Q1 2016 Earnings Call

Company Participants

- Claudio Bergamo dos Santos, Chief Executive Officer & Director
- Martim Prado Mattos, Chief Financial Officer & Controller

Other Participants

- Alexander Robarts, Analyst
- Guilherme Assis, Analyst
- Robert E. Ford, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to Hypermarcas' First Quarter of 2016 Results Conference call. Today with us, we have Mr. Claudio Bergamo, CEO, and Mr. Martim Mattos, CFO. We would like to inform you that this event is being recorded and all participants will be in a listen-only mode during the company's presentation.

After Hypermarcas' remarks, there will be a question-and-answer session for investors and analysts and further instructions will be given. . We would like to inform that questions can only be asked by telephone. So if you are connected through the webcast, you should email your questions directly to the IR team at ir@hypermarcas.com.br.

Today's live webcast may be accessed through the company's Investor Relations website at www.hypermarcas.com.br/ir. We also would like to inform you that statements during this conference may constitute forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those set forward in the forward-looking statements.

Now I'll turn the floor over to Mr. Claudio Bergamo who will begin the presentation. Mr. Bergamo, you may begin your conference.

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much all. Thanks for coming to participate in our first quarter call. Welcome to our call. This quarter was transformational for Hypermarcas. We completed the sale of our beauty business to Coty in February on February and announced the sale of our condoms business to Reckitt for R$675 million. In addition, we continue with the process of diapers business divestiture. With these initiatives, the company has become a pure pharma player in the quarter.

Our results for this quarter now as a pure pharma player were in line with our goals and budget in spite of the deterioration of macro and political scenario in Brazil. We had good results in many fronts, which I'd like to highlight.

In terms of operating results, we reached an EBITDA of R$310 million, with a margin of 37.5% of net revenues, representing 11.2% growth compared to the same period of 2015. This EBITDA puts the company in the right path to deliver our R$1.1 billion EBITDA guidance for the year.

In terms of sales, our net revenues reached R$825 million (sic) [R$827 million] (03:24) in the quarter, representing a 12.1% growth compared to the first quarter of 2015. In terms of sell-out demand, we had a growth of 11.9% according to IMS Health, [ph] already (03:43) net of discounts. This result was 0.7 percentage point of both the total pharma market growth that was 11.2%.

We had sell-out demand growth in all segments of the market. As we highlight the results to the prescription drug market where we had a demand growth of 19.3%, or 7.3 percentage points, above the total market performance which was 11.8%. These results come from our innovation strategy with the continued launch of new products such as the Addera D3, which was ranked the number one launch in the market in 2015. Also these results came from the improvement in our productivity of our physicians, sales force team that made possible not only successful introduction of new products but also market share gains in established prescription products such as Maxsulid, Mioflex, Predsim, among others.

In the OTC market, we also had growth above the market with sell-out demand increase of 12.4% or 1.2 percentage points above the market growth, which was 11.2%. Many of our brands gained in market share in the quarter, such as the Benegrip anti-flu, Epocler, Estomazil, Coristina and Doril. In terms of innovation in the OTC, we can highlight the launch of Estomazil in bottles and the continuous market share gains of product launched back in 2015 such as Doril Enxaqueca, the liquid Benegrip and Vitasay Stress among others.

In terms of financial results, this was a key quarter for the company's change in the capital structure when we became a positive net debt after receiving the proceeds from the sale of our beauty business. We ended the quarter with a net cash position of R$217 million after hedge gains. This number does not include the proceeds from the sale of condoms in the value of R$514 million. In addition, our organic cash flow from operations has improved in the quarter. Because of these factors, the company now is in the condition to distribute dividends to its shareholders for 2016, and we announced early today that we will distribute R$0.25 per share, including dividends related to 2015 and interim dividends.

