Q2 2017 Earnings Call

Company Participants

- Eduardo Fischer Teixeira de Souza, CEO of Region II
- Leonardo GuimarÃ£es CorrÃªa, VP of Executive Board
- Rafael Nazareth Menin Teixeira de Souza, CEO of Region I
- Ricardo PaixÃ£o Pinto Rodrigues, Former IR

Other Participants

- Daniel Gasparete, Analyst
- Enrico Trotta, Analyst
- Georgia Jorge, Analyst
- Gustavo Cambauva, Analyst
- Luiz Mauricio Garcia, Analyst
- Marcelo Garaldi Motta, Analyst
- Nicole Hirakawa, Analyst
- Rodrigo Fraga, Analyst
- Wilfredo Jorel Guilloty, Analyst

Presentation

Operator

Ladies and gentlemen. Good morning. Thank you for coming. (Operator Instructions) I would like to give the floor to Mr. Eduardo Fischer. Please, you may proceed.

Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Good morning. And thank you for your participation.

I'd like to highlight 2 points that I think is the most important in this opening message: The continuity of our growth cycle and evolution of our operational efficiency.

As for our growth strategy established two years ago, we were able -- we were successful in delivering one more record in launches for a quarter, reaching more than BRL 1,300,000,000 launched in this period.

Besides this record, it's important to point out that this is the Third Quarter in a row with launch growth. And this growth trend is what we are looking for.

Still in this strategy, I want to point out that the products we have launched in the market follow our goal to supply new stores, increase in the penetration in the markets we are already. And also, the global sales potential of the company. The results of this planning already shows in sales volume. We reached the third consecutive quarter of sales growth, reaching almost BRL 1.5 million in units sold in the period. Similar to our launches, our goal and expectation is to deliver growth in contracted sales volume for the next quarter.

It's also important to point out that we've seen an increase in real estate demand, also in the conversion rate of customers who look for definite sales. This behavior only reinforces our belief that we've done the right move when we aim at growth and we were already harvesting the fruits of this plan.

Nothing of this comes without an efficient operation. We also have to celebrate this quarter. We reached our largest gross margin since 2010, reaching 34% level. This, in a scenario where the price products was very challenging. We still see opportunities for operational efficiency because we see productivity gains in an important economic scenario.

Finally, I would like to highlight a very important point. We are, for more than two years, in this growth strategy. In this context, we increased the purchase and disbursement with our land, as well as we increased investments in technology and people to support this operation, even though our company is still generating cash in a robust way, quarter after quarter. And we want to continue to do this operational growth.

Thank you. And I will give the floor to Leo.

Leonardo GuimarÃ£es CorrÃªa {BIO 17189838 <GO>}

Before going to questions and answers, I'd like to address 3 specific points. Let's start with LOG. Yesterday, we published the -- a call from the board to deliberate about the increased capital in the company and the MRV board is recommending this capital increase for the following reasons: The logistic with house market in Brazil is incipient and there is no public company 100% dedicated to this. The demand of traffic restrictions in large cities, especially the migration from the traditional commerce to e-commerce, is expediting the growth of this market. LOG is the most lowest cost player. LOG is present in 9 Brazilian states. LOG has a different strategy. Let's say it's a retail strategy, leasing relatively small areas for first-line clients. This strategy proves to be perfect, with the vacancy rate very low, 10.8% for LOG compared to 26%, which is the Brazil's average.

Interest rate curve in Brazil is decreasing, not only Selic. But actual interest where we see through the different NTN-C [ph]. I don't think the comparison is perfect. But the price to FFO has increased substantially. But it's aligned with the yield decrease benefiting LOG.

The previous point mentioned and the commercial knowledge of LOG can be introduced in an investment that will create value to MRV. Finally, LOG's plan is to apply approximately half of this increase in CapEx reduction to debt. This BRL 150 million will provide in average a yield on cost of 15%, increasing the LOG's FFO. The debt amortization will also increase FFO. We see that the sum of these 2 increments apply to the sharpest [ph] current multiple of about 20x will give MRV the doubling of capital in 12 months. In addition, this will be strong enough to continue.

