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Q2 2013 Earnings Call

Company Participants

- Jose Antonio do Prado Fay, CEO
- Leopoldo Saboya, CFO, Administration, IR

Other Participants

- Alex Robarts, Analyst
- Chelsea Konsko, CREF
- Denis Parisien, Analyst
- Jose Yordan, Analyst
- Luka Cipiccia, Analyst
- Sambuddha Ray, Analyst
- Wesley Brooks, Analyst

Presentation

Operator

Good morning. Welcome to the BRF SA Second Quarter year 2013 conference call. This conference call and the presentation are simultaneously transmitted via webcast in our website, www.brf-br.com/ir.

At this time, all the participants are in a listen-only mode and later we will conduct a question and answer session. Instructions will be given at that time. We would appreciate if each participant submit only one question. (Operator instructions)

Forward-looking statements related to the Company's business, perspectives, projections, results. And the Company's growth potential are provisioned based on 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 change. As a reminder, this conference is being recorded.

At this conference are Mr. Jose Antonio do Prado Fay, Chief Executive Officer. And Mr. Leopoldo Saboya, Chief Financial, Administration. And Investor Relations Officer. I would like now to turn the call over to the management.

Jose Antonio do Prado Fay {BIO 15337837 <GO>}

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Good morning, to you all. Thanks for having us in this results presentation for the Second Quarter of 2013.

I would like to begin saying that what we are showing is pretty much in line with our thoughts in the last three or four quarters' meetings. The main figures, the Company is showing good figures, robust financial position and good operational figures.

Of those few, we believe that we can have better figures in the future. But considering the scenario and the global scenario and even the Brazilian scenario, we think that the Company is showing very, very positive results.

The main figures for this quarter, I would like to pinpoint the relief in costs which we believed that would happen. Since October-September last year, we are feeling that the market, the grain price should have some relief during 2013. And not that much what is really happening.

We see corn in -- corn mostly in Brazil detached from Chicago prices. And we have a strong and very big winter crop for corn which makes the price -- the corn prices really to touch the minimums.

And the soy still shows volatility. The soy complexes still show volatility and still resists the prices -- has a price resistance. And this is completely related to the dollar. So it's one on one in dollar, which means that we still are facing some kind of pressure in soybean meal mostly.

The second point is the FX volatility during this quarter. We have a strong volatility of FX to real-dollar. All in all, this is good for the Company. But it puts some costs mostly for internal markets. But all in all, this increase -- the devaluation of real, it's good for the Company.

Another point is the start up of our Innovation Center. We just started up our Innovation Center near Sao Paulo, in the Sao Paulo area in a city called Jundiai where we are concentrating all of our knowledge in R&D, which we do not have done it before because we have guys spread around the country and we have many R&D centers. Now we concentrated that in Jundiai. And we put there a very modern and one of the best in the -- the world-class innovation center.

This is crucial to keep on improving our strategy, developing our strategy, which is to focus on value-added consumer products. And we are very, very keen about the possibilities that it's open now, this Innovation Center.

Another point is the bonds issuance. We had a very good result on our bond issuance. And Leopoldo will get in details after. But I really believe that it was a very, very good operation of the Company.

And another point, an important point. And that's during this semester we are finishing the commercial infrastructure that we need to consolidate to have more productivity on our sales force, which means that from now on we can have all our products, all our brands in our distribution centers. We can have the same frontend in our sales force for everybody. This is what's very, very important to keep on. And it's one of the last steps in our merger processes.

So putting some figures in internal markets, I would say that what we are -- we really want to figure out is that we are delivering a promise that we made in the second -- in the end of the Third Quarter last year, when we finished the ruling of antitrust authorities, that we will -- we had planned to recover volumes that we were losing in the market since we suspended and we sell some brands and some brands were out of the market.

So we recovered that. We have strong figures in growth when we look for the same stores, let's say. So same store sales are very, very strong. And this is due to very good planning and excellence in execution that the Company had during this time.

For external markets, although the global scenario still is challenging, Europe is showing some improving. And mostly Middle East keeps on having a good performance. I would say that we have the advantage of the FX, of course. But the good management of volumes, price. And costs made a very interesting recovery in this market.

For Food Service, we see some de-acceleration of the growth, mainly due to that the consumers are making choices of where to go to -- regarding the out of home consumption. And we see that still we maintain our volume. We have, let's say, a poor portfolio and we move some mix from basic -- returning to the basics more, let's say, the Food Service area.

And the Dairy Products, we are putting -- we are posting very good results in Dairy Products. Part of this is due to structural measures that we did since September last year where we right-sized the business. And due to the growth in cheese, we could put in place the strategy of the decrease UHT fluid milk, which has a poor profitability normally in Brazil.

And so, this result partially is done --it's due to the structural measures and of course partially it's due to a juncture of factors that are being positive, mostly due to the dry that happened in New Zealand. That makes all this sector more profitable during this semester, let's say.

So now I will ask Leopoldo to put some details. And then we'll return for Q&A. Thank you.

