Q3 2012 Earnings Call

Company Participants

- Claudio Roberto Ely, CEO
- Eugenio De Zagottis, IR Director

Other Participants

- Andrew Johnson, Analyst
- Irma Sgarz, Analyst

Presentation

Operator

Hello?

Claudio Roberto Ely {BIO 15364128 <GO>}

Can you start with the Safe Harbor announcement and then we go?

Operator

Okay. Good morning, ladies and --. Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based upon the beliefs and assumptions of Raia Drogasil management and on the information currently available to the Company.

Forward-looking statements are not guarantees of performance, they involve risks, uncertainties, and assumptions because they are related to future events and therefore depend on circumstances that may or may not occur in the future.

Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Raia Drogasil and could cause results to differ materially from those expressed in such forward-looking statements.

Today with us are Mr. Claudio Roberto Ely, CEO, and Mr. Eugenio De Zagottis, Investor Relations, Corporate Planning Vice President, and Gabriel Rozenberg, Investor Relations and Planning Director.

Now I'll turn the conference over to Mr. Claudio Roberto Ely. Sir, you may begin your conference.

Claudio Roberto Ely {BIO 15364128 <GO>}

Welcome to the presentation of Raia Drogasil reference to the Third Quarter of 2011. Now I will transfer to Mr. Eugenio to run the presentation.

Eugenio De Zagottis {BIO 7193695 <GO>}

Hello, everybody. First of all, thank you for being in this conference call with us.

On page three, I'll cover the highlights of the quarter. We ended the quarter with 828 drugstores in operation. We opened during the quarter 24 new stores and we closed three stores. We achieved gross revenues of BRL1.45 billion in the quarter, a growth of 17.8% over the previous year. And that growth also corresponded to a same-store sales increase of 11.2%.

Our gross margin corresponded to 26.2% of our gross revenues, a 0.7percentage point margin expansion in terms of gross margin. We have an EBITDA of BRL81.1 million in the quarter. That corresponded to an increase of 18.6% over the previous year and that basically means that we remain for EBITDA the margin in line with that achieved in the Third Quarter of 2011.

Our net income totaled BRL39.7 million adjusted. That corresponded to 2.7% of net margin, also in line with the previous year. And finally, the highlight of the quarter was a strong cash generation of BRL112.4 million after several quarters of cash pressure.

On page four, to give more details in terms of our store development, out of the 24 store openings we conducted in the quarter, 18 of those stores corresponded to Drogasil stores, while only six corresponded to Droga Raia store. This is not a surprise for us because of the preparations for the incorporation into RaiaDrogasil, which will take place in the end of November, at the very end of November.

We had to suspend the opening of new Raia stores that haven't been fully licensed until the beginning of the Third Quarter. The reason being is that we have to transfer a myriad of licenses for every store that we manage, which basically means from the (literal) point almost reopening those stores and a RaiaDrogasil. So as those license migrations take time to happen, if we had opened stores during the last quarter that had been fully licensed, we wouldn't have the time to transfer all those licenses to the new Company so that these new stores, now after the incorporation, they would be left alone (with our) licenses.

So in the area of these six stores, as they were rightfully licensed in the beginning of the quarter, we were already working on the transfer to RaiaDrogasil. So this suspension means that after the incorporation is over, that basically means from December 1 onwards, we will see a huge increase in new stores openings by Raia because a lot of stores, they have been left for the last quarter of the year.

Another important point is that we closed three (technical difficulty).

Operator

Sir, you may start again with the conference.

Eugenio De Zagottis {BIO 7193695 <GO>}

Okay. I apologize to everybody due to any kind of unforgiveable technical problem. We fell for a couple of minutes, but now we're back.

So I was on page four, talking about the new stores openings. And just to conclude on this page, it's important to mention that the stores we have under operation at the end of the quarter, 34.3% of them were still undergoing maturation. So a significant number of stores which economic potential has not been unleashed yet.

On page five, I'd like to talk about our geographic coverage and market share growth that we experienced in the quarter. As we entered in this quarter in two new markets, Bahia and Mato Grosso do Sul, we can say that we now operate in states that represent 84% of the Brazilian pharmaceutical market.

