Q2 2018 Earnings Call

Company Participants

- Eugênio De Zagottis, Corporate Planning & Investor Relations Officer
- Marcílio D'Amico Pousada, Chief Executive Officer

Other Participants

- Joseph Giordano, Analyst
- Luciano Campos, Analyst
- Thiago Macruz, Analyst

MANAGEMENT DISCUSSION SECTION

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 Second Quarter of 2018 Results. The audio for this conference is being broadcast simultaneously through the Internet in the website, www.rd.com.br/ir. In that address, you can also find a slide show presentation available for download. We inform that all the participants will be only able to listen to the conference during the company's presentation. After the company's remarks are over, there will be a Q&A period. At that time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of Securities Litigation Reform Act from 1996. Forward-looking statements are based on 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 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. Marcílio Pousada, CEO; Mr. Eugênio De Zagottis, Investor Relations and Corporate Planning Vice President; and Gabriel Rozenberg, IR and Corporate Planning Director.

Now, I would turn the conference over to Mr. Marcílio Pousada. Sir, you may begin your conference.

Marcílio D'Amico Pousada

Okay. Thank you. Good afternoon, everyone. Welcome to presentation of the results for second quarter 2018 earnings. As always, Eugênio will present the numbers. And then we'll highlight some (02:22), okay. Eugênio?

Eugênio De Zagottis

Hello, everybody, and welcome to the RD conference call. This was a challenging quarter for the company still with disappointing revenue growth and the loss of operating leverage pressuring the mature stores, so this has an effect in our markets. As painful as we think this market has been we believe that this environment is very important in driving consolidation for the market and making us stronger for the medium- and long-term. It's important to mention that when you compare us to competitors and I think the numbers that should be reported by other drugstore chains and wholesalers on the next quarter, I think they will point that it was still very strong on a relative basis, so this environment will position us to keep consolidating the market and driving value creation.

So we ended the quarter here with more than 1,700 stores; we opened 62 new stores and closed five stores. Gross revenues reached BRL 2.8 billion, 11.6% of growth and same-store sales growth was 2.5%. Gross margin amounted to 29.1% of gross revenues, a 30 bps pressure mostly because of the low inflationary gains. Our EBITDA reached BRL 316.6 million. This would be less 8.4% of EBITDA margin and an increase of 5.2% in nominal terms. Net income reached BRL 142 million, a net margin of 3.7% and an increase of nearly 3%. Cash flow amounted to BRL 68 million negative in the quarter, free cash flow with a total cash flow of BRL 154 million negative. And finally, we entered the State of Pará in this quarter with three stores in Belém. We believe there's a huge opportunity there to fill the gap left by Big Ben (04:26) in the market.

On page 4, we can provide more details in terms of store development. So we opened 62 stores in the quarter and closed five stores. We maintain a very robust performance for the new stores, which is absolutely in line with historical standard. We are recreating the guidance of 240 new stores both from this year and from next year. We believe that the challenges that we have, they are conjoint to our challenges. They're not structural challenges and we're still very positive in terms of the expansion. We believe the expansion will remain a major source of value creation for RD. We ended the quarter with 26.2% of stores still in the maturity stage. On page 5, we can provide also details on our geographic footprint. As I was mentioning, I think one of the main highlights here is our entering into Pará with three new stores.

We have seen great initial results, so we are very optimistic about this market. As Big Ben closed all stores and Big Ben was the leader and best operator in the state, we believe there is a huge gap to dispute and we think we have a great chance doing that. We have 20 other locations already signed and we're still looking for more stores here. We ended the the year at São Paulo with a total of 926 stores. Here in the bottom of the page, we highlight how our growth strategy, which was hugely concentrated in São Paulo until the end of 2015, started becoming more decentralized since 2016. So in the second quarter of 2016, we had opened 125 stores in the states out of a total 196 stores, so nearly two thirds of the stores were in the sphere of São Paulo.

