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# Q2 2020 Earnings Call

## Company Participants

- Eugenio De Zagottis, Vice President, Corporate Planning & Investor Relations

## Other Participants

- Guilherme Assis, Analyst
- Irma Sgarz, Analyst
- John Ferreira, Analyst
- Joseph Giordano, Analyst

## Presentation

### Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to RD People Health and Well-Being Conference Call to discuss its Two Quarter '20 Results. The audio for this conference is being broadcast simultaneously through the Internet in the website ir.rd.com.br. In that address, you can also find the slide show presentation available for download. We inform that all participants will only be able to listen to the conference during the company's presentation. After the company's remarks are over, there will be a question and answer period. At that time, certain instructions will be given. (Operator Instructions)

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of RD management and on information currently available to the company. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to the future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of RD and could cause results to differ materially from those expressed in such forward-looking statements.

Today with us are Mr. Eugenio De Zagottis, Investor Relations and Corporate Planning Vice President; and Fernando Spinelli, Investor Relations and Business Development Director.

Now I will turn the conference over to Mr. Eugenio. Sir, you may begin your conference.

### Eugenio De Zagottis {BIO 7193695 <GO>}

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Hello everybody. Welcome to Raia Drogasil's second quarter conference call. Obviously this is a quarter that was significantly impacted by the pandemic. Obviously, we had like every other retailer in the world, much lower sales than normal, which for a fixed cost business generates loss of operating leverage during the quarter. On top of that, we also see the price cap increase being postponed from March to May. So part of the inflationary gains on inventories that happened -- should happen in the second quarter has shifted to the third quarter, part of the gain were here, part have been shifted. But this has generated a lot of pressure for profitability as well as cash pressures related to a much higher cash cycle. But obviously these are very short-term trends and as I will talk during the presentation, we have very encouraging signals already for July and beyond.

So I think in the end what matters here is the acceleration we have been able to produce in our strategy. As far as digital, which saw a huge gain during the quarter and also in terms of our health care strategy, and I'll talk more about this in the end of the presentation. So, straight to the highlights. We ended the period with 2,162 stores. We opened 55 stores in the quarter with no closures. Our market share was 13% on a national basis, flat versus last year with some gain in Sao Paulo. But obviously, this is a quarter in which all the neighborhoods of high income people have been down a lot because of more higher compliance to the social isolation because of shopping malls being closed and so on. So we were penalized here by the fact that the demographic market mix changed a lot. In normal circumstances with a stable demographic mix, our share would have increased almost 100 bps.

We did BRL4.7 billion in revenues, 6.3% total growth with minus 7 for mature stores. Gross margin of 28%, under this pressure, basically because of the postponement of the price cap increase which shifted part of the gain that should happen now to the next quarter. We got an adjusted EBITDA of BRL232 million, 4.9% consolidated margin, 3.3 percentage point pressure, and this is exactly loss of operating leverage, same expenses, less sales. Net income BRL62 million, 1.3% net margin, 2.3 percentage point reduction. But I think the fact that we have an positive net income after a quarter like this speaks to the resilience of this business. And finally, big cash flow pressure BRL440 million negative free cash flow, BRL550 million, total cash consumption. But these whole cash became inventories, cash cycle went up and this is transitory. So we will get back in the coming quarters back to our normal leverage ratios.

On Page 4, talking about the expansion. So as I mentioned before, we ended the period of 2,162 stores, we opened 55 stores in the quarter, which are 8 more than in the same quarter last year, which is a good performance. But to look at the semester, the gap that we had in March wasn't overcome. So, we opened 94 stores in the first half of the year versus 109, 15% more last year. So, but this is not a big gap considering everything that happened in the quarter and we are still very confident that we will deliver the 240 guidance for new stores. We have a full pipeline already at home, we are already working on next year's pipeline. So we have no doubt that the 240 will be open in a normal basis and this 240 stores, which is our guidance will maintain the current diversification, both in terms of geographic and customer segment strategy that we have recently persuaded.

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On the next slide, we have more on that. When we talk about geographic diversification, I think by the -- at this point, everybody understands well that point. But when we talk

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about demographic diversification, I'm not sure the level of diversification that we have done in our expansion recently has been clear to everybody. So we bring this chart here to help make the message. So if we look into two quarter '18, last 12 months, 38% of our stores were upscale stores. If you look back '17, '16, '15, '14 the number was much higher than this. It was at some point more than 50% of stores, they were upscale stores, but already the second quarter it was only 38%. And this 38% fell down to 23% and now to 18%. So when you look last 12 months openings, we have 52% of those stores, hybrid stores so they are enabled to serve both upper class and the expanded middle class. While 30% of the expansion has been in popular areas and they are fully focused on the Brazilian expanded middle class.

So if you look today, the inventory of stores that we have for the company, 64% of those stores, that service the expanded middle class. Only 30% of pure upscale, 42% are hybrid upscale and popular and 22% they are purely popular stores, fully focused on the Brazilian emerging middle class. So we're talking about 911 hybrid stores, with 334 openings last three years and 471 stores popular, with 174 openings over the last three years. So it's already a very important operation, the one that we have to serve expanded middle class. This is -- this 64% of our store base that service the expanded middle class, this is a legacy from the Farmasil initiative. The popular stores were our toughest format for a very long time, but with Farmasil, we learned how to execute in the super popular format and we introduced a lot of learnings on the popular and to some extent hybrid store, most on the popular stores. So today, this is a -- both formats are performing really, really well, sometimes ahead of the upscale stores and we are very confident in this expansion and this measure will keep on going. When we talk here about popular, we are putting together popular and super popular just like when we talk about upscale, we are putting together the premium and the super premium stores. But let's zoom on the super popular stores which is the direct inheritance of Farmasil, now with the Raia Drogasil brands.

