GRUPO HERDEZ SECOND QUARTER 2018 RESULTS CONFERENCE CALL TRANSCRIPT

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PRESENTATION

Operator:

Good morning, everyone, and welcome to Grupo Herdez's Second Quarter 2018 Results Conference Call. Before we begin, I would like to remind you that this call is being recorded, and that the information discussed today may include forward-looking statements regarding the Company's financial and operating performance. All projections are subject to risks and uncertainties and actual results may differ materially. Please refer to the detailed note in the Company's press release regarding forward-looking statements.

At this time, I would like to turn it over to Mr. Gerardo Canavati, Chief Financial Officer. Please go ahead, sir.

Gerardo Canavati Miguel:

Thank you, Nicole (phon), and good morning, everyone. As usual, we will start with an overview for the quarter and then an outlook for the year. At the end, we will take any questions you might. Andrea?

Andrea Amozurrutia:

Thank you, Gerardo. Net sales in the second quarter increased 7% compared to the same period of last year to Ps. 5.2 billion. Net sales in the Preserves division grew 5.1% with outperformance in the ketchup, mayo, mustard, tea, and tomato puree category.

Among our commercial initiatives for the quarter, we launched the Naturally Happy campaign, or contentos por naturaleza, for our Del Fuerte tomato puree, aimed at promoting the healthy and quality features of our product. The campaign was largely welcome by consumers, and despite significant discounts from our closest competitors, we have maintained our market share.

In Herdez, we launched the marketing campaign, Kitchen Garden aimed at promoting our vegetable product line, while strengthening the positioning of the brand commitment to the environment. Our product have labels with four various of seeds to assemble a mini garden by adding water and sowing them at home.

For McCormick, we launched a new mayo guacamole style as we seek to diversify consumption occasion. It is worth noting that the mayo with flavor segment is growing at a double-digit average rate of more than 20%.

In the Frozen division, we reached Ps. 873 million in net sales, 0.7% lower than the second quarter last year, mainly explained by the relocation of freezers of Helados Nestle, lower traffic at our Nutrisa stores, and a tough comparison base. Lower traffic figures were mainly driven by unfavorable weather conditions in the quarter. On the other hand, same-store sales grew 3% benefited by average ticket growth. It is worth noting that average ticket continues its ongoing trend of improvement started in the third quarter of 2017.

On the export front, our sales reached Ps. 415 million, 60% higher than the 2017 due to 69.7% and 30.4% growth in home-style salsa and mayo, respectively.

Consolidated gross margin in the quarter reached 40.6%, almost 1 percentage point increase when compared to the same period in 2017, mainly explained by a favorable sales mix and a better absorption of costs due to price increases implemented in the past 12 months.

Consolidated SG&A relative to net sales reached 26%, 30 basis points higher than in the second quarter of last year, resulting from an increase in warehousing and distribution expenses for preserves due to high inventory levels. For the Frozen division, SG&A also increased 1.7 percentage points to 52.7 due to the soft volume performance experienced in the quarter.

EBIT rose almost 13% to Ps. 775 million with a margin of 14.9%, or 80 basis points higher than the same period of last year. In the case of EBITDA, it totaled Ps. 909 million, 10.4% higher than in the same period of 2017. The margin reached 17.4%, or 50 basis points higher than the same period of last year, benefited by a lower cost structure.

Majority net income for the quarter reached Ps. 344 million, 56.3% higher than last year, boosted by a significantly higher income coming from MegaMex, and a solid performance of our Preserves division in the quarter.

In MegaMex, net sales totaled Ps. 3 billion in the quarter, an 11.9% increase compared to last year, driven by a healthy mix of price and volume. As seen in previous quarters, guacamole and home-style salsa categories continue to outperform in the portfolio.

For our financial structure, consolidated net debt to EBITDA ratio in the quarter was 1.6 times, while net debt to consolidated stockholders equity ratio reached 0.31, practically unchanged when compared to last year and the first quarter of this year.