So quarter-by-quarter, the number of new openings in São Paulo has fallen down and new opening in other states has gone up. So in this quarter when you look on a last 12 month basis, only about a third of the stores were open in the state. Two thirds were open in other markets. So this is a transaction coming as a result of the fact that we have a true national platform in which we make money in a very consistent basis in every market in the country. We're the only chain in Brazil who can claim to have a national profitable presence, nobody else, nobody else can say that. All the other chains they make money in their native locations and native regions but when you look at the expansion they don't make money in virtually any region. For us we have a full national platform, which we have been taking advantage for the last two years. This is not a quick-fix as a response to increased competition in São Paulo which is indeed happening. This is a strategy that has been unfolding for two years.

When you look at the market share, we gained 10 bps on a national basis and lost 80 bps in São Paulo. We believe one of the explanations for the share loss in São Paulo is exactly the growth decentralization. According to IMS, in the second quarter of 2016 we're opening our expansion share was 10.9% in São Paulo, meaning of every new stores opened, 11% of them belong to us. Now, this is only 5.7%, primarily because we have decelerated the growth in the same, but to some extent also because other players have accelerated growth here in São Paulo. So (08:28) our share loss, I think to some extent is a self-fulfilling processes since we have decelerated growth here. But what I like to point out is that the magnitude of the share loss has been amplified by criteria adopted by IMS which creates life and I'll show why on the next page.

If you look here on page six and our focus here on the bottom of the page, on the real growth, this chart depicts the annual growth at each quarter of Raia Drogasil when compared to the other large chains who are part of Abrafarma, and when compared to the total market. We can see that RD has been well ahead of everybody, but Abrafarma and to this quarter was growing almost in tandem slight ahead of the average of the market. This quarter something very different happened. We see that Abrafarma also decelerated on a real basis, but the average of the market went up.

Abrafarma including our G accounts for nearly 50% of the Brazilian pharmaceutical market, I think 45% or 46% to be precise. So if the average has accelerated, but the large chains are growing below, what this means is that the growth is coming from small chains and independents. But the problem here is that while large chains report real demand for IMS every month, the data that IMS captures for small changes in impairment is selling the data from wholesaler. In April, IMS reported unprecedented market growth of 17%. So in our view there is a big selling pitch here, distorting the number.

I think in the next quarter this should become clear, so we'll see how it happens. But obviously, there is share loss in São Paulo, mostly from the decision to decelerate our growth here, but to some extent also we can see competitors opening stores here. We can ask if those openings are sustainable or not. We have our opinion on that. But growing less here is a decision that comes from opportunities in other states.

On next slide, we highlight the revenue growth here. So we grew 11.6% of top line in the quarter. The retail operation grew 10.6%, while 4Bio grew 36%. So 4Bio keeps growing at a very fast pace, and also with much better results as we have seen in this quarter, and I'll talk about them later. When you look category-by-category, the main highlight has been OTC, which has grown the share in the mix by 140 basis points. It's important to highlight that the switch from brand, from products of previously Branded Rx and now have become OTC, accounts for 40 bps out of the 140 bps. But still despite that, OTC is doing really well.

When we look at Branded, Branded lost 70 bps, but 40 bps is due to the switches. So if you discount the switches, branded has been almost flat, it's only 30 bps pressure and has been in line with the previous quarters. Generics has grown 3.4% in terms of revenues. But if you look at volume, the growth has been almost 14%, which you believe it's a very good number. These reflects proactive investments by the company in terms of pricing and mix for Generics to make us more competitive. This has been going on for a couple of quarters. And the best thing is that we are investing prices, but our margins are still constant, because we have been able to gain, to have all the commercial gains.

We have been able to compensate some of those investments in regions and categories where we don't have pressure. So we are not in contemplative mood in any format like this. We are being very active in terms of managing the company and to expand to the environment that we have. So in a couple of quarters when the comp base stays low, and this comp base (13:03) these volume growth we see now in Generics will translate in revenue growth as well. So this is a good thing for us.

On (13:15) of the 11.6% consolidated revenue growth, 2.5% has come from the same-store sales growth. Mature stores fell by 1.4%. There is a positive calendar effect of 60 bps in the quarter. But there is also a negative 60 bps seasonal effect from the World Cup. So in the end, seasonality and calendar they net off and the real impact is 1.4%.