Leopoldo Saboya {BIO 16137418 <GO>}

Thank you, Fay. So moving forward here, now looking into more details, the results and performance of each business unit, let's now jump to page six, please.

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Here we have the first half at a glance. This is the contributional margin for the mass markets and also the export market. You can see a very balanced contribution from last year. So a good recovery from last year. A good performance, though. And very well balanced between the two main markets, Brazilian and export markets.

On the next page we can see that practically all this, 2.8 BPS of enhancement of our EBIT, from 4.2% to 7% was due to the enhancement of our gross margins. So it was a very well managed performance in pricing against costs after having a continuous increase in our cost basis, as was explained by Fay.

Turning to page eight, you will see that all this better performance was fully translated to the adjusted EBITDA and also the net income. So much better figures on both a quarter basis or a half basis when we have this performance, putting the Company fully back to business as usual performance. In fact, it is even higher than the historical margin levels for the first half of the year.

Now, on page nine, we start a comparison that I think it's pretty important for us to focus on to understand the short term. So comparing the Q2 with the Q1 '13 to see what were the changes and how we see that evolving looking to the full year of 2013.

Here you can see that we -- against all odds, we could even increase the gross profit of the Company by 1.4 basis points. But the adjusted EBITDA only grew by 0.3 basis points compared to last year, mainly due to more expenses. And all of this, the Second Quarter that I will give more detail in a while.

On the net income, in fact this drop from first to second is fully due to the FX effect on the net exposure. And just reminding that this is a non-cash effect, though.

Moving forward on the next page, on page 10, we see the evolution of our adjusted EBITDA since last year toward now. So our consolidated EBITDA for the first half was 12%, which is above our historical levels. In fact, the historical level of the Company, if you remember for a full year, was around 11.5%. This is the number that we always said premerger.

So the first half of the year, which is the weakest half for a normal year, showed a 12%. That, as emphasized, was previous performance. Of course, it's still below our potential. And we -- even facing this result, a lot of difficulties or volatility that is part of our business.

Moving to the next slide analyzing the top line of the Company, this is another factor to be emphasized, that we can see that on a quarter basis, we don't see any kind of effect of the potential revenue cliff that could have happened in our results if we did nothing regarding the TCD execution.

So we can see that on a quarter basis our top line growing, in fact. And on a half basis, it was 11.8% higher revenues than last year.

On slide 12, we have the breakdown of our net sales. And this, if we consolidated all the categories that we call processed, you have the figure in the detail in our earnings releases. You can see that the amount -- the relative amount of processed food by revenue in year-to-date is almost the same we had last year.

And remember that everything that we had to sell and to suspend was predominantly not to say full processed and branded, which emphasizes our capacity and our performance to fully recover this percentage lost in processed foods now in this year, 2013.

Regarding cost of goods sold in this quarter, it happened pretty much what we expected. There was some accommodation, some easing in the cost basis. It was not a big reduction, partially offset by the FX impacting in the cost. But it was positive specifically toward the international market because it was exactly the opposite affecting in Q1 where the pickup in the corn prices affected the international margins. I will give more details later on.

Just giving some more figures on what is going on in the market, for corn, when you compare to Q2 last year, it was -- in reais prices, market price was only 2% lower. But when we compare corn prices during Q2, compare it to Q1 this year, it was 19% lower, showing the good perspective FI set of the new crop and good perspectives for the second corn crop, the so-called safrinha in Brazil. That should have some impact on the FX going forward. But it's still positive.

On the other hand, soybean meal hasn't decreased that much because of the FX effect and because there were some doubts or some cautions regarding all the soybean complex performance. So in terms of soybean meal, we had a 4% lower price than we had last year and 5% lower against Q1 this year. But here the final message is that we have an even cost which is positive for us to keep on repeating our growth thrust growing forward.

On the next slide, we give more details on SG&A, which I think it's pretty important to understand this. On a relative basis, we see in Q2 a different trend from what we have been seeing for more than four quarters in a row, which was a continuous enhancement of our performance.

What happened in this quarter specifically? So more than half of this change. So 80 BPS is fully due to marketing and trading expenses, more trade, though. So it was on purpose that we expected our cost accelerating in this quarter because we had to. It was a quarter more challenging in terms of moving volumes and making our sales not to lose ground due to some slowdown of consumption in Brazil.

And on top of that, we had another effect that was due to some other expenses that we could say that they were due to the half but that was accounted in this specific quarter. So that's to say that we still keep under very tight control of this threshold. And we keep having the perspective of the SG&A enhanced on a year basis, 2013 against 2012, which is the management target for the year.

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Moving forward on the financial position. So I'm now on slide 15, our liquidity shows a very positive figure in Q2, which is total liquidity of BRL3.8 billion split into BRL2.7 billion of cash and equivalents and BRL1.1 billion as a revolving facility. On the net debt, we finished the quarter with BRL7.4 billion of net debt.

And here as well on this chart, we must emphasize very well our very timely bond issuance totaled $750 hundred million with the lowest coupons ever issued by a corporation in Brazil. And we did a liability management that totaled $550 million, including this $150 million of an exchange offer of our older bonds that we have.

