Y 2015 Earnings Call

Company Participants

- Eugenio De Zagottis, Investor Relations and Corporate Planning Vice President
- Gabriel Rozenberg, IR and Corporate Planning Director
- Marcilio Pousada, Chief Executive Officer

Other Participants

- Guilherme Assis, Analyst
- Joseph Giordano, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Raia Drogasil Conference Call to discuss the 2015 results. The audio for this conference is being broadcast simultaneously through the Internet in the website www.raiadrogasil.com.br/ir. In that address, you can also find the slide show presentation available for download.

We inform that all participants who have already able to listen to the conference during the company's presentation. After the company's remarks are over, there will be a Q&A period. At that time, further instructions will be given. (Operator Instructions)

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Raia Drogasil management and on information currently available to the company.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future.

Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of Raia Drogasil and could cause results to differ materially from those expressed in such forward-looking statements.

Today with us are Mr. Marcilio Pousada, CEO; Mr. Eugenio De Zagottis, Investor Relations and Corporate Planning Vice President; and Gabriel Rozenberg, IR and Corporate Planning Director.

Now, I'll turn the conference over to Mr. Marcilio Pousada. Sir, you may begin your conference.

Marcilio Pousada {BIO 16117399 <GO>}

Okay. Thank you. Good morning, everyone. Welcome to the fourth quarter corporate results of Raia Drogasil. Eugenio will detail (inaudible) for the Q&A. I will stress some items that are important for 2015 and I will go for 2016. Eugenio, please.

Eugenio De Zagottis {BIO 7193695 <GO>}

Well, hello, everyone. First of all, thanks for attending our conference call and we're very proud to present record results for 2015, in spite of the very challenging economic environment in Brazil that we are all aware about.

I think these numbers underscore a couple of things, I mean, the defensive nature of our market, which is driven by the aging population, the fact that we have a very strong balance sheet and positive free cash flow generation. This makes a huge difference in a market like this. And finally, the standard of execution that we have constituted over the last two years, and that realizing the vision that made Raia Drogasil to merge as one.

In this quarter, we are combining the numbers of 4Bio. Consolidation means that only the fourth quarter is added, combination means pro forma bringing 4Bio considering that 4Bio has always been part of Raia Drogasil. So these are combined numbers.

So we ended the period with 1,235 stores in operation. We opened 156 and closed 15 in the last year. We reached 9.4 billion in revenues, 21.1% growth. Looking only at retail, we did 2.5% same-store sales growth. Our gross margin reached 29%, 1.2 percentage point expansion.

Our EBITDA totaled 743.5 million, a margin of 7.9 and a 0.9 margin expansion. And it is important to consider that if you were talking only about Raia Drogasil, it's an 8% EBITDA margin. 4Bio has lower margins, so the number goes down from 8% to 7.9%.

The adjusted net income totaled BRL391 million, 4.2% margin and 44% increase. And finally, we recorded positive free cash flow for the third consecutive year, BRL110 million this year but we recorded a total cash consumption of BRL20 million, especially because we tripled our interest on capital distribution.

On the next page, I mean, we have all the details concerning the combination of Raia Drogasil and 4Bio. I have no intention to talk about the numbers here. We are providing these numbers for you so that you can reconcile what Raia Drogasil did with what you have in your models and so that you can start build the consolidated models from now on. And now you have the historic data to back it up.

On page 5, this is here, when you put it together our story that this was another strong year of accelerated growth with margin expansion and value creation. If you consider the company in 2007, this is our initial year as a public company Drogasil did its IPO. From 2007 to 2015, we multiplied our revenues three times -- we multiplied our store count three times, we multiplied our revenues five times, and we multiplied out EBITDA 9.5 times.

So my point here is, I mean, this value creation was done with tremendous quality growth and the yield variation as a public company almost entirely. So we know it's cliche to say that the best is ahead, but reality is that we have 15 years of growth considering that the ageing of the population is at an inflection point right now considering also that we have only 10% of market share in such a high growth market. So, we believe that the growth story is not at the beginning, it's maybe in the middle.

On the next page, you can compare 2015 to 2011, the numbers before the merger. And since the merger, we increased the store base by 59%. We entered eight to nine states that represented 11% of the Brazilian pharmaceutical market. We increased our gross revenues by 97.4 million nearly doubling. Our EBITDA increased 153%. We increased our ROIC by 6.7 percentage points, and as a result, our market cap increased 174% during this period.

