

Company Name: Herdez
Company Ticker: HERDEZ* MM
Date: 2014-10-24
Event Description: Q3 2014 Earnings Call

Market Cap: 15,076.80
Current PX: 34.9
YTD Change(\$): -11.57
YTD Change(%): -24.898

Bloomberg Estimates - EPS
Current Quarter: N.A.
Current Year: 1.716
Bloomberg Estimates - Sales
Current Quarter: N.A.
Current Year: 13860.167

Q3 2014 Earnings Call

Company Participants

- Gerardo Canavati, Chief Financial Officer
- Andrea Amozurrutia, Head of Financial Planning and Investor Relations

Other Participants

- Miguel Mayorga, Analyst
- Daniel Sanchez, Analyst
- Robert Lampl, Analyst
- Diego Mayor, Analyst

Presentation

Operator

Good morning everyone and welcome to the Grupo Herdez's Third Quarter 2014 Results Conference Call.

Before we begin, I would like to remind you that this call is being recorded and that 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.

And I will now turn the call over to Mr. Gerardo Canavati, the company's Chief Financial Officer; and Ms. Andrea Amozurrutia, Head of Financial Planning and Investor Relations. Please go ahead.

Gerardo Canavati, Chief Financial Officer

Thank you, Vicky. Good morning everyone and thank you for joining us. Andrea will begin with an overview of the company's performance in the quarter and then I will share with you some additional insight on the pace and progress of the restructuring at Nutrisa and our initial outlook for the coming quarter. As usual, we will be happy to take any questions you have at the end. Andrea?

Andrea Amozurrutia, Head of Financial Planning and Investor Relations

Thank you, Gerardo. Our performance in the third quarter we remarkably solid, given the overall consumption environment, which remained weaker than expected. Obviously, raw materials were largely in our favor and we benefited from the year-ago comps, but most importantly, we saw our commercial initiatives driving topline growth.

In Mexico Core, the largest segment of our business, which includes our traditional processed foods portfolio, six of the eight categories have comprised 80% of sales. So, double-digit increases in both volume and net sales.

Most notably, tuna volumes that were significantly lagging in the first half of 2014 rose almost 30% over last year after the price reduction that we announced in the previous quarter.

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On the export front, sales continued to increase at double-digit rates of more than 30%. Conversely, Nutrisa sales dropped 8.6%. This was almost entirely due to the rationalization of the product portfolio where the number of SKUs have been reduced by one-third since the first quarter of 2014, approximately 10% of total sales at that time.

In combination with the sub-consumption environment, particularly in a specialized retail, which has affected traffic stores. Regarding our operating performance, consolidated EBIT margin before other income and expenses expanded 1.3 percentage points this quarter to 14.6%. This reflects topline growth and the benefit of lower key raw material costs, which more than offset our investment in marketing, advertising and promotions in order to drive volumes, as well as the 12 million pesos of extraordinary expenses at Nutrisa related to management restructuring coupled with inventory write-off. Despite the non-cash expenses this quarter for the ongoing factory consolidation at Los Mochis and Nutrisa's extraordinary items, EBIT margin rose more than 80 basis points to 14.2%.

Moving on to the equity in associates where MegaMex's pre-tax income accounts for approximately 90% of the total, we saw a double-digit increase which is broadly explained by the earn out charge registered in the previous year. Finally, at the bottom line, consolidated net income totaled 372 million in the quarter with a 10.2% margin. This represents a 1.5 percentage point expansion from the year-ago period.

As for our financial position, our cash balance rose to 1.3 billion pesos this quarter, up 93 million from the second quarter after buying back 94 million of our own shares. Leverage ratios remained healthy with a net debt to 12-month EBITDA ratio of 1.7 times. With that, I will now turn the call over to Gerardo.

Gerardo Canavati, Chief Financial Officer

Thank you, Andrea. Our performance in the third quarter was very solid, particularly in the context of our industry and we are pleased that our execution strategy is delivering. In that context, I would like to elaborate a bit more on what's happening at Nutrisa and MegaMex. First and foremost, our confidence in the potential of Nutrisa has been reinforced with the new and clearer brand vision to become the benchmark of wellness so each of our clients can have a healthy lifestyle.

To achieve that, one of the first things that we realized was that the brand and the business needed to be revitalized. This process has included a management shakeup, an extensive product portfolio rationalization, closures of underperforming stores and termination of under-managed franchise contracts. With no doubt, all these changes at once have had a significant short-term impact on performance in a weak retail environment.

As you may know, same-store sales for the 30 businesses that comprise Mexico Specialized Retail Association are 5% down year-to-date. However, we strongly believe that this is the correct path in order to secure our long-term goal of doubling the size of the business.

