Q3 2017 Earnings Call

Company Participants

- Alexandre Moreira Martins de Almeida, General Manager, Brazil
- Lorival Nogueira Luz, Chief Financial Officer and Investor Relations Officer
- Patricio Rohner, Chief Executive Officer-OneFoods
- Pedro de Andrade Faria, Global Chief Executive Officer

Other Participants

- Eduardo Ordóñez Bueso, LatAm Credit Research Analyst
- Lauren Torres, Analyst
- Pedro Leduc, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to BRF SA Conference Call to discuss third 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'll conduct the question-and-answer session. Instructions will be given at that time. We would appreciate if each participants make only one question.

Forward-looking statements related to the company's businesses, perspective, 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 will be presented by Mr. Pedro Faria, Global Chief Executive Officer; Lorival Luz, Chief Financial and Investor Relations Officer; and Alexandre Almeida, General Manager of Brazil; Patricio Rohner, One Foods' Chief Executive Officer.

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, ladies and gentlemen. Thank you for attending today's conference call. I'm very pleased with the results we present in this quarter, mainly reflecting consistent operational improvements in the base indicators of virtually all of our markets.

As a result, this third quarter marked the recovery of our profitability with an EBITDA of BRL 1.074 billion, which is the highest since the end of 2015, a margin which is higher than historical levels. In Brazil, we continue consistently the growth trajectory that began in May of this year. Once again, we gain market share totaling 54.6% of the market in this quarter.

In addition, I would like to highlight the volume growth of approximately 9% on the yearly comparison and 4.5% against last quarter due to both improvement in our service level, as well as a much better commercial execution.

I would like to speak a little bit about Banvit, a company that has proved to be another very successful case of our M&A strategy, in line with the company's globalization plan and the OneFoods' long-term strategy.

The success of our post-acquisition integration efforts by the OneFoods team, coupled with the favorable market condition, led our Turkish unit to record highest results in its first quarter represent the numbers, represent an EBITDA margin of 23% this quarter, reaffirming the potential of the operation as a very important avenue of growth for BRF and OneFoods.

In the international division, we evolved our volumes sequentially in response to more assertive business execution. This reflects our management program, Global Optimization, where we're seeking to maximize the profitability, take advantage of commercial opportunities in different regions through a dynamic product relocation.

In addition, I have just returned from a trip to Asia where in China, we celebrate the signing of an MOU with COFCO Meat, which has the aim of increasing cooperation between companies around food quality and safety issues. China is an absolute priority market for us and through this cooperation we can combine forces and contribute more effectively to quality and food security in the country, maintaining a growth demand for protein.

From a cost perspective, we saw grain prices at its lowest levels in the third quarter as a result of a record harvest in Brazil this year. We will enter 2018 with a very comfortable level of inventory, which will give great visibility throughout the first semester. However, we believe and are expecting a lower national harvest, which should then lead to an increase in the grain price level compared to 2017.

I would like to finish my speech with some strategic highlights that also marked our quarter. We have announced the reopening of Jataí our plant in Goiás as of January 2018. This is a unit dedicated to halal food production with a capacity of 40,000 tons per year, should employ more than 50 direct employees.

In addition, we have finally received the release of the Mineiros plant by the Ministry of Agriculture to resume our exports operations. This is a symbolic landmark for the company after what we went through in the second quarter.

Lastly, I also like to celebrate the arrival of Alessandro Bonorino as our head of HR and Lorival Luz who joins me in this conference as our CFO and IR. I also like to announce Elcio Ito who was previously occupying the role of Chief Financial, Executive Officer to the Vice President of Integrated Planning Supply from the – start of next year onwards.

I would like then to give the floor to Lorival, who will comment a bit more in detail, the financial highlights of third quarter 2017.