We also, during the quarter, carried out reorganization of our pharma business with the creation of three new business units: the first one, the Consumer Health, which will be composed mostly with our OTC business; the second one, the Branded Prescription products business composed with our medical or the physical demand business under the Mantecorp Farmasa brand in the RX, OTX and Dermoscosmetics segments; and the third with the Generics and Branded Generics composed of Neo Química's business. These business units will be focused on the development of our strategy and operations for each of the segments for continuous improvements in the results and value creation for the short, mid and long-term.

The new business units will be supported by three functional areas: sales, operations and R&D. In R&D these functional areas will be operated with the business units as an integrated way. In regards to R&D, the company decided that it's a key strategic area and (08:24) heavily this year and its advancing very fast in the creation of a new innovation center, which should become operational by the end of 2016.

In these new areas, the company promoted many internal leadership in line with our meritocracy value and also hired new professionals in market whenever necessary. On this respect and also in line with our succession program, we created a new function of Pharma Vice President, which will be held by Marcelo Santos, who has been an Executive with the company since its foundation in 2002. During his career in Hypermarcas, Marcelo has been the leader in many areas of the organization and his former position was General Manager for Operations and Innovation Officer of our old Consumer Division. Marcelo will report to Luiz Eduardo Violland, current President of the division.

We believe this new organization model will allow an excellent balance between focus and synergy so that we can improve even further the effectiveness in the allocation of our resources, leveraging on higher operating efficiency. It will also allow us to strength even more our ownership and accountability values in a continuous search of improvement opportunities for the different businesses.

To finalize (10:08) my part of the call, I'd like to stress that our diaper business ended in this quarter a series of improvements in our price and has become a standalone operation under a completely independent management team, headed by Mr. Luiz Clavis, our former Sales Executive Officer for the Consumer Division. The business completed the successful implementation of series of price increase to offset the foreign exchange hike during 2015 without material losses of market share.

Thank you very much. I will pass over to Martim.

Martim Prado Mattos {BIO 16015889 <GO>}

Good afternoon, everyone, Martim speaking. Starting on page three of the presentation, organic growth of continuing operations was 12.1% in the quarter, of which 70% coming from price components and the remaining 30% from the volume components. Gross margin dropped 2.2 percentage points compared to Q1 2015 with the impact of the depreciation of the Brazilian real on dollar-denominated costs as the main negative component, which on the other hand, was offset by price increases achieved. Compared to the fourth quarter of last year, there was a 40 bps improvement as a function of better mix but also due to some price increases.

Operating expenses increased 6.2%, amounts lower than both growth and inflation in the period, leading to a 2.1 percentage point dilution of such expense. Therefore, continuing operations EBITDA preserves virtually the same margin as last year, posting a growth of 11.2% to R$310 million in the quarter.

The financial result was R$149 million negative in a quarter when we had the prepayment of R$2.8 billion of the company's debt. We generated R$87 million of one-off financial cost in the quarter. Moreover, we should stress that the second installment of the sale of the beauty business was only received in February. So that the financial revenue in the quarter did not reach its current full potential. Discontinued operations had a net result of R$800 million after taxes as a function of the capital gain on the sale of the beauty business completed in February. Thus, net income for the total company was R$1.008 billion in the quarter of which R$118 million was related to continued operations.

On the next page, cash flow from operations was R$257 million, with over one-third of this amount coming from the realization of working capital that was not transferred in the sale of the beauty business. It's also worth highlighting that as advanced (13:36) the capital gain on the sale of the beauty business did not cause cash payments of taxes given the utilization of about R$300 million of tax credit.

On the last page as already mentioned, gross debt ended the quarter with a significant drop compared to the end of last year to R$2.190 billion. This was only possible because of the tender offer we carried out in February to repurchase almost the totality of our bonds. Now in April, we also exercised the call options on the bonds. Therefore, as of today, the bond has been fully paid.

Even after such prepayments, the cash positioned ended the quarter at R$2.055 billion, which will be used to prepay other debt and to pay dividends as announced this morning. Thus considering non-realized hedge gains, our net debt after hedges by the end of the quarter was positive in R$217 million, even before we received the remaining amount related to the sale of the condom business of approximately R$540 million.