On slide 16, we can see that we could not only enlarge our average terms, our duration, to five years, as well we reduce our coupons of both. That's in reais and US dollars. And having a more interesting, I would say, funding structure, being half of the funding sources being capital markets, which should be the trend for an investment grade company and a company that is becoming more and more global.

What you see here, the debt maturities schedule is also very positive when we look to this schedule. There is no big concentration in the short term. So pretty well distributed and very, very tranquil for the Company to roll over in the coming years.

Now explaining the financial leverage. And here I'll take some more minutes to explain how it happened going -- saying from last year. So you do remember at that time when we achieved the peak of this leverage by Q3, we said that the Company would enter in a deleveraging program. And we did. We are delivering that since mid of last year on a consistent and continuous basis.

Now we are at 2.22 times EBITDA as leverage. We had pretty good cash from operations. You see the full concept. And net of CapEx generated in this quarter of approximately BRL450 million that you don't see here as a debt reduction, a net debt reduction on a quarter basis, only because our MTM of the hedges due to the big FX changes and interest changes on a quarter basis.

Just another reminder that it goes to the net debt as an obligation. But it's a non-cash effect. So that's why we have to emphasize again the deleveraging the Company despite the US dollar appreciation. We should continue some of this deleveraging towards the end of the year.

Looking to the investments in the first half of the year. So we totaled approximately BRL1 billion. And here we made the split not only looking to what was due to first and Second Quarter and not only to the type of investment, being growth, support, efficiency. But making a more managerial breakdown of those investments to make it a link to the guidance.

So in terms of our biological assets, the so-called breeding stock, it was BRL255 million in the semester, which is alongside with our guidance of BRL500 million for the year.

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Another opportunity, which is the CapEx excluding the leasing, which is the build to suit facility that I will comment on, we had BRL524 million, which compares to our guidance of BRL1.5 billion.

So that's to say that we are running below the guidance and we should deliver a year below what we expected. And that's in line with what we have been commenting on in former quarters with you.

Just to reemphasize what we presented last quarter, the acquisition here, BRL1.07 million, it's the Federal Foods acquisition in the Emirates. So it's not a CapEx cost. But it is investment, as well the leasing. So the leasing here we have to account into our assets. But it will have an equal effect in long term payables which is zero or a neutral for EGA [ph] concept. And also it is a lot of cash of the Company that was spent doing those because they were real build to suit.

But this is just more detail for everyone to be on the same page that we are investing -- keep on investing in the growth on the strategic items, on food and processing not only in Brazil but abroad and not jeopardizing our future growth. But being -- working below historical levels and below the guidance we gave last year.

And here, one example of our recent investment, on page 19 is the so-called BRF Innovation Center. So this is a state of the art complex here nearby Sao Paulo, a city called Jundiai City. It is really -- it's going to be an enabler for BRF to become a more innovative company, to be ahead of the trends in the market for all the types of products we can test and develop here.

We have even some facilities, they are -- they have the scale of a real facility. So they are not only our QC. It's a real facility that can replicate the environment of a plant. So we will for sure fast-forward our time to market with our innovations.

So when we talk innovations, on page 20 we just give in one page how we are seeing and how we are thinking in the background of what are the trends that we've studied in the market. Not specifically in Brazil. But this is all of those items. They are global trends meaning, at the end of the day, healthiness or more concerns regarding convenience and sustainability and all those aspects. And when you link these trends with the launches we are making, they are fully matched.

And you can see the next page, on page 21, just some examples of the launches we are making. So the Greek yogurt we launched. And this is the drinkable one which was the innovation that Batavo brought to the market, which is a pretty good product, though. Not to say all the other products here, just examples of this that I would just give some emphasis here.

On the Sadia branding and display in all the international markets, it was standardized in the way we will use the packaging and the brand name with what can be used locally, what is the global slate. So this was -- this is a modest step toward being more global, more standardized global wide.

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Now to finish the presentation and turning to the Q&A, I'll just give one slide on every business unit just to give a little more color on what happened in each market.

So starting with the domestic market, we have again to emphasize the great performance we had on the same store sales growth, that here on the right of chart 23, you can see that when we compare -- or when we make the adjustment in the first half of '12 with the same portfolio that remained in the Company, we had -- grew in revenues of more than 32%.

So this is incredible how we could recoup not only what we intended. But we went beyond that. And of course this creates an opportunity for the Company going forward.

We see on slide 24 a little more color, what happened in the quarter. So instead of the analysis on the growth on the last of the charts, I will concentrate in my analysis on these gray bars, the ones that compare what happened in Q3 with Q1 of this year.

Here you can see that I'll -- it is explained here that there is only 0.5% growth in volume. But in fact what happened is that the mix we could enhance because we sold more processed against Q1. But selling more processed means that mitigated the mix effect on the pricing. But we had to make some consent on pricing and some more marketing expenses. That compressed the EBIT on a quarter basis.

Then, I move to the EBIT analysis. There you definitely see a better result than last year. But a quite important margin compression of 6.1 BPS comparatively to Q1. How that is -- how can we explain this compression?

