Q3 2014 Earnings Call

Company Participants

- Claudio Bergamo dos Santos, Chief Executive Officer & Director
- Martim Prado Mattos, Chief Financial Officer

Other Participants

- Robert E. Ford, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Hypermarcas Third Quarter of 2014 Results Conference Call. Today with us we have Mr. Claudio Bergamo, CEO; Mr. Martim Mattos, CFO; and Mr. Breno Oliveira, IRO and Treasurer.

We would like to inform you that this event is being recorded and all participants will be in a listen-only mode during the company's presentation. After Hypermarcas' remarks, there will be a question-and-answer session for investors and analysts when further instructions will be given.

We would like to inform you that questions can only be asked by telephone, so if you are connected through the webcast, you should e-mail your questions directly to the IR team at ir@hypermarcas.com.br. Today's live webcast may be accessed through the company's Investor Relations website at www.hypermarcas.com.br/ir.

We also would like to inform you that statements during this conference may constitute forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those set forth in the forward-looking statements.

Now, I'll turn the floor to Mr. Claudio Bergamo, who will begin the presentation. Mr. Bergamo, you may begin your conference.

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hello. Hi, thank you very much all for participating in the third quarter conference call on our results. In this quarter, Hypermarcas posted net revenues of BRL 1.187 billion, a 6.8% growth compared to the same period of last year. Excluding the impact of third-party drug manufacturing contract with Merck Sharp & Dohme, the net revenue growth was 10.7% compared to the same period of last year.

In the first nine months of this year, the net revenues amounted to BRL 3.379 billion, a 7.6% growth compared to the same period of last year and excluding the Merck Sharp & Dohme, the MSD contract, a 9.1% growth.

In the third quarter, the company posted adjusted EBITDA of BRL 286 million, an 8.1% growth compared to same period of last year. We've had a margin of 24.1% of net revenues, a 30 bps expansion against the same quarter of last year. These expansions were reached in spite of higher marketing expenses, which was partly offset by reduction of selling expenses.

In the nine months of this year, adjusted EBITDA increased 11% to BRL 833 million, with a margin of 24.6%, which is equivalent to 75.7% of Company's guidance for the full year. The company reached this performance, despite the increase of marketing investments in line with our strategy of continuously strengthening our brands with the end consumers, the medical community and in the point of sale.

The improvement of company operating performance, combined with the reduction of financial expenses, increased Hypermarcas net income to BRL 118.8 million in the third quarter, a 48.1% growth compared to the same period of last year.

In the first nine months, the company net revenue expansion was 64.1% compared to the same period reaching at BRL 331 million. In addition, free cash flow reached BRL 188.1 million (sic) [BRL 128.1 million] in the third quarter, a 10% growth compared to same period of last year. In the first -in the nine months of this year, free cash flow was BRL 434 million, a 20.2% growth compared to the same period of last year.

In the Pharma division, our net revenues reached BRL 653 million in the quarter, a 6.6% growth compared to the same period of last year. Excluding, the Merck's contract, the Pharma division growth was 13.8% in the period. The company focus in our pharmaceutical market remains at generating end-demand for our products, with higher market investments, closer relationship with clients and increased presence in the point of sale.

We have launched in the quarter around 20 campaigns for many of our brands and products, such as for Neo Química, Benegrip, Estomazil, Epocler, Engov and Tamarine, among others. In addition, the company launched relevant products in the quarter, such as the omeprazole, one of the main molecules for generics market, and the OTC, the Migrainex, for the treatment for headaches and migraines, as well as the brand extensions for Epocler and others.

In dermocosmetic, the company launched also many SKUs such as Glycare for facial cleaning, Episol with 100% protection for sunscreen. In branded generics, the company launched Neocoflan for the treatment of muscle inflammation. The company also has been consolidating recent launches such as the Addera d3 vitamin D in the presentation of pills, which became the most successful launch in the Brazilian market for the year.

During the quarter, also, the division launched and continues implementing our program called Hypertrade, which was implemented for the entire field team of the division. This initiative will allow for standardization of our execution at the point of sale and better control of our invested resources.

In the Consumer division, the sales for the quarter was BRL 534 million, a 7% growth compared to same period of last year. In order to stimulate demand and support recent launches, the company intensified our marketing campaigns in the quarter. It has launched market campaigns in total of nine brands, including new ads for Bozzano deodorants, Risqué nail polish and Monange hair care line care line. Commercials for Jontex condoms and merchandising actions for Bigfral adult diapers were also taken to the air in the quarter. The division innovation index reached a peak in the quarter of 76% of products being launched in the last 12 full months.

