Q1 2013 Earnings Call

Company Participants

- Martim Mattos, CFO
- Mr. Claudio Bergamo, CEO

Other Participants

- Kyle McCarthy, Analyst
- Lorre Serra, Analyst
- Robert Ford, Analyst

Presentation

Operator

Good afternoon. Welcome to Hypermarcas First Quarter 2013 Results Conference Call. Today with us we have Mr. Claudio Bergamo, CEO Mr. Martim Mattos, CFO and Mr. Breno Oliveira, IRO.

We'd like to inform you that this event is being recorded and all participants will be in a listen-only mode during the company's presentation. After Hypermarcas' remarks, there will be a question-and-answer session for investors and analysts, where further instructions will begin then.

(Operator Instructions) We would now like to inform you that questions can only be asked by telephone. If you are connected to the webcast, you could email your questions directly to the IR team at ri@hypermarcas.com.br. Today's live webcast may be accessed through the company's Investor Relations website at www.hypermarcas.com.br/ir.

We would also like to inform you that statements made during this conference may constitute forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those set forward in the forward-looking statements.

Now, I'll turn the floor to Mr. Claudio Bergamo, who will begin the presentation. Mr. Bergamo, you may begin your conference.

Mr. Claudio Bergamo

Thank you very much all for participating in this call. Welcome to Hypermarcas First Quarter 2013 Earnings Conference Call. This quarter, the company continues its strategic plan of sustainable, profitable and organic growth with cash flow generation to shareholders based on (inaudible).

Sustainable organic growth of our brands and products through better distribution, better point of sale and management, intensification of our marketing activities including among other factors our product launch program. Superior operating profitability of our business through the consolidation and simplification of our operating platform, increasing productivity and implementation of our improvement initiatives with reduction and dilution of operating expenses and higher margin of our products. And positive cash flow generation with reduction of net debt and as permitted dividend distribution.

We believe that on this quarter, despite the challenging macroeconomic environment, the company performed well in all the three variables and payables defined as I had just mentioned.

Flipping over to page six, in the quarter, in the organic front, despite soft beginning of the year, sales in March recovered and the company ended the quarter with net revenues of BRL958 million, representing organic growth of 6.8% compared to the same period of 2012. Not considering non-core business in the consumer that were discontinued in 2012, the company's total growth was of 9.4%. The consumer division ended the quarter with a growth of 10% and 16.2% considering non-core business.

In Pharma division, the sell-in sales advanced 4.5%, below our expectations mostly due to a more conservative attitude by our client, which did not anticipate in purchases this year before the total price increase as we had seen in previous year.

Continues on to page seven, on the other hand, the sell-out demand of our products for the Pharma division remained quite positive in the quarter. Again, the company reaches another pick up demand in the quarter and a new pick up market share of 8.8%. Our Pharma segment grew equal or above the market in the quarter, result on an average of 16% on a weighted basis after discounts.

Flipping to page eight, in terms of operating results, the company finalized the quarter with adjusted EBITDA of BRL227 million, representing 18% growth compared to the equivalent period of 2012. EBITDA margins increased 230 bips from 21.4% to 23.7%, such gains occur from both gains in gross margin and SG&A expenses reduction and dilution, even after a light increase in marketing investment.

In the third front, cash flow on page nine, also the company had a good quarter with cash flow from operations of BRL184 million, represent growth of 32% compared to the previous year. And free cash flow of BRL150 million, represent an increase of 67% compared to 2012. This cash flow allows a reduction of our net debt by BRL100 million.

In summary, in the first quarter of 2013, the company achieved good results in the three fronts we described: sustainable growth, operating profitability and cash flow. As we had seen in this quarter, our results show an important potential of operation leverage, then net revenue growth of 6.8% resulted in an EBITDA increase of 18 and free cash flow advance of 67%. This is due, along with other factors, to the efforts in the several ongoing initiatives for improvement in the company to the operational focus on results and to the beginning of a new order scheme cycle after the enormous investment into Q2 since our IPO in 2008.

I'll pass over to Martin, who would describe a little more in details the numbers.

Martim Mattos {BIO 16015889 <GO>}

Good afternoon, everyone. Martim speaking. We can begin on page 11. We see that gross margin in the quarter was at 63.9%. The highest level over the past nine quarters with 1.8 percentage point increase compared to 1Q12, primarily, as a function of our consolidation of manufacturing project, both in Pharma division, which had started showing productivity gain in Anapolis, after more than a year since it's open as well as in Consumer, which is in the initial stage of migration of production lines to Senador Canedo.

On the next page, taking about the company's operating expenses, we see that there was a nominal and as well a marginal increase in marketing investment. On the other hand, expenses of a more fixed nature, the SG&A before marketing were reduced both a nominal and on a percentage term in a combination of expenses control and operating leverage called by the growth seen in this year.

