Q2 2013 Earnings Call

Company Participants

- Breno Oliveira, IRO
- Claudio Bergamo, CEO
- Martim Mattos, CFO

Other Participants

- Alex Robarts, Analyst
- Andrea Teixeira, Analyst
- Loredana Serra, Analyst
- Magash Chasae, Analyst
- Robert Ford, Analyst
- Tobias Stingelin, Analyst

Presentation

Operator

Good afternoon. Welcome to Hypermarcas' Second Quarter of 2013 results conference call. Today with us we have Mr. Claudio Bergamo, CEO; Mr. Martim Mattos, CFO; and Mr. Breno Oliveira, IRO.

We would 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 when further instructions will be given. (Operator Instructions)

We would like to inform you that questions can only be asked by telephone. So if you are connected through the webcast, you should e-mail your questions directly to the IR team at ir@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 that statements 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 will turn the floor over to Mr. Claudio Bergamo, who will begin the presentation. Mr. Bergamo, you may begin your conference.

Claudio Bergamo {BIO 16015846 <GO>}

Thank you very much. Thanks everyone for attending Hypermarcas' conference call to discuss the results of Second Quarter 2013. Starting on page 5, in the Second Quarter of 2013 Hypermarcas continued its strategic plan of sustainable, profitable organic growth with cash flow generation and net debt reduction based on the organic growth of its brands, superior operating profitability and cash flow generation with net debt reduction.

As seen on page 5, after a soft start in the year, Hypermarcas sales accelerated in the Second Quarter of 2013, reaching net revenues of BRL1.069 billion. This numbers represents organic growth of 11.7% on the same basis comprised -- compared to the Second Quarter of 2012.

This acceleration occurred in both divisions of the Company, especially in Pharma which achieved net revenues of BRL601 million with organic growth of 13.3% on the same basis comparison. The Consumer division had a net revenue of BRL468 million in the quarter with organic growth of 9.8% on the same basis, excluding -- on the same basis.

Excluding brands and SKUs that were discontinued in 2012, core brand growth was 14.6%. It's worth to highlight that this growth of both divisions and the Company reflects the consistent and current implementation of the strategic plan launched still in the fiscal year of 2011 to achieve sustainable, profitable and organic growth.

As can be seen on page 7, in the Second Quarter of 2013, our Pharma division reached again another record sell out demand of over BRL1.3 billion, measured on the list price by IMS Health in the quarter. The division also reached a record market share of 8.9%, demonstrating that the demand for our products in the market are still very strong.

It is also worth to highlight that in the times of high volatility in the macroeconomic environment, that like the one we are experiencing in 2013, low ticket price portfolios and daily use products like ours tend to be more resilient and so less volatile than products that are more dependent on credit and discretionary consumption, such as durable, semi-durable goods as well as (apparel).

This feature can be seen on page 8. In the recent evolution of the growth rates of retail markets according to IBGE, which shows that growth in the Pharma and Cosmetic categories such as ours ranged between 8% and 12% in real terms while Brazil's total retail market has actually dropped in 2013. These dynamics also contributed to the Company's growth in the quarter.

We can highlight also that Hypermarcas has a consumer standard type of portfolio. And the most relevant variables for our sustainability of our business is employment and total wages. As can be seen on page 9, in spite of recent macroeconomic volatility, we still have in Brazil a very rapid acceleration in both of these variables. Recent employment rates close to 6% and still a rising total wage in spite of persistence of both target inflations. Both variables support our business in the mid and in the long terms.

In term of operating results, as can be seen on page 10, we highlight that the Company has been executing a series of actions aimed to reduce the cost of its operation and improve the productivity of its labor force and the allocation of its resources. The Company reached in the quarter a record level of adjusted EBITDA in the amount of BRL258 million, with a growth of 14.9% compared to the same period of 2012.

This growth was higher than the revenue growth of 11.7%, given that the Company managed to improve its adjusted EBITDA margin from 23.5% to 24.1% in the quarter.

