Q3 2018 Earnings Call

Company Participants

- Elcio Ito, Chief Financial & Investor Relations Officer
- Lorival Nogueira Luz, Global Chief Operating Officer
- Pedro Pullen Parente, Chairman & Global Chief Executive Officer

Other Participants

- Alexander Robarts, Analyst
- Antonio Barreto, Analyst
- Danniela Eiger, Equity Research Analyst
- Leandro Fontanesi, Analyst
- Luca Cipiccia, Analyst
- Lucas Ferreira, Analyst
- Thiago Duarte, Analyst
- Victor Saragiotto, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to BRF SA Conference Call to Discuss the Third Quarter 2018 Earnings. This call is being broadcast via Internet at our website, www.brf-br.com/ir. At this time, all participants are in listen-only mode. And after the company's presentation, there will be a Q&A session, when further instructions will be given.

Forward-looking statements about the company's business outlook, projections, results and growth potential are assumptions based on the management's expectations regarding the future of the company. Assumptions are highly dependent on market change on the countries and the industry's economic conditions and on international markets. Thus, they're subject to change.

As a reminder, this conference is being recorded. This conference will be presented by Mr. Pedro Parente, Global CEO; Mr. Lorival Luz, Global VP; and Mr. Elcio Ito, CFO and IR Officer. Now I will give the call to Mr. Pedro Parente, so he can begin the conference. Over to you, Mr. Parente.

Pedro Pullen Parente {BIO 2058839 <GO>}

Thank you. Good morning, ladies and gentlemen. I'd like to begin by apologizing for my voice. These are things that are outside our control. But let's move on with our presentation for the day. The earnings achieved in the third quarter of 2018 are shown on slide number 3 now. They begin to reflect our recovery strategy at BRF, which we announced in June. We can clearly see operating results with an upward trend, better margin, active pricing of our products, and an integrated strategy to plan our production and sales in addition to asset monetization.

In this scenario, we highlight again our commitment with the deleveraging goal in 2018 expected to close the year at 4.35 times adjusted EBITDA at the company, according to the operating and financial restructuring plan, which we'll be addressing later on today.

On slide number 3, we make a comparison, our numbers for third quarter 2018 and second quarter 2018, and we also post the results of the third quarter 2017. As you can see, there is significant improvement in our adjusted EBITDA, improvement of 63% third quarter compared to the second quarter. Also, a significant reduction of almost 72% in nonrecurring adjustments.

At the end of the day, our EBITDA reported is BRL 415 million in this current third quarter compared to a negative figure of BRL 301 million in the second quarter of 2018. Naturally, it is not possible to calculate the percentage variation, but it is possible to say that there was a shift, a change in our turnaround of BRL 700 million in our EBITDA reported in the second quarter 2018 vis-à-vis the third quarter 2018.

In order to get to our net income from EBITDA, as you know very well, in this case, we have to deduct depreciation and include the net financial income, lower tax, and nonrecurring items just as we did this quarter in terms of the hyperinflation in Argentina.

Now, I kindly ask you to move to slide number 4. On slide number 4, on this slide, we show in a very summarized manner, but also in a powerful manner, a diagnosis of the economic financial status of the company today. We moved from adjusted EBITDA of BRL 604 million positive and we come to negative net income of BRL 802 million (sic) [BRL 812 million] (00:05:33).

So how does it happen? Firstly, it happens owing to nonrecurring adjustment that I mentioned before, BRL 189 million, but also the depreciation of BRL 488 million, coming from the net financial result which is basically payment of charges, our debt, taxes like I mentioned before, and hyperinflation in Argentina. We can clearly see that in order to turn negative net income into a positive number, and this positive number representing the return on capital that we all expect to see, the company has to work in four pillars.

And now, I want to show you that we are very active in all these pillars, all these areas, so that over time, and let us underscore this: these results take time for two reasons actually. Firstly, because this company – the company's business is a long-chain business and it's only natural, we all know it. And on top of that, in addition to time, we have to consider the prior status of the company vis-à-vis its performance in the market and also vis-à-vis its operations, therefore, requiring adjustment. We're going to talk about this again, adjustment in several areas.

So firstly, we need to improve the operating income. This is front number one. We're going to have several initiatives. We're already deploying these initiatives, for example, vis-à-vis our commercial strategy. On this slide, slide number 5, we're showing the measures that we're taking in order to improve the operation result. When it comes to revenues, we have our commercial strategy. We have a very good strategy, very well defined in the domestic market in Brazil, in the Halal market and also in Asia.

Clearly, we also need to be very active in our pricing, particularly in our major brands: Sadia, Perdigão and Kidelli. Now it's important to make it clear that this is not only restricted to a rising price, but also combining our mix. As for prices, from August to September, we have 12% increase in our processed products. And in natura products, over 20% increase from April to October, clearly showing a very active policy of our management.

Like I said before, it's also important to highlight our product mix. In natura, lower value-added products versus higher value-added products like processed foods, processed products. We had an improvement in our mix of 3.7% favoring processed products in the current quarter compared to the same quarter of the previous year.

However, when compared to the second quarter of 2018, there was an improvement of 8.6% in processed products compared to fresh or in natura products. Therefore, an important improvement in our mix. And like I said, also improving our commercial revenue.

In addition, when it comes to our commercial efforts, we're also working very strongly to lower our losses stemming from FIFO and also from the stock out and disruption of failing to meet our customer demands. We're strongly working on this through our Brazilian market. And also in order to increase the number of customers and the number of SKUs or items by client and purchase from our company.

We're also working on channels. We have significant efforts to optimize the push-pull strategy. In other words, demand versus liquidation of products, owing to changes in foreign markets, for instance. We also want to work in many different channels like cash and carry (00:10:40), retail, routing, DDP, and we also want to have full recovery of the food service channel. As we all know, it is a channel that had many losses in our company. This is being considered right now and it's a topic that is very significant for us.

