

## Q1 2014 Earnings Call

### Company Participants

- Rafael Nazareth Menin Teixeira de Souza, Chief Executive Officer Region I
- Rubens Menin Teixeira de Souza, Chairman
- Unverified Participant

### Other Participants

- David Lawant, Analyst
- Guilherme Vilazante, Analyst
- Luiz Mauricio Garcia, Analyst
- Nicole Hirakawa, Analyst
- Rafael de Pinho, Analyst

## MANAGEMENT DISCUSSION SECTION

### Operator

Good morning and welcome to MRV's First Quarter of 2014 Earnings Conference Call to discuss the results of the first quarter of 2014. Today with us are Mr. Rubens Menin, Chairman of the Board; Rafael Menin, CEO; Leonardo Corrêa, CFO; Monica Simao, IRO, and Mateo Sorga (00:27), IR Manager. The audio is being webcast at the company's IR site.

Before proceeding, let us clarify that any forward-looking statements that may be made during this conference call relating to MRV's business outlook, operational and financial projections and targets are based on the beliefs and assumptions on the part of the company's management and on information currently available. They involve risks, uncertainties and assumptions and have to do with future events which therefore depend on circumstances that may or may not occur.

Investors should understand that general economic conditions, industry conditions and other operating factors may affect the future performance of MRV and converts to results which differ materially from those expressed in such forward-looking statements.

I would now like to turn the floor over to Mr. Rubens Menin, Chairman of the Board. You may proceed, sir.

**Rubens Menin Teixeira de Souza** {BIO 15387481 <GO>}

Good afternoon to all. Once again we would like to thank you all for participating in our call. I just wanted to open the call today. A month ago, I became Chairman of the Board and I am no longer the CEO of the company. I am very active but our call is going to be headed by Rafael, the new CEO of MRV and I'll turn the floor over to him. Rafael, please?

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

Good afternoon to all. Thank you all very much for participating in our earnings conference call. I would like to start by highlighting an aspect which is essential for the sustainability of our business and this is sales. We had an excellent result in the first quarter, the best ever in the company's history. And we are highlighting the sales because there is an imbalance between supply and demand.

Despite the moderate growth of Brazil, there is full employment and people from the lower classes are moving upwards. Brazil is also a young country and our country, our real estate properties are bought by young clients because they are getting married, they are leaving their parents' homes or they're stopping to pay rental.

As regards to supply, what we saw was problems in the segment and this allowed us to gain market share in the market where we operate. Also, our company helps us a lot in the launching phase and helps us sell faster. It's also important to highlight that in the last 12 months we have completed more than 40,000 units and we are closing this cycle which started in 2010-2011. With the more mature infrastructure we have in place now, we are going to deliver better units. We are very confident that we will have healthier margins in the next two quarters and we're going to be able to generate more cash.

## **Unverified Participant**

Good afternoon to all. Thank you all very much for attending. We have a presentation on the site and I'm going to move to page four. The objective here is to talk a little bit about cancellations and to make some additional comments. The cancellations have been happening in the region of 20% of the contracted sales. We do not expect a change in the percentage of cancellations relative to sales and the market is strong. It is important, however, to make some clarifications and to draw your attention to certain points. We see that the market is strong. Our clients, when they choose to cancel the contracts, they do so during the construction phase and this a characteristic of Crédito Associativo.

We transfer clients during the works and therefore, those who are unable to be approved by the banks, they are not really choosing to cancel. The fact is that they could not be approved by the banks to get credit. This happens during the construction works, we cancel their contracts and we are able to sell the units again.

This is extremely important when we compare this to the most usual method for the medium and upper segments, when the transfer happens at the end of the construction works. Therefore, you can only be certain about the cash or whether the client will keep the unit or not at the end of that period. This is a significant difference relative to the

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segment where we work. And this makes a big difference because clients want to keep the units that they are buying.

Moving onto page five, you will see that we have been able to resell all the units during the construction phase. The market is strong and we have been able to transfer these units to bank with a gain, even with updating of the price of sales according to the INCC. We have been able to post a gain in the resale of the cancelled units.

Our objective is to ensure that we keep the units. We have the SICAQ project. It is a project that allows us to expand in different cities. This is our objective. But for the time being and with the visibility that we have now, we see that cancellations is a fact in our industry. But it can be managed.