It is important to understand the reason of this improvement, as can be seen on page 11. A great portion of this improvement comes from the gross margin increase in our business to 65.8% in the quarter, 3percentage points above the gross margin in 2012; as well to the 0.4percentage point drop at the SG&A expenses, excluding marketing, in spite of the 1.1% increase in the investments -- in the marketing investments of our brands. Our efficiency gains allow us to invest more in our brands and even so deliver our results.

The gross margin increase can be attributed among other factors to the improvement in our plants, with productivity gains, increase in production and scale as well with the (inaudible) and consistent management of our commercial policies.

As can be seen in the next page 12, the productivity of our Pharma plant grew materially, more than doubling over this past six quarters to a record level of more than 1,500 units per employee per day. This is the result of a long, hard continuous work that we have been doing in the plants by the (inaudible) manufacturing products.

During the quarter also, as can be seen on page 13, we had more than 25 campaigns to support many of our brands, such as Doril, Apracur, Paixao, Fluviral, Pom Pom, among many other that are now on TV and radio. Much of our marketing investments has been dedicated to a continuous improvement of the exposure of our brand in the point of sale, as can be seen on page 14.

We are far from reaching the ideal point. But we are progressing daily consistently so that our products can get the right space they deserve, leading brands that achieve continuous -- that receive continuous marketing and demand generation in brands. It is a work that has been done together in the partnership with several of our clients, intensified by the new sales structure we introduced in 2013.

Also. And not less important, as can be seen on page 15 and 16, we restructured the whole innovation process in the Company. We have today a continuous pipeline of launches in both divisions, in Pharma and Consumer. In Consumer, we launched in the quarter new shapes and packaging of Pom Pom diapers, mouth-washes and new tooth brushes in the Sanifill line and also bath line of Cremer Disney brand.

The new nail polish collection with Brasil por Risque order also reached the market. In Pharma we launched, as can be seen in page 16, Rinosoro Jet, new package for Neo Quimica brands in the segment of generics and branded generics, in addition to the new versions of Predsim in our prescription line.

Summing up, as you can see in page 17, we have a good Second Quarter putting us on track to deliver the guidance that we announced for the year of BRL550 million (sic-see presentation slide-13 "BRL950 million") in EBITDA. In the first half of the year, Hypermarcas accumulated a net revenue of BRL2.028 million, with a growth of 9.4% and an adjusted EBITDA of BRL485 million, with a margin of 23.9% of net revenue, in line with the goals defined by the Company.

Thanks all for the attendance and I will now hand over to Martim, who will discuss the numbers in more details.

Martim Mattos {BIO 16015889 <GO>}

Good afternoon, everyone, Martim speaking. On page 19, beginning from the net revenue, the quarter had an acceleration of the growth in Pharma after a First Quarter of lower weak purchases by our client, resulting in organic growth of 9% in the first half of the year. In Consumer, the growth seen in the First Quarter was maintained. With that, the consolidated growth in the quarter was up 11.7%.

On the next page, we can explain the good gross margin growth of 3percentage points to 65.8% by a mix effect of 1.1percentage points influenced mostly by the purchase volume rationalization in Consumer and by a margin effect of 1.9percentage points as a function of better productivity in Pharma and result of the consolidation of the customer operations in the state of Goias.

Flipping over to page 21 which talk about operating expenses, the year has been marked and should continue to be by a higher volume of marketing investment. This increase was of 1.1percentage points in the quarter to a level of 20% of net revenues. In the first half of the year the accumulated increase was of 70 bps. SG&A expenses, ex-marketing, which is mainly composed of fixed expenses, increased less than the net revenue expansion, leading to a 40 bps dilution in the quarter.

On the next page we see that the adjusted EBITDA reached the amount of BRL258 million in the quarter, a record (14.9%), with margin of 24.1%. It was possible to reach this amount because of the strong gross profit increase in spite of the higher marketing investments.

Net income in the quarter, on page 23, was of BRL19.3 million, increasing almost BRL50 million compared to 2012. In spite of the negative FX variation of about BRL150 million in the quarter, with the good operating result and the reduction of the net debt cost, it was possible to achieve a positive net income.

