Q1 2014 Earnings Call

Company Participants

- Joel Kos, Chief Financial Officer
- Luis Fernando Memoria Porto, Cheif Executive Officer

Other Participants

- Alexandre Falcao, Analyst
- Renato Mimica, Analyst
- Unidentified Participant
- Yag Patel, Analyst

Presentation

Operator

Good morning, and welcome to Locamerica's conference call to discuss the Results of the First Quarter of 2014. At this time, all participants are connected in listen-only mode. Later we will open for the Q&A session when you will be given further instructions. In this quarter Locamerica will also take questions from the press, right after the questions of market analysts. (Operator Instructions) This conference call is being simultaneously translated into English and questions may be asked in English or Portuguese. Questions may also be made on the webcast platform.

I would like to remind you that this conference call is being recorded, and that the audio will be available at Locamerica's website in 24 hours. If you do not have a copy of Locamerica's release, you can get it at the company's website at www.locameric.com.br/ir. This call together with the slides is being simultaneously webcast and may be accessed through the Company's website.

Before continuing, I would like to clarify that any forward-looking statements that may be made during this conference call relating to the company's business outlook to the operational and financial projections in market and targets relative to its growth potential are based on the management's expectations and assumptions relative to the Company's future. These forward-looking statements depend on the general economic conditions on market and international conditions and have to do with conditions that may or may not materialize.

Today with us is Mr. Luis Fernando Porto, CEO and President and Mr. Kos, IR Officer. Mr. Porto, you may proceed sir.

Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Good morning, everybody. It's a great honor to welcome you to Locamerica's conference call on the results of the first quarter of 2014. First of all, it's important to say that this quarter was marked by significant improvements in our operating margins and profitability vis-a-vis a tough fourth quarter in 2013.

Net income totaled 4.9 million in the quarter, an improvement of 11.3 million against the net loss of 4Q '13. While EBITDA and EBIT up 17% and 33% compared to 4Q '13 -- accounted for a margin expansion of 5.4 and 5.8 percentage points respectively. In 2014, we expect a gradual recovery margins to historical levels of the company.

Also during this quarter, there was a remarkable improvement in the industries competitive dynamics and that all major players are now tracking contracts more rationally. More recently, we noticed a decrease in the bank credit lines to the sector which helps to explain in more cautious stance, recently adopted by most leveraged player. Today we are in a privileged situation from a financial point of view with a debt duration of 4.6 years largest in the industry with only 27 million in debt amortizations scheduled for the next two years and no need to turn to the debt capital markets before 2016.

Also today highlight that the factors of the 90% of our companies net debt it's fixed, protecting us from any further hikes and interest rate enhancing also our competitiveness vis-a-vis smaller players. After a tough 2013, the first quarter of 2014 comes as an inflection point in terms of growth of the total fleet and volumes. We closed the first quarter with a total fleet of 28,405 cars, an increase of 2.1% year-on-year and that in 2013 there was a reduction of 3.4%. More importantly, the rental fleet at the end of the period grew 6.8% compared to 4Q '13 in lined with the acceleration in rental revenues expected for the coming quarters.

Another important achievement was ending the quarter with a balanced inventory of used vehicles of sale at 3,014 units, a 37% drop vis-a-vis the peak of 4,813 cars in 3Q '13. Finally, on March 31st, S&P reaffirmed our long-term credit rating at brA with stable outlook.

In the next few slides, before we move onto our operating performance, let us take a look at some trends regarding the industry scenarios from the perspective of the first quarter of 2014. Slide number three, we show that sales of new cars dropped 1.7% in the first quarter of the year, compared to the first quarter of last year, while the sale of used cars was 8.5 during the same period.

In April, sales of new cars dropped 11.7% y-o-y and dropped 4.5 YTD compared to the same period last year. We believe that the shift in the demand of used cars instead of new cars, perspectives for the used car segment is likely to continue this year primarily driven by the recent increase in the price of new cars by slowing economic activity and by lower consumer confidence and also a tight credit for cars.

