Q2 2016 Earnings Call

Company Participants

- Eduardo Fischer Teixeira de Souza, Corporate Executive, Chief Executive Officer Region II
- Leonardo Guimaraes Correa, Chief Financial Officer, Director of Investor Relations
- Rafael Nazareth Menin Teixeira de Souza, Corporate Executive, Chief Executive Officer Region I
- Ricardo Paixao, Investor Relations and Financial Planning Director

Other Participants

- Alex Ferraz, Analyst
- Daniel Gasparete, Analyst
- Guilherme Capparelli, Analyst
- Gustavo Cambauva, Analyst
- Luiz Mauricio Garcia, Analyst
- Marcelo Motta, Analyst
- Wilfredo Jorel Guilloty, Analyst

Presentation

Operator

Ladies and gentlemen, good morning, thank you for waiting, and welcome to MRV Engineering Conference Call. We would like to inform that all participants will be in listen-only mode during the Company's presentation. After the Company's remarks are completed, there will be a question-and-answer section when further instructions will be given. (Operator Instructions)

Now, I would like to turn the floor over to Mr. Rafael Menin. Please Mr. Rafael, you may proceed.

Rafael Nazareth Menin Teixeira de Souza {BIO 16905756 <GO>}

Good morning, everyone. It is a great pleasure to release our second quarter 2016 results. Despite a challenging scenario, we continued to report good operating and financial results. It is important to highlight that for all indicators we've had growth in the second quarter 2016 when compared to the same quarter of the same year.

We must mention our subsidiaries, as I've said before, we are doing our homework so that all projects managed by Prime and MRL have the same levels of efficiency as MRV.

The equity line results show that we've had considerable growth but we haven't achieved the level we would like to. We continued to invest time and human resources so that in the mid-term our subsidiaries can report positive results.

And lastly, I'd like to highlight that for the first time, we have started our largest mid-term strategy after major investments in our team, IT, back offices and processes we have managed to achieve excellent operating levels in the cities we operate in.

As of now, we have decided to speed up the acquisition of plots of land in the cities where we had an inadequate land bank volume when compared to market's potential, the next stage will be to legalize this land bank.

As this process progresses, we will have a much larger number of cities with adequate inventory, which will allow us to reach new sales levels.

Thank you everyone, and I will turn it over to Mr. Eduardo Fischer.

Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Thank you, Rafael, good morning everyone. Continuing with the strategy Rafael mentioned, I'd like to highlight two important points to our mid and long-term strategies. But first of all, I'd like to point out that has been very important in the last few years, cash generation.

We are in a capital intensive industry and over the last few years, we have been growing our focus on reducing leverage.

I can safely say that in all of its areas, the Company focuses on cash generation. So, we can show that by having reached four recurrent and consistent years of cash generation. Now to mention the two most important strategies in terms of operations to us, I'd like to highlight two points.

First, the increase in our productivity, especially in construction sites. Our expenses on wages and labor account for 50% of our construction costs and we have had great progress in those areas.

Over the last couple of years, we have increased our productivity by close to 25% with considerable gains in processes and costs especially. These are crucial points to the increases in our efficiency and there is still room for even more growth.

Close to 50% -- I'm sorry -- In our best construction sites, our efficiency has been 50% higher than our current average today. That's an important figure.

Another important point to mention is the increase of the construction speeds in our projects. We have made huge efforts to increase the speed of construction and the change in construction processes together with constant training, investment in the teams and equipment will bring us excellent benefits in the future. We'll be able to reduce our business cycles and our construction cycle.

Also considering the last couple of years, we've had an average growth of close to 20% in the speed of construction in our project and we see an opportunity to have an additional reduction of 30% to 40% when compared to current cycle.

So these two strategies, the speed of construction and productivity increases together with what Rafael mentioned about increasing penetration in cities we already operate in will give us a possibility to take MRV to a much more efficient level and for greater expansion in the coming years.

That's what we're betting on. And I'll now turn it over to Leo.

Leonardo Guimaraes Correa {BIO 15387486 <GO>}

Good morning, everyone. My comments on LOG will be very brief due to regulatory reasons. Last night, LOG filed for an initial public offering as was published in Fatos Relevantes [ph]. Therefore, we are in a quiet period, but we are very optimistic concerning the success and the interest of potential investors.

With regards to Urbamais, we have concluded our first project Parque Atlanta, and 90% of the plots have been sold. We have launched our fourth project in Campos dos Goytacazes which has already reached 50% of units sold. Urbamais has been growing and consolidating its operations.