On the next page, the free cash flow was of BRL85 million in the quarter and of BRL27 million after interest expenses. The accumulated amount invested in the year is at BRL115 million, with stable cash conversion cycle compared to the First Quarter of this year at 100 days, in spite of the temporary increase in our inventories related to the transfer of our production to Goias.

Once again, we were very satisfied with the results of this quarter and we hope that you are as well. These results are in line with our expectations -- our internal expectations and in accordance with our strategy of sustainable profitable organic growth with cash flow generation.

Thanks everyone for the attention 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)

Robert Ford, Bank of America Merrill Lynch.

Q - Robert Ford {BIO 1499021 <GO>}

First of all, congratulations on the results. I thought they were very impressive. And when you look at the acceleration of revenue in the Second Quarter, despite some of the tiny issues in the First Quarter and within the context of a deceleration in many other consumer segments or the adverse consequences of food price inflation putting pressure on discretionary income, Claudio, I know you said that the category is growing. But nevertheless can you talk a little bit about what you are doing in terms of the sales efforts, in terms of the innovation, in terms of maybe some of the pricing and segmentation strategies to distinguish this performance? And what expectations do you have and what levers do you have at your disposal over the balance of the year to drive that revenue along?

A - Claudio Bergamo {BIO 16015846 <GO>}

Thanks, Bob. Well in fact, as I said, despite all these uncertainty -- macroeconomic uncertainties and volatility, our category as a whole has grown in both markets something around 13% in the first half of the year compared to the same period of last year. I think, as I said, a great portion of that is that when the disposable income for consumption, when -- it's less used in the durable and semi-durable.

At the end, the disposable income for consumers (and for) products ended up growing up. But that's just hypothesis. That's what I have been seeing in my experience in Brazil. And despite the fact that you talk about a lot high inflation levels in Brazil, it is important to notice that still the increase in wages in Brazil has been on the top of and above the inflation levels. So that the total disposable income is still growing up and our employment is still very low historically saying. As -- we believe that the structural variables continues there and then we still have a good platform to continue securing the type of initiatives that we have been doing.

Coming to the second part of your question, the key variables we have been pursuing first is an improvement in distribution and in the shelf space. A great portion of our marketing budget has been dedicated now to executing better at the shelf. We increased our direct sales to clients from what we prior have around 2011 to up to now, now from around 20% to 40%. Nowadays we sell directly to clients something around 40% and 45%. That does give us a very good opportunity to be close to the shelves and a better management of shelf space of our brands.

As you know, more than 80% of our brands are number one and two brands. So -- and we continue investment in the (new generations) either through medical doctors visit or high media things in the channels so that to reduce reserves in many categories, a better space and better management. So I think that one of the key variables that we have been pursuing, to do that we had restructured our sales force in the beginning of this year strongly. We still have the opportunities to improve a little further. But clearly this is one of the key areas that we have been pursuing.

Our second area, it is the innovation process. We had somewhat retained some of our relaunches because we want to first to restructure the sales force before we accelerated our launches of new products and new -- and the brands. So now we believe that we do have a much better execution out there in terms of sales and merchandising. So we already have introduced some new launches in the first half. But we will accelerate these launches from second half moving forward.

I think they are the two main areas. I think another important area that the amount of investments in marketing as we grow and total scale, we continuously grow our total marketing budget and our -- the productivity of that marketing budget as well. And -- so that we can sustain properly our brands and continue to invest in the launch of many of them. So I just addressed some of the changes. I hope I have answered. If you have any further clarifications.

Q - Robert Ford {BIO 1499021 <GO>}

That's very helpful, Claudio. And just back to the gross margin improvements, right. They are phenomenally impressive. And when you look at the Pharmaceutical business which arguably is much further down the road in terms of consolidation, you still increased the gross margin by 180 basis points, Consumer products up over 4percentage points. And there you are in a very incipient stage in terms of consolidating operations at Senador Canedo.

And I was curious, when you look at Pharma specifically, right, which is probably the canary in the coal mine or the model for what we can expect in the personal care -- the Consumer division, can you talk a little bit about your -- the scalability of your manufacturing facility? What kind of capacity utilization do you have now. And as you begin to consolidate the remaining operations from Mantecorp?