So the chart on the right shows a drop in demand for new cars, resulting in an annual reduction of 8.4% in the manufacturing of the results, still the inventories rose to 45 days of sales in 1Q '14 up from the 30 days reporting the same period last year, and these historical levels of 35 days. We settled down and it is expected to announce new measures to encourage sales of automotive industry, 2% unemployment in the sector in the near future.

The next slide shows funds released for auto financing, totaling R$37.5 billion in the first quarter of 2014, down 6.4% compared to the same period last year. On the right, we see that new cars prices rose 1.9%, while used cars up 1.2% in the same period.

Let us now turn to our operating financial performance. Slide number five shows a breakdown of our fleet, which totaled 20,405 cars in the first quarter, up 2.1% year-on-year an inflection point in terms of the total fleet growth. In 2013, we see a reduction of 3.4%. More importantly, the graph on the right shows that the rented fleet at the end of the period accelerated 6.8% compared to 4Q '13, which should guarantee a strong recovery in the growth of rental income this year.

Next slide shows that as of December last year, we adopted a policy of reducing our inventory of used cars, reaching 3,014 units or 10.6% of the total fleet. This gives a peak of 17.1% in the third quarter of 2013. I'd like to highlight that we plan at least to maintain the current level of inventory for the income for the next quarter.

On the next slide, we highlight the growth in the rental revenue of 4.1% in the first quarter compared to the fourth quarter of 2013 due to larger volumes of 3.8% and 0.2% [ph] of rental rates. On slide eight, on the left hand side, the total value of new contracts signed in the quarter remains robust representing more than 1,800 cars, up 18% year-on-year. On the right hand side, we show the commercials pipeline for the coming months, which remains at historical record levels with more than 24,000 cars for tenders, which highlights the resilience of the outsourcing industry fleet even in the scenario of macroeconomic slowdown.

On the next slide, we show the results of our strategy of market diversification and client portfolio. The mix of the fleet represented by compact cars dropped to 56%. And at the end of Q1 2014, we had 362 customers, up 17% year-on-year.

On slide 10, we sold 2,742 cars in the quarter, a slight 4% drop year-on-year and in March and April, sales of used cars improved and reached 1,029 cars and 1,165 units respectively, which is in line with our expected sales for the rest of the year. We would like to note that we've doubled the number of stores in the retail segment in December and we expect these stores to start performing in the second half of the year. Retail and (inaudible) increase its share relative to the sales. On the next slide, we highlight an increase by 6.3% relative to the first quarter of 2014, which is in line with the levels expected for the year.

On slide 11, our EBITDA was R$41.3 million in the quarter, up 16.8% growth relative to the fourth quarter of 2013, the margin expanded 5.4 percentage points, which is 49% on the revenue from rentals in the period. For the next quarter, we expect the recovery of our margins to historical levels of the Company by approximately 55% which is going to be driven by; first, the benefits of our cost reduction program implemented in Q2 in the second half of 2013, and an increased efficiency of the fleet mix and higher utilization rates.

Our EBIT totaled 22.4 million in the quarter, as sharp increase by 33.4% relative to Q4, 2013. This represents a margin improvement of 5.8 percentage points, and the margin went to 26.6%. On slide 13, we post a net profit of 4.9 million in the quarter and 11.3 million increase relative to the net loss of Q4, 2013. This improvement in the Company's numbers reflects the expansion of operating margins with a 4% growth in rental revenue, 17% growth in EBITDA and 33% growth in EBIT.

In the same period, operating costs fell 5% and SG&A expenses reduced by 11%. The gradual improvement in operating margins during the year should translate itself into increased profitability in 2014, since 90% of our debt is in fixed rates now.

I would now like to turn the floor over to Joel Kos, our CFO.

