Alpargatas Q3 2024 Results

Melina Rodrigues: Welcome to Alpargatas' third-quarter 2024 earnings call. I'm Melina, Alpargatas' Investor Relations Director, and with me today are Liel Miranda, our CEO, and André Natal, our CFO. This videoconference is recorded and simultaneously translated into English. Please note that any statements made during this conference regarding the company's business outlook, projections, and operational and financial targets are assumptions of the management based on currently available information. The Q&A session will follow the initial presentation. For those who wish to ask questions, please raise your hand using the icon in the Teams toolbar and wait with your microphone muted until we call on you. I'd like to turn it over to our CEO to start the presentation. Liel, please go ahead.

Liel Miranda: Good morning! It's a great pleasure to be here to discuss our third-quarter results. As we've been discussing throughout this turnaround year, we have a very clear two-step strategy. This strategy aims to regain our competitiveness in segments with a strong presence, such as the women's and grocery channels. To achieve this, we've adopted a much simpler portfolio strategy. We've been working extensively on our portfolio, streamlining processes, and gaining scale and competitiveness.

The second step focuses on sustainable growth. This involves expanding our international growth in the various markets we operate in, especially in the 15 markets where we invest in brand efforts and build commercial relationships. We also have opportunities in Brazil across sub-segments that are not yet fully developed for Havaianas and Alpargatas, such as the specialized channel, where we currently have a lower market share compared to the grocery channel, so we're doubling down on this segment. Additional opportunities lie in the men's and children's segments, where our potential for growth across the entire pipeline is even greater.

Our innovation pipeline is also accelerating—we're bringing products to market faster. We're already seeing results in the third quarter that validate our strategy. Two key points stand out: first, our growth in market share by 1.3 percentage points. Our growth strategy in Brazil within the grocery and specialized channels is already yielding results, aligned with our best margins in the last decade, demonstrating efficiency and a 10% reduction in fixed costs, adjusted for inflation. Our service capacity, a longstanding barrier to Havaianas' growth in Brazil, improved to over 70% in recent quarters—though not ideal yet, it's significantly better than the 30% level when we began this turnaround. We'll continue improving our operational competencies, aiming for an OTIF (On-Time, In-Full) delivery rate exceeding 85% in the coming quarters.

Regarding our portfolio strategy, as I mentioned, we've simplified our SKUs by about 50% without losing volume, while gaining market share. This means we've focused on growth-driving SKUs and improved execution. Today, Havaianas is the second most admired brand in Brazil, up from seventh last year. We launched a new men's product line in Q3, already experiencing high demand and helping us gain market share in an underdeveloped segment. For sustainable growth, notable Q3 advancements include a 13% volume growth internationally, alongside continued distribution cost improvements, especially in Europe, where we faced prior issues. By addressing these, we're better positioned for 2025 with a more effective and cost-efficient distribution model. We reorganized our commercial structure in Europe, adding experienced footwear professionals to help expand our market share in underdeveloped channels like key accounts and organized retail. Additionally, we've sped up our innovation cycle, reducing the launch time from 18 to 12 months, and we're committed to translating trends into faster launches, particularly for specialized and men's segments, where we see more growth potential.

There are numerous examples of our work with the Havaianas brand, such as our successful collaboration with Dolce & Gabbana, which created a significant online buzz and sold out globally within 72 hours. This launch in our 15 priority markets—Brazil, Asia, the United States, and Europe—generated extensive brand engagement. Another successful launch was the Havaianas Point, which is now among our top three products in DTC sales, proving its strong potential as we plan its rollout to more channels. Finally, our strong cash position reflects our efforts over the past 12 months, with each quarter showing positive results. With our clear two-step strategy—competitiveness and sustainable growth—we're confident in our growth potential across segments and geographies. Now, I'll pass it to André, who will cover our quarterly results.

