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Betterware de Mexico, S.A. de C.V.

Third Quarter 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

Luis Campos, *Executive Chairman*

Andres Campos, *Chief Executive Officer*

Diana Jones, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Cristina Fernandez, *Telsey Advisory Group*

Eric Beder, *SCC Research*

Alvaro Garcia, *BTG*

PRESENTATION

Operator

Welcome to Betterware's Third Quarter 2021 Earnings Conference Call.

With me on the call today are Betterware's Executive Chairman, Luis Campos; Chief Executive Officer, Andres Campos; and Chief Financial Officer, Diana Jones.

Before we get started, I would like to remind you that this call will include forward-looking statements, which are subject to various risks and uncertainties that could cause actual results to differ materially from expectations. Any such statement should be considered in conjunction with the cautionary statements and the Safe Harbor statement in the earnings release and risk factors discussed in the reports filed with the SEC. Betterware assumes no obligation to update any of these forward-looking statements or information.

A reconciliation and other information regarding non-GAAP financial measures discussed on the call can be found in the earnings release issued yesterday as well as the Investors section on the Company website.

Now I would like to turn the call over to the Company's Executive Chairman, Luis Campos.

Luis Campos

Thank you, Operator.

Good morning, everyone, and thank you for joining us today. I will begin my remarks by providing a summary of our third quarter performance and highlighting the key features of our differentiated business model that has allowed us to have a 20-year history of constant and profitable growth and will allow us to continue to grow going forward. Then Andres will discuss the main drivers of our performance for the third quarter and our expectations for the rest of the year and beyond. Diana will then review our financial results for the quarter and year-to-date.

During the third quarter, our net revenues increased 4% on top of the almost 200% growth we saw in Q3 2020, while EBITDA was down marginally compared to the same period of last year due to the increased operating expense structure that was needed to align the Company's operating capabilities to the new, much higher level of revenues this year after last year's extraordinary growth that show an almost 200% year-on-year revenue increase. Our cost structure is now aligned to our current level of operations. As such, going forward, we expect to recover the additional operating leverage that we achieved during 2020 as revenues grow.

For the first nine months of the year, we are pleased with our revenue growth of 69% and EBITDA growth of 75% compared to the first nine months of 2020. From 2001 to 2020, Betterware had a compounded annual growth rate of 23% in net revenue, 27% in EBITDA, and 24% in our associates and distributors network. This growth accelerated in the last five years, from 2015 to 2020, to a compounded annual growth rate of 57% in net revenue, 64% in EBITDA, and 63% in our associates and distributors network.

And in 2020, which was an exceptional year for the Company thanks to the features of our differentiated business model and our three strategic pillars, we were able to capture the growth opportunity and grow 135% in net revenue, 154% in EBITDA, and almost tripled the size of our distribution network from 438,000 by the end of 2019 to almost 1.3 million distributors and associates by the end 2020. For Fiscal 2021, we expect our growth in net revenue to be closer to the lower end of our previous guidance, which implies growth in net revenues of approximately 49% and growth in EBITDA of approximately 48% on top of the triple-digit growth seen in 2020.

Our consistent ability to deliver strong growth rates reflects the advantages of our differentiated business model. We expect the strength of our business model, combined with execution of our growth initiatives, to fuel a double-digit compounded annual growth rate in net revenue from 2021 to 2025. This rate of growth positions us to achieve our target household penetration of 40% by 2025.

The main features of our differentiated business model are, number one, our high cash flow generation. Historically, we have had low Capex requirements. We expect our Capex to return to a more normalized level of 2% to 2.5% of net revenues per year beginning in 2022 and going forward as we move past the investment in our new national distribution center that reduced our cash flows during 2019, 2020, and 2021. Going forward, our investments will mainly be focused on technology. We also have a negative cash conversion cycle, which allows us to generate cash as we continue growing.

In the past, these two factors combined have allowed us to have a cash conversion rate of approximately 65% of EBITDA, and given that we are nearing the end of our Capex investments, we expect to return to this rate in 2022 and going forward.

