Y 2018 Earnings Call

Company Participants

- Breno Oliveira, Chief Executive Officer
- Vivian Angiolucci, Chief Financial Officer

Other Participants

- Gustavo Oliveira, Analyst
- Joseph Giordano, Analyst
- Thiago Bertolucci, Analyst

Presentation

Operator

Good morning, and welcome to Hypera Pharma's conference call to discuss results relative to the Fourth Quarter 2018. Here with us we have Mr. Breno Oliveira, CEO; Ms. Vivian Angiolucci, CFO; and Mr. Adalmario Couto, IRO.

This event is being recorded, and during the company's remarks all participants will be active in listen-only mode. After that, we'll start a Q&A session, when further instructions will be provided only for analysts and investors. (Operator Instructions)

Some information contained in this conference call might include forward-looking statements about future expectations. Such information is subject to risks and uncertainties that may lead those expectations to differ considerably from what was expected.

I would like to turn the conference over now to Mr. Breno Oliveira, who will start the presentation. Please, Mr. Oliveira, you have the floor.

Breno Oliveira {BIO 17215392 <GO>}

Good morning, everyone. Welcome to our conference call to discuss results for the year 2018. Before I start talking about our operating performance for the year and the quarter, I would like to give you a brief update about the work being done by our independent committee, which has been happening according to plan, but we do not have a final deadline for the conclusion of that work.

Having said that, I like to move over now to our operating and financial performance. Highlighting first our advances in terms of innovation, one of our main sustainability pillars for the mid-to-the-long run. That is on slide number three. We have invested more than BRL180 million in innovation this year, or 5% of our net revenue, quite expensive numbers for the Brazilian pharma segment. Our innovation index grew in the year, and for the past 12 months it reached the level of 31% in the 4Q, another record set by the company.

That was the first year where we had the operation of our Hynova, our innovation center, which counts on state-of-the-art technology and this is working on innovation P&D for new products. Hynova operates at 100% of its capacity and has been contributing, along with other business developing initiatives, to increase our innovation pipeline, which closed the year of 2018 with over 330 new projects.

In the year 2018, we are talking about 70 new launches, 36 in the 4Q, another record for us, as we will show in the next slide. In terms of branded prescription, we launched Ofolato iron for consumer health, we launched Doril DC 500, an extension of our traditional painkiller brand, Doril. For the generic and similar products, we launched Centrotabs, a vitamin supplement, our first participation in the poly-vitamin market, a market of over BRL1 billion in Brazil.

Besides investing in innovation, we also improved our productivity in our Anapolis plant. The new leadership for operations, who joined the company in mid-2017, allowed us to increase our capacity by 14%, with a highlight for lines which were used to bottlenecks and now have increased productivity by 25%. We have increased the number of shifts, we implemented six by two routines in certain lines, we improved productivity and we started an aggressive investment plan for new recruitment. In 2019, we will start expanding our main solids plant, and the idea is to double capacity in the next two years.

In 2018, we also increased our marketing investments. We increased by 12% our medical visits team, one of the most productive in Brazil, and at the end of 2018 we reviewed our medical panel in order to increase the coverage of doctors who received visits from 72% to 77% of the total number of doctors. On the commercial front, at the end of 2018, we restructured our sell-out field team and with this initiative, we will double our direct coverage for point of sale moving from 38% to 55% of coverage, especially at the mid-size retail segment.

Moving now to the operating performance on slide number five. Our net revenue grew by 6.4% in the year, with a highlight for the growth of our Neo Quimica brand, which was boosted by the growth in market for similar and generic products and by our initiatives to increase production capacity. As for branded prescription and consumer health products, our performance fell short of what we expect in the second half, which led to a drop in revenues in the 4Q. On top of that effect, the comparison basis for the 4Q was quite challenging as we had mentioned in previous calls. For the fourth quarter in 2017, we grew by 18%.

We had very good performance in terms of recent launches for branded prescription products, such as the ones for the Colflex and Ofolato lines, and we grew traditional brands such as Maxsulid. However, for the vitamin D market, where we also lead, we saw a slowdown in the growth rate for the market, which moved from 32% in the first half to

2% in the second half. And, of course, competition remained very fierce throughout the year. As for consumer health, we saw a strong growth in line extensions for Maracugina, Tamarine and Biotonico Fontoura and also the repositioning of the Miorrelax product. Those were positive surprises. That growth shows that for OTC market, innovation and investment in marketing make all the difference.