A third of this compression. So approximately 200 BPS, or 2percentage points, it was due to marketing and trading expenses, as I said before, on a consolidated basis. Another third of that was only due to the gross margin compression. So it was the cost that stayed flat because the -- all the cost reduction in the short term affected positively the international market. But it was zero effect for domestic market roughly.

And the remaining third of these whys of this compression is other expenses due to the half and due to some other collateral effects of the need for Company to move volumes and not lose ground in some categories that were not performing or not rolling the way we expected. So we had some more transitory expenses in this quarter that we don't expect to maintain in the coming quarters.

So in a nutshell, we saw in fact the consumption that has decelerated in this quarter alongside with the whole Brazilian consumption. But when we look forward, we keep being cautious but with a very positive trend, especially when we understand what happened during this year. And we see, as of today, the first of July and the perspective for August, they are better.

So we can say as of today that it seems that the more complicated months have gone. And now we see a better trend for domestic market. But keep in mind that we are still

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navigating in a more complex and a more volatile environment domestically and internationally.

Export markets, giving the highlights of that on page 26, we -- I'll make the same comparison of the gray bars, that the gray bars they compare Q3 with Q1. We see that we could -- grew volume in net sales, although we had a little compression in our prices even with the FX being positive.

But that fact didn't jeopardize our results. It was, in fact, the other way around. This little compression in prices we had expected. In fact, we said last quarter meeting that we saw some accommodation in prices especially in the Middle Eastern market and in the Japanese market.

But all this compression in prices, they were important for us to keep on moving volumes and they were more than offset by the cost reduction that -- the same thing that affected us in Q1 benefitted us in this quarter in the export market on a cost basis.

So that's why we could have such a great increase in our profitability, putting the export division in a fully business as usual performance. And all the conditions of the market, at least nowadays, gives us a good perspective for the coming quarters, although we keep that sense that we'll still see a lot of volatility in our fronts for sure.

I will skip the three next slides that they show details by market, because we've -- both Fay and I, we've already mentioned the highlights of market by market. I'll jump to the Food Service performance on page 31.

Here it's basically the same reading as the domestic market. We had not that big difference in reduced magnitudes compared with the domestic market for sure. We can see on the EBIT compression that it was basically due to gross margin compression. But maintained in a pretty good level. When we see the performance of the entire half, it was around 16% in terms of EBITDA. So for Food Services, it's a pretty good margin.

We know and we have recognized that this division can go further. And the potentiality for this is beyond that. And we are working on this half to return. And bear in mind that the second half for both the domestic market and Food Services is still to come, which is the second half and precisely the Q4 that presents pretty a good perspective in the results for us.

But what we have to say that we -- what we felt in our bones during this quarter was a market that grew in Brazil. But it is growing with less speed than it used to grow in the last, let's say, eight years at least.

So Food Services was a market that the penetration of eating out of home was still very small in Brazil, grew quite a lot during these eight years at least. And now it's reducing pace. It's not reducing the size of the market. It does reduce in pace. And now we are seeing that trend and calibrating our strategy to better perform in a market like that.

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So the last but not the least is the Dairy business. That represents a pretty good performance for the first half of the year. We are here absolutely delivering what we said we would do. That was, first of all, a right-sizing of the UHT division.

That explains this dark blue bar here in volumes by 18.8% down last year levels. It's because we made that. And that was crucial for us to have a better performance in cost and pricing in this market, especially in a year like this that we are having this increase in milk that we are originating on every new basis in Brazil.

So even with this environment, we could boost our profitability in the UHT milk and also boost in the processed division. That put the divisions not in the full potential. We are still not here benefitting from all the linkages and the synergies with the BRF system that will start now in second half to appear.

But for sure we have started. We made this turnaround regarding our positioning in terms of every category in the Dairy division. And now it opens a good perspective for this division going forward.

So guys, having said that, I will turn it to the operator to listen to your questions. Thank you very much.

Questions And Answers

Operator

Excuse me, ladies and gentlemen, we will now begin the question and answer session. Each participant may ask only one question. (Operator instructions) Wesley Brooks with Morgan Stanley.

Q - Wesley Brooks {BIO 16407564 <GO>}

Hi, guys. So first question, just trying to get a better feel, obviously in Q2 you had some benefit from lower grain prices and a weaker currency. And your export margins were really good. So can you give us some sort of quantification on where you think your export EBIT margins can get to in sort of Q3 and Q4 now with the weaker currency and even lower grain prices?

A - Leopoldo Saboya {BIO 16137418 <GO>}

Wesley, its Leopoldo speaking. Thank you for your question.

Of course, in terms of quantification, we won't give precise figures because you know we don't guidance the margins for our entire units. But we can of course discuss the conditions for us to grow or to not to grow margins on a quarter basis.

So first of all, what we had to take into account is that, in this quarter, we had the full benefit of the cost compression because the dollar hasn't affected the cost of our

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products. We were kind of consuming corn and soybeans. But on the more -- on our older FX, if you understand.

Now in Q3, we don't have the cost pressure. But we don't have the benefit of the FX anymore. It's going to be the other way around. We will consume inventories made with a more devaluated real, which means that, in terms of corn, we lose this tailwind.