Number two, we are an asset-light business. We manufacture our products through third-party suppliers. We currently work with more than 100 certified factories in China and Mexico. This allows us to scale to meet sharp increases in demand, as we did in 2020, and provides us with flexibility to adapt if the demand environment flexes down.

We also deliver our products to our distributors through six third-party carriers. On average, we have been working with these providers for more than 15 years. We have built strong and trusting relationships with our business partners, who have scaled their operations to meet our growth. This gives us the flexibility to adapt to changes in demand.

Our cost structure is very flexible. Year-to-date, 8% of our total costs are variable. This allows us to adjust and keep our profitability levels, achieving operating leverage in periods of growth and adjusting our expenses when it is necessary.

Number three, the flexibility of our business model. We have the capacity to quickly react and adapt to changes in the environment. Our new monthly catalog allows us to react faster than before to changes in the economic environment in order to adjust our commercial strategies to any particular situation. After the extraordinary growth seen in 2020, the first nine months of 2021 have been a transitioning period where our main objective has been to consolidate our network of new distributors and associates, again, during 2020 and adapt our operating capabilities to the new much higher level of revenues.

Now we have successfully consolidated our network of distributors and associates, practically maintaining the same number of active associates and distributors as we had by the end of 2020 with a much more solid base. And our operating expenses structure is in line to support our current operations and our growth for the next years to double our household penetration to 40% by 2025.

During the third quarter, we faced three unexpected external headwinds.

The first one, overall consumption in Mexico declined compared to the previous quarter, showing the first contraction since Q2 2020 and the first third quarter with quarter-on-quarter decline since 2014. Consumer confidence also decreased 3.7% during the quarter.

Number two, people accelerated the return to pre-pandemic activities, redirecting their spending to products and services that they were not spending on during COVID, such as for the return to in-person activities in the back-to-school season and traveling during the summer.

And last, supply chain disruption in China, mainly the increase in freight costs from China, which have lasted longer than what we expected, and the rationing of energy, which is causing partial and total shutdowns in some factories, impacting the timely receipt of product and increasing product costs. Our business has proven successful during several economic environments, and we have a proven track record of navigating headwinds.

This has us confident that, based on our flexible business model, our three strategic pillars, and our ability to adapt and react to different situations, we are well positioned to achieve our long-term objectives to double our household penetration to 40% by 2025 while also increasing our share of wallet. This would also result in doubling our net revenues from 2020 in 2025.

I will now turn the call to Andres, our Chief Executive Officer, who will discuss the main drivers of our operational performance in the third quarter and our growth expectations for the rest of the year and going forward.

Andres Campos

Thank you, Luis, and good morning, everyone.

I will start by highlighting the main operational drivers in the third quarter. We are pleased with our third quarter results, as, even considering the external headwinds faced during the period and the tough comparison base to Q3 2020 when we grew almost 200%, our net revenues for Q3 2021 grew 4%. As mentioned in our last conference call, in 2021, we have been focused on consolidating our larger sales force after the extraordinary growth we achieved during 2020. We are pleased with our progress up-to-date, as we practically maintained the same number of active associates and distributors that we had at the beginning of the year.

While we have faced a higher churn during 2021 because of some of the associates and distributors gained in 2020 returned to their pre-pandemic lifestyle, we've managed to retain most. And more importantly, we've been able to continue to attract new associates at the same rate that we had in the pre-COVID era. During the quarter, 468,000 new associates and 16,000 new distributors joined our sales force. This demonstrates that we have the right strategies in place to continue to grow our sales force and thus penetrate more households. After this successful period of consolidation, we are confident that our distributors and associates network can return to growth in the final quarter of 2021 and years to come.

As Luis mentioned, during the quarter, we faced three external unexpected headwinds: number one, a decline in consumption in Mexico; number two, a shift in the spending towards products that people were not spending on during COVID; and number three, the supply chain disruption in China.

As a response to the first two headwinds, we are adjusting our commercial strategies to adapt to current conditions. These changes include, among others, a change in our product mix to make it more attractive for our current associates to continue selling and for new associates to join the network of distributors and associates. While early, these adjustments already began to show positive results and are expected to continue to lead to improvements during November and December 2021. This, combined with the increased frequency of catalog distribution, is expected to generate increasingly positive results in 2022 and going forward. We are closely monitoring the economic environment to further adjust our commercial strategies in case it is necessary.