I see new capital inflows in the future for LOG through IPO or any other form of the capital market.

The second point is about the FGTS. This fund was created in the midst of the '60s in a very successful model that made it survive for the last 50 years. The government, whether through the ministry of cities, planning or even Caixa, who is the fund manager, have been working strongly in this macro dynamics of the fund to establish the parameters to preserve the fund profitability in the long run.

The low-income construction segment plays an important social role in terms of improving housing and the labor. Regardless the sector, we need to keep this continuous, all classes and the federal government agree with the importance of the stability of the use of this fund's money. The payment of inactive accounts decrease the liquidity. But does not prevent the continuation of the use of the fund. With the lower Selic, we have a decrease in the potential of the return. But even though, we still have a capacity to fulfill the budget for the Minha Casa Minha Vida program. So the fund is an important source and healthy source to finance lower-income housing.

The last point is about cash dividend and debt. I'm not going to reemphasize any messages. MRV is conservative in point of -- financial point of view. And we have a policy for low deficit or inexistent. And gross cash -- high gross cash. In our segment, we are subjected to the volatilities of the Brazilian environment. The longer the debt terms, the better. These policies, do they have a cost? Yes. The credit spread cost are a part of this gross cash. But it's totally compatible with our operations.

In general, if we can anticipate rolling out or prepaying future debts using a possible open windows of the market, we will do. And at last, about the dividends, I will say that the profit of 2016 was capitalized of about 50%. The remaining 50%, half, has been distributed in June and the second half will be distributed within the next two months, not being impacted by this capital inflow to LOG.

Now we open for questions and answers.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Luiz Mauricio Garcia, Bradesco.

Q - Luiz Mauricio Garcia {BIO 17432519 <GO>}

I have 2 questions. First, related to gross margin. We see a consistent improvement. Historically, have -- had adapted due to several factors, in financial factors, taxes, et cetera. But since your building cycle is shortening, you see that this margin is increasing. So my question is, what do you expect for gross margin? And how close it can be of the hedging margin? And also, if you can include the issue of work saving and improvement in the product? And the other is SG&A. You said that you expected to increase this, due to the expectations on volume increase, keeping it stable. But my question is, from now on, we will see SG&A stable or what do you expect for that?

A - Rafael Nazareth Menin Teixeira de Souza {BIO 16905756 <GO>}

Well thank you. Good morning. For the gross margin, it increased. We have a delta, basically by inflation, taxes and financial expenses. And the signaling of this increase is that the gross margin still has space to grow. It went from 26% to 34%. So we still see some space for the gross margin. And this shows all the management we have for the last 3, four years. So we have some business adjustment, work saving, the right product, the core BI [ph], HR. We have been dedicated in preparing the company for a new cycle that is just beginning. We also are comfortable -- the company is comfortable in managing a complex business with a long cycle. We have a significant entry barrier. But this is the differential of the company. And we show that it's possible to manage complex operations even -- always reporting consistent and better gross margins. We have a very well management work. And the region we went after the IPO had worse performance. But along the time, we decreased this gap. We still have some marginal space. But we are optimistic. Part of the work has already been done. But we will still improve. As for new products, the company is for the low-income customers. We have a product that is perceived by the customer as the best product in the market. So it's important to look ahead. And we cannot stand still. Our product is copied, the facade, the conception; they copy us. But we want to increase this quality gap in relation to what is in the market. We expected a cost increase. But we still have a very good gross margin. For SG&A, we increased our G&A with administrative expenses and commercial expenses increased in the last three years. But we did this looking ahead. I cannot manage the company looking to the past. I can -- I need to look to 2019, 2020. We need to qualify the team, to have the right size of the team. So we had an increased investment in IT, the quality, HR people. And from now on, we will harvest the fruits of these investments. You were seeing an increase in launches. This will be accelerated in the second half. And with this, we expect a higher sales volume. And consequently, an increase in revenue. And this will be in the size that we perceive as the right size. And the last point, which is that we will bring better return to us. We see the bottom line evolving, since this will increase in SG&A will be almost the same size we saw previously, okay?