Now back to the year, in page 7, we ended with 1,235 stores including three 4Bio stores. We opened a total of 156 stores, which was a record last year. We closed 15 stores in the year. This was a higher store closure pace than usual. But outside if you reach them I mean, there is nothing suggesting that it should repeat itself. The (inaudible) valuate our portfolio. We decide where we want to (inaudible) where there is any plant [ph] existing, we should just move on and it so happened that we closed 15 stores in the year.

Looking on the right chart in the page, the new stores considering non-mature stores, I mean, they account for 33.5% of our total store portfolio. This is the year-on-year store portfolio since the third quarter of '13. So this is a reflection of deceleration of our growth pace that is just starting as we plan to open 195 stores next year.

Page 8, this is our current geographic footprint. We have already 63 stores in Northeast. So this is a very highlight for us. We have more than 700 stores in Sao Paulo, almost 100 in Rio [ph]. So, it's a pretty good presence already, but we only have 10.6% of national market share. This was the single year with the highest market share expansion that I've seen, which is a reflection of high growth under a very difficult scenario in which many of our competitors are losing ground.

Sao Paulo was a key highlight because of the size of the market, 80 bps increased 2.7 percentage points in the Northeast, and we slightly lost share in the Midwest. What happened here is that we haven't opened a single store in Goiania ever since we did the acquisition of Santa Marta. So, we will give the time for Goiania to show the increase than through just stores. So I think there is nothing bad here. Brasilia, we'll open some stores next year, that will be only towards the end of the year, so this is not something structural.

So moving on now on page 9, talking about the revenues. We reached BRL9.4 billion of combined revenues. 9.2, Raia Drogasil; 186 million, 4Bio. So, we increased annual revenues by 21.1% and quarterly revenues by 21%. It's important to mention that the 1.4 billion that we added in revenues this year alone is the actual size of [ph] of the fifth largest Brazilian chain. So I can comfortably tell you that we are every year almost like buying the number one player in the market, but just about two times EBITDA while doing that. If you repeat this year the kind of growth we had in 2015 we will be talking BRL1.9 billion revenue increase. So, the numbers get -- which is a very positive thing because of the size of the company. We believe revenues we had in the year is very material. This gives a tremendous purchasing leverage and tremendous scale benefit as well.

Raia Drogasil grew 20.6% in the year, 20.3% in the quarter. 4Bio grew 48.1% in the year, 61.3% in the quarter. It's important to mention that since we came in and financially stabilized the company by capitalizing, by establishing supply credits and by increasing inventories, 4Bio accelerated significantly. So, we are very happy for 4Bio. Our goal is to see 4Bio in five, six, seven years reaching BRL1 billion in gross revenues.

In the right here talking about the retail sales mix. First, in the year HPC increased 20 bps and OTC increased another 20 bps, so 40 bps increased in the front store. And then 30 bps decreased in branded and 10 bps in generics. This is a nice mix effect, obviously it's not as stronger as generics outgrowing the rest, but the branded is the lowest margin we have in the business. We're talking about something like 20% of gross margins. While the front store was more than 30% of gross margin. So if you keep sustaining this kind of mix effect, I mean it makes a difference in our margins in the end of the day.

In the quarter specifically HPC increased 50 bps. Because of the Zika virus outbreak in Brazil, we saw a pick in insecticide, we saw a pick also in insect repellents. But still even if you took out the pick, HPC would still have been the main growing category in the quarter. I know that this is highly counterintuitive for everybody. We acknowledge that HPC has a higher income exposure than the rest of the mix, but still given we serve the middle class, given our execution, given the format, given the focus on more (inaudible) and upscale categories, which customers are less price sensitive, this for us has been business as usual.

On page 10, we've talked already about the top line, the combined top line growth, but now digging into specifically Raia Drogasil and the retail part of the execution, we grew same-store sales by 12% and we grew mature stores by 8.3%. The first point I want to stress is that we already -- we did really well versus a very strong comp base. So, we're looking to an 8.2% comp base next year and there is also a 0.6 percentage point calendar effect that harmed the quarter.

So everything else constant, we will be seeing 8.9% mature stores over 8.2% last year. So it's been a great quarter in terms of revenues. I think we are doing tremendously in our stores. Same-store sales 12% comping over 13%. Something that is interesting to mention is that as we increase our store base in the existing markets, obviously there is a cannibalization involved in that.

This doesn't matter (inaudible) new stores, because we already calculate the IR disregarding the cannibalized sales, looking only at the marginal sales. But it helps to illustrate how cannibalization affects same-store sales. I mean, an easy comparison to make here is, if you compare the total growth in the Q4 to the same-store sales growth on the -- sorry, I repeat, if you combine total growth in the 4Q '14 with same-store sales growth on the 4Q '14, there is a gap of 7.5%. In '15, there is a gap of 9 percentage point.

