Q3 2012 Earnings Call

Company Participants

- Claudio Bergamo, CEO
- Martim Prado Mattos, CFO

Other Participants

- Bob Ford, Analyst
- Irma Sgarz, Analyst
- Lore Serra, Analyst

Presentation

Operator

Good afternoon. Welcome to the Hypermarcas Third Quarter of 2012 results conference call. Today with us we have Mr. Claudio Bergamo, CEO; Mr. Martim Prado Mattos, CFO; and Mr. Breno Oliveira, IRO.

We would like to inform you that this event is being recorded and all participants will be in a listen-only mode during the Company's presentation. After Hypermarcas' remarks, there will be a question-and-answer session for investors and analysts, when further instructions will be given. (Operator Instructions)

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

We also would like to inform that statements during this conference may constitute forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the Company's actual results to differ materially from those set forward in the forward-looking statements.

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

Claudio Bergamo {BIO 16015846 <GO>}

Thank you very much all for participating in the call of the Third Quarter results of Hypermarcas. We will split the call into two pieces. I will talk about the highlights of the quarter and Martim will talk about more specific about the numbers. As we usually do, we will do the call using the presentation as a supporting material.

As we -- we start on page five. In the Third Quarter, Hypermarcas continues its strategy of sustainable and profitable organic growth based on three foundations -- sustainable earnings growth with superior operating profitability, supported by strong cash flow generation with net debt reduction.

Turn to the page six. The performance in the Third Quarter of 2012 shows that the Company is treading this path in a satisfactory way, with several consistent results that are worth highlighting. In the organic growth -- in the organic front, the Company grew 19.2% compared to the Third Quarter of previous year. In the year to date through September, net revenues reached BRL2.9 billion, corresponding to a 14.7 expansion compared to the same period of 2011.

Regarding the operating profitability, the adjusted EBITDA advanced 64.5% compared to the Third Quarter 2011 with BRL218 million in the quarter. In the year-to-date through September, the adjusted EBITDA amounted to BRL635 million, corresponding to 75% of Company's guidance of BRL850 million for the fiscal year 2012.

On the financial front, the Company had an excellent performance in the quarter, achieving very important numbers, such as the cash flow from operations of BRL234 million, 102% above Third Quarter 2011. And free cash flow of BRL172 million, 135% above Third Quarter 2011. The Company continues its delevering strategy and reduced its net debt in the quarter by BRL77 million.

Going to page seven, the superior economic and financial results in the quarter came alongside the satisfactory top-line performance. In the Third Quarter, Company net revenues reached a historical level, reaching BRL993 million in the quarter. That amount corresponded to a 19.2% growth in the quarter above the performance of 12.4% in the first half of the year. And representing a growth of 15% in the year to date through September.

Going to page number eight, in the Pharma division, sales in the quarter (sell-in) had a 39.4% growth compared to the same period of 2011, achieving net revenues of BRL531 million. In the year, the division reached an organic growth of 25% compared to 2011. In the quarter, the Pharma division reached a record level of manufacturing output, with more than 45 million units produced in September.

Going to page nine. In addition to the strong net revenue (selling) organic growth performance, the Pharma division reached historical record of demand sellouts of about BRL1.1 billion, advancing on the previous quarter level and maintaining demand over BRL1 billion according to IMS Health data. This demand represents a 24% growth compared to the same quarter of 2011 and is 52% higher than the equivalent quarter of 2010.

Going to page 10. Additionally, Hypermarcas Pharma division intensified media support to its brands. During the quarter 17 OTC brands were presented in TV, radio and other media campaigns, including anti-flu analgesic brands such as Benegrip, Coristina, Doril, Fluviral, Melhoral, among others. Aiming at creating new growth opportunities, the Company strengthened its OTC portfolio with our line extensions in the antacids category with the launch of chewable tablets and Estomazil brands, with consistent support of point-of-sale material, Internet, TV and radio campaigns.

The increase in media investments came alongside with high productivity of sales forces, higher direct sales to retailers, better point-of-sale management, with improved exposure of our brands in the stores.

The Company also broadened the distribution and portfolio of generic products, introduced new molecules, such as the nimesulide, one of the top 10 selling products in Brazil. During the quarter also, the Pharma division progressed towards more efficient operations and introduced cost reduction initiatives in the Rio de Janeiro plant. In the Anapolis plant, productivity has been increasing in a fast pace since the beginning of the year.

