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Q2 2017 Earnings Call

Company Participants

- Miguel Mickelberg, Chief Financial Officer
- Paulo Eduardo Goncalves, Chief Investor Relations and Structured Finance Officer
- Raphael Horn, Co-Chief Executive Officer

Other Participants

- Bruno Mendonca, Analyst
- Daniel Gasparete, Analyst
- Jorel Guilloty, Analyst
- Nicole Hirakawa, Analyst
- Rodrigo Fraga, Analyst
- Victor Tapia, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Welcome to Cyrela Brazil Realty Conference call, where we'll discuss the Second Quarter of 2017 Earnings Results. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session, and instructions will be given at that time. (Operator Instructions) As a reminder, this conference is being recorded, and the audio will be available at the Company's website at www.cyrela.com.br/ri.

This call is being simultaneously translated into English and is being broadcast over the Internet. Questions can also be asked by participants connected abroad. The earnings release published yesterday, 10th of August, after the close of BM&FBOVESPA trading session, can also be accessed on the Company's website.

Before proceeding, we would like to mention that the forward-looking statements that may be made during this conference call relating to the Company's business prospects and projections and operating targets related to its financial growth potential are predictions based on management's expectations about the future of Cyrela. These expectations are highly dependent on domestic market conditions, the general economic performance of the country and international markets and therefore, are subject to change.

With us today are Mr. Raphael Horn, Co-CEO; Mr. Paulo Eduardo Goncalves, Chief Investor Relations and Structured Finance Officer; Mr. Miguel Mickelberg, CFO.

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I will now turn the conference over to Mr. Raphael Horn. Mr. Horn, you may now begin.

Raphael Horn {BIO 19714328 <GO>}

Good morning. Political turmoil remained in focus in 2Q '17. This led to great uncertainty as to the approval of the tax adjustment reforms, especially the social security reform.

On the other hand, economic prospects have not been significantly affected by the political scenario. In June, deflation was recorded for the first time in 11 years, which brought the 12-month inflation rate as measured by the IPCA rate to 3%, below the midpoint of the inflation target. Unemployment rate peaked in April at 14% and fell in June for the first time since 2014, reaching 13.3%. The benchmark interest rate fell to 9.25% in July, the lowest level since October 2013. This also contributed to the BRL2.3 billion surplus in Brazilian savings accounts. We still face a tough economic scenario, but these improvements have boosted our energy.

The Company sales in Q2 reached BRL756 million in spite of April being a tough month, with public holidays falling on all weekends. We would like to highlight sales of finished units, which reached BRL262 million, a 32% rise quarter-on-quarter.

Financial results have been affected not only by isolated contingencies in Vitoria, but also because cancellations continue to have an impact on results and also the high number of units considering the size of our operations. Our scenario is improving slowly, but we believe we can now envision better results. Our focus is still cash generation so that we can have a better balance sheet.

Now, I will comment on our operating results. On slide five, we'll talk about Cyrela's launches. In Q2, our launch has amounted to BRL640 million, 7% higher year-on-year. In Q2, launches reached BRL1.3 billion, 3% higher year-on-year.

In this quarter, we launched nine new products, seven in the City of Sao Paulo, one in Rio and one in the Midwest region of Brazil. Excluding swaps, the volume launched in Cyrela's share was 970 million, 16% higher year-on-year. The Company's share in the volume launched in Q2 was 70% compared to 83% year-on-year.

On slide six, we would like to highlight the launch of the project Living Wish Lapa in Sao Paulo, which was 50% sold in the first month.

On slide seven, we'll talk about our sales performance. In Q2 '17, pre-sales totaled BRL760 million, 35% higher than the BRL550 million reached in the second quarter of 2016. Sales reached BRL1.3 billion, 16% higher year-on-year. Excluding swaps, pre-sales amounted to BRL920 million in Cyrela's share, a 14% growth year-on-year. The State of Sao Paulo and Rio de Janeiro jointly accounted for 85% of sales in the quarter.