Joel Kos {BIO 17590108 <GO>}

Good morning. On slide 14, we talk about our current debt profile. At the end of Q1 2014, the Company's net debt was R$512.8 million, and in that cash and cash equivalents amounted to a R$172.8 million, with only 27.1 million of debt maturing in the next three years. Currently, the duration of the debt is 4.6 years, the longest in the industry, and we estimate that our current cash position plus the cash expected in the next year will be enough to fund the company's investment plan with no need to incur new debt before 2016.

In the last slide, we believe that this Company's cost for capital structure will be a competitive advantage for the Company in the years to come. With 90% of the loans maturing the long run, this private debt declining to 2.2% in the quarter relative to 2.8% in Q1, 2013 and the percentage of the fleet given as collateral is now 22% relative to 36% quarter-on-quarter. Our net debt EBITDA ratio was 3.3 times and we expect to reach our target of 2 to 2.5 times at the end of this year.

We can now move to the Q&A session.

Questions And Answers

Operator

Ladies and gentlemen, let us now start the Q&A session. (Operator Instructions). Our first question comes from Bruno Duarte [ph] from Santander.

Q - Unidentified Participant

Good morning. I'd like for you to give us some color on the fact that you mentioned. You talked about the competitive dynamics, I'd like to know whether in your opinion this more rational stance by the market in the price that is charged by the competitors. In other words, whether this has to do with the recent hike in the interest rate. And regarding the increase in prices, you've chosen to offset the increase in interest rates, actually now it's down to 11%. And if you think that the price increase has more than offset, this increase in interest rates?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Thank you very much for your question. Yes, we do take that this is one of the reasons for the improved competitive scenario. More specifically, on this topic, we noticed an improvement in prices, which more than offsets the increase in cost, which allows us to have better margin in the next quarters and the next years. And we're sure that when this happens like in the last six months, we're seeing the current price increases as a main cost, not only interest rates, but also significant increases in terms of vehicles buying prices, IPI increases. Because we also had price increases, because now the automobile industry needs to provide cars with air bags and other accessories. So of course, we'll need to spend more the capital expenditure is higher.

So we see some interest rates impact, but also inflation impact in our industry. This in itself would warrant a price increase, but as we highlight in our release, we also see lower credit lines to this sector. And this leads to smaller players in the certain difficult part in terms of funding, therefore, they have to be more selective or sometimes they need to lead the market. So our understanding these are the reasons for better pricing, and today we can say that the margins are better.

Q - Unidentified Participant

Okay. So taking all this into consideration, what do you think happened from last year to this year when we look at the ROI and the contracts and the capital costs. Can you say that this relationship improved or do you think that the increase that we had in the ROI, the contract was certain reflection of the higher capital costs?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

No. We see that regarding the contracts for the first half of the year vis-a-vis, last year we see an improvement as well as 5% of the ROI -- ROIC of the Company.

Q - Unidentified Participant

Thank you.

Operator

Our next question comes from Alexandre Falcao from HSBC.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Good morning. My question has to do with the market for used cars, and I have two questions. The first is the following. If this level of inventory that you currently see, are you planning to maintain that level throughout the year and going forward? And how about the stores that you opened last year? Are you going to be able to sell more cars? And I wanted also to understand the new dynamics for our new cars and used cars. The inventories are higher, the prices are higher, April was a worst month than the first quarter. Can you talk a little bit about that?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Thank you, Alexandre for your question. Maybe first answer is the following. Our level of inventory is the maximum level. In the next few quarters and years we are going through try to improve those levels, but I think these levels will be the buffered stock, the maximum inventory for the Company. The level of inventory depends on the performance of the store, which has to do with your second question.