In 2018 however, our growth in consumer health products was impacted by a more moderate growth in the anti-flu medication market, where we also lead. In 2017, it grew 23% and in 2018 it grew only 3%. For 2019, the company has very aggressive initiatives to speed up growth in those markets, vitamin D and anti-flu medications, including mainly launches of new products, new presentations of older products, on top of investments in marketing and promotional actions at point of sale. We are working on those fronts since the fourth quarter of 2018.

Approximately 80% of our pipeline of innovation is directed on branded prescription and consumer health products, which should also boost the company's growth along those lines in the mid-to-the-long run. Even with those additional challenges, we closed the year with an EBITDA and net income of BRL1.320 billion and BRL1.138 billion, respectively which are in line -- those figures with the guidelines that we have set for 2018. The operational cash flow grew by 14%, totaling BRL1.067 billion, another record set by the company, and that contributed for us to close the year with a net cash of BRL1.060 billion or BRL500 million after the payment of interest on own capital relative to 2018, the fiscal year which happened on January 9, 2019.

Interest on equity paid out totaled BRL0.97 per share, a growth of 5% when compared to the previous year. The growth in dividend payout is something we have sought since we became a company totaled focused on the pharma segment. For the fourth consecutive year, we managed to increase dividends per share and that was possible thanks to a combination of sustainable growth of our operating results and the strong cash generation we have managed to deliver. I would also like to emphasize that, as we have detailed in our explanatory notes in our financial statements, note number 13 to be exact, we recently had a favorable ruling concerning the ICMS tax lawsuit and has been ruled in favor of us. We are now trying to assess to quantify those gains. It is a very complicated -- complex calculation, but we should have a clearer picture as we move into the first quarter of this year.

Lastly, as I mentioned in the Hype Day last December, one of the main points of focus for the company in 2019 will be optimizing our working capital. We always have had a commercial policy that favors a high inventory levels to avoid stock-outs, provided the fact that we have high margin products in our portfolio. With operational improvements that we managed to achieve both at the plant level and at our logistics operations and with an increase of our coverage that I just mentioned, to over 50% of the market, I believe we can have the same level of quality services offered with a lower investment in working capital.

The optimization of our working capital will allow us to concentrate our investments more efficiently on innovation and CapEx, which will be accelerated now to guarantee our sustainable growth in the mid-to-long run. With the possibility of those extraordinary gains

I mentioned relative to the ICMS tax lawsuit, we are now considering speeding up that optimization process of the working capital, which was forecasted to take place throughout the year. We are planning to anticipate that for the 1H19.

Now, I will give the floor over to Vivian, who will comment on the results for the year and the fourth quarter.

Vivian Angiolucci {BIO 19917048 <GO>}

Thank you, Breno. Good morning, everyone.

I will start by talking about revenues, on slide number six. Net revenue for the year, as Breno mentioned, grew by 6.4%, with a highlight for generic and similar products, and also the performance of the several launches that we had. For the quarter, net revenues saw a drop of 6.5%, driven as we mentioned by a very aggressive comparison basis that we experienced in the previous period, where we grew by 18%. The absolute level of revenues in the fourth quarter is in line actually with the previous quarters of 2018. On top of that, we also saw a slowdown in growth and an increase in competition for anti-flu and vitamin D products. As Breno said, the company has been implementing a very aggressive growth plan for those markets.

As for gross margin, we closed the year at 71.6% or 1.9 percentage points below 2017. That reduction was concentrated in the second half of the year and was impacted by a higher representativeness of sales of generic and similar products, the Real devaluation, and also by an increase in dollar packed inputs. For the fourth quarter, we closed the quarter with a gross margin of 68.6%, also impacted by those same three factors.

As for marketing expenses, they grew by 8.2% in 2018, reaching the level of 22% of net revenues. That variation comes from our strategy around the sell-out activities. Throughout the year, we increased our medical visits team by 100 employees, and reinforced investments at the points of sale. The idea is to make our new launches go to market as efficiently as possible. For the fourth quarter, our marketing expenses were slightly lower than the fourth quarter of last year, but that is mainly due to the fact that we fragmented payments throughout the year, phasing payments throughout the year.

SG&A expenses amounted to 17.7% of the year's net revenues, and 16.7% in the quarter. That represents a drop of about 1 percentage points compared to '17, both in the year and in the quarter. Sales expenses saw a drop of 0.4 percentage point in the year, as a percentage of net revenues, that reduction reflects the use of a benefit in the amount of BRL24.3 million in the year and BRL9.3 million in 2017. That higher benefit comes from increased investments in innovation that we made this year. In the 4Q specifically, on top of the benefit, we saw an impact of BRL15 million in '18 and BRL9.3 million in the quarter -- fourth quarter of 2017.