I think you mentioned in the press release that you consolidated some of the semi-solids and that sort of thing. What kind of improvements do you expect? And the growth that you must be having upon the generics is pretty heady, right. So you are -- I am just curious how much more operating leverage you see in that business and what kind of a lift do you think you can get from the existing -- consolidation of the existing manufacturing facilities from Rio?

A - Claudio Bergamo {BIO 16015846 <GO>}

Yes, I think you got a -- you're touching a good important point, that the way we designed the Anapolis site is really to be the most effective and the lowest cost producer in the industry. And in fact all the growth that you have been seeing in both our singulars and in our generics business, given all the investments we have made, are creating what I call a vicious cycle in the plant because we are increasing productivity. But at the same time increasing the -- reducing lead times, simplifying the flows. But at the same time we are gaining a very high scale for one site only.

And that allows the reduction cost of not only the generics, it's (technical difficulty) and singular. But allows the reduction of course of all manufacturing products, given that the fixed costs are diluted among the higher volumes that we have been achieving in that plant. We have been achieving production record levels every month and we have already -- I have already allowed an increase in capacity that will be implemented by the end of this year. So we will be able still to continue growing the production level. We have enough capacity. And as you grow that process -- also you mentioned an important process, the Mantecorp integration. We are on schedule on Mantecorp integration; we already ended the liquids integration. And we expect it to have fully integrated by May and June next year.

So that again will improve more -- will bring more production level into the plants. And as we continue -- if we continue growing as we have been growing in the singulars and generics and with Mantecorp, that plant will continue gaining scale and by gaining scale we should expect -- we shouldn't have any reasons to not expect continuous further dilution of fixed costs and efficiency improvement.

So just to give you a figure, our production level in 2011 for that plant was 26 million units. In 2012 was 37 million units. And this year it's 43 million production units per month. And we are already running in the last month around -- something around 50 million units. So basically we more than doubled the production in that site. And frankly I think that we are continuously moving forward on that chain.

Q - Robert Ford {BIO 1499021 <GO>}

What's the current installed capacity if you are running right now at about 50 million units, kind of peak month production?

A - Claudio Bergamo {BIO 16015846 <GO>}

Well depends on -- it's line by line. It is very diversified. But we do have enough capacity now. Capacity is not an issue. And also capacity addition is (technical difficulty) (cheap).

Just to give you an idea, one of the areas we could have some capacity constraint, which is the solids for generics and singulars. We allow (inaudible) an increase in 20% capacity, bringing two new equipments and that BRL50 million CapEx.

So it is an investor that you can get, did not suffer capacity, in a timely manner and with low CapEx. So capacity is not an issue. What is an issue, infrastructure. What is important to understand is the infrastructure, which is the toughest thing, even from a cyclical plant, is the quality department, the registration. And these are (technical difficulty) and the air-conditioning. So this is what the expenses, is the infrastructure. Once you get that, to increase the capacity itself, which is buying new lines, this is not expenses.

Q - Robert Ford {BIO 1499021 <GO>}

And are there any visa delays with -- or approvals required for any capacity expansions if there is nothing structural?

A - Claudio Bergamo {BIO 16015846 <GO>}

No. We are all on schedule. We have done very well. Actually, the opposite; we became -- foreign visa, they ask us to bring people from all other countries to use our site as an example of a site from (inaudible) in Brazil. So we had been allowing -- we had been receiving visas from people from all over the world into our site looking to the -- as a model.

Q - Robert Ford {BIO 1499021 <GO>}

Thank you very much. And again congratulations.

Operator

Andrea Teixeira, JP Morgan.

Q - Andrea Teixeira {BIO 1941397 <GO>}

It's actually Andrea Teixeria from JP Morgan. Just as a -- and thanks again for taking my follow-up question on the English call. Just, Claudio, you obviously you had a great result. But one of the things that we wanted to clarify also in terms of the taxes. I mean there is a lot of moving parts on the tax benefits and potential changes.

