems in the political arena happens, we will see a gradual recovery of the economy towards 2017, and we will be well positioned to grow in our brick and mortar stores as well, in this economic recovery for next year and also the drop in the SELIC rate, that tends to substantially reduce one of our main expenses, which is the interest expense and also improvement [ph] for Luizacred which has a strong impact from the reduction of SELIC rate. So once again, I believe that we are quite well prepared to tap into all the benefits of this economic rebound and the better indicators and the migration of E-commerce to electronic commerce.

And now Roberto Bellissimo will take the floor and then we will be available to answer your questions.

Roberto Bellissimo Rodrigues {BIO 17269312 <GO>}

Good morning, everyone. Thank you for participating in our call. Let us start on page number three, where we show the evolution of our stores. We opened four stores in the quarter and 11 stores in the last 12 months. We have more store openings that should happen in the last quarter of this year.

And when we look at investments, we invested BRL28 million in the third quarter, 78 in the year which is lower than last year, but especially in technology, it is higher than last year and this is one of our strategic focuses.

On the next slide, number four, we would like to highlight the evolution of our growth quarter-on-quarter. And you can see very clearly that the first one of 3% than 5% in the second quarter, and now 11% growth in the third quarter, showing a positive evolution. And in the year 6% growth compared to the IBGE of 8% drop for the sector, so a difference of 14 percentage points vis-a-vis this IBGE ratio, which shows our market share gains.

And brick and mortar stores, as you can see here on the lower part of the slide. At the beginning of the year, it was negative and then we have this rebound. And E-commerce growing by 24% in the quarter, accumulating 28% in the year. According to the E-Bit, the E-commerce grew 10%, we grew 24% and for the year to-date the market 7% and we 28%. So you can see a strong market share of gain in our online operations.

On page number five, we show the evolution of our gross margin 1.5 points more than last year. Operating expenses -- the breakdown, you can see that selling expenses dropped by 1 percentage point vis-a-via our overall sales, a very strong dilution and also administrative expenses dropping by 1.5 point more in gross margin and practically 1.5 in reduction of our SG&A.

Almost 3 points evolution in our EBITDA. And we had the effect of the reduction of our equity income of 0.3, mainly at Luizacred and then afterwards, we will be talking about that. But both Luizacred and Luizaseg continue to be very consistent, contributing to our equity income of about 15 million, 16 million every quarter, representing 0.7% of our net revenue.

On the next page, page number six, we show this evolution of EBITDA that went from 5% the same quarter last year to 8% this quarter, one of the highest EBITDA margins ever since we went public and due to the growth in our margin and dilution of operating expenses, and a rigorous control of our expenses with ZBB and also the Expense Matrix Management.

On page number seven, our financial result. This quarter also we see an improvement vis-a-vis last year for the first time in this year. In the quarter, SELIC was comparable to the same SELIC rate last year and we improved by 40 basis points in the quarter. Highlighting the other financial expenses here; ex-interest on receivables prepayment that dropped from 47 million to 37 million, representing basically the cost of our debt service, which dropped because of the drop in our indebtedness level.

Interest from prepaid receivables grew due to the growth of our sales basically, and the growth in Cartao Luiza, Luizacard was very stronger this quarter also aligned with our strategy, growing by more than 20%. Sales by means of our Luizacard and sales by means of third-party cards growing as well, due to the increase of sales and E-Commerce. I would like to remind you that this expense is totally linked to the CDI and that has started to go down and that will continue to go down in the next few quarters. So this will have a positive impact on our financial expenses in the future.

When we look at our net indebtedness in the quarter, reduced over BRL100 million from June to September, from BRL850 million to BRL750 million. And when we look at the 12 month -- in last 12 months, BRL475 million, reducing our leverage quite a lot. And due to the growth of our EBITDA and reduction in our net debt, this is why we were able to get a very good reduction in our leverage and working capital contributing to our cash generation as well.

In 12 months, we improved by 300 million. Our working capital in the quarter, a little bit over 80 million, and practically all the lines, especially in a better relationship between inventory and suppliers.