On page 9, we see the gross margin has fallen down by 30 bps. Out of the 30 bps, 20 bps relates to lower inflationary gains on inventories, because the price increase this year was somewhat lower than last year. So it's a 20 bps impact on the quarter, but this is almost nothing when you look for the total year. So on a structural basis, the margins fell down by only 10 bps. There is also a 20 bps pressure from 4Bio. 4Bio has lower margins, so when it all grows retail, this will press gross margins down, but there is also 10 bps in other commercial gains that we have obtained. Finally, we see 1.7 days of cash cycle pressure, of which 1.4 days is coming from receivables. The fact that the month ended in June increases the balance of receivables, so this should normalize next quarter.

On page 10, we can see there is a rehiring pressure at the expense level, and this pressure doesn't relate to expansion efficiency. This is really the reflection of a loss of operating leverage if our mature stores are fading 1.4%, are decreasing by 1.4%, there is less revenue structure of the expenses. So the total expense pressure has been only 20 bps, but then we can break this now. So labor represent 30 bps of pressure, rental 10 bps, logistics 10 bps, and new stores and other 10 bps. So these pressures were mitigated by a G&A dilution of 20 bps, and by dilution arising from the 4Bio growth of 10 bps.

So all-in-all on page 11, we see that our EBITDA amounted to BRL 316.6 million in the quarter. This represents 5.2% nominal growth versus same quarter in last year, and this implies a margin loss of 50 bps. But it's important to mention that 20 bps relates to inflationary gain or lower inflationary gain on inventory. So the structural margin loss because of the revenue momentum has been only 30 bps, which I don't think is a bad number considering how weak the top line has been. We see that if you consider only the 1,600 stores that we had in operation since the 2Q 2017, we have seen here an EBITDA margin of 8.9%. So there is a pressure from the stores to shorten our numbers. The retail business is 8.6% of EBITDA margin and 4Bio is 3.1% of EBITDA margin.

On page 12, net income amounted to BRL 141.8 million, 2.8% nominal growth and a net margin loss of 40 bps. This relates to the EBITDA margin pressure offset by taxes, but there's also a big (17:07) here from non-recurring expenses. We had BRL 6 million in non-recurring expenses. We have basically almost BRL 10 million of consulting expenses related to our Strategic Planning that takes place every five years. But there is also BRL 3 million in tax credits from previous year, which is partially offsetting that non-recurring expense.

On page 13, we see that the free cash flow has been very similar to the second quarter last year, BRL 68 million negative with a total cash flow of BRL 154 million also close to the BRL 134 million we saw in the second quarter last year. Any quarter, when you compare year-to-date, (17:54) fourth quarter is the best quarter in terms of working capital. So, generally, Q1 to Q3 when you compare to Q4, there is a pressure, Q4 to Q4, then it's a more realistic figure. And what distributes there will be some pressure in terms of free cash flow.

Finally, on page 14, we see the performance of the stock. So, our share has fallen 37% year-to-date versus a fall of 5% for the Bovespa. Obviously, when you look to the IPO, the cumulative gains are very stagnant.

I will now pass to Marcílio, and then I'll be back to provide some IR highlights and then for the Q&A. Thank you.

Marcílio D'Amico Pousada

Okay, Eugênio, thank you. Just to report the short-term achievements to talk about the results. We know how difficult is to make good results when we have this momentum in sales, and we believe that we have the cycle for this quarter, maybe next quarter also. And we did a very, very good job in the past to increase the productivity in the stores. Even we have this very good productivity in the stores, we achieved the best number (19:11) number this quarter is very, very good for us.

Let's talk about our short-term achievements. We entered Pará. Pará is the first market in the north area with (19:23) together, okay, reduces start very, very good. We believe you can do the same result we did receive and to receive we have 20 stores opened to-date of this year. We (19:38) the second player in the market is very, very quickly. We have to focus on A/B customer again, okay.

The other good thing which changed our pricing strategy in generics is, we saw a very, very good elasticity in price. And we presented our gross margin and we present all store total increase our average ticket. This is good for us, and it could bring for us more customers in the future.

We started to accelerate our digital strategy. With all the stores with a good recollect, the customer can buy by Internet or for us for in the site and completed a store, no network, the product is ready for the customer. This is doing very, very well. And this show for us that the customer is ready for the digitalization to start to the migration asking and using the app and they use the Internet also. And it starts to (20:46) delivery services in 15 guest house and we believe this will be very, very important for the future. We have planned to put this in more major cities in Brazil.