We have 25 such stores. We have opened 4 stores this year already, and we have 7 more in the pipeline for this year. So it will be a 11 additional stores this year alone. If you look at the last 12 months stores opened, we're talking 6 stores for this year to end of last year. These stores are projecting 26% internal rate of return, they are projecting revenues between BRL500,000 and BRL600,000. So these stores already a new strategy is already a reality. And we'll open more and more of this. Additionally, we have 50 to 60 popular stores that should be converted to the super popular format over the coming quarters. So, because, when you talk about the super popular, it's even more promotional than the popular, the mix is more generics-driven than the popular, the operating model is different as well, we have shorter working hours. So in a lot of these stores, we believe we can do better with a super popular performance.

So this format, either as a function of our expansion or is a function of migration of existing popular stores, we will get more and more of our attention coming forward. So our commitment to the expanded middle class I think it's very clear and it's not only a promise. This is our current reality as well as the chart shows. Then talking about the geographic diversification. So we ended the quarter as I mentioned 2,162 stores. Drogasil is the number one drug store brand in Brazil in terms of revenues and Raia is the number two brand in terms of revenues in Brazilian pharmaceutical retail. Obviously, we have a

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huge presence in Sao Paulo, nearly 1,100 stores. We are opening like 30% of these stores across super stores still in Sao Paulo, but then almost 70% are already outside of Sao Paulo.

This is not counting the Onofre acquisition. And Onofre is the most start gain in Sao Paulo but only looking at only the 240 organic openings, one-third nearly has taken place in Sao Paulo. We have just closed one of old DCs in Sao Paulo, the one located at our headquarters. Our oldest DC, a kind of an anachronic layout and but served as well up to now. But this was already planned when we opened the Guarulhos DC, which is our largest and most modern DC. Now, we have both Guarulhos and Embu service Sao Paulo. These closures should have happened in the first quarter, because of the pandemic, it was rescheduled, now happened in the second quarter.

I like also to highlight our growing presence in the North. We have already 49 stores, we are the number two player in the region. In Para alone we have 38 stores. This was our fastest expansion anywhere. And finally, when you think about the Northeast, we already have 265 stores in the Northeast. We are the number two player in the region. And we already sell despite being there for only there six, seven years, we already sell 50% of what the leader sells. But with much higher maturation momentum, so we have contracted revenue growth there because of a lot of mature stores, and way more wide space for us to keep on building up our operations.

So in a couple in some -- over some time, I don't know one, two years maybe we will be 70% of the leader, something like this. Not to mention that we are already leaders in the main metropolitan regions like Recife, Salvador and Belo Horizonte. In these regions, we are already the number one player, even though we have very less stores, but our stores are way more than everybody else. And then another highlight here goes to the South. We have 223 stores in the south, we are also here the number two player. If we compare ourselves to the leader in the south, looking only at the retail revenues, we have already 73% of their revenues. Obviously our presence in the region is much more recent and obviously, we have also way more upside in terms of maturation than they have. So this is a figure that will grow also in the coming year and have also way more wide space.

Here, it's important to mention that we are much bigger than the leaders in Parana, where we entered before, not only in county [ph] but mainly in the countryside but in both regions. But even when we look at Santa Catarina, a region in which the leader has entered way before us, today we are larger than them. We are slightly larger in the (inaudible) then we are way larger in the countryside, the only state in which we are significantly behind is Rio Grande do Sul. To give an idea, we have 47 stores, this is kind of 40% of what we have in Parana and Rio Grande do Sul is slightly bigger market than Parana. But this is an operation that is going really well, we already accelerating our growth there. We see a lot of opportunities there. And we are opening in the next quarter a new DC to support the acceleration of our expansion into Rio Grande do Sul. Shifting gears here to market share. Our national share was 13% flat over the previous years. But as you can see, Sao Paulo we had some gain also. But if you look here in this table dark green, bottom right, it's obvious here that the premium stores especially when I'm looking here at mature, but it's still same matched for total same stores are mature.

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We see that premium stores performed way below hybrid and popular stores in the quarter. This is because the bulk of the shopping mall stores are premium stores and they were closed for a long period, but also the fact that the social isolation compliance was much higher with the extreme population, then with the popular population. So these demographic mix shift due to the pandemic was favorable and it hit our market share. If we normalize for that, if we maintain at the same market raising by income of the last year our market share would have grown from 13% to 13.8% on a national basis in Sao Paulo from 24.7% to 26.3%. So as the market normalizes, so will our market share, this is already contracted.

Next page, page 7, talking about our mix. So, first and foremost, our total revenue growth was 6.3%, retail growth was even less than that 5.4%, but 4Bio growing nearly 24%. Generics and OTC performed well. HPC in the middle and branded suffered a lot because the drop in prescriptions, consultations, elective procedures et cetera, et cetera, et cetera. So the number of prescriptions written by physicians has declined sharply and this has affected branded in a very direct way.

And the next slide is probably the slide 8, maybe the most important slide of the deck here, because not only we talk about the comps in the quarter, but we can extrapolate what the next quarters looks like based on the July data here. So first, in the second quarter total revenue grew consolidated 6.3%, mature stores minus 7%. So very significant loss of revenues here. But when we look at July, we already saw in July nearly 1% overall mature store growth. If you consider that, inflation is around 2.5%, 2.8% something like that. This is already not a big gap. And depending on what happens in August and September, it could be even be the case that we further close these gap versus inflation. So this already means that when you look at the third quarter, we will see a quarter way closer to normality. But the main information here is when we take out the 124 stores which are shopping mall stores which are suffering in disproportionate manner out of the base. So if you look only the freestanding stores, they have grown 5.8% on a mature basis, 5.8% versus an inflation of 2.3%. So we are talking already today with the pandemic still hanging around 3.5% real growth at our freestanding stores.