Moving on to slide six, I may be repetitive here relative to what Rafael said. But this is a very strong market. The demographics, the supply and demand balance make us feel more comfortable. And I would also like to draw your attention on the investment we have been making on the brand. Our clients perceive the value of the brand. We were awarded different prices in different cities. And the important thing is that we managed to get a premium in the prices relative to competition.

This has to do not only with the products that we are delivering and we can measure quality according to different standards. Caixa Econômica Federal has statistics about the number of complaints. And our number of complaints is extremely low and even lower if you compare with the volumes that we deliver through Caixa. We have a very strong product, perceived by clients as a quality product and this allows us to price the products appropriately.

Moving onto the next page, as regard our results I would like to draw your attention to the gross margin relative to the same quarter of last year. It is in the same region, in the region of 26%. It is 26.4% relative to 26.2% in the first quarter of last year. In the first quarter of last year, there were some reversals relative to taxes deriving from the new tax rate in December 2012. This is a clean margin, however, and we see the margin becoming very consistent and the operation becoming also very consistent as the old projects are becoming ready. We are seeing an improvement in the gross margin.

From the point of view of expenses and specifically selling expenses and G&A, we also see a productivity gain. The selling expenses in Q1 2014 are higher than in the first quarter of 2013, but if we compare that according to contracted sales, you will see that we have been more efficient in terms of selling expenses per unit.

As regards G&A expenses, our G&A has been consolidated and what we see for this year is an increase at the inflation rate. Some areas in the company are presenting better productivity and achieving gains and we have been able to absorb the additional growth in the last few items, since we have closed the cycle and achieved 40,000 as regards the deliveries as well.

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On slide eight, we have a little bit of information about our subsidiaries. I draw your attention to LOG. If we mark the properties to market, we will see an expressive gain (11:26). LOG would represent BRL 1 in the price of the share. It is developing very well and delivering on its properties and LOG has operations in different geographies and we see very strong demands in some areas.

But the market is much more used to the São Paulo and Campinas regions, but we have had good deliveries in all the regions. And as regard Urbamais, the first launch, it's going to take place in July. We have a cycle of launches underway. Urbamais is going to grow in terms of launches and it's going to make an important contribution to the company.

And just to end my comments on page nine, we see the focus on the repurchase of shares. We have been paying dividends above the usual. This is going to take place also in the second quarter. And we have been focusing on earnings per share.

Cash generation is totally channeled through shareholders. And at this earnings per share level, the repurchase will be more aggressive than it has been so far. We have some 7 million shares in our treasury. And we will cancel from time to time those shares that we repurchased.

We are now going to move to the Q&A session.

## Q&A

### Operator

Ms. Nicole Hirakawa from Credit Suisse has a question.

#### **Q - Nicole Hirakawa** {BIO 18242556 <GO>}

Good afternoon to all. Thank you very much for the presentation. I have two questions. The first one has to do with ROE. Can you make comments about what you see as the main drivers in terms of profitability? And if you could give us a little bit more color about what we could weigh for the medium to long term.

And the other question has to do with the sale of launches apart from Minha Casa Minha Vida. In this quarter these sales have decreased. So what is the expectation for gross margin for the new launches? I remember you said that in some cities, given that the price has been reviewed - had been reviewed two years ago, the margin was a bit squeezed. Could you give us some more color about it?

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

Hi, Nicole. This is Rafael. As regards ROE, there are two important aspects. The first one is the resale. We are going to do this as possible. And then we want to focus on recovery margins. As was said before, as the older units are being delivered, we had the launches of 2012 and 2013 and these units are more relevant for the company and the gross

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margin goes up. The margin grows gradually quarter on quarter and we see a recovery quarter on quarter. We will be seeing a higher margin from now on and the ROE will go back to the numbers that we saw in the past.

As regards Minha Casa Minha Vida, we are launching 70% of our products under Minha Casa Minha Vida. The company has not changed the mix. What happens is that some products in smaller cities, we have not been working with Minha Casa Minha Vida. We don't want to sacrifice the margins of the company, so we go out of Minha Casa Minha Vida. We sell these new products for BRL 120,000, BRL 125,000, thinking about the gross margin so that the gross margin is at the same level of the gross margin of the other projects.