We expect the results of this quarter. We are very, very optimistic. And we know that our strategy is only long-term and created very long-term, okay. If you look at our sales. If you look in, we had, for 2016, 60% of our sales made from São Paulo, right. At the end, it will be less than 50% of sales in São Paulo area. This proves that we set a national chain. We're the only player in this market that had a national chain which help us to fight against the competition like our share gain, okay, city by city, territory by territory. Then our performance for the new stores is very, very strong.

When we take the decision to open less stores in São Paulo, open more stores in north and northeast, this helped in the results of the company and you can see the same quality in your stores. You then see the same kind of competition. The competition still have the stop-and-go strategy, to open large stores and then broaden and try to (22:11), okay. Then this is very, very important for us in the long-term vision.

The other thing that can help us is the Generics. We did a lot there in other countries. And Generics took a very, very good role in to help the consolidation of the market. When it started to decrease the price in Generics, and if you look at various markets through that, this can help us to bring some competition out of the market and help us to consolidate the market in the future also. Then, despite the results in this quarter, we are very confident that we have a great value in the company in the future.

Right now, Eugênio will talk about our IR activities and then we'll be here for the answers.

Eugênio De Zagottis

So, first thing is, the date for the third quarter release will be October 30, and we have the RD Day for this year already scheduled. It takes place in São Paulo on October 11 in the same venue we did last year at Vila Bisutti, and it's to start at 8 AM. So, obviously, we always have huge local attendance, but everyone who can make the commitment to come from the U.S. or Europe and can be here, I think it will be worthwhile and we are in the middle of strategic planning process and our idea is to provide some visibility on the strategies for the next four, five years during this event. So, I would highly advise anyone who can make the effort of attending.

And finally, we have three upcoming conferences in which we'll be presenting. So, on August 22, we'll be at the Healthcare Checkup by JPMorgan in São Paulo and then we have two conferences one in Europe, one in the U.S. So, September 10 to 12 we'll be in the Morgan Stanley Conference in London. It will be myself and Gabriel. And finally November 13 to 14, Marcílio and Gabriel will be presenting at the CEO Conference at Bradesco in New York.

So, now we're ready for your questions. Thank you very much.

Q&A

Operator

Mr. Thiago Macruz from Itaú would like to make a question.

Q - Thiago Macruz {BIO 16404924 <GO>}

Hi, guys. Good afternoon. You've mentioned that you don't envisage opening that many stores in São Paulo as you did in 2016 in the near term. Should I anticipate that that's something that you shouldn't do from now on? And if that's the answer to that question is yes, should I then think that you feel you're closer to your market share cap in the region of the state of São Paulo?

And a follow-up to that question guys, if you maintain your guidance for store openings this year and you're not depending so much on the region on the São Paulo state, should I think that the vintage for this year should carry lower returns? Can you generate the same sort of return in other regions where Raia Drogasil might not have their strongholds as you're doing in the region of the São Paulo? These are my two questions. Thank you very much.

A - Marcílio D'Amico Pousada

Marcus, thank you for the questions. So, the first thing is, as you can see from my numbers, quarterly numbers we provided, I mean, the things in terms of decentralizing will grow out of São Paulo, and in the region has been very natural and very progressive. I mean, there is no question here. We didn't start today, we didn't stop a single day and say, hey, let's stop São Paulo and let's find some other place, it has been natural, as our operation has been grown outside of São Paulo. And the other element here is that, we saw, I think, from five years ago to two years ago, a huge window of opportunity to occupy some wide spaces, especially the city of São Paulo.

So, if you look at the number of stores we opened during this period in (26:28) in all these regions where we already had a reasonable presence, it was very big. So, there was a window of opportunity to take advantage of the market to advance the position and we did this with tremendous quality, obviously cannibalization is higher in this market, but it had the revenues per store, we have opting there have more than justified the investment that we made. But when we look today, the capacity to grow in São Paulo, I don't think the best place is the place we were able to do during that window of opportunity. So, I think the current pace is probably more representative of what we'll be able to do in São Paulo from now on.

