Q3 2015 Earnings Call

Company Participants

- Eugenio De Zagottis, Investor Relations, Corporate Planning Vice President
- Marcilio D'Amico Pousada, Chief Executive Officer

Other Participants

- Joseph Giordano, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Raia Drogasil Conference Call to discuss its Third Quarter of 2015 Results. The audio for this conference is being broadcast simultaneously through the Internet in the website, www.raiadrogasil.com.br/ir. In that address, you can also find the slide show presentation available for download.

We inform that all participants will be only able to listen to the conference during the company's presentation. After the company's remarks are over there will be a Q&A period. At that time, further instructions will be given. (Operator Instructions)

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 on the beliefs and assumptions of Raia Drogasil management and on information currently available to the company.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions, because they relate to future events and therefore depend on circumstances that may or may not accrue 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. Marcilio Pousada, CEO; Mr. Eugenio De Zagottis, Investor Relations and Corporate Planning Vice President; and Gabriel Rozenberg, IR and Corporate Planning Director.

Now I'll turn the conference over to Mr. Marcilio Pousada. Sir, you may begin your conference.

Marcilio D'Amico Pousada

Thank you. Good morning, everyone. Welcome to the presentation for the results of third quarter of 2015 Raia Drogasil. As always, Eugenio will present his slides of the results. And before the Q&A, I would like to touch some points. Eugenio, Please.

Eugenio De Zagottis {BIO 7193695 <GO>}

Hello, everybody. First of all, thank you for attending our conference call. This is another very strong quarter by the company, one we -- we feel very, very good about. But this is the first quarter that we start comparing against a strong comp base. As you remember the demand -- the huge margin gains we've seen in the last 12 months, we've decided on the second semester last year. So it's a very good quarter, but it's a quarter comparing versus our third [ph] comp base. So we are talking about the 20 basis points EBITDA margin increase.

We ended the quarter with nearly 1200 stores, so it's 1177 stores. We opened 37 stores in the quarter and closed two stores; we achieved 2.4 billion in gross revenues, a revenue increase of 20% with 12% for same-store sales growth. Our gross margin reached 28.9% a 100 basis points increase versus the previous year. And EBITDA of 181 million, 7.6% EBITDA margin and a 20 basis point margin increase.

Adjusted net income totaled 95 million, a 4% margin, while we register again positive free cash flow of 68 million in the quarter and 66.7 million of total cash generation.

We are very happy with the fact that the Raia Drogasil stock has entered the IBOVESPA and the IBrX-50, probably the two most important indices in the Brazilian Stock Exchange. So this is already bringing us increased liquidity to our stock. And we have increased this quarter, the stock opening guidance for 2015, which is going from 130 to 145 stores. So I think this is really the main new level of the quarter.

On the next page, I like to share a couple of things about our expansion. As we mentioned we opened 37 stores in the quarter, year-to-date we have already opened 94 stores against only 80 stores we had opened in the same period in the previous year. So we are really growing at a faster pace than before. If you look last 12 months we have done 145 new stores. So we are now increasing the guidance of the year from 130 to 145, which basically means that we opened in the fourth quarter of this year, the same number of stores we opened in the fourth quarter of last year.

So we are just reflecting the fact that we are already at a different pace in terms of our store opening. And we are really paving the way for a new and stronger growth pace starting 2016. We are yet to release the guidance for next year; we should look this in the Raia Drogasil day, in the beginning of December. But obviously we are searching a new buyer now and we can only go not with that buyer. We have a huge pipeline of contracts to support our expansion coming forward. It's very important to mention that the quality of the stores we have opened and of the contracts we have signed are super. So we are not sacrificing quality at all, by increasing our growth. We really believe we can sustain the same quality, but at a faster pace.

And another thing that I like to touch is, we see a lot of people taking in the market about new stores changes doing this much, there are also changes doing that much. Means store is not a single currency, a news store for early means of corner store absolutely top quality location, a store that we expect to sell R$700,000 or R$800,000. A store that currently generate R$100,000 in monthly EBITDA. So I think we have not only more stores in the rest [ph], but opening better stores in the rest and this is really what matters. We have a year the youngest store portfolio in probably five quarters, we have 66.8% on matures stores, 33.2% of stores still in the maturation process.

