Q3 2019 Earnings Call

Company Participants

- Adalmario Ghovatto Satheler do Couto, Investor Relations Officer
- Breno Toledo Pires de Oliveira, Chief Executive Officer

Other Participants

- Caio Moscardini, Analyst
- Gustavo Oliveira, Analyst
- Joseph Giordano, Analyst
- Thiago Bortoluci, Analyst
- Tobias Stingelin, Analyst

Presentation

Operator

Good morning. Welcome to Hypera Pharma Third Quarter 2019 Results Conference Call. We have Mr. Breno Oliveira, CEO; and Mr. Adalmario Couto, CFO; and IRO are here with us today.

We would like to inform you that this event is being recorded. All participants will be in a listen-only mode during the company's presentation. We will then have a Q&A session only for investors and analysts. Further instructions will be given then. (Operator Instructions) We would like to inform you that questions can be asked by telephone. If you are connected through the webcast, you should submit your questions to the IR team at ri@hypera.com.br.

This live webcast may be accessed through the company's Investor Relations website at www.hpera.com.pr/ir. We also would like to inform that statements during the conference may be considered forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those set forward in the forward-looking statements.

I would like now to turn over to Mr. Breno Oliveira. Mr. Breno Oliveira, you have the floor.

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

Good morning. Welcome to our Q3 teleconference call. Before I start talking about the operational performance, let me give you an update of our independent committee. We are expected to conclude the project by year's end.

Let me move on to the operational portion on Slide 3. Our sell-out grew by 11% in Q3, above 10% for the second quarter in a row, with the market share in Consumer Health, in Generics and Similar. In Consumer Health, we outperformed the market once again due to new launches, Benegrip Dia e Noite, Atrofem and Atroveran, the good performance of our promotions to consumers and more assertive investments in marketing and visibility in the POS.

In Similar and Generics, for the third quarter in a row, we have gained market share. We have been benefited from Neosoro, Flavonid and Doralgina performances, and also due to recent initiatives to improve our bottlenecks in the plant, resulting in more availability of products. In Prescription Products, our sell-out also outperformed the market in the quarter. When we exclude the vitamin D market, it remains challenging. After the change in the guidelines that we reduced the number of prescriptions in this category since early 2018, the growth sell-out in Q3 is proof that were evolving quarter after quarter.

Let me talk about three of these sectors. First, more focus on sell-out growth. We started focusing on sell-out since the beginning of the year, and we focus the compensation incentives. We raised the importance of the sell-out in our executives' bonuses for the end of the year. Earlier this year, we have a new department to work on our major sell-out initiatives, and they are in charge of the implementation of these initiatives with our retail network and distributors. We have boosted the coverage and stores and the number of physicians visited, bringing the company closer to customers and doctors alike. Other initiatives have strengthened -- have been strengthening the concept of sell-out in our company, engaging our teams contributing to the growth in several pharmaceutical market categories.

The second factor is innovation, on slide 4. We've introduced over 120 products, and we've invested more than BRL350 million in R&D. In this quarter, investments are in excess of BRL60 million and 24 new products. In Consumer Health, we've introduced new lines Finn xylitol,and Lacto-Leve, our traditional brands Lacto-Purga to regulate intestinal function. We've introduced an antacid called Gastrol. It's a 30-year old brand that has been promoted or advertised in the media to reinforce our presence. In Prescription Products, Episol, Hydraporin, Colflex Complet and AdderaCal, an extension of the brand Addera that associates vitamin D and calcium in one single pill.

The third factor is the strength of our brands. We are leaders in the OTC categories with several brands in the Brazilian pharmaceutical market. And we are also amongst the top players in prescription and generic drugs with the brands Mantecorp and Neo Quimica. We've been investing in our brands at the POS and the media and also in doctors' offices.