In terms of share loss, it also depends on what the other competitors are doing. So yes, in the short-term, if the customers are lost because there are more people opening stores. But in our view, the new entrants who are entries towards here, we believe the open stores were not delivering, who are not are feasible. So, I don't think this will continue over the longer term. And in the area of São Paulo, I think is doing a good expansion here. They take advantage of the same window of opportunity we saw five years ago. And so, I think it makes sense for them, but I don't think they'll be able to maintain this pace forever as we were not able to maintain this pace.

So, yes, I think in the short-term, this probably mean we'll lose some share in São Paulo, but we're still opening a lot of stores here, I think, (27:58) will reduce over time. So, we believe that progressively we can gain more share in the state of São Paulo.

And finally when we look at these into IRR, this is projecting around 20%. So, this is very consistent with our long-term track record. Last year, it was ahead in the track record. I think we had the best year in 2017 for – in a five-year period. This year is a normal opening. It's not as stellar as it was last year, but it's absolutely in line with what we have done historically and we're still seeing 19% to 20% IR when we project the store for the full maturation.

Q - Thiago Macruz {BIO 16404924 <GO>}

Thank you very much, guys. Just one follow-up question, given the scenario that you just explained to us, does it make sense to think that maybe now it's time to pursue M&A, Eugênio, do you think that some specific regions were higher and Drogasil have not been successful thus far. It would make sense to go after a regional player, do you think that this is something we could see in the near term? That's my last question. Thank you very much.

A - Marcílio D'Amico Pousada

Macruz, just before answering this question, just a follow up on the previous question. We also ask that if growing outside of São Paulo means lower IR and if they absolutely and I have adamant way, no. Today, especially when we factor out cannibalization, many of these markets outside of São Paulo, especially when we are thinking about the North, Northeast and Midwest, they also deliver higher IRs than in São Paulo. Because São Paulo has cannibalization, in those markets cannibalization is still much lower. And for the last year or two, we also understand cannibalization better. This is one of the elements that prompted us to reduce the openings in São Paulo. We have a better grasp for what cannibalization is.

So, and again, I mean we are the only chain, there's not a single exception here. There's not a single other chain who can say that. We're the only chain who has 20-plus states where we can grow with 20% IRR, every other states in Brazil will make money in the core market. They are being able to grow profitably in their native market. Maybe in one or two states they get it okay, but in the rest, it is then a disaster because of high entry barriers. Nobody can do what we're doing here without sacrificing IRR. So, this is really the testament to fact that we have a national footprint and a national presence.

Anyway, Macruz, what's important also, we are opening more than 200 stores every quarter if you look in the last 12 months (30:56) second quarter 2016, this is very difficult to do. I think the competitions do more than stop-and-go, establishing they're doing the same strategy that shoots the plates, (31:07), it starts like a chess game that I told you. We had all this (31:14) well, then opening their in São Paulo more than our state is only part of our strategy, because their stores are competitive. We know where we've got few up of our consolidation in the markets.

A - Eugênio De Zagottis

And in terms of then going to your second question, when you look at the ambition that we have in terms of consolidated in the market, I'm sure that at some point M&A will make sense for us. So, we are not allergic to M&A nothing like that. But the problem is that, we have a huge quality buyers when you look around the market there's a very small number of assets that has the underlying quality we'll be comfortable with. I think those assets are not available today. I think those assets are very expensive so the day they're available we have to be very comfortable in the value creation ability. So, yes, this will come to the picture eventually, but I don't think it's in the charter.

Q - Thiago Macruz {BIO 16404924 <GO>}

That's super clear guys. Thank you very much.

A - Marcílio D'Amico Pousada

Thank you.

Operator

Mr. Luciano Campos from Bradesco BBI would like to make a question.

Q - Luciano Campos {BIO 16181710 <GO>}

Hey, good afternoon, Eugênio. Good afternoon, Marcílio. My first question is actually about this market share trend in the State of São Paulo in one of the aspects that you also commented in the press release about the impact of pricing decisions that you have made that also influenced your market share in the region. I think Marcílio was also explained that this pricing change is probably was more concentrated in the Generics segment, if I understood it correctly. Could you please elaborate a little bit more about what was the strategy change in terms of prices that you did, if it is just São Paulo or if it's generalized and a little bit more color when it started?