Obviously, there is nice acceleration growth, 4Bio should grow a lot. But you can look here to the fact that there is revenues coming out of mature stores -- same stores actually into the total sales growth. But still we're able to do 8.3% in mature stores, we should be 8.9% disregarding the calendar effect.

On page 11, gross margins increased by 1.2 percentage point in the year and 0.8 percentage point in the quarter. So it's a continuation for margin expansion trend. We recorded a very deep cash cycle reduction of 4.9 days fueled by opportunistic purchases that increased the inventories, but much more than increased accounts payable. And we are always looking at the net effect this leads to which is what matters cash flow wise, but this was very good for the company.

On page 12, talking about expenses, sales expenses increased by 100 basis points from the same quarter last year. Solid bps can be credited to labor and obviously. I mean, we had a favorable increase of 9.17% [ph] and our price increase was much lower than that. We also believe that the headcount of the stores is slightly ahead of what it should be. So that's given an opportunity to somewhat adjust that number, but not majorly.

Electricity, I mean this is a line we even shouldn't be talking about because electricity used to represent 0.4% of total revenues. But 0.4% suddenly became 0.7%, which certainly puts pressure because of the whole electricity situation you know well.

The good news is that going forward, I mean even if you went back, won't get back to past numbers, but if this will build pressure again we should observe a similar number to this.

And then finally, pre-operation expenses arising from acceleration of growth represented 0.3 percentage point expense pressure. This is a choice. I mean, we are doing what's best in the long term. I mean, if we have to take some pain in the short term to create tremendous value long term, we'll do that very comfortably. So it's the cost of growth, but the cost of growth pressure there is a spend by 30 bps. And going forward we expect to maintain the current level, mainly trying [ph] increase.

We are also (inaudible) in which we just sit. And finally, when you think about administrative expenses, what looks as a 10 bps pressure is in the end a 20 bps dilution because as you remember in the fourth quarter in 2014, we earned a provision, variable compensation because we had over provisioned (inaudible) that very year. So if you appropriate it to the correct quarter, we should have had 2.6% instead of 2.3% in the 4Q'14.

So not only this is a 20 bps dilution economically speaking, but also this will be the record quarter. This is the lowest administrative expenses that we've ever had in the company. So, it shows that we have been able to dilute it and it's also important to stress that we are investing in our structure as needed for us to grow and for us to deliver our (technical difficulty) a good example is category management. We significantly increased the area over the last two years. We also restructured our area and we have today a much more costly area, but operating much better also than before. So, despite of these investments and doing what's right, we have been diluting 20 bps, so this is (inaudible).

And finally, when we look at EBITDA, BRL743.5 million, 37% increase over the previous year, 90 bps margin improvement. In the quarter, it's a 20 bps margin pressure because of the 30 bps pre-operation expenses and because of the 30 bps comp based of the 2014 which was artificially inflated by and the provision of that compensation and still considering this margin loss the EBITDA increased 18%, it's a very good figure.

And here on the right part of the side, I mean when we calculate the effect of the stores we opened during last year and the total profitability, I mean there was a significant profitability drag in the short term. So, we would have had a margin of 8.3% over BRL9 billion of gross revenues instead of 7.3% over BRL9.6 billion. So both on reais and percentage wise, the initial year of expansion program is a drag, but this drag becomes a huge value -- a good source of value creation going forward.

For Raia Drogasil specifically, EBITDA was BRL737 million, an 8% margin. This is what you should compare to your models and for 4Bio it was BRL6.6 million, 3.5% EBITDA margin. Obviously a huge difference in margin and EBITDA margin between Raia Drogasil and 4Bio partly is related to the scale but partly is related to the business model.

4Bio is a much better asset utilization than Raia Drogasil. So for example, the CapEx are almost non- existent and the working capital is much smaller. A good way to compare the two is look at the EBIT margin, which will be 5.5% versus 2.4% and then the scale comes into play. But still regardless of the fact that 4Bio brings the margins down, we're not driven by margins, we're driven by returns, and I think -- we think we have tremendous returns over the longer term.

Net income, adjusted net income increased 44%, 70 bps margin increase. And in the quarter, 10 bps margin increase corresponding to 25% growth. And here talking about non-recurring expenses and here I want to make myself very clear. We don't like non-recurring expenses. We don't abuse non-recurring expenses. We don't report routinely non-recurring expenses, but when they happen, we have to acknowledge them.

And we have, among other things, just did an acquisition. I don't know how many acquisitions we did in the past -- in the future, maybe none, but maybe some. But the reality is that if you should do an acquisition you do just acquisition because it's something -- we're not severe acquirer, it's something that's not normal in the business model.