With that, I will now turn the call over to Gerardo.

Gerardo Canavati Miguel:

Thank you, Andrea. Let me elaborate further on the performance of our Frozen segment. Lower net sales in the quarter was primarily due to a shortfall in our execution regarding the reallocation of several freezers for Helados Nestle, together with the production constraint in one of our most sold SKUs. Clearly, we view this as a one-time event.

As for Nutrisa, sales have shown a positive trend in the past weeks, which will help reduce the gap versus our 2018 target. As a matter of fact, traffic figures have shown significant improvement.

Regarding the launch of our new Nutrisa brand architecture that started in March aimed at communicating actively the positioning in the wellness segment and leveraging on the Mexican identity of the brand, three global campaigns are being implemented: product launch, store activations, and participation in large events, such as festivals and concerts. We will continue to closely monitor the six stores under this new format and will start relevant findings to provide you with a diagnosis on consumer impact in the rest of the year. We are confident and we have seen very, very encouraging signs in the acceptance of the new brand architecture.

Going back to Grupo Herdez, it is important to mention that for the next 12 months reducing working capital is paramount. This will be done through technology and revising commercial conditions with our suppliers to reflect current trends. We expect to see this benefit in the start of 2019.

Last, but not least, I would like to make you aware of the change in the presentation of the Company's financial information regarding the new IFRS 16 that will be effective in 2019. As you probably know, this will require us to capitalize the majority of our leases. Our preliminary estimate in the profit and loss statement is a slight impact in EBIT, more interest charges due to the right of use of these leases, and an increase of about Ps. 1 billion in liabilities just for this rule.

Keep in mind that, by no means, IFRS 16 adoption impacts real cash flow and will not be taken into our financial covenants. It is just a rule for presentation and we will do our best to explain it in the notes of our financial statements.

To close our remarks, regarding our annual guidance, we are reducing our top line growth to a mid single-digit rate. However, in terms of EBIT and EBITDA, we reiterate stable margins when compared to last year.

At this point, we will open the line and take any questions you might have.

Operator:

Thank you. Ladies and gentlemen, if you would like to ask a question at this point, please press star, and then one on your touchtone phone. If you are on a speakerphone, please be sure to pick up your handset or depress the mute function so the signal can reach our equipment. Again, that is star, and then one.

We'll take our first question from Álvaro García with BTG Pactual.

Álvaro García:

Hey, Gerardo and Andrea. Good morning. Congrats on the results. I have a couple of questions. The first one is on this impact from the reallocation of Helados Nestle and the production constraint on that one particular SKU. Could you quantify that? For the quarter, per se, will we see any more impact for the rest of the year? Just wanted to get an idea of maybe what, let's say, the Frozen sales run rate might be without taking that into account. That's one question.

My second question is on the working capital front. It's obviously a big priority for you and as we approach, let's say, 2019, I was wondering if you can sort of give us a timeline or walk us through where we should begin to see improvement first. Obviously suppliers are probably the most relevant item there but just, how far can your technology take you and if you could just give us more color on what'll ship first? Thank you.

Gerardo Canavati Miguel:

Thank you, Álvaro. Good morning. All right. The impact on the reallocation would be approximately 5% of the sales of the segment in the quarter. Our big issue is that we were very slow in planning this for the seasonality so we lost that. We will not recover those sales because of the seasonality of the business. Several measures have been taking place so we're confident that we will recover the operation, not the sales, going forward. Now, keep in mind that, for the rest of the year, the seasonality is a down trend.

In terms of working capital, we are—when you see our working capital we have a lot of seasonality products that we will not change because of the nature of the products, like corn, like tomato puree, etc. What really moves our working capital in terms of inventory are the two biggest category lines - and here we're talking about mayo and tomato puree. We will not focus on the small SKUs, we will focus on being more efficient on demand planning. If we can reduce our demand planning process by five or ten days, then we can see a strong reduction in our inventories.