And in terms of our other dynamics, in terms of pricing, of course we have to balance very neatly how we keep a price in dollar terms accordingly in each market performance not to lose volumes, right? So I particularly don't see a big space for margin expansion. We -- because the margin levels, they are great for international divisions.

So our big challenge is to maintain the type of margins we've achieved during this quarter. I think that's the indication.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

And adding on Leopoldo's answer, I would say that when we look for the production scenario, what caught my attention mostly is that we don't see that there is potentially an imbalancing regarding to the equation of supply-demand for the short term, since Brazil is not growing its allocation and new assets recovery its internal market.

So the -- globally speaking, the supply-demand equations are pretty much stable, which is good for the business.

Q - Wesley Brooks {BIO 16407564 <GO>}

Okay. And so, the -- sort of the smaller Brazilian producers that -- a lot of them cut back production significantly in the second half of last year when they were losing money. Are you not seeing them ramp up production at the moment?

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

It's very hard to say. Of course, they have some means to increase production that -- but, all in all, I'd say we expect that they increase somewhere in the second half. But until now, according to our readings in the internal market, the allocation is not growing in Brazil for this month and next month.

Q - Wesley Brooks {BIO 16407564 <GO>}

Okay, fantastic. Then, just lastly. So putting that into the context of the sort of -- the normal commodity chicken cycle, I mean, do you have a view on when the cycle is going to peak this time around? Is it like Q4 of this year? Or, maybe because of the Brazilian cost advantage plus the FX, maybe conceptually this cycle could be more profitable and longer than previous cycles for Brazilian chicken producers?

A - Leopoldo Saboya {BIO 16137418 <GO>}

Well it's a pretty good question but pretty tough to answer. I'll give --.

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Q - Wesley Brooks {BIO 16407564 <GO>}

I know.

A - Leopoldo Saboya {BIO 16137418 <GO>}

No. But I'll give you how I particularly see that going forward. And after the big crisis that we had in 2008 and all the collateral effects over 2009, we had -- we didn't see in the market so big investments in new or fresh capacity globally.

And Brazil and United States, they are the big players, biggest exporters in the chicken business, right, of course that, which means that the potential capacity for the production in the world is not, let's say, tremendous even if everybody puts all the plants to work to capacity.

But of course we have a risk. As always, we will have that the production can, in the short term, react positively to some incentives being reevaluated in Brazil or more profitability in the industry in the United States.

So although we concede that we may see some, let's say, good perspectives on incentives for Brazil and United States industry to grow capacity, I don't see a big risk of damaging or jeopardizing completely the scenario that we see. So your call that this could last little longer, of course we need to wait a little bit to confirm that.

But this is a possibility or assumption that should -- I mean, the rivals in the market may lead to that, although it's early to confirm, if you understand what I said.

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Q - Wesley Brooks {BIO 16407564 <GO>}

Makes a lot of sense.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Yes. And we still have to consider that probably the grain, the cost will relieve for the 2014 since the US should have a good crop for this year, which means that working capital to recover capacity will be less than it used to be in the last two years, let's say.

So there is many, many variables to analyze. But all in all, in the middle term, let's say, our view is positive.

Q - Wesley Brooks {BIO 16407564 <GO>}

Excellent. Thank you very much.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Thank you.

A - Leopoldo Saboya {BIO 16137418 <GO>}

You're welcome.

Operator

Luka Cipiccia with Goldman Sachs.

Q - Luka Cipiccia

Yes. Good morning. Thanks for taking the questions. A follow up to some of the previous caller on actually innovation. I was just wondering if you could give us some visibility on how should we think about new launches, product innovation, as well as white spaces maybe going forward. Clearly you had a sense of urgency to try to recoup volumes this year.

So as we move forward into the second half after the TCD impact will diminish as we look into 2014, if you could share some visibility on how we should think of that as well as what is your interest in expanding maybe into categories where you are not today and what would be, in your view, the most attractive spaces to look at.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Luka, the point is that during this time that we were following the rules that we have from antitrust authorities, a lot of energy of our R&D guys were took by to rebalance our portfolio between Sadia and Perdigao brands in domestic market. And then to repositioning our categories to face that in that rule.

So in the interval, we delivered many new products. And part of our strategy of volume recovery was based on innovation, new products, mostly in frozen ready to eat categories. What we maintain? Our focus.

Now we have a better infrastructure to R&D and we do not have to rebalance our portfolio and so on. So we will improve and accelerate our programs in portfolio renovation and bring some innovations to Brazilian consumers. This is the strategy that we align -- we planned during the merger progress. And we are on track on that regarding to this startup of this Innovation Center.

For new categories that the Company are not in, I would say that this is not our first step in innovation. We have a lot to do in the categories where we are already in.

Q - Luka Cipiccia

Okay. And if I look into the third and the Fourth Quarter, how should we think about the differential that you're currently showing when you present your growth rate adjusted for the capacity that you're trying to -- sort of how -- the established growth rates, as we move forward, when do you think are going to normalize really?

