Q4 2013 Earnings Call

Company Participants

- Leonardo Guimaraes Correa, CFO
- Rafael Menin Teixeira de Souza, COO
- Rubens Menin Teixeira de Souza, CEO
- Unidentified Speaker, Unknown

Other Participants

- Enrico Trotta, Analyst
- Frederico Mendes, Analyst
- Gustavo Cambauva, Analyst
- Luiz Mauricio Garcia, Analyst
- Nicole Hirakawa, Analyst

Presentation

Operator

Good morning. Welcome to MRV's conference call for analysts and investors only. The Company is going to talk about the earnings of 2013.

Today with us we have Mr. Rubens Menin Teixeira de Souza, CEO; Rafael Menin Teixeira de Souza, COO; Leonardo Guimaraes Correa, CFO; Monica Simao, Chief Investor Relations Officer; and Gerson Mazer, Investor Relations Executive Manager. (Operator Instructions).

Before going on, we would like to let you know that any forward-looking statements made during this conference call relative to MRV's business outlook, operating and financial goals are based on MRV's management assumptions and rely on information currently available.

They involve risks, uncertainties and assumptions because they relate 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 MRV and lead to results that differ materially from those in such forward-looking statements.

Now, we are going to turn the conference over to Mr. Rubens Menin Teixeira de Souza, CEO, who will begin the presentation. Please, Mr. Souza, you may go on.

Rubens Menin Teixeira de Souza {BIO 15387481 <GO>}

Good afternoon, everyone. We are going to start our conference call relative to the year of 2013. I'd like to highlight that differently from many analysts in the market, I thought that 2013 was the best year ever for MRV. MRV thinks that 2013 was the year that it had the best performance ever. I'd like to mention some important points because our activity is very complex and it's still important for us to go in that in some details.

I'd like to highlight four important points. First, in terms of cancellations, our cancellations grew a bit by the end of the year and that was a bit unexpected. What happened in fact was a change in the credit policy in banks, especially for the Caixa Economica Federal. Credit was a bit more tightened and with that we had a bit more cancellations.

It's not very much of a problem. We know that we have been selling apartments very fast. But unfortunately the outlook changed a little, not much. Things are not going to change much for the future. But we had an increase in cancellations because of the banks and that's really (technical difficulty) so much.

Another important highlight was the decrease of production in the last quarter. And you know and we have announced in the First Quarter of 2013, we signed a workforce adjustment agreement with the ministry of labor. And with that, we have to change some procedures in production. Basically, some basic services like masonry [ph] is going to be performed by own teams and not outsourced teams as we had in the past, as we subcontracted third parties.

We started that in the first -- on the 1st of January already on 2013 and we had to prepare the Company for that, for as much run risks in the processes. So in the last quarter, we changed the production structure. And with that, we had a bit of decreasing production. This was expected. It was not something unexpected. We decreased production and we are picking up in the First Quarter of 2014.

But there was a decrease in production in 2013 and a bit in January this year. But this was something that we had to do. We had to decrease the pace of production and therefore a bit of our revenues.

Another important point in our release is about Prime. Prime is a company that is controlled by MRV and it operates in the Mid-West. The last quarter Prime was very bad and consequently it affected our EBITDA margin, not the gross margin, because it's consolidated below MRV. But anyway, it did yield bad results.

And the reason for that is, firstly, because it's based in the Mid-West Brazil and especially in Brasilia and Goiania. Goiania prices were a bit affected in the market. Probably it is the worst market in Brazil today, Brasilia and Goiania. And Prime works at a level of MRV, especially in Brasilia, with a more competitive market. And so we had to give discounts and that did affect Prime and the speed of sales.

Also some of the (technical difficulty) performance took a little longer with that. Costs went a bit up. So again nothing very relevant. But they did go up. And also we had a problem with Prime in a cost of BRL60 million in terms of licensing in the Federal District. So all that altogether brought some negative results for Prime.