For three years now, we have been investing very strongly to develop a new channel, a retail channel. This year, this project is going to enter more and more stable phase, we had to build the back office, softer the marketing structure, we needed establish the logistics to take the cars to the stores. This all has been put in place and tested and now we want to stabilize their operations at a higher level. Once the operations are stable, we are going to replicate that model and open new stores. This may allow us to increase our capacity to sell relative to the need to sell, and this can be -- can allow us to improve the levels of inventory or to renew the fleet at a faster place. And this has the churn would allow us to reduce depreciation and maintenance costs. The fact that we can sell the car and replace the car, the better our levels of maintenance will be. This is a scenario for our stores and relative to the stores we currently have, we believe that in the second half we should achieve big sales in those stores. This will allow us to think about new investments and expanding wholesale and retail stores, and our focus in the next few years will be to increase sales in the retail channel.

About new cars, what we see is that the economy slow down, it's putting a drag in the sector and the expectations of the new vehicle market and the automakers were maybe too optimistic. From our point of view, there is no doubt today that there is uncertainty relative to the macroeconomic environment and this has an impact on vehicle buyers.

There is a demand problem today specifically for brand new cars, and it has been proven that measures such as reducing IPI tax are just temporary measures. They are just relief measures, so to speak, they don't solve the problem. I don't think the government is willing and neither does it have the ability and the capacity to implement short-term measures. There is nothing that we learned from any other source other than the press, but they are starting measures relating to loans and financing. This will be very good for the brand new car market and also for the used car market, because this will allow us to tap funding and will be good for both markets.

What I see today is that the problem in the new car market and the used car market has to do with split, this gap between the price of new cars and used cars is increasing, this gap is widening in the last few years. And today it is a big advantage to buy a used car. If you think of it in terms of a business deal or on your ability to pay in the case of consumers who use loans. So the price of new cars is extremely high. Consumers are unable to pay those prices and they cannot get loans to buy new cars. So they go to the used car market and this gap in price is spread, it's a big advantage for consumers. So we think this year will be at least as good as last year or even better, and these dynamics should remain as long as the price of new cars remains high. This spread maybe widen a little bit or even shorten, but the dynamics should continue the same.

We expect measures on the part of the government, but nothing relating to taxes or to measure that would impact the cash position of the government. They don't have much leeway in that respect. We think it would be a good measure on the part of the government if they could encourage consumption that would be good of course for the vehicle market, but not for the macroeconomic scenario. The government is trying to hold inflation down and fueling consumption would not be a good measure, but for our market, it would be very good.

Q - Alexandre Falcao {BIO 5515455 <GO>}

And if I may, do you have any large contracts expiring? Do you have any pressure to sell, this year?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

In the first semester, we renewed all the contracts that we expected to renew. In the third quarter, more than 60% of the contracts had been renewed as well, and we have only for the fourth quarter of the year, our contracts that should be renewed, but there is nothing major expected for this year. The large contracts had been renewed.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Thank you very much.

Operator

Our next question comes from Renato Mimica from BTG Pactual.

Q - Renato Mimica {BIO 15374054 <GO>}

Good morning, Luis. Good morning, Joel. I would ask you to elaborate on the profitability topic, you showed an important sequential expansion in the margins of the first quarter. I'd like to understand what your plan is for the remainder of the year in terms of trends, especially operating margins. Do you still expect that recovery on a quarterly basis? Do you expect some recoveries for the second quarter, in terms of profitability, sequential recovery? And is this recovery from the pipeline or operating leverage, or do you expect to see any important major expenses, cost cuts, so that we can measure the expansion and profitability going back to historic levels?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Thank you very much for your question. We do expect a continuous improvement, so the next quarter, our expectation is that for the next quarter, the margin will improve a bit. And as the year follows, we hope to reach our historic levels of 55%. You've said, these are the first outcomes of the measures taken us, but we're not going to stop at that. We are preparing new measures for the Company as a whole. And the most important platform for margin improvement will not be made in the top line. It will be made at the operating levels.