As it relates to the supply chain disruption in China, our operations have been impacted mainly by two factors. The increase in sea freight costs. We have been able to partially mitigate the impact in our freight costs due to the contracts we negotiated at the beginning of the year, but the increase in costs has lasted longer than previously expected. This translates in an impact of approximately 1.6% of net revenues for the third quarter, and for the fourth quarter, we expect the impact to be approximately 1.8%.

And the second impact comes from the recent limits in the use of energy. This limits our suppliers' operations and reduces their capacity. This factor did not significantly impact our operations during Q3 2021, but it will for Q4 2021. The impacts for 2022 are still uncertain and depend on how long it takes for the situation to normalize. Recent events indicate that it should not take too long to normalize.

Given that we expect these three headwinds to last at least for the rest of the year, we now expect our results for Fiscal Year 2021 to be closer to the lower end of our previous guidance of 10,800 million pesos in net revenue and 3,200 million pesos in EBITDA, which implies net revenue growth of approximately 49% for the year and EBITDA growth of approximately 48% for the year on top of the 135% growth in net revenue and 154% growth in EBITDA in 2020.

For the medium and long term, we are accelerating our plans to manufacture a larger share of our products in Mexico. This shift is aimed to, number one, diversify risks of concentration in China; number two, give us greater commercial and operational flexibility and allow us to reduce inventory levels on products manufactured in Mexico; and number three, help us advance in our sustainability agenda, reducing our carbon footprint and creating more opportunities for indirect employment in Mexico.

Now moving on to our long-term organic growth expectations. In terms of household penetration, as previously stated, our target is to reach 40% household penetration by 2025. We feel confident about achieving this goal due to the next reasons. Our target market in Mexico has approximately 29 million households. We know that, today, we have approximately 25% household penetration, which means that approximately 7 million households buy our products today. This means there are still 22 million households we do not yet reach. According to diverse market research carried out by our business intelligence unit, we estimate that more than two thirds of those 22 million households will be willing to buy Betterware products if they knew an associate who would sell to them.

To reach all those potential households, we need more associates. Given the fact that we are the category builders of home solutions market in Mexico with a unique and broad product offering with no direct competition, we strongly believe we can reach our 2 million associate goal by 2025. As years go by, people are more and more in need of a gig to generate an extra income. So, we have a good tailwind effect from this long-term trend as well.

To do so, we are carrying out strong strategies within our three pillars.

First, we are close to launching our new BetterNet 3.0 app for associates and distributors. This new app will enhance usability, allow us to communicate more seamlessly with distributors and associates, and motivate them more by showing them constant income opportunities with gamification features. We expect this to help us increase associates' and distributors' activity and sales levels as well as increase their life span with Betterware.

On the other hand, we continue to improve our business intelligence tools, such as our penetration digital map, which distributors use to find white spaces to recruit more associates, as well as our loyalty and incentive programs, which are more and more effective as time goes by. We are also expanding the benefits that people can obtain from selling Betterware, like well-priced phone packages through Betterware Connect and much more. This strengthens people's willingness to continue to sell Betterware.

Also, our new e-commerce platform, which we launched last year, is consistently showing positive results. Even when total e-commerce sales are not relevant to total revenue yet, third quarter of 2021 revenues were 44% higher than revenues in second quarter of 2021. And September revenues were 95% higher than revenues in August 2021. This will continue to grow at a fast pace, allowing us to reach more households.

Given all of this, we are confident we can continue to grow our sales force to reach all those potential households.

Now I will explain what we're doing to increase share of wallet. We currently participate in more than 11 category niches. We believe we have a strong potential to expand our share of wallet within these category niches.

Our first strategy is to do so are, number one, increase our catalog frequency from nine per year to 12. This will increase the number of times the customer sees our catalog throughout the year and allow us to place seasonalities more assertively, thus increasing frequency of purchase per household. Second, we are doubling the number of new products within these catalogs. This will result in an increase of approximately 30% in the number of total exposed SKUs per year. Third, our new home renovation category is growing a lot, and we see a great opportunity to expand it even more.

