Q2 2017 Earnings Call

Company Participants

- Breno Toledo Pires de Oliveira, Chief Financial Officer & Investor Relations Officer
- Claudio Bergamo dos Santos, Chief Executive Officer & Director

Other Participants

- Alexander J. Hahn, Analyst
- Guilherme Assis, Analyst
- Gustavo Piras Oliveira, Analyst
- Luciano Campos, Analyst
- Maria Paula Cantusio, Analyst
- Robert E. Ford Aguilar, Analyst
- Thiago Macruz, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to Hypermarcas' Second Quarter 2017 Results Conference Call. Today with us, we have Mr. Claudio Bergamo, CEO; and Breno Oliveira, CFO and IRO.

We'd like to inform you that this event is being recorded and all participants we connect it in listen-only mode during the company's presentation. After the company's remarks, there will be a Q&A session for investors and analysts only when further instructions will be provided.

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

We also would like to inform you that statements made during this conference call might be based on forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could lead the company's actual results to differ considerably from those set forward by these forward-looking statements.

Now I turn the floor over to Mr. Claudio Bergamo who will begin the presentation. Please, Mr. Bergamo, you may proceed.

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Good morning, everyone, and welcome to our conference call, to discuss the results of the second quarter of 2017. Company's net revenue in this quarter reached BRL 852.3 million, up 5.6% from the previous year, the same quarter of last year, the second quarter of 2016. This sell-in sales expansion within the quarter did not reflect, however, the real growth rate of the sell-out demand for the company's product in this quarter, which amounted to about 10% when compared to the same quarter of last year. This connect was mostly driven by an above historical average product, Stockhouse (03:03), which was of around BRL 35 million. If we were to exclude that effect, the sell-in sales growth would have reached about 10%, which will be in line with the growth in our demand.

It is also worth mentioning that this sell-out demand occur because of a mismatch between our sales forecast and production. We started the quarter with low inventories when we had a forecast of a more conservative sales drive for the quarter. We had a very good recovery of demand starting in mid-May, and we had no time to speed up production. It's also worth mentioning that this growth in demand was stronger in our most profitable market of consumer health and prescription products or Branded Prescription which recorded an average growth of 15.8% above the market average at 8.7%. This performance is due to a series of factors such as the continued investments in media and medical promotion, better execution at the point of sale, and also, to successful launches in the quarter.

It's worth also mentioning that Hypermarcas started operations of its new research and development center, and it also received the permit from the regulating agency. And it also managed to further improve its innovation index which reached a record level of 27.6% in the quarter.

The company also completed its organizational restructuring after finalizing in March the sale of its Disposable Products business to Ontex. In terms of operating results, the company posted EBITDA for continuing operations of BRL 318.9 million with a margin of 37.4% of net revenues.

The company also improved its cash flow performance, with operating cash flow of BRL 306.6 million, again, BRL 306.6 million which represents an increase of 36.6% when compared to the same quarter of 2016. Because of all those events, the pro forma net cash position in the quarter ended the period at BRL 636.1 million. We are in this case already considering the capital reduction of BRL 821.9 million, which was completed in the beginning of July this year, which was equivalent to BRL 1.3 per share. In this year, the company has already granted almost BRL 2 per share between dividend and capital reduction on top of the repurchases the company has been executing.

Also a highlight for the quarter was the company's net profit of continuing operations which reached BRL 238.6 million, a growth of 35.5% when compared to the second quarter of 2016. After having already reached continuing operations EBITDA in the half, in the semester, of BRL 668.3 million and also given several other variables, including demand generation figures for its products, the company believes to be well positioned to reach its guidance for the year which in terms of EBITDA from continuing operation sits at around BRL 1.2 billion.

Thank you. I'll now give the floor over to Breno, our CFO, who will be addressing our figures in a little more detail.

Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Good morning, everyone. This is Breno speaking.

Moving to page 3 of our slide presentation, you see a growth of our continued operations growth at 5.6%, above the average increase which we saw in the beginning of the first quarter, an average of 3.5% for Hypermarcas with the highlight for the generic products. As it was mentioned, we had above-average stock-out at around BRL 35 million, which of course impacted the revenue for the quarter.

The gross margin was 74%. When comparing to the previous quarter, out of which 6% was due to the sales mix, which was more concentrated on generic and similar products. However, that margin was in line with the gross margin which we posted in the first quarter of this year.