Lorival Nogueira Luz {BIO 16180455 <GO>}

Okay. Thanks, Pedro, and good morning to all. First, I would like to report some important financial data regarding this quarter. As already mentioned by Pedro, the third quarter results showed a consistent recovery in the company's profitability where we reached an EBITDA of almost BRL 1.1 billion, an increase of 87% against the second quarter of this year and 21% against the same period of last year, 2016. The EBITDA margin reached a 12.3% above the company historical average, which is an important milestone for us. The third quarter also marked the reversal of the trends servicing the first semester of this year. And now, we've generated a net income of almost BRL 140 million in the third quarter of 2017.

Now, I will highlight the main drivers of these results. First, and it's important to highlight the growth of our volumes of almost 10% in this quarter, mainly in Brazil and in international division, where volumes increased by 9%, and 6% in these two regions. We also demonstrated an increase in our margins and a recovery in our margins in OneFoods, but still supported by the strong performance of our Banvit operation as already described by Pedro here.

Another important thing to highlight here, it's really our discipline on our zero-based budget initiative, which I can say that is truly embedded in this company. This discipline on a way to manage our SG&A led us to report the lowest level of SG&A as a percentage of the net revenues in this company. So reaching (08:17) 15.8% the ratio on that. This definitely demonstrates the team's austerity in the management of our expenses and our continuing efforts on our zero-based budget plan, which as I have mentioned is truly embedded in this company.

In addition, we took another important step towards the goal of reducing our leverage through the cash generation of BRL 436 million as per the CapEx of the company. The recovery of EBITDA combined with this strong cash generation and strong cash position that we have, and the lower level of uncertainty gave us the confidence to, in October, pay down the revolver facility in the amount of $650 million. This amount we have drawn back in the first – in the second quarter of this year. It is important to note that this revolver remains available for the company in the total amount of almost $1 billion.

I'd also like to note that in September, we joined what we call PERT, which is a Special Tax Regularization Program, that impacted us on the EBITDA positively around BRL 90 million.

Also, excluding the positive impact on PERT, on this PERT, our recurring EBITDA reached the BRL 1 billion level.

Finally, to conclude, that the company financial management continues to be a strong priority for us. We are focused on identifying opportunities to strengthen our balance sheet and aiming at extend our debt profile and reduce our leverage, maintaining our discipline in the CapEx and OpEx, ensuring the company's consistent growth.

Based on that, I would like to pass the word to Mr. Alexandre Almeida, who will give you more details and highlights on our Brazilian market and operations.

Alexandre Moreira Martins de Almeida {BIO 20255277 <GO>}

Thank you, Lorival, and good morning to all of you. As Pedro mentioned, we reported good results in Q3 in Brazil, mainly an improvement in our volumes. This progress in Brazil is based on three pillars: first, execution at the point of sale; second, improvement of the numerical distribution; and third, disciplined execution of our brand strategy. Regarding the execution at the point of sale, it's embedded in our program called Ideal Store (11:28), when we aim to improve month after month the exposure and the availability of our products in the various formats of Brazilian retail markets in our local regions.

Regarding the numerical distribution pillar, through disciplined approach to the market, we reached a monthly average of 175,000 customers serving in the last quarter. We achieved a growth of 5,000 clients over the previous quarter and 10,000 clients over the first quarter of this year.

Third, as for the brand strategy, we continue to advance in the adequacy of our portfolio and price position between our main brands, Sadia and Perdigão. As an example, we gained a 1.3 points of share in the ready-to-eat meals category driven by the successful return of the Perdigão Lasagna line.

Another category I would like to mention is Filled products in which since the beginning of the year, we have been working to increase our presence in new and existing customer. As a result, we performed a double-digit growth in this category in the third quarter.

Internally, we continue to develop in our third brand which will bring additional operational gains from the leverage of our plants and we also saw a segment of the market where we are not yet present in Brazil. This brand, we initially have 13 SKUs in nine sub categories and we'll be in the Brazilian market from February 2018 and on.

With this, I finished now my - all my comments and we can open the Q&A. Thank you very much.

Q&A

Operator

Excuse me. Ladies and gentlemen, we'll now begin the question-and-answer session. Our first question comes from Lauren Torres, UBS.