On slide eight, we'll address sales speed. The Company's annual SoS was 31%. Looking at sales speed by period, projects launched in 2016 have been, on average, 70% sold.

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On slide nine, we'll address Cyrela's total inventory. At the end of Q2, inventory at market value totaled BRL6.4 billion, 3.1% down quarter-on-quarter. The change in our inventory can be seen in the chart on the right.

On slide 10, we can see a breakdown of our finished units. In the quarter, we sold 11% of finished units at the beginning of the period. Adding the inventory of projects delivered along the quarter and pricing of units at market value, the finished units inventory increased by 0.5% quarter-on-quarter. We are aware of how important this matter is to the Company, and we'll keep on focusing our efforts on these products. Rio and the Northeast Region accounts for 42% of finished units.

On slide 11, we'll talk about delivered units. In Q2, Cyrela delivered 14 projects, totaling 4,100 units. In Q2, we delivered 8,600 units in 27 projects. Delivered units accounted for a PSV of 1.2 billion, 9% higher quarter-on-quarter.

I will now turn the floor over to Paulo, who will present our financial results.

Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Thank you, Raphael. Good morning. On slide 13, we'll present our financial results. The Company's partnership with MAC has ended, and our auditors considered that all projects related to such partnership should be recognized using the equity method and not consolidation. Pro forma results will be used to compare periods, and the equity methods will be used for MAC.

Gross revenue was BRL591 million in the quarter, down by 10% quarter-on-quarter and 5% lower year-on-year. Such reduction was mainly due to a smaller ongoing construction volume. In Q2, gross revenue was BRL1.2 billion, 11% lower year-on-year.

Gross profit in the quarter was BRL154 million, 22% down quarter-on-quarter and 36% lower year-on-year. Year-to-date, gross profit reached BRL351 million, 30% lower year-on-year.

The Company's gross margin in the quarter was 26.7%, 4.2% lower than the 30.9% from the previous quarter. Such decrease in our margin is mainly due to cancellations, interest booked under costs due to a fall in recognized revenue and also increased revenues from product suppliers through swaps, in which margins are typically lower.

In Q2, the Company incurred losses amounting to BRL141 million, mainly due to the BRL122 million impact caused by the Gran Parc project in the City of Vitoria. Year-to-date, losses amounted to BRL137 million against the BRL106 million profit year-on-year.

Please go to slide 14 now to see our profitability. In the first quarter of 2017, our return on equity measured as the net income of the past 12 months over the average shareholders' equity was minus 1.5%, and our EPS fell by 37% of real.

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On slide 15, we'll talk about our customers' financial solutions. In Q2, transfers, trust of deed and payoffs amounted to BRL739 million, 0.4% lower quarter-on-quarter and 7% lower year-on-year. Considering units, transfers, trust of deed and payoffs totaled 3,100 units, 2% lower in the quarterly comparison and 9% lower year-on-year.

Slide 16 shows the Company's cash generation. In the first quarter of 2017, cash generation amounted to BRL64 million in comparison with BRL118 million quarter-on-quarter. We would like to highlight that in Q2, the Company invested BRL20 million in Tecnisa, had a larger volume of indemnities in the Gran Parc project and had higher interest payments from corporate debt.

On slide 18 (sic slide 17), we address our indebtedness. Gross debt at the end of the quarter was BRL3.4 billion. Our cash was BRL1.6 billion. Thus, our net debt was BRL1.7 billion. Of the total gross debt, 65% is related to loans for construction and 57% is long-term. Our net debt over equity ratio was 27.3%, 0.2% higher quarter-on-quarter. The low debt level confirms Cyrela's financial solidity and puts us in a privileged position to take advantage of the opportunities in the real estate market.

We'll now begin the question-and-answer session. Thank you.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Alex Ferraz with Itau BBA. Mr. Alex, you may begin your question.

Our next question comes from Nicole Hirakawa with Credit Suisse.