Turning to page 11, in the Consumer division, net revenues reached BRL462 million in the quarter, corresponding to a 2.2% growth in the quarter and a 3.7% in the year-to-date through September. That sales performance was influenced by the restructuring and the rationalization process underway in the division. Although these initiatives will not generate results in the near term, they are on the right path for creating the necessary conditions for superior, sustainable performance in the mid; to long-range.

Turn to page 12. In particular, the portfolio rationalization process is a fundamental step towards strengthening the focus on leading brands, with higher growth and profitability potential. This process was intensified in the Third Quarter with the end of production for outsourcing, rationalization of SKUs and discontinuation of low-margin, low-growth-potential brands. This process does not pose any financial loss to the Company, as the EBITDA of these businesses is close to zero. And it will also help in the process of focusing on leading brands with gains of exposure, sales force productivity, mix improvements, among other benefits. In addition, this rationalization process will reduce working capital needs and product loss expenses.

Turning to page 13. Although consolidated sales and these initiatives respond to 5% of total revenues, they will allow to focus efforts on 34 brands from previous 58 brands. And they will result in a material reduction of 40% of the number of SKUs in the Consumer division. In that perspective, the real organic growth in the division, core business was 6% in the quarter and 7% in the year, slightly below market growth of around 10% to 11% in the period.

Coming to page 14, in parallel to the portfolio rationalization project, the division introduced in the Third Quarter a new restructure of unified salesforce in order to increase its presence in the high-growth channels, such as pharma sales -- pharmaceutical retailers, cash and carry stores, as well in key accounts in the food retail channel. At the same time, point-of-sale promotion teams were placed under a single leadership with standardization of policy and higher frequency of visits to points of sales.

Regarding manufacturing and logistics, the first transferred product lines of deodorants and oral care are already operating in the new plant located in Senador Canedo. In addition, our shipping of products to north, northeast and south regions was fully transferred to the new distribution center in Goiania, which started operating in April 2012. During the quarter, Sanifill's oral care products and York's healthcare products were relaunched, in line with the strategy of renovating (dormant) brands in the high-growth, low-penetration categories, as you can see in slides 15 and 16.

Coming to page 17, during the quarter, our result that is worth highlighting is the free cash flow after net interest expenses in the amount of BRL122.2 million compared to a negative result of about BRL6 million in the previous year. This was the Company's record for the quarter and corresponds, in the end, to the main indicator for shareholders. It gives consistency to the sustainable organic growth strategy, creating (inaudible) cycles in the Company, showing that the initiatives that have been pursued since 2011 are in the right path and leading to the expected results.

Turn to page 18. The superior financial performance in the quarter has already shown to be consistent and satisfactory since the beginning of the year. The cash flow from operations was BRL610 million and the free cash flow was BRL430 million for the year. If we consider the last four quarters of the Company's cash flow from operations, the value was about BRL900 million and the free cash flow was BRL690 million. This free cash flow amount corresponds to a yield of 7.2% based on last Friday's share price, in line with the top quartile of the world-class peers.

The Company's management believes that it is in the right path to turn Hypermarcas into the vast consumer-health-related company in the emerging world, with consistent organic growth, good capital returns, strong operating cash flow generation, with potential of becoming a solid dividend payer in the mid; to long-run.

I will pass to Martim to talk about the more specific numbers.

Martim Prado Mattos {BIO 16015889 <GO>}

Good afternoon, everyone. Starting on page 20, we see that growth was up 19.2% in the quarter, being 39% in Pharma and 2.2% in Consumer. However, at about 5% year-to-date and 4% in Q3 of revenues in the Consumer is going through a discontinuation process, as mentioned by Claudio. Given that the performance of this product was off a decline of close to 37%, then organic growth in the core divisions of (inaudible) was up 6% during the quarter.

On the next page, we had a 5.8% gross margin evolution in the quarter. Margin increased from 69.7% to 76.3% as a result of net price increases and also better product mix. In Consumer, the gross margin was of 46.3% in the quarter, slightly ahead of the 45.5% seen in Q3 2011.

On page 22, we see that the adjusted EBITDA achieved BRL218 million, a 65% increase for the previous period, with (consequential) margin expansion from 15.9% to 22% of net revenues. That significant margin increase in the quarter is related to the fact that with the revenue (inaudible) compared to the previous year, we had a strong fixed cost dilution, in addition to a strong gross profit increase as a result of a combination of revenue and gross margin improvement.

