Q1 2019 Earnings Call

Company Participants

- Leonardo Almeida Byrro, Executive Vice President - Planning, Distriution and Supply Chain
- Lorival Luz, Global Chief Operating Officer, Chief Financial and Investor Relations Officer
- Patricio Rohner, Vice President - Halal Market
- Pedro Parente, Global Chief Executive Officer
- Sidney Manzaro, Vice President of Brazilian Market

Other Participants

- Alex Robarts, Analyst
- Antonio Barreto, Analyst
- Isabella Simonato, Analyst
- Leandro Fontanesi, Analyst
- Luca Cipiccia, Analyst
- Lucas Ferreira, Analyst
- Thiago Duarte, Analyst
- Victor Saragiotto, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Welcome to the Q1 2019 BRF S.A. Conference Results -- Results Conference, rather. This is being broadcast by -- over the Internet at www.brf-br.com/ir. All participants are in listen-only mode. After the Company's presentation, we will start with the Q&A session, further instructions will be given then. Please ask just one question. (Operator Instructions)

Statements made during the teleconference related to the Company's business, projections and results and the growth potential of the Company are merely forecasts based on the Company's expectations as to the Company's future. These expectations are highly dependent upon the market, the economic performance of the country, the industry and international markets and are subject to change. This teleconference is being recorded.

This conference will be conducted by Mr. Pedro Parente, the Global CEO; and Mr. Lorival Luz, the Global Executive Vice President and Finance Vice President and Acting RI Director. Turn over the floor to Mr. Pedro Parente.

Pedro Parente {BIO 2058839 <GO>}

Good morning, ladies and gentlemen, who are listening in for our results conference, earnings conference for this first quarter. Thank you for connecting. To me, this is a very important moment because it is the last results conference call that I will be leading as CEO because in our next quarter, this call will be led by Lorival, who will be, as announced, our CEO as of June 17 of 2019. I'm happy because this earnings conference is bringing about a certain consolidation of trends, which are relevant to our Company. First of all, there is an increase in both net revenues and profitability. We will breakdown these figures in a minute. We see that also there is a gross margin increase for the third consecutive quarter and this is important even though there is a cost -- grain cost inertia. Those of you who are following us know that although that in today's market grain prices have been lower. In our costs, we have to consider the prices for the last six months and the last six months that will be affecting the results of this quarter have had an important effect compared to year-on-year and the last quarter.

We therefore, have been finalizing our work and we have a high demand for protein and the frozen raw material inventories as well because our plants were unlisted in Europe, we accumulated frozen raw material from 140,000 tons and we are around 45,000 tons today, which is the figure which we consider ideal for us not to have any market supply problems and this reduces the pressure for future liquidations. You can imagine what it takes to bring the inventories down from 140,000 tons to 45,000 tons how much effort in prices this has led to.

I also refer to other positive aspects we have had in terms of our logistics chain in the complexity and expenses. With this -- the inventories, we have to remind you that we have frozen raw material and therefore, this has to be stored properly. And the fourth point, we have a high demand for protein and as all of you know and that we have seen attentively, the situation of the swine flu in Africa and this has impacted the Chinese market. The news is -- in the newspapers you can see, we don't have to go into this, but we know this is part of a cycle and Lorival will provide more details concerning the subject, but it's not only in terms of demand that we and the markets in general anticipate or have a positive outlook for the demand of protein, but also, this is a scenario that has been confirmed in terms of favorable costs in inputs for our actions. As I have said, we have an important beginning of positive and favorable trends for our Company with results that begin to reflect the adjustments initiated in the second quarter of 2018 and are in line with the goals disclosed in our strategic planning.

Going on to Slide 5. You can see the breakdown of results. I have made some qualitative comments, but here we have the figures, some important details. Also, we have had a reduction in volumes. This reduction has been expected because of the movement the Company has been doing in a firm way and in order to recover our margins and you can see this in the next line in net revenues. Although we had a reduction in volumes, you see the net revenues increasing by 4.7% year-on-year and it has a drop concerning the quarter of last year, but we know that in 2018, all of the markets were open, except for Russia, which is closed in December of 2017 and therefore, this is not a comparison made in the same conditions.

Our gross profit has grown 10% compared to last semester and our adjusted EBITDA increased by 9.3% compared to last quarter. And it's worth mentioning that there is a difference in terms of calculating because there is the application of the IFRS 16. This is important data that we would like to call your attention to. Net income loss of continued operations has been reduced by BRL133 million in terms of losses. This is now at BRL113 million this quarter nad this calls your attention that this first quarter in 2018, the basis of operations was much wider than the basis we have today. Therefore, although we do have a loss here in this column, this loss compared pursuant to the basis, you can see it still a positive figure.

Our net income in terms of losses is slightly above BRL1 billion, but this is the effect that I called your attention to in our last earnings conference, which is the appropriation of the differences of exchange rates related to the sales in Argentina. So there is no surprise here. This is a known fact. What is important here is that these are discontinued operations and confirms the information that I gave out during the last earnings conference. And calling your attention that there is no cash effect here. This is merely accounting and it's expected and because of accounting norms, we cannot make provisions for this in the -- we couldn't make provisions for this last quarter. This was the advice of our external audits, but now we are doing it in this period due to -- with all the transparency we have been doing.

In our next slide, we have two important pieces of information that signal the improvement of the operational performance. On a third quarter in a row, we have had an increase in our gross margin, going back to the levels above 20%. We have attained 20.6%. This is a very relevant piece of information because when we compare with the first quarter of last year and the fourth quarter of 2018, there is a seasonal effect that in the first quarter is weaker in terms of sales and the fourth is stronger in terms of sales because of the celebrations, the holiday season.