On page 13, you see that the adjusted EBITDA grew BRL35 million compared to the same period of last year, reaching a margin of 23.7%, the highest level since 2Q11 as a function of a gross profit increase of almost 9% combined with the dilution of fixed operating expense. This result represents a good level of operating performance for the company in the first quarter and support the adjusted EBITDA guidance of BRL950 million for the year of 2013.

Now, on Page 14, talking about net income, which was up BRL102 million or $0.16 per share. There was an increase of about BRL61 million in the same quarter of the last year, mainly because of the improvement of the operating results that despite a lower contribution of positive effect variation over our debt, as we can see on this chart on page 14.

On page 15, talking about cash flow, again, the operating improvement compared to 1Q12 accounted for the increase in the company's cash flow from operation, which combined with a CapEx reduction, as the intensity of the manufacturing restructuring projects decreased (inaudible) BRL61 million increasing free cash flow in the first quarter to 115 million.

As a consequence, as we can see on the next page, our net debt, which started the year at the level of BRL2,701 million was reduced by BRL150 million by the free cash flow of the quarter and increased by 63 million as a function of the net debt service. After a positive FX variation of 26 million and other non-cash effect over our net debt, it was possible to reduce net debt by 100 million to BRL2,601 million, representing a leverage of 2.75, the adjusted EBITDA guidance for 2013 of BRL950 million.

We were very satisfied at this result and we hope you have also enjoyed it. On our view, it shows consistency with our strategy of sustainable profitable organic growth with cash generation and net debt reduction. We do believe we are on the right track and we have been working a lot to reach this object.

Thanks for your attendance. And we may now proceed to the Q&A session.

Questions And Answers

Operator

Thank you. The floor is now open for questions from investors and analysts. (Operator Instructions) Our first question comes from Robert Ford, Bank of America.

Q - Robert Ford {BIO 1499021 <GO>}

Hey, thank you and good afternoon everybody and congratulations on the quarter, guys. With respect to the charges that you threw up on pages 11 and 12; you look at those big improvements in gross margin across business divisions, as well as the improvements in SG&A and as you consolidate a little bit more of the consumer products businesses and other, can you have them? And here you're going into the cough and cold season; I would expect that from the manufacturing perspective even at Anapolis you have room to improve efficiencies further.

Can you comment on the outlook for big margins within the context of the more sluggish economic environment, competition, as well as the sustainability of some of your fixed cost, because there are two, I think you've gone into more of the shared services structure and you've made some similar strides in that regard. Do you have additional room to reduce that fixed cost structure as well? I know it's convoluted question, I apologize for the nature, but you've got lot of good things happening and I just wanted to address them.

A - Martim Mattos {BIO 16015889 <GO>}

Sure, Bob. No problem. If we just, would divide your question in two major points, one is gross margin trends and the other one is the secret transit trend. So, talking about gross margins and then dividing again the issue in two different assets, one is the Pharma and the other one the Consumer. On the Pharma front, you know that we've been dealing with this big project of consolidation of our operations in Anapolis and basically a lot of last year -- most of the last year's quarters, we mentioned to you guys that the productivity levels at the new facility was not in accordance with our expectations. And in spite of the gains that we had have been moved the operations to the new facility.

Now, it seems that we are being able to pick up with this lack of productivity that we have in our initial stages after the new manufacturing at a new site with new people, new infrastructures, so it was, everything completely new. And now it seems like we are getting on track to have a good level of production, which also brings a good profitability level and then good margins on the Pharma side.

On the Consumer side, it's basically the same story, but it's the beginning of the story. So, we are starting to produce at the new subsidiary, at Senador Canedo. We have some important gains moving the operations there, but on the other hand we still have the initial productions of a lot of our different lines, lacking a lot of productivity that we expect to have some point in time. So we assume there, this is the same story, again, we have new people with new machinery, possibly new infrastructure with which we have to view. So that's the stage where we are now in terms of gross margins for both divisions and those are the effects that mostly are affecting the level that we have seen.

In terms of the fixed expenses of the company, one of the highlights that we have as we mentioned for the commercial expenses is actually temporary, because we're changing from one structure as we've discussed of sales decline on the customer side and we are changing to a different structure. We're still hiring some vigorous team, changing some of the resources that we have. Therefore, a different type of sales force and anything in that -- in that change, we are at least temporarily spending less than what we had forecasted.

On the other hand, on other types of commercial expenses and also on the G&A, we have had a lot of opportunities to try to hold some of the expenses that we had during the year of 2012 and work with the structure that is (inaudible) support our operations as a whole.

So, in that case, in that structure, that's the nominal type of those structures, it's enough for us to run the company for some time ahead and also to support more additional revenue coming from our sales team.