On the next page, here we have our most updated geographic footprint of the 1,177 stores, 568 are Raia stores, 609 are Drogasil stores including about 20 Farmasilstores in this figure.

We saw a very strong market share gain in the quarter. For the second quarter in a row we gained 80 basis -- we gain a 0.8 percentage points in market share. So it came from 9.2% to 10% on a national basis, we increase market share in net receivable [ph] market.

So, in Sao Paulo we went from 20.6 to 22.3 so this was the most significant increase if you consider or how big already the share is; in the Southeast we came from 6.6 to 6.8; in the Midwest 12.4 to 12.5; in the South another great game 4.8 to 5.5, really driven by the maturation of the stores in these markets and also by the maturation with the brand in this market. And finally in the Northeast from 1 to 2.4.

I think these market share gain reflects the fact that we are executing in a much better way than we were executing before. I think you can't deniable how the merger has made us stronger, not only bigger but stronger and better. So by deploying at Raia good things to Drogasil -- by deploying Drogasil good things at Raia with platforms and profits and all of that. (inaudible) we are operating significantly better. So this is really showing up in our market share gains.

Another thing here is that we have a lot of distress competitors because even though we are in effect with these low defensive resilient, while main companies high debt and have constitute a big debt in order to fund the organic growth over the last few years. So it's not difficult to -- some companies pay interest rates north of 20%, especially it's more than middle sized companies, sometimes as high as 23% 24%, 25%. So a company in a situation like this, they have to cut on inventories; they have look cut on people, they have to increase prices and with the opposites, we are getting stronger by the day.

Next page, our total revenue growth was 20% in the quarter was 12% of same-store sales growth and 8.1% for matured stores. This shows how resilient this cycle is, we are seeing more of the same in the fourth quarter, October is proving to be a very strong month, so we are sustaining this kind of pace.

And another highlight of the quarter is that (inaudible) was the top performing category opposite weather factors evolve in that. But even despite favorable weather for the category, that type of categories that maybe suffering mostly these categories. But we are gaining a lot of revenues in categories that are very important to us like skin care, for example.

(inaudible) skin care injury should be more subject to the macro scenario than oral care, but again we have to sit, imagine and executing with skin care. And the Brazilian consumers is so beauty driven that -- this category is just flying.

On the next page, talking about our gross margin. We ended the quarter 28.9 of gross margin, 100 basis point improvement over last year. Another highlight is a huge improvement in cash cycle; we reduced cash cycle by 7 days in the quarter. So what happened here is that as we are growing and our suppliers need to sell part of what others are selling. We are able to do great deals with what suppliers in which you get better discounts in which we make good accesses and nice inventories, but you have huge accounts payables improvement to do that. So as a result of that we have gained seven days in cash cycle mostly because of (inaudible) on accounts payable expense.

On page eight, let's talk about the expenses, and expenses have really been the challenge over the quarter. After two years of stable expenses with an inflation as high as 9% we finally starting to see pressure again. So, in total our SG&A increased by 0.8 percentage point. The administrative expenses increased by 0.2 percentage points. This is kind of artificial effect because the comp base of the 3Q '14 was unusually weak. So what happens here is that we had (Technical Difficulty) compensation in the first semester of 2014.

And we compensated that in the second semester of '14. So this is an effect that we see in the quarter and we've seen the next quarter. This type of competition allow us in 2014, was 20 bps lower in the second semester because it had been 20 bps higher in the first semester. So economically speaking we are stable on SG&A but then we have seen 60 bps pressure on the sales expenses.

If we compare year-on-year labor represents 30 bps of pressure. Let's remember that we just increased salaries from June to July by 9% and the sales from June to July doesn't grow 9%. Obviously we have another three quarters at these level salaries. And the sales will grow further doing that. So I think this is really the worst moment for the labor expense. I think it should be slightly better as we move ahead and as we grow our readiness. Electricity also pressure our number by 20 basis points and pre-operation expenses as we started accelerating pressure by 10 basis points.

