Q1 2014 Earnings Call

Company Participants

- Eugênio de Zagottis, Director-Investor Relations & Corporate Planning
- Marcílio D'Amico Pousada, Chief Executive Officer & Executive Director

Other Participants

- Luciano Campos, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Raia Drogasil Conference Call to discuss its 2014 results. The audio for this conference is being broadcast simultaneously through the Internet through the website www.raiadrogasil.com.br/ir. In that address, you can also find the slideshow presentation available for download.

We inform that all participants will be able to listen to the conference during the company's presentation. After the company's remarks are over, there will be a question-and-answer period. At that time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Raia Drogasil management and on information currently available to the company. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to future events and, therefore, depend on circumstance that may or may not occur in the future.

Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of the Raia Drogasil and could cause results to differ materially from those expressed in such forward-looking statements.

Today with us are Mr. Marcílio Pousada, CEO; Mr. Eugênio De Zagottis, Investor Relations and Corporate Planning Vice President; and Gabriel Rozenberg, IR and Corporate Planning Director.

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

Marcílio D'Amico Pousada

Good morning, everyone. Welcome to the Raia Drogasil results presentation for the first quarter of 2014.

As always, Eugênio will present the highlights of the quarter. And just before the Q&A, I would like to stress a few points about the results and about our expansion plan.

Eugênio, please.

Eugênio de Zagottis

Hello, everybody. First of all, thank you all for attending our conference call.

We're very happy to begin the year with solid results moving back along the right direction of our historical margin expansion track record. So this was a good quarter with solid results and before talking more about the process, just to clarify that the first quarter of the year cannot be comparable not in terms of any other quarter, because we have vacation month in January, because February is a short month, it's carnival. So, it's always a lower – scenario of lower sales and higher expense as a result. But on a comparable basis before the (03:41) I think the strength of the numbers we're presenting.

We ended the year with 986 stores in operation. We opened 18 stores and closed 1 store in the quarter. Our revenues reached BRL 1.7 billion, 19.5% of growth and 12.7% of same-store sales growth. We reached a gross margin of 26.9%, 0.3 percentage point margin increase and our adjusted EBITDA reached BRL 87.3 million, an increase of nearly 32% over the first quarter of last year and that represented an EBITDA margin of 5.1% in the quarter. Our adjusted net income reached BRL 40.7 million. We have increased it by 54% over the same period last year, and we reached the net margin of 2.4% in the quarter. And finally like every other first quarter, we had negative free cash flow and total cash flow. This is really the seasonal profile of the quarter. So that's normal and we'll give more details on that in a minute.

In page four, to give a highlight about our store development program, we opened 18 stores in the quarter and closed one store, and we opened two stores that were previously suspended for rebranding, so (05:07). We reiterate guidance of 130 stores for this year. We're fully on track to do it. We have already 96 signed contracts as of today and we have until late August to get the remaining contract signed and we have a lot of negotiations and calls and that should not be an issue. What has to be considered this year is that first of all this is lower open quarter when compared to last year, because last year we had just bought stores in Goiania and we opened 24 of those stores at once in the first quarter. So obviously, the first quarter when we don't have an acquisition to do, it is low-work quarter than usual. So this is one thing.

The second thing is that the fact that we have the World Cup starting in June will increase the concentration of the stores to be opened in the second semester of this year. Not only it will be impractical to open stores during World Cup because of travel costs and the frequencies, but on top of that the fact that the government is getting ready for the World Cup means that licensing store (06:26) because we're competing with venues related to the World Cup with hotels. And the whole priority of the government right now is to get everything in place for the world cup.

So, we're on track in terms of contracts. We're hoping to be concentrated on the second semester, but definitely we'll open 130 stores when they finish. Talking about our store portfolio, 33.3% of stores are still undergoing maturation.

On page five, we'd like to give the highlight of our geographic presence and specially, I like to mention the entry into three new states in the Northeast. So we have as of now a very successful operation in Bahia with 16 stores plus an operation that is progressing very well that projects high levels of revenue for store for when the store completes the maturation with good levels of gross margin, almost from day one. So inspired by the success in Bahia, we are accelerating our pace into the rest of North East.

So, we will open next Tuesday our first store in Recife in the state of Pernambuco. This is the top state marked in the chart and we have also contracts signed for further stores in Pernambuco as well as stores in the state of Alagoas and Sergipe, so I'm going down the map. That will be opened over the next few months. In total, we have already 18 contracts signed for the Northeast including Bahia that should you go over the year something like 25 openings in the Northeast. Some are starting in Bahia and then start in the new markets.