Finally, I would like to highlight our gross margin, which is a very important point. And we have to understand that very thoroughly. You know Gerson, Monica, they are always available to talk to you. But the market did understand things in a wrong way. When we talk about gross margin and NPC adjustments and all the adjustments that we had, the gross margin went up in 2013. We started the year, if you remove out this external effects, at 20.5%. We went to 24.5%, 25% and we ended at 28.5%. The margin grew 20% from 20% to 28%. It is a lot; it grew a lot. And it is what we expected. So this is very important for you to understand.

You have to understand the gross margin at what point we started to understand how we ended. So indeed there was an increase in gross margin if you exclude those external factors. And this is something that is very important and it's something that you can talk to Gerson, Monica and Leonardo about that.

Well just to close then -- Leonardo is going to talk and also Rafael and we are going to open for Q&A. But I would like to say something important. In 2013 we got something that was really exceptional. We broke our sales records. We sold 20 million past [ph] in 2013. So a very good result, very strong. And that will bring future confidence as we sold a lot at good prices and we'll see this effect in 2014 and 2015.

Another important thing is that we were able to do something very nice. LOG Company build, delivered 40,000 units. So the company is much better than it was in past. We have all areas well balanced. And more important than that, we did 40,000 units with a positive cash of BRL560 million, this is a lot.

And to close, how do I see 2014? Well 2014 is a year with which I'm very positive and optimistic. I'm continuing telling you that margins are not going to go down. They are going to go up. We are going to continue generating revenues. And why is that? Because we are going to grow more, sales are going to grow more again in 2014 as they did in 2013. It is a strong market. We have the products and the Company is going to grow in a balanced way generating margin, improving margin and generating strong positive cash flow.

And the Board of Directors is proposing now to increase dividend payout for the year. So we are so convicted of what we are proposing that we want to increase dividend payout. Not because we want to please the markets. But because we believe that this is going to happen. We are going to increase dividends and we believe that 2014 is going to be a very positive year.

So I would like you to contact us. Let's talk about the year. Let's try to understand the Company better. Because some of the things that we think are good are being misinterpreted as bad. But the time will say that we are doing the right thing.

Well just to close, I would like to say that Rafael and Eduardo are here with me. They are taking important positions in the Company. Many of you already know Rafael and Eduardo. So I'm going to turn it over to Rafael just for him to say what he is thinking about the Company reality and in line with what we have talked about.

Rafael Menin Teixeira de Souza {BIO 16905756 <GO>}

Well. Good afternoon everyone. On my behalf and on behalf of Eduardo Fischer, I would like to talk a bit about the transition that is happening in the Company. We hired BCG several months ago. And in the process we are trying to identify what would be those that would have the right features for the Company's succession plan. In the process, Eduardo and myself were chosen as future CEOs of the Company, of course that we have had to have the approval of the general shareholders meeting.

But the idea is that we are going to follow with this model. This model is not going to take any rupture for the Company. We have been with the Company for a long time. We know the business. We know the market very deeply. And we are very sure that with this model Company management and values are going to be maintained. And we are certainly going to have an even more positive and bright future ahead of us.

Thank you very much. We are going to have lots of opportunities to talk. And now I'm going to turn it over to Leonardo.

Leonardo Guimaraes Correa {BIO 15387486 <GO>}

Well I'm going to make some very specific numbers of the quarter. Gross margin, Rubens has talked about that. But I like to call your attention to the fact that MRV is reducing the quantity of developments with partners. And therefore, we tend to have a higher percentage in these developments or close to that.

As for selling expenses, well, we are expanding our own sales force because we believe that in this way we are going to better align Company strategy since the beginning of the process with our clients. Our product is very specific. And therefore, expertise and know-how do make a difference. The web and own sales forces are the things we are focusing on.

In this quarter, the expenses went up compared to the previous quarters but because we increased sales. If you think of the percentage of sales hired, we have a decrease from 6.3% to 5.3%. As for sales, we continued to expand. And in 2013 and 2014, we also are going to continue the projects that we call SICAQ; that is, we just completed the sale after approval of the financial institution. With that, we minimize the Company risks and we enhance our cash flow.