As we used to say last year, after the programmed capture of synergies, the Company's fixed operating expenses were adequate and were maintained this year from last year's. On the other hand, revenue was depreciated in 2011, especially during the second half, in particular, in order to lead the reduction of inventories in the chain.

Flipping over to the next page, page 23, net income was of BRL68 million in the quarter and BRL79 million year-to-date. In addition to the strong contribution of the operating performance this quarter, we did not have any significant effect of FX (inaudible). And therefore we had financial expenses that better reflected the financial cost of our debt.

Before going ahead, it is important to stress that as we detail in the earnings release, we had this quarter effect of the non-cash effect of nonrecurring items in our financial statements. Both parts of this effect are due to our efforts in anticipating nonrecurring expenses that we will bear over the upcoming quarters, especially related to the consolidation of our operations in the Consumer division, the Matrix Project. The main goal of this initiative (inaudible) to reduce the difference between (inaudible) and adjusted EBITDA over the coming quarters because of reduction of no recurring expenses in the future.

On page 24, cash flow from operations was of BRL234 million in Q3 and of BRL 610 million in the year to date. These amounts are significantly higher than the ones in the equivalent periods of 2011 and they reflect again the improvement in the Company's cash conversion cycle. Cash flow from operations seen through the year of 2012 has become more and more predictable, consistent and closer to the adjusted EBITDA.

On the next page, we see that Hypermarcas' cash conversion cycle decreased in Q3 to 87 days, leading to the sixth consecutive drop since Q1 2011. Of this 32 day decrease compared to Q2 2012, about 19 days are due to provisions and write-offs about which we have already mentioned. And the remaining 13 days is a result of a four-day improvement in accounts receivable, four days in inventories and five days in accounts payable. This level of 87 days is therefore the best indicator for the adequate working capital needs for our operations.

Flipping over to the next page, page 26, we had a free cash flow of BRL172 million in the quarter, the second best result in our history, only below 4Q 2011, when we executed the sale of the home care and food (inaudible). Our free cash flow after net interest expenses was of BRL122 million, the fourth consecutive quarter with positive performance in this line, meaning that we have managed to reach our goal of quarter after quarter reducing (inaudible) debt.

Last, as we can see on page 27, as a function of our assessment of the business environment in which Hypermarcas is inserted and based on the internal purchase process that we have been constructing over the last five months, we maintain our guidance of adjusted EBITDA above BRL850 million for the fiscal year of 2012, reminding that the adjusted EBITDA in the year has already reached 75% of this goal. And we are introducing a projection for the year of 2013 (technical difficulty) Q-and-A session.

Questions And Answers

Operator

(Operator Instructions) Bob Ford, Merrill Lynch.

Q - Bob Ford {BIO 1499021 <GO>}

Good morning, everybody. And congratulations on the quarter. It was very impressive.

When you look at the difference between these phenomenal sell-in numbers in Pharmaceuticals and the sell as measured by MS, there is a pretty big gap. What do you attribute that gap to?

A - Claudio Bergamo {BIO 16015846 <GO>}

The main gap is due to the fact that the Third Quarter of last year we were conducting a destocking process. So that's why we had a sell-in growth of 39% despite the fact that we had a sellout drove (inaudible) 24%.

Q - Bob Ford {BIO 1499021 <GO>}

And Claudio, is there an element here that is the new molecules that you have in generics or some of the innovation that you're doing in OTC?

A - Claudio Bergamo {BIO 16015846 <GO>}

Yes. When we see the growth of the demand for the Pharma -- and I don't know if you remember, Bob, when in the last quarter, we reached slightly above BRL1 billion in demand, we were a bit skeptical about it if that would be sustainable. But we -- fortunately, it continues to be not only both the BRL1 billion demand. But also we reached demand close to (BRL1.0 billion).

Very important is that seems that our line has entered a new level of demand. When you look today the key drivers of that and you split that growth between the branded products and the similars and generics, both markets are growing; despite the fact that the branded products are growing around 12%. But the similars and generics has been growing at a 36% pace.

That growth has been influenced primarily because of the gain of market share of generics, which is a function of both new molecular introduction, as well gain in distribution, as well the similars market, given that the Farmasa (inaudible) increase of sales reached -- has been -- it has been triggering continuous growth of both of these markets in generics.

On the branded products, the 12% growth is also in our mind a very good level for the moment. And I think the key drivers of that growth has been the increase of the advertising for the OTC more that we have been conducting since the beginning of the year. And for more the prescription-driven (customers) because of the increased productivity of our doctor visiting force. I think they are the key drivers of that growth.

