Q2 2017 Earnings Call

Company Participants

- Eduardo Galantemick, Executive Director, E-commerce
- Frederico Trajano Inacio, President
- Marcello Ferreira, Director, Luizacred
- Roberto Bellissimo Rodrigues, CFO and IRO
- Unidentified Speaker

Other Participants

- Fabio Monteiro, Analyst
- Guilherme Assis, Analyst
- Joao Mamede, Analyst
- Maria Paula Cantusio, Analyst
- Richard Cathcart, Analyst
- Thiago Macruz, Analyst

Presentation

Operator

Good morning. Thank you for waiting. Welcome to Magazine Luiza's Second-Quarter 2017 Earnings Conference Call.

At this time, all participants are connected in listen-only mode. Afterwards there will be a question-and-session and further instructions will be given. (Operator Instructions)

Now we turn the conference over to Mr. Frederico Trajano, CEO of Magazine Luiza. Mr. Trajano, you have the floor.

Frederico Trajano Inacio {BIO 17269235 <GO>}

Good morning, everyone. Thank you for joining us for our conference call related to the earnings of the second quarter 2017.

Today I have all the management of the Group with me, and we'll all be here to take your questions at the end of our presentation. Roberto Belissimo, our CFO is here with me.

Like I said in the previous quarter, my expectation about the second quarter of this year was of as good earnings as we had in the first quarter. We ended the first quarter talking about this, but it was even better. We posted figures even more robust in nearly all of the lines in which the first quarter was already very positive. And at the end of the day, we posted the highest quarterly net income ever since the IPO. So, the highest in the track record of the company.

We're already very confident about the quarter, vis-a-vis the moment of the company. Retail relies heavily on a very well-designed strategy, but also a very good team. And our team is going in a very positive performance phase: all lot of inspiration, hard work, and a lot of balance. And the performance and the implementation in our figures, strategies and the search for operating indicators as well.

However, in addition, we also had more robust economy than I expected personally and we highlight PMC/IBGE in April. Particularly in May, our category in May went up 3.8%, vis-a-vis May of the previous year. PMC, one of the most robust retail sale indicators we have available in Brazil.

And pretty much due to an economy that is already immunized, so to speak, about the Brazilian crisis, the political crisis, and at the same time also owing to the capital injection stemming from inactive FGTS accounts. So, we have to highlight that there is a pent-up demand, and if you inject money in the economy, people want to start buying again.

The penetration of products in Brazil is very low compared to other countries in the world. And when Brazilians have extra money in their pocket, they want to buy things; they want to make their dreams come true. And in our industry, when there is a crisis, it is first to be affected, but it's first to recover when we have an upturn. So, this quarter we also had a recovery effect exceeding our expectation and also with beneficial results.

When it comes to microeconomics, the rationale of streamlining both online competitors and also offline was maintained, so we see players that are more rationale. Some still struggling cash wise and being forced, therefore, to adopt commercial policies in a sustainable manner. This was always Magazine Luiza's philosophy.

And when everybody plays the same rules of the game, the team that has a more robust strategy model, which I believe is what we have -- human service platforms. So, this player at the end of the day is above other players under the same conditions in terms of strategy and execution in-house and that's why we benefit. I believe that a structured characteristic that we expect to see in future quarters, competition wise, and we also like to work and operate under this philosophy and context.

The major highlight -- well, actually I had several highlights in our bottom line I will be mentioning by channel. E-commerce persists, driving our growth quite a lot. Growth of 55% vis-a-vis the previous year, very solid, robust growth already happening for many quarters.

And I also highlight sales by mobile app. We had our app with a lot of share in this growth, over 6 million downloads. More than 50% of our traffic is already mobile, both from apps and also our website. The bulk of our sales already stem from our app, mobile apps and devices.

And we are going to launch two interesting items in this regard: free navigation, we are just about to launch. We believe that this has come to stay. We believe the future of e-commerce will be mobile, so we're launching now navigation to our customers who are buying 3G, 4G. Eduardo is going to talk more about it later.

And e-commerce also benefited from store pick-up available in 100% of our operations of our stores today. And the products that are eligible are very high. We improved in our DC, ensuring that more customers will benefit. And in several stores we have just one-day delivery time for store pick-up and extending to other units as well, but the vast majority is focused on 48-hours delivery time to buy online and have store pick-up.

There is no shipping fee, so that's a benefit and a huge advantage to customers. And in-store pick-up we also have something new: we're launching a partnership with 99Taxis, which is a cab app, for transportation in general. And it gives a bonus BRL20 -- a BRL20 coupon for customers to use to store pick-up purposes. So can have up to BRL10 with a cab to go to the store and then go home.

So, there will be no additional cost to go for the store to pick-up the (inaudible). It's a very good partnership and Eduardo is going to give more detail with a partnership with Brasilo [ph] and 99Cab (sic), the app, but I wanted to announce it right off.

And in e-commerce we had an increase in traffic and conversion.

I see that as a very sound and healthy strategy, and we highlight new channels, particularly Magazine Voici [ph]. More than 100,000 stores were included with more than 500 stores in total with very high sales growth.

