

Q3 2014 Earnings Call

Company Participants

- Jose Roberto Lettiere, Chief Financial Officer and Investor Relations Director

Other Participants

- Kevin Gallagher, Analyst

Presentation

Operator

Good morning and good afternoon ladies and gentlemen. Welcome to Alpargatas Third Quarter 2014 Results Conference Call. Thank you for standing by. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions to participate will be given at that time. (Operator Instructions)

Before proceeding, it is important to mention that any forward-looking statement provided in this conference call depends on domestic and international macroeconomic scenario, the footwear markets in Brazil and abroad and other operating factors that could affect the future results of Alpargatas.

The participants of this conference call are Mr. Jose Roberto Lettiere, CFO and Investor Relations Director; Mr. Jose Salvio Moraes, Investor Relations Manager and Mariane Weger, Investor Relations Analyst.

I would now like to turn the conference over to Mr. Jose Roberto Lettiere. Please go ahead, sir.

Jose Roberto Lettiere {BIO 16358413 <GO>}

Good morning or good afternoon to all of you. We are going to talk about the third quarter 2014. Before we start, I'd just like to make few comments about our performance during the third quarter. I would like to start talking about the domestic operations and make some highlights and in the sequence we'll talk about our international operations, before we talk specifically about numbers in our Q [ph] figures.

Start with our domestic operations, I would like to highlight that our Sandals volume increased which was an impressive volume 15% volume growth in the quarter and also our brand extension corresponded on average to 44% of the stores revenues in the quarter. You may remember that we launched the brand extension line during the second quarter using World Cup event.

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So far the two stores we opened are performing okay and the information we are receiving from our consumers are really helping us in order to continue progressing in this strategy. But the key highlights of the month in our domestic market was really the sandals volume growth, as we are producing more volumes using our new factory in Montes Claros.

Then sporting goods, our demand for running footwear also grew during the quarter and after that second quarter impacted by the World Cup. Our Mizuno sales volume increased 6.5 percentage points and our Timberland business also had an impressive volume growth around 30%. Apparel and sports accessories also increased nicely during the quarter around 2.5 percentage points in volume.

Our retail as considered September 30, we had at that time 478 stores in operation, of which 366 were Havaianas. We opened new stores during this period talking about year-on-year, we opened 66 new stores, of which 61 were Havaianas, we're talking about exclusive stores and not own store, but also -- but we're talking about the franchise store.

Our revenue also grew significant in terms of same store sales basis, Havaianas has grew 11%, our outlet stores, Meggashop brand grew 20%, they are showing a recovery after again a bad second quarter growth. Our Osklen stores also grew less compared to Havaianas but also put same store sales growth around 1%. Talking about Osklen, continued talking about Osklen, I just highlight that we consolidated our option to acquire another 30% of the capital of Osklen. It was exercised on September 30. Alpargatas now hold 60% of Osklen stock.

Now, talking about our international operation. I'd like to start with Argentina, our Argentina operations, we had another quarter of growth, Argentina is really recovering month after month of our restructuring we conducted during the second quarter specifically, and volume revenues and these events are really showing a very important recovery, and for the consolidated results it was again another very good results contributed to the overall Alpargatas business.

Also in terms of cash and cash net debt, Argentina now is generating cash and we are generating net funds in order to support our future investment in that country after a long period without any kind of investment, due to the economic crisis in that country.

And talking about our Topper brand in that country, I would like to highlight that Topper is recovering market share, is recovering profitability and it's maintaining the leading position in sporting goods regarding volume and also maintain the leading position regarding share value.

Talk a little bit our sandals international operations. Again not specific in the quarter because we had the seasonality as you know, the third quarter for our international sandals operation is a weak season. But talking about year to date figures, we are experiencing a very good year with our international sandals, volume growing, our EBITDA margin is accelerating quarter-after-quarter and talking about nine months year to date, our EBITDA margin that we delivered is around 22%, which is totally aligned with our plan.

So we are progressing regarding volume growth, we're opening new stores, we're reaching new customers and profitability and cash generation are coming in line or even better than we planned.

Now, before we move to -- talk about the more details regarding our figures, I'd like to make another highlight for Tavex. You may had an opportunity to read or to follow the communications regarding our Tavex equity, so I'd like just to say that three -- two important points before the first one just to make sure that we have the two in the standing about our Tavex exactly.

Alpargatas net contribute to the liquidation of the tender offer which are in place, so which means that we are going to continue with our indirect stake in that business, which is 18.7%. Another important point to mention is that, in up to 180 days after the liquidation of the tender offer, members of our Board which are not associated with our controlling shareholder will opt for one of the three possibilities.

