Q2 2019 Earnings Call

Company Participants

- Fabio Adegas Faccio, Chief Executive Officer and Interim Chief Information Officer
- Laurence Beltrao Gomes, Chief Financial Officer and Investor Relations Officer

Other Participants

- Irma Sgarz, Analyst
- Joseph Giordano, Analyst
- Robert Ford, Analyst
- Thiago Macruz, Analyst
- Tobias Stingelin, Analyst
- Unidentified Participant

Presentation

Operator

Good afternoon, ladies and gentlemen, and thank you for waiting. Welcome to Lojas Renner's Conference Call to discuss the results of the Second Quarter of 2019. We would like to inform you that today's live webcast, including the slide show, may be accessed at Lojas Renner's website at www.lojasrenner.com.br, Investor Relations section, at the webcast platform and the MZiQ platform as well. (Operator Instructions) We would like to remind you that questions coming from journalists will be taken by our press office at 55 (11) 3165-9586.

Before proceeding, we would like to clarify that forward-looking statements that might be made during this call related to the business perspectives of the company, operating and financial projections and targets are beliefs and assumptions of Lojas Renner's management as well as information currently available to the company.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions as they relate to future events and therefore, they depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors may affect the future results of the company and may cause results to differ materially from those expressed in such forward-looking statements.

Now we would like to turn the floor over to Mr. Laurence Gomes, CFO and Investor Relations Officer. You may proceed, Mr. Gomes.

Laurence Beltrao Gomes {BIO 15361799 <GO>}

Good afternoon, everyone. Today, we're here to talk about the main highlights of the second quarter of 2019 results. And with me, we have Fabio Faccio, our CEO; Paula Picinini, our Investor Relations and new Business Director; and Luciano Agliardi, Controller.

In the second quarter, we had a good pace of sales, with the net revenue increasing by 13.4%, same-store sales up 9.3% growth, with 70% of this growth coming from the higher flow or higher traffic in our stores. We highlight the fact that in spite of a slowly recovering economy and the absence of coats, we were able to offset these effects by means of the good acceptance of the collection and the efficient execution of our operations.

Regarding the commercial strategy, we were able to decrease the reliance on winter items by means of a differentiated collection transition and a high reactivity in the chain. With that, we were able to keep adjusted inventory levels and this allowed us to have very healthy markdown levels in spite of a more promotional market environment. This way, the 100 basis points drop in our gross margin for the second quarter of '19 was due basically to the effects of the exchange rate on the imported items.

In the half year, same-store sales reached 10.8%, a percentage that is quite higher than the sector, showing our ongoing share gain. Gross margin was 100% bps[ph] lower than the first half of '18 due to the exchange rate. In relation to the operating expenses and same-store sales, net of the effect of the IFRS 16, there was a 14% increase due to the execution of restructuring projects related to the digital cycle and the expansion plan and projects such as the RFID, the centralization of our customer service center, the restructuring and increase in the team of technology and data and the preparation of the operation in Argentina estimated for the end of this year. And these additional expenses will bring about benefits in the medium and the long run.

Additionally, if we were to adjust the expenses based on the postponement that occurred in the first quarter of '18[ph], our SG&A would have grown as well as the revenue. And for the six months year-to-date, we had an operating leverage of 100 bps in SG&A over our net revenue. Regarding the other operating expenses, the increase was due mainly to the going back to normal of the provisioning levels for the profit sharing program for our employees due to the operating performance that we delivered so far, which is better than the performance that we delivered in the same period of last year.

Regarding the EBITDA margin of Retailing Operations, the 2.4 percentage point reduction was a consequence of the lower gross margin, 100 basis points of the higher level of provisioning for our profit sharing program and 60 basis points here and the postponement of some expenses of the first quarter of '19, representing 30 basis points of reduction.

The adoption of IFRS 16 brought about the negative impact of an additional 60 basis points on our operating margin. So net of these effects that we have just mentioned, our EBITDA margin of Retailing Operations would have been similar to the second quarter of '18 in spite of many investments being made in structures and new projects. In the half year, the EBITDA margin from Retailing Operations was relatively stable and aligned with the performance that we expected for the year of 2019.