And it also highlights something very important: We grew 55% in e-commerce and we have the best historical levels of customer service -- and customer service at (inaudible). So growing 55% with a very balanced operation is really tough, but our logistics, our team of development also worked hard to improve integrations in the platform. And also our order tracking system, information available to customers and the purchase experience, both pre and after sales, the service team, so everybody is fine tuned. So, we congratulate them on the business volume driven by the sales area with very positive levels of service.

What about stores? A big highlight is 15% same-stores sales growth, very robust figures. Double-digit growth in all departments of the company: south, southeast, midwest, virtual, northeast, many regions. The greater Sao Paulo as well, results were really positive. But I also highlight the performance in the northeast region, double-digit growth, very high growth, and also virtual store's growth in small cities with amazing performance; for many years performing really great, a very great model. And we can see the results of this model for a while now.

And at the same time this quarter -- well, smartphones was not the only star. We always had wide line, great numbers. Smart TVs with very positive growth in our TV line this quarter and furniture also recovering well. So, when it comes to different departments and regions, we have a very balanced and well-distributed growth and we are even more confident for the future.

For brick and mortars, we have an expansion since last year and now we are accelerating our expansion, 27 new stores for the last 12 months in our group of stores. This quarter alone we opened another 12 stores, so really accelerating the expansion pace. We firmly believe the older channel model and the store is a very important point of contact with our consumer, supporting the website growth, giving options like store pickup, and with a local network to deliver, to have home delivery in the end-consumer [ph] my delivery. So, it's very important to match e-commerce with brick-and-mortar stores and it's important to improve the number of stores.

We have 5,000 municipalities in Brazil, about -- we still have a long way to go tapping into a new markets. And now that we have economic upturn, we want to expand with more digitized stores. Speaking off digital transformation stores, we keep on implementing IT efforts to digitize stores. It is a pillar of our strategy.

We already concluded mobile sales in all stores and now we are just about to conclude the implementation of the Stockist mobile for the team that works at the store back office. Working on inventory and also the implementation of store pickup. So we have the right stores available to provide good services.

So, we have Stockist mobile in all stores and now we have the PIN pad mobile, mobile PIN pad, so the seller can get the order and the credit card data so we can close the sales in less than 2 minutes compared to 40 minutes in the past. Greatly improving productivity in our group of stores and improving consumer experience as well. So, PIN pad is in nearly 200 stores and we are about to have another 800 stores implemented by year-end, which is our goal. For mobile sales, at the store level we also have several digital inclusion services available to support our customers who are buying IT to better use technology. Fabrizio Castillo [sp] is going to give you more detail later on.

Definitely -- well, (inaudible) is an installation service. It's very successful, very high acceptance rate at the store. All devices have to setup the installation and, as customers go home, they can also call our call center for additional support in addition to the WiFi plan with carriers in many different areas in Brazil. And we also launched the after-sales plan in mobile sales with our carriers, telephone carriers.

So, if you want to buy a postpaid model at Magazine Luiza, we are very much focused on providing good data plan, so through mobile sales you can do it in less than two minutes. So we think we are going to have a sales leap postpaid of all telephone carriers due to a digital sales process at the point of sale. And Fabrizio is going to share that later on.

So I think we also evolved a lot when it comes to logistics. I have talked about a level of service and reduction of delivery time at a store. We also have lot of room and fruit to reap, and we also increased the e-commerce volume, brick and motors, logistics space owing to the right efforts of Kaizen and continuous improvement

and also Lean manufacturing. We are implementing this for logistics purposes in all our DCs and greatly improving the productivity per square meter and by logistics operators in our DCs. So, we greatly leverage our result, owing to this improvement in management logistics in a very remarkable manner and also maintaining high level of service. And also shorter delivery time.

And last, but not least, marketplace. I'll highlight e-commerce growth where we don't report GNV yet. GNV, well, we could be reporting but first we want to focus on our platform. We don't loan to give too many -- a lot of information, but it is robust. We have more than 250 sellers and 550,000 SKUs available to our consumers. It took us 60 years to get to 50,000 SKUs and in less than one year since we launched the platform, marketplace platform, we reached 550,000 SKUs available to our consumers. So now we are very excited with marketplace implementation and I highlight that we're doing that, as we always do, in a very consistent manner. So, the level of service of marketplace today is nearly as good as the level of service at e-commerce.

So, very positive numbers for marketplace as well and our (inaudible) sellers. We are one of -- when it comes to platforms, we have the best assessment by sellers involved. And this has a lot to do with the acquisition and integration of Integra Commerce startup from (inaudible), with a lot usability, easy integration for the seller in Magazine Luiza's platform.

Any seller interested in being integrated uses Integra Commerce and automatically it's -- well, because we have a hub, if you wanted to connect with another marketplace the option is available. So Integra Commerce has greatly helped us to expedite the implementation of new sellers and also improve the level of service, but we still have many things to work on. And we are even above our expectations when it comes to the extension growth of marketplace.

Another highlight is our corporate governance. The addition of two members in our Board of Directors: (inaudible) is one of the main professionals in personnel management in Brazil. Very close to (inaudible) Foundation and (inaudible), one of the experts in IT in Brazil. With the innovation center in this DC, one of the founding members and in charge of figuring out (inaudible) success, IT engineering. So great members to our Board, giving more support.