And then we have here and that's by far the main factor, the first relevant losses recorded in third-party PBMs over the last 16 years. When we started doing business with third-party PBMs. Here what happened, and this is referring to a specific program in which the client is Petrobras, this is not a default by Petrobras, this is a default by a company named Global.

This company named Global, they (inaudible) for Petrobras. So instead of Petrobras reimbursing them what the employees had spent, Petrobras started paying a certain fee per person from us. As a result utilization increased a lot and they got tremendous losses and they defaulted. So we're negotiating with the PBM because we are here accredited to a third-party PBM that managed the Global program.

So we exactly negotiated with PBM, but let me be very clear that we will have material losses here. And so we have provisioned those expected losses. We don't expect for these to repeat; again, first time in 15 years. And also as a result of that, we have also adopted a more stringent provisioning criteria, which was also a BRL1.1 million non-recurring charge. So we don't expect to see recurring expenses in other quarters, but it is what it is.

Next page talks about our cash flows. As I mentioned, this is the third consecutive year with positive free cash flow generation. We generated 110 million free cash flow versus 76 million previous year, 610 million resources from operations, 500 million after deducting working capital investments and 110 million free cash flow.

Then the total cash flow was a negative 20 million, but let's take into account here that interest on equity has tripled from BRL40 million to BRL120 million.

So this was a choice we have again and this is of course a very good cash generation for us.

Next page, talking about the ROIC, we present this chart every year, we recorded a significant ROIC increase from 15.1% to 19.4%, so this is 4.3 percentage points. If we compare to 2011, the year before the merger, we're talking almost 7 percentage point increase. So this is very material, and let's remember that one-third of the stores are still maturing. So, if we have our full portfolio of stores mature, ROIC would be something about 30% today. So with the high marginal return, we've always been talking about in our expansion, now we are starting to materialize in our consolidated ROIC result. The other thing to take into account is that as we accelerate the ROIC will probably be maintained flat or even some slight pressure on this year and maybe in the next. But then as the results come, we should be on the up-trend again.

So to conclude before passing to Marcilio for his considerations, we generated last year a total shareholder return of 41.4% considering share price increase and considering interest on capital distributed. Those investors would watch that the Drogasil IPO has had a cumulative total shareholder return of 25% since 2007. So this is a very long period and those who invested at a high IPO has had 28% since the end of 2010, another very strong value creation base for the company. We recorded 58 million in trading volume. As you know, we joined the IBOVESPA and IBRX-50, the two main industries in Brazilian stock exchanges this year. So, it was a very, very good year for us in every aspect.

And now I will pass to Marcilio for his considerations and then will be back for Q&A. Thank you.

Marcilio Pousada {BIO 16117399 <GO>}

Okay. Thank you, Eugenio. Okay, let's go to page 18. What's important here. My point is to discuss with you what's good for us in -- what was good for us in 2015, okay. We have two good points to stress here. The number one is the accelerated organic growth. We opened 156 stores, but not only stores, we opened the stores in the best corners possible in the city. We choose every part of the process to understand when you have to open a store, it had to be the best store as possible for this community for this (inaudible) which is very, very good for us. It helped us to increase the returns in all the stores and which helped us in these amazing results that you are talking of 2015.

We have with us right now 200 contracts signed in 2015. Same time you are looking to reach the same good results in new stores for 2016, 2017 also. We also changed the guidance for our 165 stores in 2016 and 195 stores in 2016. The other point that helped us a lot for a good 2015 results is acquisition. In all our operation metrics, we did better this year. If you look first into the Net Promoter Score, we reached our record level in November. When you look for the stock-outs, the employee turnover, the inventory losses, we reached the best number in all these historically in both companies.

If you have the results, retail business is very, very important. If you operate it stable with no problems, with no big challenges and every day understood the process, one day is better than the other one in the process in all the operation metrics, okay.

Another thing that was much better than the past we did the category management. We started this with good results with Dunnhumby partnership. We have started to understand better all the customer behavior and this has helped us in the gross margin (inaudible) help us in the future margin also.

The other point that we increased a lot in the operations side is the human research operation, okay. We shrinked the bar, we are much better in how to take care about our 26,000 employees, we know very well the people, we train well the people and (inaudible). It is good for us because we had people back in the store to serve our customers.

I think these two points help us to increase the margin. We reached 7.9% in margin. When I just started in the company 2013, my first goal was 7% in two years. So I think I have reached more, right now we have 7.9%. ROIC increasing 15.1% to 19.4%, shareholders return at 41% and we are in IBOVESPA right now which is very good for us as well.