The adjusted EBITDA margin also shows growth since the second quarter of '18 when we had a very poor figure because of all the phenomena that are known, the strike of the truck drivers, among others, but we overcame the 10% level and we are now within the commitment of our strategic planning that we would reverse the tendency in the fall of the adjusted margin and we would then be closer to our historical margin as of 2020. Obviously, in the light of the events that I mentioned, a vision that we had a pressure, a demand pressure due to the swine flu from Africa and China and the cost of raw materials. This is not a guidance or commitment, but we do expect that there is an upward trend, which may recover at a speedier pace towards our historical margins. So this is what I had to say. I would give the floor now to Lorival. So he will provide you with an industry overview.

Lorival Luz {BIO 16180455 <GO>}

Good morning, everyone. I will begin by giving you an overview of the industry and highlighting certain situations that impact our sector and also BRF. On Slide 8, in terms of the grains and protein prices, you can see, and it's important to put -- to highlight what you see on your left hand side, which are the prices for soybean and corn from June 2017 -- July 2017, sorry. And on the left, that's the average price in the second half of 2017, which impact our CPV, our cost in our financial statements that we disclosed in the first quarter of '18.

Just reminding for the sake of reminding our audience is that what we see here is the increase in grain price, which in average increased corn by 29% and soybean increased by 18%. If we put this and analyze this more in depth in terms of regions and other costs, this reaches almost 30% to 35% in terms of impacts for the second half of 2017 until the second half of 2018. And this is to say that the cost that we have today in our CPV that shows in our results for today are basically the effects of the grain price in the second half of last year. That is we are bringing forward -- we are carrying with us that the -- this price. As you know, the cost of a live animal is -- reflects the cost of grain.

Looking at the current scenario, if we take the same data, the current data, and then we can see that the price today for corn is around BRL33, which is a price very much in line with the last -- the second half of 2017. And in the same fashion, you can see a drop in the grain prices. And we already have the data, and we should put this into perspective that the results and perspective is that the crops -- the crop that we have for CONAB, that CONAB has released is that we see the first crop. It goes from 54 million tons to 68 million tons.

And the point of view that we have in terms of grain is that we have a positive outlook concerning the following month, the next month. And of course, I have some things to say on impact of consumption due to the decrease of pork in China. Going on to the right side -- right-hand side of this slide. We can see chicken and pork prices. We see that we have had a recovery of the prices at the end of the year and for the beginning of this year both for poultry and pork. We see -- especially in poultry, less in pork because this is the effect of excess of offers that we had in 2018 because of closings in Russia.

This is a long chain. And what happened? The Russian market was closed. And in 2018, we had all the offer that we had allocated beforehand. And that is why we had a price effect, and it has an effect now -- as of now from the first quarter. And the perspective here is that in 2018, we'll start a positive year for 2019 because of the cost of grains. And we will be repositioning, and then we'll have overcome the effect of the increase in grain prices that we had last year.

On the next slide, we also must highlight how we see and what the data brings in terms of China and what the Company is doing and looking and managing this particular moment. Some of the facts, and I have to put this into perspective are: China is very relevant. It accounts for half of the production and consumption for world pork. Pork is the protein which is the highest consuming -- consumed protein in the world. It's double the amount of beef. This is the protein which has grown more in the last years. Another factor is that the global market, the trading -- the world trading for protein is very low. If we look, pork represents 8 million tons only. And this is -- basically, 2 million is China, China with imports that they need annually. And also, the other exporters are Brazil, Europe and the US.

And then we see here putting in perspective the current moment, the current scenario. With the African swine flu, there are also foci in Europe, which may impact the European production and the capacity of Europe meeting other markets that require imports. Brazil has a net capacity in terms of consumption and production that is -- doesn't meet 1 million tons. We're speaking of 500,000 tons, 900,000 tons, which is low.

If we -- and then I will give you more information on the cycle, but putting into perspective what is happening in China and taking the information that we have from there, from local consulting companies, we have information that the number of poultries of female animals and young animals, we have to see that this effect that you may have a clash in terms of production, which may represent a drop by 20%. We are speaking of China for 12 million tons, -- 10 million tons, 12 million tons. If this goes to -- if this moves forward, the figure can be higher. And this figure is relevant, and none of the other proteins will be able to support or meet in the short term. So there will be, in the short term, a lack of balance between offer and demand, which will not be adjusted due to the offer. And this will be expected in the short term, and we need to adjust.

Looking to this and analyzing it, what may happen. If we take the price of pork and looking at beef and poultry, we see that pork and cost and poultry and chicken cost 0.56 times a poultry, the pig and then we have the price. Therefore, the substitution effects will depend on the income, the income of the population where there is a deficit in terms of production and where is the consumption. It's in China. The average per capita rate in China is lower than the per capita GDP for Brazil. Therefore, the likelihood is that there will be a trend of replacing for the lower cost in protein, which has an impact in replacing this because of the sales effect.

And what is important to see is the time, in how much time can you increase the effective production of pork. If Brazil today or other country wants to increase their pork production, the cycle is long. You have to increase the animals and the mattresses and the gestation time and the time the pork needs to be in confinement. The sales need to be in confinement for -- to be produced. And then we need at least three years. You can increase this in a lower term, but you can only bring it down to two. In terms of consistency, you need more time, more than three to more years.

The cycles for chicken, for example, is much shorter, but you need to start with genetics and eggs and breeding. You also need to increase the production, but you still need a year. What can -- what do I want to say with this? Until this period, the balance or the adjustment will not take place due to the offer. It will have to level off due to the demands and the price levels and in the world scenario because no other country, it will be possible to substitute or replace and meet the demand that may come from China.

However, I think we should take other factors into account. Let me just make a point. Converting swines, the amount of feed it needs, and I'm talking about corn, soybeans and other nutrients, it's about 6.4 kilos for every kilo of pork. That's the ratio. When you reduce the number of animals in China, a significant drop. There will be a reduction in 'the consumption of grains.

Again, there will be impact on the supply because it's given. It's there because we have a better grain production. But grain costs will be down and you were slaughtering fewer animals. So the trend is a positive impact. That's a downward trend in prices of grains because we have slower demand and production. The effect of the migration. Okay. Fine. You may migrate to poultry, but the conversion is about half. It's about 3 kilos. So the consumption will be smaller in any way.