As for marketing expenses, they represent 23.4% of the net revenue, a drop of 0.6% due mainly to a one-off reduction in expenses with free samples in the quarter. Marketing expenses grew 11.1% in line with the company's strategy of investing in media and medical promotion.

Sales expenses grew 5% in the quarter, accounting to 12.7% of the net revenue as opposed to 12.8% in the second quarter of last year, due mainly to a growth of 38% in our expenses with research and development, and a reduction of 17% in our expenses with freight and logistics, a new level which we have been observing since the third quarter of last year.

G&A had an increase of 12.7% due to the higher representativeness of corporate expenses in the remaining business after the sale of the Disposable Products Business. With that, our company's EBITDA reached BRL 319 million, a growth of 4.6% and a margin of 37.4%. Our financial result was a revenue of BRL 26 million this quarter when compared to financial expenses of BRL 51 million in the second quarter of last year. With that, our company's net profit for continuing operations was BRL 239 million, an increase of 35.5% when compared to the second quarter of 2016.

Discontinued operations accounted for a negative net result of BRL 43.6 million due mainly to non-cash expenses with assets write-offs which were not part of the Disposable Products Business on top of expenses related to transactions which took place after the deal was closed. So, the total net income for the company, including continued and discontinued operations, reached BRL 195 million in the quarter, a growth of 10.5% when compared to the second quarter of 2016.

On the next slide, page 4, we see the cash conversion cycle closed at 155 days, in line with what we saw in the second quarter of 2016. Working capital as a percentage of net revenues closed the quarter at 40% within the interval observed in the past months between 38% and 40% of net revenues.

The operational cash flow was BRL 307 million in the second quarter, a growth of 36.6% when compared to the same period of last year. It's impacted mainly by accounts receivable. The free cash flow remained stable at BRL 223 million due to the receivables in the second quarter of 2016 of a price adjustment relative to the sale of the cosmetics business, which in this quarter an increase in investment in CapEx and R&D because of the building of our new Innovation Center, the Innova (12:30).

On page 5, we see the company's net cash position closed the company at BRL 1.458 billion. Considering the cap reduction at BRL 821 million, which was there in the beginning of July, we closed the quarter with a pro-forma net cash of BRL 636.1 million.

Thank you all for your attention and we remain available for Q&A.

Q&A

Operator

Thank you. The floor now is open for questions from investors and analysts. Mr. Robert Ford from Bank of America would like to post a question.

Q - Robert E. Ford Aguilar {BIO 1499021 <GO>}

Well, we have three questions, please. First, are you comfortable with the level of age of your inventory, or do you think you'd need to conduct some adjustment in that respect, please? That's the first question.

A - Operator

Yeah. And the second question?

Q - Robert E. Ford Aguilar {BIO 1499021 <GO>}

And the second, along the same lines, you seem to be increasing the offer of credit to commerce. Can you elaborate a little more on your strategy for working capital?

And lastly, looking at your innovation pipeline, what makes you more excited for this year in terms of launches in your pipeline?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, this is Claudio speaking. In reference to your first two questions, which are in line, we are quite comfortable with our inventory levels for the different channels. We conduct a very strict control on a client-by-client basis, DC by DC, distribution center by distribution center, to control the inventory levels. It's not news to anyone that our policy is to keep safety inventories for all channels, so that we do not run a risk of stocking out. Now, this will occur to a larger extent in products under the Branded Prescription products and OTCs and to a lesser extent for generic and similar products.

In any event, that's a policy we've been adopting for some time now. And in quarters such as this one, for example, where we saw a slight one-off stock-out of some products shows that policy is correct in our view. We are talking about products with a gross margin of over 80%. So, the cost of our stock-out is huge when we compare to the cost of unloading and inventory to the channel, of course.

It's also always important to mention that our clients are always looking into inventory levels in comparison to past demand, and we're looking at future demand. So, of course, there is sometimes somewhat of a mismatch between points of view because the demand for some products grow strongly, and because of that, we carry some inventory. But we do that – but, looking forward and we're taking into account, of course, investments we are making in some categories. As an example, Alivium we have been investing strongly in this quarter in this product. In this quarter, we launched Alivium gel caps and 400 milligram.

