Q2 2018 Earnings Call

Company Participants

- Jose Gallo, CEO
- Laurence Gomes, CFO and IRO

Other Participants

- Franco Abelardo, Analyst
- Guilherme Assis, Analyst
- Gustavo Oliveira, Analyst
- Joseph Giordano, Analyst
- Luis Felipe, Analyst
- Maria Paula, Analyst
- Robert Ford, Analyst
- Thiago Macruz, Analyst

Presentation

Operator

Good afternoon, ladies and gentlemen, and thank you for waiting. Welcome to Lojas Renner conference call to discuss the results related to the second quarter of 2018. We would like to inform you that this conference call is being recorded and simultaneously translated. This slide of this presentation will be available on Lojas Renner website at www.lojasrenner.com.br in the Investor Relations section at the webcast platform and the (inaudible) platform.

As a reminder, questions will be taken by telephone and through the platform. Also we would like to inform you that this event is being recorded and all participants will be in listen-only-mode during the company's presentation. And after that we will initiate the Q&A session when further instructions will be provided. (Operator Instructions)

Before proceeding, I would like to mention that any forward-looking statements that are made during this conference call related to the company's business outlook and operating and financial targets represent assumptions from the management of the company as well as information available to the company. Future considerations are not guarantee of performance as they involve risks, uncertainties and assumptions as they refer to future events and as such depend on circumstances that might or might not happen. Investors should understand the general economic conditions, industry conditions and other operating factors could also affect the future results of Lojas Renner and therefore could lead to results that differ materially from those expressed in such forward-looking statements.

Now I would like to turn the floor over to Mr. Laurence Gomes, CFO and IR Officer. You may proceed, sir.

Laurence Gomes {BIO 15361799 <GO>}

Good afternoon, everyone. We are here today to comment on the main highlights of the second quarter of 2018. Next to me, we have Gallo, our CEO; Paula Picinini, our General Manager for our IR and New Businesses; and Luciano Agliardi General Manager, our Controller.

The second quarter of the year was characterized by good pace of sales, even with late arrival of winter and the flow of stores being significantly impacted by the truckers' strike and the Brazil games and the World Cup. Despite all that we were able to have a very consistent performance.

In the second quarter 2018, we posted growth of 2.5% -- we grew 2.5% in same store sales. This performance when compared to the rates for the industry really reinstate our recurring gain of market share. We believe that if we exclude the effect of the strike, our same-store sales would have reached 5%.

In terms of gross margin, I would like to highlight, an increase of 0.7 percentage points. Also, this is a consequence of a favorable exchange hedge which was hired for imported goods. In terms of operating expenses in the second quarter, we were up by 11.7%, mainly reflecting an increase in our number of stores, with an increase in the area of sales, which was up by 10%. Operating expenses per square meter was up 1.3% and this percentage was below the inflation increase of 4.4% in the last 12 months.

As a consequence, retail EBITDA was up by 16.2% in the second quarter of '18. EBITDA margin went from 18.6% to 19.8%, growing 1.2 percentage points in the period. Gross margin growth and lower provisioning of profit sharing also accounted for this performance. Revenues from financial products totaled BRL81.3 million in the second quarter of '18, up by 2.9% vis-a-vis the previous year and that was a result of growth of the co-branded portfolio of Meu

Cartao. The quality of the portfolio and the delinquency levels are under control even though the natural half result material of the co-branded and lower growth of the private label percentage began generated higher volumes of provisioning. Therefore, total adjusted EBITDA totaled BRL434.2 million, up by 13.4% in the second quarter of '18.

Margin went from 23.5% to 24.4%. Also, I would like to highlight our net income posted growth of 41.9% going from 193 million to 274 million. This performance reflects operating improvements that we already mentioned, the reduction of the negative net financial result and lower growth of the expenses with depreciation, in addition to the effect of a lower tax rate as a consequence of tax adaptability of amounts related to investment subsidies in the last five years.

And finally, as a consequence of our performance, we were able to move forward 1.3% points in our LTM ROIC that went from 20.6% to 21.9%. So these were my comments and now we are available to take your questions. Thank you.

Questions And Answers

Operator

Thank you. Now we will initiate the Q&A session. (Operator Instructions) Our first question comes from Thiago Macruz from Itau. Mr. Thiago, you may proceed.