André Natal: Good morning, everyone. Starting with a review of the numbers, these slides reflect our capital discipline over the past 18 months. The first chart shows a consistent working capital release, now six consecutive quarters of positive cash generation. Since the initial turn in Q2 2023, we've released over R$600 million, with R$73 million this quarter alone. This is primarily due to a substantial reduction in average storage days—down over 30 days year-over-year—and an increase in supplier payment terms by nearly 30 days, with minimal change in collection days. These are the results of our inventory and procurement management efforts, bringing raw material orders back to historical levels.

On CapEx, the blue chart on the right shows a slight investment increase from the previous quarter but still within our original annual budget. We're only proceeding with essential projects and expect slightly higher second-half spending as previously guided, though year-to-date investment is 70% lower than in the same period in 2023. We're significantly reining in capital allocation, focusing only on critical areas.

The green chart below shows our indexed fixed expense reduction, preserving gains since last year, though with slight seasonal fluctuations, primarily due to currency effects from Real's depreciation. We've added an inflation-adjusted yellow line to reflect real expense declines since Q1 2023, revealing a 15% reduction. Factoring in exchange rate effects, this nominal flat line would equate to an 18% real expense reduction since Q1 2023.

This consistent working capital release has led us to a net cash position, with leverage reduced from nearly three times EBITDA to -0.2x. Moving forward, we're maintaining this financial discipline to support growth and gradually recalibrate capital structure.

Our cash flow on the next slide shows R$186 million in total cash release this quarter and over R$600 million year-to-date. Since May last year, we've reversed approximately R$1.1 billion in free cash flow, countering the previous R$1.2 billion burn.

Our sales cycle slide shows a 3% reduction in sell-out versus Q3 2023, which mainly reflects a mix shift within grocery channels rather than a loss in competitiveness. We observed growth in the specialized and DTC channels, while grocery remained flat overall, with a slight shift toward the lower-market-share traditional segment. Sequentially, we gained share across all channels in Q3, maintaining stable sell-out year-over-year.

Sell-in grew 13% year-over-year due to a low base in Q3 2023 from chain inventory drawdown, with no unusual stock build-up this year. Inventory levels across the chain remain normalized and aligned with seasonal demands.

In the supply chain, our internal inventory has been declining due to inventory sell-down efforts. We're rebuilding raw material and finished goods levels to align with seasonal demand, with production and material procurement returning to sustainable levels. We're now in a healthy operational range for raw materials, preparing for the high-demand summer season.

Moving to domestic sales, volumes grew 13% year-over-year but are still 9 million pairs below 2021 levels, suggesting room for further scale benefits as we regain market share. We achieved a record gross margin of 44%, outpacing prior levels despite operating below full scale, indicating significant margin potential. Our adjusted margin also reached a record of 46%.

Internationally, the recovery is underway, though gradual due to the focus on domestic stabilization and seasonal timing in key markets. U.S. volume grew over 30%, with minor reductions in distributor markets as we reprice for profitability. Our gross margin expanded by 6 percentage points year-over-year, supported by production, distribution, and operational efficiencies, although we're still below optimal scale.

Our next slide details Rothy's sequential margin improvements, from a $30 million EBITDA loss to approximately $10 million positive EBITDA. This turnaround stems from G&A efficiencies, marketing effectiveness, and logistics improvements, placing Rothy's ahead of peers in a challenging market.

Melina Rodrigues: Before we open for Q&A, I apologize for the technical issues at the beginning of the call. We’ll provide a transcript on our IR site and notify you via email. Now, let’s move to questions, starting with Guilherme Vilela from JP Morgan.

Guilherme Vilella: Good morning, Liel, Natal, Melina. I have two questions from JP’s side. The first is about the US. Back when the new management came in, there was a very positive step to clarify and share the management's diagnosis of what needed to be done. This helped a lot in guiding both results and strategy for the Brazil operation, especially when looking at the US. My question is, do you have a similar diagnostic framework for the US, to help us understand what the strategy would be for that market? A follow-up question is, how would international results look excluding the US? My second question is on capital structure. Today, it seems the company's leverage level may not be ideal, so I would like to understand what alternative approach you have in mind to reach your target. Thank you, everyone.

André Natal: Thank you, Guilherme. Liel will start by answering your first question, and then I'll take the second one, okay?

