CONFERENCE CALL TRANSCRIPT

2Q19 EARNINGS

AUGUST 13, 2019

Operator

*Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Magazine Luiza's conference call, referring to the second quarter of 2019 results. At this time all participants are connected in a listen-only mode. Afterwards, we will have a question-and-answer session when further instructions for you to participate will be given. If you need any assistance during the call, please ask an operator for help by pressing *0. Now we would like to turn the floor over to Mr. Frederico Trajano, CEO of Magazine Luiza. You may proceed.*

Frederico Trajano - CEO

Good morning, everyone. Thank you very much for participating in our results conference call for the second quarter results. As usual, I am joined here today by the Company's entire Executive Board, who will be available for the Q&A session after presentations by me and Roberto Bellissimo, who will discuss the figures. Exceptionally at this call we are also joined by Márcio Kumruian, the Head of Netshoes. He will also be available for questions about the ongoing Netshoes operations, which, starting with this second quarter's earnings, are being incorporated to Magalu's balance sheet.

Let's talk about the second quarter. I like to say that many of the great results the Company has been posting in the last few years derive from our strategic clarity and consistency, combined with a fast and disciplined execution. This is what I think happened in the Magalu digitalization cycle that ended last year. Based on the first quarters of this year, this will most likely be the case with this new strategic cycle going forward. In this current cycle, our focus is on building the platform popularly known as the marketplace, which will allow us to grow in a non-linear way. This is what I have been calling "China-paced growth" since the beginning of the year, because a platform does not grow alone, it grows with the help of other companies, large ones included, who start selling their products to our millions of customers as well. I am very happy to have witnessed, both in the first and especially the second quarter, very consistent metrics of progress in this new strategic cycle announced at the end of last year. Even more so because, as I like to say, Magalu's main competitor in 2019 is the 2018 Magalu. Our comparison basis with last year is extremely strong, and I think no other Brazilian retail company has such a strong comparison basis as Magalu 2018, particularly the second quarter of 2018, one of the best quarters in our history because of the World Cup, with our hugely successful campaign "Sai Zica". Almost all of our sales in the first half of last year were concentrated in the second quarter, including one million TV sets, leading to a 20% share of TV sets at the time. It is a really big challenge to achieve "China-paced growth" on top of as strong a comparison basis as 2Q18.

The strategic pillars of this new cycle are, as we have been saying in our recent calls: China-paced growth, especially in the active customer base and their shopping frequency; marketplace growth and increase of services provided to sellers, which we call Magalu as a Service, or IP as a Service, the second pillar of our strategy; growth of the app's customer base, as we have been focusing many efforts on our app as a universal remote control or control center for the platform, our superapp. We have made significant progress on this front. We have new categories, fast and efficient delivery, as well as improved service level in retail and strong Big Data operations, which are the pillars announced at the beginning of the year.

This quarter we delivered on all fronts, and I will discuss our figures in my presentation to symbolize this delivery, make it tangible. But first I would like to highlight two very important aspects of this delivery; one is the marketplace, our second strategic pillar, which I like to call a platform because I think it is much more than simply opening the channel for sellers. It is really about taking the entire infrastructure and providing these networks to sellers as a service. This will be a long-term process. We have had many significant deliveries, though it begins with an increase in the number of sellers and in revenue, which we delivered brilliantly this quarter, even exceeding our internal expectations.

The second aspect is new categories. I think most of the Executive Board's time, and my time, was dedicated to concluding one of the most emblematic acquisitions in our history, which is Netshoes. Because we have a 60-year history in a specific category, it was very important for us to bring out the big guns when moving to a new category, hence the impactful and strategic move that was the acquisition of Netshoes. It was a grueling process, extremely competitive and complex, for involving a company that was established in Cayman, listed in New York, and operating in Brazil. This was one of the most complex M&As ever, not only for us, but for our advisor as well, taking up a lot of our time. It started in the first quarter, but it was mostly concentrated in April, May and June. It was absolutely intense for us and Márcio, Graciela and the Netshoes team who worked really hard in the process.

So, this quarter we delivered on these fronts. I will begin my presentation on page 3, highlighting the first pillar of our new strategic cycle, which is the customer base, already including Netshoes customers. I repeat, we have basically ten days of Netshoes results, but by incorporating the Netshoes base into our figures we reached an active customer base of 22 million customers who actively purchased in the last 12 months, an increase of 53% from the previous base. Even excluding Netshoes, our customer base would have seen very strong growth of 30%. Bearing in mind that the comparison basis included the World Cup, and even in physical stores the base grew 20% from last year. We are also focusing on selling products with lower average ticket, because it is key for us to increase the number of consumers and their annual shopping frequency.

Despite the exponential growth in marketplace, we managed to improve customer metrics, which is a huge challenge because we have less control of third-party service quality than our own. For example, we have the RA1000 accreditation from Reclame Aqui, our maximum score at Reclame Aqui. We do not discriminate between e-commerce and marketplace, we include both in the same metric. Most of our competitors discriminate 3P from 1P. With our marketplace accounting for 25% of total e-commerce sales, we maintained the RA1000 accreditation at the stores. Call center waiting time improved significantly to less than a minute. Call center satisfaction also improved, with a substantial decrease in PROCON complaints and civil lawsuits. This represents great progress on all fronts.