You have any update on that in terms of the discussions we have been seeing not only how you could potentially impact on the changes in the taxes through the states, which I believe was kind of like set aside. Negotiations with one of your biggest customer is not taking the benefit of your -- of the tax situation and in the taxing incentives that they might have. So any pressure you are seeing in terms of negotiating prices on the back of that or -- and also anything on the changes in -- the proposed changes in tax? I would appreciate. Thank you.

A - Claudio Bergamo {BIO 16015846 <GO>}

Well I don't know -- I mean let's talk about the overall tax and government because with clients, zero problem, no problem at all. On the government proposal, basically that was put into the (Madaveta). How do you -- for discussions. Given that the political moment now that the government, central government increasing, I think it's very hard to form the (campaigns) in the Congress now. To be frank, I think it's almost an impossible mission given that the benefit is very questionable, is questionable for -- at regional development point of view, it's questionable as to -- in terms of as a fiscal, state fiscal fitness. States would loose revenues.

So this is very tough now to cash in Congress the loss of revenues for each state at this point. But we know that many states are suffering a lot because of what government -- central government did in terms fiscal incentives. Because if you don't know -- I don't know if you know. But many of the central government incentives like IPI for automotives or even physical things from (technical difficulty).

Q - Andrea Teixeira {BIO 1941397 <GO>}

Zero. Okay, interesting.

A - Claudio Bergamo {BIO 16015846 <GO>}

No, zero problem. Because our clients if they don't want to get from -- they have so many warehouse around Brazil. So they can buy from whatever they want. But zero problem, we don't have any problem in Sao Paulo.

Q - Andrea Teixeira {BIO 1941397 <GO>}

That's great. And one last question, in terms of your -- how the moving parts -- and I know it can be a question to you, Claudio, to Martim, to Breno, on the potential -- on the changes. And I understand that you are having a better cost of capital now on your debt given that you are deleveraging. And if you can, I guess qualify what you're expecting?

And lastly on your -- there are some assets that maybe put up for sale, real estate assets. Do you have any timeline on those? I would appreciate. Thank you.

A - Martim Mattos {BIO 16015889 <GO>}

Andrea, Martim. In terms of cost of capital, we've been seeing -- well, we saw some upgrades recently from the rating agencies, as a good indicator that the cost of Hypermarcas' capital is decreasing as we improve the operating results from the Company. I think a good reference is this recent issuances of debt at a cost of 110% of the CDI.

And this of course helps us to manage the financial side of the Company, the balance sheet of the Company. But at the end it doesn't change our policy, our desire to maintain a trend of deleveraging the Company, both in terms of -- both by the contribution of the free cash flow after interest expenses and also obviously through the increase of EBITDA. So we have been seeing a decrease in the leverage of the Company over the past few years and we are doing our best for that trend to continue.

Q - Andrea Teixeira {BIO 1941397 <GO>}

Great. Thank you, Martim. And on the assets?

A - Martim Mattos {BIO 16015889 <GO>}

In terms of the assets, we have stated before that we have a few either currently non-operating assets or that will become non-operating in the near future. We have the intention to divest some of them. But those are big assets and may take a while before we can achieve that. We have been already working with that hypothesis, trying to reach possible buyers. But I would say it's probably in two years, time frame of up to two years before we finish the divestiture from all of them.

Q - Andrea Teixeira {BIO 1941397 <GO>}

Okay. Great. Thanks Martim. Thanks Claudio.

Operator

Tobias Stingelin, Santander.

Q - Tobias Stingelin {BIO 1557190 <GO>}

Yes. Thank you very much again for the follow-up in the question. I wanted to understand in regards to the provisions. It seems to me there was a big reduction in tax provisions during the Second Quarter in regards to something called (inaudible) in state of Sao Paulo, some sort of renegotiation of outstanding liabilities.

Can you please just explain exactly what it is and where I can find on the balance sheet the reversion of the provision -- on the income statement the reversion of the provision? Thank you very much.

A - Martim Mattos {BIO 16015889 <GO>}

Tobias, this is related to a contingency of ICMS that was already deemed probable loss that with the program of Sao Paulo state to renegotiate the debt of the companies with the government. We decided to enter that program of paying that amount in installment. So what we chose at the end was to pay it to reduce all the possible fines that we would have if we were to lose that discussion. So entering this program, we are not paying those fines, which is a significant amount of, if I'm not mistaken, 50% of the total amount. So with that, our total debt in that case was reduced by approximately -- to approximately 60% of the original amount. And we will pay that in approximately 60 months.