So as the shopping malls keep on catching up in terms of performance, obviously this will drive our performance more and more towards closer to this 5.8% that we are seeing now. So this is a structural number, this is what matters. This quarter, what happened in this quarter would tell us what the retailers are, many other business around the world, people et cetera, I think never happens again. So the quarter in its own doesn't matter because even you could say there is a lag that is of high leverage, but even that legacy standpoint, because this leverage is sitting in our inventory. In the coming quarters, it goes down and it looks like this quarter, never happen. But the trend that the July figure set, this is in my view what matters looking forward.

On page 9, talking about digital. So our digital channels we sold 7 times as much as same quarter last year, a huge growth. So digital channels already account for 7.6% of our total sales. And then there are couple of messages here. First is that, Super Apps only represents 10% of the 7.6%. So we work with Super Apps, it's great, it brings more demand, but 90% of the demand we generate with our own customer acquisition based on our stores. So this is very important. We don't depend on anyone for these digital

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sales. The second point is that if you want to compare us to other players in the industry, who are mostly regional players, we have to look at apples to apples here. We have to face here that we are truly national player with a presence in 23 states. There is a huge discrepancy in store density and market share across these markets.

In most of these markets, we have just launched digital. Obviously, Sao Paulo, Rio, Gravatai [ph], Belo Horizonte, Porto Alegre, they already had digital. But in a lot of smaller markets, we just launched digital. So when you look at our bottom markets in terms of penetration, we are at 2%, 3% penetration. But this is a number that will increase very fast as we focus more and more of those regions. Then there are a bunch of capitals with double-digit penetration. And then our highest penetrated capital has 18.6% digital penetration. So when you compare us to other players who are regional and therefore they enjoy a high store density, high brand awareness, et cetera, and have a service that has been there for very long time. The number to compare is the 18.6% and this number is trending further up. Finally, we had 3.4 million cumulative downloads in the quarter. I will talk more about digital by the end of the presentation.

On Page 10, our gross margin totaled 28%, under this pressure, mostly because of the postponement of the price gap increase. We advocated for this postponement with the government, so with ABRAFARMA our association. We need -- it was a necessary relief for population which was especially in the beginning of the pandemic, it was a very difficult moment, a huge economic sanitary pressures, obviously, we would love to have maintained this for longer, but being affected in which the bulk of the raw materials are imported, we believe two months is a very contribution from our value chain to the whole population. But what matters here in terms of the gross margin is that if the price increase had happened at the end of March like normal, the full gain would happen in the quarter, as we only have -- now we only have one month of gain, it's the May month. But still a big portion of the gain has shifted to the third quarter. It's neutral when you look at the year, but it matters a lot in the quarter.

We have a loss also a meaningful 30 bps that negative net present value adjustment in the margin because of our very high cash cycle, which will also normalize in the coming quarters. So talking about the cash cycle, we have a 25-day pressure versus what would be the normal level. And this is a choice that we made. This is why cash reserve exist so that we can use cash in moments like this to guarantee to our customer, a great service level. So, let's consider here that we have a value chain, that is a very long run, it relies a lot of imported raw materials. We didn't know how the value chain would hold up during the pandemic. So we made the choice here of maintaining very high inventories to support our service levels. The other thing is that there is an operating leverage effect here because we have let's say, new entry towards the same entry that's normal, to the same new entries for less sales. So these are low pressure the cash cycle. And finally, in a normal quarter like this, we would have a very high levels of inventories in the end of March. But at this point in time, the cycle will be already lower than in the first quarter. But because of the pandemic, because of the price increase postponed, we held a longer inventory level for much longer. But the good news is that this level, this 80 days of cash cycle will go back to normal within the next quarters. We believe we'll end the year with a normalized working capital.

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Page 11, talking about operating expenses. I mean here where we had 23% total expenses, a 2.2 percentage point pressure versus last year. And obviously we can't talk a lot about several micro effects, but in the end what matters here is loss of operating leverage is the same expenses with a much lower revenue level, so we lose dilution. So obviously as sales normalize, so will expense dilution. This has driven a big EBITDA pressure of 3.3 percentage point, it's the combination of the loss of operating leverage with the postpone of the price increase which has shifted gains on the next quarter. So all in all, our EBITDA was much lower than a normal EBITDA level.

Page 13, when I talk here about non-recurring expenses, we have BRL2.2 million net non-recurring expenses in the quarter. But there are a lot of ups and downs here, a lot of moving parts. So we used to the grant with BRL25 million that we have already donated to help equip public hospitals in smaller cities outside of the large capitals. These are cities that are again very affected by the pandemic. So our social responsibility towards our communities, we decided to make this BRL25 million donation. On top of the BRL25 million, there is also BRL0.9 million administrative costs related to the donation. I'll talk more about the grant that we instituted. But this has already been capitalized in the fund, and now the fund is the best in this for the hospitals. We also had BRL8 million in consulting expenses related to future projects. Just to make clear -- be clear here, anything that relates to digital will gets expensed normally. So we're talking about other initiatives here.

But on the other hand, we have a BRL30 million net nonrecurring gain related to tax from previous year. So all in all, BRL2.2 million net nonrecurring expenses.

Page 14, BRL62 million adjusted net income, 1.3% margin. And as I mentioned in the beginning, just the fact that we had positive profitability in a scenario like this, speaks loads about the resilience of our business.

Finally, page 15 cash flows. We have a big free cash flow pressure of BRL440 million. Total cash from operation of BRL550 million. If you look at the cash cycle line, this is all there. This is basically high cash cycle. This generated a peaking leverage, which is 1.2 times. So it's not a terrible number even at the peak. You can say it's a low leverage even at the peak, but this number will get back to normality within the next two quarters. And just to finalize here, also -- we have also taken a lot of new credit lines from the market for us to absorb this cash cycle pressure and also to have further cash if we need to invest more cash, which we don't think we will. But we were able to raise that at very favorable levels given our AAA rating. And now we have a big cash reserve.