Q - Lauren Torres {BIO 7323680 <GO>}

Hi, and good morning, everyone. I believe this topic and question was approached on your Portuguese call. But seeing some share price pressure on your shares this morning, I think it'd be helpful if you could just talk a little bit more about the gross margin pressure in Brazil. I think with the expectation or knowing that grain prices have come down notably on a year-over-year basis, that didn't more than offset the FIFO effect and the negative mix impact.

So, could you just talk a little bit more about the component of that and maybe more importantly, looking forward I guess, heading into the holiday selling season, how do you expect the mix impact to change and I guess even next year with a better consumer in some of these brand launches, how do you expect that to turn and maybe recover margins going forward, more on the gross margin line? I know you're doing a great job on the EBITDA margin line. But what's happening on the gross margin line? Thank you.

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

Thank you, Lauren.

Q - Lauren Torres {BIO 7323680 <GO>}

Okay.

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

Lauren, thank you for your question. This is Pedro. I'll give you a perspective on a few of your questions and then Alexandre will dive into details of gross margin in Brazil. So, I think first of all the margin, the gross margin we are reporting in the third quarter I don't – I firmly don't believe it is equilibrium margin and we should be a sequential improvement of that as we go along.

I believe very much that the way I would look our numbers, actually we are hitting a very strong result in terms of contribution math and actual financial results with a margin that is still below what I believe should be the equilibrium. But I think also it means we were very successful in our strategy of liquidating stocks, making sure that we occupy the space in the market, and that we resume our trajectory of market growth reporting. I think very healthy volume growth throughout all of our categories.

Actually, you want to know what we are expecting for the season – the strong Christmas season, I am moderately optimistic about this campaign. Because we have seen one very important element already turning around, which is the propensity of consumers to downtrade. I think the third quarter marked – I think the first moment in which we saw actually a reversal in debt, still very timid. But I think consumer confidence is back, and I think we have a very strong positioning for the festivities campaign. We're seeing early results of that in our operation. So, I am quite optimistic for this Christmas season.

I would now give the floor to Alexandre, so he can comment on what he sees for the gross margin.

A - Alexandre Moreira Martins de Almeida {BIO 20255277 <GO>}

Okay, Pedro. What we had - and we'll talk about gross margin. Of course, it's affected by the mix. We have deliberate increase of volumes in the In Natura segment. Because this is very important for us to be present in every single occasion of consume - of - in our - end customers. Also I think we had a great success in the volumetric categories like filled-in product, and we cannot separate the performance of BRF in Brazil off the total market. The market is not growing, and we are - we were able to grow in this scenario keeping the relative with the - in price between us and the competitors. So, we still have the premium prices in the market. And this is very important for us and we will continue to do so.

The market in Brazil for food had a deflation in the prices and this, of course, affected everyone. Our strategy was for us to regain our footprint, our share of the market, and then take advantage of the recovery of the consumer market, we almost start to see just now because that would benefit the premium brands.

And regarding the future, as I mentioned in the Portuguese call, I don't see any future price pressures going down. On the opposite, we are already prepared to and announcing to the market that we will have a price increase in the early - in the January 2018 without any immediate pressure on the cost side. So, we should evolve on that side also not only on the total margin, the absolute margin, what really we pursued during this year, but also on the percentage basis, margin for the future.

Q - Lauren Torres {BIO 7323680 <GO>}

And can I just quickly ask as a follow-up then with the new brand launches next year coming in, and I guess, thinking about the consumer environment 2018, I'm guessing you're expecting more of a positive mix impact or will some of these brand launches have a negative effect on your mix?

A - Alexandre Moreira Martins de Almeida {BIO 20255277 <GO>}

So, I think for the third brand, it is a strategy of additional gains. It will not compete directly with Perdigão and Sadia. And we'll be present in the segment that we are not really solving today the low prices segment.

In that sense, if you go and talk about the overall margin, it may have a percentage base, it may have a negative impact. But it's - the volume will not be significant, but there are additional benefits on diluting costs and then making usage of our spare (20:05) capacity in the plants. We will more than offset that. And we really, will not take - it will not take part of Perdigão and Sadia market. So, it's another kind of view to this third brand is really how much it will add to our result regarding better utilization of assets and also better utilization of raw materials.