Of course, we want to make an adjustment in this mix in the short term, but meanwhile, we will continue to operate with the same mix. We are very comfortable with the current levels of margin for the products and in the next few quarters, this is going to be seen in our balance sheet. Have I been clear in the explanation?

**Q - Nicole Hirakawa** {BIO 18242556 <GO>}

So at the end of the day, the margins of the new projects as you - in line with the margins of Minha Casa Minha Vida?

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

Yes, in the larger cities. At BRL 145,000, we have a comfortable margin. These margins are comfortable and in those cities where the ceiling is BRL 115,000, we have launched products above that ceiling and therefore, outside the Minha Casa Minha Vida scheme, whilst keeping the same gross margin.

**Q - Nicole Hirakawa** {BIO 18242556 <GO>}

And what is the gross margin?

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

We cannot give guidance on gross margin, but what I can say is that in the next few quarters the company will report a growing gross margin and if we compare the first quarter of 2013 to the first quarter of 2014, the margin has improved already. There has been an adjustment in taxes and in provisions for maintenance. And this has a nonrecurring effect. We therefore think that from this point on, the margin will recover gradually at a more comfortable level.

**Operator**

Mr. David Lawant from Itaú BBA would like to ask a question.

**Q - David Lawant** {BIO 16370172 <GO>}

Good afternoon to all. I have two questions. The first one is the following. Could you give us a little bit more color about other expenses, other operating expenses? It is a similar

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level to the lines that we saw before? And also I would like to ask about the results of BRL 14 million (19:29). I just wanted to see if there is a residue of prime. And how many more quarters are we going to see these results of prime in that line? And then I would like to ask you about the market and about the Caixa selling task force. This has taken place in some places. It's going to take place in other cities. So can you talk about that please?

## A - Operator

Hi, David. As regards your first question, in this other operating expenses, in the quarter there was a higher volume of contingencies which arose. The values are relatively small. We are talking about BRL 3 million, BRL 4 million. And these amounts have to do with some older projects. I don't think the figure is going to increase. Much to the contrary, we have been hearing efforts to allow an early delivery to clients. And this account is going to go down. But some of it will remain.

As regards the interest stake in our affiliated companies, in Q1 the result was better relative to the first quarter of 2013. And what we are going to see from now on is a better result. We are going to see our income a little bit higher in the next quarters. The issues relating to prime have been addressed. This project has been performing better and in a short while this will be at the same operating level as compared with MRV.

Relative to the market, as was said before, it is essential to understand that demand in our market is strong. It continues to be strong and the supply of product has been reduced quarter on quarter. Many companies have left the Minha Casa Minha Vida market in the last two quarters and we have been acquiring market share in this market.

We have increased prices in the last few quarters and at the Caixa event in São Paulo, we also have all those - this coming weekend and in other weekends and these events are extremely important for MRV. And we have very much confidence that sales will be very strong. The month of April was very good for us and May also was very strong in terms of sales so far. We don't see in the next few quarters any reason to believe that sales should decline. We expect consistent sales in 2014 and we are confident that this will take place.

**Q - David Lawant** {BIO 16370172 <GO>}

Thank you very much.

## Operator

Mr. Garcia from Bradesco has a question.

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

Good afternoon. I would like to follow up on the Pro Solutio portfolio. This has grown in the first quarter. Can you make any other comments about this portfolio? Also I heard from some companies that given the trade-off between a client that defaulted, between the transfer and the delivery of the keys, companies to avoid cancellations had to bear this defaulting. Do you see that happening? Is it an analysis that is true? Is it preferable not to have a cancellation at the time of delivery, so how does MRV see the Pro Solutio portfolio?

## A - Operator

The Pro Soluta portfolio grew strongly, but when you look in terms of reais, that is not so big. It is a small portfolio relative to our overall portfolio and we manage the Pro Soluta portfolio. And when we have to define whether we are going to sign or not, we look at the balance of the client and we only accept to keep the portfolio and the client if the client meets certain credit conditions, including income, total debt of the client and so on.

We have our own parameters to manage this portfolio. A large part of this portfolio is still - before the process of delivering the keys, which is extremely important for us as regards collection. I don't see this portfolio growing very strongly or representing greater volumes than we have now. There is going to be growth, but its share relative to the overall portfolio is small.