Operator

Our next question comes from Gustavo Cambauva from BTG.

Q - Gustavo Cambauva {BIO 17329406 <GO>}

I'd like to go back to the G&A point. Was there any -- something that was not non-recurrent? Rafael's explanation is clear. But when you see the bridge, you see we have this line of other expenses. Was there any specific thing for this leap in the Second Quarter compared to the previous year or not? Should we work with these numbers? And my second question relates to the -- what you mentioned in the opening, the strategy -- the growth strategy. You had good improvement in terms of launching. But to reach that

40,000 units that you mentioned as the company's goals. I think that in 2018, can you reach this level of 40,000 units? The operation is running well. So you have enough cash. Or this goal is for a midterm, for only 2019 or 2020? Or is this feasible for 2018?

A - Rafael Nazareth Menin Teixeira de Souza {BIO 16905756 <GO>}

Gustavo, this is Rafael. Well for the G&A, we have some one-offs in the first. But now the level is close to that. Maybe we'll have a decrease in the Third Quarter. But looking to the year, the company's G&A level will be about BRL 300 million. We won't see many changes. As for launches, we can have more launches than what we are doing. Even with the increase in the Second Quarter, our pipeline indicated much more launches in the first half. And the great difficulty are the permits, the licenses. With this unemployment and the company going down, the company wants to hire. But we are unable to launch due to the city bureaucracy. But we are getting more and more mature. And in a certain moment, this will happen, it's impossible to launch what we have been launching only. So this is much higher. In most of the cities we are, what we see is that demand is more than supply -- more demand than supply. Meaning that launching more in the regions with low supply, the sales will happen. I'm not going to launch a product when I have a balanced presence. I mentioned, SÃ£o JosÃ do Rio Preto, which is our benchmark. I have products all over the city. So we cannot absorb any more. So we have the micro regions of the cities. But when you look at the commercial portfolio, most of these micro regions are badly supplied. So to launch -- launches are crucial for us to grow. And it's impossible not to see this in the next quarters. We need to overcome all this bureaucracy. Today, we have a land bank which is more mature than last year. So this will happen. This is the expectation. Last year -- next year will be different. The launches will be different than two years ago, okay? Okay.

Operator

The next question comes from Enrico Trotta from ItaÃº BBA.

Q - Enrico Trotta {BIO 16742911 <GO>}

I'd like to comment the equivalence line. We saw a good improvement in the equivalence line. I'd like you to elaborate the performance of this colligated or controlled companies? And what we can expect for the second half, because of the equivalence will be lower? The second question was mentioned by Leo about the investments in LOG. And this will not impact MRV. But I'd like to know what will be the impact for the cash flow? Because this will be smaller compared with the expectations we had in the beginning of the year. The policies of last year will be maintained for the dividend due to this investment in LOG and the cash generation for the year.

A - Leonardo GuimarÃ£es CorrÃªa {BIO 17189838 <GO>}

Good morning. First, the issue of equivalence. We see improvement. The prime operation, as I mentioned many times, is in an excellent situation. Prime's gross margin in the average of MRV is higher. So the efficiency level is okay. It's in a region where the economic dynamics that is very good, is the West region, the agricultural region; and this is very positive. Another important aspect for Prime, since the company -- this decrease in Selic will be helping in bringing a lower interest burden or load. This improvement will continue. We saw some one-off events that accelerated. But the trend is this. Of course, FINAL

