Q4 2016 Earnings Call

Company Participants

- Eugenio De Zagottis, IR & Corporate Planning VP
- Marcilio Pousada, CEO

Other Participants

- Antonio Phis, Analyst
- Joseph Giordano, Analyst
- Marcus Sena, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Raia Drogasil conference call to discuss the results of the year 2016. The audio for this conference is being broadcast simultaneously through the Internet in 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 only be able to listen to the conference during the Company's presentation. After the Company's remarks are over, there will be a Q&A period. At that time, further instructions will be given. (Operator Instructions)

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 circumstances that may or may not occur in the future.

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

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

Now I will turn the conference over to Mr. Marcilio Pousada. Sir, you may begin your conference.

Marcilio Pousada {BIO 16117399 <GO>}

Okay. Thank you very much. Good morning, everyone. Welcome to the presentation of the Fourth Quarter 2016 for Raia Drogasil. As always, Eugenio will present the slides and I will stretch some points after Eugenio, okay. Now we'll go to Eugenio. Eugenio, please.

Eugenio De Zagottis {BIO 7193695 <GO>}

Hello, everybody. Welcome to the Raia Drogasil 2016 conference call. The year was outstanding for the Company from whatever respects you would look at and here we have some of the key numbers that highlight the performance. So we ended the year with more than 1,400 drug stores in operational on Brazil. We opened the year 212 stores. So this is 12 stores more than the guidance we had provided for the year. And then we closed 27 stores.

Gross revenues reached BRL11.8 billion, 25.5% revenue growth with 14.3% same-store sales growth. Our gross margin reached 29.6%, 60 bps better than previous year, whilst EBITDA reached BRL987.6 million and a margin of 8.4% and a 50 bps improvement versus 2015.

Adjusted net income reached BRL499 million, 4.2% net adjusted margin and an increase of 28%. And finally, this was the fourth consecutive year of positive free cash flow generation. We generated BRL35 million in free cash flows and after paying interest on cash of -- after paying interest over that, we had BRL107 million of cash consumption in the year.

On page 4, we can put the numbers of the year ended with a longer term perspective. And I think for me, what -- the message I get from this chart is the capacity that this Company has of growing at a fast pace while creating sustainable value. The compounding capacity of this business is tremendous. I mean, in 2007, when Drogasil became public, Raia and Drogasil had BRL1.8 billion in combined revenues. We added BRL10 billion of revenues ever since to reach BRL11.8 billion this year. But our number of -- we had 410 stores back then, we now have more than 1,400 stores. And all this growth was done with tremendous margin improvement as we have a record high EBITDA in 2016 and a nominal EBITDA close to BRL1 billion. So I think we still think the best is already. So I think we can create tremendous value through organic growth.

Our vision, as you know, has been leading the consolidation of the drugstore industry in Brazil and I think the numbers on the chart, I think they point to the success in delivering the vision. We reached an average market share last year north of 11%. So we've gained as an average for the year 100 bps in market share obviously from the Fourth Quarter, it's much higher than that. But you see that it's a very consistent market schedule.

When we look the next group, the number two to number five companies in the market, as a group they once had 21% of market share, they now have 16% of market share obviously which is not a leading performance across the group. You have one company specifically that is in very bad shape (inaudible) members. But I think the message here is that we are completely detaching ourselves from the pack in terms of total scale and in terms of revenues per store as you can look on the right. There is a very big gap in revenue per store. So none of the other new contenders have the kind of cost structure that we have. In a fixed expense, those like this, this means we have much better dilution than the others. So this is competitivity at the end of the day.

And finally before getting into the details of the year, if you compare -- this is the fifth year -- it also shows the fifth year of since the merger. And we can see the kind of progress we are able to make. Obviously the initial years, as we all remember, were very painful, very challenging. But once we got on track, once we concluded integration, I mean the results have been remarkable.

We increased the store base by more than 80%. We increased revenues by nearly 150%. The number of employees increased 67% only. EBITDA grew more than 200% and we expanded our ROIC by 8.8percentage points (sic; see slide 6, "8.8%") and it has reached 21.5% last year. And obviously if all stores were mature, the number will be much higher than this.

I'll now get into the details of the year. On page 7, we opened last year 212 stores and we closed 27 stores. I think it's important to break down these closures. I would say we had 17 stores closing of which I would consider business as usual. Then we had another 10 store that were more like one timers, I mean they were restructurings that we pursued.