Next page, we see that the stock price went up like 8.6% but below 21.6 percentage point below the IBOVESPA. Our average trading volume reached BRL200 million per day, it's I think a very high level. And we have just announced that -- just announced yesterday night, we will have our General Assembly to approve our split of our stock. So our idea is to split our share base by 5. This is important because now in Brazil with the very low interest rates, individuals are getting more and more to invest in the stock market. And because there is a minimal volume of shares that they have to buy given a high price, the barrier is very high for individuals. So we believe that by having a lower nominal share

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price, this will allow way more individuals to buy our shares and this will help liquidity and the pricing of the stock as well.

Finally, just summarizing what we have seen here. Obviously this was the quarter, big pressure of 7% in terms of mature store decline, 3.3 percentage point EBITDA margin loss. We saw diminished frequency by the customers, but somewhat larger average tickets. But the good thing is that the net promoter score of our customer has increased a lot in the quarter. So the customer who has seen has appreciated all the adaptations we have made in our stores to service them with full security towards their health. When you talk about the challenges in the quarter, they are highlighted by our 124 shopping mall stores, which were initially closed, then open with reduced hours. But until this very day, they have diminished traffic, even though the traffic is improving. So these impact also penalized our comps by 5.7 percentage points. When you look at the share, the fact that the upscale market suffered more than any of the market because of shopping malls and higher compliance of the social isolation has limited our share gain. And finally, huge loss of operating leverage and other pressures, which explains the EBITDA margin that we had in the quarter.

The great news here is that the third quarter is shaping up to be a pretty reasonable quarter. All shopping mall stores have resumed operation. The numbers are still lower than normal, but they are starting to pick up. In total, we did in July, 13.8% total revenue growth with 0.8% positive at mature stores. But if we exclude shopping malls and then this is really the asset class [ph] to where the business is trending. 19% of growth with 5.8% for mature stores way above inflation, 3.5% real growth. This is really encouraging, and this is something we carry forward.

And finally, when we think strategically, we have been able to leapfrog our strategic plan during the pandemic. And at the same time, we are in a very strong shape. We have very low leverage than a few -- than larger players are suffering. We are probably the only player maintaining an uninterrupted expansion. We are delivering the full 240 new store guidance. I think nobody else opened stores in this space, but even within the space they aim at achieving nobody is delivering what they initially planned, we are the only one. So this gives us a big gap in the year to build up. We opened a new distribution center in Rio Grande do Sul to accelerate expansion into state that has a lot of wide space for us. And finally, we are -- our strategy implementation has leapfrog during the pandemic. We are in a very different place in terms of digital, I'll just give more details. And also in terms of health care.

If we shift to the page 18, we can talk about one of our main strategies, which is the resignification of the pharmacy. So this is what we call New Pharmacy strategy. So this new pharmacy, is a big departure from what a traditional pharmacy used to be. This is a pharmacy that involves a fully digital experience within the store and outside of the store but also turns the store into a Health Hub that can support the community in a lot of ways. So if you start here with the Health Hub, since the beginning of the year, we have applied 0.5 million injection shots in our stores or more than something like 1500 stores do injection shots. We did 12,000 immunization shots. The only reason we couldn't do more is because we had to use part of the inventories for our own employees. And because the licensing for vaccinations is still cumbersome. We have only 43 licensed stores. But this

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number will go up very fast and we want to do more and more of these services. So this is going forward, Health Bub bringing service to the store, this is not a promise, this is starting to be a reality.

The other reality here as far as services is COVID serological tests. We have done since May when we started 225,000 serological tests. If we look only at the month of July, we did 158,000 COVID tests at 800 plus stores with huge capillarity, 213 cities, 22 states. It's important that we -- I was looking recently at the numbers of one of the leading labs in Brazil. I mean, our total testing number for COVID is 75% of what they do, but -- which is already impressive. But if you look only serological tests, we're already one of the leading testers in the Brazilian healthcare value chain, not only across drugstores, we have more than 50% share within the drugstore space. But this testing volume is already very meaningful when you look at the overall healthcare value chain, not only the drugstores.

And we are also seeing telemedicine picking up. We started learning with our own employees so 15,000 consultations for our employees from the Albert Einstein Hospital, which is the most prestigious Brazilian hospital. So we provided free consultation for every single employee and we saw a huge adoption 15,000. We launched the digital solution named Saude em Dia, meaning like -- something like your daily health in which we offer telemedicine services in partnership with Dr. Consulta and Conexa Saude, two of the most sexy healthcare start-ups in Brazil. Obviously, we're still talking about low volume, it's still early days. It's more a pilot human than anything else, but this is already starting to happen.

And another thing that's picking up is digital prescriptions. We just passed in July 84,000 digital prescriptions and something like 10% of the controlled medicine sales has already been done with digital prescription. So this is significantly picking up. When we talk about digital, as I mentioned before, 7.6% total percentage -- of the total sales 7.6% of the retail is already digital 7 times growth versus first quarter last year. We see that digital customers spend way more and have a higher frequency than normal customers, 2 times spending, 1.3 times higher frequency. And again if you look in our main markets it's double-digit everywhere. And our top markets in digital penetration, it's almost 20% digital penetration already.

When you think about omnichannel not only we have Click & Collect in every single store, and has been so since 2018. We also introduced in the quarter free neighborhood delivery to 100% of our stores. So this is our own store people doing pedestrian delivers up to 500 meter radius of the stores. We deliver in 1 hour already in 22 cities and in 4 hours in an additional 49 cities. And we have 345 stores like mini DCs doing ship-from-stores all over Brazil. So this has significantly accelerated during the pandemic. We are taking full advantage of our capillarity. The main assets that we bring here to the digital space are nearly 40 million digital customers than our -- and 2000 stores as a hub for customer acquisition and then the capillarity 2000 stores. So the bulk of the transactions if the customer picks up at the store or we deliver without paying delivery fees or without charging delivery fees with our own personnel.