We believe that we can measure and improve at the operating and administrative level. So those were the first measures, other measures are being planned, and we will disclose them in a timely basis. We won't rest before our operating margins return to our historic levels. This is what we lost last year, due to unexpected return and an imbalance in our inventories. Now we have balanced inventories and the measures that we took last year are now mature. We do have other things that are going to be implemented, we're planning, analyzing and we're going to deploy other measures, we won't rest before this happens. So we do intend to show this quarter-after-quarter. We're not waiting for the future, we're doing it right now.

Q - Renato Mimica {BIO 15374054 <GO>}

Thank you very much. Good morning.

Operator

Our next question comes from (inaudible) from Merrill Lynch.

Q - Unidentified Participant

Thank you very much for the call. I just wanted to go back to the competitive environment, you have talked about an improvement, and that small players are being pressured by higher interest rates, has this improvement being seen relative to smaller players or are you seeing less aggressive prices on the part of the most relevant players, or actually have made competition more difficult for you? So where do you see this improvement in that scenario?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Thank you very much. It is across the board. No doubt, it was not only Locamerica who suffered last year, other medium sized and large players also suffered. That cost is not a cost that only Locamerica have, when we speak in terms of increase in car prices and interest rates, it goes for everybody. But I specifically mentioned the smaller players, because when we analyze competitiveness and competition, we analyze it for the market as a whole. 50% of the market is held by small and medium sized players and another 50% is held by medium sized, large players.

100% of the market today has been able to improve prices, and this was driven by a cost increase and all players in the market has to deal with profitability. We have to make money, we have to be profitable to survive in the years to come. And we see this very clearly, and has been so said in the last quarter of last year and the first quarter of this year.

Q - Unidentified Participant

Thank you very much.

Operator

(Operator Instructions) The next question comes from Yag Patel, HNC Capital.

Q - Yag Patel {BIO 5993207 <GO>}

Yes, hello. I'm sorry. There might have been something that has been answered previously, but I might have missed it in the translation. Could you comment on returns on invested capital? You're getting on new -- new deals that you're signing up over the last few months in terms of you budget. That will be my first question. And then if you have ROE, essentially what ROE would likely to be for this year? And that will be my second question. I have some follow-ups as well.

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Good morning. In the first quarter, from the new deals and renewals, we have on average an ROI of 20% in ROIC of 14.5%. In other words, return on investment capital of 14.5%.

Q - Yag Patel {BIO 5993207 <GO>}

Okay. I'm sorry. I heard 14.5% ROIC, and then what was that 20% number?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

ROI.

Q - Yag Patel {BIO 5993207 <GO>}

So, ROI is 20% or ROI is 14.5%? ROI is the same thing of ROIC? But what it's in terms of ROE?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Return on equity 20%, return on investment capital 14.5%.

Q - Yag Patel {BIO 5993207 <GO>}

Okay. Got it. And in terms of share buybacks, the Company had in a situation where they're trading below book value. So a question just in terms of future growth, is it more economical for the companies to grow by expanding a fleet or the one economical for them to buy the shares back? How do they think about that?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

We are very disciplined and very strict in terms of Company's cash, but right now we are way below our equity value, and we understand that we can have a buy back both on the side of the shareholders, that will be interesting, but we're still thinking about that in a planning phase.

Q - Yag Patel {BIO 5993207 <GO>}

Okay. And what about the management team, have they been buying back shares -- management, the founders?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Yes, some managers are buying back shares.

Q - Yag Patel {BIO 5993207 <GO>}

I asked the founders, not the owners?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Did you understand?

Q - Yag Patel {BIO 5993207 <GO>}

No, I asked -- what about the owners, the management, the owners of the Company, not the managers, but the principle shareholders.

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

No. The owners haven't bought anything yet. We're--

Q - Yag Patel {BIO 5993207 <GO>}

Thank you.

Operator

(Operator Instructions).

Q - Unidentified Participant

I would now answer a question asked by (inaudible). And his question is about the used cars and the trend for the results in used cars. He wants to know about the trend for the results for used cars. And if we should expect losses in CPA or BPA or if we should see a result closer to zero?