In terms of market share growth, this was a good quarter. We reached 9.1% of national market share, an increase of 0.4percentage points in the quarter. We had, I would say, in most states very good market share increases. Sao Paulo is probably the higher end of the quarter. It's our main state. And even though a lot of people believe this is a mature market, that there's no -- that eventually could no longer be -- offer such nice growth opportunities, we still managed to increase our market share by 2percentage points, from 19.4% to 21.4%. And there's still a lot of room to keep on growing in Sao Paulo.

Espirito Santo was another highlight, increased one percentage point in market share, from 8.3% to 9.3%. And Rio de Janeiro, same type of increase, from 4.4% to 5.4%, 1.0%. Then, a strong highlight also was our performance in the Midwest region of Brazil, in Distrito Federal, which is where the capital of Brasilia is located. Our market share increased by 0.3percentage points to 15.7%. In Goias, it increased by 0.2percentage points, we reached 13.7% after several quarters of a negative trend in terms of market share. And also, Mato Grosso, a market we entered in the Second Quarter of the year, we reached 2.9%. And Mato Grosso do Sul now, we just opened in the middle of the quarter, was 3% of market share.

We would also like to mention here that we concluded the acquisition of 26 stores located in Goias that belonged to Santa Marta. So considering the strong operation we already have on the Midwest region and these new stores that will be opening in the First Quarter of the year, we expect to have in the beginning of 2013 more than 120 stores in the

Midwest region, which will absolutely consolidate our leadership in that important market of Brazil.

We also highlight the strong performance in Santa Catarina. This is a market we entered last year, where the bulk of the stores (ascend) in the year, where we have close to 3% of market share. And finally, our entry into Bahia, the main market in the Northeast region, where the biggest population and the biggest market potential lies. We are very happy with the beginning of operation in that state. We now have seven stores, we had six at the end of the quarter. And we have probably a 10-year growth story in the Northeast region ahead of us. So I would say this is a very important market entry and that's a market with great potential ahead.

On page six, talk about our revenue growth. Our total revenue growth in the quarter amounted to 17.8% over the previous year, while mature stores, they grew by 7.2%. It's important to highlight that we had a negative calendar effect in the quarter as this year's quarter had less working days than last year's, and that amounted to 0.9%. So if we leveled that with last quarter, our growth would have been 8.1%. Even the 7.2%, the performance, that leaves us very happy because we're talking of stores only that has been operating for more than three years, so this is really performance-driven type of growth.

In Raia, that growth of mature stores corresponded to 5.7% in the quarter, while for Drogasil the number was 8.6%. The main reason of the difference between Raia and Drogasil in terms of mature store growth lies in the comp basis. In the Third Quarter of 2011, Drogasil grew only 5.1% while Raia grew 10.5%. So when we stack the two years together, just the arithmetical summation of the two years, basically Raia's number would have been 16.2% versus 13.7% for Drogasil. In both cases, real growth that makes us very, very happy and very confident about the future.

Page seven, talking about our product mix. Again, Generics was the fastest growing segment. It grew by 23%, and that corresponded to an increase in the total product mix by 0.5percentage points over the same quarter of last year. It's also not new for Hygiene and Personal Care once again was one of the strongest categories. It grew by 18.7% and it reached 29.2% of the total mix versus 29% in the Third Quarter of 2011.

On page eight, talking about our gross margin. We reached in the quarter a gross margin of 26.2%. That corresponded to 0.7percentage points of increase over the Third Quarter of 2011. I believe gross margins was really the defining number of the quarter as the adoption of a new tax regime that is helping us convert outstanding tax credits in excess of BRL100 million that has been hanging on our balance sheet for something like five years now.

So this new tax regime basically means that instead of buying from our suppliers and having our suppliers collecting our taxes on our behalf, we now pay for the projects without pre-collection of taxes, so when we transfer from our distribution centers to our stores, then we have to pay our own tax bill. And since we have a tax (only) to make, we can use our outstanding tax credits against it. So this new regime is very important in terms of the conversion of the old tax credits, but it had a consequence.