Liel Miranda: Great. Thanks for the question, Guilherme. I believe we have a very clear diagnosis regarding the United States. First of all, over the past years, we haven’t reached the necessary scale to sustain an operation with all the marketing investments and commercial structure we have there. Therefore, our priority is to have a winning commercial proposition. For this, we’re revisiting our portfolio. As I mentioned, we recently launched a men’s product line, which wasn’t strongly represented in our portfolio but has more appeal for the American consumer. This is just one example of how we’re focused on offering products that better suit the tastes and styles of the American market.

Secondly, we’re restructuring our US operation, which currently has negative financial results. We're working this year to begin 2025 in a better position by reducing commercial and operational distribution costs, along with optimizing marketing investments, to make the US operation fit its current scale as soon as possible.

The third part of this strategy involves exploring go-to-market models that would enable access to channels where we currently have little to no penetration. The US is a market dominated by organized channels with major clients, primarily key accounts. At the moment, we lack access to these key accounts because we don’t have the scale, creating a situation where lack of scale limits distribution, and vice versa. We’re exploring potential go-to-market alternatives that will enable us to access these channels. In summary, we’re continuously enhancing our portfolio for relevance across all markets, including the US. We're also working to align the US cost base with the revenue generated by the operation while actively seeking alternative market approaches that would enable both top-line growth and cost-base reduction. I hope that gives you a clear picture of our strategy for the US. Natal, over to you for the other parts.

André Natal: Guilherme, let's continue. You're right that our current capital structure isn't optimal. However, reaching this level was important given the circumstances. As you may recall, we previously leveraged in an unplanned manner, resulting from a series of capital allocations and rapid deterioration in results, leading to a concerning leverage level. Until recently, discussing optimal structure wasn't sensible, as the priority was to significantly reduce leverage to gain confidence in our operations, ensure consistent results, and eventually plan for gradual, intentional, and controlled leverage increases based on a solid capital base rather than unintended leverage from unrelated decisions. I think the company has done well in this regard, achieving significant solidity.

In terms of your second question about returning to a reasonable level, we're already having these discussions, although there are some practical challenges. One approach could involve distributions to shareholders, but in the short term, this faces some restrictions. In the long term, we envision this happening normally as the company has done historically, but for now, last year's impairments—Ioasys, Rothy's, and others—have exhausted our historical profit reserves. Legally, these distributions require a profit reserve, which we lack due to recent impairments.

In the short term, we're starting pre-payments, as we now have cash well above our operational needs. We're prepaying credit lines and debts without significant exit penalties. While our carrying costs are low and yields on our cash are similar to our borrowing costs, we're paying down debts where feasible and exploring further options for controlled leverage increases as we rebuild our profit base and study other shareholder distribution methods. So, while I can't specify more, we're comfortable with our current position and confident that gradual, controlled leverage will be possible over time. I hope that answers your question as well.

Guilherme Vilella: Makes perfect sense. Thank you very much, everyone.

Melina Rodrigues: Moving on to the next question. Laryssa Summer from XP Investimentos. Laryssa, please go ahead. We'll enable your microphone.

Laryssa Summer: Good morning, Melina, Liel, Natal. Thank you for taking our questions. I have two on the international front. We saw strong growth in both volume and gross margin this quarter, yet EBITDA hasn't responded. First, on gross margin, I understand that this improvement is structural, following the adjustments Natal mentioned, but I'd like to know what room exists for further improvement, or if additional adjustments might come. Secondly, on EBITDA, how can we expect this figure to rebound? I assume it will be a combination of operational leverage and expense control, but where will the main savings be, in terms of expense lines, and could you give a sense of timing? Congratulations on the results, and thank you again for answering.

André Natal: Hi, Larissa, thanks for the questions. Good morning! International EBITDA has indeed improved year-over-year, though we're still in negative territory, so we can't be overly pleased. But it's a first step, as the improvement reflects not only gross margin gains but also gradual scale recovery. Your phrasing was spot-on; we see this expansion as a sign of our initial recovery. We'll continue on this path with clearly defined actions, though they're not simple. For international EBITDA recovery, part of our focus is on reducing expenses, as scale compression still limits efficiency in these operations. We've already undertaken studies and identified expense containment measures for next year.