If you compare versus the previous quarter I would say energy is not affected because it was already high than the previous quarter, but still labor is increasing our expense by 30 basis points. Logistics related to the northeast expansion is pressured by 10 basis points. Pre-operational is pressuring by 10 basis points and then the others, more pressures totaling 10 basis points.

Next page, we achieved an EBITDA of 181 million in the quarter, 7.6% margin and a 20 bps improvement versus the previous year. It's important to mention that if you look last 12 months we had an EBITDA margin of 8%. What happens is that when inflation is higher there is bigger a polarization between the second quarter that is when we get the good news from inflation versus the other quarters when we get the bad news from the inflation.

So 8% is a made of three quarters between 7.4 and 7.6 and one quarter at 9.5. If inflation goes down, probably the second quarter won't be as strong, but likely the expense pressure in the remaining quarters won't be as peak and compensating for one another.

And finally, if you consider just the stores we had in operation on December 31 last year. And we attribute to those stores, the full corporate G&A and the full logistics expenses. These stores -- they would have an EBITDA margin of 8.3% in the quarter. So we have a 70 basis points of pressure from the past recently opened. This is only part of the maturation potential, because we have stores that are too maturing but they are in the second or third year of maturation. Here we are just counting the effect of the stores open in this calendar year.

Next page as I mentioned the cash generation was one of the highlights of the quarter. We generated 68 million in free cash flow with a positive working capital contribution and we had a total cash flow positive by R$67 million.

Considering the full nine months of the year it's a 74 million positive free cash flow. And a 14 million positive total cash flow. So result from operation totaled 440 million versus 320 something last year. Operating cash flow after working capital 318 versus 161 and we also investing more because we accelerated the growth. So there is a big investment for the stores of the fourth quarter. For the stores of the third quarter and for the stores of the first quarter next year, 244 million versus 187 and still a positive free cash flow.

And it's also important to mention that any quarter when compared to the fourth quarter this has a disadvantage, because the fourth quarter is cyclically the best quarter in terms of cash flows. So comparing the third quarter versus the fourth quarter last year is still showing a positive number, it's a really, really strong year.

Well finally, our stock has been performing really well. We had an appreciation in the year of 55%, for those in drug stores, who have been with us since the Drogasil's IPO and believe us we have some people who have been around for all the time. They have enjoyed a compounded annual growth rate of 27% as a remainder of [ph] -- an average annual return of 27%, this grew both the share appreciation and the interest on capital paid during the time.

For those investors who ended through the higher IPO they have seen an average annual return of 32%. So these are even -- with higher than private equity kind of returns for a initial company. We are very happy that we entered the two main indices in Brazil the IBOVESPA and the IBrX-50. And now the liquidity has been improving as a result of that, we have seen an average trading volume of R$60 million in the quarter.

So I'll now pass to Marcilio for this consideration. And then we will go to Q&A. Thank you.

Marcilio D'Amico Pousada

Okay. Before I go to slide, we are very proud of our results. We know how difficult is to managing this business in his macro environment in Brazil. But we are also very well about the expense because the inflation is very difficult to the run the business, to contain the expenses in Brazil because of inflation rates.

I put in this slide, two examples of how we work with expenses, okay. Let's go to labor cost first. Our focus, I will tell you -- our focus is always with customer service, we have to be the leader for the customer, the best service also. We remember that we are reaching nearly 80 customers only. And we had a long term strategy, when we look for the labor that means to find people and to reduce the cost, but does not, we never think like this. We think like how to find productivity to make -- achieving strong better, having better customers with more productivity.

Then we start to reduce all the process in those stores, start to make it planned for all this process and we are working two years in this process and help us a lot to start to -- or reduce the people in the store or start to achieve more purchases in the stores, with more sales. What we reduced? We reduced, for example the data lines, we reduced the work control between the stores and offices. We reduced the maintenance of the stores, we reduced the turnover. We have all this process led to achieve better position to us, where you can see this now results in the end of 2016 in the beginning of 2017.