One, maintain Alpargatas the indirect 18.7% stake in Tavex or sell Alpargatas stake in Tavex to Camargo Correa, our controlling shareholder at the tender offer share price or continue the business restructuring and continue restructuring the textile business. So this is an important decision and communication to the market as we are talking about this subject in the past -- we had been talk about this subject in the past months. And we believe that with this communication, Alpargatas will had more flexibility in (inaudible) to continue our growth strategy supporting your consumer core brands.

Now moving to the financial envelope. I will start talking about our revenues providing some of the case about the revenues generated in the quarter. The consolidated figures, we had our net revenues growth is 7.7 percentage points. We have highlight as I mention to a main sales in Brazil and overseas Mizuno and Timberland are recovering, a very strong performance in -- with Topper in Argentina and also our apparel and accessories in Brazil.

One important point to mention is that Forex impacting our revenues. If you look our growth in pesos, Argentinean pesos, we had a 50.6 percentage point growth in pesos. In a dollar base, we also had an important growth 31.4 percentage points. And as the real devaluated against the dollar and against the euro, when we do consolidate the figures we generate the 7.7 percentage points growth in reais.

In terms of the split between business; sandals represent 53% of our total net sales, sporting goods 41% and our textile business in Argentina represented 6%. Talking about the region, comparing quarter 2013 with the third quarter of 2014 the international business continues representing more or less something close to 30%, so it's a flat against last year. Now more reinforced by Argentina with better profitability and also in the international sandals business. So not only represented a good proportion of our net revenue, but also correlate [ph] and support our profitability consolidated figures.

Talking about our net revenues as I mentioned, it is important to mention that the third quarter represented an important movement -- fast movement compared to the second

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quarter. Our brand started really recovering the performance we did -- we had in the second quarter and looking ahead we could already realize -- note that October starting the third quarter (inaudible) of course the economic situation is not progressing as we wanted, as we wish but our brand are nicely performing and it started performing nicely in the fourth quarter.

So especially in the sporting goods we see that towards the end of the year we should recover part of the volume we lost or we do not performed in the second quarter during the World Cup. So the consumer confidence are moving slightly -- is improving slightly, but for our brands we do expect a positive impact mainly as we are entering in the high season for Havaianas, flip-flops and also for sporting goods as during the Christmas season, these categories are more leverage due to this periods.

Then our gross profit this year and especially third quarter was heavily impacted by two major factors. One the exchange rates as we have part of our cost structure indexed to the dollar. And also we have to reduce some prices in our sporting goods categories. As the competition, we're facing are heavy so we have to adjust price in order to continue growing our volumes specifically for the Mizuno brand. So we have reduced our gross profit from 41% to 37.7 percentage points in the quarter.

And another, but conversely we had some positive points I'd like just to mention to which offset these exchange rates and the price, average price reduction in our sporting goods, which were the modernization of our textile manufacturing in Argentina, a better fixed cost dilution in Argentina as we restructured the business. And also another element, which is progressing regarding margin proven is our most clients for sandals, which we are progressing nicely towards our run part. So we are, every month we were diluting more and more our fixed cost. So we would expect for next year a better margin generated from our most client.

So talking about the gross profit and the gross margin. Our EBITDA margin moving strong 12% in third quarter to 2013 to a 14.9% in third quarter 2014 before ForEx and commodities. When we consider the impact from the ForEx and certain raw materials and some commodities then we have this heat in our model. So our models ended at 11.6 percentage points. Our net income also suffered a little bit compared to last year, mainly due to the EBITDA as we mentioned, we put an EBITDA flat in terms of phenomenal amount and a slight reduction in margins, that also impacted this net income, the restriction conducted in Argentina and some claims here in Brazil in order to restructure and centralize operations in our sporting goods. So we had R\$11 million related to the non recovering items.

Okay. And also another element which impact in a small amount but impacted also negatively was the difference between our financial results. Last year our financial results were slightly higher than this year as we managed last year a higher amount of cash and this year we have a light amount of cash, so financial results were a little bit lower.

So talking about cash flow, a little bit about cash flow. Considering the last 12 months we continue generating operational cash flow, so operational cash flow generation were

R\$167 million, which were sufficient to fund our loans, our shareholder remuneration and also to pay the 30% of the first stake of Osklen. So, ending the cash balance on September 3 with R\$540 [ph] million, so roughly R\$0.5 billion in cash.