Let me -- having said that, let me just make it clear that the company is paying close attention to it. But we are realistic. We are very realistic because at a point in time, it will be addressed either because China will contain the outbreak of that flu or as a result of investments and studies that have been conducted to come up with the vaccine or a medicine that can address the problem and contain that spread once it happens, they will go back to business as usual in production and supply and demand will be balanced again.

We are aware. Again, we are realistic because this is a long chain effect. And decisions we make today will have impact in two, three years, any investment decision made now if we increase more -- if we increase our production even more. And we have to take into account when China addresses (Technical Difficulty) increased production in other countries and then China addresses its own problems, finding its own balance. So we have to be very realistic when assessing these variables. It's a very cyclical industry, and we have to be prepared for today, but looking ahead into the future so that we can be just as prepared for that change that will eventually come.

At this point in time, the Company is prepared. It's poised to resort to both international and domestic markets because of this supply and demand imbalance today. We are working very hard with the Chinese authorities. We have met with them recently here in Brazil, and we talked about the certification of plants. The Agricultural Ministry is in China as we speak. We have six certified plants to meet the Chinese market or to meet the demand of the Chinese market. We have all the documents ready for another 4 units to meet that market. And as I said, we are paying close attention to the situation today. So I wanted to make that clear to you. That was important. And then, of course, you have the chance to ask questions and ask for further clarification.

So these are changes that will result in important changes for the entire industry. But this will take place only for a period of time, and we have to be cognizant of that finality of that period so that we don't incur any adverse effects if we jump to conclusions and make swift decisions looking on the short term only. We're not doing that. We are taking into account the short term, the midterm and the long term before we make a decision.

In summary, I think Pedro addressed it already, but let me just make further comments on Q1 of 2019. Despite some grains and their direct costs, we actually have expanded our gross margin. Especially compared with Q4 2018 because of the holidays' effects in the first quarter, we have improved our gross margin nonetheless. There were some volumes impact, but there was a reduction when compared to Q1 2018. Income and gross profit are higher. The average price has expanded about 13% as a result of our price repositioning, both domestically and internationally.

Onto the next slide. Let me talk about the Brazil effect. We have been impacted by grain prices that are higher, over 30%. That was a volume related impact as well, most of it because of higher prices, as we said before, and the new repositioning of our investments this first quarter, about 30,000 tons less, but maintaining our 45% market share of our products. This is consequence of fantastic work we've been doing and perfect execution of our strategy implemented last year. And that applies to every channel, every category -- categories and our focus on food category. So that's why we have these price impacts, volume impacts and at the same time, maintaining your market share. Everything reinforced by campaigns, marketing campaigns in Q1. We invested more in marketing year-on-year. And this is all aligned with what we have been planning in recent years.

Onto the international market now. Volumes are down. There are two effects. The first one was earlier this year. One of our plants was discontinued, could not export to Saudi Arabia anymore. There were some restrictions. But on the same week, we had other plants that have been certified. We now have a total of eight companies that are certified to export to that market, which are enough to meet that demand. But we had a reduction in exports during that transfer from one plant to another plant. So the impact lasted three weeks and that impacted our volumes.

So we had to change procedures as to the health certificates in the Itajai port that impacted March exports so they were delayed or transferred over to April, a little over 10,000 tons. Let me point out that especially in the Halal market expansion, which is aligned to our strategy, we are selling processed product. The contribution margin is more relevant than those are sold in bulk. So we have better margins and better share as well.

Now let me talk about free cash flow on Slide 14. Q1, we had BRL253 million. It is a trend. It's important to say that. And this is what we're looking for the entire year. And we're not considering the closing of that sale of Europe and Thailand and about BRL95 million that happened in Argentina because the cash was only recognized in April.

On to the next slide, indebtedness and leverage. Our leverage was 5.64 times. Two effects are there when compared to last year. First quarter of 2018, we had a positive EBITDA as to Europe and Argentina's operations when we don't longer have that now. The other effect is higher exchange rates that have affected our results. Q2 of 2018 was when we had the effects of the restructuring. And we had BRL360 million EBITDA. Given the current scenario not only in terms of grain prices and market perspectives, we expect better EBITDA than that of the second quarter of 2018. Our leverage will be below 5 times.

Let me just make an explanation here because -- let me talk about IFRS 16 because that was implemented this year. We had impacts in the first quarter of about BRL158 million and we'll have to report it just like all the other companies. But let me point out that if we were to annualize the EBITDA effect and at the same time in our income statements that every contract obligations that will impact, it's about BRL2.4 billion. The IFRS effect alone would be a 3.8 leverage level. In other words, the effect is greater in EBITDA than in the obligations in the debt. So it's a positive effect as to the EBITDA, BRL2.4 million. If you were to calculate that with the annual EBITDA about 632, you would have a positive effect.

In other words, to our company, adopting IFRS 16 does not generate a negative impact when we talk about leverage. And there's something else. IFRS 16 does not have impact in gross margins when we're talking about operational improvements and expanding the Company's gross margin above 20%. We're talking about debt improvement regardless of the IFRS implementation and its effects.

I think this concludes our presentation, and we can now move on to the Q&A session.

Questions And Answers

Operator

We will now start the Q&A session. (Operator Instructions) Isabella Simonato, Bank of America, asks the first question.

Q - Isabella Simonato {BIO 16693071 <GO>}

Good morning, Pedro and Lorival. Thank you for taking my question. I have two questions. First about the volume and the domestic market. We're negatively surprised. How could you have maintained market share year-on-year? Do you believe that consumers can withstand that price increase? What's your take on the consumption per category? And my second question is about the prices of commodities. There's a major drop in prices. What's your take? When do you think that these lower prices will be reflected on your results? And let me talk about the swine flu. When do you believe that increased protein will affect you and the entire industry?