If you look at the energy, also energy is our fast expenses in our P&L in the stores, okay. We have the label (inaudible) and after that is energy. Energy increased a lot in this year and in the next year, in the previous year also. Our focus here is not only to reduce the cost in energy.

Our focus is how to build a store more efficient, how to build a business more efficient with productivity. We know the energy costs will be the saving here right now, in the future. Then with how to rolling the LED light to the stores, we are revising all the air conditioning specification, we create a standard here of how to compute energy if you take store prototype. We really believe that it will help us in our cost only 2017, 2018 because we have to modulate the store and opening new stores modulate to the energy.

In the next slide we talk about our strategic with new stores. Always people like new (inaudible) for the new stores so good. Why you don't opening more store than others. Why -- we opened 300, 400 stores, then we accept the challenges here, what the challenge to open more store. The number one challenge is always people; how to hide the people, how to hide people in the stores. We stood at the wall with (inaudible) opening up 400 stores the next year, the following year after 400 stores (inaudible). We go toward this because we are -- we just opened a store (inaudible) the store for us in the same pace and the same quality that you have the store right now.

The second point is how we will accelerate the process, how we can hide more locations, not looking for locations, looking for corners. We know how important is the point of the sales, the location of the store, okay. We are looking for the best corners in the country. It's very difficult also in Brazil they like store opening requirement and it is very difficult to (inaudible) the openings during the year. Looking for 2013, 2014 we always opened too many stores in the end of the year, it's not good for our business, it's not good for the (inaudible).

We are working all these challenges and we are much better right now, we have the team right now which is ready for the opening store. We are training the team, you have all the careers that's ready for this. We expanded our real estate team, also we are proud of our corporate team. We have -- in this team we almost have 150 years of age. The people grow very well as far as business work with us for 30, 20 years. They know very well all the stores will increase the contract for us, we had much more contract with us right now and we set up a better process.

We are implementing PMO [ph] process to shut better the floor to open the store, the construction, the light and (inaudible) you trained achieving way in ahead to send the merchandiser for the stores, better way now we are ready to opening more stores.

Then we increase ours, above right now is a 145 stores per year is the number for this year 2015, this will be the minimal number for the next year also. We really believe you can reach -- we can open more store near in the future, but we don't know right now, we are challenging to achieve and try to achieve more store in the future.

Okay, this is what we have right now, we're ready for the question and answer for you. Thank you very much.

Questions And Answers

Operator

(Operator Instructions) Mr. Joseph Giordano from JPMorgan, would like to make a question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hi. Good morning, Eugenio and Marcilio. Thanks for taking my question. So I have a question on the expense side, you've seeing some pressures from the -- on the selling expense side and I understand that has parts on the salary inflation rate. So I'd like to understand how you're going to mitigate those impacts going forward. Should we continue to expect some gradual margin expansion despite higher and higher comps.

And also how should we reconcile that with the faster accelerated store openings going forward. So basically, we may see some additional pressure from the new stores? Thank you.

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

Thank you Joseph. Thanks for the question. I mean, inflation is really the main challenge we have. The top line is growing significantly, we have sustained gross margin expansion but at times like this inflation of 9%. It's very difficult to sustain, to keep the stores flat in terms of expenses. I think we are in the worst possible timing versus expenses, because I mean salaries increased 9% from June to July, the sales have not increased 9% from June to July.

Maybe they can increase from now to the trending quarters. So the labor is higher now, but it will remain flat for another nine months. So within the next quarter you will see the same -- let say absolute expansion in the same -- in the existing stores. But with higher sales to better dilute that, but still I think sales expenses will be pressured, we just expect to reduce the levels of pressure, prices what we have seen in this quarter. The acceleration of the expansion causes pressures on the pre-operation expenses.

So this is part of the story as well. But I mean on the positive side, we're starting to see labor expenses not pressure any more. Energy, year-on-year the pressure stood there but quarter-on-quarter is no longer pressuring. So the energy is at high level but is not growing further as a percentage of revenues. And if we maintain a good sales momentum, I think we will improve the level of sales expenses dilution, we have shown in the quarter.