Its pre-sales considering only Urbamais percentages in the second quarter 2016 reached 27 million and a net income of R$5.2 million. Its -- land bank adds up to 1.5 billion and that will allow for the Company to continue to expand.

We will now move over to questions and answers.

Questions And Answers

Operator

Thank you. We will now start our questions-and-answer sessions. (Operator Instructions) The first question is by Mr. Luiz Mauricio Garcia from Bradesco.

Q - Luiz Mauricio Garcia {BIO 17432519 <GO>}

Hi, good morning. I have two questions. The first one has to do with your cash position. I'd like to hear about the Company's position. I'm sure we'll hear more once the political scenario has been better defined, but the Company still has very high cash levels considering corporate debt without carryover costs and I would imagine that this sector will be capital intensive from here on forward. So the spread between cash and debt could be reduced.

How do you see that looking forward? And what can we consider in that sense? And another question has to do with cash generation from now until the end of the year. I think soon the Company will have zero leveraging in terms of net debt. So what can we expect from the Company in terms of dividends payout? What will be the practice considering a new political and economic scenario with better visibility?

A - Rafael Nazareth Menin Teixeira de Souza {BIO 16905756 <GO>}

Good morning Luiz, with regards to your first question, we're beginning to see some silver linings. Economy figures are looking better in terms of production and consumer trust, but we are still being cautious.

Obviously, we're looking at all of these things. We like it and we'd like things to move in that direction, but there haven't been any changes with regards to our policy of being cautious, keeping net positions and high cash.

With regards to both of your questions, more specifically, we will continue to have high levels of gross cash. Even if we reduce leveraging, we will continue to have high cash levels and we're going to roll some corporate debt, but we will continue to reduce our indebtedness and to have a negative net debt and therefore, we'll be cash positive.

With regards to the dividends, let me repeat that the Board's view is still the same. So this excess capital, this excess cash out will be paid out to shareholders through share buybacks or maybe dividend.

That will depend on the decision is made, but I don't think we've come to the point where we'll make that decision yet. We'll be waiting for more consolidation and for the entire environment to improve.

Operator

Next question is from Nicole Hirakawa from Credit Suisse.

Hi, good morning everyone, I have two questions. First, can you talk a little bit about how financing and transfers have been taking place in Minha Casa Minha Vida, My Life My House Phase III in the second quarter? Can you talk about higher interest rates and affordability and the social component and their effects on the transfer ratio?

Also if within the new parameters of the program you see a need, a greater need for percentage receivables with no collateral for the properties or if you think you can change it under current parameters.

We've also heard a lot about the 1.5 levels. How optimistic are you with that level considering current parameters, drop in prices and a drop in income, does that make sense considering that we no longer have the list by the government? Thank you.

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Hi, Nicole, this is Fisher. Let me start with your first question. My House, My Life III and the impact it has on our operation. What we've realized over this period of time is that there has been no additional difficulty or drop in volume due to changes in the program.

Initial, actually it was very good to us. We discussed that in the past because of the changes in the caps in many cities which were at their limits to us and had been so for a few years. So this is a positive thing to us, looking at it from a very objective point of view.

In the last few months, the States have been stricter in credit granting, but it doesn't have anything to do with Minha Casa Minha Vida III or the 0.5% interest rates in those price level. So the My House My Life III has been very good to us especially because of the increasing caps in the cities we operate in.

With regards to receivables with no collateral, it has not affected our receivables with no collateral policy. Obviously that is very, very well managed. Here at the Company, we pay special attention to it so much so that if you look at it, we've set some safe provisions due to potential default in those receivables, so it has not been affected by Minha Casa Minha Vida III.

Although the government has provided more disclosure in terms of what they're defining, we believe that might be something complimentary to MRV, some of the obstacles we thought we would not be able to overcome in terms of the area of the apartment on the list [ph] we have overcome those.

But still it will depend on subsidies. So it won't have that much of an impact. Obviously, we need to wait for this to come out formally and officially. This is how it's going to fit in with our operations and how it's going to affect us. Thank you.

Q - Luiz Mauricio Garcia {BIO 17432519 <GO>}

Okay, excellent, thank you very much.

Operator

The next question is by Mr. Gustavo Cambauva from BTG Pactual.