And finally innovation, product innovation more specifically, and not only innovation in the mix or presentation of new products, we also work on all topics related to packaging and also in the context of new weight in our packaging because we believe this is what our consumers really want. So we clearly have a good commercial strategy. And once again, we highlight this is already happening, and this is expressed in the figures that we posted and that I recently mentioned with a price rise and the change in mix. As for costs and expenses, naturally, it is important to work in both areas. For expenses, we want to generate surplus – a surplus impact, positive EBITDA, several initiatives and they are listed on this slide.

And now, I'd like to draw your attention to something that I always highlight. This is just hard effort (00:12:24) business as usual trying to search for operating excellence and excellence performance. This is how we manage to recover the company's income and not only promising. There is no silver bullet. We just have to do the best we can, and we're very confident when it comes to all our initiatives related to better operating and commercial results. And this is very significant in these areas that are absolutely critical to our earnings.

As for front number two, which is related to nonrecurring adjustments, the main nonrecurring adjustment has to do with impact from the Weak Meat and Operation Trapaça.

On slide number 6, we have an impact on the third quarter 2018 BRL 100 million vis-à-vis the third quarter of last year, and corporate restructuring BRL 47 million this quarter and (00:13:40) the third quarter of 2017. And it's important to mention that these measures that we announced – now, we are on slide number 7 – this is related to safety, integrity and quality, which are nonnegotiable pillars of our strategy. And certainly, I'm fully convinced that for the future, the company will no longer have to spend more with these items because we already are in the state-of-the-art in terms of safety, integrity and quality. Like I said, this is nonnegotiable pillars behind our strategy.

Our next front has to do with depreciation. As we can see, the level of depreciation is slightly similar to the net financial result, around BRL 500 million quarter-on-quarter, which is an important impact. To move away from our EBITDA and getting to net income, we started by deducting BRL 1 billion by quarter approximately as you can see on the figures.

As for depreciation, and moving now to slide number 8, we have initiatives related to an increase in our asset turnover. We do need to improve our asset turnover. And this is very strongly tied to the second item on the slide, the second bullet, which is higher installed capacity utilization. This is part of the targets and goals assigned by our Vice President for Operations. We want to have a better use of our installed capacity, and naturally it involves the efforts of all our commercial VPs, Brazil, Halal, International.

Another very important point, which naturally has an impact on both depreciation and financial accounts, is divestment of operational assets. Cash generation in our project, like I said before, is to be around BRL 5 billion. And I would like to draw your attention on front number 4. We show some slides. Front number 4 showing our initiatives. At first, they are not those that come from divestment of Argentina, Europe, and Thailand, which we'll be addressing later on, but these activities, these initiatives, we have BRL 500 million of noncore asset disposal, reduction in our inventory, working capital and other initiatives.

Therefore, BRL 488 million concluded and ongoing another BRL 700 million to BRL 800 million working capital. As a reminder, we have significant seasonality in the last quarter of the year vis-à-vis the use of working capital, the need to improve our inventory owing to celebrations and the holiday season. And naturally, there is a dramatic reduction in the last two months of the year.

We also have FIDC. We are in the quiet period. So all we can say that our goal is BRL 750 million. We have the bank and the implementation of all initiatives. But we cannot disclose further detail right now. And like I said, other initiatives amounting to BRL 100 million. So in these initiatives, we have approximately BRL 500 million. And our estimate is additional BRL 1.5 billion, BRL 1,750 million until the end of the year.

Moving now to another very interesting item, which is the status of deleveraging. Slide number 10 shows something that we highlight again and again. There is a question mark here, some anxiety. And we don't consider this to be so truthful. We have two phases broken down on this slide. One phase shows non-binding tenders and as you can see, in terms of Argentina, we already had all the previous steps. Teaser, NDAs, infomemos, offers and 14 offers up to now, non-binding offers for Argentina. In Europe, Thailand we already have met all the early steps. And we had eight offers related to these assets. In Argentina, we had offers to all our assets over there.

Now we just started the second phase. The data room is open, both for assets Argentina and also in Europe and Thailand. The management presentation for Europe and Thailand is happening as we speak. So this is actually happen right now. We have the presentations ongoing in London. Due diligence is also ongoing. And out of the 14 offers, we selected 8 players to continue in the process and we expect to have binding offers by mid-December. The same goes for Europe, out of the eight offers, we selected five players. And like I said, due diligence is ongoing and the binding offer is expected to happen in mid-December.

So slide 11 is my last slide before I turn the floor to Lorival and other VPs. We have an overview of our program. We see that of the divestments of operating assets, we expect to raise around BRL 3 billion, for the other initiatives, BRL 2 billion, totaling BRL5 billion. Of those BRL 500 million have been already concluded. We know that there might have a concern because this is a program very much concentrated in the last months of the half of the year, but that's because of the nature of the operations and the divestment process. And we are working within a structured program with well-defined stages, and we are also working to encourage the competitiveness regarding our assets. So we are calm regarding this program. Of course, not everything is on the hands of BRF. This also depends on the other players. But I know that this work is being done with a lot of determination. And once again, I want to draw your attention that we do not see here a flag, a yellow flag that right now might be raised regarding the range and the reach of these targets.

So now, I will turn the floor to Lorival and rest my voice for the Q&A session. Thank you very much.

Lorival Nogueira Luz {BIO 16180455 <GO>}

Good morning, everyone. Thank you for participating on this call. I will start on page 13, and the objective is to provide you a highlight on the main event of the businesses that we had now in the third quarter of 2018 and to stress our priority for the next coming quarters in order to recover margin. And that's what we are working on.