In the media, we are one of the top advertisers in the country. We have renewed our sponsorship of the soccer package for Globo TV 2020. It will be even better than that of 2019. Our brands will be -- will have more exposure during the soccer games. And the news grid in terms of doctors' visits, we have hired over 100 people to promote our products, Mantecorp with physicians. This new team will focus in the new portfolio products we're introducing in Q2, 2019 and early 2020. As the result of all these initiatives, the financial highlights are the following; a 6.4% growth in net income and 11% [ph] in net profit in continued operations. On top of that, we have interest of our own capital of 161 million, a payout of 60% with a dividend yield of 3%. Our ROE keeps on growing quarter-on-quarter reaching 14.8% in Q3. Net revenue was impacted in the quarter due to power problems and water supply in Anapolis due to a short rainfall. For this reason, the plant hasn't been operating at full capacity, but that won't impact our sell-out.

Finally, I would like to point out that we have been investing in our manufacturing complex in Anapolis that will increase our production capacity, including vitamins and supplements as early as 2021.

I'll turn over to Adalmario and he'll be talking about the results of the quarter in further detail.

Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

Thank you. Breno. Good morning, everyone. Let me start first about revenue on Slide 5. Gross revenue, net of returns and unconditional discounts was very close to the company's sell-out in PPP, it's almost 8% growth. Under the sell-out growth, due to the basis of calculation, just like I commented in the previous quarter, that growth was driven by an average price increase of about 4.5% and a volume increase of 3.5%.

Our net revenue exceeded BRL1 billion for the first time as of -- since we started working in pharmaceutical market only. Net revenue was 6.4% . The low gross revenue to boost the growth of sell-out, and that happened with the major distributors that increased the level of promotional discounts. As to the gross margin, we had a drop of over 3 percentage points when compared to Q3 2018. About half of that drop was driven by structural factors that keep on impacting the profitability of the Brazilian pharmaceutical industry such as the devaluation of the local currency, payroll increases, and as I said in the previous teleconference of Q2 2019.

The average exchange rate for the quarter was BRL 3.80 when compared to BRL 3.48 in Q3, 2018 that impacted our gross margin about 80 bps. For Q4, the average exchange rate will be at about BRL 3.91 range. We will keep on putting pressure on the gross margin levels when compared to the previous year. The payroll increase impacted 70 basis points in this quarter.

On top of the structural factors, gross margin received a negative impact in 60 basis points for the provision of losses of finished goods and inputs. And we also had impact of 60 bps in the mix effect our products, especially through the growth of similar and generic drugs. As to the EBITDA margin, it was 29.5% in the quarter, a drop of 90 bps when compared to Q3 2018, especially to the reduction of gross margin, but also because of more investments and medical visitations, R&D and the growth of general and admin expenses.

In doctors calls [ph], we have new sales reps, just like Breno said, on top of additional expenses of samples and promotions. We have a 35% increase in R&D as a result of the development of our over-the-counter projects that will be the basis of our future pipeline, along the lines of keep on investing to increase the scope of our portfolio and to outperform the market in the mid and long-term.

General expenses increased their stake in 70 basis points as a consequence because of higher payroll expenses. Other revenues were positively impacted by tax credits and a better provision for contingencies. As a result, the net profit grew 11% year-on-year, reflecting less income tax because of the own capital declared in Q3 2019.

On to Slide 6 now. Our cash position is very positive and solid, about BRL1.4 billion, an increase of almost BRL160 million in the quarter. Despite CapEx and intangible investments, our net cash position is BRL840 million. The operational cash flow was BRL299 million in Q3, and it has received a positive impact by reducing working capital investments as a result of the commercial policy change in Q1. In the quarter, working capital investments accounted for 37% of our net income compared to 41% in Q3, 2018. As a result, we had a drop of almost BRL15 million in working capital investments. As a result, the operational cash flow conversion as a percentage of EBITDA was a little over 100%. Free cash flow in the quarter was below Q3 of 2018 as a consequence of additional investments to expand our production capacity in Anapolis.

As Breno put it, the company approved interest on own capital of BRL161 million when added to the declared amount of the first semester. We have a total of BRL483 million to be paid out in January 2020.

I'll turn over back to Breno for his final remarks.

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

Thank you, Adalmario. More focus on sell-out. Recent launches, innovation investments in our brands are already yielding results. We are heading in the right direction to grow sustainably and to gain market share in the mid-term. We believe that the Brazilian pharmaceutical market will continue to grow, and Hypera Pharma is better prepared to capture opportunities in the different segments in the market, because we have a portfolio of leading brands, a lot of capacity for investments in a very positive and robust pipeline of innovation.