There was an impact in our margins by 0.8percentage points. What happened here is that for all suppliers that have the kind of tax planning in which they own their own distribution company. What basically do is that they sell from the manufacturing facility to the distribution company by very low prices. They pay lower taxes in this type of tax planning and then they ship from the distribution company to their clients at normal prices. So their whole margin is made of distribution company and they have significant tax savings by shipping through a lower price from the manufacturing facility.

So for manufacturers that don't have any tax planning of this sort, nothing changed. But in these situations, the taxes that they are saving, we have to supplement that to the state. So basically, their tax break became our additional tax burden. This change alone represented 0.8percentage points of gross margin. So if not it had happened we would have posted gross margins of 27% in the quarter, which really represented the trend that we had after a lot of improvements in our purchasing terms.

So our main challenge now is to deal with this pressure, so we're dealing with that in many ways. One of them is negotiating our loss with the suppliers. We'll have some levels improvement coming from that type of negotiation. We're also talking to the tax authorities in the state of Sao Paulo, I don't know if anything will come from that. But finally, we have price adjustments to make.

So in the best scenario we would be back to the normal margin in the First Quarter of next year. If that's not possible, at least we expect to be, in the First Quarter of next year, much better than we are in this quarter, so something in-between and then progressively offset through the year. Let's see how things evolve.

What's important to mention here is that we no longer accumulate retained taxes. The taxes that we are consuming we are converting to cash by using this tax regime. They are all old taxes that have been accumulating balances for more than five years. So as a last resort, after we convert these outstanding tax credits to cash, we can always drop out of this tax regime and go to the previous regime, which basically would bring our margins instantly back to 27%.

We have a significant improvement in the cash cycle in the quarter, also due to the usage of this tax regime. So when you look at our cash cycle in the end of the Third Quarter, it basically meant a 15.1-day improvement over the Second Quarter of this year and basically we got back to the same level of last year.

Out of the 15 days of cash cycle improvement, 10 days are structural as we have rebalanced inventories across all distribution centers. But 4.5 days is basically the taxes that were contained on our inventories. Because since the supplier paid on our behalf, we accounted that tax paid as part of the inventory. Now in the new regime, we unleashed that 4.5 days and that's basically allowing the tax to be recovered account and that will be turned into cash over the next quarters. If we get back to the old regime, we'd loose this 4.4 -- this 4.5 benefit, but the current tax outstanding, that amounts now to BRL73 million and that in the beginning of the quarter accounted for something like BRL100 million, they will be converted for good.

On page nine, talking about our sales expenses, we had an increase in our sales expenses of 1.4percentage points over the Third Quarter of 2011. Basically, the sales expenses of the quarter, they are in the same level of the Second Quarter of the year, however, overall we had to apply in July the annual salary readjustments that corresponded to 6.5% this year. So the difference in 0.5 -- 0.4percentage points from the second to the Third Quarter of the year is the annual salary readjustment. Except for that, we would have been at the same level of the previous quarter. So looking back to the Third Quarter of 2011, the bulk of this 1.4percentage points is explained by the headcount increases we promoted at Raia and also the salary readjustment, 0.8percentage points.

In addition to that, our commercial leases increased by 0.2percentage points. This is due to how the property market in Brazil is picking up over the last -- over this year and even couple previous years, so this is -- the property market is just going up and up and up. And as a result, even though we're protected through our contracts, when the contract expires and we have to renegotiate our terms, then we are subject to these market increases, so 0.2percentage points.

Then we have two pressures that are very related to the growth process. As we opened recently two new distribution centers, the first in Rio in the beginning of the year and the second in the countryside of Sao Paulo that we recently completed, the increasing logistics because of new distribution centers amounts to 0.2percentage points. Then, we also have a third in pre-operational expenses of 0.3percentage points as the growth program of this year is very concentrated in new markets.

And whenever we open stores in new markets like Bahia, Mato Grosso, and so on, and even Santa Catarina. First we don't know how (valuzation) of new stores work in the beginning. So there's a learning curve and it takes longer to (all the same) stores. And also, because we have to train people that we have hired in this market, before opening the store sometimes we're paying salaries and rental for stores that haven't produced a single cent of gross profit to pay for the bill.