And the compliance area, very successful. In the current world, while we are more susceptible to problems of compliance, every company is more successful -- susceptible. And our Board wanted to have a compliance area with experienced, seasoned professionals, so we welcome it very, very positively.

And as to our brand, we launched the second season of the reality show Digital Mission [ph] partnering with Global News [ph], a reality show. We have 12 episodes in which we get a family in a store and we turn it into a digital family. We launched in July and we have a great impression of the program and it's part of our purpose to help Brazilian families to better use technology. Ordinary Brazilian citizens, not those who are experts in technology.

And now on Sunday we will be starting to be on another TV program benefiting from the economic upturn to strengthen our brand. Always very much focused on a digital platform with human interface, but also digital channels.

Once again I congratulate Magazine Luiza's team for the performance this quarter. And I also thank all the shareholders and partners for the support in the first part of the year. And now I turn the floor over to Roberto.

Roberto Bellissimo Rodrigues {BIO 17269312 <GO>}

Good morning, everyone. Let us begin our presentation on slide number two. Here we have the main highlights, financial highlights.

Sales growth 26% this quarter, compared to 5% in the market. Very significant market share gain. In e-commerce 55% growth, compared to 12% in the market. Also, even higher market share growth.

E-commerce 28% of our total sales, excluding marketplace, a very high share in our total sales.

We grew a lot in our gross profit. The gross margin went slightly down, basically due to the change in the mix, owing to faster growth of e-commerce. But this margin was full offset by a dilution of expenses, which was very strong, of 2.1 percentage points. And our SG&A level is, again, around 22%. Certainly one of the lowest SG&A levels in retail.

Our expense level increased 15% versus 26% of net revenues, so the operating leverage was very high. EBITDA increased 45%. We had our highest EBITDA margin on a quarterly basis of our track record, 8.7%, and net income was the highest of our track record at BRL72 million, ROE of 40%.

In addition, we also highlight cash generation this quarter. We greatly improved our working capital, reduced our net debt at 12 months nearly BRL600 million, a very low level, only BRL268 million. The lowest level since our IPO. And this net debt over adjusted EBITDA is the lowest of our history, 0.3 times EBITDA.

Cash generation this quarter. Operating cash was almost BRL400 million this quarter and for the last 12 months, operating cash flow was BRL950 million. Therefore, improved cash generation that was very robust. And another highlight, Luziacred. It keeps on reducing delinquency, growing sales, improving the portfolio, which is very healthy, and also improving income compared to last year. Despite lower interest rates for revolving credit, since April we lowered revolving credit to 990 [ph] and as part of that Luizacred managed to improve income and profit.

On the next slide, slide number 3, we show the evolution in the number of stores. 27 stores opened last year. We highlight second quarter and also growth in investment, both on a quarterly basis and the first half of the year, increasing investment in over 50% vis-a-vis last year. We highlight IT, which accounts for nearly half of our investments, in line with our strategy.

On slide 4, we show the performance of the gross revenue, the sixth time in a row that we grow at a higher rate: 26% on a base that was higher, 5%, last year. And e-commerce keeps on growing at a very high pace, also over a base that was already very high.

On slide 5, we show the performance of gross margin. (Inaudible), like I said, before due to the mix effect and an important highlight is the level of operating expenses. We diluted selling expenses and SG&A expenses.

G&A expenses, for instance, increased only 6.5% this quarter. This stems from ZBB and EMM expense management matrix.

As to some expenses, we greatly diluted personnel expenses. This has to do with digital transformation of brick-and-mortar stores. The implementation of mobile sales, which increased a lot productivity by seller, and also store pick-up, which helped us to reduce shipping expenses. Overall speaking, we reduced 2 points in expenses, one of the best reductions we had in our expenses.

As to equity income, Luizacred 8% higher, with FX 16% higher. Also contributing to the total result.

Now, on the next slide, we talk about EBITDA. Evolution of 1.1 point, so basically we lost 1 point in the margin, but have 2 points in expenses. We went up from 7.6% to 8.7% reaching EBITDA of BRL236 million, 45% growth in EBITDA vis-a-vis last year.

On slide 7, a couple of comments on financial results. We also had a very good evolution. Percentage of financial expenses went down from 5.4% to 3.7%, a dilution of 1.7%. And part if it was in the prepaid interest account, pretty much related to the CDI drop, but the other part, which has to do with debt service, went down 1 point -- 1.9 to 0.9 of net revenue and this is very much related to a little reduction of our net debt and also CDI.

As to net debt, you can see a reduction was R$587 million in 12 months, or 0.3 times the beta. It went down last 12 months and also went down this quarter BRL444 million to BRL268 million. And this is after payment of dividends and stock buyback last year, so total cash generation was very strong.

And a lot is influenced by improved working capital was well. Over 12 months, it improved BRL516 million, including improved inventory turnover, will reduce 11 days of inventory turnover this quarter to 69 days. I also highlight that's a very good turnover, one of the best in retail as well. And at the same time, we managed to increase average purchase time in a very sound, sustainable manner, but not only for inventory and its suppliers. We improved nearly all accounts of working capital. We also highlight reduction in tax or recoverable tax and account, once again amounted to BRL100 million for the last 12 months.