SG&A lost relevance, both nominally and also in relative terms. That is the result of an optimization of expenses and important gains in infrastructure costs and travel costs. It is important to mention, in the line of other operating expenses, that we were benefited in the year, as we mentioned before, by the lease of our DC that we used for consumer products. The amount of that lease in the year is of BRL120 million. In the 2Q, as mentioned, we also had a gain coming from a compulsory loan that was reimbursed to us by Eletrobras.

In summary, we closed the year with EBITDA margin of 35.4%, slightly higher than 2017, representing a growth of 7% when compared to the previous year. That increase in profitability resulted from a decrease in SG&A expenses, which more than offset the drop in gross margin in the period.

Now, net income from continuing operations, on the next slide, came at BRL1.135 billion, a growth which was below the EBIT growth because of the lower financial revenue in the period. As we mentioned in the other quarters, that is a consequence of a lower average net cash in 2018 and a decrease in the interest rates. That effect was partially offset by a lower payment of TJCP tax in the period.

Moving on to cash flow and debt level. We reached a record level of operating cash flow in 2018 at BRL1.066 billion, which represents a growth of 14.4% when compared to 2017. It was impacted by better result in the period and also by new policies of supplier negotiations. The operating cash flow in the quarter was BRL167 million when compared to the last year. That is a consequence of this mismatch between our inventory terms and our supplier negotiations.

The free cash flow saw a drop when compared to the previous year and totaled BRL846 million, a consequence of resources received in 2017 relative to the sale of our disposable products units. If we exclude the non-recurring effect, the growth in free cash flow would have reached 15%. In 4Q18, we took BRL125 million in loans from Finep at very attractive costs, linked to investments in innovation already mentioned by the company. We closed the year with a debt level of BRL94 million below 2017 and a reduction of its effective cost.

Net cash totaled BRL1.060 billion or R$500 million after the payment of interest on capital, which is equivalent to 0.4 times EBITDA for continuing operations. We reiterate our strategy of maintaining our net cash at a slightly positive level to be able to invest in expansion and innovation in the coming years. Once again, our strategy for capital structure is sustainable, both by the amortization of our debts and by our tax base, which allows us to recover some of those figures.

The cash conversion cycle saw a slight deterioration in the fourth quarter, because of the number of days for accounts receivable and an increase in input inventory, which was not followed up by terms negotiated with suppliers. It is important to emphasize that there was no change in our commercial policy as of recent. And accounts receivable, it is only proxy of what we received in the previous quarters.

Within this context, the slight increase in the days of accounts receivable is due to three factors number one, the fact that we fragmented the payments last year so some payments were pushed to 2019. The second effect was that the last working day for the year was the 28 of December and in 2017 it was the 29. So we lost one working day for receivables' purposes. And lastly, our revenue from discounts, which was also lower in the fourth quarter and of course the calculation basis for that indicator. As anticipated by Breno, the use of working capital is our priority for 2019.

Now, I would like to give the floor back over to Breno for his final remarks.

Breno Oliveira {BIO 17215392 <GO>}

Thank you, Vivian. In summary, we have invested more than BRL180 million in innovation, we launched 70 new products, and we elevated our innovation pipeline to more than 300 projects. And we did all that at the same time we delivered our EBITDA guidance for the year. We grew our operating cash generation by 14%, and increase our shareholder compensation by 5%, reaching the level of BRL0.97 per share.

For the year 2019, we have established as guidance net income of around BRL1.225 billion, a growth of around 8% when compared to 2018. Historically, we always provided guidance for EBITDA, but after divesting our consumer units, and with a more stable capital structure, we started in 2018 a transition process for guidance from EBITDA to net income. This year, we are providing guidance for both metrics, and for 2019 we will only provide guidance for net income. We believe this to be the most relevant metric for our investors.

We remain confident in the Brazilian pharma market in the long and the mid run, because of the aging population that we have, which results in a very good potential for growth in our market for the next five to 10 years. Our market is resilient, with attractive margins and Hypera is the company which is best positioned to capture the opportunities offered by this market. We are the company that most invests in the sector, we have the most diverse portfolio in the market, we have a highly professional management and we are increasing our production capacity to face growth demands for the next 10 years.

We will now start the Q&A session. Thank you.

