Q2 2017 Earnings Call

Company Participants

- Elcio Mitsuhiro Ito, Head-Finance
- Pedro de Andrade Faria, Global Chief Executive Officer, Financial and Investor Relations Officer

Other Participants

- Gustavo Gregori, Analyst
- Lauren Torres, Analyst
- Sarah Leshner, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to BRF SA Conference Call to discuss the Secord Quarter 2017 Earnings. This conference call is being transmitted via webcast in our website, www.brf-br.com/ir. At this time, all participants are in a listen-only mode, and after the presentation, we will conduct a question-and-answer session. Instructions will be given at that time. We would appreciate if each participant made only one question.

Forward-looking statements related to the company's businesses, perspectives, projections, results, and the company's growth potential are provisions based on expectations of the management as to the future of the company. These expectations are highly dependent on market changes, economic conditions of the country and the sector and international markets, thus are subject to changes. As a reminder, this conference is being recorded.

This conference call will be presented by Mr. Pedro Faria, Global Chief Executive, Financial, and Investor Relations Officer. Participates also in this call, Alexandre Almeida, Pedro Navio, Leonardo Byrro and Elcio Ito.

We'll now hand the call over to Mr. Pedro Faria who will begin the conference call. Mr. Pedro, you may begin.

Pedro de Andrade Faria {BIO 15115819 <GO>}

Good morning to all those present. We had a very intense quarter. We have started in a troubled and difficult scenario with a Weak Flesh Operation and now the political problems in Brazil. I think we ended in a more positive direction. We have grown and strengthened ourselves despite the adversities we have faced. We concluded the work of the steering committee where we're able to map the main points of improvement that BRF needed and which was the starting point for the main changes in both the management model and the organizational structure. Within the new organizational structure announced, we have Alessandro Bonorino joining us as Vice President of Human Resources, bringing a very extensive experience from IBM.

We have made some internal reorganizations all focused on a much more integrated and transversal management. We're able to manage the Weak Flesh event in a positive way and we were prepared to demobilize our dedicated crisis response structure, bringing back our executives to day-to-day business. The event impacted us in approximately BRL 160 million in the first semester. But with all behind us, what remains are the lessons we learned and the opportunities. We continue to work and improve our controls, focus even more on the quality of our products.

Looking forward, the event has influenced major consumer markets to elevate even more their quality standards. We hope this will differentiate BRF from its competitors potentially gaining more market share in the medium term.

I'd like to think that the end of the second quarter marks the beginning of a transition period for BRF. A transition marked by an emblematic data, which should be end of all caveats (03:23) our anti-trust authority restraints, bringing back (03:31) latest outstanding categories and removing constraints with respect to creating new brands and product lines.

It also marks the transition to a new business model and new organizational structure, which we believe is ideal to resume the growth and profitability of the company. This transition is also valid when I think about our results, despite the different dynamics we face in each of our regions. Even with a very weak month of April, impacted by non-recurring events and the Brazilian calendar, we saw a good sequential recovery in the following months.

And we closed the second quarter with a very strong growth of volumes, showing continuity of the recovery process throughout the semester. As a result, we reported net revenues of BRL 8 billion and a EBITDA of BRL 575 million. If we're only to exclude the impacts of the Weak Flesh in the quarter, this number would have been much closer to BRL 700 million.

In Brazil, the good news comes from the reversal of the total market share loss trend, which has been happening since the end of 2015. In the last Nielsen report, referring to the last two months, we have gained 0.8 percentage points of market share, returning to a considerable position or 54.4% of the total market.

If you look only at the sausage categories, which have a very strong importance for balancing our production given the high volumetric characteristic of this category, this growth was even more expressive, almost 3.5 percentage points coming from both Perdigão and Sadia brands. When we analyze these numbers in detail, we see that the growth is resulted of what we call a share of handlers or daily share within the point of sales we are already present, which shows us that the hard work that we have done on segmentation, improvement of the level of service, execution and pricing differential between the brands has worked quite well for us, allowing us to increase the number of items sold per customer (05:45) single most important driver of share gains.