So considering all of that -- improving results, EBITDA, working capital -- we managed to reduce our financial expenses, net debt, and consequently, we improved our net income.

On slide 8, we show the growth of net income, BRL10 million to BRL72 million. In the release, we also had a disclosure about the return on invested capital. On a quarterly basis we show, as of now, the ROE and we also greatly improved our ROE to a level of 30%. ROI 30% and ROE almost 40%.

On page 9, we show Luizacred figures. Once again, a lot of increase expediting growth 26% revenue. The portfolio also increased and NPO had a dramatic drop. Provisions also decreased a lot. So Luizacred, despite lower interest rate, managed to save, when it comes to provision expanding, funding costs with higher profit compared to last year.

So these were the main highlights, the main financial highlights. And on slide 11, we have the outlook for the future and I will give the floor back to Frederico.

Frederico Trajano Inacio {BIO 17269235 <GO>}

So, lets us move straight ahead to the Q&A, and then we can talk about the outlook for 2017.

Questions And Answers

Operator

(Operator Instructions) The first question is from Fabio Monteiro from BTG Pactual.

Q - Fabio Monteiro {BIO 3711690 <GO>}

Good morning, everyone. I have two questions. The first question -- well, Fred you talked about streamlined market in online, offline, a more rational approach. I would like you to elaborate a little bit more in which (inaudible) or do you see this rational approach, both online and offline? Do you consider an average price rise or a reduction in price concerning market players? And when it comes to shipping and installment, could you give us some flavor?

And the second question is about marketplace. Fred, you also talked about it already, but I'd like to better understand the level of service part. I know marketplace is relatively small, but in your opinion, what are the major challenges to maintaining the level of service? And can marketplace this year reach 5% of GMV online? Basically, these are my questions. Thank you.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Good morning. Thank you for your question. When it comes to the rational approach in the market, streamlining approach, there are two facets: the players that used to operate with very low margins, which were not enough to pay their expenses, their operating expenses. A lot of these players eventually filed for Chapter 11, went out of business, or shut down their stores.

And other players used to run their business at low margins, but are still managing to survive, but having a hard time. And they have to show more robust margins for their shareholders or the refinancial institutions which support them. So in this regard -- by and large, we see more rational policies for prices and mostly for installments, so an attempt by everyone to charge the price that is necessary to be charged for the operation to be sustainable. Not expensive price, high margin, but just enough to pay G&A or for cash generation purposes.

That's what I refer to as sustainable and rationale. Though we feel the rational pricing strategy, balanced strategy, but that's not the reason why average price is going up, but I don't see striking differences in terms of commercial practices and policies. It happened in the past. It happened more online, rather than offline. And online our operations used to charge prices below the cost, pricing the merchandise below the cost. They would buy from suppliers -- and we've talked about that already, right? I talked to you about this many times. So this no longer happens. And in online for many players there was significant new pricing. Not at high levels, but minimum levels, Just to balance the operation or zero EBITDA or not so negative result.

But I don't see this changing. It makes no sense running the business or selling for a lower price than you buy from suppliers. So, for online mostly we saw that happening, but because our model -- the cost structure online in our case is shared with brick-and-mortar store, therefore, lower compared to players who are online only. Then our model is more superior and sustainable over time. And then we greatly benefit many quarters in a row from this model that is simply better. I see it that to make money in Brazilian e-commerce there are only two ways, there is not a third way: either you're multi-channel or you're marketplace. Ideally that is what we're doing. We want to have a multi-channel marketplace.

So, answering your second question already, our strategy is to be a digital platform, a brick-and-mortar store, and human interface. And to provide a good level of service it is very important that everything that we have is a point of uniqueness available for e-commerce and brick-and-mortar store. For instance, store pickup, the store network. It has to be available for the seller as well, so we are investing a lot to enable our network, which supports brick and mortar and e-commerce, to what the sellers do. They are all projects that we are focusing very heavily for next year. But even in the short term, when it comes to level of service, because we have a profitable operation, a balanced online operation, we are not being desperate for this jump to marketplace. It has to be consistent.

Marketplace is just to improve our profit and not to save our operation, so we are doing this very consistently. Today we are the most stringent retailer for inbound selling. So we have, you know, the default score of the customer, a lot of red tape, just to have the right people in. And invest a lot in IT and monitoring and tracking. If something comes in we can disconnect sellers and we sometimes would have standby if there is (inaudible).

And we also have the seller score. If the score is low, we disable to have the right level of service. But because we don't have a desperate move, but rather very consistent, solid move. We are very careful in order not to harm our greatest asset, which is customer relations.

Q - Fabio Monteiro {BIO 3711690 <GO>}

Thank you. Thank you very much, Fred.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Thank you. Thank you for the question.

Operator

Our next question is from Richard Cathcart, Bradesco.

Q - Richard Cathcart {BIO 16457807 <GO>}

Good morning, I have two questions. The first question is about improved inventory days and how you manage to achieve that. Mostly stores do you see or a little a bit of both? And we're wondering if we expect to see improvement in the future quarters.