We also increased NPS for physical stores and e-commerce, and also achieved significant NPS for 3P purchases, which is still lagging behind 1P but is way above our initial expectations and continues to grow. In sum, customer satisfaction metrics, which have been very important for us, including for determining our team's compensation, advanced significantly in the last quarter.

E-commerce, specifically, saw substantial growth in customer base; MAU for the Superapp - including the Netshoes base, which has a very high number of monthly active users - stood at 12 million in the quarter. We were recently among the top three most downloaded apps in Brazilian e-commerce. It was Netshoes, Zattini and Magalu last week. We had the Black App on all apps. So we had three of the top 10 shopping apps in Brazil last week. Netshoes and Magalu are still in the top 10 this week, attesting to the strength of this combination.

I would like to highlight the work carried out by Magalu's logistics team. We reached 40% of deliveries completed within two days. This refers to last-mile delivery alone. If we consider Pickup at Store, also within two days, we are talking about 70%-75% of Magalu deliveries currently completed within two days. These figures are already compatible with US and China operations, and many of these deliveries are actually being completed in up to one day, due to the great efforts of the logistics team. Logbee, the acquisition we made last year, really stood out as our delivery 'Uber Light,' helping us increase our share in smaller deliveries, already present in 100 cities.

Another highlight - which Edu can comment on later, as well as Décio - is that approximately 10% of all products billed by e-commerce are billed from physical stores. These are purchases made through e-commerce using physical store inventory. You remember what we said before on this topic: physical stores as shoppable distribution centers. We want to enable that as much as possible for this Netshoes operation, for both Pickup at Store and Ship from Store, website purchases, pickup at store, store inventory. We are making great progress in e-commerce. I think one of the main highlights is the app, and another great highlight of e-commerce is, without a doubt, the logistics service level, which is way higher than the market average, mostly because we work with our own network, the Luiza Network, now boosted by Logbee.

Without question, the main highlight in the quarter was marketplace. As I mentioned, it exceeded the market's and our expectations at the beginning of the year. It grew by 289% compared to the second quarter of last year. If we think about it, it took Magalu more than 40 years to achieve R$1 billion in e-commerce earnings, and over 10 years in 1P, and less than two years in 3P, marketplace. So, it really is an exponential growth like we have never seen. GNV reached R$583 million.

Something I would like to emphasize, which we included in our message from management, is that 100% of our sales were invoiced. This means that we are growing marketplace without cheating or encouraging informality, with much more control and formality, in my opinion, than the market standard. I believe strict regulatory measures will soon be implemented to formalize marketplace sales, for operators to pay taxes and sell original products, securing service quality. Our marketplace growth is not driven by informality, counterfeit products, or poor service level, like I said before. We have more than 8,100 formal sellers who follow the rules established in Brazil. We want to encourage sellers who do not operate formally to start following the rules, because we believe that is the only way a company can grow in an organized, serious country, which is what Brazil is trying to become.

Another highlight is that out of every two customers shopping on the website, one shopped in the marketplace. We have 45 centers, and marketplace grows significantly in lower-ticket products, so it stands out and helps e-commerce gain new customers.

I would also like to highlight the hard work of physical stores this quarter, because the Sai Zica promotion for exchanging TV sets was very strong at physical stores. The main highlight in the second quarter of last year was the 27% same-store sale level at physical stores, mainly driven by this promotion, since the exchange had to be made at the store. Sai Zica helped physical stores more than e-commerce last year. So, the comparison basis for physical stores was stronger. Excluding the image segment - and we also disclosed this figure in our message from management - we still managed to post double-digit growth of approximately 10% this quarter, excluding one category, which is image. All other categories grew. Physical stores still have a very strong basis, but obviously without the World Cup in the third quarter, so the level is already more similar to other quarters now between July and August. We expect to disclose these figures at the end of the third quarter. But it was a very good work, we managed to grow our active customer base by 20%.

I would also like to highlight that quality and sales exceeded expectations at new stores opened last year, namely Goiás and Maranhão, and all stores opened in current states of operation. We were extremely successful there, with higher than expected sales at these stores opened in the last twelve months. So, we are doing a great job in these new markets. We are about to enter the Pará market as well, as announced to the press, and we are very excited about this state, as well as other states like Mato Grosso, and Brasília as well, where we should open stores by the end of the year. We are very excited about the expansion of our physical store base and the renovations in progress to turn stores into distribution centers.

We launched a campaign that was, in my opinion, as strong as Sai Zica, which is the Smartphonize Brazil for exchanging mobile phones. We paid up to R$2,500 for customers to exchange their old devices for new, premium ones. We launched this campaign at the end of May, so it only covered one month in the second quarter. In the third quarter it will cover basically all three months for the comparison basis. The campaign has been very successful, similarly to Sai Zica last year, when we exchanged TV sets, and now we are exchanging mobile phones. This buyback business was not popular in Brazil. Once again, Magazine Luiza got a head start by making this format popular in the country, which also helps physical stores, where the products are exchanged, in an even more frictionless way than e-commerce. So, the campaign will significantly help the quarter's comparison basis.