Q - Robert Ford {BIO 1499021 <GO>}

Thank you, Martim. So, even on Pharma, it sounds like, still opportunities to improve rate but a lot more runway on the Consumer Products side, is that correct?

A - Mr. Claudio Bergamo

I just need to complement what Martim said, one. You're right, we had made quite good progress in terms of productivity in Anapolis, but still we are moving ahead of that. If you are, as you know, consolidating also in leading our Senador Canedo plant, we will have a big piece of the consolidation happening on August and on Anapolis happening in January, we expect that it should closing down by somewhere around May, June of next year. So that will help the cost of the product we still produce at Rio de Janeiro sites.

One thing we have done last year and I think was a good program and we launched a re-manufacturing program. And the way we do that in Anapolis and we do by weights. So the first weight was one of the solid flat re-coup and there was a huge success we had, like, the lead times going down like one-third of what it seems to be before.

So what are we doing now? We are rolling out that program to the August, pieces of the flat and we believe that as these broad impacts through many of the different fights within the contracts, we will get some advantages (inaudible).

In the Consumer, like Martim said, we are just a year-and-a-half behind Pharma. The process is, the first thing you do, you'd really move the assets and you concentrate and then you implement the productivity improvement products. I believe that the phase of the productivity improvement will be factored in Pharma given that it's a less amount of different factors of the product, less work in progress. So it's a more direct type of production lines. So we really, probably will be able to improve productivity. That's the pattern we are doing in Pharma.

Last point I think is important to mention is that, we are also doing with this centralization effort of the project matrix of Consumer. We are verticalizing many of the -- some of our packages that we used to buy in the marketplace, such as the bottles and consolidated cash flow, the cash, that also grew, probably led us to a very good cost position for this projects, given that you will be 100% fully verticalized.

Q - Robert Ford {BIO 1499021 <GO>}

That's great and impressive, I know that's exciting. And then just lastly, Claudio, if I may, can you comment a little bit about the competitive environment in terms of pricing and promotional activity that you see across all lines of business?

A - Mr. Claudio Bergamo

Well, I think, this year most of the companies are impressive through price increases, given the environment of last year's real wage increases and also the devaluation of reais. So in that respect, it hasn't been quite challenging as it was in prior years and most of the companies are behaving the same way. So, I think, in that respect, it was good for businesses.

Q - Robert Ford {BIO 1499021 <GO>}

Okay. That's very helpful. Thanks again. And again, congratulations.

Operator

The next question comes from Kyle McCarthy at HSBC.

Q - Kyle McCarthy {BIO 17404797 <GO>}

Hi, good afternoon, everyone. Thanks for taking the questions. Can you please give some more color on the rationalization on SKUs and brands and the customer decision that the company is targeting the third quarter 2012? Are you still implementing it or it is already done, what can we expect for the next quarters?

Also, we have been driven from some distributors that the demand was soft in the beginning of the year. So if you could, discuss a little bit the market sellout has been recovering after the first quarter would be? Thank you.

A - Mr. Claudio Bergamo

I'm going to answer the first one, (inaudible). In terms of rationalization, basically, the process, the different definition and of the instruction and simplification and SKU rationalization and execution was already done last year, in 2012. This year, basically we are now selling some of the former stocks of some of the items we just completed. Just to give a figure in the first quarter, only BRL3.9 million out of 415, so less than 1% was related to non-core as opposed to last year which was a 24%, which was in around 80%. So, it really reduced from 8% to 1% and I believe that this process was dull and as we move the year, the difference between non-core and core should converge, and we believe that for the next year we (inaudible). Can you repeat the second?

Q - Kyle McCarthy {BIO 17404797 <GO>}

Yeah, sure. The second question was regarding the demand. We have been hearing from some distributors that the demand was stocked in the beginning of the year. So, if you could discuss a little bit if the market sellout has been recovering at the first quarter would be good. Thank you.

A - Martim Mattos {BIO 16015889 <GO>}

Yeah. For us our demand weighted after discounts was 16% growth for the first quarter this year vis-a-vis first quarter of last year. In fact, the year started a little softer and then accelerated on March and we've ended with this level, which we believe it's quite good. So I think, we expect and then we wait for that, the economies that we're accelerating, we saw that on March, somewhat we saw now on April, but we have to wait now, because the market is quite volatile now for us as well in the marketplace. So, we have to wait to see what happens in the second quarter.

Q - Kyle McCarthy {BIO 17404797 <GO>}

Okay. Thank you very much for that.

Operator

Our next question comes from Lorre Serra at Morgan Stanley.