We believe that the Northeast is a great market. It's the fastest growing market in Brazil. It features a major city, very, very attractive place. I think the model, the format that we have bodes very well in those markets especially for affluent A and B consumer. So, when we go to the regions initially, all we do is actually the same stuff we do in São Paulo or in other space where we compete. We try to service well the A and B population in those areas. And we do that in Bahia. It will be no different now in the remaining state of the Northeast.

Talking about the market share. First of all, we published what we call comparable market share that IMS is expanding, continuing the base or the panel. So IMS reports an adjusted figure, we doubt any new informant is added to the panel over the last 12 months. So we have a national share growth of 0.6 percentage points, reaching 9.4% on panel market share, and we grew market share in every state, where we compete. The main highlight was in the Midwest region, fuelled by acquisition we did in Goiânia and also by strong performances in other markets. The total market share including the new entrance that didn't exist in the base in the first quarter of next year is 9.1%.

On page six, I'd like to provide more details in terms of our revenue growth. Our total revenue increased by 19.5% in the quarter. If we take out the close stores from last year's comp base, the surviving stores closed, the new stores opened, growing 21.7%. It's a very expressive figure. Mature stores grew by 12.7% – same-store sales grew by 12.7% and mature stores grew by 7.6%. Inflation was 6.2%, so we are reporting real mature store growth of 1.4%.

A couple of things have to be mentioned here. The first thing is that we have a very hot and dry summer months in the quarter especially January, but also February to a less extent, and this did help a lot, but it helped because we were ready to play with the seasonality with the correct programs being executed in stores, the right pricing assessment, so we took full advantage of the favorable seasonal quarter.

The second thing is that we're comparing a very depressed comp base of last year. We had grown by only 2.2% in the first quarter of 2013. So, this is the easiest comp of the year. We had – obviously to have a strong show in the year. As you reach the second quarter, we have to point out the fact that the comp base grew at once by 3.5 percentage points. So the second quarter is probably the toughest comp base for the year, because the increase is very sudden; and on top of that, we have the World Cup in January (11:33), which in fact is very difficult to predict, but certainly it's not helping our revenue. So, there is – there will be some kind of revenue loss because of the work, because of more holidays and so on. So when you look in second quarter, it will be a different scenario on the revenue side, and as a consequence on the expense dilution side. But as I'll mention later, I think we have a very strong gross margin scenario ahead and overall, we still expect to deliver some type of margin expansion in the second quarter of this year.

Talking about our product mix on page seven; it's remarkable how the front store has been well of recent. We have HPC grow – gaining one percentage, 100 basis points in our sales mix based on the strong seasonality, based on our execution, based on store renovations that are starting to have an impact here. OTC was also very strong, 0.4 percentage points on a comparable basis with the first quarter of last year. And even though these strong seasonality harms OTC sales, I think our execution has been through so much over the year that we were still able to increase penetration of OTC in the sales mix by 0.4 percentage points in a very adverse seasonality for OTC. And then pharma as a total group, below the rest of the mix. So, there is a positive mix effect here.

In terms of gross margins on page eight, we increased our gross margins in the quarter by 0.3 percentage points. Our gross margins reached 16 – 26.9%; and here we see the first result of opting out of our special tax regime and getting back to the normal tax institution regime. As you know, we have adjacent tax status over the last several quarters in order to recover more than BRL 100 million in outstanding tax credits, again in the state of São Paulo. This illustrates little bit on a cash basis, but of course it harmed our gross margins by 0.4 percentage points, because tax – the fact that several (13:51) tax planning and that fall in our shoulders as we became our own tax payers.

Now – last December, we moved out of this special tax regime with the tax credits already fully recovered. And as our investors are rotating, we're starting to see the benefits. So in this quarter, we estimate that 0.2 percentage point of the margin gain was due to the normalization of the tax situation. And we'll see another 20 basis points improvement probably already in the second quarter of this year. So we're getting absolutely back on track in terms of our gross margins. Just as we have been planning the market.

When you compare the cash cycle, if you look on from an accounting perspective, it looks like we are three days heavier in cash cycle. However, we have to consider here that first of all in the first quarter of last year that was reported in our earnings statement, we discounted approximately 2.5 days – 2.2 days sorry in accounts receivable.