We bought a company in Goiania in 2013 named Santa Marta. I think we had bought something like 25 stores back then. They were very important to increase our presence and our market share in Goiania. But we felt that in some neighborhoods we went too far in terms of store density. So we decided to close six stores this year, those acquired ones. So that we could better (rinse) with the revenues across increasing stores, increase our revenues per store and our margin in the operation. This was successfully done. So these are kind of one-time closures.

And also with Farmasil, as we concluded the partner and as you now have a clear strategy of rolling out starting in Sao Paulo, we feel that it doesn't make any sense to manage at this stage in the game a decentralized-type of folio like we had. We had stores in the countryside of Parana and one store in the countryside of Parana -- one store in (inaudible), two in Rio, two in Goiania. So we decided to close the stores but which we could not adequately manage to be able to focus in Sao Paulo to be able to start our expansion. So those were four stores being closed. So then I would say they are kind of one-timers.

17, they represent kind of expected base moving forward also. Figure on the right, when we looked at the store portfolio, 34.7% of our stores are still undergoing maturation with very high percentage of 32 stores. So this is the highest, the greenest portfolio since 2013.

Flipping to page 8, we can discuss our geographic presence and market share growth. I feel the first message here is obviously Sao Paulo is a very important and meaningful market for us. We have more than 800 stores in the state of Sao Paulo. This year alone, we added more than 100 stores in Sao Paulo and we think this is great. But we already have a very meaningful presence outside of Sao Paulo. So if you look in the Northeast for example, it's a very new market, we're just in the beginning. We already have 98 stores there. We have more than 100 stores in Rio. We have 137 stores in the South, something like 104 stores in the Midwest.

And another important thing is that this year on top of adding new stores to those that reach the markets, we will also enter three new states. So I think we are at the same time expanding the network and increasing the deficit in the markets we compete. We achieved in the Fourth Quarter an amazing comparable market share of 12.5%. So the market share on a national basis grew 2.2percentage points in one year. This is a comparable figure. So all the new information that I announced just started capturing, they are out of the game here. The extra market share number is 11.8, which I think it's a really good number and a really -- best progress over this year.

In Sao Paulo, the comparable market share went up by 300 bps from 21.9% to 24.9%. What's happening here is first is the effect of 100 new stores come aboard. So this is very meaningful. The metrics of the portfolio, despite cannibalization, is doing also well. So this is another thing. And we saw this year competitors closing stores. We saw on roughly closing something like 15 stores and we saw a small player named (inaudible) closing even more than 34 stores. So this is a consolidation is happening at a very good pace and we are very happy where we are and we think we still can have -- we still have a long runway ahead of us even in the state of Sao Paulo.

Then in the South -- in the Southeast, we increased from 6.9% to 8%, in the Midwest 12.9% to 13.7%, in the South 5.5% to 6.5%. And in the Northeast we doubled the share from one year to the other, from 2.7% to 5.4%. We are still in the beginning, we think we could have in the Northeast similar share to the one we have in the Midwest, for example.

On the next page, we reached BRL11.8 billion in new revenues of which BRL11.5 billion were Raia Drogasil and BRL356 million were 4Bio. So consolidated revenue growth was 25.5%. What's important here is that we added this year alone BRL2.4 billion in new revenues. So this is like -- this is more than the size of the number four companies in the business.

So the magnitude of the full gain that we're able to post as a year is very, very meaningful. So we are progressing this Company from our competitors in terms of scale. Raia Drogasil grew 24.2% in the year on the retail business and 23.3% in the Fourth Quarter. 4Bio grew a staggering 92% in the year and a still staggering 81% in the Fourth Quarter. So the numbers we have in 4Bio are better than any expectation we have. And obviously this has an impact on the value of the option to buy the remaining 45% of 4Bio and when we discuss the net income, we see an effect from this performance in more numbers.

In terms of throughout the mix, I think the best way to summarize this is that everything pharma is doing a very strong and very -- is doing very well and very consistent. So Branded Rx grew 25.1% in the year, 25.9% in the quarter. Generics, 24.2% in the year, 26.8% in the quarter. So Generics was the highlight in the quarter. We're starting to see very good generic numbers (inaudible). OTC similar numbers 25.1% in the year, 24% in the quarter.

Then what's different is HPC. HPC is not in the same level. I can hardly call it a problem because we are talking 22% annual growth. But in the quarter mainly due to a very strong home base of last year because of Zika, because of with the recurrent fails, it was in the quarter 17.6%. What is also happening in HPC is that in our core categories and in the value-added categories. And actually those are the ones everybody was worried about, we are doing really good in skin care, in hair care and so on, in cosmetics.

But then where we are struggling to some extent is on (inaudible) categories where customers are more price sensitive, there is more cross-channel competition. So it's been somewhat tempered there. But still the average numbers are good and obviously pharma is performing at a very high level. The bar is very high even for HPC to try it.