Q - Bob Ford {BIO 1499021 <GO>}

That is very helpful. Thank you, Claudio. Then when you look at the personal care business. And diapers in particular, you had been seeing some very explosive growth for Pom Pom. And then there was going to be a reconfiguration of capacity to meet that growth. Now it appears as if you've chosen to delay so you can optimize the -- you move off the capacity basically to Senador Canedo, from what I understand.

How much of a drag do you think that put on the personal care business, just simply not being able to satisfy demand for Pom Pom in the quarter? And when do you expect to have that capacity online?

A - Claudio Bergamo {BIO 16015846 <GO>}

When you look to the consumer figures, we have to be careful, because that figures it should split again, as we did in Pharma, branded and similars and generics. If we split into the cosmetics business and the diapers business, they are very different situations.

In the cosmetics and the health-related products -- let's put it this way -- in the cosmetics and the health-related products, our growth for the year has been 16%, which we think it is a very good level, given that we are being very disciplined in not putting stocks in the chains. So that pretty much represents in our minds the demand for that product.

But if you look to diapers, we pretty much have been at a zero level growth for the year. And that is a function in one part because we have driving to profitability the lower-end brands such as Sapeka and Cremer. And on the other hand, there that we do have stronger demand, which is in the Pom Pom. We haven't been able to supply the market with that demand. Given the trends of trade-up, that market has been faster than we anticipated.

Just to give you a figure, the Pom Pom brand as a brand independent has grown in the year for 16%. And I believe we could at least double that growth if we had capacity in place. So we are working now to have that capacity. And we will have that capacity in place from the Second Quarter moving on.

Q - Bob Ford {BIO 1499021 <GO>}

That's very helpful. Thank you very much. And again, congratulations.

Operator

Irma Sgarz, Goldman Sachs.

Q - Irma Sgarz {BIO 15190838 <GO>}

Good afternoon. I was wondering if you could comment a little bit about how you see gross margins develop from here, both in the Pharma segment, as well as in the Personal Care segment. And specifically regarding the Personal Care segment, where you've done I think three price increases in the year to date for the (dieters) business and are very focused on driving profitability. But we haven't necessarily seen too much of a change in the overall gross margin in the year to date in that segment. Maybe if you could just map out how you see the gross margin, (if you are able to cover your costs, or) --

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

When we think about the Pharma division, the level of gross margin seen in the Third Quarter already represents a very good level considering that most parts of the (inaudible) division of moving our production to Anapolis have already been captured. So that (inaudible) level. We still have some opportunities, especially in terms of the efficiency of the plants.

However, on the other hand, given that the generics and similars, they grow at a faster pace than the rest of the (inaudible), that still represents a slight dilution of the average gross margin. But overall, I think the Third Quarter represents a good proxy of our margin.

On the Consumer division, you are right. We still have some opportunities of improvement of margin, especially on the segments more related to diapers and oral care. In that respect, the consolidation of the production in Senador Canedo that will be finalized by the first half of next year should help us a lot in achieving that improvement. But on the way to get there, we also have to see how the new production at the new site will develop and how fast we can achieve those improvements.

Q - Irma Sgarz {BIO 15190838 <GO>}

And so just taking it up from there, you would say that really the production consolidation is a major driver of gross margin improvement on the Consumer side, whereas the price increases that you put through in the year to date (don't necessarily) have that much of an impact. Is that correct?

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

Yes, correct.

Q - Irma Sgarz {BIO 15190838 <GO>}

Thanks.

Operator

Lore Serra, Morgan Stanley.

Q - Lore Serra {BIO 1506730 <GO>}

Thanks for taking the questions and congratulations on the improvement in the numbers. I wanted to ask a question about the guidance levels you are setting. And I appreciate that you are giving any guidance, because most companies don't.

But if I look at what you are guiding to next year, it is about 12% growth or maybe less in EBITDA, depending on whether you finish this year with BRL850 million or above BRL850 million. And I wanted just to conceptualize. If you are going to get a lot of efficiencies from the full consolidation of all the assets and the sort of follow-through of the improvements you've made this year in the Pharmaceutical division. But even partly in the Consumer division, is there a view that -- well, I guess I would've expected you to guide a little bit higher. And I'm not sure if that is because you think that margins may be more under pressure in the Pharma division, or -- if you could help us conceptualize kind of how you are thinking about that 950, that would be really helpful.