Now talking about the results on Financial Products. That was BRL91 million, with a 12% increase vis-a-vis the second quarter of '18. We see that the generation of revenues, mainly by Meu Cartao whose portfolio grew by 38%, was the biggest driver of this result.

Regarding delinquency, in spite of the total growth of 22% in our portfolio driven by the co-branded cards, we had a lower percentage of past dues. And the weight of the net loss on our portfolio was stable and this reflects the good quality of our credit. With that, the total adjusted EBITDA was higher by 1.8%, reaching BRL441 million in 2Q '19, with a growth of 250 basis points in the margin. Net of the effects of the IFRS 16, the total EBITDA would have grown by 4.5% and the margin would have been 190 basis points lower than the second quarter of '18 due to the factors that I have just mentioned. Year-to-date, this margin was relatively stable vis-a-vis the second quarter of '18, and it was also in line with our internal expectations.

And, lastly, the net income of the quarter reached BRL235 million, with a reduction of 380 basis points in the margin, and this higher reduction than the EBITDA margin was due to the going back to normal of the effective income tax rate that had been lower the second quarter of '18 due to the deductibility of the amounts that were considered as a subsidy for investments in the quarter. So net of the effect and of the impact of IFRS 16, the net income would have grown 1.8% in the quarter. And in the half year, net income went up by 2.7% or a growth of 6.5% on a comparable basis. Thus, the ROIC of the last 12 months reached 21.7% in the second quarter of '19 or 22.1% in a comparable basis of same-store sales. These were my initial remarks. And now we are available for the Q&A.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Mr. Thiago Macruz from Itau. Mr. Macruz?

Q - Thiago Macruz {BIO 16404924 <GO>}

Good afternoon, everyone. My first question has to do with consumer finance. We saw that this was lower than we expected due to the growth in the portfolio of Meu Cartao, I would like to know if there was a change in the strategy of pricing for this product, be it in the spread or the fees that are charged? And my second question has to do with the KPI. Laurence, could you give us an update, integration of online and physical load, click and collect, with the inventory from the stores and not from the DC? What about the red book of the RFID project?

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

Good afternoon, Thiago, and thank you for the question. Regarding revenue from Meu Cartao, there is no change whatsoever in the spread or the rates or the fees charged, just the growth of the portfolio occurs first and the revenue comes from the installments and the revolving credit that comes afterwards. So this is just business as usual. And we're expecting the third quarter to continue to have healthy results from our financial operations. And we expect a good half year -- second half year for this operation.

And the second part of your question, I think Fabio will answer it.

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

Thiago, good afternoon, and thank you for the question. There are a few things that we can already talk about RFID. Starting by RFID, we have just finished the test. We tested this in the store for a long time and then in a group of stores and we are rolling this out now with 32 stores already rolled out. And that each week, we do this with a group of stores. And this has been very helpful for us in terms of productivity of the operation and avoiding store count shrinkages. And by the end of the year, we should be reaping some initial fruits.

The idea is by the end of the year having 100% of the brand-new stores already rolled out with RFID. And with relation to omni, we are still sensing some of the initiatives. We have click and collect in some stores for quite some time, but the use of the inventory in an orchestrated fashion in our stores, we are still doing some tests. So we are testing the reserves of inventory of some stores and greater portfolio, likely in order to test our operation and guarantee that when we can sell directly from the inventory of other stores, that we have a very smooth operation with no stress for our clients.

And first, we are doing this and over the year, we will be testing the sales with inventory from other stores and then roll it out in the following year. Click and collect, we assume using about 28%, and the conversion of the clients that do click and collect, with an additional purchase of about 14% and as soon as we have this omni already in place, we will have a higher penetration of the click and collect.

Other initiatives that we can talk about in terms of digitalization, we have a pilot of omni already testing in some stores, the Youcom, the click and collect with the inventory of the store itself and also the marketplace of Camicado increasing and facing more sellers, more SKUs. And we want to do this with a high degree of quality for home and decor products.