And when you discuss about the trading side, there's no historical levels. But we are investing over BRL 30 million in this launch. So, we are quite confident, quite confident that it is a great launch, a promising launch, the first signs are very promising. We had a growth in demand in the first quarter for Alivium of 35%. The Alivium brand is quickly becoming the leader brand in ibuprofen in Brazil. And that's one of the main assets in terms of painkillers and similar. It's a very important case because we are able to maintain, at the same time, the products for children, drops. And at the same time, we are working in the media for adults with a 400-milligram gel caps, and we are taking to doctors the 600-milligram option. Basically, that's it.

As for the pipeline, needless to say, this is one of the company's main focus. In other words, innovation. We have been working hard for some time by now in creating and building our new innovation center. We had some delays, we were like three months behind schedule, but it is now a reality. We have received our permit from the regulating agency 20 days ago. We are now in a phase of hiring personnel to run the center, and I'm sure this new innovation center will become an important, a very important platform for the company in the coming years.

Just to give you some figures, Bob, today, we have, without including launches which have been already made last year, early this year, and in the second half of this year, we have in terms of projects in our waiting list, if you will, around 200, 210 projects. And after they are launched, they will account for an additional revenue in the fifth year, that's how we work, of over BRL 3.5 billion, just to give you a rough idea, ballpark, of the size of, the dimension of things that we have in the pipeline. A lot of good things in our pipeline, and we do believe strongly that that's a definite way for the company. And thank God, we are now well-equipped, better than we ever were to achieve that.

Q - Robert E. Ford Aguilar {BIO 1499021 <GO>}

Thank you, Claudio and congratulations.

Operator

Mr. Luciano Campos from Bradesco would like to ask a question.

Q - Luciano Campos {BIO 16181710 <GO>}

Good morning, Claudio, everyone. My first question is about the sales force. Last year, you announced you had an idea of creating a sales force for each business unit. Where does that stand by now? Do we have the full cost for all that, and when do you expect to have that up and running at full speed?

And a second question, if you could please remind us, what is included under other operating expenses? Just give us some color on that entry for this quarter. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you, Luciano, for your question. This is Claudio speaking again. I'm going to address the first question and then Breno will address the second question.

As for sales forces, we started this current quarter with a new makeup for the business units. It is now totally verticalized in terms of sales and marketing department. So, the answer to your query, starting in April, we began operating this way. We had to create positions for those sales forces. Two-thirds of those new spaces or spots have been filled, and I'm talking about field crews.

As for the strategy and trade and branding, we have been working on it for about six months already. The result of this new strategy, in my opinion, is that I can say that part of the success we've enjoyed in terms of sellout demand for Branded Prescription and OTC, part of that success is already being driven by that strategy, in my opinion. So, we are putting more focus to that. So, because of that we are having a better execution, I'm sure of that. A good example of that would be our results for flu medicine in this quarter.

Yeah. For example, just for Benegrip, an increase in demand in this quarter of 38%. It's an excellent level of growth. I'm talking about demand sellout. And in the case for Benegrip Multi, we had and a demand which was threefold what we had in the previous year. So, let's say, the BRL 35 million stock-out. A third of that, BRL 15 million, can be associated with flu medicine alone and that's a result of a very well done execution, a work made with focus, with mobilization towards our flu medicine product.

I'm not going to say it's only that, of course, because it's also a result of big efforts in investments, in media. We've been making, in this specific case, investments in OTCs regardless of the economic crisis. We are not going reduce our investments. We have not reduced our investments quite the contrary. We have been gaining productivity because of what we do, be it in OTCs and other areas. And of course, if our competitors have been more conservative and we see several cases where we see that happening, more conservative actions, when you have that scenario, you end up seeing improvement in our market share in those markets because we have continued to invest whereas other competitors have not.

So, demand for those products is going really well. And part of that good performance is due to this new model we have adopted about a year ago. I'll now give the floor over to Breno, who will address your second question.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Luciano, this is Breno. As for the others entry, BRL 22 million for eventual tax-related – and the main item was a reversion of provision for tax contingencies relative to the ICMS for the basis of calculation of PIS/COFINS federal taxes that came from a decision, a ruling from the Supreme Court at the end of the first quarter. That's basically it.