These strategies should increase the purchase per household. That said, we still have more strategies to come going forward to expand these category niches where we play, thus achieving an increase in our customers' share of wallet.

Overall, we are pleased with the continued operational progress we made in the third quarter of 2021 as we continue to focus on driving household penetration and start to roll out strategies to increase share of wallets. As we enter the fourth quarter, we are adapting our strategies to the current operational environment and are confident in our positioning to continue growing during the quarters and years to come and to capture the important opportunities we have for the coming years.

I will now turn the call over to Diana to review our third quarter financial results.

Diana Jones

Thank you, Andres. Good morning, everyone.

As Luis and Andres provided our third quarter financial results and guidance, my remarks will focus on our year-to-date performance. Please keep in mind that the currency I will refer to when reviewing our results is the Mexican peso, which is our functional and reporting currency.

For the first nine months of the year, we continued to show strong results. Total net revenues increased 69% year-on-year. Gross margin expanded 288 basis points to 56.9%. EBITDA increased 75% and EBITDA margin expanded 115 basis points to 30.3%. Our net income increased 461%, and our adjusted net income increased 49%.

For the last 12 months, our ROI has been 212% and our return on invested capital has been 222%. Our balance sheet remains strong in the third quarter of 2021, even as we face headwinds, reflecting the strength of our business model. Several metrics make it evident; among others, our net debt-to-EBITDA ratio, which closed the quarter at 0.1 times. Our net working capital, calculated as a sum of the trade accounts receivable plus inventories minus accounts payables, was essentially zero at 41 million pesos. Our equity increased by 1,153 million pesos from 335 million pesos in Q3 '20 to 1,488 million pesos in Q3 '21 as a result of retained earnings and net of a dividend payment of 1,380 million pesos for the last 12 months.

Additionally, we were able to successfully refinance our previous debt under favorable conditions with a long-term bond issuance in the Mexican market and invest on our campus, which will allow for further productivity and improved margins. The investment of approximately 1,100 million pesos associated with our campus is financed with these new long-term debt, where the order book was oversubscribed by more than 3 times, which demonstrates the strong support from investors for our business model and their confidence in our ability to continue to grow going forward.

The flexibility of our asset-light business model and our cost structure, which is highly variable, enable us to gain operating leverage as the business grows, and our strong cash flow generation gives us the ability to continue to return value to our shareholders with our ongoing dividend payment.

I will now turn the call over to Operator, and we will take any questions you may have.

Operator

Our first question is from Cristina Fernandez with Telsey Advisory Group. Please proceed with your question.

Cristina Fernandez

Hi, good morning.

I wanted to ask about the outlook for the year, the revised outlook, and what it implies for the fourth quarter. On the revenue line, it seems like it still implies a reacceleration to double-digit growth in the fourth quarter. As you think about the macro situation in Mexico and some of the kind of supply chain constraints, what gives you confidence that you can see that reacceleration in October? Perhaps maybe you can share with us what you're seeing so far in October.

Luis Campos

Yes, Cristina, this is Luis.

Let me begin telling you that you probably will remember that last year we grew a lot of our sales force, mainly in Q3 and Q4, and it was because there was an extraordinary spend in home products. And there was a tremendous unemployment due to COVID at that time. In fact, we ended last year with almost 1.3 million associates and distributors. At the first quarter of last year, we ended with 478,000. It means that in basically two quarters, in the second but mainly in the third and fourth quarter, we almost tripled the size of our sales force.

This year, it has been a little bit different once we came back to normality. The first quarter was still triple digit, very strong triple digit. But then in the second quarter and third quarter, many people went back, many of our associates went back to employment, and they began spending money in some other things like the preschool spending and traveling and some others. Just to put it in perspective, okay, during the second and third quarter, our churn got to 4.5%, well above the 2.8% of pre-COVID churn, okay. Then what we did was to recruit, okay, to consolidate our sales force recruiting very intensively, okay.