On page 10, of this 23.3% revenue growth in the quarter, 13.2% was same-store sales at the retail level, 8.1% in mature store sales growth. The calendar effect here is positive 0.3%.

Then page 11, our gross margin for the year extended by 50 bps mainly due to the inflationary gain in inventories that took place in the second and Third Quarter. And when we look at the Fourth Quarter, we gained 10 bps of gross margin. The cash cycle, which also related also to buy in margin, was flattish versus last year. We reduced 0.2 days of cash cycle. So we think this is a very good number. (inaudible) of the reduced cash cycle in the previous two years. And I think maintaining the cash cycle level, we think it's a very good performance.

Page 12, we express here the expense trends. So when we look the whole year, we saw an expense pressure of 20 bps, which was still concentrated on sales expenses. G&A was flat and G&A would have been diluted if not for specific pressures on the Fourth Quarter.

So going to the Fourth Quarter, in terms of sales expenses, we achieved a 40 bps dilution. So the Fourth Quarter was in line with the third and Second Quarter of the year. What happened here is that because we opened our stores in a very balanced way through the year with 46% of that being opened in the first semester, those store had the time to breakeven, had the time to start generating profitability to the level which they are offsetting the expenses from the new stores that came around in the second semester.

So as a result, because we had so many stores generating cash. And last year, at the same point in time, only a small number of stores was at that stage, the bulk had been opened in the second semester. We had a big pressure from store opening. So 50 bps improvement this quarter versus same quarter last year.

On top of that, 4Bio -- the mix effect in the 4Bio growth diluted another 10 bps of sales expenses. On the other hand, marketing, rentals and store closures, each has pressured by 10 bps and there the aggregate 40 bps effect.

In terms of G&A, we have an increase of 30 bps of which 20 bps were due to higher provisioning of variable compensation and 10 bps was due to a peak in labor contingencies. So we think there is a 30 bps effect here that is transitory and we expect to get back to the normal level already in the First Quarter of next year.

On the variable compensation side, what happens is the combination of two things. First, this was a tremendous year so we are paying very high bonuses for a good reason. But then there is another effect which is the outstanding shares we have granted in previous years, when the share price goes up, our provision has to be adjusted by that. So we obtained to some extent, the cost of the -- we are bearing the cost of share price increase over outstanding shares granted but not vested. So this effect was a very meaningful last year.

As a result, EBITDA for the year grew by 50 bps reaching BRL998 million on a consolidated level and in the quarter we gained 10 bps of EBITDA margin. If we assume only the 1,208 stores were already had operating on December 31st last year and we attribute to those stores the firm logistics in G&A expenses, meaning not considering the cost of the stores opened -- the losses in the stores opened through the year, gross revenues obviously will be lower, BRL11.4 billion versus BRL11.8 billion. But EBITDA would have been BRL1,017 million and the margin was at 8.9%. This is only to illustrate the cost of opening stores on the current year performance.

But if we look at the Fourth Quarter, the contribution margin of the new stores opened for the first time ever was positive by BRL3.2 million because a lot of stores were opened early and had enough time to start making money and to more than offset the cost of the store being opened in the second semester. Then comparing the two groups that we operate, Raia Drogasil reached -- the retail business reached BRL970 million of EBITDA with a 8.5% margin, BRL702 million of EBIT and an EBIT margin of 6.1%.

4Bio did a very good BRL17.3 million, a margin of 4.8%. But EBIT margin was 4.8% also. So there is very little depreciation because the (inaudible) so the EBIT margin is also very high here. 4Bio is a very efficient business in terms of return on invested capital and I'll briefly provide some numbers on that.

Next page, adjusted net income. When we look at the full year, it has been flat at 4.2%. When we look at the quarter, we had a 50 bps margin pressure. Of the 50 bps margin pressure, 10 bps was due to higher income taxes. So higher EBITDA, high taxes. And 40 bps was due to higher financial expenses. Of this 40 bps, 10 bps is actually interest accrued, 30 bps has to do with 4Bio.

And it is important to understand how 4Bio is accounted for in our numbers because we have a call on Brazilian shares and we have (inaudible) in four years. What happened was that we consolidated 4Bio and we considered asset 4Bio is 100% ours. Then there is -- we recognized as that the value to be paid for the remaining shares. And because the performance was so good, what happened is that we re-did our projections, we're now expected to pay more than initially and as a result this difference is reflected as an interest expense. So this is a nonrecurring effect. So there is a 30 bps 4Bio pressure here.