And the second part of this question is for instance if you already had time to observe what is the impact of that? Normally, if you are more competitive in prices you could see your market share reacting relatively fast. I would like to know if that was the case if you can observe your market share kind of recovering in a store-by-store basis or anywhere any basis that you can see that it can help us to understand what is the impact of this strategy in the market share? Thank you. Those are the questions.

A - Eugênio De Zagottis

Luciano, thanks for the question. The first message here is, I don't think this is a quarter that when we look at IMS, we should spend a lot of time talking about share because there is a lot of noise in this quarter. For example, I have mentioned – we reported 17% revenue growth in April. I mean, there is no chance, the market grew 17%. The fact that the large chains are maintaining the same pace they were having or the same trend they were seeing previous quarters. But the overall market accelerated really shows that acceleration is taking place in the edge of the market. (34:16) change in dependents, who report selling data and not selloff data. So this is a very noisy quarter.

I think we'll have to wait for probably one or two more quarters, probably next quarter, we can already have a more realistic picture of where – where the share is. But I would assume there is a share loss in São Paulo. The fact that we are growing less – then second our (34:43) is much lower than it used to be both – first and foremost because we decided to decentralize over time and second, because there is also more activity will probably mean a share loss in the short term, but not at this magnitude. I think the work we do in terms of pricing – Generics has been a key focus, but it's not the only focus. We have also invested (35:07) in Branded for example.

When you look at constant gross margin on a consolidated basis, it doesn't mean this is flat everywhere. At any given point in time we'll optimize our prices. We have seen the markets where we have to invest more and we see the markets – and we also look at the markets where we can harvest some margins to fund that. So, this is a very dynamic thing, obviously, with new entrants in São Paulo. We heavily invested over the last two years in São Paulo. We are increasing entry barriers. We are defending our market share here. It's very difficult to predict where this is going, how fast the share can go up. But the fact that we saw a 13% volume growth in Generics in such a certain way I think it's a very good indicator of the elasticity as Marcílio has mentioned.

Q - Luciano Campos {BIO 16181710 <GO>}

Eugênio, just to confirm. So, it's too early to observe like May, June, and July, you don't see any particular trend already associated in terms of market share exchange relative to this price strategy. It's too early, is that what you are saying?

A - Marcílio D'Amico Pousada

No.

A - Eugênio De Zagottis

It's too early and there is too much noise in the data. So, it's both. I'm not here to also criticize IMS. It's important that (36:31) their methodology is the only possible methodology that in a way that they can talk to 80,000 pharmacies and that they will provide them the multi-demand. So, what they do is the large chains inform them. Those small chains they capture through wholesalers. So there – but the thing is there is noise in the base. It's very difficult to look at (36:50) quarter-over-quarter, but generally when you look year-over-year you'll see a reasonable picture. This time because of this huge selling peak in April, I think even the year-on-year reading is compromised. But it's an intrinsic limitation to the only way IMS can capture data. I think in the next quarter, I think you get to normal visibility again.

Q - Luciano Campos {BIO 16181710 <GO>}

Okay. Thank you, guys.

A - Eugênio De Zagottis

Thank you.

Operator

Mr. Joseph Giordano from JPMorgan Bank would like to pose a question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Hi, good afternoon, everyone. Thanks for taking my question. Eugênio, I have like a couple of questions here. So the first one is still like on this Generics pricing; I like to understand here like how have you been changing your suppliers base in order to maintain your margins relatively flattish or if this comes from basically best – better procurement terms? And then looking at the cost cut initiatives, last year we had like several (38:02) like changes in (38:04) plan, renegotiation of salaries, some strategic layoffs. So here I'd like to understand if we have like any initiative here that is worth highlighting to (38:18) potential operating de-leverage pressure into the second half of the year as per my understanding it seems that growth remains a little bit challenging in the more mature markets given competition? Thank you.

