Conference Call Transcript
4Q13 Results
Smiles (SMLE3 BZ)
February 5th, 2014

Operator:

Good afternoon, ladies and gentlemen. At this time we would like to welcome everyone to Smiles 4Q13 results conference call. Today with us we have Mr. Leonel Andrade**,** Chief Executive Officer, and Mr. Flavio Vargas**,** Chief Financial and Investor Relations Officer.

We would like to inform you that you will be in listen-only mode during the Company's presentation. After Smiles' remarks are completed, there will be a question and answer session. At that time further instructions will be given. Should any participant need assistance during this call, please press *0 to reach the operator.

We have simultaneous webcast that may be accessed through the Company's website: www.smiles.com.br/ir. The slide presentation may be downloaded from this website; please feel free to flip through the slides during the conference call.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities litigation reform act of 1996. Forward-looking statements are based on the beliefs and assumptions of Smiles' management and on information currently available to the Company. They involve risks, uncertainties, and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Smiles and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I will turn the conference over to Mr. Leonel Andrade, Smiles' Chief Executive Officer. Mr. Leonel, you may begin your conference.

Leonel Andrade:

Hi, good morning. Thank you very much. Welcome to our results conference call, we are very glad to share our 2013 results with you.

This was our first year as an independent Company. We were very successful on our IPO and also successful on stock returns so far, especially considering the general Brazilian market's performance. This year resulted in impressive R$207 million of net income.

Our 4Q was especially rewarding, with a 35% year-over-year growth on miles accrued by all our partners except GOL. Our margins with Smiles and Money and Miles products endured with strength and consistency. On the quarter, the net profit reached almost R$67 million, growing almost 6%, quarter over quarter. We intend to pay a 95% payout over our 2013 results.

It was the result of an approximation with the financial market, developing joint products with every bank in Brazil, and also developing very innovative products, highlighting our *Clube Smiles* (our Smiles Club), the purchase, the reactivation and the transferring of miles, among other products. We kept, especially with Smiles and Money, the pioneering spirit and consistent growth in this product's share in the Company. It all resulted in higher engagement of our customers and significant increase in miles accrued.

Additionally, we partnered with important companies and it is worth to highlight our partnership with PayPal, worldwide leader in online payment. PayPal made Smiles the first Program to offer international retail redemption. Also, in the retail segment we are very proud with our investments done in Netpoints. In our opinion, the best way to have, in the future, a strong relevance with retailers in the Brazilian market, allowing us to keep our focus in the frequent flyers in Smiles.

We also went back to the media with a significant ad campaign, emphasizing that Smiles is the preferred program among frequent fliers in Brazil. One of the main important topics for last year was how close we stayed with GOL, strengthening our relationship and our corporate governance. GOL remains our main airline partner, responsible for roughly 90% of our redemptions. Our strategic alignment allowed us to develop joint programs and products for our customers.

Not only are we seeking and bringing new international partners, but we are also strengthening our relationship with our current partners: DELTA, AIR FRANCE, IBERIA, KLM, and QATAR.

All in all, 2013 was a consistent, rewarding, and challenging year. We ended the year delivering a performance according to our shareholders' and customer's expectations. We are prepared and motivated for a very challenging 2014, especially considering the unoptimistic macroeconomic factors we are likely to face, with a muted consumer environment and harder competitive features.

I would like to introduce Flavio Vargas, our CFO. Flavio is going to talk a little bit about our financial performance.

Flavio Vargas:

Hi. Thank you, Leonel, and good morning, everyone. Thank you for participating in our 4Q earnings conference call. We are very happy to share the comments from our 2013 results with you.

Initially, we are very pleased with our first year performance as an independent company and we believe we have met the expectations from our IPO, in terms of metrics for the program. We enjoyed a strong performance regarding miles accrued and redemption growth, impacting revenues and gross billings positively during the year. We achieved a net profit of R$66.7 million in the 4Q and R$207.8 million for the full year of 2013.