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we still have some volatility in the results. But the trend is an improvement in this equivalence line. Now regarding LOG. The inflow, capital inflow, in LOG has no impact in our dividend. I will reinforce this: we had the dividend already determined to be distributed. We did half of the results of the 2016, the other half will be distributed. Of this, we have already distributed another half and the second half will be distributed now during the second half of this year. We are always very careful, because Brazil is full of surprises. But this will happen and the capital inflow to LOG will not impact our dividend policy. This is already determined. And LOG, we see is very clear, this capital inflow is value generator to the company. In one more year, the FFO of the company will increase. Our commercial activity is highly successful. We have a very low vacancy rate. If you look at the state of SÃ£o Paulo, our vacancy rate is 4%, totally different from the market. And it's decreasing. So our commercial strategy. And we've been challenged during the roadshows with this strategy, that we call it a retail strategy, is proving very successful during this crisis that we are facing. There is a chart, because LOG has a series of works. We have the infrastructure. We will build the warehouses as the demand comes. But we have all the warehouses built. So now we have to optimize this investment. CapEx is marginal and has a very high result. The -- well, we think LOG is with the right commercial strategy. And it has operate -- independent operations, scale, et cetera. And MRV will have a positive result from its investment in LOG.

Operator

Mr. Daniel Gasparete from Merrill Lynch.

Q - Daniel Gasparete {BIO 17999254 <GO>}

Your comment about the perspectives for the second half and 2018, this BRL 522 million in this number of units is maybe is a reflects some launches that were not accepted? Or is it a level that we can look for, for the rest of the year? And what do you think can be a bottleneck? You have commented that the acceptance or approval level of the units were enough to sustain the level of launches. But what can go wrong in this perspective? That's it.

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Good morning. Let's see, launches. The disclosure of July -- well, it was a record. We were not able to do what we have as a goal. But this is for -- we have growth for 3 consecutive quarters. So we are fulfilling what we established as a strategy in the past. But not as rapid. And what are the bottlenecks? Legalization. It's not market, it's legalization. And this can take longer, no, depending on the city. But we will see. For 3 quarters, we see we are launching more than the previous quarter and the sales curve is following it. So this Third Quarter is also starting with one more step. What we see is that at every quarter to have more launches and consequently more sales. And another point that Rafael mentioned, we need to look through the operation and be prepared to digest it different. We see space, we invested in technology, in land, in G&A and people. So that we will increase our operations effectively. But the bottleneck is legalization. But this is not any -- so difficult, because even though we saw our growth. So I think I answered your question.

Q - Daniel Gasparete {BIO 17999254 <GO>}

But June, right, you saw this as an effect of what we had in the past. I agree, we see that you are increasing month after month. So you see that July is the current level?

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Yes. It is a current level. Well we have some volatility, it is not linear. Of course, I depend on third parties and this causes some variation. But month after month, as you mentioned, we are launching more and selling more. So looking ahead, what we see is what we have in this quarter plus what we have in July. So for the second half of this year and 2018 is the level that we are delivering today and more, okay?

Operator

Our next question comes from Mr. Rodrigo Fraga from Citi.

Q - Rodrigo Fraga {BIO 20043127 <GO>}

I have 2 questions. First, about commercial expenses. What is the view of the company in -- like products like Grand Reserva Paulista and products that have a higher liquidity than the rest of the average of the portfolio? How much this can influence in the commercial expenses as a percentage of sales? Do you expect this to happen? And what would be the level to reach? And as for the statements. With these guaranteed sales, these statements will be less and less expressive. How do you expect the pace of this transition? And looking for the guaranteed sales, is this level stable level of the business? Or do you still have space or room to reduce this dynamic?

A - Ricardo PaixÃ£o Pinto Rodrigues {BIO 22108148 <GO>}

Good morning, Rodrigo. This is Ricardo. Commercial expenses. What we see from now on is downhill in relation to the sales. Some buildings, like Grand Reserva Paulista, in the beginning, we have to spend more with marketing, especially to show the product. Then you have the word of the mouth, people comment the sales and we can reduce these expenses. So commercial expenses will be smaller or lower in percentage. Statements, this was really something that we didn't like. We implemented this. It was a sales strategy. We expected to have a higher -- and we see this in around 12%. So we now have these guaranteed sales. We have a project to implement this on 100% of the sales. So the trend for this mutual rescission continue. We will reach 15% that we are seeing. And in a long term, this will turn to 0. This mutual rescission will turn to 0.