Let me elaborate on the specifics of the restructuring. At this point, the entire management team has been refreshed; marketing, operations, supply chain, human resources and finance. We have closed more than 30 stores that either didn't comply with our quality standards or that were underperforming. For the remaining stores, we've hired and trained new staff and are optimizing inventory, layouts and merchandising at the retail level.

And even though our main focus right now is in our own stores, the growth of Nutrisa volume in the modern channel will increase five times from the time of the acquisition. Since the crossover benefits of the integration go both ways, now we've begun to introduce Aires de Campo organic products at 30 plus Nutrisa stores, which perfectly complement the brand positioning of Nutrisa and the reference of Wellness.

In terms of the product portfolio and sales mix, more than three-quarters of the drop in sales comes from products that did not comply 100% with regulatory standards. In short, all the commercial products including supplements and food labels sold at our stores have been scaled up to meet Grupo Herdez quality standards, and certainly, consistent with the Nutrisa brand.

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We expect 2014 to be the inflection point for Nutrisa and that the key elements of this transformation are nearing their end. The fourth quarter will still reflect extraordinary charges that we are making and you can expect that the total figure for the year will be around 65 million instead of the 40 million that we were originally expecting.

One-third of this amount is due to layoffs, one-third approximately for inventory write-down and the rest for amortization charges arising from the stores closures. With all this, we see a solid path to recovery starting in 2015.

To conclude my comments on Nutrisa, I don't want to minimize the missteps we have made after acquiring the business. It took us too long to integrate the business and put in place new management. Yet, we probably changed the portfolio too fast. And like many in our industry, we overestimated the pace of the economic recovery for the year. That said, we believe we are making good progress and remain confident in our expectations of the business.

Moving on to MegaMex, the business line that continues to drag performance most is Don Miguel. Don Miguel faced significant refrigerated capacity constraints, protein price increases and raw material shortages in the recent quarters. We have stabilized the constraints with SKUs rationalizations, co-packing agreements and production schedules. Unfortunately, as our biggest customers are in the convenient channel, we faced shortages that translated in sales that will not come back this year. Some ongoing CapEx investments will increase capacity for the next year.

Even though the competitive environment in guacamole is still tough, we have seen avocado prices stabilize as part of the cycle. Our performance in our core categories remain strong and we have focused in this category. One of the biggest parts continues to be the growth of our Herdez brand that been a cumulative increase in sales of 17% in the past five years.

Let me conclude with our expectations for the remainder of the year and initial outlook for 2015. Even though we are not expecting a significant recovery in the fourth quarter, we should close on a high note for 2014. This optimism is based on the actions we continue to take on the commercial front and the commodity outlook. That means that excluding Nutrisa, topline growth for the fiscal year should close with a mid single-digit growth rate, while operating and bottom line results should grow in the low double-digit range.

And this is despite the fact that we are expecting higher taxes for 60 million in the fourth quarter. At Nutrisa, however, we will not achieve flat performance year-over-year and sales should close approximately 10% below of 2013. As for EBITDA, we are expecting the margin to close on a high single-digit, including extraordinary charges. As for 2015, we will be issuing our guidance in the coming months. But I can tell you that right now we are a bit more upbeat about topline performance. The competitive environment will definitely be aggressive and pricing strength will depend on category. Notwithstanding, we expect organic sales to rise in the mid single-digit range, and if weather and commodity markets co-operate, gross and operating margin will also expand.

At Nutrisa, we will definitely expect the return to double-digit growth rates, while at MegaMex we estimate about 10% year-on-year growth and the net income to be consolidated.

That concludes my prepared remarks this morning. So, we are now ready to take your questions.

Questions And Answers

Operator

Thank you. (Operator Instructions) And we will take our first question today from Miguel Mayorga. Please go ahead.

Miguel Mayorga, Analyst

Hello, Gerardo and Andrea, thank you for taking my question and congratulations on results. It was a very nice surprise to find those strong results mainly in Mexico. I have two questions, the first one, you, Gerardo, talked a little bit about it, but I just would like to understand the positive trend that we saw in Mexico. I understand that it's sustainable and

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should improve further by 2015. I would just like to hear a little bit more about this.

And the second one would be related to MegaMex's performance on this quarter and what I would appreciate is if you could share with us how it performed earlier in terms of sales or EBITDA margin, if you could give us some idea about that? Thank you.

Gerardo Canavati, Chief Financial Officer

Thank you, Miguel. Well, in general terms, we have seen a little bit upbeat about the consumption environment, definitely it would depend on formats, it would depend on channels. But food is a little bit up. Overall, we have seen that growth has been flattish, but September was very high note in terms of consumer companies, at least with the analysis that we make.