Looking ahead, we will return to focus on the growth of our numerical distribution, that is the number of point of sales that we buy products. This is another way to grow and gain share. And now, with the end of the antitrust restriction, we approved with our board the creation of a new brand, which will have a portfolio product with very attractive prices to operating the so-called entry segments. We are now moving on to developing and implementation phase of this very important project.

In addition to bringing growth and improve our operating leverage by diluting fixed costs, this new line of products will also help us optimize our chain by improving raw material utilization. In the international market, we see each of our regions evolving in the same positive direction despite weaker moments. We have Asia emerging and growing sequentially, at the same time, recovering profitability with an EBITDA margin of 17.2%. We see Europe still below its potential, but already showing the signs of recovery in the UK and Continental Europe. With the exception of the positive seasonality in the region, the volumes in the region remained low due to a Weak Flesh Operation and constraints to our operation, but clearly presenting better prices.

On the other hand, we continue the challenge of (07:16), given the high inventory and less weaker demand across the region. Despite the difficult competitive scenario, we have maintained the strategy to protect our market share, we've seen a very strong growth in market share in the in the Gulf region of almost 3.4 percentage points on the yearly comparison.

On the other hand, we have not been able to test the prices worldwide, given the scenario of excess supply. The additional impact of the Saudi Arabia tax, which has not been seen in the first quarter 2017 due to inventories and the lower grain cost benefit also due to high inventory level caused our margin recovery to be a little bit stalled. However, for such data, first and second quarter, a significant decrease of the exports to the region on the quarterly comparison. If we look only at the Saudi market, which is the region largest, this drop is even more relevant, almost 22% decline on the yearly comparison.

This movement is allowing for a fast reduction of inventories and we already began to see the opportunity to pass prices. The quarter also marks the conclusion of the (08:28) the month of June numbers already consolidated in our BRF figures. I'm very happy to say that the results are far better than planned. We continue to see great potential in the acquisition, not only in the domestic Turkish market, but also as a means to complement and diversify our position across the region.

Regarding the financial part, our leverage is definitely higher than desired, but we have a very (08:57) to reduce it. We secured throughout the quarter a very comfortable cash position of more than BRL 10 billion and we have reaffirmed our commitment to bringing down leverage to 2.5 times our EBITDA until the end of 2018. In order to accomplish this plan, besides the anticipated operational improvement, we have a set of initiatives already in action. We remain very disciplined regarding M&A, dividend and share repurchases. And second, we have reduced our CapEx and OpEx intensity. We invested BRL 450 million in the CapEx versus BRL 795 million in second quarter 2016, creating savings of more than BRL 500 million in the second semester compared to 2016.

We continue to work on capital initiatives, focusing on reducing inventories and planning out production chain versus our clear (09:49) expectation. Fourth, we have been working on selling some of company's non-core assets. Finally, we announced on a relevant track, we sold our revenue (10:00) shares in the approximate amount of BRL 500 million which will also reduce the net debt. These initiatives added to the operational improvement we are observing should continue to evolve during the second semester, allowing us to reach our goal of cutting down our investments.

We have now concluded our conference call. And we will remain here for questions and answers.

Q&A

Operator

Our first question comes from Lauren Torres, UBS.

Q - Lauren Torres {BIO 7323680 <GO>}

Yes, hi. Good morning, everyone. Pedro, a very general question like I just wondered how you're thinking about the second half improvement? I think you did say that quite clear that a lot of the dynamics should be working in your favor going into the second half or maybe what you've seen so far in the second half. But I guess I'm just trying to separate maybe what's just easy comps and the environment versus maybe the environment getting better and the initiatives that you're taking?

I'm just trying to understand so with a lot of changes that are occurring at BRF, how much of this is imposed by you, meaning that the changes with the company are bringing about these positive developments versus just easy comps and Weak Flesh going away and these other issues that lead on to the results of (11:33) the first half being an issue and maybe not being an issue in the second half. So if you could generally response to that that would be great. Thank you.

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Thank you so much, Lauren. I find it also very difficult task to make a clear distinction between what is the cyclical conjunction (11:52) improvement and the result of our continued efforts to improve BRF performance. Of course, I would tend to be a little bit more biased towards the second one. As I see that the second half dynamics are clearly being dictated by much more favorable position in the Brazilian marketplace, represented here by the good news of an increase in market share, but also volume trends and profitability coming back. I think this is very much the need to our exercise in improving our service to the market and also creating a strong differentiated position for the clients and now embraces a more numerical distribution strategy.