In this first slide, we show a Brazil snapshot. As you know, Brazil works with processed food mainly, and that's where we have to tap into the benefits of the brand and the strength of the brand and the quality of our products which is one of the foundations, one of the pillars of our product. Along with that to strengthen, with these new officers, we are very much focused in innovation. We already launched in this quarter the Qualy Light, with zero lactose. But our objective is to increase margin and share by launching new products that will bring us not only practicality to consumers but also healthability to our products.

So, this is a front that is important for us. We are focused on that, and this is one of our priorities, which is to position our brands in this industry in this segment with that characteristic and recovering share as well as market.

On the slide 14, it's important to mention the exponential execution we are already working on from the second to the third quarter. You can see here a stronger recover of margin from the second to the third quarter, and that is thanks to commercial execution. We have positioned our products in the right way knowing how important it is to adjust prices in the natura segment, as well as in the processed segment, as Pedro has already mentioned in the beginning of this call.

And also here, we should stress the customer service and the execution, especially with the number of products sold, and also once again the right execution, avoiding the stock out. Here, we had a reduction in FIFO expenses, 30%, and this is money. This is a significant amount. We already had that in efficiency (00:25:34), and that's what we are looking for. It's important to stress that this improvement, that those happen despite of the adjustments of inventory levels that we are also working on. So, as you know, we have high levels of inventory and we are reducing those by managing inventories at an efficient way, the way we use those products. So, even doing that, we still have that execution improvement and that margin improvement that you can see.

About the prior year, obviously, there is a margin drop especially because of the increase in the grain prices. You know that this has happened. It was around 40% to 45%. This is something that happened. We are adjusting that into our prices, and this will keep on happening so that the company can go back to its right profitability and then transfer prices so that we can adjust this price increase in our direct cost results, obviously leaving the focus on operating excellence both in direct and indirect costs.

Now, turning to page 15 about our position in the market. Here, our market share, we have lost market share, it was very low, 0.6 percentage point, but that was because of price increase. When you increase the price, the market tends to follow it or not in the coming weeks. So, we have this adjustment regarding the market share, but our priority is really to have the profitability and to aim at better gross margins. We want to grow and also to have better margins. And here, we maintained our active client base and there is a good performance here and price positioning, as you can see, both for processed foods, as well as for margarines, positioning and showing the strength of our brands.

About the Halal segment, I am now on page 16. Here, we see a relevant position, maintaining our market share and the importance of our position in this market. We do have a relevant footprint and here, the share is up 750% and expanding even more in processed foods, in a way that we can improve profitability and this is one of the priorities as well.

On page 17, we see the recovery of our margins, with an increase not only of margin prices, the right position, but also an increase in volume. So here, the focus is always to increase process, adding value. And also regarding Turkey, we have the right mix of products. I was recently in Turkey and the operation is very much focused. And we wanted to serve customers with healthability. We have the right margins there. A lot of things that can be replicated here in Brazil. And there, we have a business with chilled foods and we see an opportunity and a relevant footprint for the future as well. And so, we see a right position here and an improvement in prices and in margin.

Obviously, when we turn to the international market and then we'll be talking about that in the slides 18 and 19, we have all the impacts of the restrictions we suffered for European exports as well as Russian exports. Obviously, because of that, when these volumes are not there anymore, when you compare the impact year-on-year that's relevant. We lose almost all the EBITDA in the quarter and that's why we are working on a better execution for Brazil for the Halal market. And also here we had the restructuring announced in the prior quarter of our industrial units that produce and sell – the units that sell for those markets.

We had to make these adjustments on those units, therefore it starts to show. And also, divestments. About Russia, as you have seen some plants are now unable to go back to export to Russia, that does not benefit us directly. But we do have an indirect benefit because this volume of production will be sent to Russia also before it will be sent to China. And therefore, we will have here an adjustment in the supply and demand.

Our company was not listed to be able to export to Russia, but others were. So we will be able to have a price adjustment for pork meat here in Brazil. We should be benefited from that in the next few month about consumption.

Now, I'm turning to page 20, 21, talking about the Southern Cone. We had a very efficient management in terms of cost in this region. There was an improvement in the EBITDA margin from the second to the third quarter and then stabilization vis-à-vis the prior year and the main volume here and the main percentage of this operation regarding Argentina and we are already advanced in our divestment process.

So, now, I think with the summary of the main highlights, I think once again, our priority is commercial execution, recovery of margins in Brazil and the Halal markets. Obviously, considering the impact of that, we had an extraordinary effect of plants being shut down both in Europe and Russia, measures that also have impacted the market.

And now, I will then turn the floor to Elcio, who will talk about the financial information.

Elcio Ito {BIO 18281069 <GO>}

Thank you, Lorival. Good morning, everyone. I will start with the working capital, and I would like to stress that the focus of the company and the management is a strong cash discipline, not only in the financial area but throughout the whole company, so that we can be following our goals and always with safety, integrity, and quality.

On working capital, on page 22, it's important to analyze the working capital with more precise and accurate, if you make an annual comparison, considering the seasonality of our business, the seasonality of second crop and also the inventories for the celebration items that we have. So comparing to last year, we had a reduction of 6.5 days, when we analyze a year today, if we have that overview, that year-to-date overview, we had 10.7% of NOR, vis-a-vis 9.7% of NOR this year, so a reduction of 1% of NOR which is significant in here vis-à-vis the working capital.

When we compare against the second quarter of this year and then we have the seasonal impact, we have the second crop. That's when we have an increase in our balance of inventory and values that's relevant, because 70% of corn in Brazil is produced here during the second crop period of three months (00:34:23). So we take advantage of our inventory levels and the position of our companies to have that additional inventory. We have the festive products that grow over the year, and we have the sales at the end of the year.