So, we expect that as spending goes on and the economic development continues at least at a higher pace, maybe not as all of us expect, consumer will pick up and we see that rolling over for next year. So, in terms of execution, as we have mentioned before, we have been very focused on trade marketing. We have revamped our own team. So, we have a lot of confidence on that execution in terms of clients, in terms of channels and in terms of activities. We have had a lot of activities along the brands, a lot in point-of-sale, a lot in terms also in advertising and a lot in terms of allowances with clients. So, it would be more a combination of those tools in order to grow more rapidly, about half, the one single-digit range.

In terms of MegaMex, I think that, as I mentioned, our sales shortages come from Don Miguel, but the other two businesses are performing very good. In terms of margin -- normalized margin, we have said that MegaMex normalized EBIT margins are in the same range as Grupo Herdez, plus/minus 1%. We haven't seen any change in that. We have a lot of confidence of our new team. You can recall that MegaMex, we also had a management shuffle 12 months ago. So, now we have new people in place in marketing, in finance, in operations and we have a lot of confidence that the team is addressing the issues in capacity that we are experiencing in Don Miguel is very good and that next year is going to be a high note for MegaMex in terms of sales, in terms of cost and in terms of execution.

Miguel Mayorga, Analyst

Okay, thank you very much, Gerardo.

Operator

And we will now go to Daniel Sanchez with BTG Pactual. Please go ahead.

Daniel Sanchez, Analyst

Hi, Gerardo and Andrea, thank you for taking my question and congratulations on the results. I was wondering if you could just give us an update on your expansion plans for Nutrisa. Should we expect to see any more closures of underperforming stores? Should we expect more openings of large stores outside the metropolitan area of Mexico City, less openings of kiosks or like which are your expansion plans for Nutrisa for early 2015? Thanks.

Gerardo Canavati, Chief Financial Officer

Hi Daniel, good morning. Net openings for fourth quarter should be in the high single-digits, maybe eight to nine stores. And after saying that, we think that the majority of the closures have been taken place this year and we should -- we have closed 33 stores year-to-date and we're going to open about 38 approximately. So, net-net, this year we're

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going to be flat. So, we open and we close almost the same amount. We are aiming to finish all this restructuring in this fourth quarter, the majority. So, for next year our plan is to open between 50 and 60 stores a year. Now, that's a combination in our formats because we have the big stores, the kiosks and the ice cream shops. So, depends on the growth of the big stores, but we are generally opening more kiosks, to answer particularly your question. We have opened a lot of kiosks in one of our biggest customers, that is Liverpool and those are really small formats, about 12 square meters.

So, the number of openings right now is more biased to kiosks. That may change in the future, but right now we don't have the expected information on particularly the formats.

Daniel Sanchez, Analyst

Okay, very helpful. Thanks.

Operator

(Operators Instructions) And we'll take a question from Robert Lamphere [ph] with POG Investment Management. Please go ahead.

Robert Lampl, Analyst

Hi, thank you. It's Robert Lampl from Alquity here in London. I got a couple of questions. The first is if you can give some input or guidance as to how large does wellness industry is in Mexico and what you think is a reasonable target in terms of time for you to achieve your goal, which you mentioned on the call of doubling the business?

Second is on the cost side, now that you have this tailwind of this advantage of input costs, how much of that are you reinvesting in your products and are you seeing any -- have you seen any trends in the Mexican consumer and in your product than they are going more for a lower value-added type product within your portfolio? And lastly, on your export, if you could talk a little bit about that and I mean 30% growth is a great number, but is that -- how pleased are you with the size of your business given the 30 million Mexican Hispanic market in the United States?

Gerardo Canavati, Chief Financial Officer

Thank you, Robert. Okay, first, I think it's very difficult to have an industry size about Wellness because it's comprised of a lot of things. So, we have some small categories that could be Wellness. We haven't added that up. What we know is that the growth of these categories in terms of organic, in terms of Reynolds [ph], in terms of fresh and natural products is increasing, but we don't have at this time a number in terms of the category. I think it's more about a trend.

And we have seen, for example, in the organic space, that a lot of brands are coming in and that there's a lot of fresh produce in organic. So, in our spectrum, when we think about Wellness, we are talking about products, we're talking about health, we're talking about products that could be good for you or products that could be better for you. That's where we are focusing our efforts. We will work on that number, Robert, to come with a industry-size.

Second, on this tailwind, are you referring to cost in commodity price?

Robert Lampl, Analyst

Yes, commodity costs, exactly.

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Gerardo Canavati, Chief Financial Officer

Commodity cost, and that relates to price decreases? That's your question?

Robert Lampl, Analyst

In terms of promotions and your -- and how much you have to help out the retailer and so forth to move even more volume?

Gerardo Canavati, Chief Financial Officer

Okay, so in general terms, the atmosphere is very competitive. We have some brands that from a price index maybe they are 40% higher, meaning that there are lot of brands that sell at lower prices. It could be a private label or it could be low-entry brand [ph]. But generally speaking, we have not lowered our prices; this year only in tuna because of a particularly situation in the market. But we have been more aggressive in point-of-sale promotions and as you mentioned, some of our clients are doing a little bit better.