And at the same time, one of the things that were already present in the last few months was the mobile sale or digital service, at any point in the store, so that the clients can use it, and this is bringing a great satisfaction and enchantment to our stores -- our customers. We already had this functionality, but it started to increase in terms of usage. And we see levels of our enchant meter that give us very satisfied or record historical enchantment levels. And we believe that part of that comes because of their digital experience, and they are already seeing an improvement, not in terms of -- in the bottlenecks that we had, but a lot remains to be done. These are a few of the examples that we already have in place that the omni integration will -- well, we will be reaping fruits from this as of next year.

Q - Thiago Macruz {BIO 16404924 <GO>}

Thank you, sir. So it does make sense to imagine that once you have a ramp-up of RFID and you start to use the stores' inventories in a more structural fashion than today, the margin of the online operation is lower than it could be, so you still have room to increase it.

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

Yes, you are correct. And besides, this should drive the level of sales because we have a better service and we see that the penetration of this service online, and click and collect is higher in the areas that are closer to our DC. So when we are able to use more delivery points and click and collect, we will be further reducing this expansion in the whole country and you have a higher operation. And the margin of the operation goes down because we avoid to send or to ship the products, or at least you reduce the size. So it does help the margin of sales that are carried out online.

Q - Thiago Macruz {BIO 16404924 <GO>}

Thank you, very much.

Operator

Joseph Giordano from JP Morgan.

Q - Joseph Giordano {BIO 17751061 <GO>}

Good afternoon, everyone. Thank you for the question. Operating expenses, you talked about changes in the rollout of the collections. And I would like to have some additional details regarding this change. It is something related to the big data strategy that allows you to have more intelligence to the process. And in the collection management, when we get to July, the weather is usually cooler. So do you have a recovery in the third quarter already? And gross margin, especially for the second half, when we look at the improvement in terms of supply and the competitive environment, could we think about some degree of expansion from now on?

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

This is Fabio, thank you for your question. When we talk about the assortment of our collection, in the quarter, in the second quarter, if we think about May and June mainly, these are months in which we have a cooler weather. This didn't happen this year, and I believe that part of what we were able to achieve with the good level of sales was because of our reactivity, so to say. We have been working on that for many years, being more agile in the divestment of collections in production and the shipping of the collections to the stores. So this agility that we have developed allowed us to have a higher degree of balance in this collection.

And the other part, historically, we see winter having a smaller participation of heavier items, and we balance this with the data -- on the data that we already have. I wouldn't say that this is already with artificial intelligence of the use of big data, but we are working with algorithms and artificial intelligence from now on. But still right now, we don't have a contribution from that. But data analysis has always been present. And also, we believe these items would have a good performance regardless of the weather. So there was a very good blending of items in this mix and they have a good performance when you don't -- when you have both warmer and cooler days.

And some other items that didn't have -- that could have had better performance, which are the heavier items, winter items. But now in July, we already have the cooler weather coming, and we had a good sale of these items, working with a very lean inventory with the added assortment and selling this in a more hybrid inventory in the warmer days, and in cooler days, we also have an inventory of these heavier items.

And another part where we advanced a lot in our analysis was in terms of opportunities that we had in winter in smaller stores and with the good assertiveness on the part of the team in terms of development and construction of the collection and distribution. But I would not say that we already had the support of artificial intelligence or algorithms. This will come from now on, that is to say to the future, this is an initiative that we are already building. Some of our tests are already well advanced, but they are not being reflected still in this quarter and with a smaller number of SKUs, maybe Laurence could add.

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

Good afternoon, Joseph. Thank you for the question. In relation to the gross margin, I think that the second quarter was important and we were satisfied with the commercial strategies that Fabio referred to in this environment that was rather conventional due to the weather and bringing forward promotions in the market. And we had the low growth of our inventory, it was very well adjusted. It was fighting, and probably we will change collections with very well-adjusted inventories and the level of markdowns was very healthy as well in this quarter.

And in the third quarter, well, the third quarter started well, higher than our expectations, in fact, with healthy margins. And I believe that the second and the third -- the third and the fourth quarters, we'll see a recovery in our gross margins. And for the full year, well, we continue to believe and we continue to trust the possibility of seeking stabilization in our gross margin by the end of this year vis-a-vis last year.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you.

Operator

(inaudible) from Santander.