Q - Thiago Macruz {BIO 16404924 <GO>}

Good afternoon. I have two questions. This was a very unusual quarter because there were some non-recurring items that affected the quarter like the World Cup and the truckers' strike. I just want to understand that if we turn the quarter you were able to make some adjustments to the fact that you sold last. I mean, what about inventories. Is it correct to assume that you will see some pressure on the gross margin because there were things that happened in the second quarter and the second question is about consumer finance. It's difficult to make any projections with a good degree of assertiveness.

So the concept, looking forward is important to us. So after the second quarter, do you still maintain that view that the growth of this business this year should be between 0% to 5%, I mean still in the single-digit, so these are my set of questions. Thank you very much.

A - Laurence Gomes {BIO 15361799 <GO>}

Thiago, thank you for your questions. This is Laurence. Regarding the inventory question, we believe that our inventory is well -- is of a good size. We do not believe in any impact of any additional markdowns going through the third quarter. So we still believe that in terms of our gross margin, it is possible to -- we believe to deliver higher gross margin in the third quarter of 2018.

The contribution of the exchange rate in the following quarters will be lower once you compare to the base of last year, but I don't see any major impact or any concerns related to the magnitude or the composition of our inventory, the assortment of our inventories.

Now in terms of the second question, as we've been saying since early this year, we believe that there will be a drop in interest rate due to Central Bank regulations. There will be further stabilization in terms of growing the portfolio of Meu Cartao. And also we should increase the maturity of Meu Cartao portfolio because this maturity is bringing along further provisioning. The portfolio is healthy, but it's an older portfolio. Therefore, it requires an additional provision. So all in all, the answer is that we continue believing in that initial expectation of good financial results from low to average. I think this is what we should expect for 2018 in terms of financial products.

Q - Thiago Macruz {BIO 16404924 <GO>}

That's fine, thank you very much for the answer.

Operator

Our next question comes from Joseph Giordano from JP Morgan. Your may proceed, sir.

Q - Joseph Giordano {BIO 17751061 <GO>}

Good afternoon, everyone. Good afternoon, Laurence and Paula. I have two questions and my first question has to do with the average ticket or maybe also another question related to assortment. Average ticket grew about 1% to 1.5%. All I want to understand, whether you had any unusual promotional activity throughout this first half of the year in terms of your gross margin projection, maybe it could have been higher. I just want to understand whether this makes any sense within that context.

My second question is that we've seen growth in your e-commerce platform. I would just like to understand what was the e-commerce contribution percent for sales and to the overall performance of the company?

A - Laurence Gomes {BIO 15361799 <GO>}

Joseph, thank you very much for your question, this is Laurence. I think what we saw in the second quarter is that we anticipated some promotions because the weather was not very favorable, some players started their promotions in April. And as we usually say, we take very good care of (inaudible) positioning, that's very crucial. Our value proposition remains very sound and we had to make some adjustments due to the very competitive landscape. Maybe our gross margin would have been a bit higher than what we had. So that was the answer to your first question.

Your second question, given the fact that this was a very unusual quarter due to different reasons, we cannot yet talk about same-store bonus share. What I can say is that we are growing four times the growth of the fashion market in annual basis.

Q - Joseph Giordano {BIO 17751061 <GO>}

Fine, thank you very much.

Operator

Our next question is from Mr. Guilherme Assis from Banco Brasil Plural. You may proceed sir.

Q - Guilherme Assis {BIO 16143141 <GO>}

Good afternoon. Laurence. Good afternoon, everyone, thank you for taking my question. I would like to elaborate a bit on your gross margin. I think all your comments and your answers were very clear when you talk about the quality of inventory and you also talked about the exchange rate. I understand that the exchanges for this last collection was at BRL3.30, but looking forward and I think you already said that the foreign exchange now could probably experience some pressure or could put some pressure on the gross margin. So I just wanted to know whether you would transfer that to prices or whether there is some space in this competitive environment to do that. I just want to understand how the gross margin will evolve considering that foreign exchange item.

And the second question relates to G&A. You presented a very dilution in your salary expenses even with the opening of new stores, the Uruguay stores are approaching maturity, but G&A didn't have that same dilution. I don't know whether your e-commerce investment and other initiatives related to logistics will have any impact, but I want to know whether we should expect an early dilution of G&A looking forward. Thank you.

A - Laurence Gomes {BIO 15361799 <GO>}

Guilherme, good afternoon, this is Laurence. Thank you for your question. Well, you are correct. The foreign exchange has a lower contribution and will have a lower contribution looking forward when you look at a like-for-like basis, but for the entire of 2018 the exchange is 3.32. And we have a very competitive exchange rate because of our exchange hedging policy.