A - Leopoldo Saboya {BIO 16137418 <GO>}

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They tend to normalize, Luka, especially because we start to compare to a more comparable basis of last year, of Q3 and Q4. So we don't -- as I said, both of our initiatives and launches in order to offset partially or in full the effects of the TCD implementation is done. So we don't have flow of that going forward.

Q - Luka Cipiccia

Okay, that's good. Okay. Thank you very much.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Thank you.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Thank you.

Operator

Jose Yordan with Deutsche Bank.

Q - Jose Yordan {BIO 1496398 <GO>}

Hi. Good morning, guys. I just have one question. Thanks a lot for disclosing the comparable growth excluding the TCD. It's a helpful thing that we hadn't seen before.

And so, now that you did, I'm curious as to what the growth rates on the same basis were for the Fourth Quarter of last year and the First Quarter this year, which were the first two quarters after the divesture, the first full quarters. So that's just my question, if you can give some sort of -- if you can tell us what the number was for those two quarters to put them in perspective, what happened in the Second Quarter this year. Thank you.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Thank you for your question, Yordan. And just taking here the figures, we do have and we have disclosed that during the Q1 -- on Q1, only taking Q1 and the same store sales for domestic market, the same 32.4% that we presented for the half, it was 38.3%.

For Q4 probably I don't have it here. Oh, I do. Yes, for -- I do have for the second half '12 compared to second half '11 in the same store sales for domestic market. So the growth of that time was 50% growth. And that's -- all these materials, they were public and they were available on the earnings releases in both Fourth Quarter earnings and First Quarter this year earnings.

Q - Jose Yordan {BIO 1496398 <GO>}

Okay. Great. That's useful. And so, I guess, I mean, it has been slowing down somewhat. And as a result, I assume that we should continue to expect the slightly higher marketing expense rate for -- at least for the rest of this year.

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A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Yes, I would say that what we are expending in marketing is pretty much the normal that the Company should expend. And for the First Quarter, we were less active in trading and marketing and even above the line. So we expect to keep our marketing investment for the rest of the year.

Q - Jose Yordan {BIO 1496398 <GO>}

Okay, that's great. Thanks a lot.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Thank you.

Operator

Alex Robarts with Citibank.

Q - Alex Robarts {BIO 1499637 <GO>}

Thanks. Hi, everybody. I want to go back to the export market. Clearly that was the big positive surprise for us. And I think going beyond the macro factors of grain and currency into kind of the factors that are really about the marketplace, I had kind of three parts to the question.

I mean, in March, you kind of unveiled for us this reorganization of the international business, 17 country launches, Sadia brand. And all these kind of factors. And so, I guess kind of starting with Europe.

And this is a key market, interesting when you strip out the volume and the currency issues, it seems like you got about a 4%, 5% higher dollar price in your exports in that market. And just wondering if you could kind of comment about that. Is that perhaps more because of mix and you have more processed there in Europe, or just general demand recovery?

The second thing is that the Americas now has come, as a region, right, more important in terms of sales than Europe. And obviously a lot of that is Argentina. Can you tell us about how the Quick Food kind of restructuring and transition is going? That would be the second part.

And the final part is, when we think about the goal, right, of having the direct distribution getting to about 30% of your international business. And how are you moving toward that? Are we still kind of on track to get to that level by the end of next year? Thanks very much.

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A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Thank you, Alex. I will try to remember all the questions that you did in one question.

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So let's begin by Quick Food in Argentina. Really in Argentina, we are now deliver -- we are execution -- we are executing a very, very strong merging process. Since we have Quick Food, we have Avex, we have Danica. And even Sadia commercial businesses there. So there is a strong restructure there. The scenario is really a challenging scenario since we have price control and, on the other hand, we have inflation about 20%, 25%.

But even in this scenario, we can see -- personally, I am very keen about the future of Argentina because, even in this so. So strong and challenging scenario, what we are having in Argentina, we are having a, let's say, break-even process. We are not making money there. But we are not losing big money there. So we are almost in the break-even.

When we see some cost -- production costs, mainly in the chicken production, we see that we have figures -- we are improving the figures of the yields and so on. And we still have some figures that are the same figures that we are in Brazil.

Of course, when we go to export from Argentina, with 5.5 pesos per dollar, it destroys a lot of results. Then we are focused on the domestic market pretty much than export. But in the future, I believe that Argentina could be a good export base for our business, talking about Quick Food.

Regarding to the results in external markets, we did not increase processed food exports. But we grabbed some margin in distribution. So since we acquired the Federal Foods and we are improving Arwaki [ph], which is our distribution in Saudi Arabia that are having more share in our sales in the total, which means that when we go directly to the shelf, directly to the consumers, we can have better margins. And this is an important figure for Middle East mainly.

The same we have in Europe, not with the same intensity. But in Europe we see some improvement in the results in Europe since the turkey markets are getting better and we are having better prices since production in Europe seems to decrease mostly in turkey, which gives us some price advantage regarding to the whole. This can explain some points in our margin. I would say that Europe and our distribution in Middle East should take -- we have to take into account that.