Operator

Ms. Nicole Hirakawa from Credit Suisse.

Q - Nicole Hirakawa {BIO 18242556 <GO>}

The first question, we see an increase quarter-to-quarter of around 15%, representing 15% of the portfolio after the case [ph]. This level would be around 20%. What do you think will be the stable level for your portfolio? And how do you see the trade-off for the portfolio size after case [ph] and migrating to another cycle? And the question is about the gross margin. Companies have been reporting positive effects in budget review, very favorable in terms of cost. Can you quantify what you can do -- what work in gain of efficiency to be more clear about this margin from now on?

A - Leonardo GuimarÃ£es CorrÃªa {BIO 17189838 <GO>}

Nicole, in relation to PBD, we've been seeing that when the banks have this movement to decrease your rental value, we would have no choice. We started to finance a larger part for the customers. In the beginning, we didn't have all this knowledge about credit. So we developed several tools. And we are much more careful in using several tools for this default data, to understand who is a good payer, who is a bad payer. We are also working in the institutional part to improve the quality of the credit we are providing. So we will stamp in the record of the real estate, the debt of the client. I know we are still subject to fiduciary. But we -- and this will improve our credit and our negotiation power with that discussion with the customers. Now going to the numbers specifically, Brazil is facing unemployment, economic recession and this led to the higher default. And this is reflected in the BBT [ph]. Since we are working more in providing credit to improve the quality of the credit we are giving. And we are doing almost all products. Some products we need to give higher credit than what we would like. If we have a mutual rescission of a product that is very close to be ready, we need to provide a higher credit volume. I don't see any change in the level of what we are doing. These products that require more credit, this ends up reflecting in the price. And this is what we are seeing.

A - Ricardo PaixÃ£o Pinto Rodrigues {BIO 22108148 <GO>}

Nicole, this is Ricardo. Just to complement, the percentage of finished inventory is decreasing. And in terms of gross margin, well, Rafael has mentioned and talked about this gross margin and improvement in our processes. And this is reflected in the hedged margin. But again, we see the gross margin increasing. But not increasing in the same proportion that it used to be.

Operator

Our next question comes from Marcelo Motta from JPMorgan.

Q - Marcelo Garaldi Motta {BIO 16438725 <GO>}

Two questions. In your financial results, you mention in the release that the total volume increased. But if you look at the average cost of this financial expense, it seems to be higher than the previous quarters. Do you have any prepayment that generated any extraordinary or extra expense making it higher? And I'd like to understand what we can expect from now on. The second question about the minorities. If you can -- you see a value higher than the average? Do you have any specific thing, a mix of product, something like that?

A - Leonardo GuimarÃ£es CorrÃªa {BIO 17189838 <GO>}

Marcelo, about the financial expenses, everybody analyzes the balance sheet. The balance sheet is a snapshot of the quarter. At the end of the quarter, we have some change. We have higher debt than that, that was the snapshot of June. But what we discussed here inside the company is that we would like to have a lower value of capitalization in financial expenses and have a more current expenses. Obviously, it doesn't make any difference in the results of the company. But we are thinking about for the next debt instruments to have something for working capital so that the new debt will not be part of this capitalization process. And with this, we will have greater volume for expenses and less for capitalization. But this is just punctual; it's a mark.

Q - Marcelo Garaldi Motta {BIO 16438725 <GO>}

Okay. And about the minority, any specific point?

A - Leonardo GuimarÃ£es CorrÃªa {BIO 17189838 <GO>}

Well nothing new, nothing specific. Well we used to have more partnership. We have some works and some specific business. We have had a greater or smaller participation or interest in new projects. The partner is more involved and ends up being a controller or having a higher participation or a greater participation.