So as a consequence, our net financial position is continued to be very healthy with R\$140 million positive. Shareholder compensation as I mentioned, we are continued to see our policies anticipating interest on capital and this year, year-to-date (inaudible) paid R\$84.3 million and the next payment is planned for December 17, in order to complement the three initial anticipations for increase on capital. And next year according to our dividend policy, we are going to complement after we close the year. So, in summary the key highlights about our considering, key figures are result and now we are here Salvio, Marcio [ph] and myself. We are here to answer your questions and doubts. Thank you.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions). Our first question comes from Kevin Gallagher with Equinox Partners.

Q - Kevin Gallagher {BIO 18041567 <GO>}

Hi, good morning. Thanks for taking my questions. My first question is, I was just curious about the sporting goods sector in Brazil. And I, my question was, I was wondering, if the tax benefit that your company's got related to the World Cup, if that was, is that was the cause in the weakness in the sporting goods sector.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

No Kevin, no. There is no tax benefit related to World Cup. What -- when we, but when we mention World Cup what we mean is during the World Cup month specifically may, this is was flee World Cup, June and some part of July sales were stronger in products related to foot ball not in other sports like running and other casual or training. So what we sold very well.

Q - Kevin Gallagher {BIO 18041567 <GO>}

Yeah, I understand that, but my question was certain competitors seem to have to done ICMS tax benefits extending through 2015. And I was wondering if that was the cause of the weakness for our -- to sporting goods.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

No, no, no. We have, we have the ICMS tax benefits in our operations in Paraiba State where Havaianas, one of our Havaianas plant is located and also the sporting goods plant. And also we have ICMS benefiting Montes Claros plant in Minas Gerais. But those benefits are for a long term, for everything that is produced and sold from this plant. Not related specifically at the World Cup event. Okay.

Q - Kevin Gallagher {BIO 18041567 <GO>}

Okay, I understand.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

Everything that in other words. In other words, everything that we make in these states in sandals and in sporting goods, we have the ICMS benefit. Okay.

Q - Kevin Gallagher {BIO 18041567 <GO>}

Okay. Thank you. My second question is, one of the important parts of the strategy for Brazil, the combination of price increases and up-scaling the product mix. I was just curious in the current environment that seems to be a tricky thing to do and also wondering if you could comment on that?

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

Yes. Sandals, we have a strategy which is we do price increase once a year, when we do change collections, okay. In this environment as we mentioned, we have inflation with -- I would say it's on target procedure what the government say but is around 6.5%. So we are analyzing price increase in order to recover our margins as service inflation (inaudible) 6.5 percentage points, okay.

So the inflation in services is really heating the pockets of our consumers and these of course is generated an less confident in our markets. But one important point is -- talking about specifically now about Sandals, okay. The Havaianas brand is very strong as you know, brand awareness is very high. If you see that value is what we look, we really analyze which is very important for our brands.

So the preceded value for Havaianas is very strong in consumer goods considered all categories its own over there, the branches with its higher preceded value. So for this reason, we believe that we will be in a position to continue increase our price in line or slight above inflation looking ahead, looking in the next collection.

And also when we see -- we will be expected continue to see our mix of high-end products being growing. So two impact, one we believe that we are going to continue increasing price, okay. We want to recover product inflation and also we are going to continue increasing our mix, selling higher.

In the sporting goods, the environment is more competitive, after the World Cup, the international brands implemented a strategy which was to promote the promotions and sales for the foot, for the soccer boots that's what the football shoes. So in this specific category we see the market a little bit more difficult in terms of price increase because of the competition.

In the World Cup where we are leading -- we were leaders (inaudible) we had also to make some adjustment during the World Cup and now we are recovering our price to

only -- as we are getting close to the Christmas season and the next year's summer season.

So in other word in Sandals we see more opportunities to continue increasing our price and more competition or more difficult to increase price in sporting goods here in Brazil. Okay.

Q - Kevin Gallagher {BIO 18041567 <GO>}

Okay, that's very helpful. Thank you.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

Okay.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I would like to invite Mr. Jose Roberto Lettiere to proceed with his closing statements. Please go ahead, sir.

A - Jose Roberto Lettiere {BIO 16358413 <GO>}

So, thank you for your participation in this conference call. We are very confident that our brands in our -- all our regions we have business and starting with Brazil, where we are looking the fourth quarter as an important quarter for us. Where we are expecting good growth in terms of volumes for our Sandals and for our Sporting Goods and categories.

We are very confident out about our Argentinean operation after all the restructuring we conducted in that country. So despite the very tough year in the Brazilian market, in our domestic market we do expect that we're going to end the year and continue growing our top line, which is a very important key indicator for consumer business.

So thank you very much for your participation and we are here always open and available for your further questions. Thank you.

Operator

That does conclude Alpargatas' audio conference for today. Thank you, very much for your participation. Have a good day and thank you for using Chorus Call.

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