We posted net revenues of R$187.6 million in the 4Q13, which was up 20% over the previous quarter. Our strong financial results were mainly due to our decision to advance ticket purchases and financial revenues from financial investments.

It is worth mentioning that the recent USD appreciation did not impact our unit price of miles as one would expect, due to the advanced sale of miles to Financial Partners in the amount of R$400 million in April last year.

Moving to slide number four, we present the evolution of our gross billings and miles accrued. We reached R$1 billion gross billings in 2013, which was up 10.3% on a year-on-year basis.

Speaking about the last quarter, our gross billings were R$286 million, up 7.3% over the previous quarter, chiefly due to the significant growth in Smiles & Money gross billings. We closed the year with 38.8 billion miles accrued, up 8.2% over 2012. If we consider all partners excluding GOL, in the 4Q, we grew an outstanding 35.2% over the previous year.

Moving to slide five, we highlight the strong engagement of our customers and the attractiveness of our program. We grew 16.8% over 2012 on redemptions, with 30.7 billion miles redeemed in 2013, awarding almost 4 million tickets and products over the year.

On slide six, we present the performance of the products' margin. Our margin with traditional awards, which are awards redeemed on a 100% miles basis, reached 40.6%, up 13.2 p.p. over the previous quarter. The Smiles & Money margin increased from 38.9% to 46.9%, in line with the 1H13, with an increase in the products' share within the Company's portfolio.

On slide seven, we present our breakage rate. We ended this quarter with a 15.5% breakage rate, which we believe reflects a good balance of profitability and attractiveness of the program.

Moving to slide eight, we present our net income. We obtained net revenues of R$187.6 million on the 4Q, broken down into R$100 million from miles redemption and R$79 million from Smiles & Money. Our cost of redemptions and operational expenses totaled R$131 million on the quarter, leading to an operating margin of 30% and an operating income of R$36.3 million. Our net profit for the quarter was R$66.7 million, representing a margin of 35.6%.

On slide nine, we present the performance of our shares since the IPO. We obtained a 50% gain, while BOVESPA index was approximately 5% negative, during the same period.

In line with our commitment to shareholders, our Board proposed the payment of additional R$160.3 million on dividends, to be approved at our shareholder's meeting scheduled for April. Additionally, we have already paid R$37.1 million in dividends in the 2H, which should total almost R$200 million, representing a payout of 95%.

I would like now to thank you all for the attention, and open the floor for the Q&A session. Thank you.

Mario Pierry, Deutsche Bank:

Good morning, everybody. Congratulations on the strong quarter. Let me ask you two questions. The first one is related to miles sold to GOL. I think I saw an increase of about 38% year on year, while we are seeing this balance actually declining in the previous quarter. So, if you could explain why it is such a sharp increase to GOL. And also when do you expect to see the impact of the new accrual program implementing at GOL? When should we see an impact from that?

The second question is related to the balance of the miles that you pre-sold to the three banks in the beginning of 2013, if you could give us what is the balance remaining, and when do you expect the balance to expire? Thank you.

Leonel Andrade:

Hi, Mario. Thanks a lot for your questions. Let me answer your first question. Related to GOL, what we did was just an incentive program for the last two months in the year. You know that GOL changed the program, and we are just building with GOL a similar commercial relationship that we have with the banks. So, we developed some programs, some incentives, some opportunities; we see some opportunities to increase the redemption and increase the engagement of the customers.

We just did it. Of course that when we see GOL in the months ahead, probably GOL will remain in a conservative accrual in the future, because they changed the program, they made the programs better for frequent flyers, as you know, but at the same time they reduced the offer for the non-frequent flyers, which, in our opinion, is correct, is good for the engagement in the future.

The program now, for the frequent flyer, is much better, is very competitive, it increased competitiveness. All in all, I think what we did is just an incentive program like we have with banks, and in the future GOL — we can develop it again or not, something like that, but for this year GOL will have probably the same amount or a little bit less than they had in 2013.