And our suppliers balance finances our inventory today, so we have a positive with growth in sales and positive cash generation. Net income on the next page, 25 million in the quarter, 41 million in the year, still impacted by the level of interest expenses.

And on page number nine, we show Luizacred, highlighting growth in sales of Luizacred of 12% and Luizacard in Magazine Luiza especially 22%. We can say that the participation of Luizacard in the brick and mortar stores of Magazine Luiza has reached the highest level of all times due to a very strong partnership between (inaudible) stores and Luizacred and this is very important to increase loyalty of our customers.

And another important highlight in the result of Luizacred is the non-NPL, as you can see at the end of last year it was 12.7. In nine months it dropped to 10.6, dropping by more than 2 points going back to historical levels before the crisis, late 2014, early 2015. And this has been helping Luizacred improve the situation regarding allowance for doubtful debts.

And on the next page, we show that the operating income of Luizacred went from 15 million in the third quarter to 45 million this year. Last year there had been a tax credit because of the increase in the tax rate from financial institutions and this year we do not have this effect. So we have a higher tax burden, so the net income was lower, but the operating income was much higher than last year's with a ROE of 19% annualized, which is a very good return.

Now, I would like to give the floor back to Frederico.

Frederico Trajano Inacio {BIO 17269235 <GO>}

We would like to open for your questions. And I would like to say that we gave you more information regarding our strategy of digital transformation in this release, and I would like to remind you that the company's strategy is to become digital with physical points. And we have five pillars for this digital transformation, multi-channel is the first one; then digital inclusion; digital stores, digital platform, marketplace and digital culture. We have 25 projects in these five pillars and, you know, release we gave you a lot of visibility for the evolution of this process. So, in this release, we tell you how we are executing this strategy.

As I said, all our executives are available here to answer your question and also our purchasing officer.

Questions And Answers

Operator

Ladies and gentlemen, now we would like to start our Q&A session. (Operator Instructions) Our first question comes from Mr. Fabio Monteiro from BTG.

Q - Fabio Monteiro {BIO 3711690 <GO>}

Good morning, everyone. Could we talk about same-store sales that increased 5.5% in brick and mortar stores? You talked about E-commerce quite a lot, but in brick and mortar stores, traditional stores, what's your highlight in a specific segment? Because you said that you gained share in image or TV, white line and telephony or maybe per region, is there any highlight, was growth balanced in all the regions? And maybe you could give us some color about the effect of physical brick and mortar stores becoming digital. I know that this is not yet in all the stores, but how much is this contributing to growth in your brick and mortar stores?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Fabio, this is Frederico. Thank you for your questions. As I said, in our conventional stores the highlight was the Northeast, growing almost the same as E-commerce, a very significant growth. On a comparison base that has a lot of opportunity to grow with our virtual stores that are in a way digital stores, the stores that we have in small municipalities with less than 50,000 inhabitants with very good results.

For quite some time, but especially in this quarter, these are smaller markets where we have a good market share, but we continue to grow and they had a very good performance. And also in the Greater Sao Paulo area -- the Greater Sao Paulo area is the first one to feel and the first one to recover from economic changes. So, we had a very positive quarter for the Greater Sao Paulo, which in the previous quarters was being impacted and this was a very good turnaround for us.

And about categories, I would like to turn the floor over to Fabio, and then I will come back.

A - Fabricio Garcia {BIO 17269261 <GO>}

Good morning, Fabio. In categories, the major highlight for white line, image and telephony. In telephony and image telephony and image, we grew by two digits. In telephony more and in white line lower. What we see is that only Magazine Luiza is growing in these areas, in these categories. About the Greater Sao Paulo, as Fred said, the growth in Greater Sao Paulo besides everything that we have been doing, in the stores we also focused on digital transformation in this region. So this helped quite a lot.

We changed IT in almost all of the stores, and this is allowing us to gain market share. And about the impact of digital transformation, in the stores that have already been transformed, we see 10 percentage point higher than the other stores. So this is helping our bottom line as well. So, these are the highlights that I could mention about our growth in our brick and mortar stores.