Second question, (inaudible). Could you elaborate more about Magazine Luiza's strategies for Black Friday? I know we still have three months down the road, but possibly already have the planning. So what are your thoughts about how consumers may react to Black Friday this year? Thank you.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Good morning, Richard thank you for your question. Roberto is going to answer the question about inventory.

A - Roberto Bellissimo Rodrigues {BIO 17269312 <GO>}

Good morning. Good morning, Richard. Thank you for your question.

About inventories, what I can say is that we managed to improve in both channels. Turnover in brick-and-mortar stores improved a lot, but e-commerce had an even better turnover compared to brick-and-motor stores. Naturally, because we don't have inventory in the store display, everything is centralization at the DC . So our e-commerce turnover is around 50 days, for instance, which is a very efficient inventory turnover level.

And as e-commerce grows faster than brick-and-mortar stores, it also drives the average down. But in spite of that we improved our turnover in e-commerce and also brick-and-mortar stores. At store level, this is also related to sales growth, which also supports. So inventory turnover at stores improved as sales went up and also owing to internal processes developed for supply purposes with more accuracy.

The turnover trend is very positive. Average purchase terms for both channels is similar. So as e-commerce grows, we can -- to drive average turnover downwards and maintain average purchase time equal. So working capital dynamic trends is very positive for us in inventory versus consumers.

Fabricio and Eduardo are going to going to talk about Black Friday.

A - Unidentified Speaker

Fabricio speaking. Good morning, Richard. We're already working on Black Friday. We expect to have a good last quarter and it is critical to have Black Friday as a good event, so we're working a lot with our suppliers. As usual, the categories that may stand out at Black Friday are white line and IT items. So we're working on it; we expect to see an increase in our inventory in October to support the campaign. I believe it will be in late November. E-commerce?

A - Eduardo Galantemick

Richard, Eduardo speaking. Thank you for your question.

By and large, this is the most challenging time of the year for us. We'll be facing a base of last year of 40% growth, which we had in the last quarter, and we're very confident about what we are planning to do. There are three phases that are pretty well set. First, November before Black Friday. How can we sustain the growth, the strong growth exceeding any kind of pent-up action? And then we have Black Friday and everything related to IT items, our ability to maintain a stable platform. We've been managing to do that over the years and our IT team is working heavily on this as well.

And the third phase is right after Black Friday, which is a quick return to our operations. And logistics is fully dedicated as a team, so we can go back to delivery times as soon as possible in order to have the first or a great first two-week period and a great fourth quarter. So we are very confident; we are planning ahead.

Q - Richard Cathcart {BIO 16457807 <GO>}

Thank you. If I may ask a follow-up question, you talked about more rational competition. You also talked about the reduction in the number of installments and more sound prices. What about free shipping fee? One of your main competitors in increasing the level or the volume of free shipping. Do you have -- what's your opinion on this? Does it make sense? Do you feel any impact?

A - Unidentified Speaker

No, we don't feel any impact, we grew 55% this quarter, so it was even better than the first quarter, and I believe the competition started this policy in early May so we didn't feel this effect. We have a policy of free shipping and it happens in a very clever manner.

We have this for everybody who buys via app, which makes sense at the end of the day. If you buy through the app, usually this customer is a recurring customer so we don't have acquisition costs to sell to him. So, the shipping cost offsets, so we give free shipping for those who buy via app. We want to encourage people to buy through app. And it's very considerable.

We also have free shipping for brick-and-mortar stores . So, if you compare app plus store pick-up, we have a substantial, sustainable part of our sales online, which have this free shipping. And sometimes it's also with more profitable categories.

So, I prefer to have a smart free-shipping policy for specific channel, specific pieces that prove to be sustainable and not so non-recurring. Sometimes you give on a quarter and have to step back, so it makes no sense to do otherwise. So, we will keep on having free shipping under this model for store pickup, because we're going to have even better delivery times, leveraging our multi-channel, and also our app, which is our bet for the year.

Q - Richard Cathcart {BIO 16457807 <GO>}

Crystal clear. Thank you.

A - Unidentified Speaker

Our next question is from Joao Mamede, Santander.

Q - Joao Mamede {BIO 15265292 <GO>}

Hi, everyone. Good morning. I have two questions as well.

The first question, Fred, you mentioned in the presentation about Mobile Pinpad in the stores and the rollout. I think I missed the number of stores that already have Mobile Pinpad implemented out of the total.

And a follow-up question, what about the behavior of stores which already have the bulk of the initiatives you mention implemented for the digital transformation? Could you tell us some numbers? Sales per square meter, for instance, or gross margin, EBITDA margin at the store compared to an old store, which doesn't have everything implemented yet. Just to give us flavor about the gain in productivity or any other metrics under this reform.

I wouldn't say reform, but once we have these initiatives implemented. Second point, a common topic over the last discussions with you, due to the very strong cash generation mentioned by Roberto, almost BRL1 billion generation of operating cash, the company's balance sheet today is very comfortable and a common question is what will happen in the future assuming generation remains strong.