Questions And Answers

Operator

Thank you. We'll now start the Q&A session for investors and analysts. (Operator Instructions) Joseph Giordano from JP Morgan would like to ask a question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Good morning, everyone. Thank you for taking my question. Actually, two questions. Number one, about the project pipeline and the innovation index, we saw very high volume of products coming to market especially in the fourth quarter. I like to understand how we should look at that innovation index in terms of trends. 50% you said when compared to when you talk about 2021 and 2022. I would like to understand if we could already expect to see this year the company resuming growth at 2 percentage points to 3 percentage points above the market.

Number two, about gross margins. We saw -- we know that there is going to be a price increase for drugs, medications. So I would like to understand or to hear from you if that is enough for you to recover all that price pressure coming from KPI and FX effects?

A - Breno Oliveira {BIO 17215392 <GO>}

Well, okay Joe. I will address the first one and then Vivian will address the second question. So as for the innovation index, we have a target which is 35%. We never said 50%. Today, we are at around 31%. Based on our forecasts, 2019 should remain flat in terms of innovation, because we measure that metric including the past five years. So, we had big launches in the past, especially those related to Addera, which starts to leave the innovation index, but we have new products in the pipeline to add to that index. So at the end of 2019, early 2020 we should peak at I'd say 35%, which is our target, as I said.

As for the growth of 2 percentage points to 3 percentage points growth above the market, that is for long run. We pursue that target in the mid to long run, especially when we talk about the sell-out, which is our final demand for our products. Yes, we do believe we will be able to reach the target in the mid-to-long run.

A - Vivian Angiolucci {BIO 19917048 <GO>}

Hi Joseph this is Vivian speaking now. As for margins, the factors with the highest impact in 2018 as I said was the US dollar and the increase in the dollar price of inputs. We see those factors stabilizing. The US dollar is stabilizing and I do not expect input prices to go up this year. I think we have reached a limit. So from now on the tendency is to have better picture, an improved picture. In the second half with the increase in price, we should have seen recovery of the margins. We should see that going forward.

As for the mix, which also has an impact in the margin, I think we need to divide that in two fronts. In the short run, we do see a faster growth for the similar and generic products market. So, we could have a slight impact coming from that front on the margins. Now for the mid run as most launches of the company and most of the pipeline is concentrated on branded prescription and consumer health products the margin should start to recover, yes. Start to recover, yes.

Q - Joseph Giordano {BIO 17751061 <GO>}

Okay, thank you. If I could ask a follow up question about the mix, if you could give us more color on the kind of impact that you will have on your receivables. I understand generic and similar products perhaps have a higher impact on the receivables. Am I right?

A - Vivian Angiolucci {BIO 19917048 <GO>}

Not really. Generic and similar products do not have a higher impact on receivables. As I mentioned, the main impact we had on receivables in the fourth quarter came from the fact that we fragmented payments in the third quarter. So we pushed some of the payments from the second quarter and third quarter to the first quarter of this year. So, some payments were pushed back to January of this year. That is where the change is coming from. Okay.

Q - Joseph Giordano {BIO 17751061 <GO>}

Okay, I understand. Thank you very much.

Operator

Mr. Thiago Bertolucci from Goldman Sachs would like to ask a question.

Q - Thiago Bertolucci

Good morning, everyone. Thank you for taking my questions. I have two questions. The first one, about gross margins, could you perhaps give us a breakdown on the pressure drivers? And, number two, as for the guidance, how do you see -- how are you dealing with the ICMS lawsuit? Thank you.

A - Vivian Angiolucci {BIO 19917048 <GO>}

Okay starting with the gross margin effects, it is about a third for each one of the factors, about a third. One third for mix, one third for FX, one third for input prices in dollars.

As for the ICMS lawsuit, as I mentioned, we are now planning to offset gains that we may obtain with this lawsuit with this adjustment in our working capital that I mentioned that we plan to anticipate to push or to bring to the first half. So we should see no impact on the guidance because one offsets the other.

Q - Thiago Bertolucci

Okay, thank you. Have a nice day.

Operator

Mr. Gustavo Oliveira from UBS would like to ask a question.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Good morning. I would like to go back to the beginning of the presentation. I think I missed the very beginning of the call -- the conference call. I would like to have more color on that drop in revenues in the quarter. I would also like to understand what's your estimates for market growth? How much has the market grown? You mentioned Addera D, you mentioned more competition. How much does that account for in your sales as a whole? Where did you see that slowdown affecting revenues? And also, what would your short-term plan be to revert that as early as the 1Q? You did mention some payments being pushed to January. I would like to understand that a little better, what happens in the quarter in terms of revenue? Thank you.