We also have a discipline for finished products. We are adjusting here also little by little and in a very effective fashion our inventory levels. And for the frozen raw material, which has been one of the main challenges of the company since last year, we had a relevant reduction in terms of volume, BRL 104 million. But at the end of the day, we're talking about 40,000 tons of frozen raw material meats in general that are part of the process of streamlining and providing more efficiency to the chain. And so that we will be better off to face the cycle of 2019. So, this is what I have for working capital.

Now, turning to free cash flow. The highlight here is operating positive of BRL 106 million despite of all the working capital impact that I just mentioned that CapEx is in line what we had in the quarter of last year – the same quarter of last year in a very disciplined fashion and with prioritization of our investments always focusing on the capital efficiency. Pedro talked about that. This is one of the main objectives and the focus of our own planning which is the better use of our assets and our CapEx or the management is totally based on that.

And then to conclude on the page of indebtedness, page 24, we have a leverage of 6.74 times because of two important aspects here. First, FX, if we have had an FX at BRL 3.80, our leverage would be at 6.49 times, and the main impact being here was the year-to-date EBITDA. We have here BRL 16 million vis-à-vis the figure that we had last year. So, the combination of these two factors did bring up our leverage.

When we look at our debt profile, we had the renegotiations of the debt and maturities. We'll keep on having the discipline and the trajectory of improving efficiency, extending the debt, already working in the refinancing for the coming years.

So, I now conclude the call and the presentation, and we will open the session for Q&A.

Q&A

Operator

The first question is from Luca Cipiccia, Goldman Sachs.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Good morning. Thank you very much. My question about the Brazilian scenario, looking at the fourth quarter. Obviously in this quarter, we start seeing a price recovery and margin recovery, which is significant but already had several headwinds. And I would like to ask you, if you can give us some more color about the fourth quarter, which is usually more favorable.

Do you think the market will be responsive in terms of mix and competition? And what about the consumption scenario, do you see an indication? Do you believe you will continue having those sequential improvement quarter-on-quarter on your mix, and more importantly on margin?

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

Thank you, Luca, for your question. This is Lorival. I will summarize what the fourth quarter, what we have had for the fourth quarter and obviously we already have impacts for that from the third quarter. What we mentioned in terms of price increase, both for processed food as well as for in natura. And then when we talk about in natura, both poultry and also pork, we do not have in the third quarter a full understanding of this impact. So, we start having a fourth quarter with an impact of – the posting of everything that has happened in the third quarter as well. This is relevant to take into consideration in the fourth quarter.

In addition to that, as you well said, the fourth quarter, that's when we have the holidays, and what we can tell is that we are doing very well in the festive products. We are growing when we compare that to the same period of last year. We still have October and November ahead. So, this is very much – but we'll see a concentration in December. But, so far, the cycle that we are at, this show an improvement vis-a-vis the prior year and that makes us very optimistic regarding perspective.

And also we are already doing a lot in terms of commercial execution with the sales team. Our position, as I had said vis-a-vis several initiatives, and we expect that this will be happening in a consistent fashion over the next quarters, not only in the fourth quarter, but also in the coming months. I don't have here a crystal ball that we'll turn things from one day to another, but this is thanks to the work that we are developing consistently.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Thank you very much, very clear. Now. Just a quick follow up. We can see that in this current quarter there was several one-offs and adjustments, lower EBITDA compared to the second quarter. So could you give us more color about directions for the future? Do you expect to see a reduction in impacts or what about visibilities for Q4 in some of these variables?

A - Operator

Based on what we can see, this is the trend, you're right, a reduction of impact as events and circumstances in the past are over. So the impact will be lower. Maybe just some remnants, about the disclosure of operations Carne Fraca and Trapaça, maybe some one-offs. But there is a downward trend of these adjustments and impacts.

Q - Luca Cipiccia {BIO 6914452 <GO>}

Perfect. Thank you.

A - Operator

Thank you.

The next question is from Danniela Eiger, Bank of America Merrill Lynch.

Q - Danniela Eiger {BIO 20250080 <GO>}

Hello, Pedro and Lorival, Elcio. Thank you for taking my question. My question is also about the fourth quarter and the outlook. Pedro made comments during his opening remarks that we should expect to see a release of seasonal inventories in Q4. I would like to understand if we should also expect cash generation in this quarter? Like Luca said this is a favorable quarter to the company. So I'd like to understand if there is room for cash generation already in Q4. As for festive products, you said they are going up, I'd like to understand if this growth is via volume or price? What about the performance of the mix? And do you expect to have any increase or additional price increase in Q4 on top of the third quarter? Thank you.

A - Operator

Thank you, Daniela. Good morning. Let us answer your question. In terms of cash generation for Q4, the answer is yes. There is a positive expectation. And then there are some relevant items. Firstly, in the third quarter, we build and set our inventory base for festive products. So we have an impact of about BRL 150 million. And over Q4, in October and November, we still build this inventory, and in December you zero this number. So speaking of the third to Q4, we have a gain of BRL 150 million.

Another aspect is that over Q3, you also work on inventory of corn stemming from the second crop. This is when we buy like Elcio said, and this is also set over Q3. And then over Q4, even though you buy, you also use more inventory rather than buy it. So you have some relief so to speak and also a release of working capital that is turned into cash.

Another important aspect is that we have a continuation of our efforts to reduce the use of frozen raw material. This was partially done in Q3. We already have in October this posted, and we have this brand over Q4. So this is an absolute commitment to reduce that finished raw material inventories.