So next year, as our growth program, we'll be more focused on the current regions. And as the learning curve in the new markets has already been exhausted, we expect to be able to fade that extra pressure off our numbers. So I would say 0.3percentage point of pre-operation expenses plus 0.2percentage point of new distribution centers is very related to our growth program. And over time, we hope to see improvements in that.

On page 10, talking about the administrative expenses, and that, besides the cash cycle, is best news of the quarter. Our G&A accounted -- represented 2.6% of gross revenues, a significant improvement over the same cost of last year when we posted 3.4%. What's happening here is that first, as we unified our senior and middle management structure, we had some people leaving the Company and that's a good savings. Most important than that was also the fact that we are keeping new hires at the corporate structure to a very minimum. So basically we're keeping in absolute terms, our G&A costs and then the growth that we have obtained has diluted our figures.

Then in the quarter, as a result of the lower performance that we achieved because of the gross margin pressures, we are also making the corresponding adjustment to our variable compensation allowance. So it's important to mention -- to explain that until the Second Quarter we were absolutely on track with our budget, so we were provisioning the target of variable compensation for everybody in the Company. And now, as our margins dropped significantly below what we had for cash that we are also adjusting accordingly our compensation provisions.

So the reason we have this save of 0.3percentage points in compensation provisions exactly because of the gross margin (profit). So the fifth fact of the quarter -- looking forward, when our margins recovers, of course, this 0.3percentage point will go up again. But as long as we have lower margins we believe that our G&A -- we will have to compensate on the variable compensation allowance.

On page 11, talking about our EBITDA, we reached BRL81.1 million in EBITDA, adjusted EBITDA, in the quarter. Despite of the margin pressure that we faced, we still managed to balance our EBITDA margin. We kept it in line with the previous year. So what basically -- and it's interesting that, for example, when we look first at the previous year our gross profit increased by 0.7percentage points. But of course, that without the tax changes, it probably would have been something like 1.5%. Then administrative expenses, it improved 0.8% over the previous year, and sales expenses, it increased 1.4% over the previous year.

Another number that we like to share is what would our profitability have been if we hadn't opened any store in this year. So basically, we take the initial stores which we started the year and then we measure their results and then we take the full G&A of the Company out of those numbers. So basically, without the new stores opened during this year, we would have achieved BRL1.4 billion in gross revenues. We also -- we would have achieved BRL89.5 million in EBITDA.

So very clearly we lost something like BRL8 million in EBITDA because of the pre-operational expenses and the negative initial results of the recently opened stores. And we would have posted an EBITDA margin of 6.3%. Remember that we had an impact of 0.8percentage point of the gross margin due to the tax -- to the taxes adoption. And without that, it would have been about 7.1%.

We reached a net income, adjust net income, of BRL39.7 million, which basically remains in the similar level to the Third Quarter of 2011. We posted the same level of depreciation that we have been posting every quarter, like 1.9%, and we sustained the same level of net financial revenue of the previous quarter and net interest expense of 0.1%.

Finally, talking about our cash flows. We had a cash generation in the quarter of BRL112.4 million. Basically, we had BRL71.6 million in resources from operations, versus BRL63.7 million in the Third Quarter of last year. Then we had a working capital improvement of BRL97.4 million. So the cash cycle alone was BRL103 million. But it's important to mention that because the taxes on inventories were taken out from inventories and cash cycle as a result and put on the tax to be recovered account, basically out of the BRL103 million improvement in cash cycle, BRL50.4 million was taxes on inventories.

On the other liabilities and the other current assets and liabilities line, that was where we posted almost BRL30 million negative, that BRL30 million negative would have been BRL20 million positive. So we deducted BRL50 million from that because the taxes on inventories, they were not immediately converted into cash. They would be converted over the following quarters. So it is (doth) the cash cycle, but then it increased the other current assets and liabilities account. Finally, we invested BRL56.6 million in the quarter.

Then, to conclude the presentation, considering our share price of BRL22 that we had on November 12, that implies in an average annual return of 29% for every investor that entered the Company during the Drogasil IPO in 2007, and then an average annual return of 47.6% for all Raia investors who invested in its IPO in 2010.

