Conference Call (English Transcription)

Vulcabras Azaleia S/A

Earnings Release 4Q19

March 3th, 2020

Operator: Good morning and thank you for waiting. Welcome to the Vulcabras Azaleia conference call to discuss results for 4Q19. Present today with us are Pedro Bartelle, CEO of the company, Mr. Wagner Dantas, CFO and Investor Relations Officer and our Investor Relations team, Mr. Valdinei Tortorelli and Ms. Letícia Marcellino Carvalho.

We inform you that this event is being recorded and that all the participants will be only listening to the conference call during the presentation of Vulcabras Azaleia. Then we will start the Q&A session, when further instructions will be provided. If you need any assistance during the conference call, please request the assistance of an operator by entering a * zero.

This event is also being transmitted simultaneously through the internet, via the webcast, and can be accessed at www.vulcabrasazaleiari.com.br, where the respective presentation is available. The selection of the slides will be controlled by you. The replay of this event will be available soon after its closure. Please note that webcast participants will be able to register, via the website, questions for Vulcabras Azaleia, which will be answered after the end of the conference, by the IR area.

Before proceeding, we would like to clarify that any statements that may be made during this conference call regarding Vulcabras Azaleia's business prospects, projections, operating and financial goals, constitute beliefs and assumptions of the Company's Management, as well as information currently available for Vulcabras Azaleia. Future considerations are not performance guarantees and involve risks, uncertainties and assumptions as they relate to future events and therefore depend on circumstances that may or may not occur.

Investors and analysts should understand that general conditions, industry conditions and other operating factors may affect the future results of Vulcabras Azaleia and may lead to results that differ materially from those expressed in such future conditions.

I would now like to give the floor to Mr. Pedro Bartelle, CEO of the company, who will begin the presentation. Please, Mr. Pedro, you may proceed.

Mr. Pedro Bartelle: Good morning. Welcome to the results conference call of Vulcabras Azaleia.

2019 brought many challenges and difficulties for the Brazilian market. The economy rehearsed a recovery that did not happen. According to IBGE data, the retail trade grew 1.8% in 2019, but in the footwear and clothing segment there was a stagnation scenario, with a positive variation of only 0.1%. In response to this scenario, Vulcabras Azaleia sought to implement actions that ensured the expansion and consolidation of the Company as one of the largest footwear companies in the Brazilian market.

An important step in the 4th quarter of 2019 was the conclusion of the second expansion of the Company in its factories and the beginning of the third phase of expansions. With the investment, the company now has 70 thousand square meters of covered area in Ceará and 60 thousand square meters of built area in Bahia. Moreover, following the trends of market innovations, it implemented a new leather manufacturing process using straight machines, the famous knit leather uppers, which, in addition to providing greater comfort to the consumer, has a more efficient production process.

In the DTC (Direct to Consumer) channel, taking advantage of the existing structure for Under Armor e-commerce, since October the Company has internalized the Olympikus and Azaleia brands e-commerce platforms to its own operation, aiming not only at better margins, but also a closer relationship with the consumer.

The set of these optimization, communication, and innovation actions increased our market share, growth led by sports brands, recording total revenue of R$ 373.9 million in the quarter, an increase of 5.6% over the fourth quarter of 2018. The result is expressive, considering that this is the first quarter in which the comparison base of the previous year already included revenue from the Under Armor brand.

Throughout 2019, the Company worked intensively on the integration and absorption of Under Armor's business areas. Naturally, in an incorporation process like this, additional expenses were incurred (especially during the first half of the year), which in a way impacted the results for the period. However, from the 4th quarter onwards, with the e-commerce of all brands under the management of a single structure, and with all other departments fully integrated, Under Armor is now fully able to enjoy synergies with the other brands.

At Olympikus, the Company continues to be strong in initiatives in the running category, such as the launch of the “Corre 1” model, the best footwear with national development and manufacture for running, and the “Bota para Correr” campaign, with a racing circuit in paradisiacal scenarios in the country. At Under Armor, it brought important product campaigns and initiatives such as “Knockout Run”, clothing collection with RUSH technology and new models for the “Charged Cushioning” footwear family (developed by the brand in partnership with Vulcabras Azaleia). All these actions reflected in the construction of a solid relationship with the community of runners and in the Company's image as a reference in sports performance technology.

Efforts in sustainability continued in the period as a priority for the Company, which successfully concluded the Effluent Treatment and Reuse System at the manufacturing plant in Horizonte (Ceará). This step integrates the Water Reuse and Savings project through the installation of a treatment plant focused on reusing 100% of the generated sewage, and results in an estimated savings of 50 million liters of water per year for Vulcabras Azaleia, attesting to its commitment to the future, to people and the environment.