This is not an operational transaction. This is a financial operation. This is a kind of off-balance sheet financing. So, if we plug back here to the comp base, the accounts receivables that were discounted, we are talking 63.6 days now versus 62.8 days one year ago. This is the real calculation on the cash impact on the company; and based on the calculation, we increased 0.8 days of cash cycle.

It's important also to consider that opting out of our special tax regime is very good on the margin side, but it adds another pressure in terms of working capital, because we have to assess how much our inventories were before changing the tax regime and pay sales taxes on our inventory. So, this is 4.5 days, the increase that we had in the fourth quarter that we maintain now in the future. So this 4.5 day is economical, because it costs us money. But when you think about the performance of our supply chain management, we have also to take this out of the calculation and then we have a comparable cash cycle performance of 3.6 days. So 0.8 day negative on an economic basis, but on a performance basis and job execution, this 3.6 day is feasible.

On page nine, we had a minor sales expense pressure in the quarter of 0.1 percentage points of revenue. So, our salary went up by 0.1 percentage point, rentals are not in the same amount, but the fact that we opened less stores mitigated that impact 0.1 percentage point. So, we have basically 0.1 percentage point of sales tax pressure, but this was absolutely mitigated by the general and administrative expense dilution that we can see on page 10.

Our G&A went down by 0.3 percentage points, a very strong dilution to 2.8 percentage point. And again, we cannot compare the 2.8 in the previous quarter, because we have very less revenues in the first quarter than we had in the fourth quarter, because of the seasonality of the quarter that I previously mentioned. But it's a 2.8 from the first quarter, I think it's an impressive number; it's probably our strongest number there. What's happening since the merger in the end of the fourth quarter 2011 is that our number of stores went up by 27%, while our expenses stayed flat on inflation adjusted terms and real terms. So we're able with the systems integration to start seeing synergies here to be able to grow with same structure and do things more efficiently, more effectively.

If you compare on an absolute basis, the first quarter 2013 with 2014, expenses went up by 9.2%. Salaries alone went up by 8.5 in this period. So, we are flat when you look longer term. On a quarter-to-quarter basis, you have slightly better or slightly different quarter, but we are maintaining our expenses almost flat, and this is very important and this is helping us get back to margin expansion.

As a result, on page 11, we see our EBITDA margin go up by 50 basis points to 5.1% of gross revenues, 0.3% of this impact was in the gross margin side and 0.2% was operating expenses dilution. Another number that I'd like to share and that – it kind of highlights the impact of the new store opening is on our profitability.

This affected the 960 stores that we had operating seems the fourth quarter of 2013 meaning not considering the negative impact of the stores open or in the process of opening in the beginning of this year. Our EBITDA would be BRL 94 million instead of BRL 87 million. So, we get exactly same number of stores in year 2014 (19:27) logistics, and we have a BRL 7 million higher EBITDA than our EBITDA, when we considered these new stores, so BRL 7 million was the cost of opening stores previous first quarters.

Stores that had already operating and generating negative profitability in the first month or stores that we are paying pre-operational expansions to be opened in a couple of months, and the EBITDA margin of these comparable stores considering bigger revenues would be of 5.5%, so a 40 basis point impact of short-term growth, and I'm not talking about maturity, because if it stop growing today and we allow a store to progress the maturation process in three years, our EBITDA margin goes up by 1.5 percentage point. We're just talking short-term impact of the new store openings.

On page 12, looking below the EBITDA line, we see depreciation flat, and we see a dilution in financial expenses of 0.2 percentage points. What happened is that our average net debt in this first quarter was almost lower – was BRL 33 million below the one we had on the first quarter of last year. And when we're talking about net debt in the first quarter last year, we are including in this calculation BRL 34.5 million we discounted receivables that charge interest and again discounting receivables is not an operational move, it's a financial move this is off balance sheet financing, there's nothing wrong with that; you just have to be understood correctly.

And finally, because our EBITDA increased by 50 basis points, taxes accrued went up by 0.2 percentage points. So when we put it all together on page 13, our adjusted net income went up by 0.6 percentage points and we reached 2.4% of net adjusted net income in the quarter. So we improved 50 basis points of EBITDA, 20 basis points financial expenses, but then spend 10 basis points more in income taxes.

On an absolute basis, our adjusted net income went up by 53.6% and I think this is a very relevant number to take into consideration. For those who like to see an adjusted net income and that's not certainly my case, where margins doubling our accounting net income.