So this is like a mantra to us because it does reduce and significantly release working capital, it lower our storage costs and also third-party costs. And over time, there is a significant effort. And we don't have to make adjustments as the maturity happen. So, this is just - we follow very thoroughly this with our executive committee. We follow each one of these initiatives, amounts, so we can also have this reduction. We already had a very significant reduction, almost 40%, and this also applies to the fourth quarter. So, the answer is yes. There will be a release of working capital, other initiatives and that will improve our cash generation.

In terms of festive products, in this case when I refer to improvement, we have an improvement in volume. We do have improvement volume-wise. We do see improved volumes and also better price positioning.

It's too early to say more about it because we still have November and December, the whole month of December, to have a final position of the final mix and the final average price to say and to give an appropriate answer to your question. But as we speak, I can say that when it comes to our volume indicators, they are going up.

As for your third part of the question, like we said there was a price adjustment, a price rise. Do we expect to have further price increase in Q4? Our positioning is to seek for profitable growth. We want to be efficient in our operations, just as if we see an impact brought by cost, grain freight, and others, naturally we will search for this profitability and adapt prices accordingly.

So, this has been done in the second quarter, third quarter, since April, like Pedro said. So, we do have this commitment with the company's profitability. So, as we have an impact of our effect on macroeconomic direct factors. The company will try to be more profitable and will make adjustments whenever possible.

Q - Danniela Eiger {BIO 20250080 <GO>}

So just to clarify, what you said about the impact in the cost of grain. Are you referring to additional impact? If I understood it correctly, you could not offset - pass margins because the cost increase was stronger compared to what you pass the price. So, is the idea to react to grain in the future? Or do you still want to work on margins? Thank you.

A - Operator

Thank you for your question. Once again, if we have new adjustments and further price impact, we'll make adjustments accordingly. But we will try to work on the mix whenever necessary. Naturally, grain is important, but it's not everything. So, we do have our cost inflation as a whole and then we have efficiency in other areas as well, reduction in other costs. And then we consider not only the price of grain, but what we consider to be COGS in order to work on this equation.

Q - Danniela Eiger {BIO 20250080 <GO>}

Great. Thank you.

Operator

Next question is from Leandro Fontanesi, Bradesco BBI.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Good morning, and thank you for this opportunity. I have two questions. The first is about grain. How do you see the cost scenario for the fourth quarter? There was a drop in the grain prices but also thinking about the company's strategy, you have said that you would increase inventory to tap into better prices and to make more hedge, so what is your strategy for grains in the future?

And also another question is about the price increase. What is the mindset of the competitors? How do you see that mindset? Do you believe all of them have the same understanding regards margin and improving profitability? Thank you very much.

A - Elcio Ito {BIO 18281069 <GO>}

Thank you very much. This is Elcio. I will start by talking on your grains question. Yes, the scenario in the past weeks and the drop in the spot prices, and remember our chain is a long one and we also have inventory. Therefore, we are in a process of realizing and we are seeing a price increase. And this reduction will take a few months to show in our cycle, in our cost of goods sold. And obviously, we do have high level of inventory and 70% of that production is realized in these three months. 30% of the season in the summer is lower because of climatic effect and a lot of exports. And this is a grain production obviously, so we do have a strategy of having higher level of inventory. They're in this period of in-between crops that, historically, the price of in-between crops are higher.

We continue with our strategy of grains hedge. One thing is to have the real availability of the grains, and we are working for that second crop of next year to make sure that we will have the real availability of those grains.

And the second part of this adjustment is the price exposure to grains, and we are following strictly our policy that has been approved with the board considering the historic price. So, we are really following our commitment. Soybean always involves China and the United States. We are also following that up and closely, and that is affecting the premiums every week depending the discussions on those two countries. And this is a period of a very high harvest in the United States for soybean and corn. So, planting and harvesting are favorable in the United States and Brazil and also in Argentina. So, at least so far, we do have that scenario for harvesting.

A - Pedro Pullen Parente {BIO 2058839 <GO>}

This is Pedro. About the price increase and how we look at our competitors, obviously what we can tell you is that the cost impact that we have suffered and our competition also suffers and we can say that about our passed increases, we have seen a reaction which was important for us to have just a slight reduction in the market share, but it was not very significant.

So, showing that the competition also suffers the price impact, and they are also practicing price increases when they need. So, in light of information that they receive about the execution in the market, that's how we have this information.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Thank you very much.

Operator

Next question is from Lucas Ferreira, JPMorgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Good morning, everyone. I have two questions. The first one is on Halal. Can you talk about the margin improvement in the region? And basically, talking about Saudi Arabia, you have a better supply and demand balance after you adjusted the slaughtering issue. So, I wanted to understand if in the fourth quarter you see a volume improvement and how prices will be behaving after that adjustment. And also, I would like to understand if that margin improvement, especially the gross margin you had increase in prices that was significant, but does that also has to do with that inventory that was formed actually in the first half of the year? Does that have any effect in the gross margin, because probably you were selling this prior inventory probably at a lower cost? So in the fourth quarter, can we still expect to a margin that is close to the one that you reported on the third quarter?

And my second question is on the international market. I realize that the gross margin in international market has increased significantly quarter-on-quarter when compared to the second quarter. But we have not seen the same thing on the EBITDA. So I want to understand what happened. What was the impact to gross profit? Was there anything that happened that you can comment about? And do you believe that the EBITDA in the international market can improve?

A - Operator

Thank you. And now, we will start backwards. And after that I'll turn to Patricio (00:56:09), and he will be able to talk about what are the expectations for the Halal market. Talking about the international market, we do see a relevant effect when you have less volume, lower EBITDA and lower margin, and these refer to expenses that you mentioned. And since we are in this divestment process that involves costs and expenses related to the process whether for the process itself or the structure and the units themselves that end up impacting it, and we did have some effects there which explains partially the process and these costs.