As for general administrative expenses, we have a structure in place and we are ready to grow operations. We think that G&A expenses are going to grow less than inflation in the next quarters and years. As for this quarter, they went up compared with the previous quarter because of non-recurrent legal expenses of approximately BRL3.5 million relative to the workforce adjustment agreement that we had with the Ministry of Labor.

In the Fourth Quarter 2013. And Rubens talked about that, about Prime, I'm not going to say much about that but it did affect our results. Now without being repetitive in regard to cash generation and dividends, I would like to reinforce that the Company wants to continue with low leverage and we are privileging in our debt profile a construction funds rather than raising funds for corporate debt. Construction funds are more predictable. They are lower compared to corporate debt and we also want to boost our process of transferring clients to banks. Our net debt compared to net income is going to be close to the percentage that we have today.

The year of 2014 is going to be a year of sustainability for MRV. And in the broadest sense we are thinking of a response [ph] cooperation satisfaction of our customers (technical difficulty) development of our employees as well as the communities where we are inserted. We evolved a lot in recent years in all the senses and we believe that we still have a lot to do. This combination enables (technical difficulty) our businesses and the satisfaction of our stakeholders.

Finally, I'd like to say that LOG continuous evolving in the development of its assets. Now we have Urbamais, the Company's -- the Group's youngest company that is focused on the development of land for residential or mixed use. It's close to its first launch and it's going to contribute to results for shareholders. As for cash flow, Urbamais does not need to receive investments that are relevant because its acquisition model is based on land swap. Now, I'm going to open for questions-and-answers.

Questions And Answers

Operator

(Operator Instructions) Enrico Trotta, Itau BBA.

Q - Enrico Trotta {BIO 16742911 <GO>}

I have two questions. First is the impact of Prime on the equity equivalence line. I would like to know what is the impact that came from Prime on this line and how many projects you had and what you are expecting for the next quarters, if you are expecting a similar situation or not?

The second question is about cancellations. They continue at a high level, as Rubens mentioned. Probably it is a trend for 2014. But what is your expectation in terms of a better cancellation level for the future if we think in the years to come? Thank you very much.

A - Unidentified Speaker

Well your question is to be divided into three parts. In terms of our program, I think that this is going to be better and after we implement this project we are not (technical difficulty) cancellations. I think that this is going to make a difference for the future. I think that perhaps we are going to have the lowest cancellation rate in the country.

As for the market, the market is strong. I would say that even stronger than it was in 2013, again, because we don't have much competition. We don't have much competition in the segment in which we operate. So the market is very strong. And because of that, I think it's going to be a very good future, as we had in the past. But 2014 seems to be showing to be an excellent year with very strong sales results.

I'm going to ask Rafael and Leonardo to answer the questions about Prime. Leonardo is going to talk about the financial part and Rafael about the other parts.

A - Leonardo Guimaraes Correa {BIO 15387486 <GO>}

Well in terms of equivalence, it was minus BRL22 million. As for volumes of projects, sales in 2013 amounted to approximately 6.5% of the total projects of MRV. In terms of (technical difficulty) sold units we are talking about less than 3% of our launches.

A - Rafael Menin Teixeira de Souza {BIO 16905756 <GO>}

As for Prime, we did have an impact in the first -- we will have an impact in the first half of 2014. But we -- what's important is that we have addressed the problem. Four executives of our team joined Prime as of the end of last year. And we do believe that as of the second half of this year, Prime operation is going to be at the same level and following the same operation models of MRV. And therefore, with the same metrics. But we will be affected, not as much. But we will be affected in the first half of 2014.

Q - Enrico Trotta {BIO 16742911 <GO>}

Okay. Thank you very much.

Operator

Nicole Hirakawa, Credit Sussie.

Q - Nicole Hirakawa {BIO 18242556 <GO>}

My first question is about the share of projects that you have outside the Minha Casa Minha Vida project. Could you tell us how much these launches are going to account for this year in the total launches and how this movement will impact the speed of sales of the Company?