What to expect for 2016, that's next page, okay. We keep focusing on our strategic plan that we started in the beginning of 2014. We had four pillars in this plan and we are keeping a team to looking for these four pillars. We know that you focus in what's good for the company and we can reach good results in the process.

What are these four pillars; accelerate organic growth, we have (inaudible) opening then you can open more stores in the future also. We had to develop a new format.

We are very, very strong in the aged customers. We are very, very strong in the stores with 150 square meters. We need to find ways to build more stores or bigger stores also, we have to find ways to reach the CD customers, not all which pharmas do, but maybe we should go back and link some markets we had.

We need to understand this that is good for our future. We need to improve the category management and the shopping experience. We know the environment in the store is very important. We had delays because we are now chauffeurs in parking because it gives the customer more time inside the stores and you can store more items for these customers.

We know how the market in Brazil is different from big markets in other parts. We have door-to-door marketing, very strong in Brazil and we have a very, very good opportunity (inaudible) huge market for us.

And you needed to engage, analyze, and potentialize customers. With the CRM we know this is a journey, we are not the only looking for opportunity, but also a huge channel approach with the customers. If you look at this channel approach we're just launching today the new raia.com in the Internet to serve the customer by Internet. We have drogasil.com a new site and raia.com a new site. Then our number one opportunity for 2016 is to focus in your pillars, strategic pillars, okay.

The second important thing is to take care of the money. We know we have money in the bank, we've got tremendous competitive advantage right now. These advantages help us to buy value with the vendors and be more aggressive in new markets that we enter into or going to grow. Then taking care of the money is important in the environment like today in Brazil and we know this is important for our future also.

And the third point that's important is to work with your productivity team. We know how difficult it's to work with the inflation in this country right now. We've all day, every day we have different message that we have to increase the price, we have to increase the labor cost, we have to increase the energy. Then we have to find ways to do more productivity.

So to this we have to understand better how the people work with the label in the store and how you can -- the value and increase our high-speed platforms to serve better our customers. With all these together they can help us to do more productivity, not only in 2016 but also in 2017, 2018.

But my last message is here that our main strategy is a long-term strategy. We know that you have (inaudible) in front of us, not right now but maybe in 10, 15 years right now, and you have to be ready to be there. Then it will be easy, the best part is be easy to be the future.

Thank you very much. You can go to the question-and-answer right now.

Questions And Answers

Operator

Thank you. This floor is now open for questions. Our first question comes from Mr. Guilherme Assis from Brasil Plural.

Q - Guilherme Assis {BIO 16143141 <GO>}

Hi, good morning everyone. Thanks for taking my question. I'd like to -- I know like I have a follow-up from the Portuguese conference call and actually you mentioned -- you talked a little bit about competition, right. And you said you see a favorable competitive environment in Brazil. I'd like to know specifically about some of the players, like we saw recently a transaction with Pague Menos, which is a competitor that operates more in the low-income segment. So they don't compete directly to you, but they had a deal with General Atlantic where they are putting money in the company.

I'd like to get your views on this specific competitor if you think that it's increasing risks of pent-up competition in the northeast of Brazil, which is their home region. And also about on offering CVS, like I know that they have been revising their growth plans for Brazil and even discussing the view that they made in the past, have you seen any moves from their side and how do you see the appetite of CVS to keep on investing and growing in Brazil? So that's one question.

And I'll ask the second question, now two, which is about the loyalty program, because you also mentioned in your remarks and also in your comments in the press release that you are reviewing or revising the loyalty program. What kind of actions and improvements are you making on that program? Those are the questions. Thank you.

A - Marcilio Pousada {BIO 16117399 <GO>}

Okay Guilherme, thanks for the questions. Firstly, I mean, this current environment helps a lot in terms of competition. As one of our Board members mentioned, there has been a meeting, Brazil is divided in companies with and without debt.

Just to give an example, when we bought 4Bio, the latest interest rate -- the latest debt they have got were paying 23% interest rate. So I mean, maybe this is a very small company that was leveraged. But still, I mean, when you look around the marginal cost of debt (inaudible) 19, 20, and 21. So the spread is much bigger than it was before. Those players will have debt and who still don't have these level of interest, once they roll their alliance, once they renew the alliance they'll get this kind of interest.

And it's a huge pressure for a company that's probably already generating negative free cash flows to service interest in these individual level. So, what these companies do is they cut people in the stores, they cut inventories, they increase prices, they drop a bunch of things that are not sustainable, they lay their consumer down; and guess what, the consumer comes to us because we are there with prices, with inventory, with a nice store, better locations and all the rest that you know.