Q - Lauren Torres {BIO 7323680 <GO>}

Okay. Thank you.

Operator

The next question comes from Pedro Leduc, Banco JPMorgan.

Q - Pedro Leduc {BIO 16665775 <GO>}

Hello, everybody. Thank you for taking the question. Congrats on the quarter. Starting on the Brazil side, two points. First, we saw volumes rebounding some with market share gains. At the same time, SG&A savings bring an important margin component here. Can you talk a bit how you're smartening up the SG&A, and if it's - it doesn't seem to be like you're spending less on marketing, given the market share effort?

But also on the market share side, what you're seeing has already went through the gross margin component, but I just wanted to re-emphasize there that you're still to see the lower grain cost benefits on the longer cycle animals like hard (21:25) products for the fourth quarter?

So, these three points on Brazil, the market share, the SG&A path, and the gross margin cycle for the - especially, Christmas products. Thank you

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

Pedro. Thank you. This is Pedro. I'm going to touch on a few of your points. And also, I'd like to listen from Alexandre as well. So the SG&A side, I think it's important to say that this is the cumulative impact of very strong discipline on OpEx in the company. It has no specific significant driver, but I think it leads back to our internal organization, where we centralize a lot of our core processes, where we restart a bit of our operations scattered around the globe. And we're able to drive significant synergies. I like to believe the company is as lean as it's ever been.

If you look back into a long time series, I don't think you will see the company running as lean, as efficient as it is today. I think this is permanent, this is here to stay and this will help the company going forward on its competitiveness. When you think about more discretionary items such as SG&A, I like to remember that actually, the third quarter was a quite active one in terms of brand activations, campaigns, trade. And also, we are actually increasing the size of our workforce. So, all of these are, obviously, helping us drive volume growth. I think we have the healthiest volume growth that I've seen in a little while. And we were pretty effective in the campaign. We are tracking, for instance, brand preference indicators. They all point to sizeable gains post whiplash, making sure that the appeal of our brands, the trust, the quality is very much intact to consumers.

So I think I expect this SG&A, this OpEx to be at new level and to be with us for a long time. And I think this was the result of a cumulative learning of ZBB and how to be efficient.

For gross margin, I think we have to understand not only the photo, but the film and I think always we have a hard time explaining that what we see today in our balance sheet, I think it's just a picture. But if you think about just the price of grains today, if you think about the price which we realize in the market and we just can disregard the impact of stocks and inventories, you will see a margin already higher than what we have presented.

So, there is a lagging impact here that we always like to communicate. And of course, the fourth quarter brings very good mix. We are, like I said, modestly optimistic about share gains on the festivities. And I think for also very welcoming event, a lot of our festivity products, they will come already with a cost embedded that reflects a new lower level of grain prices. So, it should be a boost in terms of individual contribution margin of those products vis-à-vis last year in a meaningful way.

So, I'd like to leave Alex to go a bit in more details here.

Q - Pedro Leduc {BIO 16665775 <GO>}

Thank you, Pedro.

A - Alexandre Moreira Martins de Almeida {BIO 20255277 <GO>}

Okay, Pedro. As I commented in the Portuguese call, we are having this reduction in SG&A not by the reduction of sales force. On the contrary, we add people on the sales team. But also focusing more on synergies, as Pedro Faria mentioned, on the administrative expenses for the Brazil.

As an example we had – we have five regional offices in Brazil, where we are changing (25:33) concept of a business unit who are really sales ops, but of course, focused down on the market and reduced the cost of serving the market. So this is just an example to show how we are combining the growth with more action on the market with a reduction in SG&A. And that for us, it's given. So, we cannot move from the track that we have set regarding expense. So, I don't know if this is enough for you, but if you need any more clarification.

Q - Pedro Leduc {BIO 16665775 <GO>}

Yeah. This is great. I mean, very useful.

A - Alexandre Moreira Martins de Almeida {BIO 20255277 <GO>}

Okay.