Q - Lorre Serra

Good afternoon and thanks for the call and congrats on the improving results. I had a couple of questions, so let me try to ask some -- one question at a time. Any consumer -- can you give us a sense of, with the stronger growth you saw in the first quarter what were some of the factors or products that were driving that growth, specifically the 16% growth in the core brands. And then I think in Consumer I had a second question, which I think is a clarification on the one you mentioned earlier. I guess you talked about, you're doing some commercial restructuring of sales forces and when we look at the marketing expenses, they didn't raise that much in the first quarter and I know you've been talking about increasing marketing expenses for this year. So were you implying that you're holding back on the marketing expenses until all the restructuring is fully complete? So if you could comment on those two issues, I'd appreciate it.

A - Mr. Claudio Bergamo

Just a moment, Lorre. And Lorre, hi, it's Claudio.

Q - Lorre Serra

Hi.

A - Mr. Claudio Bergamo

The growth there in the Consumer, the factor that grew more was the diapers. They grew ahead of the other businesses. And as you know, we have been conducting various efforts since last year to adjust economics of our diapers [ph] and also adjust deprivations of the diapers. So we have done quite a large amount of activities since last year. And that was started this year for this business specifically in much better shape than last year. So we have adjusted now the economics for the business, remind it is now what we wanted them to be. So and this is a sector that they react fast in terms of sales towards the dice [ph] and then on distributorship. So basically, let's say, the distance in the segment was the diapers. Okay.

Q - Lorre Serra

Thank you.

A - Mr. Claudio Bergamo

In terms of the commercial expense and then talking about more specifically on marketing, no, I think we did it -- actually consolidation overall on accounts hold. I think on media, on the contrary on the media, really had a very good exposure of our brands, and what I said in the Portuguese call and I said now in English is that, we have four trade deals specifically a budget that we need to accomplish in terms of percentage of sales. So we manage in a way that we don't pass over that percentage. So we pretty much keep that -- we want to keep that and maintain it as a -- on a fall back of our budget on a quarter-by-quarter basis. What probably we will see is in the second half of the year, in the Consumer sector, specifically an increase of the marketing expenditures even that we have a very large amount of new margins coming into the pipeline for the second half of the year. Okay. Hello?

Operator

(Operator Instructions) Thank you for queuing in this call. Actually, we have a follow up question from Lorre Serra, Morgan Stanley.

Q - Lorre Serra

Thanks very much. And I'm sorry to ask so many questions, but I also had two questions on the Pharma division. One question was, I mean, we've seen a lot of growth in sale in the last couple of quarters. And so when you mentioned the difference between the 4.5 and then very high growth in the IMS, I'm just kind of wondering, if you guys have a good view on what inventory levels look like at the retail level. So kind of how long this kind of difference between those two things can last?

And then secondly, I mean, the gross margin was very strong this quarter and you mentioned some of the reasons why, I'm just wondering, do you see this level sustainable as generics, I guess, it's still growing as a percentage of your mix. That would be really helpful, if you could answer those two questions please.

A - Mr. Claudio Bergamo

The level of inventories are -- actually kind of okay. I mean, we are developing than now since 2011 across 2012. We manage very closely the reliable of inventories at declines, especially at the large distributors. And we pretty much develop a policy what we want to be the minimal and the maximum, because we cannot have too much because then put pressure on our working capital and our commercial qualities. On the other hand, we cannot have two zero, because it can create stock-out problems for our products. So we are pretty much within the band.

I think we expect that the clients will take advantage of the price increases on March as they did that in the previous years and the demands. So, that's why our selling was lower than what we expected, but that (inaudible) neither our demand nor our stock levels, which we believe are adequate moving forward.

In terms of gross margin, as Bob asked and I think probably you listen that we have numerous amounts of activities going on at front levels after the consolidations and that's the improvement, the productivity improvement, re-manufacturing and et cetera, which give us full support for the levels of the margin we achieved, that we believe that if we continue implementing, all these improvements and opportunities we get there, the margin levels shall be sustainable.

The generics aspect of that, it's not something as the label being material for the mix even the generics is still something around 6% of our -- 6% to 7% of our total Pharma division. But, also generics with improvements at the cost (inaudible) most benefit of that, because the lower the margin the more that gives us benefits and our reduction in cost as opposed to be what you see but the margins are at high enough that the impact is much lower.

So, I don't believe that continues the generics would impact, because of the size, because of the improvements and last but not least, because also of the mix of launches that we are starting now launching generics that have less competition and that once are more profitable than the once that have more competition. So, that variables, that I think will support the gross margin levels. That's it.

Q - Lorre Serra

Terrific. Thank you very much.

Operator

(Operator instructions) Thank you. The Q&A session has now closed, Mr. Bergamo, would you like to make any closing remarks.

A - Mr. Claudio Bergamo

Thank you very much all for participating in the call. Our IR department is available to answer any further questions that may arise. Thank you very much and have a nice afternoon.

Operator

The conference is now concluded. Thank you for attending. You may now disconnect.