Q - Luciano Campos {BIO 16181710 <GO>}

Okay. Thank you, Breno. Just a follow-up, Claudio, if I may. When you say that you have filled two-thirds of the positions created for this new sales forces structure, that one-third which is due left to be filled, is it a matter of time, or is there any kind of dependency, you're waiting for the approval of a new product and then you would hire the remaining of the sales force? I'd like to understand that a little more clearly. In terms of the size of this structure, has the decision been made, or are you waiting for some kind of approval from the government?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

No, the size, the model, the structure, the positions, the wages, the compensation, that has all been defined and it is part of our budget already. It's just a matter of execution on the part of human resources. They need to find the right people, just a matter of time of implementation.

Q - Luciano Campos {BIO 16181710 <GO>}

Thank you.

Operator

Mr. Thiago Macruz from Itaú has a question.

Q - Thiago Macruz {BIO 16404924 <GO>}

Good morning, everyone. I have two questions. Recently you've mentioned in some announcements the interest in acquiring licenses. I'd like to understand that this is part of your overall objective. If you could share with us some indication what kind of products are you assessing? What can we expect in the short run?

And a more basic question would be – maybe Luciano has already mentioned some of that. But just to be sure, in terms of discontinued operations, I'd like to understand now that you have sold asset, I'd like to understand the discontinued operations a little better, please.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Okay. So, once again, this is Claudio, once again. I'll address the first question and Breno will address the second question. Okay?

All right. As for the acquisition of licenses and what it brings (27:46) in terms of business development, I'd say that maybe Hypermarcas is now enjoying its best area in business development today that we've had in all our history. We are extremely active. The number of opportunities that appeared in the past six months grew considerably, exponentially, I'd say. We've been conducting several negotiations in different fronts, and those will probably have some effect starting in the second half of the year and onwards.

We have around 41 negotiations which are ongoing. And when I say that, I'm talking about all kinds of businesses from the acquisition of registration, clones, the acquisition of brands, partnerships. The only thing we are not going to do is to sell brands of third-party products because that's not our calling to be distributors. The company has, as its principle, to be the owner of its products and its brands. And in most cases, we also produce, if we do have to temporarily have third-party production, it'll be, as I said, temporary.

So, many distribution opportunities also emerge, but those are not in our focus. We're not going to use our sales forces, our marketing structure to focus our efforts on third-parties or third-party promotions. That's not part of our principle, that's not in our DNA. We do believe in perpetuating our business or our businesses. When you work with somebody else's brands, they are temporary by nature. At the end of the cycle, end of the contract, you are running against a risk of losing that product or losing your license. So, often times, the owner of the technology conducts a harsher negotiation. Anyway, it's not our cup of tea, if you will.

Now, Breno will address the second question, the one referring to discontinued operations.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Okay. Thiago, this is Breno. As for discontinued operations, the net results in the quarter was BRL 44 million negative. So, after the signing of the business for diapers, for example, we made a provision at the end of the fourth quarter of the assets. And after the closing of the deal in the first quarter 2017, in the (31:19) second quarter, we conducted the adjustments and writing off some assets, which were associated to the Disposable Products Business, but which had not been provisioned for at the end of the fourth quarter when we worked on the estimates, and some cash expenses also related to that deal as commission fees, legal fees, which occurred after the signing of the deal.

We still expect to have some expenses, or in other words, to have negative net results in the third quarter which are basically related to price adjustments with the buyer because of working capital variations. But surely, it will be at a lower, lower level, and it should be decreasing throughout the coming months and the coming quarters when comparing to the first half.

Q - Thiago Macruz {BIO 16404924 <GO>}

Thank you. Thank you for the answers.

Operator

Mr. Joseph Giordano (32:34) from JPMorgan would like to post a question.

Good morning, everyone. Good morning, Claudio. Good morning, Breno. Thank you for taking my question – actually two questions.

Number one has to do with what would you consider in terms of an optimum capital structure for the company today. Claudio did mention that you are already at a BRL 2 per share today. I'd like to understand in a bit more detail what would be the company's policy going forward given that we have something close to BRL 700 million in net cash position, in other words, generating cash in a very healthy way.

And the second question has to do with the top line. I'd like to understand in a bit more detail if you expect to recover what you lost. I'd like to understand if the sale will be better for the third quarter, if you'll start on a better foot in the third quarter.

