Vinda International Holdings Limited
2018 Q3 Results Conference Call
9:00 am HKT, 29 October 2018

Speakers

Mr. Christoph Michalski, CEO **(CM)**
Ms. Vicky Tan, CFO & Company Secretary **(VT)**
Ms. Joey Wan, Director of Corporate Affairs (**JW)**

Presentation

JW: Good Morning ladies and gentlemen, welcome to Vinda briefing call for third quarter 2018. I'm Joey Wan, IR Director. On the line we also have our CEO, Mr. Christoph Michalski, and CFO, Ms. Vicky Tan. Today's call will last for about 30 minutes. Christoph will first present the results and then we will open for Q&A. Earlier this morning we have sent you a presentation deck. Please check your mailbox or download it from our website if you have missed it. Now I would pass the time to Christoph.

CM: Good morning everyone. Thank you for being there. I will start to brief you with the result. I just wanted to remind you that both in Q3 and end of the Q1 we have a relatively few results to present. Just a rapidly to announce, we will keep you informed what Vinda is doing, and therefore I cannot give you too many detailed comments. But I want to take the opportunity to also talk a little bit about the market environment. Overall speaking, Q3 has been very challenging as you can see from our results and I think we are basically taking it back a little bit by three factors.

The first one is clearly the Chinese market development. You have seen a lot of talk about the trade war. The sentiment in the market in China currently is not particularly good. And the RMB has continued to decline, which has certain effects on our raw materials and FX loss. We still see a growing tissue market, but we also see a little bit of destocking in the trade, which results to relatively good market share trends we have seen in Q3. But also results in unfortunately for us and lower sales growth and what it might have been in the market. And then finally, I think you're very aware that we are very strong in e-commerce and Vinda's quarter three has clearly not had so many e-commerce sales and promotion as a Q2 and Q4 and therefore it has historically also been a slightly weaker quarter for Vinda. So overall if we look at our Q3 performance we grew organically a constant exchange rate at 3%. Our gross profit margin is down to 27.1% compared to 30% in Q3 2017. Operating profit is also down by the effect of the gross margin, but also by some FX effects and you can also see a relatively lower performance in EBITDA margin. Foreign exchange loss of third quarters have been 43 million dollars.

So let's talk maybe first about the revenue, the top line growth. As you know we have with a rising pulp price, which has now stabilized but still be affected by the RMB for exchange rate decline. We have done two price increases in Q1 and Q2 this year, which have basically widened the back the gap quite significantly between us and our competitors. Our competitors have very intimately followed our price increase. If I talk about some of them tried to follow us and took it back and came back much later in

July. Another competitor only increased once, and that was at the end of June. And that clearly put our volume quite considerably under pressure. And this pressure has continued in Q3. We have then increased a little bit the promotional activities, which already had some positive results, particularly at the end of the quarter. But overall we had a relatively weak growth quarter. When we look at our growth, basically the hundred percent of the slow down in growth came from China. Both in Southeast Asia and most Asia we have actually a pretty strong performance in quarter three. If you look at revenue by channel, there's no significant change. We continue to grow well in B2B. We had also a little bit stronger performance in key accounts and actually today is the traditional channels which are a little bit under pressure. While e-commerce continues to grow at a very considerable rate.

When you look at gross profit, I said already to you very much under pressure. There were a number of reasons for that. Clearly, our slow down on volume has not allowed us to cover all manufacturing fixed cost in the way we normally do. And this has basically affected our gross margin. We also saw continuous weakening of the RMB, which then created pressure on the input cost of our raw materials which are US dollars. And then basically because of the weaker sales, we have increased a little bit of our promotion activities and temporary price reduction, which led to much significant higher volumes in September, but clearly had some negative impact on gross margin at the beginning of the quarter.

If you look at our operating profits here, however, there is basically just a reflect of the exchange rate. Both selling and marketing costs had declined in absolute and relative terms. We have been very very very careful what we spent on. However, we had an exchange loss of 46 million which put a very significant pressure operating margin and that explains the key difference between the declining gross margin slightly higher decline than in operating margins.

If you look at EBITDA, it is at 10.3%. We had basically the same challenge as I mentioned on gross profit and operating profit. In addition to that, we have also had some improvement in working capital. Remember in H1, we have given you and we have shown you a relatively high capital expenditure and relatively high working capital. And Q3. We have taken steps to bring that down to our reasonable level.

Future outlook for Q4, we do not expect the market situation to change significantly in China, and therefore we expect to continue in Q4 with a stronger quarter than Q3. And we are carefully optimistic that we would have a slightly higher margin on the gross profit than in Q3. But we do not expect to achieve the same type of growth momentum that we had initially. So I think I look for carefully mid-single digit growth numbers.

So this basically concludes a quick summary of our results. And I would hand it back over to Joey.

JW: Thank you Christoph. So we are ready for Q&A session.