Now, about the margins that you mentioned for the fourth quarter and the third quarter, if that has also to do with the inventory sales. Let's put this into a perspective. Remember that the inventory for finished raw material, this is not an inventory that is there for a long period of time. This is not a inventory that I got a year ago, that I had grains that went to our center then at a very low cost. No.

The fact that we are now selling these inventories now, that does not improve the margin in itself. Because those inventories were also been built over the year in the first six, seven months of the year. So, we already had the impact of the grain costs. And at the same time, when you have that effort, not only of the sale, but also the effort of reducing the inventory levels at a stronger pace, you have to make some commercial adjustments.

So, I wouldn't say that there are margin benefits with this reduction of the inventory levels. But rather we do have an impact of part of this inventory level at a higher cost. And we try not to use them, and products with larger margins. And so when we have those inventories, going back to the right levels and this is going to happen in the fourth quarter of this year, then we take off this pressure of our sales team of having to work with these inventories, and we will have a better execution. Combining that to the execution that we are holding of number of products sold and everything else, then yes, we will be able to have an improvement after that execution.

Just another comment. We had a margin increase as you mentioned, and in spite of this impact that Lorival mentioned and this is an impact that at the moment of sale, we have to work with those margins. So when we no longer have a problem with the sale of inventory, as Lorival mentioned, we might then have a better margin. And also a final global EBITDA that will be better because we will have the effect of the sale of this product.

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

And I will turn the floor to Patricio (01:00:01) and he can tell you a little bit more about the Halal market.

A - Operator

Thank you very much, Lorival. Well you had two topics, the supply of Halal if the volumes are already – the volumes that are already going back to Saudi Arabia, and also about our prices. Well, Brazil as a whole was able to adjust to the demanded process by Saudi Arabia. Some of the process was reactive and we didn't lose some efficiency. But we had to work structurally. We have divestments in the process and we then were able to have a better performance in quality and cost.

So the commercial relations between Saudi Arabia and Brazil is already back to 40,000 tons, and this should be maintained for the coming months. So, the volume that the Saudi Arabia needs is very close to historical levels. But what we don't have in Saudi Arabia today is industrialized and raw material for industrialized products. And then with our platform in Turkey and Arab Emirates, we were able to address that very quickly. That's why we are at another level of results. And now, so, that's why we are gaining market share in processed food.

So, to conclude the concept, our margins are going very well. They are in line with historic levels, and we are doing well because we have a local platform that allowed us to have industrialized products that cannot be processed in Saudi Arabia but in the region. And the process in Brazil is adjusted and with a better performance in terms of productivity.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Thank you.

Operator

Thank you. The next question is from Victor Saragiotto, Credit Suisse.

Q - Victor Saragiotto {BIO 19504427 <GO>}

Good morning, everyone. Just a quick question. We saw on the slides, you mentioned BRL 274 million working capital gain; but when you check cash flow, we can see use this quarter and year-to-date. Can you tell us more about it? Maybe I'm missing something. Thank you.

A - Elcio Ito {BIO 18281069 <GO>}

Victor, Elcio speaking. Let me see if I understood your question. In reality, we did have some use of cash. If, on the one hand, we manage to improve greatly our inventory of frozen raw material and finished product, net of festive products. On the other hand, we had some offset, macro seasonal moments and they more than offset the reduction in inventory like festive products and also the second crop.

In reality, if we think about it all, we had cash use, but we also wanted to highlight that it was part of our early plan of monetization, having this specific levers of raw materials and finished products which are under our management, and the bulk is reverted into Q4 owing to festive products and a lower share of grain that we use over time.

I would just like to underscore, Victor, coming back to your question. On the one hand, we follow this very closely. Highlighting what Pedro said at the very beginning, we have our guidance for leverage for 85 times which is a combination of cash, operating cash of the company, and also the monetization that we addressed before.

Q - Victor Saragiotto {BIO 19504427 <GO>}

Perfect. Now, on the slide, you showed a reduction in net debt over EBITDA. One of the initiatives concluded had to do with working capital, theoretically BRL 274 million savings. This doesn't match with the numbers we see on the cash flow.

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

Lorival speaking now. Let me tell you something, what is in the balance sheet, naturally, is what happens. In the balance sheet, as you can see, we have all the lines of working capital. All the lines include an increase in inventory of second crop corn, increase in inventory stemming from festive products and we also - and in all inventory, everything is there.

What we refer to as initiatives is the seasonal effect - our initiative that we propose to work with frozen raw material inventory and finished good inventory. On this line, more specifically, we already delivered the numbers we showed. Naturally, there is a seasonal effect. So this is not despite seasonality. And seasonality will capture the benefit of the initiatives that we're working on, plus seasonality in Q4.

So in order not to be suspicious of what is being delivered, festive products, holiday season in December, December 25 and the inventory that we're building right now, that does have an impact and that uses cash over Q3 also happens in October and in November. And when it gets to December, the whole volume is adequate.

At the same time, when we build our grain inventory, stemming from the second crop, which also happens at this time of the year. Now we have a higher use over Q4. So these are the drivers that will bring this balance, and at the end of the day, in Q4, there will be cash generation stemming from these initiatives.

So I just want to highlight again, I understand your remarks, but it's also important to underscore our efforts, our initiatives and all the drivers that are being addressed so we can have this number, 434 (01:07:20). One of them is this working capital that was very detailed. And on top of this initiative, we also have divestment. And I'm confident that when you do the math and you calculate all these numbers, you will get to the numbers that we posted.

A - Pedro Pullen Parente {BIO 2058839 <GO>}

Victor, Pedro Parente speaking now. You might have this kind of reading. Net of these initiatives, working capital use in Q3 would be higher than BRL 274 million, owing to the seasonal effects. So this is just one of the initiatives that make up the total working capital. So this is how we can make both information compatible.