A - Pedro Parente {BIO 2058839 <GO>}

I would like to clarify that we -- today, we have our Vice President here today, and we will forward the questions to them. They will be answering it. So Sidney will be answering it. He's VP for Brazil. And then Leo, who is -- will be speaking of grain. Okay. Gentlemen?

A - Sidney Manzaro {BIO 17678250 <GO>}

Good morning, everyone. It's a pleasure to be here. I would like you to repeat your question concerning the Brazilian market. Why is it? Why were the figures below your expectations?

Q - Isabella Simonato {BIO 16693071 <GO>}

Actually, well, we knew consumption was not strong, but the drop was more significant than we expected. How do you see the scenario? And what is the elasticity within the sector?

A - Sidney Manzaro {BIO 17678250 <GO>}

So we have two questions then. We understand that there is a seasonal curve in the first half -- actually, in the first quarter, the market strength compared to the previous periods and due to the lower pressure in terms of inventories. And also, the improvement of the mix and the prices also caused impact. But I think the good news is the followship, that the market as a whole, all the chain was pressured due to the excess of inventories resulting from 2018. Therefore, in general, the price movement is for the entire sector -- segment, I'm sorry, and this reflects our market share.

Our market share is maintained because there is a movement in the entire market. Elasticity, flexibility in the first moment will be affected. So this is because the main categories where the effect of the liquidation actually points to, which are the categories which are considered more volumetric, sausages and others. They were more affected, and this is also where the seasonal curve, the consumption in the market is lower.

So concerning the domestic market, we are very optimistic. I believe that the point that we have been insisting on in the last earnings conferences that we pointed that reducing the inventories in the domestic market, we would reposition the prices. And this was a problem of the chain and not necessarily our problem, BRF's problem. And this accommodation happened. And we believe that because of this seasonal curve and because of the competition, we will be operating in the upper quartile where we will have a higher profitability.

A - Leonardo Almeida Byrro {BIO 17581639 <GO>}

Good morning. This is Leonardo. Speaking of the grain perspective, we have seen crop in Brazil and in Argentina recovering and American crop doing well. And this signals a good offer for grains from now on. And this would be third due to the consumption in China. And the trend for the grain price is a downward trend. We're already purchasing grain at lower prices and reminding you that we have a long chain. It's a longer chain for pork and shorter chain for poultry, and we'll see the effect of this downward trend in grain prices as of the second quarter.

And the purchase of grain is attached to the international market movement and the disputes between US and China, these impacts in prices here in Brazil. This will be felt in the second semester. And we have been following closely what's going on in China when you look at the aspects of the African swine flu. Chinese brought forward their production in order to supply the market, and this offer will be also happening with a deficit only in the other quarters. And in the trade scenario of the world, this will impact not only in swine, but also chicken and beef. Both the grain and the Chinese crisis will have a very strong impact in the third and fourth quarters.

Q - Isabella Simonato {BIO 16693071 <GO>}

Thank you very much.

Operator

The next question comes from Luca Cipiccia from Goldman Sachs.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Good morning. Thank you for taking my question. I would like to know and talk more about what's going on in China. Lorival, thank you for speaking of opportunities in the short term. But looking forward, will there be an excess in terms of offers related to this event? Starting from this assumption or based on it, how are you planning in terms of timing of capacity and focusing on the short-term outlook for the second half of the year, as is already mentioned? What could surprise us in a negative way if this happens? Would it be the lack or will it be the non-opening of the new plants, other factors? What is uncertain? What are the levels of uncertainty in terms of the trading relations between the US and China?

And the minister now that's -- what -- I would like you to talk more about how your planning is being done in terms of these demands that are -- what are you doing basically? And based on that, the last time the Company underwent a positive period in terms of the foreign market and positive earnings, the allocation of capital of Chase was -- what happened? How are you doing in terms of a scenario where the imports will be positive for the next years? How are you going to leverage this positive or upward trend in terms of allocation of capital? Could you shed some light on this, please?

Hi, Luca. Thank you for your question. Let me say something. What we are seeing -- we are looking at things in a very realistic manner. If we -- I'll start by speaking of our strategy and I will -- hello? Hi. Yes. I cannot release our entire strategy, but I can tell you what we're doing. We are obviously preparing to reap benefits in the short term. And this effect will happen as soon as we have a perspective from the Chinese in the slaughter. And I can't -- this will happen. It tends to happen in the second half of this year. So we are prepared for it. We want to meet the demand in the local market and also in the international market with the adjustments that are necessary.

We do have the plans, which are being opened. And I'm not very much concerned on the timing. If it's 1 minute ahead, three weeks for certification, the demand that we have from China will impact everyone. And what do I mean by this? And I will bring the US into the question. Even though we signed an agreement between the US and China and China eliminates all the barriers that they have now for the exports of swine or pork to China and China takes more from the US today, they don't take anything from the US, but let's suppose they take all the excess production in the US. There will be a lack of swine and pork in Mexico and other countries, which we could serve.

Therefore, we could take the first direct sale to China if the sales for other markets, which eventually the US may supply. The same thing happens with the plants. The plants will be accredited even -- or certified even in the event this happens to another player and this player exports to China. China, there will be a lack of products in the local market or with other markets, and we will be there. And the companies will be here paying attention, and we will export and meet these markets. Therefore, there are several communicating routes that can meet and reduce the impact, and this will benefit all of the countries and companies in the scenario.

Therefore, this is a very positive effect. You obviously mentioned a very relevant point, but there is a deadline. The deadline is we have to be on the lookout. If we -- for example, in a couple of years, there is a flu vaccine, this will change. That is why we have a concern in terms of the levels of investments we will be carrying out. Speaking of the strategy of the Company and the priority of the Company, as we have already said, is the deleveraging of factors, the better results, better cash generation that we have, the Company. We will be using this to deleverage to pay its debt.