But looking at next year, I think things will change just like it happened with previous years. There are ways of mitigating that with mix of products and negotiations. So I think we can only say anything more about that further down the road.

Now about G&A, as we said before the investment cycle we have at Renner not only in terms of CapEx investments, but also OpEx investments. We are certainly executing our projects and strengthening our structure in order to integrate (inaudible) online. There are also projects related to improvements in purchasing experience and we are also now getting closer to our customers. But all of that certainly depends on conditions, the environment and the pace of sales. I think that there may not be a dilution right on the third quarter of 2018, but it will be very close to the levels we experienced last year.

Q - Guilherme Assis {BIO 16143141 <GO>}

That is very clear. Thank you, Laurence.

Operator

Our next question comes from Franco Abelardo from Morgan Stanley. You may proceed, sir.

Q - Franco Abelardo {BIO 17416219 <GO>}

Good afternoon, everyone. My first question, (inaudible) visiting the inventories subject, there was an increase of 24% on inventory level. Does that impact your margins on the third quarter? Why did you increase your inventory, is that inventory of finished goods or things that you have in the stores? I just want to understand how do you see the issue of inventory looking forward, looking to the next quarter. That was my first question.

Second question is looking at the profit sharing line we see that there was a decline and the level now is much lower than what we saw in previous quarters. I know that this certainly depends on the results. So once we compare to the total profit sharing that we had last year, could you give me some visibility in terms of what would be the level for this year. Will there be a drop around 40% to 50% as well or as results improve, looking forward to second half of the year, we will see improvements in this line?

A - Laurence Gomes {BIO 15361799 <GO>}

Franco, it's Laurence again, thank you for your questions. In terms of the inventory, it is worth repeating what we said before. Our inventory assortment is very healthy and this will not put any pressure in our margins. We will stick to what is already in our commercial plan. This 24% increase relates to an increase in the share of imported goods and also products that have a longer lead time in addition to having a favorable exchange rate that favored imports goods. That's why there was this increase. It was mainly due to the increase in the volume of imported goods. So that is the main aspect related to our inventory.

Now in terms of the (inaudible) it depends on sales pressure and adjustments and lower provisions and this is related to the performance to-date, until June. We've seen especially in the last few weeks, we returned to normality. June still felt the impact of the World Cup, but we see in the past few weeks that things are getting back to normal. Now in August we will introduce the new collection and we are very confident. And profit sharing will be adjusted according to the results that we will realize from now on.

Q - Franco Abelardo {BIO 17416219 <GO>}

Okay. If you allow me another very quick question. That investment subsidies of 42 million, is that a one-off thing or do you think it will be recurring in the next quarter?

A - Laurence Gomes {BIO 15361799 <GO>}

Franco, this amount refer to a five-year period and the recurring amount that will come will be much lower than the amount of this quarter. It should be around 10 million on an annual basis.

Q - Franco Abelardo {BIO 17416219 <GO>}

I'm sorry, could you repeat the numbers because the connection was not good?

A - Laurence Gomes {BIO 15361799 <GO>}

It will be a recurring annually, speaking of around 10 million.

Q - Franco Abelardo {BIO 17416219 <GO>}

Okay, fine. Thank you very much and congratulations for your results.

Operator

Our next question comes from Mr. Luis Felipe from BTG Pactual Bank. You may proceed, sir.

Q - Luis Felipe {BIO 15162347 <GO>}

Good afternoon, everyone. I have two questions, the first is whether you could give me an update on the push and pull process [ph] and how your portfolio is performing and how that impacted your inventory that ended up with three activity in the second quarter, impacted by the truckers' strike.

And the second question is whether you could give me more details on your e-commerce operation and I know that you had artificial intelligence, you also went through the process of revitalizing the platform. So what should be expected looking forward?

A - Laurence Gomes {BIO 15361799 <GO>}

Thank you, Felipe. This is Laurence. Now in terms of push and pull, we are still sticking to our plan. We are in line with our plan. We are readily operating like you said 30% of Renner's volume or better yet. All the stores are already operating through push and pull, and then we are testing some model product in 2018. We already talked about the contribution of push and pull back in 2017 and I think that this year we already saw that push and pull products are performing better when compared to other categories that are not yet in the push and pull system. We have 40% of the total volume of the company already operating for SKUs. Therefore, I think we are just following our plan.