Q - Tobias Stingelin {BIO 1557190 <GO>}

Great. And where was it booked on the income statement, the reversion of the provision, in which line?

A - Martim Mattos {BIO 16015889 <GO>}

Considering it was already -- we had already a provision of that. So the expense of that entering the process was against the provision. So it doesn't affect the result.

Q - Tobias Stingelin {BIO 1557190 <GO>}

Perfect. Okay. Thank you very much again for the follow-up.

A - Martim Mattos {BIO 16015889 <GO>}

You're welcome.

Operator

Alex Robarts, Citi.

Q - Alex Robarts {BIO 1499637 <GO>}

A couple of things here, I mean just going back to the Consumer gross margin. A lot of questions in the Portuguese call and I kind of wanted to kind of get a sense when we look out here in the second half of the year. So you mentioned a third of this 280 basis points of expansion in the first half of the Consumer gross margin kind of related to the portfolio brand rationalization.

Then I guess in the two-thirds that's left there is a piece that is related to the fiscal tax incentives between the states. And I guess there is obviously some gains that are ongoing from Senador Canedo.

So a piece of this, it seems to be, is going to start to cycle out. And I guess when I think about second half there is a -- it's a tougher comp year on year. And if we keep kind of this view that sales are steady, guys, could you get a sense -- could you give us a sense of second half in that Consumer gross margin? Do you think it will be as -- as why the expansion of the 280 basis points or might it be a little bit less or stable? Any color on that would be great.

Secondly, marketing expenses on a consolidated basis, obviously a source of a lot of questions as well earlier. And one of the things that I didn't feel was addressed and it would be great to understand your point of view on this, I mean now that we are a little bit more on the percentage of sales than perhaps what you would have thought at the first part of the year. And understandable given the market. But 30% increase in the trade deals both in the quarter and in the first half year on year.

Could you talk a little bit of what's behind that increase in the trade deals? Is it the pricing? Is it the negotiation are a little bit more competitive? I mean that would be great. So that's question number two.

And the final question really goes back to the free cash flow idea. I appreciate you talking about the quarter-on-quarter cash conversion cycle. But when we think about and looking at your presentation of the free cash flow, it was down 50% in the quarter year on year.

And I think just to understand, is this really just because you got this temporary additional inventory currently or could it be related to the fact that the base of comparison with the cash flow last year was a little bit more outside than usual because that's kind of when you started to really get some of the working capital gains? And so is it just a comparative issue on working capital or is it something else that might bring this free cash flow down year on year into the second half? That would be great. Thanks very much.

A - Martim Mattos {BIO 16015889 <GO>}

Alex. So continuing on the question that you had on the Portuguese call -- sorry, for that. But it's better to talk with more time. So all -- starting over by the gross margin effects, just to clarify exactly what has been happening. So when we look at the Second Quarter, we had a 3% or 3percentage points increase compared to the Second Quarter of 2012. That is composed an increase of 1.8% in Pharma or percentage points in Pharma and 4.1percentage points in Consumers.

So when we look at the Pharma expansion of 1.8percentage points, the mix effect is close to zero and the margin effect is 1.7percentage points. And when we analyze that and we see the productivity gains in Anapolis, that's why we are exhibit to better profitability with an increase in the Pharma margin.

When we talk about Consumer doing the same analysis, we had a mix effect of 1.9percentage points and a margin effect of 2.2percentage points, totaling 4.1percentage points. The mix effect, 1.9percentage points, is mostly explained -- approximately 70% of this is explained by the rationalization of SKUs. Last year we were selling a lot of them, this year not any longer. So the mix this year is much better than last year.