We are balancing our performance between market share and profitability for Herdez. In mayo, we were very stable in our market share, but we have increased our market share in some focus areas where we are doing a lot of direct marketing activities. So overall, our share maybe has increased about 1%

When we think about tuna [ph] vegetables, we decided about two years to recover our leadership and we did that with strong promotions. Right now we are again leaders in modern trade, for example. So, it is very dependable on the category. I think that heart of our cost benefits are being returned to the market through investments. For example, in the next year we still have good costs in commodity, but we're going to increase our marketing investments because we're supporting some new launches under the McCormick brand.

So, you will still see an increase in our EBIT margin, but it's not going to be one-to-one versus gross margin. Did I explain myself regarding to your --

Robert Lampl, Analyst

Yes, I got that.

Gerardo Canavati, Chief Financial Officer

And you had a third question, about --

Robert Lampl, Analyst

Yes, I --

Gerardo Canavati, Chief Financial Officer

About the --

Robert Lampl, Analyst

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About the US -- no, about your export market.

Gerardo Canavati, Chief Financial Officer

Export? Okay.

Robert Lampl, Analyst

Exactly.

Gerardo Canavati, Chief Financial Officer

The exports that we register are 95%, I would say, 90% in the US, basically McCormick products that would be mayo and some peas and all the products that we co-pack [ph] for MegaMex that would be moles, salsas, nopalitos. And it is a very volatile figure because it depends on the inventory of our distributors or our partners in the US. So, I would not rely on a 30% increase to call a trend because what we measure in terms of performance would be the sell-out that our partners do in the US instead of what we sell them.

What we have done that is very small right now, is that we launched some of our brands in Central America. Central America by definition is a very, very small market and we started with that initiative about five months ago and you've seen that we are increasing the channels for a start. But again, I would say that these are some initiatives that are more based on our brand penetration; that will not give a big boost to exports.

Andrea Amozurrutia, Head of Financial Planning and Investor Relations

Just to add on these comments, our expectation for the medium-term for the exports is that if they represent about 6.5% today of total sales, they will represent approximately 10%, but this would be in the next three to five years.

Gerardo Canavati, Chief Financial Officer

Remember, Robert, that our big business in the US is MegaMex and that we do not consolidate those numbers. Last year when we consolidated those numbers, MegaMex represented of Grupo Herdez total sales close to 20%.

Robert Lampl, Analyst

Great. Yes, I recall.

Andrea Amozurrutia, Head of Financial Planning and Investor Relations

So, our biggest part of international sales, fortunately it's not being consolidated into our numbers. So, you see the ballpark of the US results in the income from unconsolidated affiliates.

Robert Lampl, Analyst

Great, thank you very much.

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Andrea Amozurrutia, Head of Financial Planning and Investor Relations

Thank you.

Operator

And at this time, there's one name remaining on the roster. (Operator Instructions) And we will now go to Diego Mayor with HSBC. Please go ahead.

Diego Mayor, Analyst

Hi, thank you. I'm sorry guys, I had some connection issues when you were talking about Nutrisa. So, I'm sorry if you have already answered this question. I was wondering if you have any margin target to share with us once you conclude all this restructuring that is ongoing right now.

Andrea Amozurrutia, Head of Financial Planning and Investor Relations

We think that we will return to the previous levels of 16% EBITDA. There would be or most of the initiatives that we are executing this year will definitely make more efficiency operation, but remember that we have said that all those savings will be reinvested in the brand since we are trying to make it a national brand with all the power that Gerardo has already mentioned about being the reference of Wellness. So, in order to achieve that, we will need to increase the marketing expense at Nutrisa and those resources will come from the savings that we will generate from the initiatives that we are doing this year.

Gerardo Canavati, Chief Financial Officer

That would be a margin for the short term, but according to our plan there is a lot of opportunities in those margins, but we will stick with that guidance for now.

Diego Mayor, Analyst

Okay. And by when do you think you can go back to 16%?

Andrea Amozurrutia, Head of Financial Planning and Investor Relations

Starting next year.

Diego Mayor, Analyst

Awesome, thank you.

Andrea Amozurrutia, Head of Financial Planning and Investor Relations

Thank you.

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Operator

And that will conclude our question-and-answer session for today. I would like to turn the conference back over to Mr. Canavati for any additional or closing remarks.

Gerardo Canavati, Chief Financial Officer

Thank you again for participating in the call this morning and we look forward to speaking with you next quarter. Please do not hesitate to contact us if you have any questions in the interim. Thank you.

Operator

And thank you very much. That does conclude our conference for today. Thank you all for your participation.

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