For your second question, Flavio will explain better.

Flavio Vargas:

Mario, thank you for participating and thank you for the questions. The balance that we have as of December 31st is around R$170 million still outstanding. Considering the current run rate and our expectations, probably most of this balance is going to be over by the end of the 1H, and probably around between R$15 million and R$20 million might last until the end of the year.

Mario Pierry:

Thank you for your very clear answers. Just to clarify, then, this R$170 million still reflects average price of R$2, correct? And then we should eventually see the prices move up?

Flavio Vargas:

That is exactly right. This R$170 million is part of the advance where we fixed the foreign exchange at around R$2 per US$1.

Mario Pierry:

Perfect. Thank you very much.

Alexandre Spada, Itaú:

Hi, gentlemen. Good morning and congratulations on the results. My first question is very simple. Do you intend to provide any type of guidance, given that this is the first year you are initiating as a public company?

Flavio Vargas:

We had this discussion, whether we should have a formal guidance policy, but we have not made a final decision. The answer right now is no, we currently do not have guidance, but we are analyzing the merits, whether we should pursue that strategy or not.

Alexandre Spada:

OK. Thank you. And if you allow me a second question, I just want to understand better the dynamics in your G&A expenses this quarter. It was really anticipated by you in the 3Q that we should have a stronger 4Q because of the execution of some marketing campaigns. I just want to understand what type of dynamics can we expect going forward?

Also, can we see in the 4Q14, for instance, again a concentration of marketing expenses, or will that be more spread during the whole year of 2014?

Leonel Andrade:

Alexandre, I think that what we did in the 4Q it's just "one shot" action because we needed to relaunch the Smiles brand in the market. From now on probably we have flat investments. We do not expect some peaks in the marketing investments.

Probably this year we are going to have investments along the year and we re putting our energy and our investments in terms of social media, Internet, relationship programs, activation, so not in branding. You know that normally in branding actions we need to invest a lot for a short period, and we are not going to do something like that in 2014.

Alexandre Spada:

OK. Does that mean that in 2014 you may spend less money with marketing than you did in 2013, or is it too early to assume that?

Leonel Andrade:

No, we are going to have similar investments, but flat along the year.

Alexandre Spada:

OK. One final question: you spent around R$20 million in 2013, does that make sense?

Leonel Andrade:

It was what we had last year and this year we have something similar. A little bit broader, but just a little bit more. If you consider that last year we just invested in the 2H, this year we are going to invest along the year and a little bit more than we had last year, but in a different way.

Alexandre Spada:

OK, thank you. That is very clear.

Eduardo Couto, Morgan Stanley:

Good morning, guys. Thanks for the call. I have two questions, if I may. The first one is on the margin side, you reported 50% gross margin, a very strong margin. So, how do you see margins going forward and do you think this 42%, 50% level is something sustainable? That is the first question.

Flavio Vargas:

Eduardo, thank you. The discussions and the questions on margins, I think we have been having quite consistently over the previous quarters. I think it is natural that the margins fluctuate, sometimes you have some better quarters, sometimes we have some worst quarters, but our view is that the margins should not fluctuate around what we have experienced over the average of the year, maybe more to the medium- to long-term view, a little bit lower than that.

But our commitment is to continue working on the margin side, continue working on having positive spread on the redemptions to keep the margins consistent, and not fluctuating as much as we did not take care of.

Eduardo Couto:

OK, makes sense. Just a second question, Flavio, regarding your cash position, you grew your cash position more than R$100 million during the 4Q, closed the year close to R$400 million. For this year we expect the Company to continue to grow its cash position, excluding potential shareholders' payment, you would have more than R$1 billion by the end of this year.

I just want to know if all this cash that you are generating, the main use for this cash is pretty much to return it to the shareholders as dividends or as a capital reduction, is that the Company's future?