Now, how do we do this is very simple. With technology. We will implement some technology going forward. The benefits of particularly this will be seen in the next 12 months until we use the tool. On the other front, we will see some benefits in the fourth quarter, very small, in our account payments. We are reducing the financial conditions on our factory and platform in order to invite our suppliers to use that and have a higher recovery rate, and that we are about 50% advanced, so we will see that benefit in the fourth quarter and that will help us reduce our working capital days.

Álvaro García:

Mm-hmm.

Gerardo Canavati Miguel:

Our target is initially between 20 and 30 days for the next 12 months.

Álvaro García:

That's great color. Just a quick follow-up on this, let's say, on working with your suppliers to get your tech and your platform out there and you've mentioned the 50%, how are those conversations going? How have they taken, let's say, these changes from your end?

Gerardo Canavati Miguel:

Well, some are very segmentated, some are going okay, because what we don't want to do is to make decisions by being unilateral. Let's say, 50% of our annual purchases are done with 50 suppliers—sorry, 50% is done with 30 suppliers, so it's very easy for us to engage in negotiations with our suppliers now. I think nobody with a reasonable mind will say yes, I accept your terms. What we are offering is more efficiency, what we're offering is more volume in some cases because we are doing some changes in our package materials. Some suppliers see this very positively when we increase our volumes with them. Obviously there are other ones that we are in ongoing conversations and by no means we will take any unilateral decisions.

I think it's very positive what we're doing with them. Also, we are working on being more efficient in our administrative process on payments. We are using our technological platforms in terms of our internet page where our suppliers can—their days can start counting by using the platform. We're very encouraged in using tools to be more efficient in our processes.

Álvaro García:

Great. I'll follow-up on this later if there's still time. Thank you. Thanks so much for the color.

Operator:

Our next question comes from Felipe Ucros with Scotiabank.

Felipe Ucros:

Yes, good morning, Gerardo and Andrea, and thanks for taking my questions. Let me start with exports. You obviously had a great quarter in the segment with very outsized (inaudible). You gave us some detail around the products behind the growth. But I was wondering if you could give us some more details around what type of clients drove that growth and specifically I'm trying to understand how sustainable these new levels are or whether some of the drivers behind it are kind of one-time items. To give you an example, if it was a new permanent client we would treat it different in our model than if it was a client that destocked too much and was recovering. Just trying to get some sense of that. Thank you.

Gerardo Canavati Miguel:

Sure. Good morning Felipe. How are you? Two things in export. What drove the majority of the growth was a delay in the first quarter, okay. What we shipped to MegaMex, salsa, particularly, was shipped in the second quarter, all right. Now, that is—on an annual basis, that is our normal operations, so you will see a normalization on the growth rate. For the year, we are expecting, in terms of volume, mid single-digits, okay, talking about the ongoing business in MegaMex. Now, what you did see was this extraordinary sale of fresh tuna that, in terms of sales, was approximately 10% of our exports. This, and I want to be very emphatic, this is extraordinary and we do not expect this kind of operations on a regular basis. It's more opportunistic. Generally speaking, our fresh tuna that is sold to our client is a recently new business, probably 12 months, very volatile and our primarily customers are within Mexico, are national.

What you will see in this business is a slower growth rate in exports but a higher rate in national—domestic sales that are mixed with our Preserves category. We had a very profitable export for the quarter, but honestly, these margins are not sustainable. We are not accounting that in our export business going forward, in our guidance.

Felipe Ucros:

Thanks a lot. Yes, and I want to rehash a little bit because the line cut off a little bit when you were explaining what happened with the movement of freezers. Not responding to Álvaro's question, I heard that very well, but when you were presenting what happened during the quarter with the movement of freezers, I didn't get that very well. If you could repeat it I would appreciate it.

Gerardo Canavati Miguel:

We were very slow to execute the strategy. This strategy should have been executed in the beginning of the year and we were slow to do it and we didn't meet the deadline for the seasonality. We really missed the best seasonality on the business. It is really a one-time-off and we have taken some measures to be on the right track. We lost about 5% of the sales of the Frozen segment on this issue, just for the quarter.