Let's start our Q&A now. Thank you very much.

Questions And Answers

Operator

Thank you. We will now start the Q&A session for investors and analysts. (Operator Instructions) Mr. Gustavo Oliveira from UBS would like to ask the first question.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Good morning, everyone. Breno, Adalmario, thank you for taking my question. My question is about two things that you mentioned. You talked about the drought in that region and how does that affect production. And here a portion of my question is to invest in the capacity. Have you implemented it or are you beginning to expand your capacity -- you have that installed capacity to boost production or not?

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

Hi, Gustavo. Let me talk about the short-term first. The drought is taking longer than usual. Usually in September/October, rainfall gets back on track. But it's been delayed dramatically this year. Just last week, we saw the first rains in Anapolis. The water reservoirs are below normal levels. So water availability is limited. We cannot therefore produce at full capacity. We had a minor impact in Q3, above BRL15 million that we did not reduce due to that water shortage. And we'll see how things will play out in Q4.

If we have full water availability, we'll be able to produce at full capacity. But we account revenue based on product delivery. Production has to be concluded by early December, so that we can invoice and deliver these products within the quarter. Especially in Q4 with the holiday season, it's even more complicated. We don't foresee any sell-out impacts. And we're not clear as to the product availability at this point in time.

As to the investments in our plant, we are in that expansion phase. Construction is currently underway, especially in the solid area, and we are supposed to expand vitamins and supplements division as well. That's the current scenario. Investments are being made, and you see the impact in CapEx, and it should be even more intense in Q4 and next year. As of the second quarter of 2020 and early 2021, we will be at full capacity then. It's not Generics and Similar products, right. It's the Rx prescription that's the incremental capacity that (inaudible). It includes everything -- it includes everything. There should be more availability to Generic and Similar products. We're, of course, focusing products that have greater margin. The operational capacity of course will be focused to these products that have greater margin, Generic and Similar products.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Along the same lines, about the CapEx, what's the forecast for 2020?

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

I cannot give you any guidance as to the CapEx. The trend or the tendency that it will increase with these events. Once we have data of next year, we can talk about it, but I cannot give you any CapEx guidance.

Operator

Tobias Stingelin from Citibank would like to ask a question.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Good morning, Breno. Let me talk about CapEx. We're not talking about 2020. Is there a number you can talk about for this year, how much are you going to increase CapEx for Q4, just a ballpark figure? My second question is, what's your take on the convergence of sell-out and to sell-in or is it going to be a smaller gap?

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

Hi, Tobias. The CapEx for this quarter was almost twice as much when compared to Q3 of 2018. And for the year, it's above a little over 50% when compared to the nine months of the previous year. That gap will increase when compared to last year, that's for the Q4, but I cannot give you any guidance, I cannot give you any numbers as to what the CapEx will be. I cannot give you any further information.

And the second question about the convergence of sell-in and sell-out. Here's what's happening. In nominal numbers or terms, sell-out and sell-in are very close together for the Q3, but the basis for comparison than 2018, we did not operate that way. So we do -- it's not the same basis for comparison, you begin to see that sell-in and sell-out convergence in terms of growth as of Q2 2020. In Q1, sell-in will grow way more than the sell-out because of that adjustment we made. As of Q2, they tend to go hand-in-hand in terms of growth. But in nominal terms, they are already very close as of Q2 of this year, last quarter. Was it clear?

Let me try to understand it. You said that you're going to increase promotions to boost sales. Doesn't that explain part of that gap despite the change you're managing the company? Yes, that explains part of it. Adalmario, I think, talked about it. The gross revenue, excluding returns, that grew by 8%.

When you talk about the drought, impaired [ph] production, that would be about 9.5%. Those 8% would turn into 9.5% -- that can be compared to the 11% growth in sell-out. When you take that returns and the net revenue, that differs from 8% to 6.5%, that 1.5% due to that more aggressive activity in terms of promotions for both Q2 and 3.