Q - Gustavo Cambauva {BIO 17329406 <GO>}

Hi, good morning everyone. I have two questions. First of all, could you talk a little bit about your gross margin? There has been a slight reduction in this quarter. You had some savings in construction and a product mix that looked like it was going to increase gross margins, but it actually went down in this quarter.

Also, what is the trend you see looking forward? Do you see a trend for improvement or will you remain at the same levels?

Second question has to do with what Rafael said initially about the Company's growth. Has it really been increasing in terms of land bank? Could you talk a little bit about these new levels the Company is hoping to achieve?

How long do you think it's going to take it to get to those levels? We see relevant -- Do we see relevant growth already in 2017 or will that take place further down the line? Could you talk a little bit about your growth strategies? Thank you.

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Hi, Gustavo. How are you doing? Good morning. With regards to the gross margin, the figure is very similar to the first quarter, a slight reduction. The trend continues to be one of gradual and slow recovery in our gross margins.

The Company has already reported a 35% gross margin a few years back. It went to 25% at the end of 2012 and we've been recovering it.

It's been gradual, but consistent. But it's reasonable to say that there will be a slight drop in the next semester and then it will go up again. We think there is room to increase the gross margin in the future. I can't say whether it's going to go up to 33%, 34% or 35%, but we think there is room for improvement, it will be a slow movement, but looking a year down the line, we believe gross margins will be more than current levels.

With regards to the Company growth MRV, starting in 2014 has been very aggressive in terms of buying land. If we look at 2007 to 2013, we were very aggressive in the countryside. Our market share in some markets was 80%, so it's very hard to grow beyond current levels, unless the Brazilian economy recovers considerably and sales levels increase considerably as well, but that's going to take a while.

But on the other hand, these metropolitan regions were much more competitive from 2007 to 2013. Everybody was buying land, then MRV wasn't as aggressive in major cities. As of 2013, we became very aggressive in those cities.

Our land bank was not balanced, it was adequate in smaller cities, but it was too small in major cities. And we spend close of R$600 million over the last 30 months, in order to have a more balanced land bank in major cities.

So as we replace and re-establish our inventory in major cities, we expect sales to grow a little bit. We have an internal study that was carried out that was included in the release for the first time. If we have enough inventory in the cities where we operate, looking at the competition in each city and the size of each market, it's feasible to think that our sales potential will be 5,000 units per month, which is much higher than current levels.

Obviously that will take time. Unfortunately Brazil is a bureaucratic country and sometimes things take a long time to happen. Sometimes in major cities, it takes even longer, sometimes we take three to four years to get the permit for a product, but what we see happening is that as we launched more products in, Porto Alegre, Curitiba, Campinas, Sao Paulo, Rio, Salvador, we've had excellent response; first based on the market size and secondly, in my opinion, there is little inventory to compete with.

There is high demand and very little supply, so it's very reasonable to think that if we have more supply in those markets that our sales levels will go up. We are not saying [ph] exactly when that will happen, it will be gradual, but I think from now on, after this huge effort we have made in terms of land bank, we believe that we'll have a positive impact as we begin to launch those product, okay?

Q - Gustavo Cambauva {BIO 17329406 <GO>}

Excellent, thank you very much and have a good day.

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Thank you too.

Operator

The next question is from Mr. Guilherme Capparelli from Citibank.

Q - Guilherme Capparelli {BIO 21476330 <GO>}

Good morning. I have two questions also. The first one has to do with the amount that have dropped in this half and gross sales percentages over the last 12 months. It's been very slow, what about the CKQ [ph]? How do you expect that percentage to drop? And as it drops, at what level will it become stable do you think? That's my first question.

And the second one is a follow-up from Gustavo's question, concerning the Company's growth in terms of inventory. You want to increase your launches, so the current R$6 billion level, is it good enough since you want to increase your supply in metropolitan regions? Thank you.

A - Ricardo Paixao {BIO 19698260 <GO>}

Good morning Capparelli. This is Ricardo. In terms of the CKQ, this is a recurring topic in our releases. A 100% of sales are already following the new simultaneous sales models. So we just recognize the sales after the bank has approved them.

We've seen a reduction especially in gross amount and what we can expect in the new model is a 10% to 12% and we've had some other expectations.

Commissions are only paid during transfer and not when the sale is affected. We have another project for the second half, we haven't talked about it yet which has to do with decreasing cancellations even more. So for 2017, our cancellation levels will be closer to the (inaudible) CKQs.