And then when the store -- when the customer is more than 500 meters away, then we do motorized delivery, but who have much shorter route given the capillarity that we have.

This is a very big advantage. And finally, we have a nearly 4 million app downloads in total, 1.4 million only in the quarter. So the ratings of our apps is increasing a lot, both in the Google Play and App Store. And digital is already picking up within the store. So in our exclusive offers that was smart coupons. We now have digital smart coupons and the digital smart coupons have increased overall smart coupon penetration by 50%. So people are using the app already inside the store, and this will further enhance as you add all the functionalities.

And finally, we're preparing the launch of Stix, our joint, our coalition loyalty program together with GPA, Grupo Pao de Acucar. This will happen in the fourth quarter. And why is it here? It's here because this is another driver for app usage and forecast digitalization.

And finally, as you know, we have a very strong purpose, but it's in times like this that we get to walk the talk. So taking care of our team, our costumers and the communities we serve has never been more important than in this quarter with the pandemic happening. This is not the first pandemic we go through. During the Spanish flu 100 years ago, Raia was already working to support our customers and my great grandfather made a name for his own during that phase. So things we have done. First thing is taking care of our team, guaranteeing they are safe and healthy, with very stringent safety protocols within the stores and DCs. We also introduced home office for our administrative staff. We put on paid leave any infected or risk group employee or people who have a risk group relative at home for example.

And even in the cases in which we put them under the government paid leave, we supplemented the income to guarantee their full income. Any hospitalization costs related to COVID were paid by us, regard even for employees who have opted out of our health insurance, we offer health insurance for everybody, obviously, they have a co-pay. So some people, they don't adhere to their health insurers, but even for these people who needed the hospitals, we paid for them during the pandemic. Every job post was maintained. And as I mentioned, we offered free telemedicine consultations for every employee. Albert Einstein Hospital is not any hospital in Brazil, this is the main hospital in Brazil. This is probably the one of the top hospitals in the Southern hemisphere. This is where my two children were born. This is where I had gallbladder and high ankles surgeries this year alone.

If you find, if you are in ambulatory in Brazil, this is the place you want to go, and this is the kind of service we are offering our employees. In terms of our customers, obviously this whole protocol thing also translates to their safety for them to -- for the stores to be a safe harbor for them. So full separation between them and employees, special hours for seniors. We accelerated the health services already mentioned not only the Saude em Dia and digital solution but with telemedicine, but also the COVID testing for example. And finally we instituted a grant named Todo Cuidado Conta which means every care accounts. We donated BRL25 million, so it's a check that has already been cashed to our pre-existing fund. But we manage this grant, we have a team involving our executive, some external people. And this is focused on supporting hospitals, which either public or beneficial hospitals who serve people for free as part of the Brazilian Public Service, Brazilian Public Healthcare System.

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So we are supporting hospital in faraway cities, far from the main regions in very vulnerable cities. We talk right now BRL16 million has been already invested, 33 hospitals were already equipped, each hospital in a different city in 14 different Brazilian states. And this is something that will leave a legacy in terms of the health equipment in these areas even after the pandemic have seized.

So these are the prepared remarks. We are now open for your Q&A. Thanks.

# Questions And Answers

## Operator

Thank you. (Operator Instructions) Our first question is from Mr. Joseph Giordano from JP Morgan. Sir, you may proceed.

## Q - Joseph Giordano {BIO 17751061 <GO>}

Hi, guys. Good afternoon everyone. And thanks for taking my question. So I have like a question on the expansion plan of the company, it remains like at a very steady and robust pace of 240 stores. So here like from your past experience, so for us I like to understand how do you see the competition for similar locations playing out because probably with the recent market movements we may be seeing some of the regional competitors trying to re-accelerate their expansion plan.

And the second question is like concerning the construction of those locations. So, I remember that in the past you guys had a very high conversion of like whatever was constructed on the street versus what was really approved to be open. So here like I would like to get like an update on how this is looking like the approval rates and how -- what's the anticipation that you have like to prepare for it to open. So basically like a store likely 55 stores that you opened this quarter when were they actually perspective? Thank you.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay, Joseph, thanks for the question. I mean, if we look at our market over time, I think we have seen different cycles. So we saw cycles, let's say, from 2004 -- 2014 to 2017 in which there were a lot of players growing, but you have always to remember that this is not a zero-sum game. We have a market that grows at a double digit based on the age of the population. So in those times, we saw a lot of competition. We saw a lot of guys grow in different regions of the country, but we were able to balance supply and demand. And if you look back we had neutral mature store, real mature store sales. So every year, our mature store sales was around inflation and we grew our total margin especially based on the gross margin. Then we got to a really different cycle in '17 and '18 in which we saw a huge acceleration.

So we saw Extrafarma opened more than 100 stores come into Sao Paulo, Pague Menos opened 180 stores, then several, the DPSP opened130 stores. So we saw a huge accumulation of openings and a big concentration of openings in Sao Paulo. So obviously

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that was a valley moment for us. But we took advantage of that scenario to respond with crisis. And so we were way more conservative in prices and we became all of a sudden very aggressive and we maintain that aggressiveness up to this date. But obviously these expansion was short-lived, as you know, it's not easy to expand, entry barriers are very high for any player in a market in which the brand is not well known. These fast expansions committed a lot of mistakes.

So we are now in a completely opposite cycle. We are now in a big cycle, in a peak in which both this year and last year, we opened more stores alone that all our competitors combined. But obviously, this is not the normal situation. What's happening now is a balancing out of the previous years. So it's a clean-up of expansion mistakes, closing stores, stopping grow and et cetera. I think what we'll see from next year onwards we will be more like the early years '14 to '17 then like what we saw last year. For example, the numbers even Pague Menos promised is not the numbers, is not the 180 they opened, DPSP they opens very less stores than any peak of 130. Extrafarma is not opening any store right now.