Q - Unidentified Participant

Good afternoon. Could you talk about what we could expect regarding marketing and sales expenses in general? Could we expect some degree of leverage? And promotions grew in your selling expenses in the second quarter. Is this regarding marketing budgets and advertising?

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

This is Laurence, thank you very much for your question. We saw -- going back to normal, in the half year, this line went back to normal, it was very well balanced. And the answer to your first question is yes, we see the possibility of new operating expenses growing less than the growth of the net operating revenue.

We already explained what happened about the postponement, et cetera, and the dilution didn't come in the first quarter. But for the third quarter, we believe in a dilution of expenses in the third quarter, and we trust that expenses will be diluted also for the fiscal year. So this is what we expect in terms of our expenses. And in promotions, this is what you mean, budget for marketing, advertising and e-commerce as well that has an activity in which we invested, and so this is what makes up this line.

Q - Unidentified Participant

Could you talk about the performance in the quarter, whether this was more macro or what was the system for the operations and a notion of same-store sales, all these questions about Camicado?

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

Yes, as we said, the environment was very promotional. The market was very promotional and we kept our price positioning. We also had an adjustment in the inventory levels, and Camicado is going through very intensive work of review of the inventory management. And we believe that in the second half, we will be able to tap into some results already.

But we are reviewing management, commercial management and developing the products and inventory management, all this is being reviewed. So as you saw yourself, we had a very well adjusted inventory with the growth of gross margin, so we didn't get into a price war. So this matters. As far as Camicado is concerned, it has to do with commercial management and inventory management as we have been repeating. Regarding same-store sales, we don't elaborate on this, and I hope you do understand the absence of an answer to this specific question.

Operator

Tobias Stingelin from Citibank.

Q - Tobias Stingelin {BIO 18290133 <GO>}

If you were to remove the structuring projects, e-commerce and the opening of stores, these are expenses that you are having now? SG&A, how would it be in the first half? How much these projects represented as a burden?

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

Well, it's very difficult to estimate exactly, but certainly, we will see a dilution. But it's very difficult to talk about figures right now.

Q - Tobias Stingelin {BIO 18290133 <GO>}

And this is...

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

Wait, I apologize for interrupting you, but in the half year, we've had a dilution in the half year.

Q - Tobias Stingelin {BIO 18290133 <GO>}

You...

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

No, we had a dilution in the half year.

Q - Tobias Stingelin {BIO 18290133 <GO>}

And for the second half, what do you expect?

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

From now on, we expect a higher dilution of expenses, reaching the end of the year with a higher dilution. This is our target for this year. And based on operating leverage, even in spite of the execution of all these projects and also expansions.

Q - Tobias Stingelin {BIO 18290133 <GO>}

You don't talk about sales performance as you said. But can you separate between apparel and non-apparel, which was essentially about 20% of your revenues? Was the difference of performance between these two categories very big, apparel and non-apparel?

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

No, there is no relevant difference.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Thank you. In relation to Argentina, could you give us an update about the project, any changes?

A - Fabio Adegas Faccio {BIO 19664887 <GO>}

Well, the project is on schedule, some tests are already being made and the whole systems part has already been built. So everything is on schedule. And by the end of the year, we will be opening the three stores, possibly the three stores in Argentina by the end of this year.

Q - Tobias Stingelin {BIO 18290133 <GO>}

Thank you.

Operator

Irma Sgarz from Goldman Sachs.

Q - Irma Sgarz {BIO 15190838 <GO>}

Good morning. I have two questions, one about working capital. Maybe you could give us an update about your working capital. The inventory was under control. However, there were some other changes. So do you believe that this situation is a one-off situation? And do you believe that this could help the gross margin? I believe it's a little bit too early to ask this question, but maybe you could talk about that.

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

Irma, thank you for the question. This is Laurence. Regarding working capital, we have already talked about the good inventory management, a growth of 5.7%, much lower than the growth in sales. And in relation to the other accounts, accounts receivables growing 23%, accounts receivable in retail grew by 16%. But if you put everything together, ultimately, we believe that the financial cycle was neutral. There was no change in the financial cycle. And regarding working capital, this quarter was neutral, with no operations and very much in line with our plan and our budget. In relation to your second question, could you please ask it again because we didn't understand your question. Could you please repeat your question? The second question, could you please repeat it?