As for the increase in inventory levels, since we have considerable geographical capillarization, we can take a product away from one city to sell in another. So we have regional and local analysis of our products much more so than nationwide inventory levels.

That is the best metrics for us. If we want to sell more, we need to have more launches in cities where we don't have enough supply. So, we're looking at micro inventory levels per region and we have been launching according to the demand in each cities.

Okay, thank you.

Operator

The next question is from Mr. Alex Ferraz from Itau BBA.

Q - Alex Ferraz {BIO 19294308 <GO>}

Good morning, gentlemen. I have two questions. The first one has to do with your sales expenses. They've increased a little bit quarter-on-quarter, why have they increased? Is it more difficult for clients to purchase products? What happened to your sales expenses? And also, could you talk a little bit about your equity line, there has been improvements quarter-on-quarter, do you think it will reach a breakeven point? Could you talk a little bit more about your equity line, please?

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Hi, Alex, this is Fischer. An answer to your first question, we've been talking about this for a while now and what's been happening is that we still have high demand especially in the low-income segment, and we don't have enough supply. So people are looking for product and what we've been realized in the last few years is that banks are much more stricter when it comes to granting credit. So to sell the same thing [ph], we need to spend more.

So this increase in sales expense that you've seen had to do with that effort. We're investing in more media, more marketing in order to bring in more clients and to overcome this credit difficulty we've seen in 2015 and especially 2016. So that's part of our strategy to keep our sales volume at the current level, so that's sales expenses.

As for our equity line, we have been paying close attention to that for over two years, especially at Prime, we had a very interesting disclosure in our release this quarter and there is considerable progress. The equity line itself already shows progress when you look at previous quarters.

So what we expect, as you can see in the release is that starting now and into 2017, that equity line should become positive.

We've already said that in the past. We have addressed the problem and now, we're just looking at the solution. So to us, that problem lies in the past. That's why we have higher and more disclosure [ph] this quarter so that you can keep an eye on that.

So we have no worries about our equity line. We assure that the figures for 2017 will be very different when it comes to that.

Q - Alex Ferraz {BIO 19294308 <GO>}

Okay. Yes, thank you.

Operator

The next question is from Wilfredo Jorel Guilloty, Morgan Stanley.

Q - Wilfredo Jorel Guilloty

Good morning. Your credit has increased by 31% year-on-year and 8% of your pre-sales has been higher than last -- 5% higher than last year. Why is that percentage going up? Do you think it will continue to go up?

A - Leonardo Guimaraes Correa {BIO 15387486 <GO>}

Good morning. This is Leonardo. Yes, receivables with no collateral have gone up. We have commented on that initially. We have been monitoring that. That's part of our business, because the more we dissociate from that, the higher levels of pro soluto receivables with no collateral.

But we are making the right provisions for that in terms of payments and we don't expect to see major increases in that figure.

You need to consider sales volumes, obviously there will be quarters when we sell products that are closer to completion or that had been completed. You need to incur more into receivables with no collateral, because delivery terms, sales are too close to delivery dates.

So there is no other way. We have to grant that kind of credit, but we don't see any considerable increases in those figures. Thank you.

Operator

(Operator Instructions) Next question is from Mr. Daniel Gasparete from Bank of America Merrill Lynch.

Q - Daniel Gasparete {BIO 17999254 <GO>}

Good morning everyone, thank you for the call. My question -- before anything else, congratulations on your results, quite impressive, my question has to do with what Rafael said about the Company's potential for growth, especially in metropolitan regions.

How do you see competitiveness in that segment? Do you think the gross margin will be compatible with what you've been reporting? That's the first question.

And the second question has to do with gains in productivity you've been reporting. Where has that increase in productivity come from? That's it, thank you and good morning.

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Good morning Gasparete. Well, with regards to growth, obviously there are different competitiveness -- levels in different markets. If you look at Rio and Sao Paulo, things are more competitive, but based on the size of the market, demand is much higher than supply.

In these two cities, we compete with three other players, that's very little considering the size of the market. So, there isn't enough supply in these markets.

Now if you look at Porto Alegre, Curitiba, Belo Horizonte, capitals in the Midwest are doing much better and the Northeast Espirito Santo, there is next to no competition whatsoever. So, MRV has done its homework. We invested in team, IT, back office, processes.

We're present in a 142 cities and MRV is currently very mature or mature enough to manage 142 cities highly efficiently.