From now on, that aggressiveness will dwindle to a certain extent. So the negative impact will be smaller between gross and net revenue. So that gap would converge from now on. Especially as of 2020, we'll have more efficiency from these investments, especially in the POS. We work very aggressive in commercial discounts, promotions to consumers that would take away from net revenue. Our focus will be on visibility and the point-of-sale. That's the kind of expense that would be low net revenue. You have production water shortage. There is the exchange rate impact. API should be high. Can you give us some direction -- some color as to margins in the next six months?

A - Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

Our expectation to be -- is that if the exchange rate at this level will be less relevant of an impact year-on-year, we won't have those levels that we had in 2017-2018. These returns is above the level that we would like to see. This is going to be reduced in Q4 and throughout next year. That's where we're looking forward.

Gross margin and EBITDA margin for next year will depend on the exchange rate level. Today, about 40% of our costs are related to exchange rate. We're still working on next year's budget. It will be about BRL410 million [ph], that's our expectation. And then our margins could go back to about 30% or a little -- a little over 30%. Thank you.

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

Let me just piggyback on that answer. Just like Adalmario, we want to have more efficiency on waste. This is going to be helpful because we project less waste for next year, and that will contribute to our margin. We want to have more efficiency and our investments, just like we said a while ago. When we boosted our sales reps teams, there is that initial impact because we have to train these people, they have to make those initial calls to doctor's offices. So the positive impact will take some time. But these expenses will reduced because they will of course generate revenue. As new products are launched, they will also impact your margin, especially at the beginning, consumer health, media products and also prescription drugs. They have lower margins at the beginning and then the expenses will be diluted, so that's the challenge for 2020. We've been trying to optimize our expenses so that we have better margins compared to those that we have in 2018. Thank you. Thank you very much.

Thiago Macruz from Itau BBA would like to ask a follow-up question. Let me just follow up on the expenses, promotions, marketing expenses are related to new launches or were you promoting older products? That's my question. Thank you.

Hi. Everson [ph], we had two impacts. We had the impact of more promotions on mature products or more mature products to gain market share. And to have a better sell-out level and new products as well, this quarter just like the previous quarter, we introduced over 20 new products. Free samples or media ads, of course you invest we more than you do in mature products. So promotions for mature products and investments for new products, these are the two components. Thank you.

Fred Mendes from Bradesco asks the following question. Good morning. I have two questions. I would like to understand the dynamics in returns. It's almost twice as much as you had in 2018. I would like to understand the taxes in gross revenue BRL45 million, 3.5% of revenues. I'd like to better understand those two lines. Thank you.

The growth we see in this quarter is related to the change in the commercial policy implemented in Q1 with less working capital. The company focus is having a sell-in level similar to the sell-out level, just like we did in the past. We have more returns in this quarter, more specifically. One of our customers in Northeastern Brazil impacted the number of returns. I think it was almost BRL12 million, because they filed for Chapter 11. And when you have these products return, we can quickly sell them, but these products were with distributors. That would be sold to this specific customer. And then with that return, we can resell them. That will help us drop the number of returns in Q4.

As to taxes on gross revenue, the impact you see is for the payroll. That's why it's a percentage, I understand. When I look at Q2, it's 5.5% of gross revenue, and I thought that you would have to do it there too. But it's a lot smaller quarter-on-quarter, but this is a one-off event, right.

Q - Tobias Stingelin {BIO 18290133 <GO>}

All right. Thank you.

Operator

Thiago Bortoluci from Goldman Sachs is asking the following question.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

Good morning. I have two questions, one is about working capital and the other one is about margin. You have an average deadline that is good but a conversion that is somewhat flat. What is the outlook for the following quarter? Can you capture more gain from the adjustment you made in Q1? And in terms of gross margin, I would like to understand the provision for inventory. And I would like to know whether it's recurring a net about the pressure on the mix.

A - Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

As to the working capital, Thiago, we are at a level that is close to our target. When we made that adjustment in Q1, our goal -- we still have a 95 day receivable deadline. You cannot be 95 sharp every quarter, it will be always about 95 days, that's our goal from now on. One of the lines that can be optimized is the inventory. Our inventory levels have been a little over average to have that safety buffer, for some products, they're still at bottleneck. As of next year, once we conclude the investments in our plant and we start running, these lines -- bottom lines where we are investing more, we'll be able to reduce our inventory levels. As a percentage of our investments and working capital, I think it should be brought down to 30%. We could have an additional gain of between BRL50 million and BRL 70million.