So this has been a benignant environment because of that, I mean Pague Menos did a good transaction with Gen-A. We respect Pague Menos as a competitor. They have been a longer-term competitor. They have had a focused strategy. They're looking different than what we do, but without any doubt, this was a good transaction for them. I cannot say anything different from that.

In terms of CVS and on-off limit, I have a huge respect for CVS as player in the US and it's an amazing player, it's an amazing company, amazing people, but the reality is that this is not a global business, this is a local business. And you are what you are in the ground. So the way we see, we don't compete with CVS.

We compete with on-of the stores, one of the execution, one of the management and we haven't seen much happening. I mean they have 40 stores, we have, in Brazil, more than 1,200 stores. They have something like BRL0.5 billion in revenues. We have BRL9.5 billion in revenues. So the reality is that the (inaudible) is just one player and we haven't seen much, but even if they started growing, maybe they make money on their own, but I don't this will be disruptive for the management.

And again, if you look at the competition, (inaudible), you are looking for the (inaudible). Okay, but local competition is tough, it's very difficult to compete with the people in another place. We know that we are consolidated in the market (inaudible) market, but we know to compete against the original guidance is very difficult for us, as you do, you do it well, but not use it again, don't use it. Having another people good business in the market also. This is a new industry that we have seen many, many new entrants, since 2000. I mean it started with (inaudible) from Chile buying a corporation our of Brazil, they've got bankrupt, (inaudible) they did very poorly management (inaudible), so a pharma bought it, they didn't do much.

With that we have Brasil Pharma and we have many others. The reality is that this is a market that on the outside looks very nice, all these new secular trends, but the reality is that in these markets, demand is very challenging execution. And there is more number of companies in the market, who will really do it well. We don't try to be the only one, but they are not that many. I mean we can count them in a small number of fingers of one hand. So I think this is a very challenging market for all new entrants.

Q - Guilherme Assis {BIO 16143141 <GO>}

Loyalty program?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Then your second question. Loyalty program, I mean as part of the Dunnhumby project, I mean we re-examined our loyalty programs. We looked at the data and we decided that we should re-launch the programs and strengthen the programs.

So we are not getting, I'm not getting into details, because obviously when we launch then you will see this is very sensitive kind of information, but I mean we want to do better with (inaudible). The way we see historically, our loyalty program has been great for us to capture data and to give the data back to the consumer in terms of benefits like exclusive offers.

But we don't think our loyalty program today is a driver for the consumer to decide where he is buying and we want, through the loyalty program to fulfill that role. And when you are looking views in 2006 and 2007, we have prepared all the platforms, try to re-launch all the programs.

A - Gabriel Rozenberg {BIO 15886659 <GO>}

There will be filings.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Yes, (inaudible). Different programs for different brands.

Q - Guilherme Assis {BIO 16143141 <GO>}

All right. That's helpful. Thank you.

Operator

Our next question comes from Mr. Joseph Giordano from JPMorgan.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hi, good morning everyone. Thanks for taking my question. I just have a couple ones. So the first one is how to cope with the inflationary pressures that we'd been seeing in the Brazilian market?

So what are the main, like initiatives that you mentioned to control better expenses and also to kind of reduce your pre-operating expenses given that you're accelerating your expansion plans.

And second, you have like a huge automation project of a distribution center around Sao Paulo. So I'd like to understand what are the expected gains, should we expect like a leaner headcount after it's fully deployed and that's it? Thank you.

A - Marcilio Pousada {BIO 16117399 <GO>}

Okay, Joseph. So in terms of inflationary pressures, we are at the toughest possible moment on that, because we have growing inflation, so when the price increase happen, let's say inflation was 8%, our price increase was 6% and inflation is not there.

So we are fighting a 4% gap between the cap increases and the actual inflation. Obviously, there has been price adjustments. So the cap, it's an, it's not an absolute limit as you know, but we have a gap and that gap is showing up loud and clear in our sales expenses.

So currently and I am talking Q4, Q1, I mean we're leading the pressure, we have pressured margins, we have gross margins to offset, to mitigate those pressures. But there is not much we can do or we could do in the fourth quarter and there is not much we can do in the first quarter, and the pressures will be there, no doubt about it.

Having said that, we'll have a second quarter, it is a very important price increase, important something like 10% price increase. So, for the first time that you see our prices or our caps going up in line with inflation. This will be important, not only for the inflationary gain on inventories on the second part which certainly will be very big, but this will also lays the foundation for our revenues to be able to further accelerate. I think that price has come up 10%, maybe we can do better than 8% matches to our growth in the second semester.

So, we'll be in that second semester, there will be a level playing field for expenses and for prices. So I think this can be very beneficial to us.