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A - Leopoldo Saboya {BIO 16137418 <GO>}

Just adding on what Fay said, Alex. And now taking one of your points, I think it was the main factor that's made this better performance in this quarter and how you should think in going forward, if we can think on quarter positive impacts are on the FX or not.

First of all, we need to understand this quarter performance. Even when we compare to last year's performance or with the Q1, the two most relevant contribution of factors for this better performance was FX and cost relief. The cost relief, looking to the very short term, it was fully because we had a price decrease still not affected by the FX itself.

So why it may be more so important this quarter? Because the FX that we had in the half of the quarter. So by mid May until end of June, only positively affected the top line but

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not affected the part of the COGS because we were long in corn and were consuming corn bought at -- corn and soybeans bought at the former FX.

How can we look now wiser looking to the next quarter? The FX will continue to be positive. But the COGS won't bring the same contribution that it posted in this quarter. So that's to say that -- and then, back to one of our strategic (inaudible) in the market.

That's, of course, when the margins, they boost in so short a period of time, as a leader, we have to control it to manage that in order not to over, I'll say, intensify or incentivate, over incentivate the entire market to increase production or to migrate production from Brazil or from their domestic markets toward exports.

So that's why we need to control this profitability on the next quarter, in order not to make a huge profitability in one quarter and then spoil the results on the quarters onward. So that's the mind of the Company. And those are, again, the main drivers for the results in a quarter basis, in a year basis. And that should be a little difference when we look forward.

Q - Alex Robarts {BIO 1499637 <GO>}

Very helpful. Thank you.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Okay. Thank you.

Operator

Sambuddha Ray with JPMorgan.

Q - Sambuddha Ray {BIO 16099198 <GO>}

Good morning. Thank you. So much for taking the question. I'm representing Alan E. Santine [ph]. Congratulations on the result. The question that we have today is regarding the cash flows. So you improved your working capital materially this quarter. So if you could share with us your expectations regarding the trend in working capital for the remainder of this year.

And on that line, if you could also share what level of operating cash flow that you plan to achieve by -- or to generate by the end of this year and the target level of net debt to EBITDA, please, those would be my questions for today. Many thanks.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Thank you for your questions. In terms of where we are in our working capital recovery or performance, we -- as you can see in the figures, we have much better than last year levels. Still, on a historical basis, it is positive.

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When we look now on what by the -- until the end of the year we have to consider two main facts. First of all, we are in the moment where we built more inventories of corn precisely because we are in the crop -- in the harvest time for the winter crop. And we built this inventory by -- as a carryover for next year. So first of all, there is this impact to be considered.

And as well, we have all the bid on the stocks for the seasonal products like the Chester and the turkey for Christmastime. But those, although they put a -- as an investment in working capital, they are not that big in order to represent a big cash consumption, right? They will be according to our expectations.

But in all the accounts, be it payables, receivables, we keep on working. And we are pretty much on track from our plan of enhancing every account that contributes to the working capital of the Company. And they should keep on a positive trend towards the end of the year, even in 2014.

Your second point regarding all the cash generation, of course we don't have this guidance or we don't give guidance on cash generation. But we keep a positive trend on that as long as we keep on generating good CFOs and with a very disciplined or very well balanced CapEx program for the remaining of the year.

Another thing that you asked is regarding our target for leverage. Our target or our, let's say, optimal leverage is around two times, which is -- precisely we are there, 2.2 is around 2 times. But we target for the year to go below two times, something is -- from 1.5 to 2 times is achievable, of course depending on market conditions, on a lot of other things, including FX. That, in some cases, it poses a pick up and doesn't have to do with cash generation or other aspects.

So we have this target to finish the year below 2 times. Of course, it's hard to precise how below it's going to be. But we are pretty confident that we will reach this threshold. Okay?

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Q - Sambuddha Ray {BIO 16099198 <GO>}

Got you. Just to follow up on that quickly, if you achieve the 1.5 to 2 times. So below the optimal level, do you think there is a possibility of increasing your dividend payout targets going forward?

A - Leopoldo Saboya {BIO 16137418 <GO>}

Oh, to be honest with you, this issue is more to do with the Board of Directors' decision, what to do with the excess of cash and liquidity.

But of course it's no secret for everyone that the Company has important conditions in terms of international growth. So at the end of the day, we are preparing ground for the Company to accelerate its growth and both -- but, more effort is to the international market.

So the trend is for the Company to maintain this. We don't have a problem of maintaining for a couple of quarters below the optimal because it's not a problem at all. It is a problem when you don't know what to do with your excess cash. But it's not our case so far when it happens, of course.

Q - Sambuddha Ray {BIO 16099198 <GO>}

Understood. Very helpful. Thank you. So much.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Thank you.

Operator

Chelsea Konsko with TIAA-CREF.

Q - Chelsea Konsko {BIO 17438250 <GO>}

Hi. Thank you for the call. I was just wondering if you could please repeat what you had said about the reasons for your reduction in CapEx for this year. There was just a lot of background noise at the time when you were discussing it and I was unable to hear.