And of course, we will be on the lookout on for new opportunities. And this will be within our strategic planning, which is to focus on Brazil, to focus on the Halal market, which are our priorities. But to no extent, we will be away from our priorities that have been established by our Board in our strategic planning.

A - Pedro Parente {BIO 2058839 <GO>}

I would like to reinforce -- and this is Pedro again. We do have this outlook, as I mentioned previously, in order to bring forward some of the points of our strategic planning. We do not have a date for this, but it's important to say that we will be using this good, positive scenario to prepare ourselves for cycles which may not be as positive.

The nature of our business is cyclical, and this is a lesson that we have to learn. And we have to learn it for good because certainly, we will follow what Lorival said. We have a long-term target to reduce our leveraging, which is 1 to 1-point times the EBITDA, so we can deal with these cycles. And this is our policy.

In summary, we're very responsible, we're very careful with the favorable wins. As Lorival Luz has mentioned, we had -- of course, this positive moment has a time to end as a well, and we can be prepared for unfavorable wins.

Therefore, we cannot reduce the relevance of this impact until China picks up on its production.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Thank you very much. That was very clear.

Operator

Our next question comes from Leandro Fontanesi from Bradesco BBI.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Good morning. Thank you for taking my question. I also have two questions, and it's also about swine. You have mentioned and made a lot of information available. How about processed goods? As an integrated company, how can we expect? And what kind of advantages do you see in terms of processed products?

And how can you see your competitors? How do you see their movements? Can we expect them to raise prices? Or will they resolve this and absorb price increase?

And the second thing, you commented a lot on grains. I understand that the company will be changing its strategy a bit, the way you are hedging and storing. In the terms of the benefits of this downward trend in grain prices, when we do our analysis, when we look at the advantages concerning the changes that you've done in hedging or storage, can we consider that this downward trends in grain prices will be captured by the company in the next quarters?

A - Pedro Parente {BIO 2058839 <GO>}

Hi Leandro. Thank you. Good morning. Concerning the impact of swine and processed products, without a shadow of a doubt, there will be an impact. And it does use the raw material from swines, yes. And you are right when you say that companies that are producing processed products and that are integrated and others which are non-integrated will have to purchase swine in the spot price.

If those of which are integrated, they will be able to capture the entire potential and will capture the adjustment of the prices, whether in their production costs, whether in raw materials, whether in the processed price.

Why? Why is this? Because even -- those which are not integrated, they have to purchase swine in the spot market. They have to pay the price on the screen. And as soon as this price goes up, raw materials are more expensive, which will pressure the margins for processed foods. And then obviously, you would need an adjustment in the final price of processed products.

So there will be a distribution in this (inaudible). Hello? Hello? There is someone on the line. I can hear you. I'm sorry. There is a reduction, which will be a price adjustment, which should go between the producer and the industry. And those who are integrated will be able to capture these effects.

Concerning grain, it's always important to notice that our vision from this company that the inventory levels, they are to us an essential factor because we do not use this to -- for our herds, that feeds our herds as a financial instrument to reposition or to reduce our cash flow.

What we have to do is that by studying what happened to the market, as Leonardo says, if our reading if the crops or if the demands are part of this, you can see that the production cost then will be more effective. And then we will have no problems. And we even do like to have adequate inventory levels even a bit higher in order to ensure the supply of all our herds and obviously within our limits and our policies.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Thank you.

Operator

Lucas Ferreira from JPMorgan asks the following question.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Good morning. My first question is about the African swine flu in China. What's your take on the impact of the international markets, the Halal market specifically? What's going to happen in Europe? Do you think the prices will go up in Europe and that would help us reopen that market to you so that you could export more to Europe?

And the last question is to Lorival. Working capital. Your financial cycle is -- or it has been low. Is that a seasonal effect? Can you hear me?

A - Pedro Parente {BIO 2058839 <GO>}

Yes. Can you hear us?

Q - Lucas Ferreira {BIO 16552031 <GO>}

Yes, I can. How much of that working capital drop is sustainable in the future? Or is it just a seasonal effect?

A - Pedro Parente {BIO 2058839 <GO>}

I'm sorry, Lucas. I think we were disconnected for some time. We picked -- we heard the first question to Patricio as to the impact in international markets, is that right?

Q - Lucas Ferreira {BIO 16552031 <GO>}

Yes. The swine fever in the Halal market, can there be better prices in there? And what about Europe? Could you reopen that market to you? Or would it have more stress in Europe? And the last question is about working capital. It has been low when compared to recent years. Is that sustainable? Or is that seasonal?

A - Lorival Luz {BIO 16180455 <GO>}

Let me just answer the question about working capital. Yes, it is sustainable because most of it is a result of lower inventory levels, especially in frozen raw materials. I'm talking about 100,000 tons less, or it's a significant amount, almost about BRL700 million in working capital. This is very relevant.

But let me point out once again that we are not concerned, quite the opposite. We're not increasing grain inventory. Again, inventory management is a key input to us, and it's not a financial instrument to improve working capital levels or our position to make or lose money.

We're always trying to get the least cost possible because it's a very relevant input. And it's sustainable, the way we see it. I'll turn it over to Patricio now.

A - Patricio Rohner {BIO 19686996 <GO>}

Good morning. When we talked about the impact in other markets other than China, as of February, March, we see stronger demand in other Asia markets, Japan and others and especially in the Middle East. At poultry, so there is a shortage not only because of Saudi Arabia, but there is surplus -- no, that's not the case.

When we talk about griller, many companies moved from griller to broilers. This is what we did, especially when we supply parts of chicken. So there is an impact there in grillers and there is a lot more to come.

We're not to move away from our long-term markets where we have a brand and distribution. We can get much better premiums there and include and expand our portfolio with industrialized products as well. But parts of the mix is more transactional based. It's not a long term per se. This is what we are considering. And the impacts are already there.