Thanks, everyone, for the attendance and support, and we may now proceed to the Q&A session.

Q&A

Operator

Thank you. Our first question is from Robert Ford of Bank of America.

Q - Robert E. Ford {BIO 1499021 <GO>}

Hey, thank you, and good morning, everybody. I had a question with respect to the price increases that were pushed through at beginning of the month, and I know that the IMS Health numbers are not available yet for April. But, anecdotally, I was curious if you're seeing whether or not these price increases are being pushed through to the final consumer and if you can share any reaction in terms of sellout at the point-of-sale for your products?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi, Bob. I think still too soon. We don't have a perspective on it yet. I think it's an area we have to be cautious with, given that the price increase of 12.5% given the current situation of the consumers' purchasing power. But I think we have to wait for one quarter at least to have a perspective on that. Normally April is a month that demand goes a little down because people tend to anticipate (16:33) sales. So we need to wait until June to have a perspective on that.

Q - Robert E. Ford {BIO 1499021 <GO>}

That makes sense. Thank you, Claudio. And then with respect to the sales in the quarter, in the Portuguese call you mentioned that you kept everybody to a quota. You didn't oversell, right. Can you give us a sense of how much demand you saw in March that may be went unsatisfied? And then do you think the industry was equally disciplined as a whole?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, first of all, I think March was very stronger demand, very strong. The year has started soft, but March was very strong. And I think not everyone was as disciplined as we were, but I think in our (17:34) doesn't make sense as to stocking the market. And we basically maintained our targets as had originally defined it in the beginning of the year despite the higher price increase that the government authorized. The trade tried (17:55) to anticipate more sales, but we were very disciplined on that respect because we didn't want to jeopardize the profitability for the year. So I think in that respect, maybe some competitors maybe didn't follow that, but I'm not sure exactly at what level.

Q - Robert E. Ford {BIO 1499021 <GO>}

Okay. And then in the earlier call you mentioned, I think, 50 – potentially a number of as big as 50 in terms of innovations and new launches and molecules. And I was curious, if you measure that with respect to the incremental addressable market, what might that represent for you this year, just that increase in those 50 launches?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

I'd say it should increase something around 5% to 7% in additional market. But more important than that I think that many of these molecules are products, especially in the case of the generics and the similars, there are more modern type of molecules, advanced molecules, which are the markets that are growing faster and in a way they substitute older markets. For example, Losartana (19:29), this will be the Losartana, vis-à-vis the Losartana. We will allow for Losartana (19:32) which is a more modern molecule than the previous Losartana (19:38). The same thing for the tadalafil vis-a-vs the sildenafil, which is a more modern molecule. So it's not only an increase in coverage in terms of percentage, but it's a better quality of the portfolio given these molecules have less competition and better margins and better growth.

Q - Robert E. Ford {BIO 1499021 <GO>}

And do you see any self-cannibalization of less modern molecules within the portfolio or do you see just an opportunity to take additional share?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

I think it happens both. At the end, if you cannibalize, it's not bad because it's with a bit better margin drug business, but also you gain market share, and then you do it both, right, and little bit also cannibalization (20:36). But this is more in the similars and generics business. On the other hand, in the prescription business and the OTC business, it's not cannibalization at all. It's just a complementary business, such as for example (20:53) become a phenomenon. We are reaching around R$200 million in revenues for this business that we just launched about three years ago. Well, this is a big deal announcing that we have done, and then hopefully we get another ones like that.

In the OTC as well, for example, we did Doril Enxaqueca, which increased by almost 80% the sales of the full brand for Doril. So in the other two businesses, all the launches are complementary. In the case of similar and generics, in a way (21:31) the former one, but the products we are launching have a better quality and better profitability, including better prices and they are more modern. So that's expected to be good news, because we are moving up in the value chain of the industry.

Q - Robert E. Ford {BIO 1499021 <GO>}

That's very helpful. Thank you and again congratulations.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thanks a lot, Robert.

Operator

The next question is from Guilherme Assis, Brasil Plural.