One follow-up. How many stores have underwent digital transformation, when will you reach a 100%?

In the case of stores where we can experiment the product is 687, and until April or May an additional 120. Then we will have all this technology furniture, which we consider telephony and IT, and also image, TV, et cetera. So, with all this kind of equipment the store becomes more consumer-friendly, and up to smart exchange, for instance, you can bring your used telephone and exchange it for a new one or give this as part of the payment. So, by the end of next year, we will have this implemented in all the stores. Thank you.

Q - Fabio Monteiro {BIO 3711690 <GO>}

Thank you very much.

Operator

Guilherme Assis from Brazil Plural.

Q - Guilherme Assis {BIO 16143141 <GO>}

Good morning, everyone. Fred, Fabricio, thank you for my question. Regarding your plan to open new stores, you mentioned that you opened new stores in this quarter, and more stores in the last 12 months. So, we see that the market is quite tough, but I understand that you have a long-term view of the business, so could we have an idea of what you consider as being a sustainable pace of opening new stores for next year, for instance? Could you be accelerating expansion? And talking about the opportunity that you see, in which regions do you think you have a better opportunity to resume growth and better market share gains? So this is one question.

And the other question has to do with the marketplace. It is part of your digital transformation strategy. You have already been able to implement quite a good part of that. And what about the rollout? What is your objective in terms of SKU, in terms of participation in your E-commerce channel?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Guilherme, good morning. Thank you very much for your questions. I will answer the first one about the opening of stores and then Eduardo will give you more highlights about the marketplace and we gave you some visibility in the release, but he will be talking about that anyway. Being very careful because we cannot give guidance about this, okay. So, I have to be very careful.

What we can say is that in the first half, we opened just a few stores because of the scenario, because of the crisis and we were giving priority to renegotiate the already existing contracts. So, almost my whole expansion team was renegotiating rental contracts and not opening stores. So, we opened less than we would like.

Our model is multi-channel. I reinforce this and we believe that the brick and mortar stores continue to be relevant. However, our E-commerce is extremely relevant and channels, it's not one plus one is two. One plus one is more than two for multi-channel. So, it's important for us to be in more markets, have more products, and the brick and mortar stores have to be lean. We are not paying the -- we are just renting small spaces and very low cost per square meter, military discipline, I would say.

And having said that, we tend to increase the number of stores that we are opening. And the stores besides being a point of sale, the stores are distribution points. They are becoming micro DCs. The 100% of the stores will have the system of store pickup so, it's very good for E-commerce as well, because it reduces the cost of delivery of E-commerce, which is the highest cost. In E-commerce the delivery is very -- can be very expensive. I cannot quantify, but we should open a significant number of stores in the future, always respecting these rules of rationality as I mentioned.

Q - Guilherme Assis {BIO 16143141 <GO>}

Where do you see more opportunity to gain market share in terms of regions? And you mentioned that the Northeast was a major driver of your growth this quarter. Do you believe you can further grow in the Northeast or is there any specific regions that you see a better opportunity for growth?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Guilherme, what I can say is that, for the next couple of years, we have already mapped in the current state, where we already have stores, we have over 300 possibilities of new store openings. So this is not a guidance. Okay. We have already mapped the potential of opening 300 new stores, both virtual and brick and mortar in all the states where we have operations. We have no preference for a state. We have to be in TV, we have to be within the ranges of the distribution centers, if the population can support the opening of new stores, so all markets are valid. So, of course, we give priority to those that bring us a low rental expense. And so, we do not have a specific preference in this regard.

A - Eduardo Galanternick {BIO 20410320 <GO>}

Guilherme, this is Eduardo speaking. Regarding marketplace, as we published in the release, we have 40,000 SKUs in this first phase up to September, beginning of October this year. We are getting into the second phase, the expansion phase that goes until the end of the year. And our biggest concern is to guarantee consistency in our catalog. And we have to give the consumer very good shopping experience. This is fundamental and for that the catalog has to be very well formatted with a very good matching.