Just like many people say, no one is seeing such a crisis this big. China hasn't opened up to Brazil in other markets as well, and we're already feeling it. Volumes that are smaller when compared to last years because of documents and report, et cetera.

We were going to have a record month in March, and we transferred the orders to April, to May. So the demand has been impacted. Prices have been impacted with a little delay because we are now shipping two month's or one month's orders without delay because of the order problems.

And we're getting ready to serve the European market. And we are ready. If they resort to us, we are ready. We are now -- we have a team in place analyzing the problems in China. And we are considering Halal opportunities, short-term opportunities. And Europe is also on our radar. They're just next. We are ready to supply the European market if that need arises.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Thank you. Thank you very much.

Operator

Antonio Barreto from Itau BBA asks the next question.

Q - Antonio Barreto {BIO 17449798 <GO>}

Good morning. My question is about the reaction of the protein industry as to the prices in China. When you look at the number of sales you have, you have very little more, just 1% in case of swine, for poultry 4%. It doesn't seem that you are making a lot of investment to boost your production. So here is my question.

Do you see the rest of the industry at the same level, especially for poultry? And what kind of production boost we could see in the next 12 months, especially thinking about poultry? Because for swine, it's a longer cycle. Just to put it in perspective, when we had the last super cycle of chicken?

The way we see it, the industry was limited in terms of availability of genetic material, trying to recover from that grain crisis back in 2012. What is the availability of the genetic material to improve production of poultry? Thinking about Brazil anyways, U.S. at 21 million tons, Brazil about 14 million tons, how much do you believe you could boost chicken production in 12 months taking into account that margin?

A - Lorival Luz {BIO 16180455 <GO>}

Thank you, Antonio. Let me give you our take on the scenario. We should see that in context. Well, we are actually looking down the road. We make a decision, taking the short-term situation into account. That's something we're not doing because again, it's a long cycle.

A decision you make today will have an impact two years down the road if the problem is addressed, the problem in China. Our production will be growing. We'll be ready and we'll have to do something with it. This is what we had back in 2018 because of the entire production and the storage, our decisions we had made before to meet the demand of the Russian market. But it was oversized.

So we have to take that timing into account, and we have to be very cautious. Is it possible to boost production? Yes, it is. I am not going to give you any details. I don't want to preach to the choir. I may change the slaughter and the age of chickens. That will reduce its optimal egg production.

You may slaughter at 54 to 60 weeks, and within that time frame, you have that optimal point. And I can expand that. I can delay that a little more. Maybe the egg production won't be five eggs a week. That may go down to three a week. That will increase production of poultry, and it does not need any CapEx or additional investments. It's not simply, but it requires scientific knowledge.

You simply move that timing away a little bit more, but the effects are relatively modest. Depending on the situation, you may have a net improvement of about 2% to 3%. That can happen. So you can improve production very quickly, 54 weeks to 60 weeks to slaughter because, you know, 45 days for egg production, you know all that, but the chicken will change that.

Okay. The industry can do that, and we do not need to increase the number of our heads -- of our herds rather. It's a more complex situation in hogs, for example. You should not be very optimistic about it because China may address the problem a couple of months down the road. You're improving production. You have to deal with it then. So this is the situation.

You may even resort to price increases or maybe address the demand. And I'll turn out to Leonardo now because he would like to make a comment.

A - Leonardo Almeida Byrro {BIO 17581639 <GO>}

When you look at the entire genetics change, to improve genetics, then you would require a lot more time. You could only boost production a year later for poultry and three years for swine.

A - Pedro Parente {BIO 2058839 <GO>}

Good morning, again. We have to look at the entire chain and the strategy to increase production without resorting to major CapEx. And you have to take into account the slaughter capacity. You have to raise the chicken. You have to have capacity to slaughter it. How can you optimize and maximize the slaughtering capacity?

This is something that the entire industry is looking for, again, increasing the number of slaughterhouse and their capacity and extending the lives of these chicken.

In the case of swine, you have a spot market. And there will be dispute for that market, the local market more specifically. And those industries that can move production in that area will have even a competitive advantage. Again, we are looking at the entire chain, but we're being realistic.

Every week, there is something new about the swine fever. It's spreading to Vietnam and other regions. We're making decisions, but again, being very realistic and considering every possible scenario.

Q - Antonio Barreto {BIO 17449798 <GO>}

But let me make a different follow-up. Where do you believe there will be a bottleneck to boost chicken production? Will that be in industrial capacity or the storage of chicken per se? Is it in genetics? Or will it be in slaughtering?

A - Pedro Parente {BIO 2058839 <GO>}

Well, the bottlenecks will happen at different points in time. There may be some bottlenecks in genetics. As you make investments, there will be other bottlenecks and even logistics bottlenecks. The demand for refrigerated containers will be an issue. So that's why we have to be very cautious. How are you going to change to move all that production in this new world dynamic? There will be several bottlenecks.

Let me just make a comment. We have the volume and demand, and these bottlenecks will impact prices as well, even though you may not meet all the demand. But once that demand is not met, there will be further pressures on prices.

But once it is met, it will impact prices as well. So we have to take that into account. Maybe meeting demand 100% may not be the perfect solution. But again, there will be favorable impacts to the industry as a whole nonetheless.

Q - Antonio Barreto {BIO 17449798 <GO>}

That was very clear. Thank you Pedro.

Operator

Thiago Duarte from BTG Pactual.

Q - Thiago Duarte {BIO 16541921 <GO>}

Good morning. Thank you for taking my question. Let me shift gears a little bit. I have two questions about the results. Could you elaborate on the SG&A issue? It's a little higher. And you talked about investments, especially in the domestic market, especially with the Sadia brand.

And that reflects on higher top line numbers. But you have postponed these expenses for Q2 because of some campaigns and sponsorships. What's your take on future SG&A? So that we can better understand. So that we can understand the expenses and gross margins that have been positive as you stated.