Q - Victor Saragiotto {BIO 19504427 <GO>}

Thank you, Pedro, Lorival and Elcio.

Operator

Our next question is from Thiago Duarte, BTG Pactual.

Q - Thiago Duarte {BIO 16541921 <GO>}

Hello. Good morning, everyone. Pedro, Lorival, Elcio, I have three questions. Actually, the first question is the follow-up of the previous discussion about slide 9 in your presentation.

Just to understand it better, out of the effects that you consider to be completed and concluded, working capital already had an impact on Q3. That's how I got it. Now, noncore asset sale, do you have the impact already? That's my question.

Second question, I understand that you underscored a couple of times, you highlighted the outlook to end the year with a leverage of 4.35 times. You never mentioned again the second, so to speak, guidance that you gave in the past in terms of ending next year around 3 times. Would you mind going back to that outlook just to better understand if there is any reason to think of a different number or higher or lower just to try to bring the discussion to something more midterm?

And my third question actually, also coming back to the previous discussion about the price adjustment, new price, a drop in market share. I would like to hear from you more specifically in terms of consumption. When we discuss with companies, I think you already have a brand portfolio for Brazil that is quite solid, Sadia, Perdigão, Kidelli introduced this year, and also Qualy. So, when we think about that market share that you posted, consolidated market share 45.8% this quarter, is there any number that you consider to be a natural market share to be pursued in your current brand portfolio? Maybe just trying to understand the price increase for the future.

A - Pedro Pullen Parente {BIO 2058839 <GO>}

Thiago, Pedro Parente speaking. As for noncore assets sale, these are completed operations and they assume cash inflow, which already happened in part and will also happen by year-end. So we do have operations ongoing, deals ongoing, BRL 214 million, part is already posted and the rest will be by year-end, ongoing noncore. So cash inflow, the operation is concluded. So we are sure about this amount.

As for the target for 2019, this is absolutely maintained. We're going to hit the target and as for 4.35, just to remind you and not to have any noise by year-end, it considers the inflow of two investments and maybe these funds could happen over the first quarter of next year owing to FX. Things that come out on the operations, BRL 5 billion and only with this adjustment which is nonrecurring owing to this difference.

So, alternatively, three times net debt over EBITDA next year, this is what obviously we want to achieve. And counting on all of the operations, all our initiatives that we announced, disclosed, and are deploying, although these initiatives are here, they are at their limit, they are delivering margin results. So it's important to take that into account. And once again, I'd like to say that considering the nature of the business, and also all the problems that we are challenged with, as a company, things do take time to happen.

As for market share, we have a clear vision that market share for us is a natural consequence of a combination of two factors. Volume, naturally, but also margin. We want to see an increase in volume, which is profitable. Therefore, naturally, we pay keen attention to our market share, but we also focus on profitable, higher volume, always delivering positive results. So we don't have a magic number or a target for market share, but we do have a clear definition that we have to run our business in a profitable manner, and volume, profit, this is our vision.

Q - Thiago Duarte {BIO 16541921 <GO>}

That's very clear, Pedro. Thank you very much. So talking about market share, when we look at that relativity rate that you presented for Brazil for processed of 116% in the third quarter, my question then is, do you consider this rate a fair one for your brand portfolio or do you believe you can expand that, if you think about the brand equity of your products?

A - Operator

Thiago, this is a strategic information. So I don't think we can disclose more information on it.

Q - Thiago Duarte {BIO 16541921 <GO>}

Thank you very much.

Operator

Next question is from Antonio Barreto, Itaú BBA.

Q - Antonio Barreto {BIO 17449798 <GO>}

Good morning, everyone. Thank you for the question. I would like to go back to slide number 9. It was very clear that this BRL 1.3 billion (01:15:12) of working capital, these are additional initiatives. So consumption would be worse if it were not like that. My question is in this BRL 1.1 billion, do you have any initiative that is interest-bearing such as prepayment of receivables, something that is another instrument that's not the FDIC (sic) [FIDC] (01:15:31)?

Also, you have the client account with BRL 376 million. So, in this BRL 1.1 billion, do you have anything there that is prepayment of receivables that is not FDIC (sic) [FIDC] (01:15:46), the receivables investment fund?

A - Elcio Ito {BIO 18281069 <GO>}

Antonio, this is Elcio. Yes, we do have some prepayments of receivables, especially coming from the international market. This is not a new practice. We have been doing it, and depending on the volumes of the country, sometimes that's more or less taking advantage of the world interest rates. And also, this is a way of optimizing our cash flow.

Q - Antonio Barreto {BIO 17449798 <GO>}

Can you disclose the amount and the interest rates, Elcio?

A - Elcio Ito {BIO 18281069 <GO>}

The amount that we have here, in addition to the prior year quarter, is BRL 150 million.

Q - Antonio Barreto {BIO 17449798 <GO>}

Reals?

A - Elcio Ito {BIO 18281069 <GO>}

Yes, in reals.

Q - Antonio Barreto {BIO 17449798 <GO>}

And my second question is when we analyze the EBITDA adjustments, we see that within the Operations Trapaça and Carne Fraca, we have around BRL 150 million in terms of idleness adjustment. How much of this adjustment will no longer be recurring? Obviously, it's been adjusted in the EBITDA, you imagine this is nonrecurring. But when will it not happen again?

I would say that you have two options. Either the situation will improve in the international markets that are generating the idleness or you will have an internal control process reducing the structure of production. What drew our attention is that in this quarter, we saw a reduction in the number of breeders (01:17:30) of almost 4%. You also had an integrated action of BRL 15 million. So it looks like you are bringing down biological assets. So this BRL 150 million of idleness, do we have to wait for the improvement of the international markets or are these initiatives on your production rationalization will adjust the whole process?