Felipe Ucros:

You were moving freezers—what I missed was the explanation of why you were moving freezers. Were you planning to optimize the operation or…?

Gerardo Canavati Miguel:

Yes. This is an ongoing concern. This would be the same as the closing of Nutrisa stores. Obviously, what we have done in that case is that we closed about 80 stores in, I don't know, 24 months, but we review the performance of the freezer on an ongoing concern so first we determined what's the cost of the underperformance and if there's a very deep root on that we will change that freezer. This is part of our operations. Obviously, this is the first time that we're doing this. The first time is that we are aiming to move a big portion of our freezers. Going forward, this will be less an impact of the total freezers that are out there.

Felipe Ucros:

Okay, excellent. We could think of this kind of as a learning curve of trying to optimize the freezer footprint.

Gerardo Canavati Miguel:

Correct, yes.

Felipe Ucros:

Perfect. Thanks a lot for that color. I'll leave it there and I'll let other analysts get in. Thanks.

Operator:

We'll take our next question from Jorge Huerta with GBM.

Jorge Huerta:

Hi Gerardo and Andrea. Congratulations on the results and thanks for taking my question. (Inaudible) outstanding results for MegaMex. Can you give us more color on your expectations about this business for what remains for the year?

Gerardo Canavati Miguel:

Yes, and I'm glad you brought that up. Simply, the execution and the growth in MegaMex is outstanding. Now, all the—the margin expansion that we are experiencing in that business comes from one big source that would be avocado price. As you know, avocado price have collapsed in the last six months. There's obviously a seasonality in the fruit that is obviously very, very volatile so we have to get used to this margin contraction and expansion.

Now, the good news is that the sellout of Wholly Guacamole, the repeat rate within our consumers, the market share and the growth is outstanding. We are growing in salsas. Obviously, under the Herdez brand we are growing in Wholly Guacamole at double-digits. We are penetrating households in the United States at a fast rate. Our opportunity is huge in terms that approximately 70% of household in the United States consume avocado, the fruit. The category processed guacamole is in the low 20s. You can imagine our growth opportunities going forward.

Please keep in mind that gross margins will be volatile but the top line in that business is great. We expect this year to close on a high note and for the next year it will depend on the avocado price.

Jorge Huerta:

Thank you very much.

Operator:

We'll take our next question from Luis Miranda with Santander.

Luis Miranda:

Yes. Hi, good afternoon, Gerardo and Andrea. Two questions regarding the operations of Preserves. Gerardo, I just wanted to understand if there was any effect similar to MegaMex in terms of inventory replacement by some customers, or by the important promotional campaign that we have seen during the second quarter and if you had to be more promotional in order to maintain market share, as Andrea was mentioning. The second question is we have been hearing a lot of comments from President of Mexico about internal inflation, especially due to transportation, logistics and the cost of fuel. If you could give us some color on the impact on Herdez? Thank you.

Gerardo Canavati Miguel:

Hi Luis. You are just talking I guess about domestic sales because you mentioned MegaMex. But talking about domestic sales, I think it's more a segmentation, and as we have discussed previously, this strategy depends on what we want to do. When lowering our top line guidance in terms of sales is because we decided in some categories not to fight for market share. Those would be lost sales. In terms—when some of our competitors are investing huge amounts of money in campaigns, in advertising, and just gaining one or two percentage of the market, sometimes we decide it is not worth fighting for that.

On the other hand, we are investing in constructing brand equity for the long run. For example, the campaigns that we have done for the Herdez, with For a Better World, have been very positive in helping regain some market share where the categories are driven by price. Instead of fighting in the marketplace with price, we built brand equity. Obviously, this is sacrificing the short term for the long run and we have always believed in that.