As regards the second part of your question, yes, the company has a responsibility between the signature and the end of the work. The company is solitarily responsible for the interest (26:14). When there is defaulting we go into our normal collection process, but defaulting has a lot more to do with the form of collection and with a lack of knowledge on the part of the client that they have to pay interest during the construction phase.

We are talking about very small values relating to the size of the monthly payments. Clients are approved by Caixa or Banco do Brasil to pay BRL 600, BRL 700 and their interest bill is in the region of BRL 15 or BRL 20. It is very important, therefore, to work on the collection efforts. It's not defaulting in the sense of delinquency and lack of payments.

As regards the cancellations, if the amount is very high, of course, we have to take that into account. But the values actually owed by clients are relatively small and sometimes very small relative to their monthly payments. And when we provide clients with means to pay it, like online or in lottery shops, the defaulting rate falls substantially. I think this is an effort that yields better results. It's an operations thing. If the operations are smoother than defaulting falls very sharply.

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

This is Rafael speaking. And as regards to Pro Soluta, it is greater before the delivery of the keys. And the same goes for defaulting. Defaulting is negligible really. During the works, the construction works, the defaulting is higher because of these problems, but defaulting is really small in our portfolio.

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

And as regards cancellations, how much of that comes from a portfolio that had been transferred? And how much from the portfolio that had not been transferred?

## A - Operator

Our cancellations take place before the products are transferred, and it's like 99.9%. So, most cancellations take place before the units are transferred. After the transfer, cancellations are extremely rare. During the construction works, there is a small defaulting

that has to do with the collection of the interest. And clients find it difficult to pay at the bank. And during the construction works, clients have time to pay and to avoid defaulting. And the keys are the most powerful instrument to collect these amounts. This is not a point that we are concerned about.

Mr. Vilazante from Bank of America would like to ask a question.

**Q - Guilherme Vilazante** {BIO 15319271 <GO>}

Good afternoon. My question has to do with the end of the last question. We saw that there has been an increase, a seasonal increase by 10%. But what drew my attention is that 8% (30:27) takes place before the delivery of the keys. And I would like to understand this cancellation. Are you working harder to make defaulting drop? So why did that increase and what has changed? What has driven this change other than deliveries?

**A - Operator**

We would expect that a greater proportion of the cancellations would take place in delivered units. So what happens if the following clients buy at the launch and these clients is then included in our portfolio after the purchase? Oftentimes the documentation is not ready or they lose their jobs and this tolerance is variable. In the past we used to be more tolerant, but in the last year, we became more intolerant to those situations.

And then the cancellation during this construction phase has gone up. Traditionally, in the last two quarters, banks have been more restrictive in terms of granting credit. They require more from clients. These were the two drivers that drove cancellations up and we believe that this is going to continue throughout the year.

But the thing is, the company has time to manage its portfolio. If we were talking about cancellations for performed products, that would be more difficult. But in our case, cancellation takes place during the works. We are able to clean up the portfolio and when the company delivers the units, we don't have many problems with the cancellations and the cancellations are also an opportunity to increase margins.

The sales in 2013 were at a lower price and this also has been a driver of our intolerance relative to the defaulting of clients or to the delays in transfers. We have been able to resell the units very fast at a higher price, even if we consider inflation. We have been able to improve the margins and accelerate transfers. We don't see therefore cancellations as a problem.

But of course, we want that to decrease in the future and the company's main project is SICAQ. It's the analysis of credit on the part of the bank during the sale. That is, the company will only register the sale after credit has been approved by the banks. This project started last year. It's being implemented, and we have been giving efforts to improve that. We believe that by year end most of the operation will be with this new model. In 2014, however, we will be seeing a higher percentage of cancellations.

(34:22) has a question.



I would like to understand about the situation of transfers in the second quarter. Has the Caixa system gone back to normal? Can you give us information about the second quarter?

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

This is Rafael speaking. As regard to transfers, in fact, in the first quarter this was lower than our expectations and the main reason for that was that in February and March, the Caixa system had problems. It was down for 20 days. And our performance was poor, especially with Caixa in February and March. In April, we have been able to go back to the same levels as 2013 and we don't see problems coming up in May. Our view is that in the second quarter, we are going to have transfers at the same level of the same quarter last year. And we believe that cash generation will be more robust in Q2. As you know, transfers are essential to boost cash generation.