Just to put it in perspective, during the third quarter, we recruited 468,000 new associates to replace those associates that left the Company during Q2 and Q3 of this year, because they went back to employment and as they came in last year only on a temporary basis. Then just to put it in perspective, these 468,000 new associates during Q3, it's almost the number of associates, the total number of associates, that we had at the end of Q1 of 2020, okay. This speaks about a totally renewed base of associates, more solid base of associates. This was quite a challenge for our team, okay. And now we have a more solid base of associates and distributors. And what we can see now, right now, is that we can begin growing again our sales force, okay.

Just to put it in perspective, okay, the churn rate, the maximum churn rate, we had during Q2 and Q3 was 4.5%. And it went down now to 3.1% as compared to the 2.8% that we had pre COVID. Then we are almost back to our normal churn. And with this strong recruiting, we will begin growing our sales force.

That said, okay, answering to your question, we feel very comfortable about the fourth quarter, okay. Regarding the headwinds, we already mentioned in the report, in the results report, okay, this decrease in consumption in Mexico and the challenge we have with the supply chain disruption from China. Then we reiterate that we are going to get, by the end of the year, we'll see the guidance, our previous guidance, probably in the lower part of our guidance, both in revenues and EBITDA, okay, in the lower level, both we are going to get there.

We are very well positioned, because of the reasons I gave to you. We are already very well positioned to begin growing next year. Of course, the first quarter of next year, okay, will be the hardest comparison with this year. But Q2, Q3 and Q4 for next year, you will see stronger and stronger growth, okay. We are going to provide our guidance beginning of the year, beginning of next year. But this is more or less the way we see it, okay. Then, yes, we are going to be in the lower side of our previous guidance, both in revenue and profit. And we are going to increasingly grow next year in order to achieve our goal for next year, then our growth goal for next year.

Cristina Fernandez

That's helpful. Then a second question is around supply chain. I guess, what are your expectations as far as the costs? I mean, you broke down what they would be for the third and fourth quarter. Do you expect the freight costs to remain elevated through 2022?

And then also the shift in production to Mexico. I mean, how quickly can you shift some of that production? And what are your expectations as far as what that penetration could be in the next couple of years?

Luis Campos

Sure. Well, as we said in the report, in the results report and also in the (audio interference). Yes, we have an impact. We are mentioning that in the report. We are having an impact for freight cost in Q3, and we expect an impact in Q4. And in terms of supplying, we have some impact in Q3, probably a little bit more in Q4. But we consider this a nonrecurring negative impact, because we are not sure, of course, but we expect these headwinds that we are having in Q3 and Q4 to dilute in Q1 and Q2 of next year, okay.

This (audio interference) is basically sits (audio interference) increasing our manufacturing in Mexico; we are working hard on that, and we are going to make progress next year. And but this is going to take some time, okay? But we do not expect next year disruption in the supply chain, okay. As you know, China is (audio interference) be a stabilization of the supply chains, in our case, we have some kind of priority with the factories we work with in China, and this is the reason why we are not having major negative impact in supply.

Cristina Fernandez

Okay. You broke up a little bit, so I missed some of the explanation, but I think I got more to say. The last question I had was, perhaps for Andres, you talk about your commercial strategies and the adjustments you've made. Can you explain more detail sort of the changes you're making to product mix to make it more attractive and for associates and distributors to join? I mean, that was something new that you hadn't talked about before, so that would be helpful in understanding the changes going on.

Andres Campos

Yes. Cristina, as we mentioned in the call, we have made some changes in the price ranges to make it easier for consumers to buy our products. This has been the main strategy in terms of making it easier for them to buy the products. I think this will help us to navigate through that headwind and help us for the fourth quarter results for the close of the year.

Cristina Fernandez

Thank you. I'll let someone else ask the questions.

Andres Campos

Thank you.

Operator

Our next question is from Eric Beder with SCC Research. Please proceed with your question.

Eric Beder

I'd like to talk about the supply chain and some of the improvements you're making. I believe you have the recent upgrade in the HQ, the headquarters supply chain flow through. And how do you look upon the Mexico City launch? And when is that, A, going to occur, and, B, what the impact it will have?

Andres Campos

Eric, we are launching the new tower of pick-and-pack lines during the fourth quarter. We have already started operations in this new pick-and-pack line. And we expect the Mexico City new distribution center to open by the end of the first semester of 2022.