Q - Guilherme Assis {BIO 16143141 <GO>}

Hi, good morning, everyone. Thanks for taking my question. I'd like to follow-up also in the Portuguese call, and if I recall correctly, you mentioned that you think you have a good capital structure, because you don't take (22:19) like the income tax advantage is low because of the tax loss carry-forwards and tax benefits that you have. But looking on that expense, my feeling is that you are not considering a special dividend distribution after all the cash that is generated, not only from operations but from the sale of the assets that you did in the past few months, right. So looking in terms of the use of cash that you had, I think, you guys concentrated a lot on the organic use with the new product lines and the pipeline of new molecules. Thinking a little bit about M&A, do you think there is any opportunity on that side in terms of adding new I think product lines that you don't have through acquisitions, not specific molecules but product lines or do you think there is any transaction or any deal that would make sense to you guys on the acquisition side at the moment or in the near-term? That's my question. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi, Guilherme. For the time being we're not seeing many attractive opportunities in the Brazilian market. We believe that the best return will be on the organic strategy that we have been pursuing. And then at this point, many companies out there to balance between value and risk and complementation to our business are not attractive enough in our view at this point.

Q - Martim Prado Mattos {BIO 16015889 <GO>}

And we're also not considering – it's not being discussed, any special dividend related to the amounts received in the sale of the two businesses, the beauty and the condoms.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. And so if I can, can I do just a follow-up? Can you give us an update on the timing or on the evolution of negotiations for disposal of the diapers division?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well as I said in the Portuguese call, we are continuous in the process, we are in much better shape now, because the decision has passed through the needs for the price increase due to the foreign exchange of last year, which generates uncertainty. So this is planned. So we have accomplished that and not losing much share. At the same, with the sale of the cosmetics, we turned the diapers business. We cut off the business (25:37) and became a full independent, standalone business. So this was the two major uncertainties that we had in the past. At this point, we don't have that. So things are moving and still tough to anticipate, but in all respects I'm thinking around the year and we are continuing on that initiatives.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. That's helpful. Thank you, guys.

Operator

The next question is from Alex Robarts with Citi.

Q - Alexander Robarts {BIO 1499637 <GO>}

Hi, thanks. I wanted to just go back to the operating deleverage that we talked about in the Portuguese call and can appreciate that the big FX movement on your dollar COGS was the principal driver for this. But looking at your marketing expenses in the quarter, the EBITDA margin could have contracted even more, but it was an interesting and rather sharp pullback in the marketing.

And I guess the question we have is twofold: one, the reduction in the samples promotions, medical visits, that was the key reason why the marketing expenses came down 160 basis points as percentage of sales. Is this something that you think is sustainable for the rest of the year? Do you think that this line item of samples promotions and medical will stay flat? Is it something that you can keep it at those levels?

And the second part of the question is you had guided I remember in the fourth quarter call for about a 100 basis points in reduction of marketing as a percentage of sales. You've done much more than that in the first quarter. Is it safe to think that we go back to the original guidance or will we see this more like 150 basis points to 200 basis points of reduction in terms of marketing as a percentage of sales? So those are the two questions. Thanks very much.

Q - Martim Prado Mattos {BIO 16015889 <GO>}

Hi, Alex, Martim. Well, the movement that we had in the quarter and we put that in writing also is that directionally without giving any specific guidance. But directionally, we think that this is a good trend for the year, reducing marketing expenses as a whole, not necessary one of those three lines there, but our idea for the year as we mentioned also during the fourth quarter is that we are seeking for more efficiencies on our marketing dollars spent to achieve the same exposures that we currently have, but spending less dollars with it. So directionally the idea is that but without anything specific either on the amount or on the specific line on the marketing side.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay, got it. Thank you.

Operator

This concludes our question-and-answer session. I would like to turn the floor back to Mr. Claudio Bergamo for his closing remarks.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thanks very much all for participating in the call. Our Investor Relations area (29:43) is available, if you have any additional questions. And have a nice day and thank you all, bye-bye.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.