The primary driver, however, will be gradually recovering scale. While I can't say we'll reach past peak levels in one season—this wasn't even the case in Brazil—we're encouraged by the pre-order levels we're seeing for Europe's upcoming season. These indicators suggest that the worst is behind us, and we're likely to balance international accounts gradually. Scale is key, explaining nearly all recent declines; it's not an issue of expense or efficiency deterioration. As we recover scale next year, we foresee achieving a closer balance in this market.

This is a gradual movement, as we've always anticipated, but we're becoming more confident that it will materialize. We're doing everything we can, having restructured the commercial team in Europe and increased efficiency measures in the US. Several promising savings initiatives are also underway. As shown in our green chart, we're offsetting inflationary and exchange rate pressures through these actions, and they're ongoing. We recently conducted over 50 internal workshops involving around a hundred employees, reviewing every expense line for further opportunities.

These opportunities will be built into our 2025 budget, anchoring corporate goals and bonus structures around productivity and efficiency. Regarding which expense lines will be targeted, they span all categories, as each OBZ package revealed new opportunities for the next year. So there's much happening, and while there isn't a single fix, we have clear, targeted actions to achieve specific savings. This is a permanent productivity effort for the company. Okay?

Melina Rodrigues: The next question is from Isabella Llamas at UBS. Isabella, we'll enable your microphone for you to proceed.

Isabella Llamas: Hello! Now it's working. Thank you, Natal and Melina! Continuing with the International topic, where we're observing quarterly progress, especially compared to the well-established Brazil operation. I'd like to focus on two main areas, starting with Europe. You've mentioned standardizing policies and rebuilding trust with clients. Could you update us on the progress with your five priority countries and any distribution cost improvements? For example, after changing logistics partners in 2023, have you considered renegotiating the contract or reducing CDS? Could this help in the future?

The second part concerns distributor markets, where you're prioritizing profitability. I believe you operate in around 110-115 countries, so are you considering contract adjustments or exiting certain markets? What would be an ideal market scope, and where are you currently? Any notable success stories from recent renegotiations, or markets that might lead this distribution segment? Thanks again.

Liel Miranda: Thank you, Isabella. I'll start here by talking about Europe. I think what happened in Europe over the past two years was a combination of, on one hand, we had reduced brand investment, which led to a loss of visibility, and on the other, we faced operational issues with our distribution, as you mentioned, including the change of our logistics operator. This had a very negative impact on the summer of 2023, and this negative impact in the summer of 2023 affected our ability to fulfill the orders we usually receive, 50% of them coming at the end of the year for 2024. So, in 2024, we still paid the price for all these past effects starting in 2022, and 2023, and preparing for 2025. In 2024, we fixed a large portion of the operational issues. We delivered on time, in the quantity expected by clients, for most of our orders, relieving the burden of customers not trusting us and placing orders for 2025 due to operational issues.

The second thing we did was review our marketing investment, placing more into brand communication. But more importantly, than simply more money, we made this investment more effective. It was overly focused on promotional marketing, which we call performance marketing, and primarily aimed at selling online with discounts. This doesn't build a brand or generate future value. We reversed that trend. Today, we are putting much more focus and more than 50% of our investments in Europe into building the brand, its values, and the aspects consumers truly appreciate.

When consumers choose to pay more for Havaianas and remain loyal to Havaianas, the past issues we faced have largely been corrected in 2024. Admittedly, we're not at 100% OTIF (On Time in Full), but we have made significant progress and continue on this journey. The effect of this, as André mentioned earlier and as the numbers show, is that our distribution cost in Europe has fallen this quarter compared to the previous year. It has been declining and is expected to continue decreasing for two reasons: firstly, due to greater efficiency, and as we regain scale, we can dilute a large part of the fixed cost of the logistics operator. Regarding the logistics operator, we have a contract with this operator that we need to honor because exiting or changing before the contract's expiration would incur a significant penalty, which would not be the right move. So, we're doing the opposite: working with this logistics operator to extract maximum efficiency and bring distribution costs back down. As you may have noticed, we are improving quarter by quarter on this journey, and the number of warehouses is part of that. We conducted an analysis, and changing the number of warehouses today would bring marginal benefits. What we need is to make better use of these warehouses by increasing volume and scale to make them worthwhile.