A - Claudio Bergamo {BIO 16015846 <GO>}

Look, with what we have to look into perspective for the guidance are twofold. One -- first of all, we don't have any pressure on the margins that should put pressure on the results. For the other hand, you are right, the consolidation process might help to spike up our results. But we have to put into perspective that we will be under the process until at least July and August of next year. So when you are in the middle of the process, we might see expenses and (inaudible) and some certain level of inefficiencies, given that you are (technical difficulty)

Operator

Pardon me. This is conference operator. Please stay connected while we reconnect the speaker lines.

And the speakers have been reconnected. Thank you for waiting.

Once again, the speaker line has been reconnected to the call.

A - Claudio Bergamo {BIO 16015846 <GO>}

Sorry. Can you repeat?

Operator

You are reconnected to the call. And Lore's line is open, who just asked the question.

A - Claudio Bergamo {BIO 16015846 <GO>}

Okay, (inaudible) her with the call. So we are going to re-answer the call -- the question.

Operator

And Lore, if you would like to re-ask your question.

Q - Lore Serra {BIO 1506730 <GO>}

Sure. I think we were talking about guidance. And I think Claudio was talking about --

A - Claudio Bergamo {BIO 16015846 <GO>}

Just hold on for a second, Lore, please. Do you hear us?

Q - Lore Serra {BIO 1506730 <GO>}

Yes, I do.

A - Claudio Bergamo {BIO 16015846 <GO>}

Just a second, please. Hold on.

Hello. I am sorry. We had a mini energy crisis here. So as I was talking -- so coming back to your guidance question, as I said, we will be, in the first half of the year at least, making many changes. When we do that, that we get a plant from one place (inaudible). But until we get the new equipment working properly, we do have to (put off) certain level of inefficiencies at that certain period of time. And that inefficiency is not necessarily -- they would be like on a recurring basis. But for that time being, we had to take that into account in the results for the next year.

Another factor that I think is important that we will be looking to opportunities to increase our marketing expenditures, especially in our efforts to increase our (inaudible) in the point of sales of our products. Because the biggest opportunity I think in terms of top line and demand that we have now 2013 and 2014 is really being able to fulfill the white space we have for our brands. So we will be selectively looking how can we do that through our marketing budgets, in the case that -- to be able to accomplish that target.

So that is why we really are issuing now in our guidance that at the first glance it looks lower than the potential. But on the other hand, we have these two things that we have to take into account that we will be looking during the next period for 2015.

Q - Lore Serra {BIO 1506730 <GO>}

Thanks. That's very helpful. And just to ask a follow-up, on the white spaces, could you give us a better understanding of kind of how -- I don't know if you want to talk about specifics or in general. But what are some of those white space opportunities you are looking to pursue next year?

A - Claudio Bergamo {BIO 16015846 <GO>}

Well there are huge, huge opportunities in both divisions, either Pharma, as well as in the Consumer division. In the Pharma, for example, when the government decided to put the OTC to behind the counter. And last year, they reversed that legislation, now we have to work with our clients to find the best area for the OTC in the stores. So we have been working with the clients in category management for that. And we have been working through some options how OTC can be better exposed in the shelves, that many of the clients are open now for that, that given that many are rethinking how they are going to explore now given that was resolved. And so there will be a set of initiatives on that front.

A second set of opportunities are in the dental cosmetics, for example, that we have many opportunities of increase our exposure impact into the stands for the Mantecorp skincare market.

In the Consumer, you have a tremendous amount of opportunities -- you can name it -- from, let's say, improving our exposure in the drugstore chains for the skincare brands, such as Monange and Paixao, as well improving the distribution for the (inaudible), as well improving distribution for Bozzano. And in the case of diapers, Pom Pom is very strong (inaudible) in Sao Paulo and interior (inaudible) states. So have many opportunities for geographic expansion, as well as the diverse geographic opportunities for Sapeka.

So there is many, many (inaudible) places that opportunities. And we have to be careful which one we choose first in order to prioritize the ones that will generate higher returns in this process.

Q - Lore Serra {BIO 1506730 <GO>}

Perfect. That's very helpful. Thank you very much.

Operator

(Operator Instructions) Showing no further questions, this concludes our question-and-answer session. I would like to turn the floor to Mr. Claudio Bergamo for his closing remarks.

A - Claudio Bergamo {BIO 16015846 <GO>}

Thank you very much all for participating in the call. Sorry for the near energy crisis here. And our RI department will be available to go over further questions that you may have. Have a nice day. And thank you very much.

Operator

The conference has now ended. You may now disconnect. Thank you.