A - Marcílio D'Amico Pousada

Joseph thanks for the question. I mean in terms of Generics, we have here a combination of things. One thing that I didn't mention that often affects Generics pricing is that there has been government – there have been price cuts in the (38:48) programs that happened in the past and (38:51) is very focused on generics. So this is like a one-off price cut and we also because of that price cut, we also did – we did an auction with our supplier. So there is some movement in the supplier base. There are some suppliers selling more to us than before. There are other suppliers selling less to us than they were selling before. There is also the fact that in more popular areas, we're also adopting cheaper generics than before. In regions where we have new entrants, we have also increased the discounts in terms of not allowing someone to bring a price gap versus us. So there's a lot of movement going on. It didn't start this quarter, it started before. It's also not confined to Generics.

As I mentioned before, we have invested in branded discounts in São Paulo, but the great thing is that we either because of better Generics purchasing terms as a result of the auction or because we can harvest margins in markets where we probably were more aggressive than necessary. We have been able to do all the required investment to defend our position without sacrificing the gross margin. In terms of the expenses, I mean obviously, last year, we did a lot of things, those initiatives were very important. We're always looking for opportunity, so there are minor things here and there, but we don't have any opportunities like we had last year. We are very disciplined in the generic side, we're very careful about that. But the message is we think long-term we are not here to optimize this quarter and the next quarter or to optimize 2018, we are here to make what makes sense and what creates value on the longer-term.

So we're not taking people out of the stores just because we have to make the quarterly data, that's not how we work. We reduced people in the stores when you had productivity gains that allow (40:48). If you don't have another product, we're always thinking for productivity gains but if we don't have a productivity gain, we can force the head count numbers down, because if we do it we will be very happy in the next quarter. But I would - I will start selling my share, because it's not sustainable. There's a limit to that.

A - Eugênio De Zagottis

Yes. Every (41:10) changes during expense looking for (41:12) okay; we are here for the customer to serve the customer well. If you compare our numbers with people in the store (41:20) with our competition, we are much more (41:23) the competition. We stay towards with this training to the product future. But if you want significant change, this number have useful (41:34) in 2016 and 207.

A - Marcílio D'Amico Pousada

And I mean, the thing is any consolidation process involves pain. I mean, if you look in the U.S. towards the 1990s, I mean (41:46) huge margin pressure from the payers. When you look 20 years later, I mean they all being on the market. They boosted their revenues, they boosted their market caps. So life is not a straight line. I always talk about, that don't play for straight line exits using financial models and consolidation involves paying. These kind of market scenarios in which we have a lot of players doing unsustainable growth, we have a lot of leverage players in the market. We have more competition and we have a market deceleration. I mean, it's a perfect market to start cleaning up. Whatever can stretch us will give a lot of (42:35). So I think this will be a very difficult environment for the other players. Last quarter I told you guys that to expect a bloodshed when our competitors started reporting. Here's the thinking, I mean, we have some margin loss, I think it's minor, but when you look at the numbers that our competitors who report, I expect a very dark scenario.

Q - Joseph Giordano {BIO 17751061 <GO>}

One follow-up question here, if I may, on the productivity side. I remember like there were several efforts here with the data leak related to this year, and data to basically improve pricing. So interior like in the past this was an expectation for a major gross margin driver. Here in this context, like what I'd like to understand here as, if this new pricing algorithm and systems already in place, and that's actually what's bringing like an edge in terms of comparative position to maintain like minimal share losses in the more mature markets here, so basically, preserve returns. Thank you.

A - Marcílio D'Amico Pousada

Yeah, I would say that to some extent, this is already happening. I mean, we will build pricing for HPC, a pricing platform for HPC and OTC. We have much bigger segmentation across Northern region than before. We do very more detailed price surveys of competitors. So obviously we have been adjusting the prices based on that. But the fact that we have a platform, already rolled out doesn't mean that we are using every resource the platform offers to the fullest extent, but we must fix a learning curve on that. In our strategic projects, now, one of the things we analyze is how to use machine learning for example to pricing. So I think this is a journey. I think yes, it helped us invest in more competitive prices, in some places especially São Paulo, and as well to the defend the overall gross margins. So this is a direct reflection of the pricing platform and also of our buying power. But this is a journey. This should keep having more and more and more.

Q - Joseph Giordano {BIO 17751061 <GO>}

Perfect. Thank you very much.

A - Marcílio D'Amico Pousada

Thank you.