Flavio Vargas:

That is pretty much the management commitment to try to pursue what is the best for the investors. This quarter and this year we are paying almost R$200 million in dividends, a 95% pay out, which is pretty much the limit on what we can pay according to the Brazilian regulation.

This commitment remains. There is the possibility of the capital reduction; this is something we are discussing with the Board. At the end of the day, this is a matter that needs to be approved at the shareholders' meeting. We are working internally with the Board, with the external providers of funding to make a formal recommendation to be approved at the shareholders' meeting.

Eduardo Couto:

OK, but you expect this strong cash generation to continue throughout the year, right?

Flavio Vargas:

Yes.

Eduardo Couto:

OK, thank you.

Gabriel Guzman, Bradesco:

Good morning. My question is about the breakage revenues in the quarter. We saw there was a R$3.2 million entry for expiration of miles, which we were expecting to see much later. Can you please comment on that?

Flavio Vargas:

Thank you for the questions. Breakage is definitely something that we always keep on the radar. We are trying to make decisions on how we can try to manage and be more creative and rational in all our promotions.

Basically, the main effect we have on the quarter is connected to the joint promotions we have run with GOL where we were granting bonus miles, but we have decided to make the accrual and the redemption linked on the promotion, so the bonus miles, the life of the mile had a very short lifespan.

That is why we had the actual expiration of miles, which according to the regular program rules, would expire only in two years. We try to be more creative, manage our costs, manage our promotions more efficiently.

Gabriel Guzman:

OK. Should we expect something for the 1Q or 2014 as well?

Flavio Vargas:

This is something that we have tested with GOL, this new model of having different life for the miles that we bonus the clients, and probably this is something we might start doing with the other partners in the future. We do not have anything on this street right now, but the principle of trying to manage the breakage and managing the overall cost of promotions is one of the priorities that we have at the Company.

Gabriel Guzman:

OK, perfect. Thanks.

Victor Misuzaki, UBS:

Good morning. Just a quick question on the incorporation of GA Smiles. This incorporation generated a goodwill of R$240 million with tax shield of R$73 million. I do not know if you can comment a little bit on your effective tax rate in the upcoming years.

Flavio Vargas:

Victor, thank you very much for the questions. The net effect for the incorporation of GA Smiles is that we created the goodwill and we also created, the goodwill is going to be amortized over a five-year period and that is going to generate over this period around R$72 million of tax shields and tax credits over this period. That is what you can expect.

Victor Misuzaki:

OK. In terms of effective tax rate, I do not know if you can comment what we can assume as your model. I mean, the amortization would be linear or—?

Flavio Vargas:

It is probably going to be linear, because we generate sufficient profits to amortize these R$72 million over 60 months. Our expectation is to have the same level of benefits in Reais over the course of these five years.

Victor Misuzaki:

OK. Thank you.

Operator:

Showing no further questions, this concludes the question and answer session. At this time I would like to turn the floor back to Mr. Leonel Andrade for any closing remarks.

Leonel Andrade:

Thanks a lot. I would just like to add a few comments. The first one is that you have our commitment to remain as an innovative company this year. We are going to develop new products and new programs with our partners, especially in terms of redemption. At the same time, we are very proud to have the partnership with GOL, we are very close and increasing our performance together and, at the same time, developing promotions, products, incentives, to our customers.

Finally, it is important to mention that we concluded our restructuring, now we have a complete team and a very good team in place. We are ready to increase our competitiveness in the market.

It seems that this year we have a very hard year in Brazil, but we remain confident that we have capacity to compete, we are very well in the market, and you have our commitment that we are going to deliver another good year, probably growing less than in 2013, because now we have a different level in the Company, in the market, but considering that we can deliver a good year again.

Thanks a lot and you can count on us anytime. Thank you.

Operator:

Thank you. This concludes today's Smiles 4Q13 results conference call. You may disconnect your lines at this time.