Basically after the relaunch of our oral care, Bitufo, 100% of our Consumer portfolio has gone through the renewal process. In the quarter, the company also relaunched our leading brand in the nail polish market, Risqué, with a new formulation which is anti-allergic, a new package and a new brush applicator. Also, we have innovated in Cenoura & Bronze's sun care line, with an additional benefit of radiation protection, exclusive in the mass market.

The division is focusing in higher capacity position in Senador Canedo plant, aiming for higher productivity after the transfer of the cosmetic lines. Most of the production is already there, and we expect to finish the total migration of our operations to Goiás by the half of next year. Since April of this year, the company has been experiencing efficiency gains and improving service levels to clients, as a function of the concentration of our distribution in our new distribution center in Goiânia.

Finally, Hypermarcas has been consolidating initiatives with the objective to further develop our network of semi-exclusive distributors, which covers already most of the whole country and is helping our division to better commercialize a more balanced mix. In addition, new categories, including deodorants, were incorporated in our Hypertrade program, which monitors the execution at the point of sale.

I will pass over to Martim to talk about more details about the numbers.

Martim Prado Mattos {BIO 16015889 <GO>}

Good afternoon, everyone. Martim speaking. Briefly, I would like to summarize the main financial results posted in the quarter. Starting on the presentation on page three, by net revenues we had 7% growth in Consumer this quarter, in particular in selected high volume category, in which we improved the value proposition to our clients and end-consumers.

In Pharma, the reported growth was up 6.6%, but is calculated on a comparable basis; given the termination of sales from third-party manufacturing contracts, growth was up

13.8%. Thus, reported consolidated growth was 6.6% or 10.7% is calculated on a comparable basis against Q3 2013.

On the next page, gross margin remains virtually stable compared to the prior year. On the one hand more favorable mix in Pharma given the termination of sales of third-party products and on the other hand, lower margin in Consumer as a function of the more promotional strategy in the selected high volume categories.

SG&A ex-marketing which are expenses of a more fixed nature dropped by 1.6 percentage points compared to the prior year, due to a combination of continuation (12:49) of expenses and operating leverage on sales and administrative structures. Marketing expenses continue to follow the strategy of supporting mid and long-term demand, with expenses increase of 3.2 percentage points compared to Q3 2013.

On page five, we can see that in spite of the marketing expenses increase, gross profit combined with the reduction of fixed expenses as percentage of net revenue led to a 30 bps increase in the adjusted EBITDA margin to 24.1% representing an adjusted EBITDA growth of 8.1% to BRL 286.3 million.

The operating results growth combined with the financial expenses reduction in the quarter compared to the prior year caused a 48.1% increase in the reported net income to BRL 119 million. This reduction of financial expenses is mainly related to the absence of FX variation impact over our liabilities, given that they have been fully hedged since the end of last year.

It is important to mention that given the strong depreciation of the BRL in the quarter, if we had not been hedged, our financial expenses in the quarter would have been approximately BRL 130 million higher than what we reported.

On the last page, we can see that both operating cash flow as well as the free cash flow also had the same direction as the operating results seen in the quarter with 4.3% and 10% increases respectively.

Thanks everyone for the attention and we can now proceed to the Q&A session.

Q&A

Operator

Thank you. The floor is now open for questions from investors and analysts. And our first question will come from Robert Ford of Bank of America/Merrill Lynch. Please go ahead.

Q - Robert E. Ford {BIO 1499021 <GO>}

Hey, thank you and good morning, everybody and congratulations on the quarter. I was curious with respect to the working capital, accounts receivable really outpaced sales in the quarter this period. And I was curious if you could explain what happened there.

A - Martim Prado Mattos {BIO 16015889 <GO>}

Bob, hi. Martim speaking. In the quarter, in addition to the promotion initiatives that we've taken in the Consumer side, so for some selected categories, one of the ways of doing so was also adjusting the commercial package to the consumer, including – our clients including the terms of receivables. So on average that led to that increase of approximately three days compared to the last quarter.

Q - Robert E. Ford {BIO 1499021 <GO>}

Okay. And do you expect any additional support in terms of working capital to the trade?

A - Martim Prado Mattos {BIO 16015889 <GO>}

Bob, on our perception this is enough and this was also made to adjust what the competition was doing. So we feel that what the levels that we are working with now a days is enough for our objectives.

Q - Robert E. Ford {BIO 1499021 <GO>}

Okay. Great. And then the underlying growth of Pharma, I thought was very impressive. Could you help us better understand the elements driving growth across Pharma categories? Because, Claudio, you mentioned some innovation and some new products, but also there's a faster growth and the switch to generics and similars and I was just curious if you could give us a sense of what the breakdown is and what your expectations are, should we see further economic deceleration.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi, Bob. Well, the driver behind this growth has been, on one side, the growth of the generics which has been growing above the total to market, as well as the similars which already has been growing faster than the total market. Also, in the total, a second driver has been the launching of new products more in the RX category, such as the one I described as Addera, which has been quite a success; and some other launches that we have been working on. Also, another driver has been the increase of the amount of sales people we have added in our physician sales force by the beginning of the year, as well the new merchandising team we put into place in the beginning of the year. So it's several factors working all together that has been leading us to continue growth and gaining market share.