So, yes, there'll be some more stores, maybe 40 more stores that prevail, maybe Pague Menos gets back to around 100. But I think these are members that can be well absorbed by the market overall. So this is one thing. The other thing is that Sao Paulo is probably very protected right now. Sao Paulo is a very difficult market for whoever doesn't have a strong brand here. It's an amazing market for us and DPSP. But it's hell for any other player because we have here maybe the two best players in the industry, playing at home here with very dense store networks, very high service levels. And Sao Paulo is such a huge city that you open 40, 50 stores and nobody knows you. You need 200, 300 stores to get noticed in a city like Sao Paulo.

So Sao Paulo has huge density areas and I don't think we'll see any major expansion within Sao Paulo. And given that this is our home market, when we are well protected here, even if you have to fight based on prices, we are able to do so any of the market and balance it out. So at any point in time, there are movements in which we are reducing prices in some places, we are increasing prices in some other places when Sao Paulo is out of that math, it's very easy for us to balance it out.

And finally, when we think about expansion, let's not forget that we have an average mature store sales outside of the pandemic, north of 800,000 per mature store, nobody has that. And we have maintained that as we have expanded organic at a place that nobody did that as well. And why that? Because we measure cannibal not only the quality of the new stores is amazing but we manage cannibalization, we know how far we can go in terms of cannibalization and when it's time to stop in a certain region and start in another region.

So that all these guys whereby huge challenge of growing because they're all regional players who doesn't have brand awareness outside that and doesn't make money outside of their home markets. And they already have huge density their home markets in which cannibalization gets very dangerous to see. So these expansion with these kind of high profitability, high returns, I mean nobody up to now has been able to replicate. And as you know, a lot of guys have tried.

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Right now we don't see any big competition for locations, but again I think we will get to a reasonable level. I'm not -- I don't think we're getting to the 2017, 2018 levels, I think it's more than '14, '17. In terms of prospection, I mean right now, the prospection for the year is over. We are already in fiscal year 2021 as far as prospection. So the stores are all set, the contracts are all there, we're already licensing all the stores. And we are already building the pipeline for next year. Someone who starts today to build the pipeline, will probably start opening a meaningful number of stores in the second semester of next year only.

## Q - Joseph Giordano {BIO 17751061 <GO>}

Perfect. So a couple follow-up questions if I may. So the first one you mentioned like price investments in the recent past call, where the recent market share. So if you could provide an update of what's your average price gap to competition on like on a regular markets, that would be highly appreciated. Thank you.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Joe, it's very difficult to generalize, because you have a lot of markets, you have a lot of different situation. But the investment that we make, we maintained, we still go back on it. So we have -- if you compare us to any drugstore chain, we have very, very competitive prices and we are monitoring that on a monthly basis, we are adjusting prices whenever it's needed, so that's another difference. I mean today, even if it's higher competition, we are way better equipped price wise to deal with it than we were in the lifecycle.

## Q - Joseph Giordano {BIO 17751061 <GO>}

Perfect. Thanks.

## Operator

Our next question is from Irma Sgarz from Goldman Sachs. Irma, you may proceed.

## Q - Irma Sgarz {BIO 15190838 <GO>}

Yes, hi. Good afternoon, and thanks for taking my questions. Just a quick follow-up on comments you made earlier, think about the mall-based stores. If you can just elaborate a little bit on how you've seen the pickup there and how that impacts potentially the negotiations that you're having with the mall operators in terms of rents, because I guess a bearable rent is coming back at the current moment when the stores are open.

And then the second question is just in terms of fulfillment model, I feel you're very well set up at the moment in terms of fulfilling the digital demand. But if you could maybe elaborate a little bit more on what you're envisioning for the next couple of years? What you may need to do to keep up with the digital demand in terms of fulfillment system network. Thank you.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

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Okay, Irma. Thank you for the questions. I mean obviously the toughest moment was the month of April in which all the shopping malls were virtually shut down. So we have zero sales. Then at some point, they started reopening, but also with very short working hours, very little sales. We were able to renegotiate all the rentals. And so obviously these rental savings was an offset. But when you look at the P&L, we didn't fully offset. These shopping mall stores today they operate at a loss, but it still is better operating than not operating, because the employees are there, who'll get to pay some rental. And in the end, we have to focus on service to customer. But it was a very difficult quarter for the shopping malls, it's picking up but it's not there yet. But so in the end, if you look at the performance for the freestanding store, it's already great. So the only doubt that we have from now towards the year-end is what kind of penalty you will pay on the shopping malls. By the time the third quarter, I mean we have 5% freestanding store comp, mature store and plus one even including the shopping malls. I mean, August is even slightly better than that. So we'll see where we are during this quarter. I don't think we'll be mature stores consolidated that inflation, but maybe it's matter that the 0.8% we have now you see. But maybe in the fourth quarter, we can be at or above inflation. The question is how much of the shopping mall demand will be back. But it's only getting better, even if it's not there yet. But if the shopping malls are fully normal by Christmas, for us that will be amazing.

## Q - Irma Sgarz {BIO 15190838 <GO>}

Great. It makes sense.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

In terms of the fulfillment, and I have to break this into two parts. One is the inbound logistics from DC to the stores, then the other is the digital fulfillment. So today we are getting back to 11 DCs. We closed one in Sao Paulo, but we will be opening one and we're opening another in Porto Alegre. I think all the main markets are already fully serviced, may be at some point we get another DC in Para. But it doesn't look like we need nothing beyond that. But obviously, as far as we open new store as far as demand increases, we will have to do something with capacity, even if it's not opening a new DC, sometimes it's expanding the DC, it's increasing further automation in DC or even moving from a new DC like we did in Rio last year.