Last December, the Company received the “Environmental Performance Award 2019” for its Water Reuse and Savings project in a large industry from the Federation of Trade, Industry, Services and Agricultural Associations of Ceará (FIEC). The award aims to recognize industrial companies that stand out in the conservation of the environment and implement activities that result in the improvement of environmental quality.

In this quarter, the Company obtained from the Ceará state government the extension of the tax incentive term for the production of footwear, until 2031, with maintenance of the same currently prevailing conditions.

In a relevant fact released earlier this year, with a focus on resource optimization, gains in scale and the search for better efficiencies, the sale of the subsidiary Vulcabras Azaleia SE was announced. The buying company, which is also from the footwear sector, took control of the operation, thus preserving the employment of the 950 employees who work in that unit. The whole production at the Sergipe plant will be absorbed by the other two plants of the Company, located in the Northeast of the country, in Horizonte (Ceará) and Itapetinga (Bahia).

We closed 2019 with the certainty that we have taken important steps and we remain attentive to new business opportunities in order to continue growing and creating value for our shareholders. We are ready for a new cycle of achievements by the Company.

For the presentation of our performance in the quarter, I would like to give the floor to Mr. Wagner Dantas, our CFO and Investor Relations Officer. Thank you.

Sr. Wagner Dantas: Good morning everyone. We started the presentation with **slide 5,** gross volume of pairs and pieces.

In 4Q19, gross volume totaled 7.4 million pairs/pieces, an increase of 1.9% compared to 4Q18 total of 7.2 million pairs/pieces. The variation in the period is mainly due to: (i) an increase in athletic footwear sales, driven by the growth in the domestic market and also the growth in the foreign market, however to a minor extent, (ii) a decrease in women's footwear, due to the decrease in the domestic market and the slight increase in the foreign market, (iii) an increase in Other footwear and Other, (iv) an increase in Apparel and Accessories sales, mainly due to the growth in Olympikus brand sales.

In 2019, gross volume amounted to 27.2 million pairs/pieces, an increase of 8.9% compared to that in 2018, of 25.0 million pairs/pieces.

On page 06, we present the net revenue per product category.

In 4Q19, net revenue was R$ 373.9 million, an increase of 5.6% compared to R$ 354.0 million in 4Q18.Athletic Footwear revenue increased 4.8%, with positive performance both in the domestic and foreign markets.

Olympikus revenue grew in the fourth quarter with the growth in the domestic market, as well as in the foreign market, although the foreign market base for comparison of prior year was already much weaker. In the domestic market, sales continued concentrated in the entry price range and presented good performance in retail sales during Black Friday and Christmas.

Revenue from Under Armour footwear sales in the fourth quarter increased on a comparative basis, with higher average price than that in 4Q18.

The Women's Footwear segment grew by 4.0% compared to the same period of 2018. In the period, revenue in the domestic market grew due to the increase in average price, however, offset by the decrease in revenue in the foreign market.

The Apparel and Accessories segment presented growth, expanding 5.6% compared to 4Q18. In the period, revenue from Olympikus brand increased and revenue from Under Armour brand decreased, mainly due to sales of inventories acquired in the acquisition of the subsidiary in 4Q18.

Other Footwear and Other segment increased, with increase in both slippers and boots sales, however with decrease in footwear parts sales.

In 2019, net revenue was R$ 1,360.0 million, up 8.9% compared to R$ 1,249.0 million in 2018.

On page 07, we present the opening of net revenue per market.

Net revenue in 4Q19, in the domestic market, totaled R$ 342.2 million, an increase of 5.6% compared to R$ 324.0 million in 4Q18. In the foreign market, net revenue in 4Q19 totaled R$ 31.7 million, 5.7% up compared to R$ 30.0 million in 4Q18.

In the domestic market, the growth is due to: (i) increase in revenue from both Olympikus and Under Armour athletic footwear sales; (ii) increase in revenue from women's footwear sales, (iii) increase in revenue from Apparel and Accessories sales, and (iv) increase in revenue from Other footwear and Other sales.

Revenue from sales to foreign market in 4Q19 increased compared to the same period last year. In 4Q19, direct sales to third parties in the foreign market increased compared to those in 4Q18, however, considering a much weaker base for comparison in 4Q18. Sales of foreign branches remained stable compared to the same period in 2018, despite the decrease in local consumption due to political instability in both Peru and Colombia.