And also, can you discuss any potential international expansion plans, or what your thoughts are there?

A - Leopoldo Saboya {BIO 16137418 <GO>}

Thank you for your questions, Chelsea. The first question regarding the reasons for the reduction in CapEx, it's important to qualify that it was not -- we are not reducing the CapEx program. What has happened is that we did last year a pretty massive or important CapEx program based on a full recovery of our capacity of both units that were sold and suspended. So we had to anticipate much of that over the last year.

And for this year, we had intentions to expend in CapEx BRL1.5 billion. And as we see the strength according to the figures, we can say that we intend to deliver below that. Some think in between BRL1.2 billion, BRL1.3 billion probably. This is most likely.

It's not -- we are not cutting CapEx. But we are making adjustments in the timing they are happening. For instance, there is one example which is the Abu Dhabi plant. As we had to -- we had some difficulties with licenses, we ended up postponing the bulk of the CapEx program. So the cash investment was, let's say, rolled over to 2014.

So things -- we are not changing our vision or our growth ambitions. But only, let's say, investing exactly what is needed and what is in our approach that we see that demand for us to invest. Your second question regarding --.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

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Regarding to expansion, to international expansion, I would say that we keep on acting on M&A market as we are in the last times. Most of our focus was on the increase of our distribution as we acquired Federal Foods. And this is the kind of business that we keep on looking for.

And our team are very aware about the opportunities that we can get. But we do not have a specific target at the moment.

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Q - Chelsea Konsko {BIO 17438250 <GO>}

Thank you.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Thank you.

Operator

Denis Parisien with Deutsche Bank.

Q - Denis Parisien {BIO 20333702 <GO>}

Hi. Thanks very much for the call. I was wondering if you could give us a little bit more color on the other factors that you said caused part of the reduction in the gross margin. You said that there was some -- one third was due to the marketing and trading, one third due to the COGS effect. And then you referred to another third coming from some transitory other expenses related to moving product around to make up for the weak demand.

Can you give us more color on that? And how does that -- how do those costs remain temporary if the weak demand remains in place? Can you just talk about that aspect and how -- give us a little bit more comfort on that being temporary by discussing it more in detail, please?

A - Leopoldo Saboya {BIO 16137418 <GO>}

A very good question, Denis. Just to -- for us to be on the same page, when I said that third, third. And third compression was not in the gross margin but on the EBIT margin, right? Just --.

Q - Denis Parisien {BIO 20333702 <GO>}

Oh, yes. Thank you. That's right.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Okay. So yes, one third of that was marketing expenses. Another third was the compression in gross margin. Then, the other was split in several other expenses.

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I'll give some examples of these other expenses, that they are transitory, for instance. There is the fact of our -- the deal that we made was due. And afterwards we had to sell to JBS because of Cade's ruling.

So this presented accounting losses of BRL30 million. That, of course, is a corporate loss. But it's split by all the business units. So this was incremental compared to Q1. Other -- and this is transitory, of course.

On other expenses, they are related to the quarter and to the operations, domestic operation itself. And they were -- they happened like -- as we had a mismatch between production pace and sales pace, we had little problems with some specific inventories that we had to fast-forward our sales. And those presented losses during this quarter.

So I'm just giving examples what happened. They are -- all these, they are little. But when we add all together. And including our other expenses that we just consider that they are due to the half but they ended up being accounted in this quarter, they represent something that we don't expect to be -- let's say expected to be seen in the coming quarters in the domestic market.

So part of that, as I said, of these other aspects of the EBIT compression, they were due to some Company issues or corporate issues. Others, they were due to the domestic market operations that we had more losses during this quarter specifically due to the products, the slow mover products, like I said. And basically it's that. There is no other aspects that affected our margins other than those.

Q - Denis Parisien {BIO 20333702 <GO>}

So these slow moving products, rather than piling them up as working capital inventory, you discounted them to move them through and you wrote that off as an expense, the difference between -- on the markdown? I'm just trying to visualize how it runs through the P&L.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Okay, good. Good. No. If it's a pure discount, it goes on the gross margin because it doesn't count on prices. But when you have some products that you cannot sell because they are very short in life, of course this is a loss. Then, the way you account is in SG&A and not in the revenue.

Q - Denis Parisien {BIO 20333702 <GO>}

Okay. So these were products that you had to throw out, then? And so, when it's a pure write-off, then you take it out of SG&A.

A - Leopoldo Saboya {BIO 16137418 <GO>}

Yes. Perfect.

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Q - Denis Parisien {BIO 20333702 <GO>}

I get it. Okay. Thanks very much.

Operator

This concludes today's question and answer session. I would like to pass the floor to Mr. Fay for his final statement.

A - Jose Antonio do Prado Fay {BIO 15337837 <GO>}

Okay. Gentlemen, thank you for being with us. As my last words on this call, I would like to say that the planning, execution. And delivery that BRF are showing make us very positive regarding to the near future. But of course cautious as we are every time regarding to the challenging environment that the Company is involved in and the high volatility of our business that we used to have in place. Thank you very much. Until the next time, bye-bye.

Operator

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

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