Today, the current net debt is nearly zero, almost net cash. So (inaudible) is going down a lot, so leveraging what (inaudible) is supporting, 40.5%, might not make a lot of sense, but now that the debt cost is lower, what about the future? What about leverage and optimum capital structure? And what to do with so much money considering your CapEx is so small you don't spend too much to keep on growing? Thank you.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Thank you for your questions, Joao. With regards to productivity at the store and the model, there are many benefits, by the way. One of them, naturally, is the increase in sales, customer satisfaction index. Because you provide a better experience to the customer at a point of sale, you tend to have customers who will come back and improve conversion. And also -- well, the main focus of digital transformation in a store today is to improve profitability. Nearly 70% of store costs has to do with payroll, so our main goal, is to improve sales per seller. And, remarkably, it is not necessarily to cut down the staff number, but having more sales per person at the store. 40% of the staff is at the back office and we tend to reduce this ratio, having more people selling at a store.

So, in 2014 our sales, very similar to what we expect to see -- similar to last year, by the way. So in 2014 we have 24,000 employees and last year sales were equivalent with 25,000. A lot of this gain of sale per seller came from e-commerce, but also a lot from the increase of sales per total number of people at the store. Because we have back office people who did not generate sales and converting into sellers or digital services or credit products, but particularly merchandise sales.

So, increasing sales by employee at the store, I cannot disclose this number, but the overall figure you can get from our release. So that's a good indicator showing you that we are increasing our stability a lot. And our digital transformation initiatives are not only for a couple of stores and you'll call somebody to make it digital, but rather this is for 100% of the stores. Pinpad in its 200 stores, but we're going to roll it out for the remaining 600 stores by year-end, so we're going to have over 800 stores going digital. We don't give a guidance how we're going to be store-wise, but 100% will be Mobile Pinpad by year-end.

By the way, we already have mobile sales in all stores and mobile stock is in, not all of them, but many of them and Pinpad is particularly the seller taking the payment. For instance, if the customer goes to the website, navigates the product, and goes to the store to buy the product, if he already is registered at the website, he don't have to do it again at the store. So the whole inventory of the website is available at the stores so the seller can see -- visualize all the inventory at a website. By year-end you'll also have the view of marketplace and e-commerce as well, so that will improve productivity quite significantly.

When it comes to cash generation, even though we are improving quite a lot, our capital structure is not ideal. We don't have excess cash. Our current operations, Joao, still have financial expense of 3.7 over net expense. I consider this to be high and low net profit. So, if you consider indebtedness of a company like Magazine, you have to consider bank debt, but you we also have to consider receivables discounts. And in this regard, if we consider a broader debt scenario, or at least expenses and services from the prepaid cost, I think we still have a long way to go when it comes to reducing indebtedness and receivables discount.

Q - Joao Mamede {BIO 15265292 <GO>}

Great. Thank you Fred.

Operator

The next question is from Guilherme Assis, Brasil Plural.

Q - Guilherme Assis {BIO 16143141 <GO>}

Hi, Fred. Hi, Roberto. Thank you for taking my question. Good morning.

I think you talked a lot about the sales performance already, but what about looking forward? We see more uncertainty down the road. I think you already talk about your planning for Black Friday and Christmas, but assuming FGTS, for instance, which supports you, that is just about to finish and end this week, do you have any plans for the future and to keep on growing your sales through all channels at a very strong pace? Or should we expect to see a slowdown? What is your budget in this regard? That's one question.

And maybe could you also talk about sales in July? July still includes that GTS, but any changes to the pace that was so strong in the second quarter?

And another question has to do with expansion. You talked a lot about store opening. The last 12 months you opened 27 stores. After some time with not so many store openings, but 12 in the last quarter, what about the expansion pace for the future? And where do you believe there is more room to grow? Maybe more virtual stores in smaller cities or any specific region you'll consider to improve your footprint, for instance. I'd like to better understand your strategy and your expectation for the expansion plan for brick-and-mortar stores. Thank you.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Thank you for your question, Guilherme. Since the beginning of the year, Guilherme, we already expected the second quarter to be not as challenging, particularly because last year in the second quarter we did better compared to the first quarter of last year, of 2016. So, the comparison base, particularly for the last quarter of the year, is more robust.

So we had already budgeted smaller growth levels for the quarter, regardless of macroeconomics, because our comparison base is stronger in the third quarter, but particularly in the fourth quarter, both our e-commerce and brick-and-mortar stores. They had great performance in the fourth quarter of last year and in the budget we expected to see a slowdown, a lower growth, but still robust growth for the coming quarters.

What is difficult to quantify is the impact of FGTS in the economic recovery of the last quarter.

Early this year I was more bullish about the economy of the second quarter, and I remain bullish. With interest rate reduction lower than 80% as they stake right now, and if you go see it, a very strong pent-up demand that may come back any time with a little bit of stimulus and initiative, I believe we have everything to have better economy. Not only in terms of share gain, in the second half of the year compared to the first half of the year.

So, what may offset the comparison base, the tough comparison base that we have, particularly in the last quarter, is a more robust economy. Regardless of FGTS, but mainly due to lower inflation rate, interest rate ,which grabbed less from consumers, and also better employment rates. So it's hard to say anything, but I am confident that the comparison base will be tougher.