Q - Irma Sgarz {BIO 15190838 <GO>}

I guess you've been talking in the last few months. Can you say something about this? Do you see an opportunity for margin increases from now on?

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

Irma, we are -- it is too early to say anything about this for 2020. We will be having our budget drafted as of September, but there are still some variations in the price of -- you have the price of commodities, the exchange rates and some in-house activities regarding quality, quality control. So it's a little bit too early to say anything about that.

Operator

Robert Ford from Bank of America.

Q - Robert Ford {BIO 1499021 <GO>}

Good afternoon, thank you for the question. Could you talk about the trend in private vis-a-vis co-branded? And what about the assortment of Camicado? Do you expect a differentiation vis-a-vis the competition for the second half? Or do you need more time in order to do the fine-tuning?

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

Bob, this is Laurence. Thank you for your question. The second half will be very important for Realize and for the operation of Financial Products of Renner. And as we have been saying, we have been developing some very important projects of digitalization and improving the shopping experience, and this has been going hand-in-hand. So the full processes, digitalizing, credit granting and the maintenance and the recovery of credits and the performance of the Meu Cartao portfolio was a very important development. But we have planned very soon, we hope we can announce other initiatives in terms of attractiveness. We are trying to deliver more competitive advantages in our private label. And based on the brand and the experience that we have in the business, we -- I think it is possible for us to create a relationship, so to say, or a way to increase our relationship with more frequency with the private label cards. So the projects are being developed and very soon, I hope I can share these innovations with you in the private label card.

Talking about Camicado, well, your question was not very clear for me. But I believe you are asking about Camicado, if there's anything that remains to be done. My -- in Camicado, we still have an opportunity for improvement in products and services. We have this challenge of improving our inventory efficiency, and we did a lot of work in this regard and this brought about an improvement in the margin and also healthier sales. The growth in sales of Camicado was slightly lower but with a healthy margin.

There is still a lot to be done, a lot remains to be done if you take Camicado products. One thing drives the other. If you increase the market place, the assortment without having to make investments, this is another way to give our clients or offer our clients more product sets we will not be working on directly but increases the opportunity for a one-stop shop for the customers. Then based on that, we are starting a long sale process in our e-commerce, with some items that we believe are important for the assortment, and with that, be more efficient in the items of the brick-and-mortar stores, increasing productivity from some items that maybe we're missing the opportunity. So adding this improvement of digital to the product part of the operation, we are able to keep inventory efficiency and start having soon. We still need some time, but we will be -- our sales improving then. I don't know whether I have answered your question, so...

Q - Robert Ford {BIO 1499021 <GO>}

No, everything is very clear. Thank you very much.

Operator

Elaine Aguilar [ph] from Bradesco. You may proceed.

Q - Unidentified Participant

Good afternoon. I would like to ask a question in relation to same-store sales. Although it was strong, do you see any kind of impact of the weather or demand because of a more difficult macro situation? And do you feel that this has had an impact on the gross margin, the fact that you have not sold many heavier items and the winter items have a worse margin, I believe. So do you see an impact from that?

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

Elaine, thank you for the question. This is Laurence. Yes, we could have had a better performance than the one that we delivered should the weather had been normal. It was lower than our initial expectations, but as Fabio said, we were very agile and flexible in our reaction. And also our commercial planning was already a commercial planning with a lower reliance on winter items.

Well, the second part of your question, the answer is yes as well. The higher amount or higher number of transition products or mid-season products, they helped. And with more wintery products or items, we could have had a slightly higher margin.

Q - Unidentified Participant

Thank you.

Operator

(Operator Instructions) The Q&A session has come to an end. I would like to give the floor back to the senior executives for closing remarks.

A - Laurence Beltrao Gomes {BIO 15361799 <GO>}

This is Laurence. Thank you very much for participating in our call about the results of the second quarter of 2019, and we will continue to be available if you need any additional clarification by means of our Investor Relations team. Good afternoon, everyone.

Operator

Lojas Renner conference call is closed. We thank you for participating, and wish you a good afternoon.