And then we have the gross margins that should keep growing to help us and we will generate dilution there should keep taking place, which will help. All we know, I think this quarter is very loose to achieve of how our life should be looking like in the near future. I mean, showing good numbers, but comp in versus are very high comp base. And as a result, posting modest margin gain 10 bps, 20 bps, may be 30 bps. So that's our expectation.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you, Eugenio. I have one additional question concerning the expansion plans. I just want to understand how is it looking like for your competitors still like. If they are also accelerating expansion searching like kind of start-up competition in the Northeast region as like I believe the second largest players is also expanding into the region.

I really wanted to understand, like how is the competition behaving in terms of expansion and also in terms of growth? Thank you.

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

I think it's better now than it was before because of the crisis. So, if SPs [ph] growing normally, they should be growing -- I don't know 140, 150 this year but they have been growing over a long. So that's absolutely no news. We entered the northeast at the same time, we are very happy about the SPs, they probably also happy about the northeast, because we bought in a much better operations, quality and everybody who has been -- every chain coordinated in the region.

So the is not affected, because there had been affected all along. So this is not here by then grow about them growing. And coming -- we are growing. In the last year they opened more stores then we did, we grew revenues very more. So, when we compare number of stores we are not comparing, revenues that we derive from those stores either the profitability that we get from the stores.

So, I feel the quality that we have is second to none. And I think the quantity they would have will probably also second to none. We have other players who are not growing as much as in the past.

For example, or that what it will more -- but it can't grow because of the capital structure. So I think outside the environment is slightly better than before.

A - Marcilio D'Amico Pousada

But it is slightly better we are losing only for quality, okay. We are just looking for quality, looking for nice stores. This is the point, this is the big difference between us and the competition. As the local for open the stores this syndicates that we will have -- we need some bulk part [ph] at rest of the country.

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

Yeah. We believe opening stores cannot be visual thinking. It's not over 200 store and you just go up and this doesn't work like that. First, you have to have the suspicion team that can bring more complex with the same quality in the same time. Second we have to had a gross units of the process to make sure that those stores were approved really great stores. We have a quality meet every Monday morning we have the Chairman of the company in the committee we have Marcilio in the committee. We have three, four Vice President, Expansion Director. So all the decisions are collegiate, all the stores we do based on internal rate of return expectation. We have our marketing analysis before approving anything. And that is not a single store that we approved without any similar synergy going on inside to validate. We don't do business on pictures. We will approve based only on what the Expansion Manager has seen. We need to have our Vice President one, two, three Vice President going there and validating the location. So, we have probably better traction, we certainly have a better analytics and a stronger performance in the process.

And finally we have to be profitable that we had internal process to open those stores without distracting too much localization and the people to operate those stores. In the end 15 stores more this year was down to forming 50 more managers and 30 more assistant managers. If we go north of that its further X mangers per year and two X assistant mangers per year.

So we have been preparing ourselves. We have earned the right to grow by working from the next two years for that to happen. What we're seeing now, is not a decision we made on the quarter or decision we made on January it is a consequence of a process of -- when you foresee the fundamentals that we start to do.

Q - Joseph Giordano {BIO 17751061 <GO>}

Yeah, just on the store closing, Eugenio. What's the aging profile of those stores where they like recently opened one that did not perform or like older one that just stop working? Thank you.

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

On the close stores I would say there are couple of recent ones. That's depending on what stores are looking at -- let's say we talk about the store we close in the last 3 years, for example. There are couple of works who are recent expansion mistakes. There are several stores who we have moved to a better location, they were monitoring that stores. That were good looking stores, but we move to a better locations so improved -- we improved the stores.

There was one store that we sold, which is a pretty good example of our how we think about returns. We have store in Sao Paulo positive, not meeting. Some positive profitability. We were offered a certain cash consideration for the location, which in this case the real estate belong to the company. And we besides of that because what we offered the store doesn't remunerate. So it's clear better off by closing the stores and for growing the stores profitability but gaining the cash that was paid -- it is just one example, but I think it illustrates how we see and how discipline we are in terms of returns.