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Yes. We expect results to be closer to zero. And unfortunately, we were unable in any quarter of last year -- we decided to equalize our inventory last year. We still have some cars left for this year, but is balancing out of the inventory is being finalized and throughout the year and towards year-end, we will be seeing the normal levels and the margins of the company for the used cars will be close to zero as well.

This is a question by Hugo Segre [ph]. I would like to give an update on the receivables, especially with the expenses with VDP [ph] with the voluntary dismissals program, and we have been working with our receivables. This has been happening as of the last quarter of last year, and throughout this year we intend to maintain the current levels or even lower levels. There is no indication whatsoever that our receivables should be different in the next few quarters. What we see is an improvement in the figures, and they had to do with the measures that we put in place.

And in addition to cost reduction measures, we are also looking at all the line items in our balance sheet and we're working on the receivables to implement measures in the next few months. And relative to VDP that's where we are hedging to lower levels.

Operator

(Operator Instructions) Since there are no further questions, I would like to turn the floor over to Mr. Porto for his final remarks.

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Thank you very much for attending our conference call. This quarter, we are very glad with the results that we posted, they're very much in line with our expectations what we think. We see a fast reversal, I mean something so fast in one quarter or it's something of a fleet. And we believe that we have just started in movement with some moves to come, some measures have already been taken or there is are being finalized. And our intention is indeed to bring our margins to historical levels. As you can see the rest last quarter was marked with the beginning of an increase in our revenues and improvement in the two revenue lines and especially a reduction of 11% in administrative cost and 5% in operating costs, which shows that we have improved in terms of revenues and expenditures, that we restate our pursuit for better operating margins is totally focused on cost reduction improvement on balance sheet items that can bring us less capital for a higher return, and our main focus of all our measures and attitudes are centered on these lines.

We think that will have low costs, which is key in an industry such as ours. It is key for to have low cost under control, so that we can see a growth in the market where on the other hand, we have a very large possibility for organic growth. We have 24,000 cars under dispute, our total fleet of the dispute right now, so the market is very large. And this is the focus that we are taking now.

We have some news for the next years and quarters we're measures in a fast and conscious way to pursuit the expected profitability. We expect a growth that is focused on profitability, and we believe that if we pursuit operating margins, we are fine at the financial level in the mid and long ranges. It's also important to highlight that we've adopted hedging measures, a cost that goes from 15% to 20% of our revenue, which is the interest rate cost. So last year we decided not to be at the mercy macroeconomic fluctuations due to prices or other factors, problems and risks or anywhere and we are very comfortable with those pillars now.

It's basically turned our variable costs into fixed costs. So once again, let me thank you all for attending the call and that with the state of the satisfaction of having reserves of the trends that we saw in the first quarter of 2014.

Operator

Now we will move on with the Q&A session for journalists. (Operator Instructions) First questions comes from (inaudible).

Q - Unidentified Participant

Good morning, Luis and Joel. Regarding the fleet, I would like to know whether you can tell us about June and July, whether you see any difference in the demand because of the World Cup, whether you're expecting different mix in the fleet capitalization.

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Good morning. You were talking about what -- purchasing what? Our CapEx for vehicles is R$380 million for this year. So we are going to invest a lot of money this year, partly due to the expansion of the fleet part due to this renewal. It's very important to maintain a new fleet to our customers from the perspective of quality and cost. So for this year, we have high expectations. So we have a perspective of high purchases especially for this half of the year.

Q - Unidentified Participant

As far as the World Cup is concerned, and the elections by the way, this is a seasonal demand, and we do not expect very important improvements due to these two events.

A - Luis Fernando Memoria Porto {BIO 17175861 <GO>}

Yes, we may make deals with some parties or companies that need cars for the World Cup or for the political campaign. But we can't see any major improvements to our company. We don't think it's going to change anything major in our lines.

Operator

(Operator Instructions) Locamericas conference call is now ended. Thank you all very much for participating. And have a nice day.