<u>Question and Answer section</u>

Anson Chen (AC) from Daiwa Capital

AC: Thank you and also the management. There are two key questions. In the first it is about do you have stepped up promotion in Q3. So, can you give more colors by segments? say do we just cut price in one or two categories or is it a price cut in all the categories be involved? That’s the first question. And the second question is, can you quantify more about the market share gap between us and our peers at the moment? Thank you.

CM: Yes okay. Thank you for your question. Well, this type of promotion we are doing in Q3 have basically been very targeted on some SKUs. As we said, we have a very clear strategy when it comes to bridge the gross margin and that is changing the mix for higher added value SKU. We had some price increasing and also cost savings. And what we have done, our price increases initially in Q1 and Q2 have been across the board and in Q3 we have targeted very specifically some of the higher added value SKUs and pushed them more significantly. That also had a very good effect. I mean you remember one of our key rollouts and key promotion for the moment is 4D-Deco. 4D-Deco has achieved very good results in Q3, and as Tempo and as Tork. Where we basically see the weakness is more in the standard SKUs of the Vinda brand when it comes to tissue.

When it comes to quantifying market share and the gap, we have actually in August our market share went already up and we took again market leadership in the Chinese market. When we look at this increase, we also got already offline share for September and we see a continuous positive trend in that. However, when we try to reconcile our market shares and the market growth that Nielsen's showing, it seems that our consumer sales for the moment are very very strong. And it seems that our sales into the trade is lower than the outsell which is basically a very clear sign of destocking in the market. This happens from time to time. These are not very long term effects because you know tissue volumes are very very high and therefore you cannot stock too much of it. But it's a clear sign that the trade also see some more difficult trading environment towards consumer in China. Thank you.

Tiffany Feng (TF) from Citigroup

TF: Hi Christoph, hi management. Firstly, I want to clarify your topline growth target for the full year. You mentioned mid-single digit, is it for the constant currency growth target?

CM: Sorry, I'm not sure if I missed your question whether or not it is the guidance for the full year? I understood, so basically as you know, we have an ambition for China which is double-digit growth in the Chinese market and then basically high-single digit growth or mid-single digit growth for the other regions. It seems to us that the Chinese market for the moment is a little bit more tough than that, and we do not expect to reach double-digit growth for the rest of the year. Therefore, we basically think that the group overall will be in the middle-single-digit growth for quarter four. And then combine that together, we do not have a growth target for the year as such, but we are unlikely to end up between five and seven percent growth to target for the year.

TF: Okay, thank you. And then my second question is on the GP margin. I still cannot recognize margin impact of the Q3 versus Q2. So, because there is almost four hundred basis points drop quarter on quarter. But given that you have three to four months' pulp inventories, so the RMB depreciation in the Q3 should only affect the purchasing costs for Q4, Right? So, because I see the Q3, the pulp cost was affected by the Q2 currency impact, which was in line with Q1, I mean the RMB currency, and also the pulp spot price in the Q2 was similar to the Q1 as shown on your presentation. So meaning that the Q3 pulp purchasing cost is similar to the Q2 and also the Q3. The ASP similar to Q2. So then how come the Q3 GP margin was significantly below the Q2? Sorry. Did I mention it clearly?

CM: Let me go back to your question first, a little bit more color and GP margin effect quarter over quarter. So we had a drop quarter over quarter of 3.9 points. The significant part of the drop is the pulp, because clearly we bought the pulp we were using in Q3 was basically bought in the beginning of Q2, which was still significantly more expensive than the pulp we bought at the end of Q4 or beginning of Q1 this year. So the effect is around 30% also. Then with lower volume and manufacturing, there is quite significant effect on covering manufacturing cost overheads and fixed cost. And this effect is about a quarter. What you then see also is despite the focus on higher added value SKUs, we had to do more sales in more coreless paper or these type of products, which basically gave us a slightly unfavorable mix this quarter. And then we had a temporary price reduction, which would explain another 35% or so of this drop in gross margin. So it's basically all these factors coming together which gives you the significant drop. And the drop was particularly strong in July and also followed into August and September we see already much better numbers, and that has to do just with the volume evolution. So in July, our sales were relatively low and then it increased dramatically from month to month to month. And therefore we are still optimistic for some sales growth in the Q4. The other thing just to remind you is that last year, clearly we have incredibly strong September with 21 percent growth. We had a very strong Q4 as well in October and November and December. So I think it is not just that our sales performance is actually probably a record high for this type of months we're talking about, but the comparative is very strong as well.

TF: Ok. So should I expect a higher margin pressure for the Q4 versus the Q3 because of the RMB depreciation?