In 2019, net revenue in the domestic market totaled R$ 1,251.3 million, an increase of 12.0% compared to 2018, when net revenue was R$ 1,117.5 million. In the foreign market, net revenue in 2019 was R$ 108.7 million, down 17.3% compared to R$ 131.5 million in 2018, mainly due to the interruption of sales to Argentina throughout 2019.

Going to page 08, we have the presentation of gross profit and gross margin.

Gross profit of 4Q19 was R$ 133.7 million, equal to that for 4Q18. Gross margin was 35.8% in 4Q19, down 2.0 p.p. compared to 37.8% in 4Q18.

Gross margin in 4Q19 maintained the recovery trend noted in 3Q19. The increase in orders led to better efficiency at plants and consequently to lower costs. Competition in the retail market continued high thus posing pressure on Olympikus footwear sales, most of which at lower price ranges.

For Under Armour, there was continued expansion with the 5 new footwear models presented at the end of October. The new models were developed in Brazil, in line with the new technologies introduced in the plants and, consequently, presented better profitability.

In 2019, gross profit was R$ 471.8 million, an increase of 5.2% compared to R$ 448.6 million in 2018. Gross margin in 2019 was 34.7%, 1.2 p.p. lower than in 2018 (35.9%).

Going to page 09, we present the selling and advertising expenses.

At the top of the slide are the graphs of Selling expenses (ex-marketing), which present R$42.6 million in 4Q19 increased 8.1% compared to R$ 39.4 million in 4Q18. As a share of revenue, selling expenses (ex-marketing) accounted for 11.4% in 4Q19, compared to 11.1% in 4Q18, a 0.3 p.p. increase.

The nominal growth in selling expenses in the comparison of the two periods is mainly explained by the increase in freight expenses and allowance for doubtful accounts, offset by the decrease in the fixed expenses line item, referring to compliance with IFRS 16/ CPC 06 (R2). Variable selling expenses were in line with normal level, and their share of revenue was also in line with that for the last quarters.

In 2019, selling expenses (ex-marketing) totaled R$ 155.8 million, an increase of 14.1% compared to R$ 136.6 million in 2018. Selling expenses as a percentage of net revenue increased by 0.6 p.p. from 10.9% in 2018 to 11.5% in 2019. Note that in 2018, expenses of Under Armour subsidiary only started being consolidated in the Company’s results in the fourth quarter.

At the bottom of the slide, we have advertising and marketing expenses which totaled R$ 21.5 million, an increase of 12.0% compared to R$ 19.2 million in 4Q18. Investments in marketing increased in the comparison of the two periods mainly due to the increase in expenses with the Under Armour brand.

Advertising and marketing expenses accounted for 5.8% of net revenue in 4Q19, compared to 5.4% in 4Q18, an increase of 0.4 p.p. In 2019, advertising and marketing expenses totaled R$ 69.0 million, an increase of 16.9% compared to R$ 59.0 million in 2018.

Going to page 10 we have the statement of General and Administrative expenses.

Administrative expenses totaled R$ 29.8 million in 4Q19, a decrease of 6.6% compared to R$ 31.9 million in 4Q18. As a percentage of net revenue, there was decrease of 1.0 p.p., from 9.0% in 4Q18 to 8.0% in 4Q19.

The main variations in the quarter are due to: (i) reduction in personnel, travel and electric energy expenses; (ii) increase in expenses with outsourced services, mainly due to the increase in logistics costs of the e-commerce operations of Olympikus and Azaleia, which started to be managed in-house in October.

In 2019, there was 20.2% increase in general and administrative expenses totaling R$109.6 million compared to R$ 91.2 million in 2018. When comparing the percentage over net revenue, there was a 0.8 p.p. increase in 2019 compared to 2018. Note that in 2018, expenses of Under Armour subsidiary only started being consolidated in the Company's results in the 4th quarter.

On page 11 shows the behavior of the financial result and the net debt.

Net financial income in 4Q19 resulted in income of R$ 7.5 million, compared to expense of R$ 6.9 million in 4Q18. In the quarterly comparison, there was decrease in interest expenses and exchange losses. In 4Q19, income of R$ 10.2 million was recorded referring to present value adjustment of ICMS debt to the Sergipe state government, pursuant to item 8.1 attachment of CPC 12. In 2019, net financial income resulted in income of R$ 5.1 million or 0.4% of net revenue, compared to expenses of R$ 6.2 million in 2018.

At the end of 4Q19, gross debt totaled R$ 43.1 million, a decrease of 28.2% compared to the balance at 12/31/2018. There was a decrease in available cash of 9.3%, reaching net cash of R$ 21.9 million at the end of the period.