I think we are clearly seeing in OneFoods a much better second half than the first half, of course it's the more seasonally strong. But I also like to believe that our strategies of continuing to shoot for market share and not to lose any space will pay off as we see a cyclical rebound in prices which are expected to happen.

And finally, we see the whole saga of grains playing out. We pointed out in the call, in the Portuguese call that we should still see month-to-month improvement in our cost position (13:21) inventory of grains. But somewhere between third quarter and fourth quarter, we should find the new norm and then have a much more stable future which I think will represent the crushing (13:34) level of our volumes and profitability.

Q - Lauren Torres {BIO 7323680 <GO>}

Pedro, if I – I guess as a quick follow-up, you talked about a better May and maybe even a better June, so those trends into July or early August – I guess the same trend is continuing, you're seeing (13:49)?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Yes. The way I would approach this, Lauren, I basically see the very early moment of the recovery in the first (14:00) quarter of 2017. These are notable event around March and April given the effect of the Weak Flesh Operation. But then the month of May, June and now July in the third quarter, really representing that we have a much more solid growth (14:20) as we talk about a recovery, both cyclical conjunction but also structural given the efforts we have implemented along many dimension.

Q - Lauren Torres {BIO 7323680 <GO>}

Good to hear. Thank you.

Operator

The next question comes from (14:42).

Hi, good morning and thanks for the call. My question is regarding the leverage trend. The segments that you – trying to get to the 2.5 times leverage by the end of 2018. Just wanted to understand a little more if you can help me bridge the gaps especially where you see the year end's number and how prepared is the company to take steps outside of the cash flow generation, asset sales and potential (15:18) initiatives in order to get to 2.5 (15:25) perspective, just also to earnings seen what is the level of (15:28) in terms of the current ratings that are at BBB (15:35) outlook if you don't deliver on that target. Thanks.

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Thank you very much for your question. I would rather not talk about year-end expectations as we have committed to the board to coming back to what is our desired capital structure throughout the year 2018. Probably, a lot of these will come from operational improvement already being perceived in the second quarter results which I think becoming much more of a prominent trend throughout the second half. But as we have presented, (16:12) make additional steps to reaffirm our position of coming back to more reasonable levels of investments.

The disposal of the shares is one such example. Our step (16:28) towards OpEx and CapEx, this clearly pointed to that direction and we are contemplating even some sales of non-core assets. So, it is well structured program, which has been presented and approved by the board, and it has certainly delivered the margin of safety (16:49) the level - adequate levels of investments throughout 2018.

Q - Operator

Thanks. Just a follow-up. Do you have an intended leverage for (17:04) the end of this year or only in 2018?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Yes. As we said, we are expecting even as we think about the ratio of net debt to EBITDA as you start having positive comps throughout second half for debt (17:21) leverage to start reverting towards the norm. But we are not giving - oh, we have not committed to a year-end future investment program that will lead us into a 2.5 times by the end of 2018.

Q - Operator

Thank you.

The next question comes from Sarah Leshner, Barclays.

Q - Sarah Leshner {BIO 15039127 <GO>}

Hi. Thanks very much. I had a question that's related to the debt level question. In addition to the 2.5 times target that you have for next year for leverage, I was wondering what other points have been important for the rating agencies in implementing the ratings several notches above the seven (18:11) particularly in light of the fact that (18:14) the methodology that they have for (18:19). Thanks.

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

I'll refer this question to Elcio, to our Chief Financial Officer.

A - Elcio Mitsuhiro Ito {BIO 21375442 <GO>}

Thank you very much for your question. I think there's several plans here to get to the 2.5 by the end of next year. As Pedro highlighted, it is composed of the operating performance improvements and all these series of initiatives which tells us how committed at the board level - from the board level to those in the management levels committed to, to bring that leverage (18:57) where we feel comfortable with, and that the target (19:01) target of 2.5 times. So, I think in addition to what should be reversal of operating results which should improve the denominator – the numerator and the denominator at the same time.