**Operator**

Mr. Rafael de Pinho from Morgan Stanley has a question.

**Q - Rafael de Pinho** {BIO 15321539 <GO>}

Good morning, gentlemen. I'm trying to reconcile the following: for some quarters now, we have seen the company reporting that prices continue to be adjusted according to inflation. Despite the cancellations, can you give me some perspective about this 20% rate of cancellations? I know that when you increase prices, you are recovering margins and I think shouldn't the margin be reacting faster? Did I miss something? Is there any other pressure on the margins in addition to the old units? When you say that you have been increasing prices above inflation and this has been so for two years now, I should think that the recovery of margins should be faster. Am I missing something here?

**A - Operator**

Let's go back to the first quarter of 2013. The margin was in the region of 26%. In the first quarter of 2013, we had those events, the margin would've been 20%. In the second and third quarter of 2013, and this is seasonal, we had the effect of INCC, which was more strong in those quarters, therefore the gross margin as compared with Q1 2014, felt the impact of the INCC.

If we remove INCC from the second and third quarter and the nonrecurring effects of 2013, the margin of 2014 was the best in the last few quarters. We delivered many units last year. In the first quarter, the margin were lower and as of now the effect of these older units will wane and there is no reason why we shouldn't see margins improve in the second and third quarter.

I think in the next few quarters, we are going to be seeing healthier margins. The margin is going to grow rapidly and we think that in the last quarter of 2014, the margin will begin to go back to the levels reported in the past. Have I been able to clarify your doubt? This is what we see happening in the company.

**Q - Rafael de Pinho** {BIO 15321539 <GO>}

It has become clear. My other question was to try to understand the cancellations. Given that for some quarters now, we have been seeing cancellations at 20%, should we think that this is a normalized level? You explained all the issues in the quarter, but I don't want to focus on the quarter. What is the intrinsic level of cancellations, a normalized level? Since everything that you have been doing to clean the portfolio, if all of that bears fruit, what is the normal level of cancellations?

**A - Operator**

There is a certain level, for example, people lose their jobs. This may happen with a statistically significant frequency. Let's talk about the industry, 20% is the average in the industry. It has been lower in the past, but today at any income level, that's what we see. That's what we see, 20% across the industry. MRV is a company that has the possibility to transfer in a shorter time. When companies take longer to transfer, many more things can happen. Our company sells and transfers very fast.

**Q - Rafael de Pinho** {BIO 15321539 <GO>}

What is the main project that can bring these levels of cancellations to lower levels?

**A - Operator**

It's SICAQ/SAC project. The company is implementing this project and what we want in the midterm is to register the companies - sorry, to register the sale to clients after Banco do Brasil and Caixa have approved the credit. MRV has a different opportunity relative to the rest of the market because of Crédito Associativo. If our efforts bear fruit, cancellations will be reduced as of 2015 and will be reduced to more comfortable levels. In 2014, the market is strong. We have been able to achieve higher prices, which offset also the losses that the cancellations could cause us and as regards 2015, the SICAQ/SAC will be essential to take the level of cancellations to a lower level.

Just to confirm, if I understood correctly, so 20% is the market average?

It is a normalized number for the market. What MRV is trying to do is work better in the market because of Crédito Associativo to bring that number down. But 20% is a market figure. This is what we have been seeing. Most companies, I mean not all companies disclose this type of data. But what we have been seeing is a cancellation at that level. MRV sees this as an opportunity to transfer soon after the sale. And this may lead us to have cancellation levels which are below the industry average.

I just wanted to understand whether 20% was the average.

The Q&A session is now ended. I would now like to turn the floor over to Mr. Rubens Teixeira de Souza for his final remarks. You may proceed, sir.

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

This is Rafael speaking. Thank you all very much for participating in this call. The company, as I said before, is very optimistic. We began a new cycle in 2012 with higher prices. The market has been strong and we are confident that in the next few quarters, we will have more robust cash generation and better margins. We are very optimistic with the company's future. Thank you very much for attending.

## Operator

The conference call to disclose the results of Q1 2014 of MRV is now ended. Thank you all very much for participating and have a nice day.

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