Q - Nicole Hirakawa {BIO 18242556 <GO>}

Hello, good morning. My question is about real estate credit. Do you believe that we have improved our situation? Some companies have talked about that already, but I would like to know your take on this. Do you still see some restrictions? And I would also like to know if that could happen to major players and leaving the minor players out of the game. Do you believe that, that is the path the banks should follow?

A - Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Hello, Nicole, this is Paulo. When it comes to loan interest rates, we have receiving good news -- we have received good news from banks. In our previous call, we said that we had rates at 9.99% per year. But now, this week, some major banks are applying 9.3% rates per year. Some banks are also using new criteria. They have become more flexible. This is not a total change, but we believe that the banks are now more proactive. They are willing to decrease the financing interest rates. Then, of course, that is going to improve the situation for us. Our delivery volume is relatively high this year. And with the drop in interest rates, we believe that we are going to be able to serve more customers.

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Now, when it comes to your second question, if we are going to see more restrictions, we believe that the banks, after the crisis goes away, they are going to have solid companies as their priorities. We don't know if that is going to happen. But what we can see right now for new financing loans, the companies that do not have a good credit with the banks are going to suffer more.

Q - Nicole Hirakawa {BIO 18242556 <GO>}

Do you believe that the banks will show some preference to major companies with healthy financial results?

A - Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Yes, we do believe that is happening.

Q - Nicole Hirakawa {BIO 18242556 <GO>}

Okay. Thank you very much. Have a good day.

Operator

Our next question comes from Rodrigo Fraga with Citi.

Q - Rodrigo Fraga {BIO 20043127 <GO>}

Good morning. Thank you for the presentation. I have two questions. The first one is related to finished units. We have seen some improvements in this quarter, and I would like to know, if you believe that that is a reflex of improvements in the demand or if you believe that that is an impact of more aggressive discounts that you may be applying in some regions. And what are the regions that are more representative in the sales of finished units?

Now, my second question is related to cancellations. They still had a great impact in the second quarter, and you mentioned that you still have a relevant pipeline of deliveries. So, I would like to know your plans related to the percentage of cancellations on these deliveries. Do you believe that we are going to see some improvements? And I would also like to know the geographic distribution of the deliveries.

A - Raphael Horn {BIO 19714328 <GO>}

Hello, Rodrigo, good morning. This is Raphael. You asked about the sales of finished units. Well, cancellations are tough, but there is an upside to this. We are going to come to a stage where we only have finished units, right? So our expectations are related to the improvement of finished units. It's actually not a matter of improving the results. If we have finished units, we are going to generate more cash. We are going to have a lower volume of construction and a high volume of finished units. That's why we said that this is our focus, and this cash is going to come from finished units. So, yes, we believe that we are going to sell finished units even more, and cancellations are drawing to an end.

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If we have more cancellations and more finished units, we believe that that is going to be the trend for the future. That's the only way things can unfold. The problem is that, we sell many finished units and we also have many cancellations. So this is just a matter of being able to sell the finished units. That's the upside to think. We are drawing to the end of the cycle of cancellations because the periods are drawing to an end. So this is the right time.

Now, when it comes to the regions and the distribution of the deliveries across Brazil, I believe that we have been selling finished units across all regions. They have similar performances.

Just a comment on your second question, we are going to deliver units in the second half of the year. In the first half of the year, we delivered some commercial projects or medium income projects in which we have great competition, but that is not the trend for the second half of the year. So that is going to help us as well.

Q - Rodrigo Fraga {BIO 20043127 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from Jorel with Morgan Stanley.

Q - Jorel Guilloty {BIO 18291521 <GO>}

I have two questions. First, I would like to know about the BRL20 million in contingencies, what are they related to, and should we expect more of that in the second half of the year? 40% of your finished units are in Rio and the Northeast region, as you mentioned. So I would like to know if you plan to adopt a more aggressive policy in those two regions since we have a tougher scenario there.

A - Miguel Mickelberg {BIO 20023910 <GO>}

Hello, good morning, Jorel, this is Miguel. When it comes to contingencies, most of the BRL20 million is related to delays in construction, but we don't have any other delays in our pipeline. So we are going to decrease that number, and the impact of contingencies has decreased a lot in comparison with the previous quarters.