Operator

Our next question is from Jorel Guilloty from Morgan Stanley.

Q - Wilfredo Jorel Guilloty

I have 2 questions. First, the average price per unit, that was about 150,000 per unit, when you had expressed an increase in the launches that you have for the future. And about the new product lines that you mentioned in the release, Bio, Eco and Premium, what should the impacts of these new products, in terms of margins and cash generation? And what's the percentage of the total launches for these new products?

A - Rafael Nazareth Menin Teixeira de Souza {BIO 16905756 <GO>}

Well this is Rafael. Thank you. As for the average price, we expect growth, an increase. We have 2 important variables. The first is this increase of the launches. The average price is higher. And this helps in the other side, increasing the volume. We have an average -- a lower average price. But we have a faster commercial dynamic. We spend more money to sell. The sales is faster. So we have these 2 components. The first is average and the increment of the share in our portfolio. The one effect should fix the other. And we see the average price increasing at the level of the inflation, okay? Nothing different. As for the new line, this is investment in product in the image of the company. We don't see any alterations in the short term for gross margin or cash generation. This is the position of the company. The company wants to be positioned as a different company, more modern, innovative. We are leader in building in Latin America. So we want to have a different positioning. You see the solar energy in our buildings. This is something that changed the perception of the consumer. We have a slight increment in cost. But the client is also willing to pay more for something that will provide a better quality of life. So our project is always looking at the long run. So invest in products, invest in quality, invest in customer relationships. This is crucial for a company that is looking for the business for the next 10, 15 years. And also, we will increase -- all the products will be launched in this new line. All products will be launched within this new line. We created 3 price levels, price ranges. And all the future launches will fit these new product lines, okay?

Operator

Our next question comes from Georgia Jorge from Banco do Brazil.

Q - Georgia Jorge {BIO 20104788 <GO>}

I have a question about the land. What do you consider about the proper land bank, considering the volume that you have that you were expecting to deliver in the midterm?

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Well we have 2 questions for the land bank. First, we saw the opportunity of growing and increase our participation in some markets. So this was the first strategy. And now in the last two years, we lived economic moment that favored us to acquire this land. So we have our strategy and then the opportunity to build a robust land bank, well located with interesting cost. And we are still looking at this mechanics for 2017 and 2018. So we have a very robust land bank that will support the operations for the next 5, six years. But also, you have the opportunity issue. Sometimes the price will change and the land will value much more. So these 2 points that guided us in purchasing the land in 2016, '17. And this is up to '18. This is our strategy for the moment, based on these 2 pillars. Okay?

Operator

(Operator Instructions) So we'll now close our Q&A session. I'd like to give the floor back for the final considerations to Mr. Fischer.

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Well thank you for participating. It was a pleasure to talk to you again and report the new indicators. A very important point, we are very confident in the market looking ahead. Brazil is a country with 65 million housing considered of low quality. So we see Brazil improving, the income will increase again. And people will not accept low-quality housing. So with this increase, we have this market, which is a market for the next 15, 20 years. So this, together with the public policy, makes us very comfortable for the future. We want to be here for the next 30 -- well, I'm 37 years old. And I want to be more 37. So the Brazilian market is still big. And it will be even bigger. And we have this intention of launching more and more. And we think about building 500,000 housings in the next 10 years. It's very interesting when we discuss with the investors. Many people, they put a very low strength in the real estate. No. We disagree. This will be strong for many years. For those who invest in the long term, this is the sector to invest. The market will be very big for many, many years. And if the company has the geography that we have -- the geography footprint that we have, we can increase for many, many years. So we are sure this is the right market to invest. And we are very optimistic. In the next quarters, we will deliver even better results. So thank you very much. And we'll see -- we'll talk again next quarter.

Operator

So the MRV Engenharia call is closed. Thank you for your participation. And have a nice day.