And the third question, looking at the marketing expenses, how can we expect that to behave for the remainder of the year? Last year, it sat at 24.5% of net revenues in the first half. It increased slightly, even though we had some one-off reductions in the second quarter. I'd like to understand how can we expect those expenses to behave for the remaining of the year, marketing expenses. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hello. This is Claudio speaking. I'll try to answer one by one.

In terms of capital structure, the company has been giving signals that the company's objective is that any surplus of liquidity be paid out to shareholders. (34:36) dividend policy, which is a policy based on the short-to-mid run. So, we'll continue to pay out dividend whenever we have a surplus liquidity. We continue to do that or continue to try to do that. So, for now, that's what I can tell you. This is a policy of the company, and we intend to preserve that policy throughout the period.

We also said that our minimum cash, our capital, our net debt should be below BRL 500 million, maybe BRL 350 million. And we closed the year with BRL 636 million. That gives us some kind of comfort for the company because then we can think or we can believe that we'll have resources to continue in our policy of dividend payout for the coming periods.

And in terms of top line, we now have BRL 35 million. In other words, historically, we've had around BRL 50 million that's been our average, despite all the efforts we've been making in our sales and the operation and planning programs to minimize those figures. But the fact of the matter is that, historically, we've been around the tune of BRL 50 million, and that happened because of reasons that we've mentioned throughout the presentation, and they are good reasons. If we had not stocked out, I'd like to say that stocking out might be a good problem to have because it implies that demand is high. Excess of inventory would be a real problem.

(36:45) we've been trying to work hard to make sure that does not happen again and that we are able to meet our demand at all times. So, we've been working hard in the production front, increasing our inventories. Our inventories were quite low when we closed the first quarter. And demand has been proving to be strong throughout the year, and there is no sign, no reason why it shouldn't continue to be that way.

Because of all that, we've been working strongly to recompose our inventory levels, so that we can, in the third quarter, meet our demand and even meet past demand which was undeserved. So, our target is certainly to meet past and future demands all the time trying to preserve our minimum inventory policy for the different channels.

As for marketing expenses, your third question, if we look at the year-to-date figures, we closed the first semester at 22.8% as opposed to 22.3% last year. In other words, a growth of 11.6%, slightly above the growth of sales which was 11.9%.

So, as I've been saying, we are doing everything we can. We are not reducing marketing expenses on the contrary. That amount oftentimes does not reflect an increase in our exposure because we work very hard in trying to buy better, in terms of having better exposure, in terms of being more assertive in our campaign.

So, we've been working focused on productivity and making the best of our resources. So, the absolute amount is in line with last year's figure, it should continue to be so. As you said, quarter-on-quarter, there might be some variance we may anticipate or a delay that's part of our everyday operations. But in terms of structure of the marketing expenses, we expect to maintain high level of investments in that front.

Q - Operator

Thank you, Claudio.

Mr. Guilherme Assis from Brasil Plural has a question.

Q - Guilherme Assis {BIO 16143141 <GO>}

Good morning, Claudio. Good morning, Breno. Thank you for taking my question. I'd like to explore a little more – a few topics which have been discussed during the presentation and also the question session. It is clear to me why there was a stock-out. As Claudio mentioned "it is a good problem to have" When we look at the numbers stock based at the end of the second quarter, we were a very low level. Can we expect an increase in that level and to what extent? To what extent can inventories increase? Claudio just mentioned that you've been working since last month to increase those inventories, so I'd like to hear that in a more detail. And in relation to that as well, do you think you could fund the increase in inventory with suppliers so that you can also preserve working capital given also the company's seasonality? That some of the questions.

And a second question has to do with the gross margin. It also has to do with a lower sale of Branded Prescription products as you mentioned. But the question is, can we expect for the coming months when inventories resume a normal level, can we expect a gain in gross margins as well provided Branded Prescription sales also increase?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Hello. This is Breno speaking. Guilherme, as inventory days – that indicator is going up. Overall, volume was flat but inventory for finished products dropped in the second quarter when compared to the first quarter. As Claudio said, the idea is to resume inventory levels soon. So, we expect the nominal number to go up. To give you a reference, the inventory for finished products in the second quarter of last year was BRL 135 million, and now we closed the quarter at BRL 89 million in the second quarter. So, the trend is to see that number go up.