The rest of the effect is a 2.2percentage points effect in margin, that is a mix of the several -- as you mentioned yourself, the several advantages of going to -- or of start -- producing in Senador Canedo. So totaling the 4.1percentage points. So when we look at the next quarters and second half of the year in Consumer, the mix effect -- you have to recall the fact that we started that process of reducing the number of SKUs by the second half of last year. So that will start -- we will have a complete cycle of that. So if you think of expansion, it's a big challenge to maintain the same level of expansion of 4percentage points when we look at the second half of 2013 compared to the second half of 2012. And I hope with that we have clarified a little bit better the questions on gross margin.

Q - Alex Robarts {BIO 1499637 <GO>}

Yes.

A - Martim Mattos {BIO 16015889 <GO>}

Talking about the cash flow, I think you got the right view about it. If you are looking nominal terms and especially if you compare as you are comparing the Second Quarter free cash flow with Second Quarter of this year free cash flow, it was reduced. But mostly because on the first half of last year we were going through the advantages of having increased the payment terms to our suppliers.

So -- but cash was not -- leaving (inter-margins), we were not having to pay for sometime our suppliers given that the terms of payments to them were being increased. And when we reached this year, it is much more normalized that effect. In any case if you compare the first half of 2013 with the first half of 2012 in terms of nominal operating cash flow, you will notice that the difference is not as great as when you look at the Second Quarter compared to the Second Quarter of last year.

And analyzing further these movements, the swings in the -- in our working capital, the Second Quarter and also the first half of the year that difference is -- it is 100% explained by the excess inventories. It is not explained by changes in payment terms or in our suppliers if you net those effects. So that's why we have been talking about the additional inventories when we analyze this line of our cash flow.

Q - Alex Robarts {BIO 1499637 <GO>}

That's very helpful. And just on the marketing expenses?

A - Claudio Bergamo {BIO 16015846 <GO>}

Yes, on the third issue, on the marketing expenses, if you look on both -- as you said, on line by line effects, in fact the one that's growing most is the trade marketing expenses. And that's basically consistent with what we have said when we set our guidance for the year, that we said that for this year we would increase that budget objective to improve -- that goes in line with the objective of improving our distribution, improving our shelf space in the stores. So that's pretty much consistent with that strategy.

Q - Alex Robarts {BIO 1499637 <GO>}

Okay, got it. Thank you.

Operator

Loredana Serra, Morgan Stanley.

Q - Loredana Serra

Just a couple of quick follow-ups. So with the comments you are making on gross margin, I appreciate it, Martim, the color you gave on the Consumer in the second half of the year in terms of the rationalization already happening. But if you look at the current level of -- and all the stuff that drove the gross margin improvement this quarter, all of that is sustainable. Is that a fair statement?

A - Martim Mattos {BIO 16015889 <GO>}

Yes.

Q - Loredana Serra

Okay. Then just briefly on the cash flow, I understand the points on inventory -- well, actually would you explain a little bit more the increase in inventory? And can you also just address, when I look at the first half of the year we see BRL115 million of cash flow. Can you give us a ballpark about what you expect to do in terms of cash flow generation on that line for the full year please?

A - Martim Mattos {BIO 16015889 <GO>}

In terms of the cycle -- or I think it's better to talk that way -- we have -- we are here assuming that the cycle for the remainder of the year should at least maintain the same levels of approximately 100 days. But when you look at the Fourth Quarter, we usually have a bit of seasonality there. The level of sales tends to be higher than the other quarters. So we always tend to have an accumulation in nominal terms of working capital by the end of the year.

Q - Loredana Serra

I am sorry. So what would be the approximate cash flow generation you think you can reach for 2013? Should we -- is it BRL300 million or what do you think for the year?

A - Martim Mattos {BIO 16015889 <GO>}

It could be close to that.

Q - Loredana Serra

Okay. Then can you just review for us why the inventory levels rose this quarter? I know some of it you mentioned was ahead of Senador Canedo. But are there -- were there other factors driving the increased inventory this quarter please?

A - Martim Mattos {BIO 16015889 <GO>}

No. That's -- well, as I mentioned on the earlier question, the main issue is inventory. And what happened as per our analysis here was that not only in the Second Quarter. But if you recall the First Quarter we also talked a little bit about that, that we had inventory growing more than we originally forecasted; first, because of the transferring of the production to Senador Canedo. So especially in diapers. In a few lines of diapers we've used a little bit more inventory to guarantee that the transition of the line would be -- wouldn't affect the sales.