And another question is that, Rubens mentioned some changes in the construction project process, the workforce adjustment agreement. Could you give us some numbers how much labor you brought inside the Company just so as to have an idea of numbers?

A - Rubens Menin Teixeira de Souza {BIO 15387481 <GO>}

Hi, Nicole. This is Rubens. Your question is very important because the Minha Casa Minha Vida project works with workers' compensation fund project. But other projects also work with the same funds in the same way. The only thing that changes are interest rates. But the government has not corrected or increased the sealing for the Minha Casa Minha Vida project. So whenever you want to buy something above the sealing, you have to think of other products. But they are similar products with the same workers' compensation funds.

So in terms of cash flow, it's basically the same thing. What you do is that you have a production agreement. You have the same transfers of clients to banks. The only thing is that they don't call Minha Casa Minha Vida, because the sealing is very low. So in some places the sealing is BRL500 million -- BRL500,000. So if it's BRL520,000, you have to go to a different program.

The interest rates are slightly higher for the buyer. But the subsidies are maintained. And this is not affecting sales for us because demand is so much bigger than supply. We see this market in Brazil and we have been seeing that for a longer time and this does not affect the market.

Proof of that is that in 2013 we sold already lots of units in this project more than 2012 with a lower Minha Casa Minha Vida share. And the same applies for Minha Casa Minha Vida in 2014. Lots of people are migrating from Minha Casa Minha Vida project to other projects because of the sealing. The flow is the same, the model is the same. But it's not called Minha Casa Minha Vida.

As for the workforce adjustment agreement, I would like Rafael to mention the labor issues.

A - Rafael Menin Teixeira de Souza {BIO 16905756 <GO>}

Well the adjustment agreement is the following. Until the end of last year we had 30% of own employees and 70% outsourced employees. With the (technical difficulty) agreement we are going to go some 45% in MRV. The impact on operation is zero. On production, we had a lower production in November-December because there was a small rupture. But in January, we are (technical difficulty) so in terms of production this is not a concern. People have been hired and things are moving very smoothly.

Q - Nicole Hirakawa {BIO 18242556 <GO>}

Okay. Thank you very much. Just for a follow-up, Rubens, in terms of projects outside the Minha Casa Minha Vida project, I understand that this transfer to clients is the same. But aren't you going to have any impact on your (technical difficulty)? Well the affordability is going to drop and interest rates are going up.

A - Rafael Menin Teixeira de Souza {BIO 16905756 <GO>}

Well it's true, Nicole. But what I'm saying is that there is no demand. The market is as (inaudible) it was in the past. But we have no demand. We have operations in 120 cities. We have been in the market for 21 years since 1994. So we know the market well. We are doing things the same way and we are alone. In 85 of the market, we do not have competition. So although affordability is lower, the market does not have the right supply and so this is not a problem for us.

Q - Nicole Hirakawa {BIO 18242556 <GO>}

Okay. Thank you very much. I got it.

Operator

Gustavo Cambauva, BTG Pactual.

Q - Gustavo Cambauva {BIO 17329406 <GO>}

Going back to Prime, Rubens already mentioned in the beginning of the call. And I think I understood it. But you mentioned discounts in Brasilia and Goiania. What was the average level of discounts that you are selling the units for?

And also you talked about some additional costs. What costs were they? Could you break down these costs in terms of losses of Prime? How much was because of additional costs and how much was because of discounts and if there is more to come?

A - Rubens Menin Teixeira de Souza {BIO 15387481 <GO>}

Well Gustavo, we have three very important points. There are others. But I'm going to highlight the three. First, there is own out [ph] of rate in Brasilia that was BRL60 million and we had to pay for that. So we had to pay BRL60 million and it was a cost of the project that we had to bear. Also, we had to give important discounts especially in two developments in Brasilia as well in Goiania.

