Q4 2016 Earnings Call

Company Participants

- Breno Toledo Pires de Oliveira, Director-Investor Relations
- Claudio Bergamo dos Santos, Chief Executive Officer & Director
- Martim Prado Mattos, Chief Financial Officer & Controller

Other Participants

- Alexander Robarts, Analyst
- Ricardo Rezende, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon. Welcome to the Hypermarcas Fourth Quarter of 2016 Results Conference Call. Today with us, we have Mr. Claudio Bergamo, CEO; Mr. Martim Mattos, CFO; and Mr. Breno Oliveira, IR and Treasury Director.

I 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.

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

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much. Welcome all to the conference call about our results regarding the fourth quarter 2016, which also represents for the full year of 2016. The year of 2016 was very transformational for Hypermarcas. During the year, we executed and finalized a series of divestments of our traditional consumer goods businesses such as the Cosmetics, Condoms and Diapers. Through these processes, we've recapitalized the company in about BRL 5.5 billion coming from a net debt position from BRL 3.8 billion to a net cash position of about BRL 1.7 billion after the closing of the Diapers deal. This process allow series of short-, mid- and long-term advantage for Hypermarcas shareholders.

The company started distributing dividend in a consistent way (02:57) BRL 0.65 per share regarding the fiscal year of 2016, of which BRL 0.06 as interim dividend, which have already been approved, and an additional BRL 0.05 to be approved in the Shareholder Meetings. This dividend represent 100% of our net profit after legal deductions.

Also Hypermarcas through all these transactions has been able to (03:29) pharma business, become a pure pharmaceutical company starting off 2017. In the strategic terms, this change are quite relevant and create many advantage for our shareholders, given that the favorable growth projections and prospectives in the mid- and long-term of the pharmaceutical market in Brazil. The Brazilian market is expected to enter a phase of aging of the population with a mature increase of older people, also expected to increase the penetration of medical treatment and also introduce new medicines that are not present in Brazil.

According to IMS Health, the Brazilian market is expected to be the second fastest growth in the world for the next years only behind India. It is also expected to become the fifth largest pharmaceutical market in the world in the coming years.

To face this many and opportunities in the market, Hypermarcas is quite well positioned. On the top of being the largest company (04:52) Brazil in the pharma retail market, the company also has the most complete product and brand portfolio of the market (05:04).

In addition, the company have a very solid and competitive go-to-market platform, being the lowest-cost producer, with a comprehensive nationwide distribution network with relevant presence both in mom and pop stores as well as the (05:27). This position allow us for a natural strategic hedge in moments of economic crisis, such as the one we have been experiencing in the last two years. It also allows for exploring a series of synergies of scope and scale, which is the foundation of sustainable organic growth.

Just for example, the performance of our company operations in the fiscal year 2016 demonstrates the resiliency of our pharmaceutical business. The company grew 11.2% even in the middle of the biggest economic, social and political crisis in the Brazilian history. We also closed the year with an EBITDA of BRL 1.133 billion, representing a growth of 19.2% over 2015 figures. These results are slightly above our guidance and (06:38) our guidance of EBITDA.

Also in terms of net income, the company reached BRL 675 million of our continued operation, representing a 95% growth vis-à-vis 2016. To take advantage of these huge opportunities and create value as we move forward, we started in 2016 – already started in

2016 (07:09) product to strengthen our business even further. We should highlight (07:16) these changes that we have been carrying out in parallel to our restructuring of our portfolio.

First of all, we have been strengthening our business intelligence with the creation of three business units: one from Consumer Health, another one from Branded Prescription, another one from Branded Generics. We completed this process in the quarter with the verticalization of the sales and trade functions. Now, starting off 2017, all our business units will have a 100% of the functions required to define and execute their own business strategies.

These changes will be transformational to Hypermarcas in the next years to come. It will allow not only significant improvement in our execution, but also increased focus will provide and give opportunities to conduct different strategies for different segments which have different key factor success.