In terms of your second question, now, across the board yes, we have seen stable market share. In a few categories we have lost one or two points and we are fine with that. In terms of our cost inflations, definitely, we haven't seen inflation slow. There's huge amount of inputs that are still under pressure - for example, board, paperboard, for example, transportation and specialized materials - and we still see that going forward. We haven't discussed any pricing action for the next year. I think it's too early. But also the dollar, or that it's, at least right now, it's in a down trend, would be a significant contributor to control those input price pressures.

I think it's too early to say what's going to happen with our pricing strategy for the next year but we are closely seeing that.

Luis Miranda:

Great. Gerardo, that was very clear. Thank you.

Operator:

We'll take a question from Mauricio Santos with GBM.

Mauricio Santos:

Hi, Gerardo and Andrea. Thanks for the call. I was just wondering, soybean prices have declined massively in the past month. Are you taking advantage of this? Do you think it's sustainable? Has it helped you offset some of the inflation you've mentioned in the other raw materials? Thank you.

Gerardo Canavati Miguel:

Good morning, Mauricio, and thank you. Yes, the answer is yes. We are not in the business of buying soybean. We're in the business of selling mayo. We are extremely hedged in soybeans and this will help us offset the pressure on the other inputs and obviously, because it's a dollar denominated input, we are also seeing some relief in terms of the exchange rate. Obviously what was driving the price down are several factors. The biggest would be ample supplies and the trade war effect and we've seen these prices in a very attractive level in order to take that risk out of our P&L.

Mauricio Santos:

Okay.

Gerardo Canavati Miguel:

Okay?

Mauricio Santos:

Thank you.

Operator:

Once again, ladies and gentlemen, if you would like to ask a question today, please press star, and then one. If you would like to ask a follow-up question, that is star, and then one.

We have a follow-up question from Álvaro García with BTG Pactual.

Álvaro García:

I wanted to follow-up quickly on the working capital front. Would there be perhaps a particular, let's say, a real life example you could share with us or an argument that you'd be able to use with suppliers on how your new systems make it easier for their customers, whether it's a fresher product or some form of cleaner time period for that product to get there? Does it make it easier on their end? Obviously from their end that they're willing to extend terms but I was wondering if maybe there was a real life example of that sort. Maybe I'm reading too much into it, but I'll stop there.

Gerardo Canavati Miguel:

No, no, that's fine, Álvaro. Well, first, I think that there are various negotiating tactics that I will not talk about but let me share with you some examples. If we have an SKU that we are planning to change packaging, we are lowering the volume in one package and increasing it in another one, so we offer that incremental volume to the supplier and asking for better terms. In the end, they will be extremely better, selling more and paying for the financial cost on receiving money instead of, I don't know, 45 days or 60 days, 30 or whatever days more. Because this is primarily a financial cost that somebody will pay, we are offering—through the factory, we are the best or the cheapest financing cost within the NAFINSA structure, right, so our goal is to share with them our financial cost so this will be a small impact.

Next, if we do—we work with suppliers in the United States for some of the MegaMex SKUs and if we are working on being more efficient in our Mexican facilities and we can co-pack for MegaMex more volume, some of our suppliers will benefit from that. That's another example where we will offer more volume, more business in order to have better terms.

Álvaro García:

(Inaudible).

Gerardo Canavati Miguel:

Yes, right. Now, this is only with a few suppliers, maybe material, package material suppliers, containers, whatever. The majority of the suppliers, we're just negotiating with them and helping them prepare for these changing conditions. In some cases, they don't have any more volume to take, right, and that's where the negotiating tactics come in.

Álvaro García:

Great. Thank you.

Gerardo Canavati Miguel:

All right.

Operator:

Ladies and gentlemen, that does conclude our question-and-answer session. I would like to turn the conference back over to Gerardo Canavati for any closing remarks.

Gerardo Canavati Miguel:

Thank you, Nicole. Thank you, everybody, for participating in today's conference call. Please do not hesitate to contact us if you have any questions. Have a good day.

Operator:

Once again, ladies and gentlemen, that does conclude today's conference. We appreciate your participation today.