Besides that, I haven't included for next year we show continuous benefiting from some of these initiatives that we had taken this year, and they are still not exhaustively explored. So we continue to explore them, but we have a new factor which is the new interchange regulation that just have come out about a month ago which should help us accelerate our growth in the similars business, especially in the big chains. With this new legislation, the big chains, which now represent around 50% of the market feel comfortable that they can start commercializing similars as well in their stores, which hasn't been the case in the past.

So that's a factor for next year. That's a new factor that we have to take into account. I think a new factor we have taken in account is that we have seen a change in the mindset of clients related to OTCs, in terms of really accelerating, the headwinds seem the benefit of having a better – a bigger space for OTC in their stores and they are more organized to category management. And we've seen that they're pushing harder on that as compared to the other periods. So that's pretty much I think are the key trends or key drivers for the growth.

Q - Robert E. Ford {BIO 1499021 <GO>}

And, Claudio, given the pipeline that you have in terms of innovation, right, you have, what, 200, 300, 400 products waiting approval from ANVISA and pretty good visibility into what's likely to be approved over the next 12 months. Given the shift towards generics and the change in regulation with respect to similars, some of the innovation that you see in OTC, what do you anticipate or do you think you can sustain current levels of growth in Pharma, should the economy decelerate from where we are right now?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, what I have been saying is that in terms of macroeconomic, pretty much I don't see – I mean, we have had a macroeconomic tough environment this year and we continue to have it next year. So – and that's just fact. And depending on who was elected, we already predicted, expected that, and that is incorporated in our plans.

I think our growth will depend much more on our internal capabilities as opposed to external capabilities. The market we are present, Pharma division and a big chunk of the Consumer division, at least half of it are much less elastic to macroeconomic conditions given that they are health-oriented and low ticket and as you have seen and we expect to continue to see as an overall market.

So I think our growth will depend on pretty much on our internal capabilities, execution capability in continuous pursuing our initiatives in the many areas that we have been already attacking and that continues doing our job in a systematic way. So both in terms of the distribution, point of sale, innovation, and (23:16).

This year actually in terms of ANVISA approval has been the lowest. They have been the lowest paced when you compare to other years. So, hopefully, we start seeing – so we have been increasing our pipeline actually. We started, so just to give you an example, last year we had 120 products in the waiting list. And as of now, we are talking and by the end of third quarter, we increased that by 206 products in the waiting list. So the waiting list has been going up. We have been able to file, to register more products then approve every year, year by year. And because of that, our pipeline has been increasing. And that give us some way, almost an assurance that for the next years we have already there quite a large amount of products waiting to be approved.

And in the meantime, we have been working in improving everyday our execution capability in a way that when we're able to access these new products, we are able to launch in efficient manner. As for example, we have done for Addera. Addera pills became big phenomenal. We will probably have around BRL 30 million to BRL 40 million in revenues in the first year. This is really a phenomenon. And we have been increasing our market share of the vitamin Ds' market and we have been up there.

Said that and I said that in the quarterlies call, it's important you to notice that nowadays, our Pharmaceutical division only covers 51% of the total market in terms of moleculars, in terms of therapeutical areas. So we still have a big, big, big space to grow. We have 49% of new areas to grow. This pipeline I just described, the 206 products on the waiting list, this pipeline increase our coverage by 10% to 61%.

In parallel, we have been working already in R&D capabilities and as well with licensing agreements that we have been pursuing, at least another 10%, an additional 10% to this 10% we have already registered. So hopefully by the end of next year, we should have something around 20% of filed new products, which would increase our coverage from 51% to 71% once they are granted. So that's a big room for growth for our Pharmaceutical division.

So, I think there is a – so that's why I said that it depend much less on the macroeconomic and much more on our internal capabilities, as well as the approval of new products. So there's lots of job to do – lots of work to do.

Q - Robert E. Ford {BIO 1499021 <GO>}

That's very comforting, Claudio. And with respect to that additional 10% right or additional 20% with the licensing, is that in terms of molecules or is that in terms of value in the marketplace?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

When I say the 10%, it represent the value. Okay, is not the number.

Q - Robert E. Ford {BIO 1499021 <GO>}

Well, that's great. And then lastly, if you could – you had...

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

It's a very interesting aspect. Now we have been able to become the largest Pharmaceutical player in the market nowadays with above 10% share, only accessing 51% of the total market. I think I mean, the point we have to make is that we became -now there are two models of pharmaceutical companies around the globe. You have the ones that are more market specialists and the ones that are more product-oriented. So the more the global players or regional players including companies, such as the Indian players and another players, that even players that are working in emerging markets, they're market-oriented because their markets are not so large. There is still – despite so many people in India, for example, it's still a very small market.