Eric Beder

How do you think that's going to impact the business here?

Andres Campos

Well, Eric, it's going to be (audio interference) probably, meaning (audio interference) we think that the most important thing is that we are on set to our start growing again our top line. We are pleased, I mentioned it before, we have managed to get the churn rates back to all pre-COVID levels. And this quarter, we saw our associates number pretty much the same as the last quarter, meaning that we are set to start growing our top line again. So even when we do expect to have less expenses, less operational expenses, coming from these two strategies that you mentioned, I believe it's important to reiterate that the most important thing will come from going back to growth in associates and in revenue during the next quarters.

Eric Beder

Speaking of that, internationally, can we get a little bit of an update? I know, I know, it's small, but on Guatemala, are you still very much focused on expanding outside of Mexico with other larger countries?

Luis Campos

Yes. We are making good progress in Guatemala, growing really fast, that will be it. And already with an EBITDA above 15%, the operations has run very well. And now we are going to finish the task of replicating our business model in order to even ignite more growth there. And we are exploring closely the possibilities of further geographic expansion over the next two years. Then we are working probably more intensively than before in this goal, okay.

Eric Beder

Right. Last question. You have share buybacks, you have the dividend. And what should we be thinking in terms of those pieces going forward?

Luis Campos

Well, as you know, Eric, we have a very attractive dividend, and we are going to continue with our policy, with our dividend policy, in the years to come.

Eric Beder

Okay. All right, guys. Good luck for the holidays.

Luis Campos

Thank you.

Operator

Our next question is from Alvaro Garcia with BTG. Please proceed with your question.

Alvaro Garcia

Hi, gentlemen. Thanks for the call. A couple of questions.

The first one is on e-commerce. You mentioned this sequential acceleration, particularly in September. I was wondering if you can sort of describe what you think is driving that acceleration and whether or not it's helping you retain associates or improve engagement? That's the first question.

Andres Campos

Alvaro, the website and the e-commerce is still not significant within our strategy to increase associates and distributors. But that said, it is important to mention that it has been greatly growing. As we mentioned in the report, in the last two months, it has grown month-on-month: it has grown 44% in September and 95% in October. So it has been growing a lot month-on-month. This is a very good sign that it's going to, more quickly than expected, start to be significant in the business.

Alvaro Garcia

Great. And then my second question is going back to sort of the changes, the recent changes on the catalog front and on the product mix front. I was wondering if you could maybe share some examples as to how that's working out into the fourth quarter to really drive that associate number higher. It's obviously more catalogs. Are there any early results, I guess, that we can see as to how that's helping the ecosystem improve?

Andres Campos

Yes, Alvaro. We just started this, but we do see good reports from this change. We expect to drive more consumption per consumer due to the increased frequency of the catalog 12 times, so we expect from this for consumers to see the catalog more frequent time and thus increase their spend with us. At the same time, we increased our innovation to double the size to that we have before in each catalog. So starting in catalog one of next year, it's going to double the size, the amount of new products that are exposed in this catalog. So we are rolling out in this, and quarter-by-quarter, we do expect to see an increase in consumer spending from these strategies.

Alvaro Garcia

Great. I guess more specifically, like the mobility category, which is new territory, any early signs from that category as to how that's sort of engaging your sales force?

Andres Campos

Well, I mean, we are focused on the 11 category niches that we have mentioned before. One of the categories that has continued to see strong growth is the home renovation category, and that has things to grow. We rolled out this category earlier and has things to grow at a very fast pace. Obviously, as people go back to normal and go outside of the homes, the mobility, as you mentioned, the mobility category starting to gain pace. So we are (audio interference).

Alvaro Garcia

Great. Many Thanks.

Andres Campos

Thank you, Alvaro

Operator

There are no further questions at this time. I'd like to turn the floor back over to Management for any closing comments.

Luis Campos

Yes. Thank you, Operator.

Well, thank you, everyone, for joining us today. We look forward to speaking with you when we report our fourth quarter results and meeting with many of you at upcoming investor conferences. Thank you. Have a good day and a good weekend. Bye.

Operator

This concludes today's call. You may now disconnect your lines. Thank you for your participation.