So we wouldn't let products to sell (through) this timeframe. And also in the First Quarter, if you recollect, we mentioned that a little bit of that accumulation was also related to sales a little bit below what we expected in Pharma. So with that, with those two effects combined, we had this accumulation in the first half of the year of our inventory.

Q - Loredana Serra

Okay. Thank you.

Operator

(Magash Chasae), BlueBay.

Q - Magash Chasae

I had a quick question. If we look at your gross debt levels from Q3 to -- Q1 and Q2, they are largely unchanged. And fair enough, the cash flow generation has been good; your EBITDA growth has been good. I am just wondering at what point do you actually start paying back that gross debt. And also given what's currently happening in Brazil with CDI going up, it doesn't make sense to kind of slow down some of your liquidity -- pay off gross debt given the cost of carry is going up? Hello?

A - Breno Oliveira {BIO 17215392 <GO>}

Hi, Magash. This is Breno.

Q - Magash Chasae

Hi. How are you?

A - Breno Oliveira {BIO 17215392 <GO>}

Hi. How are you? So we are -- what we've been doing paying down debt that we could have repaid, that we had no penalty or small penalty to pay down. We did that last year mainly. In the beginning of next year, we have some maturities that we intend to pay down, basically 2014 -- and early 2014 and 2015.

On the CDI, we are actually positive and we have a positive exposure to CDI. Our cash invested in CDI is higher than the amount of debt that we have denominated in CDI. So for us this movement does not affect us. Actually, it affects positively.

Q - Magash Chasae

Right. But I mean you have BRL1.7 billion of cash. I mean that seems to mean like more liquidity than you need to in terms of running the business on a day-to-day basis. I mean I don't understand why you are carrying so much cash and realistically you haven't paid back much debt over the last three quarters.

A - Claudio Bergamo {BIO 16015846 <GO>}

Oliveira?

A - Breno Oliveira {BIO 17215392 <GO>}

Yes. We paid down everything we could, that there was no penalty by contract. Now most of this debt is bilateral with banks and debentures in the local markets that we have to wait for the maturity. We have more than BRL2 billion maturing by 2015 and that this cash position is to face these maturities in the short term.

Q - Magash Chasae

Right. And so by year end, what are you looking at in terms of your gross debt level?

A - Breno Oliveira {BIO 17215392 <GO>}

Actually, the gross debt should increase. As you may have seen, we raised BRL400 million --

Q - Magash Chasae

Yes.

A - Breno Oliveira {BIO 17215392 <GO>}

-- to pay down debt that is maturing in the first half of 2014.

Q - Magash Chasae

Right, okay. So then any kind of reduction in gross debt will only happen in 2014?

A - Breno Oliveira {BIO 17215392 <GO>}

Yes, '14 and '15.

Q - Magash Chasae

Okay. All right. Thanks.

A - Martim Mattos {BIO 16015889 <GO>}

Just hold on the line. This is Martim. One of the idea is also to have this excess cash is the -- in moment of volatility as we are going through, especially volatility in the financial market, is to have the optionality to be able to decrease our exposure in US dollars. So we're already positioning ourselves in a balance sheet situation that if we see an opportunity in the market, any kind of volatility that is in our favor, then we could use that cash to reduce our FX exposure.

Q - Magash Chasae

Right. So that -- I mean in terms of that I guess if your dollar bonds were at attractive levels, does that basically mean you will step in and buy them back?

A - Martim Mattos {BIO 16015889 <GO>}

We have a few alternatives. It's not only that. But certainly the most attractive ones, say, with cash, it's better to go after them.

Q - Magash Chasae

Okay. All right. Thanks.

Operator

Thank you. The Q&A session is now closed. I like to turn the floor back over to Mr. Claudio Bergamo for his closing remarks. Please go ahead.

A - Claudio Bergamo {BIO 16015846 <GO>}

Thank you very much all for participating and attending our call. Our RI department is available to discuss and clarify any further questions. Thank you very much and have a nice day.

Operator

The conference is now concluded. You may all disconnect. Thank you.