

Y 2019 Earnings Call

Company Participants

- Adalmario Ghovatto Satheler do Couto, Investor Relations Officer and Chief Financial Officer
- Breno Toledo Pires de Oliveira, Chief Executive Officer

Other Participants

- Emerson Sousa Vieira
- Frederico Mendes
- Gustavo Piras Oliveira
- Joseph Giordano
- Thiago A. Bortoluci

Presentation

Operator

Good morning. Welcome to Hypera Pharma Fourth Quarter 2019 Results Conference Call. Mr.Breno Oliveira, CEO; and Mr.Adalmario Couto, CFO and IRO are here with us today. We would like to inform you that this has been recorded during the company's presentation. Participants will be in a listen-only mode. We will then have a Q&A session only for investors and analysts. Further instructions will be given then. (Operator Instructions) This is being broadcast live over the internet at www.hypera.com.br/ir.

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

I'll turn over to Mr.Breno Oliveira. Mr.Oliveira. You may proceed.

Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Good morning, everyone. Welcome to our Q4 results conference call. I would like to start by talking about the independent committee. We are finalizing their work. We'll be submitting a report to the Board of Directors in April.

On Slide 3, let me talk about our operational results. Sell-out grew by 11.3%, over 10% for the third quarter in a row. This performance helped us increase our market share in several segments. 10% sell-out growth for the year, the largest growth in the past three

years. The Vitamin-D market has been very challenging with a 10% drop in a year, with a slowdown in the number of prescriptions. However, the remainder of our portfolio has grown dramatically at 12% a year, 1.2% above market average. That growth is the result of several initiatives to promote our sell-out in different areas in the company, especially in marketing and sales. We've changed our sales policy earlier in the year and we work towards sell-out.

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We have expanded our coverage in the POSs in the first semester. We would like to be closer to retail. We have about 1,000 teams -- or people in our team, the largest in the country. We have a 38% coverage in POSs in late 2018 to 50% in 2019, and we'll be increasing that to 73% in 2020. That coverage increase is important to leverage our sales, which is about 10% to 15% in the drug stores where we are present when compared to those that we are not visiting currently.

Digital investments increased with more exposure YouTube, Instagram and Twitter. We have increased our visibility actions in our distributor network that helped increased sell-out in consumer health as of Q2. We have reinforced our team of medical demand, hiring new employees to promote Mantecorp Farmasa. The team is almost 1,000 people, the most productive team in Brazil.

Finally, the Neopharma, our platform to relate with drug store products to expand our generic portfolio. With these initiatives, we have managed to reinforce our go-to-market platform and we are closer to our patients and the medical community and with drug stores are like. And we're still focusing on innovation, boosting our investments in R&D, expanding the pace of introductions.

On Slide 4 total investments in R&D are above BRL240 million in 2019, a 32% increase year-on-year, a new company record. Our innovation rate is 33% in Q4, the largest level in one quarter for the company. With the support of the business development team, we have over 390 projects in our innovation pipeline and 95 new products, 37 in Q4.

As you can see on Slide 5, in consumer health, we have (inaudible). Engov and Finn Nutritive. It will take the Finn lying to other categories other than sweeteners, reinforcing our presence in the food segment. Rizi and Rizi-M were introduced for rhinitis. And we have also -- for Ofolato D Fer also.

In generics, Rosuvastatin, a high complex generic to reduce cholesterol. Our innovation platform has also been updated. We introduced two new products Hypera Ventures, it's our venture capital initiative to invest in startups in health industry; and a Hypera Hub, our connection platform to promote operational processes and to create new products, services and sales channels. The speeding up of new introductions, more innovation, more products in the pipeline and solid investments in R&D state our commitment to the organic and sustainable growth of the company. We'll keep on investing organically to be a more complex portfolio and we will be considering marketing opportunities to supplement our platform just like the transformation acquisitions we'll be talking about on Slide 6.

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Just like we said just last week, in December 2019, we announced the acquisition of the Buscopan and Buscopan families, the second largest family in the OTC market with over 65% market share. We'll be paying BRL1.3 billion once approvals are obtained. Last week, we announced a Takeda acquisition in Latin America for \$825 million. Neosaldina, the third OTC brand in Brazil, referenced in headaches. Nesina, a patented drug over \$200 million sales. This is the first product for the diabetes market, driven the number two brand, great reputation among doctors. It's a portfolio that cannot be replicated.