Brazil nowadays is the sixth largest market in the world and becoming the fourth largest market – I said in the next 10 years, but very probably would be larger than that and the

(28:49) became the market specialist with very strong go-to-market capabilities, both in terms of I said in the distribution, as well in terms of demand generation and manufacturing. And then I saw what we have to work now in terms of strategic and we are working in our strategic plan is that how can we increase this bar from 51% and we have already outlined every single product we are different from the past.

We are working also with – internally, but also we have been filling up, licensing, searching because some of these moleculars already exist outside Brazil. So what we have seen from many of these potential licensing partners that they have been quite enthusiastic to work with Hypermarcas in order to license many of these new product areas because they have been perceiving that Hypermarcas has really developed a very distinctive go-to-market capability. And very tough for other players to enter this market because this is a not easy market to be in. Many of these guys including – they had been trying to enter and they've been having a really hard time. So I think there is – all these things really create a very promising future for our business, Pharmaceutical business if we do the things properly.

Q - Robert E. Ford {BIO 1499021 <GO>}

That's very exciting. And if I could ask one last question and that is, you have a nice pick-up in the sell-in for the personal care items. Can you talk a little bit about smart choice-positioned products and the sell-through on those items in the most recent data that you have?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Yeah. I think in the Consumer division, we have to split our business into two areas. People have to understand that, that one area is the ones we are the leaders and the ones we are the attackers. And the ones we are the leaders represent around 50% of the total division and that's the ones we have the number one position and very strong market shares; such as the condoms market, the sickness (31:36) market, the nail polish market, the moisturing market, the adult diapers, men's care. So these are all the markets that we really have strong brands and that we are number one players; where our strategy is much more to really launch innovation, launch new products with innovation that not necessarily says smart choice, because they are very well-positioned, but different from that, it's really much more worked (32:13) category.

For example, we did for nail polish now. What we have done is really a major change. We have changed the applicator for our Risqué, which is the same level of applicator for Chanel or a high-end brand. But we have changed that. We have turned 100% of our products hypoallergenic. So we have made really substantial improvements in terms of product quality, in applications, supported by very modern advertising, exhaustive analysis by consumer, in order to improve the benefits, to increase the benefits to the consumer and we are not, let's say, for now, we are not increasing price.

So in other words, for the categories that we are the leaders, all what we have been doing is really improve the product quality, improve the benefits either tangible or intangible through marketing and not necessarily for the time being increasing price. So it's a way of being a smart choice. So there are two ways of being a smart choice. Either you position –

you offer the same product quality with a lower price point or you offer a better product quality with, let's say, a higher price point. So for the ones that we are leader, we are applying much more of this strategy of improving product and the benefits tangible and intangible.

On the other 50%, we are attackers. They're the ones we analyze more in details what would be the right price points to be and what would be the price points that you have a bigger elasticity, where the equation between price elasticity, vis-à-vis volume, is optimized. And that's the category such as infant diapers, big diapers, shampoos, deodorants, and hair coloring and especially these four. These are four categories that are really large size categories, that any share percentage, it's a big, big amount of revenue.

So that's the ones that really, the ones that we have approached, that we are finding the right price point and that goes together with the needs from the market from the consumer, which are, for these large categories they are looking for other options because there was a movement in the last through 2010 to 2013, a movement of trade-up which opened a gap in the mid-priced range market. And that's the ones we are looking for. So that's why we've seen the first signs of that results and we have to see how they're going to perform, but I think we are in the right track.

Q - Robert E. Ford {BIO 1499021 <GO>}

That's very helpful. Thank you very much.

Operator

And at this time, I'm showing no additional questions in the queue, we will conclude the question-and-answer session. I would like to turn the conference back over to Mr. Claudio Bergamo for his closing remarks.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much all. And I think this quarter for Hypermarcas, in some way, represents what's happening in the company which is really continue searching for operating results growth, but with quality, means reducing or diluting fixed and operating expenses and be able to increase our marketing and able to leverage our brand in the mid to long run, at the same time be able to offer and deliver operating growth.

But on the other hand, very important that given – as we go through this process and we are able to continue generating cash and be able to reducing our debt, be able to reduce our financial expenses, we expect that our net profit shall grow more than proportional than operating results moving forward. Given that our key focus is to use all the proceeds from the cash flow generation to reduce debt, at least when we reach two times EBITDA.

So thank you very much all for participating and have a nice day. Bye-bye.

Operator

Ladies and gentlemen, the conference has now concluded. We thank you for attending today's presentation. You may now disconnect your lines.