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

Hi, Thiago. We like to look at working capital as a percentage of the gross -- or net revenue. When we compare the number of accounting receivables with the suppliers doesn't make sense, because they're very different. And when we convert everything in reals and you compare that to the working capital, as to the net revenue, that's the number we would like to look at. In Q4, it was 46% and then 37%, just like Adalmario said our goal is between 30% and 35% working capital as a percentage of the net revenue.

Could you repeat the other question?

Q - Thiago Bortoluci {BIO 20909105 <GO>}

In terms of gross margin, would like to better understand the nature of the provision for the inventory for this quarter, is it recurring for the pressure on the mix, to what extent from now on do you believe there should be a negative impact of mix impacting your gross margin?

A - Adalmario Ghovatto Satheler do Couto {BIO 20598860 <GO>}

As to waste and inventory loss provisions, it has or it had to do with the Q1 adjustments. Marketing had a sales expectation, a calculation conducted throughout the year, the plant was prepared to sell that meant [ph] and in actual fact, when you do not sell you have waste of finished and products and inputs, and we believe that in Q4 we have several initiatives to reduce waste. And as of 2020, our focus -- our target will be aligned to what the plant will produce. We won't have that kind of impact from now on.

As to waste, I think this is it. As to the mix, we are one of the few companies in this industry that operates in every channel, we believe, both in brand, products, prescription drugs and generic products, and we want to be present in every segment. Of course, it grows more in the generic segment, we're going to keep on focusing there too, but our pipeline is focused on branded products on a short-term basis. We may have some mix pressure because of the investments we are making, and we want to make generic products more available, but on a long-term basis -- mid-term business, we would like to increase our branded products portfolio that would impact our gross margin positively.

Q - Thiago Bortoluci {BIO 20909105 <GO>}

That was very clear. Thank you very much.

Q - Joseph Giordano {BIO 17751061 <GO>}

Mr. Joseph Giordano from JPMorgan is asking the next question.

Good morning. Good morning, Breno. Good morning, Adalmario. My question is about R&D. The company has been introducing many products in the past two semesters. How much do these products contribute to the growth of the company? When you look at the 11% sell-out, how much of that comes from innovation? And I would like to better understand this innovation cycle? And finally, how much R&D investment should we be expecting in the next quarters?

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

Hi. This is Breno. The R&D investments as to growth in our sell-out between, 80% and 90% of that growth are derived from these new products, products that were introduced in 2018-2019. The baseline grows very little, just like I showed you (inaudible). This applies to the whole industry, mature products grow much less, so 80% and 90% of our growth comes from new products.

The innovation pace is about 32%, a little over 30%. The products that were introduced in the past five years, but these are products that are not growing because products that were introduced five years ago, very relevant like our tariff for example, some cannot be considered in the innovation category, that's why they are moving away from that. But our innovation rate should get to the 40% mark when compared to the 30% market that we have today. And from now on, the investment level for next year, it will be growing a little more, but we are reaching the more recurring levels, so to speak, from now on. The R&D growth was greater in previous years than what it will be from now on.

Q - Joseph Giordano {BIO 17751061 <GO>}

Perfect. Thank you.

Operator

(Operator Instructions) Mr. Caio Moscardini from Morgan Stanley is next.

Q - Caio Moscardini {BIO 20856018 <GO>}

(inaudible)

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

Hi, Caio. We're not going to comment on that potential deal. In general, we have been investing in our organic growth, that's our main focus. There is investments in CapEx and R&D. Having said that, the company has a very comfortable position in terms of leveraging. It's in our DNA. We've grown through acquisitions and we are looking at market opportunities, provided they make sense strategically speaking. And it's beneficial to our shareholders as well. That's how we are looking at potential M&As. Thank you.

Operator

This concludes the Q&A session. I'll turn over to Mr. Breno Oliveira for his final remarks.

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

I would like to thank you for attending our conference call. If you have any questions, our IR team is available. We have the Hypera Day on December 2nd. The invitation will be sent to you shortly. Let's save the date. Thank you.

Operator

This concludes Hypera Pharma conference call. Have a good day. Thank you.