There are several relevant opportunities in this acquisition, this is a transformational acquisition that states that we have an unrivaled brand portfolio. In consumer health, these brands will count our merchandising, our R&D structure and our expertise in line extensions. On top of that, we'll have more efficiency in terms of media costs, more strategic alignment, speed in our marketing actions.

In prescription drugs, we'll be adding supplementary brands in several medical specialties, that will benefit the work of our medical demand team. Hypera Pharma will become the largest pharmaceutical company in Brazil, leader in consumer health at 20% market share, twice as big as number two. In prescription, we have a sell-out of BRL2.2 billion.

I would like to conclude by talking about our guidance on Slide 7. In 2019, our net revenue was BRL1,189 million aligned with the guidance for the year. The pharmaceutical industry will keep on growing based on recent initiatives, so the company will be better prepared. For 2020, the guidances are: net revenue between BRL4.25 billion and BRL4.35 billion; net profit about BRL1.275 billion. To give you more visibility given the adjustments made in Q1 of 2019, we are giving you this guidance of net revenue for 2020 as well. This guidance is not including recent acquisitions. We may adjust them as these deals are finalized.

I'll turn over to Adalmario. He'll be talking about the quarter results and the year results in more detail.

Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

Thank you, Breno. Good morning.

Let me give you a summary of the highlights of the year and the quarter. Net revenue is BRL3.3 billion under the sell-out performance due to prescription sales drop and consumer health for the Q1 in 2019. When we changed our sales policy, we reduced our inventory levels at customers' inventories. Q4 last year, we had stable sales, despite a two digit growth and sell-out.

More water availability in our industrial facilities in Annapolis as a result of longer droughts in the region in 2019. Less water availability affected or had affected Q3 production numbers and that extended to Q4 negatively impacting our lines. We had less availability of some products and that hit our gross margin. Q4 sell-out was not affected.

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Production is back to normal now. We doubled our storage capacity by acquiring three new tanks, and we're drilling new wells and we're also acquiring new water tanks and implementing equipment to reuse our cooling tower waters. That was affected for a concentration of smaller gross margin products in our net income. The impact was 4 percentage points in Q4. Margins were also impacted and almost 2 percentage points, given the higher costs due to idle times. As a result of more effectiveness, more production and more water availability. The impact was about 80 basis points as to smaller costs in our payroll. The EBITDA margin was 24.1% in Q4 when compared to Q4 2018. That was because of the drop in gross margin and more investments in R&D.

Let me point out that in R&D, tax benefit was BRL2.8 million, in Q4 2018 was BRL15.8 million. That impacted R&D investments. Net income from continuing operating was BRL246.7 million. It was above BRL22 million. That is because of the income tax rate reduction because of more interest in own capital accounted in this quarter. Net income was up 4.5%, reaching BRL1,189 million in 2019 in alignment with the guidance given for the year.

Net income growth was hurt by the rate of products sold given exchange rate devaluation. On the other hand, net income growth was benefited from the income tax rate, a 10% increase in interest on own capital, and BRL92 million from tax credits in late 2019.

As to cash flow on Slide 9, the operational cash flow was BRL824 million, impacted by the sales of prescription and consumer health sales that were smaller in Q3 and when we reduced our inventory levels. CapEx, our fixed assets almost doubled in 2019 when compared to last year, with additional investments to expand production in Annapolis to support our growth in the years to come. Free cash flow amounted to BRL466 million for the year, helping the company to have a net cash position of BRL828 million, BRL216 million once we pay interest on our own capital made in January.

In Q4, we issued BRL800 million debenture, long-term debenture to reinforce our investment capacity. Let me point out, we have a first-line bank credit line to finance these acquisitions that Breno talked about.

I'll turn over back to Breno for his final remarks.

Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Thank you, Adalmario.