Over the last 12 months, at least since the beginning of this year, we will continue on this path, improving scale in Europe through more effective marketing investments and better service to clients, while continuing the processes, as André described, of making all these initiatives part of the company culture to bring more efficiency and thus improve margin. I think that answers for Europe. And as André briefly mentioned, what we call priority, or what we're taking orders for next year, is currently higher than at this time last year, which signals that we expect some volume recovery in Europe for 2025. So, that's the diagnosis of where we are with Europe.

In terms of distributor markets, we see a very healthy phenomenon. We are managing to grow in the higher-margin markets, mainly in Asia and some Middle Eastern markets. So, we're seeing volume growth in these markets. And when you ask about the future of distributor markets, for sure, the key markets in Asia, such as the Philippines, Indonesia, Thailand, Australia, and some Middle Eastern markets, especially the GCC and Israel, we believe we'll continue down the path of more volume with good profitability. Where are we struggling? We're facing challenges in low-profitability markets. For example, in Paraguay, we had very low prices and low profitability. We increased the price significantly, which impacted volume, but we made this market profitable. This is the work we are doing in all markets in this category. It's not about abandoning distributors; we have a wholesaler who can always buy. The focus is, that we will only sell if it's profitable for us, and if that means being present in 20-30 markets instead of 100, we want each one to be profitable and have growth potential. This is our growth strategy for distributor markets.

Isabela Llamas: Thank you, everyone.

Melina Rodrigues: Felipe Reboredo from Citi has one more question. We'll let you proceed with your question.

Felipe Reboredo: Good morning, Liel, Natal, and the entire team. From Citi's side, we wanted to understand these SG&A moves a bit better. I think you've touched on this, but if you could give us more detail on where these marketing investments and new projects are focused, it would help us better understand how to think about this line's behavior going forward and how it should reflect on profitability. Additionally, linked to this topic, you were doing very important work.

We even had the opportunity to learn a bit more in-depth about optimization, distribution, and production in Brazil. I wanted to understand these predictive efficiency models more thoroughly and what gain you expect going forward. Thanks, everyone.

André Natal: Hi Felipe, I'll start by speaking in general terms about SG&A, then pass it to Liel for more details on marketing initiatives. Just to clarify, when we look at SG&A overall, without passing judgment on specific nuances, we see year-over-year expansion. However, this is largely due to a base movement effect. In 3Q23, there was a reversal of executive fees because some executives left the company, creating an artificially low comparison. You can see that up to 3Q23, the number is artificially different from neighboring quarters because a significant portion of that compression came from reversing previous periods' executive fees. This explains part of the year-over-year comparison difference.

When you look at SG&A expansion as a strict accounting figure, it's also worth noting that the OBZ (Operational Breakeven Zone) green curve we show doesn't include marketing expenses. The company's strategy was to gain efficiency in other expense lines so we could reinvest adequately in marketing. Historically, the company was reducing marketing as a percentage of revenue and total expenses, redirecting these funds to other areas where they were not optimally utilized. We've been reversing that spiral, achieving savings across travel, IT, headcount, and every other identified opportunity to funnel these into marketing. Liel can speak further on the driver behind our decision.

Furthermore, that green curve doesn't include bonuses, and for a straightforward reason: last year, due to not meeting targets, the company didn't pay bonuses in 2023. This distorts the comparison base and explains roughly half of the SG&A difference year-over-year. Looking at the OBZ packages, you'll see all the efficiencies being built there. Now, part of this—not all, but part—connects back into marketing to boost the top line. And that's true across all geographies; we are restoring an appropriate level, with some room for geographic rebalancing, but I'll stop here for Liel to add.