But we are very well setup. And what's important is that, the DC is not only a cost issue because obviously, let's say we have today X many stores in Rio Grande do Sul and we aim to open other stores. It's easy to make an argument about expenses, having a full cost in Rio Grande do Sul, we're also sending from Parana three days a week for example. But the thing is, when you think about the very south of Rio Grande do Sul, it's too far away from Parana, even for us to get there. And the other thing is that when we get a DC in a new market like we are doing now in Rio Grande do Sul. So like we may do probably Para in the next two years. It's -- there is another consideration which is shifting from three days a week to daily replenishment to 6-day a week replenishment. And if you look at our inventory and our store demand, there is huge variability per SKU per day. So even if you have a lot of safety inventories, when we ship in three days, if a customer goes there and cleans up some items from the shelf, it may take a week lead time up the product to get replenished. So our experience shows that when we have daily replenish, you buy today, tomorrow, it's coming the other day, it's already in the shelves.

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So the quality of the response is much better. So the service level is much better and this helps comp growth as well. So we're getting that to Rio Grande do Sul, at some point to get that in Para as well. In terms of digital fulfillment, our model is based on the stores. I mean, -- and that's just -- and let's think just for a minute. I mean, this is a market in which pure-play has failed miserably. The only -- there was a pure-play player that has been out of the market for at least two, three years and even Onofre that we bought last year. And as we close the stores, it became a pure-play brand without the support of the stores, it only go south. So even Onofre is dated as a brand. But Onofre was 40%, 50% of the demand -- digital demand when we bought, today is less than 20% of our digital demand and it will progressively unveil and then go down at some point it becomes Raia Drogasil as well.

So why is omnichannel so important? Two considerations here. Customer acquisition and cost of service. When you think about customer acquisition, 90% of our digital sales are originated by us at our stores. Only 10% is super apps, like Alipay for example and like James. So, we own our demand, this is hugely in quarter. And because we have the stores to originate demand, we don't have to pay Google. And rental, store rental is way cheaper than rental. So any field player or any retailer who is trying to do digital in a new market who doesn't have a customer base, who doesn't have a big network there, we will need Google, we will need Facebook in order to grow and this is hugely expensive. And this is an economics that it's impossible to bear.

The other aspect is that we have 2000 stores to service the customer. So a big bulk of the digital sales that picked up at the store by the customer because the store is so close or delivered now by foot from a store employee was almost basically pre-existing cost. So the shipping cost we collect is zero. The shipping cost of pedestrian stores is minimal. And this is the bulk of deliveries. Then even the motorized deliveries, they are being delivered from a store to a close by neighborhood. So our delivery cost is way lower than someone who has one mini DC or a bunch of stores doing that. So omnichannel is the only viable digital solution here. And you can only win in markets where you have a store network and you will have these customer acquisition based on stores. So our efforts coming forward, I mean we are not doing and now that you see to service the demand, we are putting more and more stores to service the demand as the demand grows.

So today, we aim [ph] we have more than maybe 20 stores, we have probably 2 stores servicing demands. As demand increase, you'll have 3, we'll have 4. We can even some day have our drugstore there, take us more store and put just for digital. But it's -- the solution is within each label. This is what we believe. And this is what allows our margin in digital to be pretty similar to our store margins.

## Q - Irma Sgarz {BIO 15190838 <GO>}

Great. Very helpful. Thank you, Eugenio.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Thank you.

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## Operator

Our next question is from Guilherme Assis from Safra. Guilherme, you may proceed.

## Q - Guilherme Assis {BIO 16143141 <GO>}

Hi, guys. Hello again, thanks for taking my follow-up question here in the English call. Eugenio, I'd like to explore a little bit more on the -- in all the store formats that you have in the low-entry level stores that you're -- like building now. How do you reconcile these stores like with the digital strategy and the service strategy that you have like will these kinds of stores like they can offer the same level of service, as you know, like the premium stores? That's the first question.

And second, I think, I made the same question prior to this call, just wanted to be more clear on that. Like, what -- how there is this entry level store, you know, increase the type of city that you can tap like in terms of inhabitants like for instance for a regular premium store, do you have like a minimum capital city like a 100,000 people or 50,000 people. And for the entry level store, how far lower can you get? Can you get like 35,000 people cities, is there like a rule of thumb that we can assess the potential of these new stores? Those are my questions. Thank you.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay, Guilherme, thanks for the questions. So I'll start with the first one. If you think about digital in stores, these are the two faces of the same coin. But the difference is that obviously we're not the only retailer talking about omnichannel these days. The question is, who is not. But in most cases, the store supports the site or the marketplace. In our case, as I mentioned is the opposite. You can leave based on a website, you have to leave based on the stores. So the digital complements the store. And this is true across all income segments.

So digital is not only for the A-Class, B-Class, C-Class, we have a big focus on the emerging middle class already, as I showed in the presentation. And digital is very important for all of those segments. Same thing with health care. The things we're discussing about health care, I mean, we are not discussing to put a big clinic inside the store like CVS for example, that's not it. We want to use digital to help the customer, help journey, maybe that we already have in stores, some dedicated area for vaccinations, for injection shots, maybe you can do telemedicine within the store because you'll be able to do telemedicine from our app. We will have point -- we already have point-of-care exempts like COVID testing. The numbers we did in COVID testing are huge and they are everywhere. We are serving COVID test in obscure stores, low income stores in every store segment.

So, the value proposition is the same, where but the implementation may be different. Obviously the demand can even the service is there maybe will have a higher demand in upscale or in the low scale. If you think about A-class has health insurance, the A-Classes are already much better serviced. It's the emerging middle class with the telemedicine and these kind of things. So they can be enablers for this format going forward. Our vision for low-income format, I mean this is not about accelerating organic expansion, this is

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about sustaining this very high pace of organic expansion for much longer. This is what we believe.