And the reason is simple and it is on next page. However, we have shown a drastic reduction in non-recurring expenses. In the first quarter, we booked only $1.4 million non-recurring expenses, $0.7 million consulting expenses related to the PMO of our integration business reports continue through this year. And then we had a specific systems – miscellaneous system integration expenses related to the rollout of our – of the integration of the corporate system that happened in the end of February.

So what we showed in my view is that for the adjustments that we made last year were really (22:34) because we are looking at a much better profitability with a much lower level of adjustments; and the alliance is really getting back to normal as we become finally one company and we'll start talking everyday less about integration and everyday more about creating value for our shareholders and for our consumers.

So we believe that the true adjustments there absolutely pay amount for us to explain the recurring results based on an economic view and not purely on accounting view. So, net income grew 53.6% and not 104% because of that in our view.

On page 15, we have in the first quarter in this year just like we had last year, our negative free cash flow and negative total cash flow as well. What happens is that from a cash view point the first quarter has and always view have feasible seasonality. What happened is that the first quarter is the leanest quarter in cash cycle in the year, due to the fact that we have subsidized working capital, based on the fact that we buy a lot of seasonal merchandises in September, we sell them a lot in December, and we only pay in February. So, our days of accounts payable get up in the first quarter.

So – and the first quarter is exactly when the due arrives, so not only we have a quarter with lower revenues because of the calendar, but also we have a quarter in which we are paying the seasonal merchandising that we bought last year that we sold part on the fourth quarter, part on this first quarter. So, we've already seen the first quarter a relevant cash outlet taking place and that's absolutely normal.

When you can see the results from operations, we improved BRL 20 million, but this year comparing to the first quarter of last year, we had higher – slightly higher drain in terms of working capital. What happened is that the first quarter of 2013 was so lean and much leaner than the first quarter of 2012, and we were very, very efficient in the first quarter of 2012, and we've got something where we did something back in this first quarter. So there is a slightly higher cash consumption in this first quarter than we had on the first quarter of last year, but that's I think kind of normal and this will get back to normal as the year progresses.

We had the same level of investment this year and last year, BRL 52 million or around it, and then we generated a negative free cash flow of BRL 119 million, and the negative total cash flow of BRL 118 million.

Before passing to Marcílio, I'd like just to show that and certainly you know that as well, we're seeing a strong recording of our share price. We ended the quarter with a share price of BRL 19.6. Now we had a challenging year – last year, but in our view, the share price deteriorated way further than it should have deteriorated. So, now as our members are getting back on track and the market is already expected that from us, we saw very strong repot of 33% year-to-date increase versus a BOVESPA decline of 2.1% in the same period.

I'll now pass to Marcílio for him to sum up what we have seen in the quarter and to talk about the very important milestone for the quarter.

Marcílio D'Amico Pousada

Okay, let's go to slide 17. I'd like to show – share with you some very good main drivers for the great financial results that you have, okay. Sales, we really had a great December (26:42) January and February. And it was very well in all segment revenues to leverage the seasonality generating a total sales growth of (26:50) these are very, very good number. And we believe that exclusive relation to our coverage corporate business that was concluded on February 28th started to make a difference in execution.

Looking for the gross margin; we increased gross margin by 30 basis points. Of that, 20 basis points due to the change in tax regime that we had in December (27:12) also 14 basis points. The other 20 points – basis points moving over the second quarter was (27:22). In expenses, we had very, very good number (27:29) had an inflation was achieved 20 basis points with interest and operating expenses. It's another sign of improvement that was systems integration bringing to our business. We are very confident (27:43) especially in the second semester.

Let's go to the slide 17 right now. Group's expansion plan, roughly (27:50) next week the milestone after 1,000 stores. We are very proud about the numbers and we are the only bridge drug chain and one of a very few in Brazil to operate 1,000 property stores not including (28:05). In the end of 2011, we've had opened a total of 264 stores and closed tenders that was a part of the store (28:15) so as we reach this mark of 1,000 stores.

We are celebrating this achievement with two landmarks opening this next week. Our first airport store in the Guarulhos airport and in São Paolo International Airport, which has a lot of higher brand store that we believe that (28:33) airport in Brazil may provide the service in order to contract it. And the second landmark for us would be the internal Pernambuco market, which have Drogasil brand. We're still with our expansion in the Northeast area, where we're going to open only Bahia and we already had several contracts signed, not only in the state of Pernambuco, but also in Sergipe and Alagoas with many more openings in (29:01) expected for the next month. Including Bahia, which is already addressed to next quarters, we expect opening around 25 stores in the Northeast region only in this year.