We have all these other initiatives which had a – the commitment from the top level of the company from the board to the PO (19:24) and to the rest of the team to get to this target. So, I think it's mainly different from CapEx to working capital to your sales of non-core assets. I think there are lots of initiatives already in progress there.

Q - Sarah Leshner {BIO 15039127 <GO>}

Okay. And just to clarify my – the final part of my question was regarding compositions (19:55) with the rating agencies and whether your impression is that they are going to give you the time and the expectation I guess that you'll be able to execute on what you just described and so you expect (20:09)?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

I think we are in a process – I mean, we always have a very transparent and open discussions with them. In fact, we just released our results. We're continuing to have the same strategy, the same openness with them. We do not anticipate whether a decision (20:30) business going into the future.

Q - Sarah Leshner {BIO 15039127 <GO>}

Okay. Thanks very much, Pedro.

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Yeah.

Operator

Our next question comes from Gustavo Gregori, Bradesco BBI.

Q - Gustavo Gregori {BIO 16209398 <GO>}

Hi. Good morning. I just have two quick questions. The first one would be in the (20:57) already including the trailing 12 months Banvit EBITDA. Is that correct? And if so, where can we see the numbers for Banvit differ from BRF? So, did you get to the same (21:17) calculation?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Thank you, Gustavo, for your question. Our numbers do incorporate Banvit as of June, okay? We are not prepared yet to do disclose off those numbers because we are in the middle of a process, of a mandatory tender offer in the Turkish Stock Exchange. So we anticipate we're going to have numbers for our Turkey opportunity starting with the quarter three as we conclude the necessary step of the tender offer. But you are right, the numbers have been consolidated into BRF's numbers as of June.

Q - Gustavo Gregori {BIO 16209398 <GO>}

All right. So – but in terms of debt – and you're already consolidating the entire debt, but in terms of financial results, you're just getting the month of June in the results, is that correct?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

We are incorporating on a pro forma basis the last 12 months of development as well.

Q - Gustavo Gregori {BIO 16209398 <GO>}

Yes. In the 4.9 figure, (22:26) so my point is in the GRE (22:27) that you guys are leasing in the income statement, that only includes one month of (22:35) results, right?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Yes, that's correct.

Q - Gustavo Gregori {BIO 16209398 <GO>}

All right. Perfect. And then just a final question. You mentioned essential non-core asset sales, do we have an idea of roughly the (22:51) assets that you would be able to sell?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

We're still assessing the portfolio we have in non-core assets, but we should see them not as the most important lever towards reducing the desired capital structure, but just as an additional complementary step to EBITDA – to our commitment to our debt ratio. As of the company that we are, we tend to have some real estate-related assets. We tend to have assets that are not really correlated to our non-core – the core operations, we have forced the assets sold (23:30). It's something that we are carefully assessing as we speak.

Q - Gustavo Gregori {BIO 16209398 <GO>}

All right. Understood. And then, is it too late for us to assume then that BRF won't pay out any dividend or interest on capital until (23:48) closer to the 2.5 target that you guys see as optimal?

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Gustavo, the way I would reframe your question is, we are committed and the board is definitely committed to as a most important priority in our finance to really restore our position to the 2.5 indicated level. So that will have a consequence on the dividend policy. That will have a consequence on how we are managing CapEx, OpEx, and also all the measures we are contemplating.

Q - Gustavo Gregori {BIO 16209398 <GO>}

Okay. Understood. Thank you very much.

Operator

This concludes today's question-and-answer session. I would like to pass the floor again to Mr. Pedro Faria.

A - Pedro de Andrade Faria {BIO 15115819 <GO>}

Well, I'd like to finish our call by thanking you all for participating. As I said in my preliminary speech, I consider the second quarter 2017 to be a very important transition point for BRF as we enter in a much more favorable trend in the second half and into 2018. I would also like to thank the opportunity to share the floor today with most of my colleagues. We remain fully available to you if you have any other questions or issues to be debated with our IR team. Thank you very much for this call.

Operator

That does conclude our BRF SA conference call. Thank you very much for your participation. Have a good day.