On the other hand, as you mentioned, this will be funded or financed with suppliers. For us to increase the inventory of finished products, we need to buy more raw material. And the payment terms (42:54) for raw material is quite long, 360 days for imported raw materials. So, that allows us to avoid a major impact on working capital in the short run.

As for your second question regarding gross margins. Our indications go in a direction that, yes, we will be able to do it. If you – we manage to resume sales that we're less (43:34) spending in the portfolio. We will see better numbers in the next quarter, and this will have an impact on gross margin.

But those are one-off effects and short-run effects. Thinking in the longer run, the mid run – mid to longer run, we shouldn't see any significant variation in gross margins. In the long run, if our growth strategy across different categories, including consumer health and Branded Prescription, if they materialize, we should see a positive effect coming from the product mix.

Q - Guilherme Assis {BIO 16143141 <GO>}

If I may, third question, concerning the inventory levels for different channels, you did mention that you closely monitor that, but I am under the impression that in – throughout the channel inventories will probably have dropped significantly so much so that there was a stock out. Am I right in understanding that?

And going back to the question I've just had, would that mean that there is a good opportunity now to recover those sales in the third quarter? Do you think I'm right in understanding that from that standpoint?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

This is Claudio speaking. Yes. There was a drop in inventories. I wouldn't say it's such a high inventories, we're talking about BRL 35 million. In percentage terms, it is relatively small. But there was a drop, yes. As I mentioned, when I answered my previous question to Joseph, we are working hard to recover or resume those inventory levels so that we can meet fast (45:31) demand and also they reflect (45:32) of that in the third quarter.

Of course, it all depends on a series of factors. Demand has to continue at a high level. We need to work on our inventory levels. If everything goes right, we will recover those lost sales. But I will only be able to affirm that by October.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. Thank you.

Operator

Mr. Gustavo Oliveira from UBS has a question.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

Good morning, everyone, Claudio and Breno. Thank you for taking my question. Along the lines of demand issues in the second quarter, as I listen to some of the examples you've provided, I was under the impression that it is all linked to seasonal product. Flu medicine, cold medicine and that's a more seasonable demand, am I right? Or does it affect the whole portfolio? Are we talking also about products which are not seasonal? Sorry to insist on that same item.

A - Operator

Hi, Gustavo. It is more across the board, not only seasonal. I'll give you other examples. At Epocler grew 20% in the quarter. Estomazil grew 33%, Engov grew 30% and those are products which are not seasonal. They are actually summer, if you will, products.

When I mentioned Alivium, Alivium is also a horizontal product meaning enjoy (47:30) a 35% increase. Better even with all the competition, all of the new players, all the attacks, if you will, we've suffered, we managed to grow 20%. And we have other launches coming on. So, it is more across the board, more horizontal, and it has to do with a convergence of factors, investment in media, investment in medical promotions, better execution of point of sales, innovation. All of that put together, produces an overall effect which has been quite positive. We have to wait and see if we'll continue to be that way. But for this quarter, it was a reality.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

Thank you. So, within this trend, 10% on average. With that, do you see a gain in market share, or could you say that the industry is speeding up as a whole? You talk about growth in volume which is quite high. Does it affect all your business, or does it affect the whole industry?

A - Operator

What's been happening as I see it, we need to separate OTC product from Branded Prescription and Consumer Health, which account for over 70% of our sales. And separate those from the generic and similar products. Of course, for the Branded products, the ones I mentioned, for those products, we are growing above market average, and we are gaining market share. For the generic and similar products, we've been having some problems in the numbers, in the statistics. So, when you've been taken a numbers such as the cost at the plant, it's not really true because we know that some players having to bring the cost price down because of tax issues. I don't know if you know about this, but the tax distribution, taxation in São Paulo is levied on the factory price, not on the invoiced price. So, we need to reduce (49:56) several prices at the manufacturer. And then, of course, the price for the client is the same, for the consumer, it's the same. But the taxes are very high. Oftentimes, the taxation is always – represents a higher figure than the price of the Generics products. Of course, that will impacts our numbers.

When I talk about PPP (50:24), that number is not really true either because several players in the market provide discounts in different formats, sometimes in the form of bonuses, not only a discount. So, that number does not really translate reality. There are also new companies in the industry, so they change the whole scenario. That does not happen in the Branded area of the business because things are much more stable on that front. And we have a similar scenario in our players.