It is a market that is not good. We have developments there with higher costs and we had to give high discounts. And that did affect profitability. Just for you to have an idea, the top line (sic; "Top Life") building, you are talking about 2,700 units and we have 2,100 units. The first units went well. But then we had to decrease prices. And because we had a slower speed of sale, we had to extend the schedule.

And whenever you extend schedule, you increase prices of the development. And we like to correct costs along the development. And so if you have a longer time for the schedule, you do increase prices. So now we have a new executive there. I think things are controlled. And I think that as of 2014 things are going back to normal. But we did have this problem in the Second Quarter of 2013.

Q - Gustavo Cambauva {BIO 17329406 <GO>}

Okay. Thank you. And in terms of cost review, how much do you know?

A - Rubens Menin Teixeira de Souza {BIO 15387481 <GO>}

We are going to give you the numbers in detail because there are lots of developments. So to make things in a more organized manner, contact Monica and she is going to give you the numbers. Okay?

Q - Gustavo Cambauva {BIO 17329406 <GO>}

So thank you very much and have a good day.

Operator

Luiz Mauricio Garcia, Bradesco.

Q - Luiz Mauricio Garcia {BIO 17432519 <GO>}

So still talking about Prime, Rubens, you talked about the Top Line (sic; "Top Life") of Taguatinga. And regardless of the events of the Fourth Quarter, what drew our attention was the volatility of this project. Along the year of 2012, there were some quarters that only this development accounted for 30% of total MRV results. So could you talk a bit about (technical difficulty) makes the market a bit insecure. What is behind such high volatility? Is it cost assumptions? What is it?

And also when you take a look at Prime as a whole, of the 15 SPs that you have open, 12 are running in a loss. So (technical difficulty) transfer that to all the SPs that you have in your ITL you have 40% that are running in a loss. I imagine that some of these are non-operational. But if you could talk a bit about the dynamics?

Again, going back to the fact of geographic dispersion, it seems to us that some regions are weaker and in view of the macroeconomic scenario perhaps are not going to get better. So could you talk a bit about these events, not only Prime. But other areas, other SPs outside Prime?

And my second question was about the beginning that you mentioned that the Caixa kind of tightened credits a bit. With that you had an increase in cancellations. And the market is very much (technical difficulty) several analysts that are designing strategies are thinking about the continuity of this process. Some companies were very aggressive in launches in past years and now will have to hold things a bit more, I don't know, by reducing volumes or maybe being a bit more judicious in terms of default rates and et cetera.

Do you see that as a potential risk for 2014 and 2015, especially because we can have a stronger fiscal adjustment in the country?

A - Rubens Menin Teixeira de Souza {BIO 15387481 <GO>}

Okay Mauricio. So let me try to answer your questions in three parts. First, as for Caxia Economica Federal Bank, we have been interacting with Caxia. We have been talking to them a lot. And I think that construction companies have a very (technical difficulty) relationship with Caxia and with the government and we do analyze our problems.

I think that in real estate credit in Brazil, we have two major virtues. First because we have the workers' compensation fund, which is a fund that is liquid and it is very important for us and it has a surplus. Second, differently from other countries, Brazil has been working with credit in a very safe manner. And this is very good for us. I think that Caxia is not going to tighten credit even further. I think that there is no need for that.

So we are operating in a very safe manner. So now we are working with new developments and what is important is that those cancellations that were a bit higher in the last quarter are of units that were about to finish. And we have, I don't know, an extra of 300 cancellations. So when there was a tightening of credit unfortunately we had the (technical difficulty). But it's not something that I believe is going to be recurrent.

And in terms of geographic dispersion, I think you are mistaken. I think that this is our strength and you may think it's our weakness. And time will tell who is correct. But we do believe that geographic dispersion is important. And as you said, sometimes you have a project that is not going well in Brasilia. But it is Paraiba, in Pernambuco, in Aracaju, in Rio de Janeiro, in Fortaleza, because there we do not have competitors and we do have operations bases there.