And finally, we had BRL7.7 million of nonrecurring expense that we have adjusted in our numbers. So we have restructured our career programs to reflect -- and change the salary grids so that we can optimize our expenses. And in order to accelerate the transition to the new structure, we have BRL7.7 million in severance. This severance is fully provisioned and relates partly the Fourth Quarter, partly the First Quarter of this year.

Then we have restructured the stock portfolio in Goiania of the Santa Marta stores that we acquired and of Farmasil as well outside of Sao Paulo as I previously mentioned. This is a BRL3.9 million assets write-off non cash effect. Then we are transitioning the high loyalty program to different one and there is a cost to even the transition, we have also provisioned for BRL3.8 million. And finally, we have BRL7.8 million positive net recoveries from previous years, which is basically on the tax side.

On page 15, we generated positive free cash flow for the fourth consecutive year. And I think it's still amazing that a company that is growing as much as we are covers over 200 stores where we opened like 212 stores this year versus 156 the previous year. We were able to generate enough cash to pay for our full CapEx. So the operating cash flow was BRL524 million stemming from BRL750 million results from operation minus BRL230 million from working capital. So operating cash flow BRL524 million.

We invested over BRL489 million leaving BRL35 million in free cash flow. The total cash flow is negative because we paid BRL153 million in interest on the equity plus BRL27 million also related to interest on equity but these are taxes (inaudible). So we're talking BRL180 million interest on equity.

We also had net financial expenses of BRL42 million and then we have a tax shield of BRL80 million on those. So the total cash consumption was BRL107 million. We have a very low net debt to EBITDA position which is 0.1 times.

Page 16, we achieved another ROIC increase. Our ROIC reached 21.5% from 19.4% the previous year. And from 12.8% in 2012. So it is a really meaningful ROIC increase. If we break down by business, Raia Drogasil had a ROIC of 21.3% and 4Bio had a ROIC of 37.2%. So the point here is 4Bio is a very productive, very capital efficient format. So 4Bio came up with lower margins. But that's the (inaudible) of the business that stood (inaudible) ROIC.

And finally before passing -- before giving -- before Marcilio makes his consideration, we discuss the performance of our shares. I mean, if we look through the (inaudible) new IPO, the equity market with the BOVESPA index increased by only 11% since 2007 and this is a working number. But we were able to deliver tremendous value, tremendous share appreciation within that process. So in this year alone, we generated a total shareholder return of 74%. For those investors who bought their shares in the Drogasil IPO in 2007, we have delivered 29.1% average total shareholder return per year. And for those investors of Raia IPO in 2010, we have delivered 34.5% average total shareholder return ever since.

I will now pass to Marcilio and then we can (inaudible) the Q&A. Thank you.

Marcilio Pousada {BIO 16117399 <GO>}

Thank you, Eugenio. Okay, let's go to page 18. In page 18, I've accomplishing some points that we did in 2016, okay. The number one point is the organic growth, you know how important and how difficult to open stores in the retail business and we did this with core sentiments. In the long term, we opened more or less 40, 50 stores every quarter. This is very, very important for us and ensures the (inaudible) that we opened new stores. By the way, this was (inaudible), you know how very well with the (inaudible) of all the amenities we opened and (inaudible) we have description about that in learning about the mistakes and learning about how we make very, very good decisions goals.

The second point that we accomplished in 2016 is execution. We maintained our focus on execution. Execution is like two main drivers. Here's the first one, the cash cycle, inventory losses and stock-out to reach the history in our objective (inaudible) happened for us both (inaudible) team members and we increased a lot also our process (inaudible) pillars, employee turnover, restructure career program (inaudible) process, starting time in the stores, all these things together we are hugely achieved our equity customers (inaudible) that number (inaudible) that show us we maintain stock execution can help us for the future (inaudible).

I also consolidate new formats. (inaudible) important for the consolidation that market understand that (inaudible). Then we develop big store formats in (inaudible) here in Brazil in Sao Paulo and we opened new store each time, 350 square meters, is doing very, very well. And the validation of Farmasil format is (inaudible) in the future that we are very, very confident that the business is going on. And we started to (inaudible) the Drogasil model. We are still (inaudible) in the Drogasil format. We opened two stores in this model, a new model for us (inaudible) for next year.

The other thing that helped us (inaudible) is the gains on inventories which they (inaudible) very, very important to (inaudible) increase the opportunity for us. We did this very, very well. And we (inaudible) for stability but also to break the market share.

Let's go to page 19 to talk about the (inaudible) challenges for 2016 and that is okay. We did our (inaudible) plan in 2014 about our strategic plan called (inaudible) go for the future (inaudible) keeping the same focus (inaudible) as well (inaudible) stores this year.