Q - Pedro Leduc {BIO 16665775 <GO>}

Thank you.

A - Alexandre Moreira Martins de Almeida {BIO 20255277 <GO>}

Thank you.

Operator

The next question comes from Eduardo Ordóñez, BankInvest.

Q - Eduardo Ordóñez Bueso

Hi. Thanks for the call. From a credit perspective, can you comment a little bit on the trajectory for credit metrics? Because I recall the S&P report after the downgrade mentioned something on the lines of 3.5 times gross leverage by the end of this year. So, any comments in that direction are welcome. Thank you.

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

Yeah. Thank you for your question, Eduardo. Just like before I hand over to Lorival, that we continue firmly committed to the guidance we gave in the previous quarter of reaching an adequate capital structure symbolized by a net-debt-to EBIT of 2.5 times by the end of last year. So, I think the trajectory is very healthy. I'd like to point to our discipline in CapEx and OpEx all leading to strong cash flow generation, inventories coming down as well, which is part of the strategy and of course, the monetization of stocks held in treasury, all of them helping us in a discipline of the capital structure.

Lorival, I'd like you to add to my comments.

A - Lorival Nogueira Luz {BIO 16180455 <GO>}

Yeah. Just to add, Pedro, as you have mentioned, we are working towards the target of going below the 3 times net-debt-to-EBITDA by the end of next year, with a number of initiatives which includes of course, of course, the disposal of some noncore assets, with discipline on our CapEx and also a discipline on our working capital initiatives, in all the lines of receivables, payments, and also inventories as just mentioned through Pedro. But it's not only that. We are also working on strengthening our balance sheet, which will include the initiatives on lengthening the debt profile in order to definitely reduce and avoid any kind of liquidity risk going forward.

So, there are a number of initiatives that we are – the company and the management team is fully committed in order to improve the credit metrics and definitely, be at more confident on the credit metrics. That definitely will be recognized not only by S&P, but also by all the rating agencies.

Q - Eduardo Ordóñez Bueso

Okay. Thank you.

Operator

The next question comes from Pedro Leduc, Banco JPMorgan.

Q - Pedro Leduc {BIO 16665775 <GO>}

Hello, everybody. Thank you for taking the follow up. On OneFoods, this one, we saw here as well a nice sequential margin improvement between the lines – or not between but you actually wrote that new Turkey operations came in with a 23% EBITDA margin, substantially higher what they were reporting at least on a yearly basis. And you also mentioned a price increase in Saudi Arabia, if I'm not wrong.

Just on these two then, on Turkey, is this maybe just a seasonally strong operation for the quarter or do you see that improvements already coming in with synergies, cross-selling, or potentially sourcing so we can see bandwidth running at higher margins than before? First part.

And then, the second, raising prices, Saudi Arabia or other places there in the Middle East, is there room for it now that – is it inventories that have cleaned up? Do you see a better demand environment? How you're seeing volumes react post the price increase? Thank you.

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

Yeah. Thank you, Pedro. Let me try and give you my perspective and Patricio is also on this call. He can take you through greater details. So make no mistake, I think our entry strategy in Turkey is something very exciting. It gives us potentially one of the biggest leverage in terms of growth. And what we've seen is, I think, a flawless execution of post-merger integration.

The results that you are seeing, yes, they're benefiting from what I think is a favorable moment in the Turkish market. But I think this is a favorable moment that has some longevity to it because it comes on the wake of massive consolidation and capacity constraints after very rough years for the poultry production in Turkey. So, I think the scenario is benign. The fourth quarter should be seasonally weak. It's the fishing season. We should be used now to have part of operation who has a weak fourth quarter, but then resumes – I think good trajectory should resume for next year.

And I think what's most important and in line with your question, there is a sizeable chunk of synergies that we are to able to extract on top of Banvit pre-existing operations. And, I think, still a lot of interesting things to come, for instance, cross-selling to the Gulf. And, of course, better optimization of the entire BRF footprint. So, I think, for (31:50) Banvit seems to be a homerun in our long-term strategy.