To close, as for Prime, something that is very easy to understand. We have 60% of Prime. And SP, we have 70% of SP. So Prime, we have a small share of Prime. But a very high of SP. In the month of the launch, we sold 1,000 units. But in Brasilia, it is a very competitive market. The first month of launch we had a very good margin, both MRV and Prime. But after that we had to offer discounts.

Finally, we still have an opportunity to sell there. But because we have many units there and units are a bit pricier there, the level of discounts was a bit higher. But we did sell 1,000 units and now things are (technical difficulty) we are managing the situation. But it's not a matter of geographic dispersion.

Q - Luiz Mauricio Garcia {BIO 17432519 <GO>}

Okay. Thank you very much.

Operator

Frederico Mendes, Deutsche Bank.

Q - Frederico Mendes {BIO 19832788 <GO>}

I have two questions. The first is regarding to ROE. Your working capital is at an optimum level, leverage as well. And for you to give a return of at least 15% you would have to increase your net margin for at least 14 basis -- by at least 14 basis, that would get to 32 in our numbers. Do you have the margin to do that for the coming years to justify the valuation with your book value?

And the second question still in the line of gross margin, in this quarter you had very strong launches and we would expect a better (technical difficulty) the fact that newer developments have better margins. But moving to Third Quarter you still had a drop.

Of course Rubens mentioned there are other numbers impacting gross margin. But I would like to (technical difficulty) a breakdown and for you to tell me if I'm right?

A - Rubens Menin Teixeira de Souza {BIO 15387481 <GO>}

Well there are three points here. First, you had higher launches but the appropriation of revenues in launches is very low, because you just recognize when the development starts. So launch revenues do have a very low effect. So this is going to be more for March, as of March.

When you talk about ROE you have to think about two things. First, what kind of hedge you are going to have. If you consider that, things are a bit different. And you have to think that whatever you do is going to impact your return. Then you have revenues. If I sold more than 2012 in 2013, I'm going to have more revenues in 2014. So if revenues grow even if I have the same margin I'm going to have higher numbers. But I think that our ROE (technical difficulty) the time. But because of the non-recurrent facts that I mentioned. Leonardo would like to mention.

A - Leonardo Guimaraes Correa {BIO 15387486 <GO>}

Yes, our gross margin is getting better. But this is combined with the operating performance, cash flow cycle. We have the least capital per unit produced. And with that we are going to have a higher ROE. And as we sell more, then we have a dilution of administrative expenses. We think internally of the amount that is necessary for us to have our ROE per unit. And we are improving a lot.

This is one of our goals and it is part of the effort of our executives. We know that we have room to improve. There is still lot of room to improve. And we are focusing on that, because I think that with that we improve the Company but also the industry as a whole.

Q - Frederico Mendes {BIO 19832788 <GO>}

Okay. Thank you very much. So just for a follow-up. So for the ROE to improve you were talking about optimizing the capital structure to reflect the size of the Company a bit better. You talked about an increase of dividend payout, made the extraordinary payout. So this is a possibility that the Company is considering. Is that correct?

A - Unidentified Speaker

No. There are two things that I mentioned. So in terms of indebtedness, we are at the levels that we want to stay in terms of percentage to our net worth. So with that, we are going to have money in the Company and this money has to be allocated to dividends, to new investments. Well this is something that we are going to analyze as we move on.

Q - Frederico Mendes {BIO 19832788 <GO>}

Okay. Thank you very much.

Operator

(Operator Instructions) MRV's Q&A session is now closed. We are going to turn the call over to Mr. Rubens Menin Teixeira de Souza for his final considerations. Please, Mr. Rubens, go on.

A - Rubens Menin Teixeira de Souza {BIO 15387481 <GO>}

Well I think this is it. I think that we have put all the cards on the table. We do think that the future is very good for MRV. We are very optimistic. And let's follow this (technical difficulty) the Company and we are going to continue interacting. I thank you very much for attending the call. Thank you.

Operator

MRV's conference call to disclose the earnings of 2013 is now closed.