A - Marcilio D'Amico Pousada

And shareholders part of these results and it is important how to learn about the beginning stage in the point. We have a follow-up with the store, the sales results, average expenses monthly rent we sit together and -- heavily average think thrice check the orders and learn with the --.

Every semester with -- we finally we -- and closing start as a much money major opportunities is in low base stores from effect.

Q - Joseph Giordano {BIO 17751061 <GO>}

All right. Thank you Eugenio and Marcilio.

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

Thanks Joseph.

A - Marcilio D'Amico Pousada

Thank you.

Operator

(Operator Instructions) It appears to be no further questions now I'll turn the conference back to the company for their final remarks.

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

Well, thank you all for attending the conference call. Thank you all for your support and shareholders. To the good times, to the bad times and also the good times again. As we mentioned, this is not a strong quarter but it's a quarter in which we compared versus a very high comp base. So the margin expanded, the number should be good but the margin expansion should be as lower from now on. So I think this quarter is very typical of what we expect to see coming forward. So this is the -- our expected new I would say. Top line has been great we have a tremendous expansion proven, tremendous for tremendous returns and we are also gaining share based on our great execution on our existing stores.

We are really seeing pressure from the pre-operational side, we've seen variable pressure, I think we talked a lot about that but you believe you can mitigate that and manage that effectively. Gaining probably (inaudible) is crucial Marcilio illustrated well. We have many, many initiatives in which the corporation is doing things to help the store operate better.

So a store with a higher data line bandwidth, it's the store that has less IT problem, less or it can process the transactions faster. We are working on our staffing out rated. So maybe we can be more effective in terms of people deployment. So there are many, many examples of things we are doing and platforms are evolving, that the age of process improved a lot. So, when an employee leaves we replace in a much shorter time than before.

So that the life of the store is getting better. And as a result we're happy to start gain positivity even by having the same expenses via sales or sometimes even allowing us mainly in the short to middle term to be able to operate with the same standard of quality, but slightly less people then we have now. I think gross margin and G&A will keep being part of our margin expansion story.

And I think maybe the biggest highlight of the quarter is the fact that we were preparing an acceleration and a meaningful run for expansion. So we already move from 130 to 145. We have a new bar and now we go for 2016 we are still to meet the guidance, but it should be north of that. So when you see what you means going forward doesn't really matter what the short term preparation strength, I mean we can bear those expenses and even if it was the expense of the margins. Because we are expanding now to be much bigger company with better results in the future.

So are very optimistic above how things are going, but the crisis keeps helping us, demand still strong and to finalize, I mean we have a very strong growth horizon ahead of us. We have a 16 million gross horizon, this is not a five seasonal stores. The Chile population in the last 15 years has increased from 10 million people to 16 million people over the next 15 years which growing from 16 million people to 30 million people more than 4% annual senior growth. This will support, I think 15 million double digit market growth and we will be there exploiting opportunity, opening new stores and (inaudible) and transforming this company.

So before turning off the lines, I'd like to just to share our IR calendar for the near future, we are rewarding the fourth quarter on February 18 and the full year. Raia Drogasil heartily advise you to try to make an effort and comes out for our event. So it will be December 4, it's a Friday, there is a very good conference in the two three days before that, so you can put you all together if it show one. It will be in the morning in Sao Paulo, (inaudible) hotel.

And I mean we have more caller on our expansion and several aspects of our execution. We'll make all our executives available for Q&A. Something that will we often -- very often investors ask us, but we cannot provide because we have to meet people to focus on the business. But this is the opportunity while you have the whole team at your disposal to tackle on whatever subject you think it is.

And finally, the next conferences we are attending November 17 the Citi Bank conference in Sao Paulo. December 3 The Brazil Opportunities Conference, JP Morgan. As I mentioned, this is only before our (inaudible) conference. Trying to say one more day, which is our Investor Day. Then in January, 6 to 8 Latin conference of Morgan Stanley in Miami and 11 to 14 January JPMorgan Healthcare Conference in San Francisco. So that's all, thank again for attending the conference, for your support. Bye-bye.

Operator

Thank you. Raia Drogasil conference call is finished. Have a nice day.