On page 12 we have net income and Adjusted ROIC.

Net income in 4Q19 was R$ 45.1 million, representing a decrease of 2.4% compared to net income of R$ 46.2 million in 4Q18. Net margin reached 12.1% in 4Q19, compared to 13.1% in 4Q18, a decrease of 1.0 p.p. In 2019, net income was R$ 143.1 million, down 5.9% compared to R$ 152.1 million in 2018. Net margin decreased 1.7 p.p., from 12.2% in 2018 to 10.5% in 2019.

In 4Q19, there was a "non-recurring" revenue affecting the Company's results by R$ 10.2 million, similar to the positive effect of R$ 8.6 million in 4Q18. For purposes of comparison, if the "non-recurring" events were eliminated from 4Q19 results, net income for 4Q19 would be R$ 34.9 million with net margin of 9.3%, 7.2% lower than net income for 4Q18 of R$ 37.6 million with net margin of 10.6%.

Analogously, if the "non-recurring" events of the periods were eliminated, accumulated net income for 2019 would be R$ 128.6 million with net margin of 9.5%, 12.1% lower than net income for 2018 of R$ 146.3 with net margin of 11.7%.

Annualized adjusted return on invested capital - Adjusted ROIC3 reached 18.3% in 4Q19, last twelve months ended 12/31/2019, which represents a 4.9 p.p. decrease compared to 23.2% as at 12/31/2018.

On page 13 we present EBITDA.

In 4Q19, EBITDA was R$ 60.2 million, a decrease of 12.9%, compared to R$ 69.1 million in 4Q18. EBITDA margin decreased 3.4 p.p., reaching 16.1% in 4Q19, compared to 19.5% in 4Q18. In 2019, EBITDA was R$ 222.5 million, an increase of 2.1% compared to R$ 218.0 million in 2018. EBITDA margin decreased 1.1 p.p., reaching 16.4% in 2019. The adoption of IFRS 16/ CPC 06 (R2) (Leases) positively affected EBITDA for 4Q19 by R$ 3.4 million.

As highlighted in the previous sections, EBITDA was also affected in 4Q19 by "non-recurring" events. On the same basis of comparison and excluding "non-recurring effects", adjusted EBITDA in 4Q19 would be R$ 56.8 million, with EBITDA Margin of 15.2%, being 6.1% lower than adjusted EBITDA of 4Q18 of R$ 60.5 million, with EBITDA Margin of 17.1%. Excluding "non-recurring" events, adjusted EBITDA for 2019 would be R$ 205.5 million, with EBITDA margin of 15.1% compared to adjusted EBITDA of 2018 of R$ 212.2 million and EBITDA Margin of 17.0%.

On page 14, we present Capex.

In 4Q19, R$ 22.6 million was invested in property, plant and equipment, particularly in connection with molds. Investments in intangible assets in 4Q19 were R$ 1.0 million. This is due to the continuity of the plant modernization project. In 2019, investment in property, plant and equipment was R$ 115.9 million, up 22.6% compared to 2018, with investment of R$ 94.5 million. Investments in intangible assets in 2019 were R$ 3.5 million.

On page 15 we present the cash flow.

Cash flow variation in 2019 was negative R$ 6.1 million, with EBITDA of R$ 222.5 million, with an increase in working capital requirements of R$ 103.2 million (includes payment for acquisition of subsidiary), a reduction in bank liabilities of R$ 17.0 million and investments in property, plant and equipment and intangible assets of R$ 119.4 million. The main variation in working capital in 2019 is due to the increase in inventories due to Under Armour's retail operations, consisting of seven stores and own e-commerce, as well as the beginning of e-commerce operations of Olympikus and Azaleia managed by the Company.

So, we finished our presentation and made room for questions. Thank you very much.

Q&A Session

Operator: ladies and gentlemen, we will now begin the question and answer session. To ask a question please type star (*) one and to remove the question from the list type star (*) two.

Operator: Remembering that in order to ask questions just enter star one (* 1). Again, to ask a question please enter star one (* 1).

We have now closed the question and answer session. I would like to turn the floor over to **Mr. Pedro Bartelle** for the final considerations. Please Mr. Pedro, you can proceed.

Mr. Pedro: Thank you all for the participation in this conference call and we remain at your disposal to clarify personally and through our IR team any further points or doubts that may have been pending. Thank you very much and Good morning.

Operator: The conference call of Vulcabras Azaleia is finished. We thank you for your participation, have a good day and thank you for using Chorus Call.

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