So with regards to your first question concerning gross margin, even with more competition in some cities, based on market size, sales prices are higher and margins are higher. So gross margins sometimes is a little bit higher than margins we see in smaller cities where we have Minha Casa Minha Vida.

So, our gross margin will not be affected if we are successful in increasing our share in these markets in major cities, okay?

Now with regard to your second question concerning productivity, we're working on that in different fronts. First of all, we have been able to reduce discrepancies. In prior presentations, we said that from 2007 to 2012, we used to build 4,000 apartments a year and we rent [ph] 40,000 apartments per year. We are operating in over 100 cities from operating in 40 cities, and from 2013 onwards, we haven't grown as much and in the new cities that we started operating in, in 2009, 2010 we have increased efficiency in the second stage in these cities and getting closer to our internal benchmark. So we're reducing differences between cities; that's the first front.

And the second front has to do with gains of scale. Right now there isn't a lot of demand in some markets. Our suppliers are selling less than they used to a couple of years ago and since MRV has maintained the size of its operation, our bargaining power is much stronger. Things are very different to what they were five or six years ago.

The segment is much more industrialized. When you look at different types of construction, the way constructions are stored now is much more efficient than it used to be five or six years ago. So I think those are the three main areas; a reduction of differences between different regions, a more efficient construction process, and greater bargaining power with our suppliers. These are the three main reasons that have led to a 32.5% gross margin.

Q - Daniel Gasparete {BIO 17999254 <GO>}

Thank you, Rafael. Thank you.

Operator

Next question, Mr. Marcelo Motta from JP Morgan.

Q - Marcelo Motta {BIO 16438725 <GO>}

Good morning, I have two questions. First, could you comment on the potential ROE you can achieve considering all the changes, gains of efficiency, productivity, the reductions in your construction cycle, cash cycle, fewer cancellations; how will that affect your ROE looking forward?

And can you also comment on your other operating expenses? It's always a very volatile line. It was slightly lower in the first quarter, now it has increased slightly. What can we expect in the second half of the year considering that line?

A - Eduardo Fischer Teixeira de Souza {BIO 17580321 <GO>}

Hi Marcelo, this is Fischer. With regard to the ROE, well, as I said in my opening remarks, we have achieved excellent results based on our efforts and they will have an impact on the ROE. First of all, the increase in productivity and cost reduction; that margin, if you look at last year's behavior in terms of prices, a lot of it comes from production efficiency and not so much from pricing.

Looking to the future, we see higher demands in the market, the economy should go back to a more stable level. So that will give us another possibility for new gains. So, our expectation for gross margins comes from that and also from, as I said in my opening remarks, a reduction in cycle.

30% of our construction is being done using concrete walls. So, we'll have shorter cycles in 2016-2017, because that won't change.

But I won't give you a guidance for ROE, but we believe that figure will be higher than what we have right now and that's what we're aiming for.

In terms of other expenses, most of other expenses come from legal. I have already mentioned that two or three quarters previously. We are making huge legal efforts in order to settle all of our liabilities.

The first thing we see is to reduce the construction lag.

We no longer see that was considerable, and in terms of brokerage as well -- we're already talked about that in the past. That is now part of the contract, because there were a lot of questions and misconceptions in terms of legal.

And in terms of speeding up agreements, on average, our settlement is a third of convictions. So, we have a settlement policy, in legal terms, and that increases efficiency over the first quarter.

So, the line will be higher in one quarter and lower in other quarters, but I believe in 2016 that line will remain at the same level and still in the first half of 2017, okay.

Q - Marcelo Motta {BIO 16438725 <GO>}

Okay, thank you.

Operator

(Operator Instructions) The Q&A session is now over and I will give the floor to MRV for the closing remarks.

A - Rafael Nazareth Menin Teixeira de Souza {BIO 16905756 <GO>}

Thank you very much to all those of you who took part in the call and as a relevant point, I just want to say that MRV navigated serious crisis in the country in a very healthy position with the same sales levels. We have had an increase in our gross margin, we have done our homework and we did it very well considering a depressed economy.

We believe that we have already hit rock bottom and it's now in the past. Maybe in the near future or in the mid-term, we hope the economy will improve and since we did very well during the severe crisis, we are very optimistic for the mid to the long term.

We hope to deliver even better results. The Company is ready to serve a positive economy when the country will contribute with the Company and better indicators.

Thank you very much and have a good day.

Operator

MRV Engenharia conference call is over. We would like to thank you for taking part in the call and have a nice day.