Develop a new format, we are trying to roll out the big store format Farmasil and Raia Drogasil in 2017. We'll talk about category managing, accelerate make-up business which has been a good business in the stores. And also we are (inaudible) starts to our new platform proprietary that can help us to managing the pricing decisions of 1,400 stores around the country.

But the best important (inaudible) that the new year voice card that we're launching this year is also in Drogasil and is higher. We're going to launch this deal this year. This will be a completely revolutionary (inaudible) similar that (inaudible).

We update expand the market share also (inaudible) facilities very important for this games year. And with the macroeconomic environment for 2017 should be difficult also and we know how difficult to started (inaudible) and we've been ready to when the competition shows. So we easily become (inaudible) and increase the market share in the market, okay.

We are (inaudible) 2015 and 2016 to prepare the Company to (inaudible) some expenses. We know the acceleration environment of inflation, how close does it better in 2017. (inaudible) lot of projects and you can see some members in this year that we did there, all information (inaudible) in Sao Paulo can help things also. We did the customization for personnel costs should be expecting (inaudible). All this kind of problems to help you (inaudible).

And the last one for 2017, we are planning to have culture transformation. Of (inaudible) of the merger, we have no more (read) to talk about the Company future, okay. We did that (inaudible) integration (inaudible) what's the synergy about our two brands as to why you have the (inaudible).

So if you're (inaudible) and the score board (inaudible) for this year condition of the period to work with this prospect to cap the people. We know this is very, very important to change it to keep that your strong reported future in the Company also. That goal (inaudible).

Eugenio De Zagottis {BIO 7193695 <GO>}

We are now ready for Q&A.

Questions And Answers

Operator

(Operator Instructions) (Antonio Phis, Bergio).

Q - Antonio Phis

Thanks for taking my follow-up question from the Portuguese call. I'd like to follow-up on the potential growth of the market. We have seen in the past several years that the growth in drug companies in Brazil (inaudible) has been extremely inelastic to GDP growth, right. But what is your feeling as we move along in 2017? Is that volumes are lower like if I am not mistaken growing at around 4% to 5% and we are looking for to a lower price adjustment for the year?

Do you think that there could be any potential downside to market growth because of lower average price increase in 2017, is there any risk for that? That's one question.

And the second question is regarding the potential cannibalization of the new store opening on the existing store base. As we saw in 2016, the same-store sales growth for the mature stores was healthy above inflation, right. So do you guys expect any increased cannibalization going forward as you are opening more stores and how would you deal with that in terms of not compromising the returns for the existing stores? That's my follow-up questions. Thank you.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Thank you for the question. Market growth has been very constant. I mean if you look at the last 15 to 20 years, we've been growing 12% to 13% per year. It doesn't change much from one year to the other and the funny thing is that it's almost a flat nominal number. So for example this year the inflation I think would be average into the year was something like a 9%, 12% or 13% of growth really means 4% real growth.

So that means the market showed some kind of reduction -- so not a reduction, deceleration when I think on real terms. I mean -- and we are now getting to a year in which the economy is starting to improve, I think it appears no longer declining. But we still don't see a lot of growth for the country as a whole. I mean, we have interest rates are lower but still the consumer confidence is not there, still interest rates even though they came lower, the spreads are very high, the banks are still very -- the credit has been very tight.

So overall when you look at the whole environment, I mean it's not a recovery, I think it's a year of bottoming up maybe, okay, we reached the bottom. Now the economy will set up and progressively it could reverse the trend. I mean for us I think the markets will still grow 12%, 13%. And on a inflation-adjusted basis, I think this should be better than last year. But on a nominal basis, I think it's the same. And it's not easy to explain why the nominal numbers are always the same, it's I think also counted in two-two. But I think that I couldn't see the market growing below double digits. I think it should be double digits given our low inflation year.

In terms of the price cap increase, what happened was that for the last year the price cap went up by 12% and obviously we had the cautionary gain of 12% because we passed the food price cap. But then what happened is that consumers started becoming more price sensitive because they tried to defend from this price increase and retailers who had some extra cash in the system, because we all got a price increase higher than anyone expected, started promoting and started driving the pressure down. So in the end, yes, price caps were not withdrawn. But the actual prices they went up by 9% which was inflation. And likewise, history shows that in the year in which the price cap grows below inflation, discounts gets reduced because every retailer has inflation pressures to take care.

So I think the extra price increase, not the price cap increase, would be in line with inflation. So this answers the first part of your question.