Now, I will turn the floor over to Paulo.

A - Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Hello, Jorel. Good morning. You asked about finished units in Rio and the Northeast region. This is not news. Rio is one of the toughest regions right now in Brazil. So, yes, we struggle more in Rio to sell finished units or inventory in general. And we need to be pragmatic. We have always been, and we will continue to be and make efforts to sell those finished units, but this is not anything new. Rio is, by far, the toughest region in Brazil right now. So we have to make more efforts and try to solve this problem.

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Q - Jorel Guilloty {BIO 18291521 <GO>}

Thank you very much.

Operator

Our next question comes from Bruno Mendonca with Santander.

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Q - Bruno Mendonca {BIO 16313094 <GO>}

Hello, good morning. Thank you for taking my question. I have two questions so that I can understand your cash generation a little bit better for the coming quarters. So Paulo, I would like to know more about the disbursement schedule that you have in terms of the contingencies in the Gran Parc project in Vitoria.

And the second question is related to the increase in payables related to landbank. It is around BRL100 million. If you could also talk a little bit about that as well and when you plan to make those payments? And I would also like to know your expectation in terms of cash generation for the rest of the year. Of course, selling finished units is an important variable, and it's hard to forecast. But based on those two points, I would like to know your expectations about that. Thank you very much.

A - Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Hello, Bruno, I'm going to answer your question about Gran Parc and cash generation, and Raphael is going to answer the question related to landbank.

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Now, of the 122 million that you can see in our balance sheet, 30 million have already been paid, and we are going to spend another 90 million in the next two years. I believe that your forecast should be linear because most of these payments are related to construction.

Now, when it comes to cash generation, it is very hard for us to give you figures, but I believe that what has been happening in the past weeks shows that we are going to generate cash in the coming quarters. Someone asked about the deliveries in the second half of the year. Those deliveries are going to be better than the ones in the first half of the year, and that will help us a lot.

We are studying partnerships with banks in relation to the decrease of the interest rates. And after that reduction happens, many customers will be able to take those loans, and that is something that did not happen in the past. We had an increase in gross sales. They have increased by 25%. We have been able to sell finished units successfully. And this time, the time that we are going through right now with receivables increasing less than construction expenses, that lead us to believe that we are going to have a better cash generation.

A - Raphael Horn {BIO 19714328 <GO>}

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Now, when it comes to landbank, the 100 million payment is going to be scattered across months. That is going to be deferred in two or three years.

We have mentioned many times having an equity -- a shareholders' equity of 4. We believe that that is very important for the Company, and that's what we are going to do. And we believe that we are going to be able to do it. It doesn't mean that we are going to purchase landbanks. We may do that if we believe that's a good opportunity, but that does not have an impact on our plans. We are also looking for a good landbank. Obviously, if we purchase 1 billion per year, our -- we are not going to be able to make an need [ph], but we can still purchase good landbanks that are going to give us a good return.

So this is just something I would like to make clear for the next conference calls. If we do not purchase landbanks, you should not panic.

Q - Bruno Mendonca {BIO 16313094 <GO>}

Still, when it comes to landbank, in order for us to reach 4 billion in shareholders' equity, we should have a reduction of around 2 billion. Of this 2 billion, do you believe that you have a surplus of landbanks? And if you decrease that number, how are you going to do that? Are you going to launch new projects, or do you have any other plans like any other different initiatives to reduce that number?

A - Raphael Horn {BIO 19714328 <GO>}

Bruno, we do have plans to allocate cash for landbank, but that reduction is going to come from cash generation and selling finished units. But we are going to reduce the number of land plots that we have. We have spent less in landbank, but we should look at things in a different way as well. Maybe we can do a swap fund just as we did in 2012, which was very interesting for us. But our take-home message here is that, the plan of generating 2 billion in dividends is very important. It is going to prevail over anything else.

Q - Bruno Mendonca {BIO 16313094 <GO>}

Okay. Thank you very much.