And in addition to that, we have a lot of endpoints [ph] on projects, these are many projects going on hence evolving staffing, hence evolving salary grids, hence evolving platforms that should translate in gains. Maybe we can see some of those gains in the second semester.

So the second semester we could see neutral to positive (inaudible) strength. If the inflation declines, then the opportunity is even bigger. So when you look and speak about the year, certainly, we'll have pressure in the first quarter, we'll have a huge second quarter and then we'll have to see where the revenues will be in the second semester, but I think we saw positive second semester.

So the question is, if we can pay in the Q2, Q3, and Q4 what we lose in the Q1 or not or even if it's bigger so there could be some margin expansion for the year.

Right now our expense is we think about a neutral margin in the year, but depending on where our revenue gets after the price increase, maybe there could be some margin expansion. We will see how it plays out, but I think just like it's very tough right now. I think it'll be great going forward.

Then to your second question, in terms of the automation in Sao Paulo. Let me share how we thought about that. I mean we have three biz-units [ph] in Sao Paulo and we are growing many stores every year, especially in Sao Paulo which is our main market. So obviously, we have some spare demand, but not much spare demand.

As the number of stores grow, capacity has to grow and capacity growth can be either a new biz-unit or existing biz-unit expansion. Since we already have three biz-unit in Sao Paulo, we don't think it makes any sense to add a new biz-unit because I knew biz-unit would cost extra working capital, extra landfills [ph], extra dilutions in expenses and so on.

So we did a right calculation in this investment and the conclusion we brought is that what maximize value for the company was adding capacity in existing biz-units. And adding capacity in existing biz-units through automation is more expensive than opening a new biz-units, but also we operate at a much more effective way in that biz-unit because we operate with less labor expenses meaningfully less labor expenses and a big capacity increase for the company.

So, I don't have a magic number to throw out, but this is what maximizes value for the company without any shadow of doubt. And if you looked at biz-unit, all the strategy (inaudible) try to help with expansion, okay, every time you're ahead with expansions. Really do we see all these investments right now?

No, we need these investments for the future, let me think about the future in Brazil, in Sao Paulo area, how we can grow Sao Paulo without any problem in the biz-unit.195 stores, which is what we will open next year.

This is the relevant scale of a big biz-unit. So if we add stores at that level, it means every year we have to add that kind of capacity. Sometimes, it will be a huge -- like you see in the Northeast. And then you make sense what would you see there, but you don't (inaudible) the differences are big, (inaudible).

So, what maximize value there was exactly that. In other situations, it may be expanding the size on the visibility. In other situation, we will be adding automation to one of these industries, but logistic investments it's an ongoing thing, it's not a one-time initiative.

Q - Joseph Giordano {BIO 17751061 <GO>}

One extra question if I may. Regarding the document terms, I'd like to understand how sustainable they are given that like, those have been driving a significant improvement to cash cycles in the company. So I'd like to understand like if you think that all those opportunistic purchases one day will become like a real term for the company or it's just like one-time? Thank you.

A - Marcilio Pousada {BIO 16117399 <GO>}

The thing is, opportunistic buys, they generally consist of stuffing the channels. So you will have a supplier who has a sales target, who's not making them. He needs to show good numbers for the headquarters, I mean this is how multi-nationals work right.

And then, I mean they come to us and they ask us to take extra inventories and we do that happily by taking extra margins and by getting the working capital investment subsidized, and generally more than subsidized.

So I mean, re-working that trend is not easy. I mean this is like drugs. Once someone gets in, it's difficult to get out, because for a company to get back to normal, this means that all the channel stuff that we did last year, they're losing demand this year. So it's a very difficult cycle to get away from that.

Sometimes, okay, they will try to progress and we do over many years, but it's not easy to get out of the trap they create for themselves.

I don't think we have much of a vulnerability on the margin side, but I acknowledge, we many some on the working capital side. I think if the trend reverses, I mean this could cost us working capital, but I don't think this will cost us margin. I think the margin effect, we can mitigate, there is some we can mitigate in other ways. I don't think it's that material.

Q - Joseph Giordano {BIO 17751061 <GO>}

One extra one, is it like any specific market segments or which we see the market has been declining or it's on the drug segment, I would believe that on the branded drug side it's harder. So if it's like a generics, I notice you'd clearly be more aggressive. So can you comment on that?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Sorry on the supply -- I didn't understand the question, sorry.

Q - Joseph Giordano {BIO 17751061 <GO>}

There was a -- be more aggressive in terms of terms?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Of terms. I would say generally from stock, OTC and HPC. But sometimes even government practice [ph] can do it.