Then in terms of cannibalization, I mean obviously an investment program like this in which we opened 200 stores and 100 of those came in Sao Paulo, a market in which we already have 700, obviously cannibalization exists and obviously in an operation like Sao Paulo, cannibalization is very needful.

The numbers that we post is an average number. So in Sao Paulo, as expected, that comes below inflation because of the cannibalization. But then we have very high comps in many different parts of the country in the Northeast, in the Midwest and so the comps overall were great. But what matters for us is not cannibalization, what matters is margin (inaudible) of the new store. Opening a store that we sell 600,000 a month with zero cannibalization is the same thing as opening a store that will sell 800,000 per month with 200,000 of cannibalization.

So even though the comps in Sao Paulo makes sense to some extent, because of cannibalization the new start, they start from a higher ground. So in terms of profitability nothing happens. What matters is that our investment program delivered for each store the marginal revenues we need to pay the cost of capital which in our case, we expect the return is very high.

So this is happening, we track stores very closely, we monitor our internal rate of returns store-by-store, how it stood, how it's progressing, where it didn't work. And why it didn't work, where we have exceeded and why we have exceeded, can we do more of those. So we would track that very well. And where we are now is that we just ended the developmental the analytics to measure and predict cannibalization in a more accurate way.

So now once we open a new store and after some period of this store working, we can see how much the store has stolen from other stores, how -- because of the share and because of the large cuts, how much of the store sale is from existing customers who are now buying more because the store is more convenient and how much is completely really marginal revenues for example.

And even how much real customers from this store will be spending in other stores, which is also a gain. So we can understand store by store how big the cannibalization is, where it came from and we're now -- and we have a 1.0 version of cost reduction model so that when we analyze a new store we have a pretty good idea what cannibalization will look like and therefore how much total revenues the store much achieve to deliver the marginal revenue usage.

And just to stress upon our journey, cannibalization is a part of the game, in the consolidation -- is part of the mechanism. If you don't open a store, the competition will open the store, the other point. But if you were to gain which is big for us not for the competition.

Q - Antonio Phis

Okay. I think that is clear, okay thank you, guys.

Operator

(Operator Instructions) Joseph Giordano, JPMorgan.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thanks for taking my question. I would like to continue exploring a little bit as we did in the Brazilian conference call the expense side of the equation. It seems that the Company has been doing a good job, we acknowledge there is some like non-recurring effects here from like lower pre-operating expenses that we had this year versus the previous one, given the lower store openings.

But I would like to understand a little bit what's the potential savings for the upcoming year as the Company starts to revisit more (inaudible) plans for basically lowering the headcount per store and also operating with a lower seniority level in terms of average employee per stores. If you can give like any visibility on this would be great.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Joseph, thanks for the question. We have a ton of initiatives related to the expense side. Sometimes we are playing defense, sometimes we are playing offence. With labor expenses, we're mostly in defense. So I mean we gained a lot of productivity, we bridged our processes. It's another up and down. So all these improvements based on platform improvements, based on better trained employees because they stay for longer employment, these will effect how the store operates.

So in the end, we also implemented a staffing algorithm to standardize and optimize staffing in core stores. There were stores that were over-allocated with people, there were stores that were under-allocated with people. So we normalize that and we operate in a slightly lower headcount than before. So this is very good. But the thing is at the same time, there are pressures in several markets, we think like pharmacy cost increase and some other things.

So I think -- and another thing is that with a lower employee turnover, what happened is that the average salary goes up because I mean for any level in the staff, we have -- let's say, a pharmacy clerk we have A and B level. So when the turnover is high, your A guy doesn't get to B and he is released before that. Then another gets to go to B level with lower employee turnover, when the A gets to B before getting to some (inaudible) for example.

So we have a higher average cost per employee as a result of that. And not only we have reduced, we have some. But we have also optimized our career program and our salary increase. So a lot of positions, they now get an entry salary lower than before. So someone who is already at the salary does not (inaudible). But the next guy could be promoted like the store manager or assistant store manager to be promoted with a lower salary.

Our pharma is now -- is retained for lower initial salary than before. And I won't give a lot of detail. But you can see in our non-recurring expenses, we have severance expenses related to accelerating some of these transitions. So we are doing a lot of things on the people side. But so far we have seen those as defense. I don't know at some point the curve can shift and become an offence, something that can really dilute expenses from us.

We have renegotiated rental contracts, a ton of them. But because the (IGPM) is higher than inflation, we are seeing pressure in the rental side. When the IGPM comes down and it will come down because the effect is stronger because inflation is lower, we could see some benefits on the rental side, maybe in the second semester.