For the scenario of the Gulf, I just came back from extensive visit with Patricio there. I think we're finally now in the position to see some healthy price increases taking place both as a result of our strategy of getting rid of inventories. I think the market share trend in the Gulf is very healthy for BRF.

And then, I think, what has been very limited supplies into the region, meaning that a lot of the players have now lost their resilience there. And, I think, we will have a much better scenario going into the fourth quarter and the start of the next year.

So, maybe Patricio can complement with greater details.

A - Patricio Rohner {BIO 19686996 <GO>}

Perfect. Thank you, Pedro. And I will complement quickly the Banvit. Banvit is, let's say, what's happened in this quarter for Banvit was planned even during our negotiation with Banvit, our talks about how they were going to face that high season. And, at the end, what's happened is only two or three companies, they were having their production to the higher level to really tackle the high season. All the other Turkish companies, they were not ready because of cost, because of many other restrictions. And that's why this is one of the sites that Banvit was part of our pre-work together with the people.

The second is we put in Banvit unproportional resources. So all the changes that we were doing or we are doing in part of a production, certain improvements that they were not capable to do it, although they have an amazing team, mainly production they started even this results during July, August, even especially in September. The part of the synergies improvement and all these quick wins, they were flat from the first day.

So from the first day, we managed to reduce the cost of Banvit, to improve the efficiency on Banvit in whatever was doable in the very short term. And now (34:05) the big synergies which is the go-to-market, which is the distributions, which is the interior, which is the distributors versus co-partnering and so on. So this is something like is going to come. That's why, as Pedro said, Banvit is one of the amazing big steps that we have done. If we can call all the movements from 2014 till 2016 was a fast evolution in the GCC, this one is a big jump. It's is a kind of revolution that will take us to the next level.

While we go to the Saudi scenario to the GCC scenario, you mentioned in the question that there were a crisis. For us, a new normal, let's say. What is happening in Saudi in the GCC and so one is that (34:53) started cutting a lot of infrastructure investment and so on. And at the beginning, it was more of a financial crisis, no cash in the market and so on. Then became economic because this one was affecting the small groceries, the middle-sized supermarkets, restaurants and so on. Even the traveling among the region, the high season in hotel occupancies in Dubai and so on, they were much lower.

So what we're having today is a new normal in terms of governments, with less subsidies with more costs, more taxes and so on, which is – that was coming in the last year, year-and-a-half. And what we are having is a consumer that accepted already this situation and we can see improvements in the last two, three months, very tangible improvements in the consumer's confidence. So, they are spending more, they are coming back to the countries, they are going out for dinner, going out for lunch and so on.

And this is something that is against tax companies. It's again (35:58) that is more difficult. So, it's again (36:00) that the markets, what they want the governments for more transparency. You need to be more professional and you need to be more local which is all our value proposition. We have the local distributions. We have a local factory to supply that region. We have Brazil with amazing cost advantage and the quality and so on and the scale. And now we are flagging Turkey. Turkey didn't come yet, only very few initiatives. But this is one of the main thing that will come to our machine to put it this way of local distribution with regional services with global services and synergies.

Q - Pedro Leduc {BIO 16665775 <GO>}

Thank you very much Patricio, very useful. Thank you.

A - Patricio Rohner {BIO 19686996 <GO>}

Thank you.

Q - Pedro Leduc {BIO 16665775 <GO>}

You're welcome to (36:43) on Banvit, definitely. Thank you, Pedro as well. Bye-bye.

A - Patricio Rohner {BIO 19686996 <GO>}

Thank you.

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>}

Okay. Ladies and gentlemen, again thank you very much for attending today's conference call. Like I said in the beginning I am very grateful to the team for what I believe a very consistent set of results. We've seen improvements across the board. We believe are on a path of progressive consistent better results. I believe we should be reaching equilibrium margins by next year. I believe the company is well-positioned to take advantage of market opportunities. And I like to emphasize how much we're able to strengthen our internal processes, the way we operate to better benefit from this more favorable scenario.

With that, I'd like to conclude the call today. Thank you very much again for participating.

Operator

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