Before we start the Q&A, let me point out that we are much better off this year than the beginning of 2019. We had a major impact in gross margins in Q4, it's a non-recurring fact and we'll be recovering that margin between 65% and 70% in 2020. We made necessary adjustments last year to prepare the company for a new expansion cycle this year, acquiring new brands, not losing focus in our sell-out in our innovation pipeline, introducing new products supported by investments in our productive capacity

investments. That's how we are prepared for the 2021, both to grow in our current brands and expanding our brand portfolio.

This market has shown to be resilient, growing more than double than the market average. This industry is directly connected to the demographics change of over 200 million people in the country. That trend should remain in the decades to come. We believe that we are the company that is best prepared to benefit from these opportunities. Results will come in the years to come.

Now, we can start our question-and-answer session. Thank you.

Questions And Answers

Operator

(Question And Answer)

Okay. Let's start our Q&A session. (Operator Instructions) Mr.Gustavo Oliveira from UBS is first.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

Hey, Breno and Adalmario. Thank you for taking my question. I would like to better understand the discounts. And my second question is about vitamins, a weak category in 2019. Do you expect any recoveries in 2020, especially because of the coronavirus, do you believe that there may be impacts in that area? And my final question is about the gross margin, that was well below expectations. Thank you for the guidance, that helps a lot.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Let me answer the first two questions, and then Adalmario will field the one about gross margins. We were very aggressive in 2019, especially on consumer promotions. As we said that during the hot day, for 2020, investments will be more balanced in terms of discounts, agreements and allocations and media, and medical visitation. For 2020, the discount level should be reduced when you compare that to the sales.

Let me now address the vitamin market. In Vitamin-D market, just last year, we introduced other products. We introduced the Vitasay 50+ for -- in consumer health. As of the middle of the year, it's gained -- been gaining traction in recent months and central markets [ph] and the generics segment. We haven't detected any demand increase for vitamins, because of the coronavirus. There may be some in vitamins and flu medicines we've seen that happen in the U.S for flu medication. No, we don't have any problems there. haven't detected that growth here yet.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

And what about the production of these categories?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

There aren't any production problems whatsoever in these categories.

Q - Gustavo Piras Oliveira {BIO 15129435 <GO>}

Vitamins and flu medication?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

No, we don't have any problems there. We've been growing substantially environments, we are planning to expand that production facility. There aren't any limitations to meet that demand in these areas. We had some problems with the flu medications Benegrip in Q4, because of the water problem that Adalmario mentioned, but production is back on track. There weren't any shortages of products. As of March and April, inventory levels should go up for the winter, but guarantying the impacts in the sale of these products.

A - Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

Let me talk about the gross margin now. That was highly impacted in this quarter, because of that supply, the water supply problem in Annapolis. That's why the mix was more unfavorable, focusing in similar products. They ended up bringing the gross margin down, about 4% down. But it shouldn't happen in the quarters to come. Just like Breno said, we are going to be more effective as far as discount goes,

waste was a little over what we believe to be normal. But we stated in previous calls that we're taking action to reduce the number of waste, but that is due to the sales policy change in Q3, expected margin out waste will be smaller and returns will be down too, that was higher than expected in Q4. These are the initiatives we have some control over. Exchange rate cannot be controlled. We have been keeping track of recent. We can anticipate purchases, but there may be some stresses in 2020 margin. We're working at the 420 level. The margin would go back to 65% to 70%. Part of that exchange rate effect may be offsetted by price changes in April 2020.

Operator

Joseph Giordano from JPMorgan asks the next question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Good morning Bruno, Adalmario. Thank you for taking my question. My question is about the production impact. Do you have any backlog of orders that were not delivered in the quarter that would impact positively Q first? It's difficult to make the comparison year-on-year, but still.

My second question is about FX. Are you hedged to acquire Takeda? You have recently announced that acquisition. I would like to understand whether there's a change in the value.

And my final question is about supply chain. What about your supply chain in India and China. India is not exporting drugs any longer, what about your API suppliers in China and India? How are they behaving?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Hi. This is Breno. Let me answer your first question about the backlog. We have orders from Q4 that were not fulfilled due to those problems, there was about BRL15 million in our net income. Water supply is back to normal. The plant is resuming its normal production. We cannot replenish inventory levels in Q1, some of it, but we will go back to normal in the first semester. We cannot expand our capacity even further, to replenish our inventory levels -- our customers' inventory levels.