And in the second phase, the expectation is to place an additional 40,000 SKU at least. And then next year we will have the scale part of our program and our objective is in our catalog -- absorb extensively [ph] the Brazilian market. We believe that there are in million SKUs in the Brazilian market being sold and we will be ready to have all that.

Q - Guilherme Assis {BIO 16143141 <GO>}

You mentioned in the release, Polishop and some smaller ones, what is your strategy in this regard? What about your negotiation to have more sellers for your platform and what about the -- how does -- does this match the SKU evolution, the objective of getting close to 1 million SKUs marketplace? Do you have a timeframe for that, so that we may be able to estimate the marketplace growth?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Overall, we have a very strong relationship with the sellers' market and we started our integration with (inaudible) and the sellers that use this platform, so we are integrating with other platforms that will help us. We started with incremental categories. First, we didn't work with that before then afterwards we started to work with categories that we operate with and the speed of implementation. We believe it will be gaining scale next year, as we integrate more and more platforms. We cannot give you a timeframe and say well, up to the end of next year we will reach so much, but we believe that we will be gaining speed gradually as we integrate with many different platforms.

Q - Guilherme Assis {BIO 16143141 <GO>}

And VTEX -- in this (inaudible) with VTEX, do you have any idea how many potential sellers they could bring to you, this is the way -- is this the way you look at it besides VTEX?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Without having an internal, an in-house structure to tap into this relationship with sellers, VTEX has over 1,000 retailers on the platform. So on VTEX alone you have a very big opportunity to grow. In our CRM base, we are already participating in fairs and we already have over 300 retailers that have said they would be interested in joining the platform, but we are dealing with this very carefully, because we are very concerned because of our track record of very good services to the client, we have the best scores at the (inaudible) and we are the best in all the categories that we sell and we always receive awards for customer service.

So, we are very careful in our expansion, because we have to be consistent and we have to be sure that we will be placing sellers that have the same degree of concern that we have regarding customer service. So, we do not want to accelerate and to the determent of our consumers.

We will be placing other platforms, of course. they are naturally integrated. And we have a very automated platform that we developed together with Luizalab, which has the Open IPs and even companies that are not in these platform, they will be able to integrate, but the pace of expansion will depend on whether the seller has the same concern with the consumer that Magazine Luiza has. And we are very -- being very prudent in this regard.

Q - Guilherme Assis {BIO 16143141 <GO>}

Thank you, Fred. May I ask one last question, maybe Fabricio regarding your inventory levels at the end of this quarter. Based on my calculations you have 79 days inventory compared to 74 last year. In your strategy, what is your expectation toward the fourth quarter for Black Friday, which will be at the end of this month and for Christmas as well? And how does this reflect on this inventory, if you have an increment of five days, according to my calculations, does this mean that you have a better expectation for these two very important events, The Black Friday and the holiday season?

A - Fabricio Garcia {BIO 17269261 <GO>}

Guilherme, yes, we do have a very good expectation for the end of this year. We will have a very good Black Friday and also the GO Day, which is very strong part of the inventory, is for product for the warm season. And we expect to have a very warm November and December, which will further drive our sales. So, seasonal products and the holiday season. On the other hand, we are being able to expand our terms with our suppliers and that has been offsetting our working capital. Thank you.

Operator

Pedro Fagundes from Goldman Sachs.

Q - Pedro Fagundes {BIO 20029197 <GO>}

Good morning, everyone. I have two questions. The first one, I would like to understand your relationship with your suppliers and more specifically two points, the first one, if there is more flexibility in terms of your price policies in order to share, this more difficult macro situation right now, when we saw some remarks about that in the results published by (inaudible) and others, other manufacturers? And also, I would like to know if you still have some tailwind regarding the exchange rate vis-a-via last year?

And the second question or the second point has to do with the online market, just to have an update from you and understand the recent competitive situation. Do you believe competition is more rational or is it worse and what about the take [ph] rates of the company with this level of growth?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Pedro, thank you for the question. I will answer it myself. About suppliers, we have a very close relationship with our suppliers. We are very important clients of most of our suppliers in all segments that we operate and we have a win-win situation. We cannot win to the determent of the supplier and Magazine Luiza see these relationships as a win-win situation, otherwise it will not be good for anyone.