A - Jose Gallo {BIO 1822764 <GO>}

This is Gallo, Felipe. I will add to the question because you questioned some of the improvements. In fact the company is making a lot of things in that direction. We firmly believe that the future of the business is omni channel. We are in the midst of the digitalization of what we are calling structural project and part of that is the question you asked. Today alone we have financial operations and that financial company started fully digital from a series of good things that happened, and soon we will have our Renner Day on September 28 and in a more structured way we will present to the market everything you talked about, and not only that, but also many other important tools that are being used now in terms of credit approval and today our customer already has the store card in their smartphone.

We also have face recognition, which helps us to reduce losses. There are many interesting things in the pipeline and we are now putting all of these things together and all of that will be mentioned during our Renner Day. We also want to express our position very clearly and tell people what are we betting on, digital, and all of those synergies that we see and that are possible also down the road. Click and collect is something that is already in operation in more than six stores. And so what are we looking at when we see people in our stores, where do they go to exchange their products. I'm not going to answer all your questions, otherwise there will be nothing left to say during our Renner Day, but I can certainly tell you that we are very active and part of all of this investment also impacts our additional expenses because that relates to the building up of the business platform and also the service platform. I would just like to take this opportunity to invite you to join us on September 28 when we will be able to give you more information.

Q - Luis Felipe {BIO 15162347 <GO>}

Thank you, Gallo and Laurence. Thank very much.

Operator

Our next question comes from Maria Paula from BBI Investments. You may proceed.

Q - Maria Paula {BIO 19356895 <GO>}

Good morning. Congratulations for your results and thank you for taking my questions. I would like to take a close look at gross margin, this is another quarter when it's dropping more than 200 basis points. I would just like you to shed some more light to what is indeed impacting this operation.

And secondly, could you please tell us a little bit about the competitive environment, you said that markdown will not be a problem for Renner. But if you could elaborate a bit more on your competitive environment and what is the behavior of consumers in the stores. Going a little bit beyond the ticket when we look at this drop, it means that payment in this quarter we are already noticed a reduction in cash sales. So maybe it is because consumers are taking up credit again. So what is your view? Thank you.

A - Laurence Gomes {BIO 15361799 <GO>}

Maria Paula, thank you for your question. In terms of this drop in gross margin of Camicado in the quarter, our approach was to anticipate sales and promotion. So as to increase traffic in our stores and this happened at Camicado and we already talked about the impacts like the World Cup and the truckers' strike, they wasn't able to push figures up and so as to help us have a more satisfying result at Camicado.

A - Jose Gallo {BIO 1822764 <GO>}

Hi, this is Gallo. Well, what we see here is an environment going through a recovery process. On the other hand, we see (inaudible) as well vis-a-vis the next coming election. Some confident ratings are already giving positive signs. Consumers are not in debt and that something we when we look at the performance of the market. But sometimes we see some survey saying 60% of Brazilian consumers are in debt. Well, 60% of course they have debt because they are using credit lines.

And the press usually conveys the image that 60% of Brazilians are in debt. But if you look at the results coming from the banks, the banks are showing that Brazilians are not in debt. I think that we have to be prepared because usually it is at moments like this that we can gain market share because we have products, we have products at competitive prices, we have credit, we also have a large number of physical stores, the brick and mortar stores and all of that is being supported by e-commerce.

There are many synergies and I think that until election day we will have what you saw with a slight improvement. And so after the election we may few things. If the election is positive we will see an important move upward. But if you election is not very good. I mean, there won't be a total disaster, but considering the environment we will do what we usually say whenever we are faced with an unfavorable economy.

If you have a value proposition, a good value proposition, you will succeed. Even in moments that are not very good, you have the opportunity to gain market share. This is our position and we've been through several crisis. Well, certainly we are always very cautious and in moments like that we have to look at our inventory, we have to maximize sales, we have to be very stringent in terms of our operation expenses. But when you look at the expense line, you have to split that in to two things. You have to look at expenses that will generate new tools or that will introduce new processes or new methodologies or new technologies. And also on the other hand, you have operating expenses and these operating expenses, I can assure you they are under total control, they've always been under total control because this is part of our job.

We control our operating expenses because in a situation where the market is down, you have to be prepared to face a difficult economic situation, but when you have a market that grows very fast, you can generate results quickly.

Q - Maria Paula {BIO 19356895 <GO>}

Thank you very much for your answer.