And here's my second question. It's about what we've seen so far about IFRS 16. It's very clear. The effects in EBITDA. Can you help me understand that in the balance sheet? When you see the net debt, BRL15.5 million that you reported, that number does not seem to be including the effect of debt when you recognize leasing as debt in IFRS 16.

I want to know. Is that number reflecting that greater debt because -- especially the adoption of the new accounting practices?

A - Lorival Luz {BIO 16180455 <GO>}

Let me address the SG&A question first. Yes, that's right. In Q1, we have expanded our marketing investments, and that's according to our planning and our budget. What we tried to say is that in Q1 of last year, we reduced our marketing investments because in Q2 and Q3, we would have greater investments there because of a sponsorship we had signed for the World Cup last year.

So we concentrated those investments, then. Yes, there is more investments. That's right. But it was a seasonal effect. Q1 last year, we didn't invest in marketing. Almost everything was shifted to Q2 and Q3 last year. Looking into the future, yes, our marketing investments will be robust in our brands because these are leading brands, Sadia, Perdigao and Qualy.

The way we see it, this is an important investment, and this is something that we should continue to do because these brands have extremely important attributes such as quality. And they are preferable brands. And in the case of Sadia, that is applicable to the entire

Halal market. We have a leadership position in that market as well. So this is something that we deem extremely important then.

As to SG&A, these expenses have been planned out and under control. In the first half of this year, we're still suffering the effects of the divestitures and the other transactions. But throughout the second half of the year, the impacts of selling Argentina and Thailand and shutting down of OneFoods, we can also benefit from these effects.

Concerning the IFRS, I think it's important to make this clear. And I think you put this very well. And maybe I need to be a little bit more explicit. In the debt, when you look at the debts that we have there, you can see that this debt is the effect of accounting for the IFRS 16, which is not there because these are payable obligations which results from our current operations.

Therefore, we have not put all our liabilities that are considered debt. And in this operation, we are speaking of leasings and other operations that are used within our operation as payable operations.

This totals to BRL0.45 billion, and they are considered other obligations and are not part of the total of the debt. Even though if we did put this 2.44 under debt and we included the annual effect of EBITDA, this would render a positive figure because it's 2.445 for an annualized EBITDA around 630, 650.

It is only the impact of the IFRS 16 represents a leverage of 3.8, and therefore, lower than the total leverage for the Company. Therefore, this is accretive in terms of leverage. I'm not sure if I have made myself clear. I think you will find more details under item 23.1.

Q - Thiago Duarte {BIO 16541921 <GO>}

No, that was great. That was very clear. I was looking at it at the item that you mentioned. But in the last quarter, because of all the investments that you did, and the results that you released in the fourth quarter, you mentioned a net debt which was adjusted according to the investments that you're already doing and especially to the (inaudible) totaling BRL13.4 billion. This is a figure that converges with BRL15 billion that you disclosed today.

A - Lorival Luz {BIO 16180455 <GO>}

No, no, no. That's not it. BRL13.4 million is related to the BRL14.2 million. Why? Because cash of BRL96 million in Argentina is still not here. It will reduce the net debt. And the $340 million from the sales in Thailand and Europe are still not there. Therefore, the BRL13.3 million relates to BRL14.2 and more.

What is the effect here? The exchange rate effect in BRL13.4 million, we had an exchange rate at 3.8 and now we have an exchange rate of almost 3.9. This gives you an effect of BRL1 billion on the -- of the net debt. And this is what we're speaking of. We speak of a total net debt of BRL15.5 million. But if we consider the inflow of this cash, it would go to BRL14.2 million.

Q - Thiago Duarte {BIO 16541921 <GO>}

Okay, very very clear. Thank you very much, Lorival.

A - Lorival Luz {BIO 16180455 <GO>}

You're welcome.

Operator

The next question comes Victor Saragiotto from Credit Suisse.

Q - Victor Saragiotto {BIO 19504427 <GO>}

Good morning, all. My question, Lorival, is about something we already talked about last year on the other costs that if we don't take the grain part, which is higher than the historical average. Especially, you also mentioned the consulting services you were using and so on.

My question is on the expectation of these other costs, which could benefit this scenario of the lower grain price and also the swine flu scenario.

A - Pedro Parente {BIO 2058839 <GO>}

Well, before I gave this over to Lorival for more details, our expectation is as the measures that we have adopted mature, as we have been adopting among which the operational excellence plan, which is already implemented in all plans, we have a trend that we are expecting, which is more favorable in terms of these other costs. We have naturally -- this is not here with a lot of highlights in our explanation, but it is in our letter.

There are many initiatives that are underway. I mentioned the operational excellence initiative and management system initiatives. And all these measures have a capture curve, and they will mature throughout the year. We expect that our excellence -- operational excellence system is completely rolled out at all other plants, and this will bring a significant impact.

Therefore, I confirm that we expect a better trend. And I'll give Lorival the floor so he can give you more details.

A - Lorival Luz {BIO 16180455 <GO>}

Adding to what Pedro said, this effect on the first quarter is a negative effect mainly because when you have the reduction of the volumes and all the effects that we have put down, you have an increase in the additional costs of our idle capacity in terms of production.

To the extent that the volume goes back and the market trends that we are expecting and that we have talked about take place and in addition to all the other points that Pedro mentioned, we believe there will be an upward looking trajectory. The timing, however, may obviously, as we say -- I'm not making promises, but the trend is positive.

And it will happen as these market influences take place and if we -- among all the other captures will happen gradually to the extent that we will be rolling out the processes across plants.

Q - Victor Saragiotto {BIO 19504427 <GO>}

Thank you. Very, very clear.

Operator

The next question comes from Alex Robarts, Citibank.

Q - Alex Robarts {BIO 1499637 <GO>}

Thank you. I have two questions on Halal and China. When you mentioned -- when you highlighted the Halal segment and the increase of the prices, you commented also on what was sold. Can you comment on how you are seeing the development of the Halal market?