We are already seeing benefits from electricity costs. As the electricity production metrics switches back to hydroelectric rather than thermal electric which is much more expensive, we think a very meaningful expense dilution in power costs.

So our power -- electricity cost is escalating in the last two years, now it's starting to come down. Obviously it won't get to what it was before. But it is giving back some of that. So this is also happening.

We have a lot of initiatives on our defense. We invested -- we of course gained a lot in terms of IT utilization. We now have (inaudible) managing area automation (inaudible) automation optimization in our main district, Sao Paulo. So we have a new technology that we didn't have before. That cuts a lot of labor increase, capacity increase, productivity and so this will help.

We have a specific process management productivity process driven by consulting company named FALCONI which is taking place in all agencies. So I mean (inaudible) we have renegotiated terms that acquired us. So there is a lot of things happening on the expense side.

And next year, obviously we will have a tough time in gross margins just because inflationary gain on inventories will be much lower. We will start from a gross margin 50 bps or 60 bps lower than next year -- than the previous year. Then obviously we can there negotiate terms, we can do things in pricing and we will get back some of the difference.

But the gross margin in the end will fall down, no doubt about it because our margin trend will be defined by how much we dilute on the expense side. So I think we have a real short dilution expense in this year and that will be needed for us to defend our margins.

Q - Joseph Giordano {BIO 17751061 <GO>}

Okay perfect, thank you.

Operator

Marcus Sena, Bradesco BBI.

Q - Marcus Sena {BIO 20442131 <GO>}

I would like to make a question regarding Farmasil. You're always talking about it more and more and more about it. What do you guys think you're going to be with the export deep in the subject regarding a clear schedule of expenditure or even guidance?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

The way we see Farmasil we worked for four years to finalize the format. We started with a certain design of how Farmasil would operate. The initial numbers were not where we expected.

We started changing a lot of elements of our execution, things like compensation relating to generics penetration including some front stock sales (inaudible) slightly lower (inaudible) and CapEx optimization and as a result after the four years of doing a lot of things, the numbers we see today are very good numbers.

So now our vision, we pilot so we had for good or for bad, we have a product. So what we do now is we start expanding. But in a progressive way. So last year we opened three stores. This year we do more than three stores, we still haven't set a guidance. But it could be five, it could be eight, it could 10, something like that. Next year is the store (inaudible) worth? We go to the next step and then the next and then the next.

So we are already in expansion mode. But it's still a careful expansion because I would be lying if I told you that a pharma that has been around for four years gives us the same condition that as a pharma that has been around for 100 years of reaching (inaudible) for 200 stores. So even if we believe it's done and it's good, it could be completely irresponsible for us.

I am not going into the part if we could, I am not doing. But we should setup 50 store opening guidance right now even if we could do it I don't know if we can do it but probably we could but even less we could -- I mean if we can work with (inaudible) but that is the imagination it doesn't work, there's something missing or if I'm not able to offer this as we grow, you have a major -- that has created a major problem in the Company that doesn't need stuff to do things.

So we will be gradual. We are right in expansion mode. But it is a controlled expansion mode, it is closely monitored expansion mode.

Q - Marcus Sena {BIO 20442131 <GO>}

And regarding to mature same-store sales, with the fast expected deceleration of inflation here in Brazil in 2017, you think you are going to be capable of -- keep the same level of mature same-store sale above inflation?

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Above inflation, I think so. At or above inflation, I think so. But nominally the numbers will be different obviously. Inflation is already falling down. In the First Quarter, we have a very tough (image) because of the leap year and because the Zika virus (inaudible) last year. So -- and then the second part of the price increase, the cap would grow below inflation and the extra price we think we can grow at inflation. So we believe we will be able to maintain something around inflation. We can always be sometimes slightly less and sometimes slightly more. But overall we are reaching our target.

Operator

There appears to be no further questions. Now I will turn the conference back to the Company for their final remarks.

A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay. So just before concluding here, please go to page 20 just for us to highlight the IR calendar for this year. So in terms of earnings releases, the whole idea is to do our earnings through the end of the following months till the end of the quarter. So the First Quarter will be released on April 27th, Second Quarter July 27th, Third Quarter October 26th.

We are already confirming the four investor conferences to be held in the next months. So it will be in February still, the BTG conference in Sao Paulo. I am going to London, will be there March 13 and 14 to the Itau Latam Consumer Event. Then we will have March 29 and 30 Merrill Lynch conference in Sao Paulo and April 4th and 5th Brazil Investment Forum of Bradesco also held here in Sao Paulo.

And now to give the final remarks to this call. So I believe from any perspective we look, 2016 was an amazing year in which we have set many, many different records. So we achieved record revenue growth, record market share growth, record margins, record ROIC for the Company.