A - Laurence Gomes {BIO 15361799 <GO>}

Maria Paula, now concerning the third part of your question about the ticket, we see the Initial demand for credit, but we have to look at that with -- like a grain of salt because this is initial stage of recovery and that is (inaudible) your credit card and sales, and how debit card is also behaving in terms of means of payment. And we've seen a more intense activity in the payment of past due installments and I would also like to take this opportunity to mention that in the second quarter we introduced the negotiations portal, and this was something very important. And so negotiations -- renegotiation of debt can be done digitally.

Our customers can choose what kind of payment they want to settle their past due debt and this is all done online, it is accepted or not, but if it is not accepted, we already schedule a call to that customer and that was an important thing. Here we were able to grow more than 30% in terms of agreements that were settled.

Now to answer your question, we haven't even seen a very strong recovery in terms of credit demand.

Q - Maria Paula {BIO 19356895 <GO>}

Thank you very much and congratulations.

Operator

Next question is from Robert Ford from Bank of America.

Q - Robert Ford {BIO 1499021 <GO>}

Good afternoon, everyone and thank you for taking my question. Could you please elaborate on the impact in terms of your co-branded. I think there was a decrease there, but there was an increase in other products. What is behind that please?

A - Laurence Gomes {BIO 15361799 <GO>}

Bob, this is Laurence. In terms of the Meu Cartao portfolio, the co-branded, there was an important change in the portfolio with unification of the limits last year and also with the migration of purchases through the installment booklet. There was increased use of the credit card as well and all of that caused the portfolio increase. Not only that, but now there was a change in the provisioning methodology because in the past, before we had at Realize, the delinquency over 180 days were written off, but now they still remain in the portfolio. They remain in the portfolio with 100% of the announced provisions and that's why when we compare the number to previous number, this provision increased and look high.

Also we had to increase provisions because of IRFS and this also caused increases in our provisioning level. Not only that, but there was the maturity of the portfolio. So a portfolio that used to grow a lot, last year there was an large increase in a young portfolio, but now growth is not so strong and we have to make provisions for that portfolio because there are still amounts that are delinquent for longer period of time.

It's also very important is say that the portfolio is very healthy, delinquency levels are under control and I think this just reflects the change in accounting methodology, IFRS. And now we at Realize have provisioning amounts that are about 23% higher than the minimum required provisioning required by the Central Bank.

Q - Robert Ford {BIO 1499021 <GO>}

Thank you. I have another question, that 41.6 million, are these taxes that you intend to recover or you have the opportunity to recover even more?

A - Laurence Gomes {BIO 15361799 <GO>}

Well, that refers to a five-year period and these are amounts that have been captured in the past. I think it's also important to mention that this legislation, during this whole process, resulted from this law -- this new law and a provision of that additional law that says all tax incentives should be registered at comfort until June of 2018. So that was the fact that generated this tax deductibility.

Q - Robert Ford {BIO 1499021 <GO>}

Thank you very much.

Operator

Our next question is from Gustavo Oliveira from UBS. You may proceed.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Good afternoon. I just wanted to get a better understanding about your SG&A expenses. So, this 28% level is what you expect for the entire year or whether you will have to invest more in all of the projects you mentioned out. I also wanted to understand if you can elaborate more on this incremental investment and what is it being used for. Is that something that is a one-off thing, is this being allocated to certain projects and where is this being allocating to?

A - Laurence Gomes {BIO 15361799 <GO>}

Gustavo, this is Laurence. Thank you for your participation. In terms of the growth of G&A, due to all we said here, and if you look at our investment cycle and if you look at this moment that Renner is adjusting itself to this business model and to the new behavior on the part of consumers, maybe this will still be a very challenging year in terms of delivering a dilution of expenses vis-a-vis last year. However, what we said for this quarter is that this will be -- the number will be very close to that of last year.

And in the fourth quarter we believe that the figure should be very similar to that of the fourth quarter of last year in a like-for-like basis. All (inaudible) investments, I think there are three areas that may affect the inventory, multi channel integration and also improvement in the purchasing experience in all channels. So, these are the main areas. Involving projects is somehow will bare good results.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

That's very clear. Thank you very much.

Operator

(Operator Instructions) We now conclude the Q&A session. I would like to give the floor to Renner's management for their final remarks.

A - Laurence Gomes {BIO 15361799 <GO>}

On behalf of everyone, I would like to thank you all for participating. Thank you very much. And I wish you all a very good weekend and I will see you again in our third quarter presentation and during our Renner Day. Thank you.

Operator

Lojas Renner conference call is now concluded. Thank you very much for participating and have a very nice afternoon.