A - Breno Oliveira {BIO 17215392 <GO>}

Sure Gustavo. So as we said, to put things into perspective, I said early on, I think you missed the beginning, but the comparison basis for the four quarter of 2017 was quite strong. Back then, we were growing 18% so with the drop that we had of 6%, we are talking about an average growth for two years of 6%. It is not a tragedy, not ideal, but it is not a 10% drop, it is a 6% drop. Let us keep that into perspective, that is for selling. As for the market that you asked, market grew by almost 10% in the fourth quarter, 10%, 9.9 or actually 10% in fourth quarter. In our markets, where we operate more strongly, Addera vitamin D we grew around 5% in the fourth quarter. But if we look, as I mentioned, we saw a very strong slowdown in those markets. I do not know if you were listening already, but the vitamin D market grew 2% in the second half.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

You are talking about revenue or volume?

A - Breno Oliveira {BIO 17215392 <GO>}

Revenues. The market grew 2% in revenue. And the market for anti-flu medication in the fourth quarter actually dropped by 1%. So, we were highly impacted by those two factors and the market as a whole does not reflect that, because our dependence on those markets, anti-flu and vitamin D is stronger. They are more relevant to us than to the average market. So, those impacts are not as strong on the remainder of the market as it is on us. The impact on us is higher, but if we exclude those two markets, we would have grown in the fourth quarter around 13%. So it is no source of concern, of course we are addressing that.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Are you talking sell-in or sell-out?

A - Breno Oliveira {BIO 17215392 <GO>}

Sell-out. So, we would have grown 13% in the sell-out, excluding those categories. Even considering those categories, we grew 5% in the sell-out front.

Moving on to the second part of your question. We have been developing a plan, we have been working hard on that and of course, reflects investments we have been making for a long time, especially on anti-flu medications. I do not want to anticipate launches or brands or products because of strategic reasons, of course, but we have several launches going forward, before the winter, before the flu season starts. So many things coming up to be launched.

In the case of Addera, we will launch new presentations, different dosages, different packages, so that we can position the product better in that market. On top of course, of the stronger investment in marketing, especially for the anti-flu drugs. When compared to the original plan, we want to use media more intensively, and we have stronger initiatives at the point of sale. As I mentioned, we restructured our demand team, our sell-out team, so now we are able to cover 55% of the market, from 35% to 55% of direct coverage and with that we can have more efficient initiatives. And we know that for consumer health that is quite important. It is important to be present at the point of sale. That is basically it. Again, I do not want to anticipate too much, because we have other interested parts listening to the call, but as for the market growth, anti-flu is very seasonal. Last year it grew 22%, it is very volatile, and it quite dependent on whether conditions, on climate.

And the vitamin D market has been growing fast, saw a slowdown. In the year as a whole, it grew 14% coming from a growth rate of 40% in 2017, but we do believe that, going forward, it is a very large market, and we see market resuming the market average figures. We do not see major variations or major drops in the growth rate for the vitamin D market.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

If you are able to normalize you sale for the year, with all the initiatives you mentioned, do you think you would still have pressure on your EBITDA margin? Is that why, for the first time, you are not providing a guidance based on the EBITDA margin or is it too early to say that? How do you see that in terms of profitability?

A - Breno Oliveira {BIO 17215392 <GO>}

The change in guidance has nothing to do with that. We understand how analysts look at the company as a multiple of net income. So net income would be more relevant than EBITDA. And there is another factor, which is the new IFRS which will be enforced, which will change a lot; maybe not so much for us, but mainly for retailers. They will feel a higher impact than us. In our case, I'd say EBITDA margin will probably grow when we have the new IFRS. We have not finalized the calculations, but we did not want to be misleading. As we give a nominal EBITDA guidance, if we give it now, it would be slightly misleading.

Operationally speaking, we do not expect to see great variations in terms of the EBITDA margin. The EBITDA growth should be in line with the growth in net income, with the exception of that factor that I mentioned, that extraordinary gain related to the ICMS tax gain, which as I said, we plan -- we are now assessing the amount, but we plan to use part of those gains to adjust working capital needs.

Q - Gustavo Oliveira {BIO 15129435 <GO>}

Okay, thank you very much Breno.

Operator

Thank you. This concludes our Q&A session. I would like to turn the conference call back over to Mr. Oliveira for his final remarks.

A - Breno Oliveira {BIO 17215392 <GO>}

Thank you everyone for participating in our conference call. As usual, we remain available for questions, clarifications, our IR team as well. Thank you again, and have a nice day.

Operator

Hypera Pharma conference call is over. Thank you all for participating. Have a nice day, everyone.