Q - Guilherme Assis {BIO 16143141 <GO>}

Thank you, Fred. Fabricio, could you comment more on TV sales? We saw a change in the digital system in Sao Paolo. Do you have any plan for smart TV and the national rollout for this program? And do you believe it also helped to improve the results of the second quarter?

A - Unidentified Speaker

Guilherme, Fabricio speaking. Thank you for your question.

About digital TV, up to now it's only migrated in the greater Sao Paolo and now in July in Recife and the growth of the category was high countrywide. So, it did improve demand due to the conversion in Sao Paolo, but not in Brazil as a whole. Now we had Recife last week, in September there will Salvador and Fortaleza, and in November Belo Horizonte and the countryside of Sao Paolo. This will generate demand, but there is a pent-up demand for digital TV, from 2014 to 2016 there was a drop by half. So this category has demand and what stood out on top of our planning were our promotions and our product availability, which was superior to our competitors.

So Magazine Luiza did stand out. If you think about the northeast and the south, we had a lot of growth in this category. So we do have the demand of the conversion and also in e-commerce.

Thank you.

Q - Guilherme Assis {BIO 16143141 <GO>}

Thank you. What about store opening?

A - Unidentified Speaker

When it comes to opening stores, like we said in previous calls, we intend to recover our historical levels. If you think about the last 10 years, except for the two years of crisis we had historical openings about 50 stores per year. So we intend to be closer to this year compared to last year. I cannot tell you precisely the number, because this information is not public yet, but I mentioned in previous calls that it tends to be closer to historical levels like the one I just mentioned.

So will be opening in all regions, all formats. Always under the concept of lean stores, low operating costs, not investing so much in key money, not investing so much in civil construction, low rental fees, and fully-digital stores as well.

Q - Guilherme Assis {BIO 16143141 <GO>}

Okay, thank you. So just one last question, Fred or Roberto. The operating leverage, you already talked about -- you talked about the dilution effect of the gross margin and e-commerce growth, but this was more than offset with the record EBITDA margin of the company. If we consider we expect e-commerce to keep on growing, do you see more room for the operating leverage to remain and having a positive performance? Could you give us an idea to what extent do you think you can improve the EBITDA margin of the company through this operating leverage?

A - Roberto Bellissimo Rodrigues {BIO 17269312 <GO>}

Good morning, Guilherme; Roberto speaking. We cannot give you any projection or guidance yet when it comes to an increase of the EBITDA margin for the future, but what we can say is that there are several initiatives to keep on reducing our operating expenses, both in brick-and-mortar stores and also e-commerce. We have the opportunity to benefit from higher operating leverage in the future as we increase our sales.

Just to give an idea, our rental expenses are growing very little. Per square meter, it increased 4% this quarter. So when you grow 15% same- store sales in brick-and-mortar stores and the rental per square meter increase is only 4% that is a very strong dilution. On top of that, for instance, Fred talked about the implementation of Mobile Pinpad, Mobile Sales. We managed to decrease the number of cashiers at the stores, 2,500 cashiers two years ago to about 1,500 cashiers today.

So it is gain on productivity with digital transformation and also other expenses that we intend to further reduce, but it doesn't necessarily mean that there will be an increase in the margin. It could also be converted into more efficiency, better competitive edge, and more sales growth, etc. We do have opportunities to keep on further diluting our operating expenses, for sure.

Q - Guilherme Assis {BIO 16143141 <GO>}

Great. Thank you, Roberto.

Operator

Our next question is from Thiago Macruz, Itau BBA.

Q - Thiago Macruz {BIO 16404924 <GO>}

Hi, everyone. Good morning. My question has to do with commercial dynamics. This quarter the margin was even better year-on-year. To what extent -- well, when you comes to such levels, to what extent should we invest more in competitiveness. What about this trade-off going forward? Thank you.

A - Unidentified Speaker

Hi, Thiago. Thank you for your question. We've been managing to have high growth rates with this level of profitability. We have to work on this equation considering the margin vis-a-vis growth.

We -- actually we did not gains, but we maintained the margin per channel. And in gross margin, there was a slight drop, but weakening in the operation, like you said, in the EBITDA margin. Today we have no intention whatsoever. Well, we don't foresee a sudden change in the commercial policy, but we feel very confident to do it anytime. So, if we see growth is going down that we're willing to have more volume and grow more, then we can make use of this strategy. It will largely depend, Thiago, on how the economy will be without FGTS and at lower interest rates.

Because we don't have a precise reading, we like to have options, but we don't have a set commercial strategy, But it's very important to a company such as ours to have a healthy EBITDA margin, because should we need then we might have a more aggressive commercial policy to go for volume. We want to keep on growing: high growth rates, gain in market share. So, we want to keep on increasing our share in the market in all channels.

Q - Thiago Macruz {BIO 16404924 <GO>}

Crystal clear, Fred. Thank you for your answer.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Thank you. Thank you for the question.

Operator

Our next question is from Maria Paula Cantusio from BB Bank of Investment.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

Good morning. Congratulations on the earnings. Thank you for taking my question.

You said, you intend to expand Magazine Luiza's logistics network to sellers. Does it also includes store pick up? And could you tell us more about the customer profile, customers who buy online and have store pick up? Has this been converted to additional sales to the company?