Finally, to conclude, I'd like to share some of the highlights of what we have recently accomplished. It's important to mention that on November 5 we have opened our distribution center. It will operate in the countryside of Sao Paulo. This distribution center was conceived, developed, and implemented already under the new Company, RaiaDrogasil.

On November 10, we completed one year as a merged Company, and this has been a very busy year working on the integration of the Company. In the beginning of this week, on this Monday, we finalized the transfer of every Raia employee from the previous Raia site into the RaiaDrogasil site, which has been renovated to increase the footprint and to increase the available area for -- to accommodate all of these people coming here. And also, our Raia training center is also in the process of being shut down, just that -- in the administrative center, and all of the training programs are now competitive as the new RaiaDrogasil site.

And finally, on November 30 we will have our General Assembly to do the incorporation -- to finalize the incorporation of Raia by RaiaDrogasil. So this is a very challenging, time-consuming task we're involved in. It basically means re-opening more -- from the tax -- from the regulation viewpoint, it's like re-opening more than 400 stores, so we have to get -- to re-license each one of those new stores. So every store relies on a myriad of licenses like tax license, sanitary license, operating license, and so on, so every one of those licenses must be re-obtained by RaiaDrogasil so that on December 1st we'll be able to stop using the old Raia licenses, as Raia will cease will exist, and start using the new RaiaDrogasil license.

So it's unbelievable the level of energy that an incorporation like this consumes from the Company. But also, this is a key milestone for us to progress on our integration. Our goal is at the end of the next year to be from every regard a single Company with a single system, with a single distribution method being shared across the two brands. And to do that, the incorporation is a must-do step.

Also, after incorporation, we will now have the opportunity, if our board so decides, to start amortizing the goodwill generated on the transaction. Then, if that happens, this would imply in a tax shield of something like BRL240 million over six years. So that only exists after the incorporation is done, so the decision on whether doing that or not will be done by our board just after the incorporation.

So this is what we had for you today and we'd like to open now for any questions you might have. Thank you very much.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Andrew Johnson from AJ Capital. Mr. Johnson, go ahead. Mr. Johnson?

Q - Andrew Johnson {BIO 20119903 <GO>}

Yes.

Operator

Sir, the floor is yours.

Q - Andrew Johnson {BIO 20119903 <GO>}

Excuse me?

Operator

You can ask your question now, sir.

Q - Andrew Johnson {BIO 20119903 <GO>}

I'd like to understand how the integration process is proceeding and what's the expected timeframe for the conclusion of the process in terms of impact on results.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay. Thanks for the question. Basically, we announced the transaction last year in August. The transaction closed in November. Also, we didn't have any problems with anti-trust authorities, this transaction was fully approved without any restrictions. In the beginning of this year, the first thing we did was define our management structure, both middle and senior management, so it was very important to have the one thing that will take this Company forward in same boat and defined.

This year, we have been working on a lot of areas. For example, purchasing was probably the first area that was integrated as we renegotiated our commercial terms in the beginning of the year. So for example, now we still rely on two different systems to place the orders in the end of the day, but all of the negotiations on the terms area already unified. We have also progressed in other processes like corporate planning, like human resources and so on. We're now integrating our payroll systems and we're now doing the incorporation at the end of this year.

So as we start next year as a single legal entity, we'll be able to integrate our distribution network. This is really important. We are now -- as we have picked or as we have -- when we analyzed the (creating) systems, we decided to use the Raia system as a starting platform. But what we did was incorporating a lot of the (functionel) to the Drogasil system and that makes Drogasil excel at several of the things it does. We have already incorporated that in the Raia system. We are now doing fine-tuning to that.

And after the incorporation, at the beginning the year we'll basically -- we'll start to roll out the systems on Drogasil's distribution centers. It won't be a big bang process. It will start with one region, then another, then another and then another. And by the end, after that, will be a single Company, will be sharing a single system and a single distribution network serving both brands. So we expect that the bulk of the acquisition will be concluded by the end of next year.