A - Raphael Horn {BIO 19714328 <GO>}

Of course, the key is finished units. This is not going to happen in 2018 or 2019. No, we want to reach 4 billion in shareholders' equity, but that is going to take time. Finished units are going to be the key for us to reach that goal.

Operator

Our next question comes from Victor Tapia with Bradesco.

Q - Victor Tapia {BIO 20566083 <GO>}

Good morning. I have two questions. The first one is related to gross margin. I would like to know your expectations for the coming quarters and if we should expect more

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construction savings?

And the other question is related to cancellations on sales in the City of Rio de Janeiro. And I would also like to know your expectations for the whole country?

A - Miguel Mickelberg {BIO 20023910 <GO>}

Hello, Victor, this is Miguel. I'm going to answer your question about gross margins. If you look at our margins, you're going to see that we had an increase in the quarter because gross margins have been better than previously. So the discounts are not impacting our margins. The drop in revenues due to lower construction volumes and cancellations do have an impact on our margins. And we are still going to see other drops in revenues, but cancellations will drop as well. So our margins will depend more on sales. They can be volatile, but we believe that, that is not going to have such an impact.

INCC rate has decreased a lot. It was around 4.2% in 2016, and it's 2.2% now. And that is going to generate savings as well. So this number, the construction savings will decrease in the coming quarters.

A - Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Hello, this is Paulo. You asked about cancellations in Rio. We delivered some tough products in Rio in the first half of the year. They are medium income products, mainly in micro regions that face a tough competition. The products that we are going to deliver in the second half of the year are high income products. And we are not expecting cancellations to be at the same level of the other products. That applies not only to Rio, but the whole country. Our cancellations rate is expected to be lower in the second half of the year.

Q - Victor Tapia {BIO 20566083 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from Daniel Gasparete with Merrill Lynch.

Q - Daniel Gasparete {BIO 17999254 <GO>}

Hello, good morning. I missed the first part of the conference call. So I'd like to ask you something about the reduction of interest rates in Itau Bank, and I would like to know if you have seen an impact related to that? If it is similar to Santander's rate, I would like to know more about what you expect from banks after the drop in our benchmark interest rate. And do you believe that that is going to be offset by lower cancellations?

A - Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Yes, it is true. Itau just announced a new reduction. They are applying a minimum rate of 9.3% per year. As we said in the beginning of the conference call and as we said in the previous conference call, three months ago, they reached a rate that was below 10%, and

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that was good news. Now we are at 9.3%. Santander has also decreased rates with rates of 9.48% per year. So good news is we can see reductions in rates being applied by private banks. We don't know if that is going to have a positive impact. We believe so, but the reductions by Itau has been announced in the beginning of this week. So with this reduction, now more customers will be able to have access to those loans and credit lines, and we are going to make efforts to make that come true.

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Q - Daniel Gasparete {BIO 17999254 <GO>}

Okay. Thank you. Do you know how many of the loans that your customers have? How many customers have access to Itau's credit lines?

A - Paulo Eduardo Goncalves {BIO 20026167 <GO>}

Well, I believe that currently, in our portfolio, Itau accounts for 30%.

Q - Daniel Gasparete {BIO 17999254 <GO>}

Okay. Thank you, Paulo. Have a good day.

Operator

(Operator Instructions) If there is no other question, I will turn the floor over to Mr. Raphael Horn for his closing remarks.

A - Raphael Horn {BIO 19714328 <GO>}

Thank you, again, for your interest in our conference call. We have been facing a very tough crisis for the past 2.5 years, but we believe that this is coming to an end, and our units are being finished. So cash generation is going to come in the near future. So we are going to work very hard in the next eight months, and we are going to sell our finished units. Of course, it is a tough crisis, but we are surviving in terms of cash and debt. And finally, we are going to see more finished units, and we are going to work very hard to generate more cash, and we hope for better days. Thank you very much. See you in our next conference call.

Operator

That concludes Cyrela's conference call for today. Thank you very much for your participation. You may now disconnect. Have a good day.

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