But the popular store format, it relies on store density. So when we think about a popular format, we are not thinking about a small city. The problem in the small city is that the shopping density is very low. And the popular store, they ain't lose it, because they can sell less, we are having 500,000 per store there. The 500,000 is a volume, probably similar to that of the normal store, just the price is lower because it's more generics entry level kind of products and so on. So I don't think that this is not right now that the popular store solves the puzzle for smart cities. But it certainly does solve the puzzle for popular areas in high identity metropolitan regions and this is what we're doing now better and better. We already have 25 very popular -- super popular stores. And almost 500 popular stores, they are twins, I mean, obviously, one is a more simple in terms of fixtures, is more extreme in terms of popular and mix and so on. But in the end, our execution in popular stores started working out when we had the lines of pharmacy to retrofit them. So, they are similar, but obviously one takes it to another level, but I think they expand the market but mostly in the large metropolitan regions.

## Q - Guilherme Assis {BIO 16143141 <GO>}

Okay. I think it's very clear, Eugenio. Thank you.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Excellent. Thanks.

## Operator

The next question is from John Ferreira of Nau Security. John, you may proceed.

## Q - John Ferreira {BIO 17531063 <GO>}

Hello, Eugenio. Just a very quick question. Your new distribution center in the south in Rio Grande do Sul, could you give an idea of how many drugstores that particularly drugs -- particularly DC can support?

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay, John, thanks for the question. If we look today, we already have in Rio Grande do Sul, 47 stores, then we are accelerating, we should do this year alone more than 20 stores alone in the area. So I would say the -- and maybe there are even stores in the south of Santa Catarina, there may be better service from the Rio Grande do Sul, than from Parana. So it's like you split Santa Catarina and part of those stores get serviced by Porto Alegre. This, I would say the initial balancing of this DC is for something may be like 150 stores. But this is something that can be expanded if we need when we need, either by adding more area or by adding mezzanine or by for the level of automation.

## Q - John Ferreira {BIO 17531063 <GO>}

Great. Thank you very much.

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## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Great. Thank you.

## Operator

(Operator Instructions) It appears to be no further questions. Now I will turn the conference back to the company for their final remarks. Please sir, you may proceed.

## A - Eugenio De Zagottis {BIO 7193695 <GO>}

Okay. So I'd like to thank you all for attending this call and for your -- for our shareholders and for the long-term ongoing support. As you know, this is a very difficult quarter with very low sales due to the pandemic, low margin given the loss of operating leverage and the gross margin pressure with the postponement of the price increase. But, I mean, in the end, in the biggest scheme of things this quarter doesn't matter, because this is one in a lifetime quarter. And there are no lasting impacts on us. Even the leverage is not a lasting impact, because we have very high cash cycle which should normalize.

So what's the loss of EBITDA or net income in the quarter, it's nothing compared to our valuation compared of our -- the size of the company. But what does matter I think that some of the things we talked earlier. First, the fact that we already seen in July the freestanding stores 5.8% sales, the mature store growth. This is 3.5% ahead of inflation. And this is something that we carry forward and shows the structural strength of the company. And even if you put the shopping malls, it's plus one mature store, versus 2.3% of inflation. So this quarter, the next quarter will be already much closer to normality and maybe the fourth quarter could be a fully normal quarter depending on the shopping mall or even a better than normal quarter if we maintain a 6% or something like this, with shopping malls normalize -- fully normalized. Don't know if it will be the case, but at least there is the option.

So these are the lasting signals that we should look to. Because this is what shows where the company is going, where we are, how healthy and strong we are. We are coming from this crisis in a very strong pace, so we have fully controlled leverage and we get back in two quarters to our normal 0.7%, 0.8%. While a lot of players around the market, they are still very leverage and feeling the pains. Even though we are seeing IPOs taking place, it's only a handful of companies in the market that are IPOing or can dream about an IPO.

The largest majority is suffering and no perspective of getting new capital injected on that. We are the only -- not only we are the fastest and most consistent expansion in our market in Brazil, but we are the only untouched expansion completely unhindered by the pandemic. So when you look next year, that the gap between us and all the rest will have been accelerated. And on top of the -- these strong vital signs, I mean, we are now starting to see our new strategy, what we call the New Pharmacy strategy fully up and running with a store that delivers a fully digital experience inside it, that allows customers to order from whatever channel they want, it can be app, it can be website, mobile site, it can be call center, it can be social net or directly to the store, doesn't matter. And then they can choose if they want to pick it up, if we can deliver by foot from a close by store, if

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we deliver in 1 or 4 hours on another store, if they need a next day delivery from a DC because it's a much bigger order and it maybe don't have the full inventory at a store.

So we have all these mix and match capability in terms of ordering channels and fulfillment processes to serve the customer. What we bring to the table here in terms of digital is absolutely unique. It's a combination of 2,000 stores through national capillarity with 40 million customers and the store is the best customer acquisition machine anyone can dream about. So this is only year [ph] one can have, you can only do claim collect if your store is close to the customer, you can only do neighborhood delivery if your store is close to the customer. And these models are the bulk of all our digital fulfillment. So they differentiate us from any other players in this industry, also with investments we're doing in agile, the improvement we're seeing in the functionality of our apps and I mean in the end of the day, just the sheer scale that we have, the sheer financial capacity that we have and management team that we have to support these strategies, I mean it's absolutely unique in the industry.

And likewise, when I think about health care, more and more we will evolve into someone who the customer see as a partner in taking care of their health and not only supporting in all their health journey that gives the treatment, but even things like telemedicine, exempts and so on, that became very clear in this quarter and they are only growing, going forward. So I'd like to thank you all for attending, for your support. We don't have any upcoming conferences on our projection basis. I think all of them have been canceled. Maybe we're taking part on some virtual conferences, but anyone who needs to catch up with us, we can schedule a video conference, okay. Thank you very much. And keep safe in the pandemic.

## Operator

Raia Drogasil People Health and Well-Being Conference Call is finished. You may disconnect now. Have a nice day.

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