Also, this new product platform and configuration will help in the develop of a new innovation plan that will be more consistent and more impactful in the years to come.

Strengthening also our innovation capability had been also a major area of focus during 2016. We have separated the pre and post registration areas because one side to gain greater focus on the development of new projects for the pre registration and the other one, to face the ongoing increase of technical (09:01) regulatory demand in the market for the post registration.

In the prescription area, we created a new in-field team bringing in the most competent professionals in their field of expertise. We also started the creation of a new Innovation Center in Hannover with state-of-the-art technology which should be opened in the second quarter of 2017.

In parallel to the strength of our internal development capabilities, we also have been structuring a new business development area as never has been seen before in the company.

The combination of strength of our business intelligence with our increased innovation and business development capabilities creates the foundations for a new sustainable organic growth cycle for the company. For sure that we are very certain that we will bring (09:57) in the long run to our shareholders. Once more, I'd like to thank the support of our shareholders, market analysts, portfolio managers among other stakeholders.

On the other hand, you can count on our hard work and continuous focus on better creation. We believe we can always do better whatever we have been doing already well and believing that the impossible is possible. We will reach new levels of performance and excellence.

Thank you very much for all and that's over to Martim who'll talk more in details about the numbers.

Martim Prado Mattos {BIO 16015889 <GO>}

Good morning, everyone. Martim speaking. As usual, I will quickly summarize the main results of the fourth quarter and the fiscal year of 2016. Starting on page 2 of the presentation, growth was 11.5% in the quarter being about one-fourth of this growth from volume and the remainder from price increases. Gross margin increased 30 bps because of price increases and mix which came slightly above the cost increase effects in the period.

Operating expenses contributed 3.7 percentage points to the EBITDA margin with gains coming from all lines of expenses. Thus, the continuing operations EBITDA was BRL 262 million in the quarter, a 31% increase and a 3.9 percentage point margin gain.

Financial result was positive BRL 7 million reflecting the new capital structure of the company even before the proceeds from the sale of the Disposable business. Therefore, the continuing operations net income amounted to BRL 197 million, 2.5 times greater than the net income in Q4 2015.

In discontinued operations, we made an impairment of assets related to the sale of the Disposable business based on the value of the sale of this business of BRL 1 billion, which accounted for the greatest portion of the loss in discontinued operations. The company's net loss was then BRL 213 million in the quarter.

As stated on page 3 of the presentation, the result for fiscal year 2016 was a net revenue growth of 11.2% virtually totally composed by price. Gross margin fell 50 bps in the year, mostly given the impact of the FX devaluation on the COGS in the first half of the year.

Operating expenses adjusted in the quarter were diluted and/or reduced representing a margin increase of 3.1 percentage points. Thus, continuing operations EBITDA amounted to BRL 1.133 billion. The financial result was negative BRL 192 million on the great impact of BRL 109 million in early payments of debt, leading to continuing operations net income to BRL 675 million, virtually twice as much as what was posted in 2015.

Continuing (sic) [Discontinuing] (13:23) operations net income was BRL 500 million as due – of the capital gains from the sale of the Cosmetics and Condoms businesses in spite of the impairments of the Disposable business. Last, the company's net income was BRL 1.175 million, also virtually twice as much as the net income in 2015.

I would like to invite Breno to discuss the next slides of the presentation.

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

Hi. Good morning, everyone. Starting on page 4, in 2016, cash flow from operations was BRL 882 million, 2.7 times higher than the previous year. This, combined with lower CapEx investments and the proceeds from the asset sales of BRL 2.5 billion, led us to end the year with gross debt of BRL 908 million, a reduction greater than BRL 4 billion during 2016.

The net cash position was BRL 1.348 billion, which, when added to the BRL 352 million of non-realized hedge gains, led us to close the year with a net cash position of BRL 792 million. Considering the proceeds from the sale of the Disposable Products business and the announced dividends, our pro forma net cash position was BRL 1.382 billion.