Q - Joseph Giordano {BIO 17751061 <GO>}

All right, thank you.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Thank you.

Operator

It appears to be no further questions. I will turn the conference back to the Company for their final remarks.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay. Thank you all for attending our call. And I think in order to look ahead it's important to understand where we come from. We did a merger in 2011; 2012 and 2013 were challenging years of integration and some margin difficulty. In 2014, that integration was concluded and this was when the vision that drove the consolidation really materialized. So 2014 and 2015 were years with a huge leap on execution, which were followed by a huge leap in profitability as well.

Since the integration has been concluded, we have been challenging our own execution that we inherited. So we are looking at our processes, our platforms what we can do better, and we are questioning the status quo and we are really on a journey to reinvent our execution. And this has been an ongoing thing and there is a lot of productivity enhancement initiatives in the year.

2016 and 2017 are years of acceleration. I mean we are ramping up towards 195 next year. 165 looks like the most probable number right now. But in the end, we are ramping up towards 195. At any point, if we think we can do more, we'll adjust the guidance, if not that's the guidance we have, but 195 next year is a big number and already the 156 we did last year and the 165 now are relevant numbers, but there are numbers that bring together growth plains, they bring a rather expense pressures and these expense pressure are here to stay.

Give or take 10 bps here or there, but we'll see pressured core operational expense going forward, the cost of growth. In the first quarter, I mean I think, we'll see a similar trend when compared to what we saw in the fourth quarter.

We will see sales expenses challenged by growth base, inflationary pains, because the price increase still hasn't taken place. And to add to the complexities, we will be comping against a very challenging comp base last year.

It was our leanest sales expenses we have seen and we are hesitant now than we were back then. So, there are pressures waiting for us in this Q1 just as we had pressures in the Q4.

But the thing is, when you look at the company structurally, we are very strong in everything. The expansion is doing amazingly well, I mean, both in terms of numbers, but mainly in terms of the quality of the stores, in terms of the initial results we have been getting from those stores.

The growth of the mature stores has been very strong we saw in the fourth quarter and we've seen a very strong first quarter as well. I mean obviously, we still have some days, a week or more in February and a full month in March, but if everything moves on as it has been until now, we will see another great quarter in terms of revenues.

So, this is the most important period, this is the trend we carry forward. And the gross margins, we also had a good structuring. What will happen is that we have now, in the first quarter, a reduction of taxes in generics in Sao Paulo.

We've structured everything, but as far as our margins, it works just like the opposite as the price increases, what happens is that we bought expensive and we sell cheap. So, there is some margin pain in the first quarter, I don't think it's huge, but it will be there.

So I think we have challenge in the first quarter. But then when we get to the second quarter, we have a huge inflationary gain or event as we are trying to do as big a forward behind as we can to leverage these opportunities. And then we will carry the current sales trends. We love the fact that the prices will go up around 10%. So we'll see a second semester in which there will be a level playing field for revenues and expense for the first time in a very long term.

So we believe we'll expand margins. We'll surely expand the margin in the second quarter and we believe we'll expand margin in the second semester. I don't know if all in all this will be a neutral or a positive margin year, but I'm very confident that the momentum will carry for next year meaning what will be the end of the second semester, I think it should be good. So, we are also laying the foundation for further margin expansion ahead in 2017, 2018 and 2019.

Then to finalize or just to go over our -- some of our IR highlights, on page 20, the first thing is that we are preparing the launch of ADR Level 1. So our Board has already approved it. We are getting the necessary authorizations from the SEC from CVM. We believe this would give a great visibility in the capital markets and especially this can potentially bring a new pool of investors to the table.

The timing for implementation should be March to April. I don't think ADR level 1 is a transformational thing, but I think it's something welcomed that can happen and can help our liquidity and visibility. In 2016, we'll release our earnings for the first quarter, April 28; second quarter, July 28; third quarter, October 27.

And finally, we have three Investor Conferences already scheduled. So we have the Bank of America Merrill Lynch Conference March 16, 17 Sao Paulo. Also in Sao Paulo, the Bradesco Investment Forum on April 5 and 6. And then on May 18 and 19, we have the Itau CEO Conference in New York and Marcilio and myself will be there.

So that's all. I'd like to thank you for attending the call. I like to thank for the support of our core shareholders. We are very privileged to have a group of very meaningful shareholders that have been around; some since Drogasil IPO, other since Raia IPO. So we appreciate your trust and people who have been through the tough and the good times. And I hope to see way more good times than tough times ahead. Thank you very much.

Operator

Thank you. Raia Drogasil's conference call is finished. Have a nice day.