And then I would like to talk later about Luizacred and the sales of the private card, improved both in store and out of the store. And outsource card lost the percentage, but when you think about the card, well, there was a drop of 3% at the financing company. Is this due to revolving credit or any other factor?

And in the last call, you also mentioned that you are doing a pilot study, a partnership with Santander, similar to what you already have with (inaudible). Could you give us an update about the ongoing status of the project and if there is any news to share about partnerships and financial services? Thank you.

A - Unidentified Speaker

Paula, thank you for the question. Marcelo is going to answer the questions about Luizacred and then I'll come back to answer your first question.

A - Marcello Ferreira

Good morning, Paula. Thank you for your question. Firstly, like Roberto said, there was a significant reduction in the interest rates of revolving credit. And at the end of the day, the financial margin goes down, but we are speaking of revolving credit and the exchange for installments. And in future quarters you see the result going up.

Basically, we did this before. Every customer that walks into the store we show the best interest rates for financing purposes. For instance, a project know as sales installments. We already have -- well, we did not depend so much on revolving credit. It's smaller compared to competitors. And what we do is to continue the process to support the customer to have financing at a lower interest rate.

Possibly this is the worst quarter in terms of financial margin, because everything happens here this quarter without creating a higher portfolio for installments. So possibly in future quarters you are going to have an increase in financial revenue.

And what was the second question again? Okay.

Compared to what we do, the marketplace strategy. So products that we cannot have in the current platform providing services to customers, then we use other partners to serve our customers. Every customers who go to the stores we want them to have the better chances of having financial services, so we want to have a store for that purpose with many possibilities to our customers. So, in addition to financial products, for instance, payroll deductible loans. Santander, for instance. (Inaudible) , they provide DCC and we are creating another partnership for those customers who want to have personal loan.

So we are choosing another partner, specialized in this segment, to add another possibility to our customers to finance and to be happy. In other words, to come back to the store and be happy with it. We already have the pilot study, which has proved to be very encouraging, and in the future customers will be sharing more detail about it.

As to your first question Paula, once again, we want to be a digital multi-channel platform with brick-and-mortar stores. So, all those services that we made available through the website, we want to have them available through the seller, including store pickup, including the seller's ability to sell a marketplace product, but actually we are a multi-channel marketplace and that's how we design our platform.

So, all areas can provide the same areas that the back office provides to e-commerce and brick-and-mortar stores. All these services will be made available for marketplace sellers as well. We are making massive investments. We had a big change to our structure this year. It was the integration of labs with the IT area. So Andrea Fatala is now in charge of the whole IT area, because now all the things that we've had in our digital platforms we want to have that in our back-office platform as well. So with logistics, logistics systems that will be made available to sellers, matching payment systems. So it is important that the lab philosophy were also added to the corporate area.

Financial, PR, payroll, all systems -- WNS, PMS, logistics. All this systems should also be there. We are no longer multi-channel only. We are multi channel, multi-org. So, under this structure all the services provided to internal channels should also be made available for outside channels in the IT area.

Now this new setting should also be available to meet the needs of all these channels. That's something I want to mention. We absorb this code of our commercial PR, which was (inaudible), so now we absorb this code and the whole development team of our commercial area, which is the core of every retail business, is now being designed by Luizalabs under this new setting. It was a big change. After several years outsourcing now we have it in-house, the commercial PR, and now we maintain some service outsource systems that makes no sense being in-house. But we are more and more working on our new technology and our own ability to provide services in-house and create innovations to consumers.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

Thank you, Fred and Marcello. Fred, if I may. Just one another question. Could you talk more about the customer profile that have the store pickup? I remember you mentioned before a couple of times that usually those who buy in Magazine Luiza e-commerce had a larger share compared to those who went to the stores. So, I wonder if these customers also use the store pickup service and how much is converted into additional purchases when these customers go to the store for store pickup.

A - Marcello Ferreira

It's too early to say anything, but most of the customers who have the store pickup never walked into the store before. They are visiting the store for the first time. And of the total number of customers for the store pickup -- well, depending on the store, 20% to 30% buy an SKU or a service, installation service, for instance, or extended warranty, or a supplementary purchase. Numbers are very incipient yet. We cannot say they will remain as such in the future, but these are encouraging figures. We are further improving the conversion of customers who walk into the store to benefit more from the traffic, but this is the beauty of multi-channel. I firmly believe the best way to work on e-commerce, in

Brazil and worldwide, is a multi-channel operation and preferably with a platform. That's what we are doing as well.

Q - Maria Paula Cantusio {BIO 18652439 <GO>}

Thank you. Have a great day.

A - Marcello Ferreira

Thank you.

Operator

This concludes the question-and-answer session. We give the floor back to Mr. Frederico Trajano for the final remarks.

A - Frederico Trajano Inacio {BIO 17269235 <GO>}

Once again, I thank you all for joining us and congratulate our team for the excellent performance this quarter. And, once again, I thank you all. Thank you very much indeed.

Operator

This concludes Magazine Luiza's conference call. Thank you all for joining us. Have a great day.

--

--

--

--

--

--

--