We're opening now for questions and thank you very much.

Q&A

Operator

Thank you. Mr. Luciano Campos from HSBC, would like to make a question.

Q - Luciano Campos {BIO 16181710 <GO>}

Hey good afternoon everyone. We continue to see here, I mean the average basket purchased by each consumer every time they go to your stores continue to be quite strong partially because of the investment change of the relation of the stores and the other products and et cetera. But, we also continue to see this number ahead of your mature store, same store sales evolution. So that's an indication of the traffic. I mean how many – how often people are going to the stores.

Can you help us understand a little bit what's going on with the consumer? Are they purchasing less often, are they purchasing in all other channels and other competitors? Can you talk about that specific trend of consumer behavior? Thank you.

A - Eugênio de Zagottis

Luciano, thank you for the question. The first point here is that we are far from the – we know we are the best compass to understand what's happening to the consumer. This is a very defensive industry. We are selling pharmaceuticals and they required a few products for A and B consumer in Brazil. So not only the products we sell are defensive, but we are servicing – we are far from the frontier of market expansion or contraction.

The numbers that you mentioned, they have to do a very, very long-term trend, I mean if you look some of the great store you have today, 20 years ago, we didn't sell on a real basis not nearly what they sell today, but they had a much higher traffic than they have today.

What happened is that in a market in which we keep opening stores that some time some level of cannibalization. We'll have all the competitors opening stores, the first consumer who leaves our store either for another higher drug store that has opened somewhere or even for a competitive store, is the consumer who was far from the store and not well – that well served by the store. So, with that dynamics, we have consumers, who are marginal consumers leaving sometimes. This reduces the traffic, but then the fact that the top consumers stay increases the average ticket of the store.

This is a very, very long-term trend. Frankly speaking, we pay very little attention to volume versus trend. It has never helped us explain anything given with consideration. So, you cannot draw any conclusions here in terms of economic activity or in terms of competition, nothing like that.

Q - Luciano Campos {BIO 16181710 <GO>}

Thank you, Eugênio.

A - Eugênio de Zagottis

Thank you.

Operator

It appears should be no further questions. Now I'll turn the conference back to Mr. Eugênio de Zagottis to give his final remarks.

A - Eugênio de Zagottis

Well, first of all, I'd like to thank you everybody for attending this conference call. I think that the numbers we presented in the quarter, they are very concrete stats in the right direction, but it's just the fact, I mean we have to keep the momentum going forward and we have to – we want to have a sustained margin expansion cycle. We have a constructive view about the whole year and even the second quarter that should be the toughest quarter in the year; we still think we will be able to increase our margin. What happened is that when you look at our gross margins, first of all we are getting the full text recovery next quarter, so this will help.

The second thing in terms of the gross margin is that as you may recall, we had a change in tax regime taking place – we had a change in purchasing strategy taking place in the second quarter next year in which we started – we stopped buying products with (34:26) allowances and included those allowances on the new voices, and we've had a temporary margin sacrificed that we presented 0.4 percentage point in the gross margin of last year.

So, we are getting a very strong gross margin improvement on the second quarter. However, we also see an expense pressure and a strong one in the second quarter. Why that? Because in the first quarter of last year, we were entering exactly the very short window that we had of reduction in social charges. And in the end, even though the reduction really started on the – the reduction started on the second quarter, so our second quarter, we had for two months a 0.5 percentage point, say your social charges reduction.

When you'll make the average of the quarter, we're talking about the 0.3 percentage point in the expenses last year than we had this year only because of that. And another thing is that as our – as we are counting in the second quarter against the toughest quarter last year, the comp base was up very further. And we don't think the comp base; the monthly growth of our revenue will be – able to follow that place, especially if you consider the impact of the World Cup. It's very difficult to assess what kind of impact the World Cup can have in terms of volumes. It's certainly not healthy, but it doesn't mean it has to be a disaster, but we'll see.

So with higher gross margin, but a pressure expense basis, we're still confident we should increase EBITDA margin in the second quarter. And then as you go to the second semester of the year, we expect a more balanced picture between gross margin, expansion and between sales dilution. So, thank you very much for attending the call and especially and thank you very much for our shareholders for continued support and for keeping with us in the tough day and now in the good days as well. Thanks.

Operator

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