Going to page 5, after the divestitures of the Consumer business since last year, we have started to pay dividends to our shareholders. In 2016, we paid BRL 0.50 per share, and in 2017, we should pay BRL 0.65 per share, of which BRL 0.60 next Friday and BRL 0.05 after approval at the shareholders meeting. This represents a 30% growth of the dividends paid in 2017 compared to the previous year and a dividend yield of about 2.4%.

Lastly, we formed that, as we have done over the past years, along with the earnings release, we introduced an EBITDA guidance of around BRL 1.2 billion for the fiscal year 2017 for our continuing operations.

Thanks, everyone, for the attendance. We will now proceed to the Q&A session.

Q&A

Operator

Thank you. The floor is now open for questions from investors and analysts. And the first question comes from Alex Robarts with Citi. Please go ahead.

Q - Alexander Robarts {BIO 1499637 <GO>}

Hi, everybody. Thanks and good day. I did want to just ask two things; one about the guidance and also the second on capital allocation of the company. So I guess we gathered earlier in the Portuguese call that when we think about the new guidance of EBITDA this year, which is, I guess, about 8.5% EBITDA growth, down from high-teens last year, this deceleration in growth that you're suggesting for this year in EBITDA, is it fair to assume that it really is linked to the fact that we've got a 4% price increase in April versus the 12% in last year's April increase? Is it fair to say that that's, kind of, the main driver? And in the guidance, if you could just share with us the implicit FX rate that you've got? Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi, Alex. This is Claudio Bergamo. Yes. I think it's one of the main drivers for expected lower growth. It is the lower price increase expected for 2017 vis-à-vis 2016. As you know, that as of 2016, the average price increase was around 12% vis-à-vis an expectation of 4% for 2017.

So to keep up the same growth, same pace of last year, we need very substantial volume growth for the factor which at this point we cannot anticipate how much of that will really come into the market. There are many, many positives if you look in the macroeconomic perspective that points to a recoverage of – in terms of volumes given that the very low inflation rates that we experienced as well as the expected reduction of interest rates going forward.

Despite that, unemployment is still very high. And we would need to see both the low inflation, low interest and low unemployment really to be little more, let's say optimistic in terms of top-line growth for the time being. So as we're seeing that, we have to continue looking as we move forward in the year to see how the consumption will develop.

Also, it's important to highlight that based on the things I've been saying that we have been investing in a new structure for our business units as well a new structure for our innovation capabilities which will increase about 1% to 1.5% in terms of percentage of our expenses. So the combination of these two things lead us to a BRL 1.2 billion guidance which in our perspective is not conservative. It's realistic.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. And sorry, just the FX assumption implied in that slide, is it the current level, BRL 3.1?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

We had a BRL 3.2 in our budget as the assumption.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. Thank you very much. That was helpful. The second question is just on capital allocation at Hypermarcas this year. As you stated earlier in your remarks, last year was a transformative year. Congratulations on that. I guess in certain ways, it, kind of, amounts to a downsizing of the company. focused on pharma.

And what's interesting is the messaging around the proceeds of the recent M&A deals. You've opted to pay out a dividend most recently. And I'm just wondering, you talked about the Brazilian market, the second fastest growing one after India. It's very fragmented. You got 11%, 12% share. How should we think about Hypermarcas and the non-organic growth outlook for this year?

Is it safe to think that you are looking for M&A opportunities that, in addition to organic, you do have some non-organic aspirations, or is it really that perhaps maybe we read through this recent dividend announcement that currently the target or the potential assets in this very fragmented market are perhaps not attractive or overly priced?

And just, kind of, if you could help us think about what is the non-organic outlook for you guys, if there is one, and how you're thinking about putting capital towards that? Thanks very much.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, one aspect that the company and the controlling group wants to continue the consistent policy of dividend distribution, not only in the short-term but also in the mid to long run. Said that, still, you are right. We have space in our capital structure to eventually – if any good opportunity arises, we have a capital structure to analyze it.