Liel Miranda: Thank you, Felipe. Regarding marketing, as we see it, I explained the effect of performance marketing versus brand-building marketing. This shift was already underway last year. Today, the company is in a much healthier position, with over 50% of our marketing investments going to brand building and much less to other activities, like production, agency fees, and performance marketing, which was very different in the past. We had a period where nearly 80% of our expenses went to performance marketing, fees, and production, which reduced our marketing effectiveness. This has already been corrected, and from now on, we're much more effective in our marketing investments.

From a marketing allocation standpoint, we believe our marketing investment level in Brazil and Europe is good. So, we don't expect to increase marketing levels as we gain scale in these two regions. In Brazil, we invest 7%, and in Europe, slightly more than 10%. As revenue or growth occurs, these marketing levels should support growth without additional pressure on marketing investments. In the U.S., it's different. We made a big bet in 2024, increasing marketing investments in anticipation of additional volume. That didn't materialize, for reasons I mentioned earlier. Marketing alone isn't enough; you need the right portfolio, go-to-market approach, and proper channel access, all of which we couldn't fully establish in 2024, but we're working on for 2025—access to channels with the right portfolio and then marketing.

In the U.S., we see the potential to reduce marketing at our current scale and may revisit this in the future. In the short term, we see an opportunity for reduction rather than an increase in marketing. In distributor markets, it's a bit different because it's tied to distributor contracts. So, as volume grows, the marketing percentage grows. Again, it's not about marketing but rather choosing the most profitable markets, which we have already started focusing on with the right prices and portfolio. As these markets grow, marketing investment more than pays off, which is not true in very low-profit markets.

So, the distributor streamlining we've begun addresses the marketing aspect, and our approach to distributor market marketing is to invest in the best markets, those with the highest growth potential. This is our overall marketing investment strategy. Regarding your other question on supply chain improvement and predictive models, this is a significant journey. We came from a challenging period in 2022 and 2023, where we overstocked the chain with finished products and raw materials, all symptoms of a process that wasn't fully structured within the company. I believe that the slide André presented, on the business cycle, already demonstrates that we have the business under control. We now have raw materials at the appropriate production levels, and our finished product inventory is at the right level, much lower than in the past. As André mentioned, some of this finished product stock includes pre-2022 collections, which we are now working to sell during HavaFriday, our version of Black Friday, plus the holiday season. But the new collections, 2023 and 2024, are entirely aligned with demand. We are producing according to demand. We have finished product inventory aligned with demand, for the 2023 and 2024 collections. In terms of sell-in, it has improved, with days of stock in the chain lower than last year. This sell-in is essential to prepare for the seasonality of Q4, which is summer in Brazil, where we see approximately a 20% increase in demand. I would say the supply chain transformation is sufficient for us to operate with business cycle control and efficiency. Is the journey complete? Absolutely not. For 2025, one of our top priorities is to continue evolving, this time with predictive models powered by AI, which will greatly enhance our inventory management, raw material handling, and market supply capabilities. But I would say the most significant result we can point to is in OTIF. OTIF is your ability to have the right inventory to deliver at the right time, in the right quantity to your clients. We've gone from levels of 30% a year ago, to now operating at 70%, with fifteen priority clients—our key accounts—where we're already above 80%. We just need to keep evolving this for all clients in Brazil. In Europe, we've also increased from below 30%, and now, at the end of the summer of 2024, we're above 50%, close to 60%, which leads us to aim for around 80% in 2025. In the U.S., we're already above 80%. So, the indicators are good, achieved with significant effort and hard work, even without all the automation and systems we plan to implement, which will be a priority for 2025. Part of the capex we're allocating in 2025 is to keep improving our supply chain. I hope I've answered both parts of the question.

Felipe Reboredo: Very clear, everyone. Thank you for the answers.

Melina Rodrigues: Alright, everyone, with no more questions in our queue, we'll wrap up the call here, thanking everyone who participated and reminding you that our IR team remains available for any further questions. Thank you, and have a good day, everyone.