And in moments of crisis and moments of economic recovery as well, these are the moments when we have to sit down and we have to talk and negotiate and we plan. Everybody wants to increase sales and increase profitability. And the more balanced the relationship is, the better it is for everybody. I do not believe in this stand-up, top down or whatever. I think it has to be hand-in-hand and not top down.

And about your second question, Pedro, we have been repeating this since the beginning of this year and even last year we were already saying that we already expected a more rational market. And I say that the crisis has many negative points. It has a one positive point because in crisis, nobody can afford to be foolish because it's very, very expensive to be irrational.

Both online and offline, we see that the sector has become more rational. Companies that had a lot of liquidity in the market, a lot of credit in banks and suppliers and capital increase, with no big explanation, they growth, that growth model that were not sustainable, because of that. And based on what I've seen from the market and based on what I read about public information, the move toward rationality is present and as the crisis -- the market is no longer deteriorating. However, it will take quite a long time to recover, the good years that we had in the past and we believe that rationality will continue, not only for this last quarter, but for next year as well.

Most of the players will be obliged to be rational, even if they don't want to be rational. And we have always been a rational player, as I said at the beginning of the presentation, when I talked about our gross margin and about the exchange rate, it is still a little bit too early to talk about that, it is stable. One or other good negotiation with Black Friday, nothing very relevant, but I believe next year, it will be more relevant to lower the prices of products that are international, mainly electronics, but for this year, it doesn't play a very important role, probably more important role next year.

Q - Pedro Fagundes {BIO 20029197 <GO>}

How much of your COGS is annualized?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

What?

Q - Pedro Fagundes {BIO 20029197 <GO>}

The COGS.

A - Roberto Bellissimo Rodrigues {BIO 17269312 <GO>}

There are components -- electronic components dollarized and if you go to white line, it is less. I don't have a percentage to inform you. It can be a very small percentage and in some cases, like smartphones, they are more dollar-based. Thank you.

Q - Pedro Fagundes {BIO 20029197 <GO>}

Thank you.

Operator

(Operator Instructions) (inaudible).

Q - Unidentified Participant

Good morning. Thank you for the question. (Technical Difficulty) store pick up. You said that you will end the year with 687 stores already in the store pickup model. What other initiatives do you have regarding multi-channel?

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Thank you for the question. We have whole array of initiatives and most of our endeavors are being focused on that. We want to have very quickly 100% of our stores and the current pickup model, you buy on the website, we send new merchandise from our DC to the store and then you go there and pick it up. And the next step, once we implement it in all of the stores, is to allow the person to buy the product on the website and we deliver the inventory that is already present in the store. So, we gain delivery time. Today you have from 48 hours to 72 hours, depending on the flow in each store. And with the next step, we will be able to deliver on the same day. So, this is one additional step.

And another project of multi-channel that we are completing already, the client buys on the website and can return the product in any store. But this process was a little bit bureaucratic when the client wanted to return the product at the store. And we are improving the system, also of cancellation of purchases so that the client experience or shopping experience and the store incentive is better.

So, we will be implementing the necessary tools over next year, and clients will be able to return the product not as they have today in seven days, but they can return immediately or cancel the purchase and immediately be reimbursed at the store. So, these are the priorities that we have from the multi-channel viewpoint.

And the mobile sales, that we mentioned, that 100% of our sales people are selling based on mobile sales and mobile sales is an integrated tool. If you buy something online and you want to buy in the brick and mortar store, if you give your email and your identity number you cannot -- you don't have to fill out the new form, you already received your invoice by email and this facilitates the process and this is also part of our multi-channel endeavors.

Q - Unidentified Participant

Thank you.

Operator

(Operator Instructions) This session is closed. I would like to give the floor back to Mr. Frederico Trajano. Mr. Trajano, you may proceed.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Once again, I would like to thank you all very much for your presence and all my colleagues for participating with me. And wish you all a very good day.

Operator

Magazine Luiza's conference call is closed. Thank you very much for participating. And we wish you a good day.