Do you think that this will go into the third quarter and the fourth quarter? Are we expecting to see a level off? Or are we able to take certain actions in Saudi Arabia in terms of accreditations? Could you give us more insight in this?

In terms of China, my question is on poultry. You have swine, and this has increased in China. I would like to understand, what was Brazil and China in terms of poultry? The tariffs have changed. It went from 20%. And the minimum price has increased.

Can you comment on when the price increased or when -- how the volume was? And if you look at this effect on the African flu, what will be the local production in China? And how will this impact the demand of imports? We have seen several examples and we've seen Saudi Arabia. But what has been this in terms of local poultry production? Could you comment on all of these? Thank you very much.

A - Patricio Rohner {BIO 19686996 <GO>}

Good morning, Alex, this is Patricio. Concerning Halal, you were speaking of Saudi Arabia and the certifications. When we have a change in plants, we have fixed accredited plants. We have made investments to comply to Saudi Arabia regulations, but we lost two. But we gained three or four more, which are much bigger.

And this totals 23 in January. And this, of course, takes time to comply. What we did was to send everything that we had from the plants that were already accredited and focused on the changes in the new plants. But there was a problem in March, which was due to the documentation. What we lost in terms of volumes was not a lot, it was in Arab, in Saudi

Arabia, and basically everything was supplied by other countries in Halal: Egypt, Jordan, Iraq and so on.

We have an additional demand for the future for the markets as well. And we have delayed Saudi Arabia demands because of the time we needed to have the plants comply. Therefore, we had less volume. Our inventories, we have our own distribution, as you know. We import and we also sell. We managed to choose the best channels, the best products, the best mixes, and of course, increase prices or use promotions and discounts.

Thinking on the long term, we are thinking of this world situation. In order to advance in Saudi Arabia, we are looking at investments. But the local production is at 60% level. We also want to have the segment where we have had a very positive experience, for example, in Turkey, where we could lower prices and increase productivity and build a lot of synergy, which increased the results two-folds in Turkey.

The results today we have were obtained in less than two years. In terms of China specifically, we are using everything we have in our plans, which are not many for China, especially poultry. And this has increased the prices for us. We had an increase in all kinds. And we cannot meet the entire demands because of accreditation.

We need to analyze. We have a list that is being assessed between BPA and the Chinese government. So we are ready and all set.

And as you have said, in terms of port security, in China, they have cut down on the poultry production and it remains stable because they have to import biological capital and they have to manage the entire chain. So I know that there will be a movement, but what has been -- they have been working with less independent producers which have one animal to 500 animal, and they're promoting bigger and more robust companies for sanitary purposes. This will happen. This is a movement that we see, and we have to go on and analyze this market. And we have been having successful experiences.

We are looking at the short term and medium term and obviously in Brazil and then Halal and then Asia, and China is on our map. And how we are looking at it is to add value through experiences we are developing outside Brazil.

Q - Alex Robarts {BIO 1499637 <GO>}

I understand. Can you follow up on this? The exported volume to China and poultry now has reached maximum levels on your capacity. And to increase this even more, we -- to meet this demand, do you need a new plant, a new accredited plant and they have to approve it?

Or can you do this with a plant that is already there? Let me just try to understand this better. How can you use this in the short term?

A - Patricio Rohner {BIO 19686996 <GO>}

This has already been done. And we have increased productivity, but what we have in our situation for China depends on this. But we have a felt that there were more demand in Japan, Korea and other Asian markets where we are supplying the volumes that we cannot give to China. In China, we need more plants. That's it.

But it's a discussion that is really on fire because of the developments of China and the U.S. Brazil cannot be kept out. And as Lorival said, even if the U.S. has 100% focus, they can't even cover 10% of what they need. And Brazil could not fill this gap or the European Union to fill the gap.

Therefore, all this world trade connection on poultry has more demand in Middle East. Many companies are not meeting the Middle East anymore and are taking this to other areas.

For example, they have an animal chicken that weighs one kilo. And to increase your slaughter capacity, you should increase the weight of the chicken. And then you can sell it as a whole or sell it in parts. And today, there is a lot of demand for thighs and chests and breasts and to supply these parts to the Middle East at a better price.

So we have to adjust this, and when there are more accredited plans, whether for China, whether for Europe, this will represent a very significant transformation for the Company. But meanwhile, we are meeting Japan, Mexico and many other markets.

Q - Alex Robarts {BIO 1499637 <GO>}

Okay, thank you very much.

A - Lorival Luz {BIO 16180455 <GO>}

Let me just add something to this concerning to what Patricio mentioned. We are looking at a scenario, which is to be confirmed, that will lead to an increase in demand on the part of China. This increase will be met, generating a lack of products in other markets as we cannot meet the world demand.

Therefore, all protein companies will be positively affected regardless to where they will be exporting to. This is a very important piece of data because, of course, accreditation is important. The more plans we have, the better. But this will not stop us or other companies like BRF from seeing that there is this lack of products that will take place due to the demand that's coming from China if everything that we expect is confirmed.

Q - Alex Robarts {BIO 1499637 <GO>}

Thank you.

Operator

This concludes the Q&A session. I'll now turn over to Mr. Pedro Parente for his final remarks.

A - Pedro Parente {BIO 2058839 <GO>}

Let me just briefly summarize the company's situation vis-a-vis the current scenario. We talked about business perspectives and the gap between supply and demand, a gap that has been caused by the African swine flu in China. And at the same time, BRF has been implementing the measures we started implementing as of last half of last year: all business policies, new channels, new product mixes and integrated approach that is way more effective.

So our take is optimistic, but realistic at the same time. We're being cautious. Once these blue skies actually are confirmed, we may move our strategic plans ahead, especially in terms of indebtedness. We're not changing a well-designed and well-thought-out policy that is currently being implemented.

I would like to once again thank you, everyone, and we'll keep on working very hard on a daily basis. Thank you very much.

Operator

This concludes BRF teleconference. Thank you, and have a good day.