So, numbers are more real. But when we talk about Generics products statistics, unfortunately, are not really reliable, if I may. So, that's why we wanted to show our demand ex-Neo Química so to speak. When compared to the rest of the market, this show that there are different dynamics, and industry, as a whole, is suffering from that. And the idea going forward is to have more normalized numbers, but in answer to your query, we are gaining market share in the Branded arm of the business, and for Neo Química, it will remain flat to stable, okay. The summary of all what I've said is that we are making share in the Branded business, which is more profitable, and I'd say we are stable in the Neo Química arm of the business.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

I have one final question. I was quite impressed with the numbers that you mentioned in the pipeline, 200 projects, BRL 3.5 billion in the fifth year and revenues. So, I'm assuming there is timeline for all of those projects.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

I'm not assuming that you'll have that – all of that in place in five years. Each project – this is Claudio again. For each project, we have a forecast. For a project to be approved, we need to have an estimate, and that estimate takes into account year one, year two, year three, from the launch – five years from the launch, going forward, and then each one of those products has a different launching timeline.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

Okay, but with all those opportunities, do you believe your R&D division will increase going forward above those 8.5%? Or can you develop those projects, maintaining that R&D level?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

No. It shouldn't go up – it should perhaps go up to another 2%, our R&D. As I've said, strategically speaking, strategically speaking, Brazil still is a country with a lot of opportunity in terms of product launches. We at Hypermarcas have a lot of chances to penetrate markets where we do not operate as of yet and we – and all of that with investments in R&D, which will be quite low when compared to more mature markets. So, Brazil is a very interesting country from that standpoint because it can have a marginal revenue, which is quite high for an R&D investment, which is relatively low when compared to other markets.

That's our reality because at the moment that we're going through now in this industry in Brazil. And in our case, because of opportunity that we have. We'll give you an example. In the case of consumer health markets, there is a, I'd say, a blue ocean for vitamins, nutritional products, weight loss products, a series of markets which are growing in the U.S. and in Europe and which are only starting in Brazil. So there, we have an opportunity to grow several of those products. Some of those products are nutritional, they have to do with the food industry. So, the development is not as complex as that of a medicine and in the case of prescribed product or prescription products, our share in terms of total market is relatively low, 30% of different categories. So, again, several opportunities, for several products, for several different therapies for us to launch our product reaping our visitation for. So, I'd say we are well-positioned.

On the one hand, the Consumer Health product where you need a brand for that market. To go into a market like that without a brand is quite difficult. It will take a lot of money in terms of investment, and it will be quite uncertain in terms of return. For our prescription products, we already have a platform which is our medical visit arm. So, we are well positioned.

So, our projects are – because of that looking good, our innovation center. Just to give you an idea, our – originally, we start – we would be working at 50% of our full capacity for the innovation center, which in fact is now at 24%. We are now finishing the hiring, so I'd say by September, at most October. We'll be operating at full capacity. So, this will increase the speed of those projects. Out of those 212 projects, to be exact, so, 112, only 68 are either in the waiting list or already have registration and are ready to be launched, 68. So, most are still in the waiting list for development or in the testing phase. So, as I increased my development capacity, the flow of projects coming out will, of course, increase significantly.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

Okay. Thank you. Thank you, Claudio.

Operator

Ms. Maria Paula Cantusio from BB Investimento would like to ask a question.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

Good morning, Claudio and Breno. Thank you for taking my question. I'd like to explore the issue of expenses – marketing expenses. We see a drop in the line of medical visits in the quarter. And I remember that before you had a strategy to strengthen those visits including the fact that we anticipated the participation of these (58:17) markets in areas which are not very much explored by the company. So, I'd like to understand that drop in that line.

And my second question is the following: Going back to the gross margin issue, if you could share with us the extent of the positive impact in foreign exchange and the negative impact in the sales mix in the quarter, just to give us an idea if there was a very substantial – there would have been some substantial reduction had it not been for the foreign exchange issue?

And lastly, if you could give us update in that partnership program with international pharmaceutical companies which you mentioned in Hype Day. Any update on that?

Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Maria Paula, this is Claudio speaking. I'll answer the first and third question, and then, Breno will address the second question. As for medical visits in the quarter specifically in this quarter, there is no change in strategy. And what we do have is that free samples are accounted for when they are manufactured and not when they are delivered to clients or to the doctors in this case or sent to the doctors, because in this quarter we saw a competition between the production of finished products and the production of free samples because we use the same equipment to do that, so there was a reduction in production. So, that number reflects a reduction in production but not a reduction in distribution.

For a question of IFRS, it is accounted for this way. As for the partnership plan, as I mentioned, our business development area has been working to explore several opportunities. As I said, we have over 40 projects, which are – 41 to be exact, which are under negotiation as we speak and part of those involved those partnerships. But our focus, as I mentioned, is on partnerships where we remain as owners of the technology, proprietors of the technology. And fortunately (01:00:56), sometimes, they are deals where they are looking for distributors. And that's not our, as I said capacity. That, of course, entails a little more time to close the deal, but when we do close the deals, there will be – they last longer for the company. They will be long-lasting business or deals. We are not looking to have short-term results.

If we were to start working with distributions, it would generate a huge amount of deals because there are several multinationals which are bringing down their medical visits indicators and production numbers, and sometimes they hold good brands, and they just want somebody to distribute those brands. But it's not part of our principle, as I said.

We're looking to explore negotiations in which we will remain as proprietors of the technology, as I said. But we can talk about this in more detail in the second half next year. We will be able to make announcements on that front.

Then I'll now give the floor over to Breno. Breno? Breno.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

As for the foreign exchange, it doesn't have much of an effect on the margins any longer. The average foreign exchange in the second quarter was at around BRL 0.325, so we approximately at the level – at a stable level. So we don't see much impact coming from FX – on margins. As I said, the main impact came from the mix, slightly more negative in the second quarter.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

Thank you. Thank you, everyone. Have a good day.

Operator

Mr. Alex Hahn from Citibank has a question.

Q - Alexander J. Hahn {BIO 20656822 <GO>}

Hello. Good morning, everyone. Thank you for taking my questions. Two things that I'd like to ask. The first one is if you could talk about the 3.6% of the growth to break it down in net revenues. I understood that the increase in prices was around 4%, but to understand a little bit better, if you could give us a breakdown of the price, those 5.6%. And how do you see the second half of the year? Are you looking to increase prices in OTC consumer products? Your guidance implies 7% to 8% in growth in the second half. Could you perhaps comment on that? Is there room in pricing to reach that level or are you thinking about increasing volumes? That's my first question.

And the second one please, about EBITDA. Your guidance and thanks for confirming that BRL 1.2 billion. But if I do the math here, it seems that the second half of the year would imply a growth of 3% in EBITDA, and I'm not sure if you are imagining some kind of pressure on cost or on expenses or that maybe – there would be room to change the guidance at BRL 1.2 billion that you shared in the release?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, that's three questions, right. The breakdown and the price increase rather and the guidance, right? Okay. As for the growth of 5.6%, the difference between 5.6% and 3.5% is due to volume and mix. We need to take all of that into account. The launches we've been making has an impact on volume. Oftentimes, I'm talking more about volume of new products. So, basically, this 3.5% price and the difference is volume/mix.

As for the price increase, there is no environment or climate for price increases for the rest of the year. And Brazil inflation has stabilized, and we are still trying to come out of a recession. There is no climate for that. Our budget does not anticipate any price increase for the second half of 2017.

As for the guidance, I'll give the floor over to Breno.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Hi, Alex. This is Breno. Your math is right. For the second half, when we compared to like share, we've been talking about a growth in EBITDA of around 3%. You're right. But remember that our guidance is around BRL 1.2 billion, difficult to say exactly what the final number will be, in terms of the year's EBITDA. But we like to reiterate that the figure, BRL 1.2 billion, is good amount, it's close to that.

Q - Alexander J. Hahn {BIO 20656822 <GO>}

Okay, Breno. Thank you.

Operator

Thank you. The Q&A session is now closed. I'd like to give the floor back over to Mr. Claudio Bergamo for his final remarks. Mr. Bergamo, you have the floor.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

I'd like to thank you all for participating in our call. We remain available, myself and our IR team, to whatever follow-up questions or comments you may have. Thank you again, and have a nice day in a nice week, everyone.

Operator

Hypermarcas' audio conference is now over. We like to thank you all for participating. Have a nice day.