And actually this stems from a combination of three factors. First, resilient demand, we are in a sector that is virtually in the last year which is a sector that has proven itself time and time again in several different economic cycles. So the demand is basically there. So this is something very important and this is amazing. But it's not exclusive to us, this is for the whole market. Our competitors who also take advantage of this Brazilian demand.

Then we get to the Company-specific factors. First, a very strong balance sheet. We are in an economic environment in which interest has been very high, the basic interest rate has been very high; they were at 14%, now they are coming down. The spreads are still very high, the credit market was very tight and we have insulated ourselves from this overdue with a strong balance sheet. We don't need much debt to operate, we don't pay much interest because our leverage is very low. So we are now on route here. We only depend on our own capacity to generate cash and to deploy the cash with the returns we expect.

So a strong balance sheet has been amazing for us while a lot of competitors they have struggled because of high leverage, paying huge interest, this affects the business, the projects with the stock outs will get out because people have to save on working capital, they fire people from the store so the (inaudible) drops also. There are lot of competitors in that situation. Obviously, not number two, not number three which would mean well. But a lot of middle-sized companies are in some level of distress; sometime in high distress, sometimes they stress but this has been a source of competitive advantage for us without any shadow of doubt.

Then the third aspect is execution, our execution has been very consistent. We have been (into). So from any angle you look, we are a much better Company now than we were in year one, two, three, four, five years before. Now we did very achievement here, for example something -- I don't think it is out of state. But we call it a supply chain resolution.

In the last three or four years stock outs, cash cycle and inventory offsets which are mutually of same levels, they all went down in the same direction because generally if a company wants to reduce stock outs, they could and they have inventories to (inaudible). In two years when that expire, expiring, inventory losses skyrocket. This is how retailer get bankrupt.

All situations they pass any imbalance here between stock outs, stock cycle and inventory losses. We reduced all this in a meaningful way at the same time with something very, very meaningful and very, very difficult to do but because our platforms have been improving, our process have been improving, the assumptions that go in our proprietary system to calculate inventories, they have been fine tuned. So this is something amazing, absolutely transformational for us.

We had also reduced tremendously employee turnover. So our specialty store is now more experienced than before. This translates to higher (inaudible) level to the consumer. We are retaining a bigger number of candidates (inaudible) position. Our store managers will do better than before they would have -- they'd be more tenured than before. And we have advanced in all our cost strategy, Marcilio has covered that in detail.

In looking ahead, looking at 2017, I mean, 2017 will be a challenging year and there is no doubt about that. I mean, already in the First Quarter we have a high home base Zika last year and because of the leap year. We have one less day of sales versus the previous year.

Second quarter and Third Quarter, we have a much lower inflationary gain on events on this gain than we had last year. So for us what this means is a huge focus and productivity, a huge focus on rationalizing expenses and we also to remember that, I mean, however this year's number compared to the last year's number, let's not lose sight of the long term here because last year was an amazing year. Even if this year is not at the same level, not same to be, let's see how the year plays out.

But if you compare 2017 to 2015, 2014, 2013, 2012, 2011, I am sure this is a great year. But last year we had something very specific that doesn't repeat itself again. So we shouldn't reduce fire of the long term this year.

And a final consideration here, I already talked about aiming competitors. Consolidation is a redeemers game, it is a long-term game. We would still see a tough economy. Interests are down, the inflation is down. But the spreads are high, the credit is tight, all the big events they had huge areas of what I call special situations which is basically fixing the (inaudible) and minimizing the losses they have already booked in the balance sheet.

So there won't be an easy life for any leveraged company in Brazil, (inaudible) of those companies. And whenever our competitors flounder, we will be there and we will make strategy market share and we saw this happening this year in Sao Paulo, the competitors who closed stores, we saw that in the Midwest with a company in Chapter 11, we saw that in Brazil all over the country. And I am sure we will see companies suffering this year, I am sure we will see opportunity.

Mostly medium-sized companies, companies trying to do real ops, trying to do M&As and integrating due to the very different -- they don't understand well. So the opportunity will be on the table. It depends on us to take advantage and advance our market share position and creating value for our shareholders.

Finally, I would like to thank you all for your ongoing support. We are very proud we have so many shareholders who have been around since our -- even the Raia Drogasil. And all who have been very constant in the good and in the bad times. Their patience -- your patience was tested in 2011-2013. But eventually the Company is up in track and we have been able to deliver a lot of value and we think there is tremendous value on how to (inaudible). So thank you very much and have a great 2017.

Operator

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