A - Operator

Well, just to put things into a context, our idleness both for Weak Flesh and Trapaça are - that is being restructured. When we talk about Operation Trapaça, we have to mention the layoffs and the collective vacation period. And these are the idleness that come from the process. So, yes, this has impacted the working capital, the biological assets and also in the financial area because we are idle during this period. So, as we recover volumes and especially here for the chicken factories, these tend to reduce the idleness for the coming years. And there's another side of it, and whether integrated or idleness, but here, we'll have a final impact to which is the closing of some plants that we have and that we should not be resuming operations.

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

And, Antonio, adding to that, I think you have a right understanding when you talk about the reduction in the number of breeders (01:19:17) because this is the adjustment that we have to make once we have the markets closed to us. So you know this is a long chain, and the results and the impact that will happen are happening. And you will see them in the coming months.

We are monitoring that up and closely to exactly know up to when this is going to happen. And then, we expected that for the next year, we already have an adjustment of the level, considering that we understand that we have already done everything needed according to the current market conditions. Obviously, we are monitoring everything: opening the market, the macroeconomic conditions of the market, the international market. That's why we are talking about this reduction. But this is the adjustment that we need to do because some markets were closed for us. Okay?

Q - Antonio Barreto {BIO 17449798 <GO>}

That's very clear, Lorival. So, by your answer, I can say that even if those markets do not open, considering those adjustments, we might have a reduction in this idleness. Right?

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

Yes, exactly.

Q - Antonio Barreto {BIO 17449798 <GO>}

Thank you very much.

Operator

Next question is from Alex Robert (sic) [Robarts] (01:20:41), Citibank.

Q - Alexander Robarts {BIO 1499637 <GO>}

Hello and thank you very much. Good morning. I would like to start by Asia, the gross margin and the EBITDA, their being negative drew my attention. And you have been talking about tariffs in China, the Hong Kong situation with swine, also the situation in Japan. Can you comment on how we should understand the margin? If we are reaching the bottom, if in the short term, in the fourth quarter, you believe the margin will switch, will be positive or maybe the most important impact has been from Japan but what would be an idea in the short term about the margin?

And my second question really is about Europe. You said that BRF plants are not in the European's list. So since we are going into 2019, can we believe that next year, you might start exporting there? Or what would be a future step or an indication? What could you tell us here, if it is really possible to go back into the European market? Thank you very much.

A - Operator

Thank you, Alex. About Asia and then it could be applied to Europe as well, it was a really challenging third quarter. If we look at the fourth quarter, we might have an impact with the opening or reopening of the Russian market. Therefore, we could be benefited from that with a price recovery for the region, not directly Russia, but the volume that was directed for instance to China might go to Russia.

And then we could have a positive effect stemming from that. But this is not an effect that I should call total full reversion of this scenario. That scenario is still a challenging one, with execution that has to be very precise and efficient. And then, we might have a positive impact because of this commercial issue.

Now regarding Europe, and I am being very transparent and consistent to what we have been saying since there was the banning of our plants in the beginning of this year. We expect that this will come back. It will resume – at the time, we said it would be around 18 months. So we are not working with that possibility in the first half of the next year.

So, addressing your question, if we should start the year going back to Europe, we, of course, would love it to happen, but that's not our base scenario. Considering the work that is being done and all the procedures that have to be taken so that this happens. We are working at a very conservative base. But I should stress that all information that we are conveying to you in none of these scenarios, we're considering an anticipated return to Europe, neither a significant recovery of the Asian market. So this is a scenario that considers other Brazilian variables, Halal is still a challenging management and these two markets, both at the fourth quarter as well as in the beginning of next year.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. So to understand it well, in your budget for 2019, you don't consider this trend of an upturn or starting Europe again, is that right?

A - Operator

Yes, that's correct.

Q - Alexander Robarts {BIO 1499637 <GO>}

And finally, just to better understand, what about the release of these plants? Europe, for instance. Is it tied to the investigation of the federal police or it's not related at all with this investigation?

A - Operator

Could you repeat the question? The investigation of the police, is that what you mean? If I understood your question well, this ban took place precisely on the same date of Operation Trapaça early this year. We don't see an immediate effect on any step of investigation of Operation Trapaça. Now, what we have to do to have the plants back on the list is to show our initiatives in our plan, our controls, and then maybe we might expect to see a visit and inspection, technical health parameters.

This is not tied to Operation Trapaça or anything of the sort, but rather to performance, and quality, and qualification of these plants. And that's why it's so time-consuming because these steps have to be met through all the process.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. That's clear. Thank you very much.

A - Operator

Thank you.

This concludes the question-and-answer session. Would like to give the floor back to Mr. Pedro Parente.

A - Pedro Pullen Parente {BIO 2058839 <GO>}

Once again, I would like to thank you all for joining us today. Thank you for your questions. Like we said in the beginning of the call, we believe the earnings are beginning to reflect our recovery strategy. Operating results already posting improved margins owing to several actions.

Once again, we want to acknowledge and admit that this is only the beginning. We have this firm commitment of being very diligent in our performance. We have no doubt that we will keep on delivering positive and increasing results and we'll meet our goals presented in our strategic plan and reverse the downward margin already in 2019 and go back to historical margins in 2020.

And starting 2021, we want to deliver very promising results and even above our historical margins. This is very diligence daily efforts. So don't expect from us any promise that we might fail to deliver, particularly don't expect magical measures. We don't expect to see overnight changes in quantities or qualities. We want to deliver increasing positive results, but also sustainable results. This is key to our management. Thank you very much, again, and let's move forward.

Operator

This concludes BRF SA conference call. Thank you all for joining us today.