As to the supply chain, most of our APIs come from China. Our number one supplier is China, not so much India. In China, what we see is the resumption of shipments after the Chinese New Year, shipments are almost back to normal. There were several logistics problems, that delayed about three weeks, a week, a month, the resumption of raw material shipments. We carry inventory of these products. It will depend on how soon things go back to normal. It's too early to call.

As to FX, Adalmarco mentioned in the last call, is to -- the intention was to hedge part of that amount in U.S dollars to prevent ourselves from a worst case scenario. We started out that process, but we did that very quickly. Let's wait for things to sell a little bit, but we're still exposed in U.S dollars. Thank you.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you, Breno.

Operator

Thiago Bortoluci from Goldman Sachs.

Q - Thiago A. Bortoluci {BIO 20909105 <GO>}

Good morning. My question is about the revenue guidance. The range indicates major growth. What's the expectation you have behind the sell-out? And how do you include the market growth expectation in there as well? Thank you.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

I didn't quite understand the question.

Q - Thiago A. Bortoluci {BIO 20909105 <GO>}

How do you compare that to the market growth expectation?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

You mean the sell-out market growth, is that what you mean? What's implicit there is the level we're reaching as of the Q2 low-double-digit growth. That's above market. Market data states that will be about 8.5%, 9% growth. These are the premises we have behind the guidance, having to sell-in equal to the sell-out.

Q - Thiago A. Bortoluci {BIO 20909105 <GO>}

So is it fair to expect more market share?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Yes. That's what's implicit behind the numbers.

Q - Thiago A. Bortoluci {BIO 20909105 <GO>}

Great. Thank you.

Operator

Frederico Mendes from Bradesco asks the following question.

Q - Frederico Mendes {BIO 19832788 <GO>}

I have two questions. My question is about advertising. How much can you reduce advertising in 2020, maybe promoting more in the points of sale? And in R&D, there was a major growth in 2019, and the pipeline for 2020 seems robust. What can we expect there in 2020?

A - Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

This is Adalmario. For some time now we have been balancing our marketing investments overall. As you know we have been more active in points of sale, more and more doing so, trying to look for the best places and reassessing our market investments.

By doing so we have managed to negotiate very attractive packages with traditional media outlets, people with whom we have worked for quite some time. We have managed to increase our visibility at a discount or with more attractive packages overall. So reducing investments in advertising come from these initiatives.

What was the second question again?

Q - Frederico Mendes {BIO 19832788 <GO>}

My question was about R&D. It seems that you have a very robust pipeline for 2020. I would like to have more detail on that, please.

A - Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

We intend to keep on investing. As Breno said, we have about 400 projects. So the number should arise even further. In nominal amounts, that would grow by 10% when

compared to 2019 numbers.

When you take that as the income percentage, that will be diluted because income will grow in 2020. 2019 was the first year in which we assessed our complete R&D with almost 100% of our capacity, and the intention now is to develop projects throughout time.

Q - Frederico Mendes {BIO 19832788 <GO>}

Thank you, Adalmario. And thank you, Breno.

Operator

Thiago Macruz from Itau BBA, asks the next question.

Q - Emerson Sousa Vieira {BIO 20756065 <GO>}

Actually, this is Emerson. I think you've answered most questions we had. What's the impact of Lei do Bem? Do you believe you should increase R&D investments because of these benefits?

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

The results from that Lei do Bem, we expect a positive contribution greater than that of last year. We cannot benefit from that investments. Our expectation for the year is about BRL20 million out of those benefits.

Q - Emerson Sousa Vieira {BIO 20756065 <GO>}

Great. Thank you.

Operator

(Operator Instructions) Thank you. This concludes the Q&A session. I'll turn the floor back to Mr.Breno Oliveira for his final remarks.

A - Breno Toledo Pires de Oliveira {BIO 17653260 <GO>}

Thank you for attending this call. Let me state that we believe in the growth potential of the pharmaceutical industry in Brazil. This should be driven by the uptake in the economic situation of the country and the age of the population. Hypera Pharma is the company that is best prepared to capture that growth. Our IR team is available to clarify any questions you may have about the numbers and the acquisitions. Thank you.

Operator

This concludes Hypera Pharma call. Thank you for attending. Have a good day.

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