On the other hand, we don't see nowadays many consolidation opportunities on the existing Brazilian companies for many factors, among them the value of many of these companies expect (23:44) is too high. And we don't believe that also their portfolio will be very complemented to our portfolio. So, as we have shown over time, we are quite disciplined in terms of only embracing opportunities that really add shareholder value.

So, for now, I think a part of our effort is less on probably Brazilian consolidation and more, trying to become partner of choice for other companies, pharmaceutical companies which do have technologies which are not present in Brazil. There are many, many things that have been already explored outside Brazil in many markets that still, they're not present in Brazil and which Brazilian consumers could benefit from these technologies outside Brazil.

That type of project (24:59) not necessarily has to be with capital or M&A. There might be different type of transactions such as eventually licensing, eventually other types of distribution. And eventually, if we think that we could buy a technology that would help us a lot in many of our product, we would consider. But nothing that really have affirmed, it's just a thinking of, let's say, things that we're aware. I think that Brazil has a major, major opportunity to introduce many of these technologies in the marketplace.

Hypermarcas, now that has become the pure pharma player is the only one which is public, which has a governance – professional governance. It doesn't have a direct owner in the management. So I think there are many advantages why Hypermarcas should be the partner of choice for many of these technologies that exist outside Brazil. But because of some way we have been strong in the business in the consumer market, we are not well known still from our pharmaceutical side, now becoming only-pharmaceutical and start visiting and also through this new area, just the business that we developed, we have already have some initial early-stage signs that there are lots of opportunities out there that eventually we can take advantage of it moving forward.

Q - Alexander Robarts {BIO 1499637 <GO>}

Very helpful. Thank you.

Operator

The next question comes from Ricardo Rezende with HSBC. Please go ahead.

Q - Ricardo Rezende {BIO 16469276 <GO>}

Hi. Good morning, Claudio, Martim, Breno. So just trying to following up on the capital allocation question, but looking more of it in medium- to long-term horizon, with all the sales done and the transformation to pharma completed, how much time is the board spending discussing the capital allocation? Is there a preference for dividends or buybacks?

And then on the second question, just also following up on a question that was posted during the Portuguese conference call, you mentioned that one of the great opportunities for Generics, it's entering the larger retail chains, the larger direct retail chains, if that's the case, should we expect any effect on your working capital?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

First, no, actually the opposite. The terms for all of our Similars and Generics are much lower than the terms for the branded products. So if by any reason we start growing faster, that decision, that area with the other ones, that would reduce actually our working capital, which I'm not saying is the case. At this point, we see that all the three areas have somewhat the same perspectives of growth for different reasons, but that's not the case.

Regarding the capital allocation, I said in the Portuguese call that we believe that up to BRL 500 million, if thought from company perspective, would be more than enough in terms of as a (29:09) position. So anything above that is in a discussion at the board level, which will be the options and what are the decisions, how to – what to do with that capital. So there are many, many discussions on the table. Among them, there is the discussions as share buyback, as dividends. There's a limitation, so we cannot go further then what we have gone. So, that's not out of the question at this point.

There is also other discussion such as capital reduction. And then there is – at this time, there is not many M&A. So, that's pretty much where we are at this point. But remember that we haven't closed yet on that. So, people like to talk about the money that they still don't have. So, as a manager, our focus is to close and not text you first.

Q - Ricardo Rezende {BIO 16469276 <GO>}

Okay. Thank you. That was very helpful. So just one follow-up, the BRL 500 million in cash that you mentioned, is that a net cash position or it's your operational cash?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Net cash. When I said that – up to BRL 500 million, the net cash. Don't forget that though we had been kind of generating quite a healthy cash flow from operation, but again that's from a management company perspective, the BRL 500 million. Because you know that we don't benefit from (31:01). So at this point, that is not beneficial to have debt (31:11) in the company. That might change in the next two years to come. But at this point, there is no benefit.

Q - Ricardo Rezende {BIO 16469276 <GO>}

Great. Thank you so much.

Operator

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

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you all for participating in our call. And we will be more than glad to answer further questions through our Investor Relations area if you still have it. And have a nice day and bye-bye.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.