Q - Andrew Johnson {BIO 20119903 <GO>}

Okay. And will the acquisition of Santa Marta in Goiania be a third platform or will it be included in the existing two?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

We have just concluded the acquisition of Santa Marta. These stores will be open in the First Quarter. So these have 26 stores. These are very strong portfolio of stores in a region where our brand is very strong, so we are very enthusiastic about that transaction. And basically, those stores, they'll probably be opened over January and February. Two of the stores will be moving Drogasil store, so we are closing two Drogasil stores. Then, two of the 26 stores are very close by, so basically moving a store -- an existing store into that. Then 24 stores, there will be additional stores.

Q - Andrew Johnson {BIO 20119903 <GO>}

Okay. Thank you very much.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Thank you for your question.

Operator

The next question comes from Irma Sgarz from Goldman Sachs. Go ahead.

Q - Irma Sgarz {BIO 15190838 <GO>}

Yes, hi. Good afternoon. Thanks for taking my question. I was wondering if you could provide an update maybe on any outstanding system integration or system updates that you need to do in 2013 and whether you expect any additional expenses, CapEx, or any risk of disruptions from that. Thank you.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Irma, thanks for the question. We don't expect any major expenses as a result of the integration, especially because our corporate systems, they are proprietary. So it's our own people who are upgrading the system and who will be doing the whole integration. Probably in the finance and accounting part, where we are implementing (SAP), even though Raia had already SAP, because we want the best of both skills incorporated in the new Company, SAP will be almost re-implemented.

So with SAP it's possible that we get expenses related to that, but that's not something crazy, maybe something like BRL5 million, BRL4 million, something in that order. But not for the main system, which is the commercial system.

The timetable will be like this. The first distribution center that will have the new upgraded Raia system operating will be Ribeirao Preto. We just opened Ribeirao Preto as a Drogasil distribution center with Drogasil systems. Ribeirao Preto is currently serving only 30 stores. So we will put the new systems in Ribeirao Preto. We will also convert those 30 stores to the Raia system and then this is basically our pilot. There will certainly be (tweaks) required -- we have no doubt about that but we're talking about a small portion of the chain. And I don't think it will be something that will affect operations.

Then as we complete Ribeirao Preto and we learn from that pilot, we'll progressively do that over the following regions. We expect that by the end of next quarter -- sorry, by the end of next year the whole systems integration could be over.

Q - Irma Sgarz {BIO 15190838 <GO>}

Thank you.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Thank you, Irma.

Operator

(Operator Instructions)

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay. Well thank you very much for your attention during this conference call. This is the Fourth Quarter that we have been reporting as a merged Company. The First Quarter was the Fourth Quarter of last year when we had just done -- just finalized the acquisition. It has been quite a year. This is a year that -- I think we did -- all in all, when we look back at the last 12 months, this has been a very strong year for us. I think we have posted very strong comps at our stores. We have improved our purchasing terms significantly. We have diluted G&A in (Colla Goodray).

But it was also a quarter with challenges. We experienced pressures on sales expenses. I believe these pressures are intrinsical to the type of growth we're promoting and to the type of pre-operational expenses we have to face and advances in logistics investments that also translate into additional expenses. We always expected that that would happen, but we have been counting until now, with our gross margin increase, to absorb that and deliver a margin expansion. Because of the tax change in this quarter, we didn't manage to expand the margin. But even in a quarter where our margin was penalized by 0.8percentage points because of that, we still managed to deliver profitability in line with the previous year.

And we have now a significant challenge ahead of us, of not only completing the whole integration, as I previously mentioned, but also dealing with the 0.8percentage point margin pressure. We believe, as I already said, that in the First Quarter of next year the bulk of this pressure will probably be gone already, and then through the year we will be able to go back to where we were in terms of gross margin, a level around 27%.

We always had a scenario, as we no longer generate tax credits, that when we reached -- when we consume all the outstanding balances that we could -- if we don't slow or probably could just go back to the old system without accumulating impact that we have today, a distribution structure that is decentralized and will no longer accumulate significant tax credit.

So we know the challenge we have ahead. Looking back, it has been quite a year for us and we remain confident with the prospectus we have ahead. Thank you very much.

Operator

Thank you. We'll be closing and disconnect now.