Operator

There appears to be no further questions. Now, I will turn the conference back to the company for their final remarks.

A - Marcílio D'Amico Pousada

Okay. So first of all, I'd like to thank you all for attending this call, thank our long-term shareholders for their interest and support, and I also like to stress some of the messages that we discussed today. So the first thing is that, this is a bit disappointing quarter for us. We are in a difficult growth scenario because of the market deceleration. And I think this will last for a couple of more quarters. We believe the third quarter will be another difficult quarter because last year it was a very good quarter in terms of expense dilution. So probably we have the process, comp base in a very long term in terms of expansion, and I don't think the phased momentum will be any different from what we have seen this year. But as we approach the fourth quarter then we start becoming more hopeful because I think we have a manageable expense comp base. We have also a slightly easier revenue comp base, and we believe that some of the actions that we are taking will be already showing some results. So I don't have to really stabilize margins in the third quarter, but to the very niche we'd like to close the gap in the third quarter and position us for a better 2019.

As I mentioned in the call, just because consolidation would be good in the longer term and consolidation is painful and the market is decelerating, there is a meaning (46:59) we are not at all in a (47:02). We're making and have started to make very meaningful investments in prices, and looking state-by-state, city-by-city, neighborhood-by-neighborhood, category-by-category, product-by-product. And these investments have been, they're very important. They are funded by other gains in pricing, in buying terms, for example. So the 14% volume growth in Generics is a great indicator of the success of that strategy, and that's a couple of quarters, I think the volume growth which was lagging in growth. So I think we are on the right track here.

And another thing is that we have, as I mentioned, with decentralizing new store expansion, only one third happened in São Paulo and didn't happened this quarter. This has been an evolving process for the last two years that has naturally happened. This is not a quick fix, and with the only change in Brazil was able to decentralize the growth and still maintain growing consistent returns because we have a very profitable measure for this. Whatever we grow we make money. And when we look at some of the markets where we're growing like (48:21-26) we are giving very, very consistent returns even when compared to São Paulo. So decentralizing doesn't means sacrificing return. It's probably the opposite because growth in São Paulo now involves a lot of cannibalization, and always have to manage that. Growth in these markets has a much bigger greenfield component versus when we do in São Paulo.

I also like to stress the huge progress we have achieved in omni-channel. So today is the due date in which 100% of our store base is part of our (49:04) network. So no other retailer in Brazil has 1,700 squad with Click & Collect available, and I'm not referring to my sector, I'm referring to (49:15). With the large Click & Collect chain in retaining year-to-date, and we see very positive trends behind that. We believe the future will evolve this new transition, the store will still remain very important, and I think Click & Collect is the best example of that. As a consumer we should take advantage of technology to take some of the pain points away of this purchase experience, but it is still relying on the convenience of the store. So this is a great thing. We have a myriad of markets in which we also have local delivery, and this is the year in which our omni channel strategy, that has been in the works for at least 25 years will start to surface.

So today, and I think with this very base, through the big stores are joining with Click & Collect method. So this is positioning us very well to take advantage of that, and it is a journey, there is a lot of work to do, in terms of leveraging technology to improve customer experience, to improve our profitability and a lot of that. And I think again our specialty is delivery, which is a huge opportunity, and in the next quarters, we'll show where our market share is listed, this quarter with the IMS data is very noisy. So we may highlight the main thing about the opportunities we have and about our future. As I said before, (50:51), it's not max to swallow but it's good for you, because I think the competitive landscape in two years will be completely different than what it is today. I don't think as a competitor we'll be around in the years from today.

I think several competitors should be around this weekend, which should play as reduced expansion very sharply. We get the players who are in the industry today, maybe they won't be part of our industry in two years. So I mean, although I could be wrong, but you can write down that, I believe that two years you'll see a completely different market scenario. Expansion is cyclical. So a lot of the inclusions that we're seeing from other players, they are not sustainable and because they're not sustainable they won't be happening forever. I mean, even players who are kept alive at the end of the day, they're rational and they want a return for the investment they do. So I'd like to thank you again for joining this call and for our long-term shareholders for your ongoing support. And we'll remain available to you through conference calls or by reaching investor conference and workforce. Thank you very much.

Operator

Closing and disconnection.