CM: I think what we see is that clearly a number of effects are counterbalancing just the RMB effect. For example, with higher production, our overheads will be better covered, which takes some out. And what we see also that the Q3 purchasing of pulp compared to Q2 has been stabilized and have less pressure on US dollars on pulp, and basically the remaining effect is the exchange rate. So my expectation is that in Q4 we will have a slightly better margin that in Q3. However, we will not reach our margin that we had achieved in Q2.

TF: Ok, thank you.

Chen Luo (CL) from Bank of America Merrill lynch

CL: Hi, Chris. I've got two questions regarding Q3 result. First of all, just now you mentioned that the demand slowdown might be one of the reasons for the Q3 results. Can you also offer us a bit more colour on how much slow down we have seen so far for the retail market for the tissue paper business in China? And the second question is that given all that we have observed so far, what kind of measures are we going to take in the future? Are we going to further increase the promotional intensity or are there any other measures that we are considering at the moment? Thank you.

CM: Okay. So maybe that was a misunderstanding. I don't think when I look at Nielsen data, I do not see a significant market slowdown in China. What we see is we saw a relative sales slowdown when it comes to Vinda products, but we see increasing shares. So our conclusion is that the trade has started to destock a little bit, and this is probably a reaction of the uncertainty and the market sentiment in China. But I think I do not read today that the consumer market in terms of tissue consumption or structure of that consumption in terms of premium versus mass market products have changed significantly. So demand slow down, I do not think that’s the case today.

To your second question, what are our future measures? Well, I tell you before all competitors in China are sitting basically in the same boat when it comes to pulp supply. And all our competitors have now very significantly higher pulp cost than last year. And you have seen from some of our competitors who are publishing the H1 results were publicly listed that tissue profitability has suffered quite significantly in H1. My expectation is that they will have either to continue with some careful price increases, or to slow down the promotional activities over time in order to recover the profitability as we have done previously.

Second thing is I think for us to further the price increases is probably out of the question, as we had already significant price differential now after our two price increases. And thirdly, I think we would continue our strategy to very focus on our higher margin SKUs. So Deluxe, Tempo, Tork, Ultra Strong and things like that. And then on the other hand, our programs of cost savings in the supply chain or marketing and selling cost and G&A will continue.

Paul Yuan (PY) from CICC

PY: Good morning, Chris, I have two questions to start with you. The first one is about what your margin strategy is like. Of course, you mentioned increased promotion in September to push up in volume a little bit, which is probably reflecting your GP margin erosion quarter on quarter in third quarter. So I just wonder if there is a strategy turning point for a short while? I mean in the near term, for Vinda, suggesting that you may sacrifice some margin to defend the topline down the road in a near term? So this is the first question.

And the second one is about the accounting issue. I just try to understand what's the gap between your operating profit and EBITDA? Is it just a D&A literally? And if so, what's going so rapidly? Ok, D&A by one hundred million in the first three quarters year over year, not a large space, of only six hundred million in the same period last year. That means like a ready of about sixteen years in just one year, sixteen percent in just one year.

CM: May I take the first question concerning the margin strategy in the near term. I'm not quite sure if I fully understood your second question, but let’s go for the first question first.

So when it comes to margin strategy, well our strategy or our objective is clearly to go back to around 30% gross margin as an overall target and ambition. And I think where what we see today is that we had through a slow down of volume and all the different factors, our margin dropped quite significantly now in Q3. But we see already some improvement in Q4: A) because the pulp pricing is not increasing anymore; B) because we are covering better overheads and the mixed effect also should continue to improve that margin situation. So I think in the near term, if we talk about Q4 this year, as I said, we expect a better margin in Q4, not as good maybe as in Q2, but definitely better than Q3. And when it comes to the long term situation or more medium term, 2019 and things like that, we will do everything we can to basically bring our margins back where it should be. And I'm also much more confident that over time, all the competitors will have a little bit of lower promotion, would have a little bit of a price drop, because the situation for them is not sustainable either. So I think these effect will help. And then clearly, we do not have any particular view on pulp prices and RMB development, but we do not expect things to get significantly better. So I think we are counting on a relatively stable situation, and if RMB weakening would continue significantly, or pulp price would increase, clearly we would have to look at further price increase in 2019. So now I'm not sure, Vicky, do you want to take the accounting question? I'm not sure if I fully understood the question.

VT: Yes, I can take the accounting question about the difference between our operating profit and EBITDA. There are two key differences. One is always the depreciation of our fixed assets and the other will be the amortization of those intangible assets we have, which we got from the acquisition of the Essity, the former Hong Kong and Southeast Asia and North Asia business. So, these two major components will be the key difference. The last one will be the interest expense to be paid. Of course, I'm sorry that is not in the operating profit. So, maybe between operating profit and EBITDA will be the depreciation and amortization of intangible (assets).

Closing

JW: So I think that's about the time and thank you very much for calling in. And if you have further questions, feel free to give us a call or email us, thank you. So that's the end of this call. Thank you very much for your time. Bye.