As for LuizaCred, our financial operation continues to grow substantially. We grew 50% in the second quarter, the loan portfolio grew 44%, reaching approximately R$10 billion, and it is the largest independent financial operation in the market in terms of loan portfolio size. The Luiza Card base reached R$4.6 million in the second quarter. We started selling the Luiza Card on the internet as well, upon first purchase, and it is really taking off. Netshoes already had a card that was selling well in its operations. The highlight in financial operations is that our credit card is co-branded as Magazine Luiza/Mastercard, issued through a JV with Itaú. It is the first choice of many of our customers. Their monthly use frequency of the Magazine Luiza Card is seven times. This is a very strong figure, showing that the card is the first choice of many of our customers, who really like using it not only at Magazine Luiza, but off-us as well, outside the Magazine Luiza base, such as supermarkets and drugstores.

For Netshoes, I think we have already highlighted the strategic rationale for it. Both Eduardo and Márcio will be available today to talk about progress on the integration front. Márcio, specifically, will talk about the first results at Netshoes. We cannot disclose quantitative information, but he will be able to answer your questions with qualitative data.

I will now turn the floor to Beto, then I will come back very quickly to talk about third-quarter outlooks and then open for questions.

Roberto Bellissimo – CFO and IRO

Good morning, everyone. Starting with the highlights of our results, total sales grew 24% on a 43% basis in the first quarter of last year, which is very high, reaching R$5.7 billion. We already talked about the marketplace and e-commerce sales performance. Marketplace gross profit grew so much that it already has significant contribution. Gross margin decreased by 0.8 percentage points in the quarter, mainly due to the Lei do Bem cancellation. Operating expenses remained stable at approximately 22% of net revenue, despite the higher service level, acquisition of new customers, and faster service and logistics.

With that, EBITDA stood at roughly R$300 million, expanding by 27.2%. Proforma net income was R$108 million, with margin of 2.6%. Operating cash flow remains strong at R$700 million, with ROIC of 17% in the quarter and 23% in the last twelve months. We continue to grow strongly, with high return while generating cash.

We ended the quarter with a strong net cash position of R$800 million - despite the investment in acquiring Netshoes and the payment of Netshoes debt - and a very strong total cash position of R$2 billion, including credit card receivables available.

Then we had an evolution in user base, which Fred already mentioned. Store number also increased, with more than 100 new stores in the last twelve months, the highlight being 27, 28 stores in the last quarter with the Shoestock store. We expect to open roughly 50 stores in the quarter after entering the Pará state as well.

We are increasing investments in line with our strategic plan. We invested over R$200 million in the first half, the highlight being technology and logistics, which grew the most.

Then we have sales performance again, with accumulated growth of approximately 26% in the six-month period, compared to only 3% in the market according to IBGE, so we had a very high market share gain. In e-commerce we grew 56% in the quarter compared to the market's 11%, so we grew a lot more than the market. The highlight was marketplace, with also stood at R$1 billion in the first half of the year, and total e-commerce stood at almost R$5 billion in the first half, with still very few days of Netshoes results.

Then we have the evolution in expenses, which went from 21.7% to 22%, a small variation that was in line with the strategy to increase service level, Luiza Card, app, and focus on customer. The equity accounting item went from R$10 million to -R$3 million, mainly due to LuizaCred and IFRS 9. In BR GAAP, according to BACEN, LuizaCred posted very strong results of R$35 million in the quarter, once again. After an evolution in EBITDA, margin dropped from 8.5% to 7.2%. With the nonrecurring effects and IFRS 16, which were positive, total EBITDA margin stood at 8.8%.

As for financial results, net financial expense went from 2% to 2.3%. That was mainly due to the increase in Luiza Card sales, in line with our LuizaCred expansion strategy. Working capital continues to perform strongly, remaining negative in the quarter at R$600 million. Inventory turnover was very balanced, at around 72 days of inventory turnover, similar to the same quarter of last year. This represents an average shopping period of 92 days, also similar to the same quarter of last year.

Here we have net cash position, and this variation was fully related to the Netshoes acquisition, as I said. We will show you a breakdown of cash flow and total cash position later on. We had roughly R$1.9 billion in total cash, almost R$2 billion, with cash generation and all of these investments we mentioned, including the acquisition of Softbox at the end of last year and Netshoes this quarter. With that, proforma net income stood at R$251 million in this first half and R$108 million in the quarter; considering the LuizaCred results in BR GAAP, that would be a profit of R$130 million for Magazine Luiza proforma in the quarter.

LuizaCred continues to grow strongly, reaching 4.6 million cards. Almost 600,000 app downloads. Expenses stood at R$6.4 billion, especially with Luiza Cards growing substantially by more than 30%. As a result, LuizaCred's net revenue has been growing a lot, and this quarter we had the highest net revenue growth rate of the last five years at more than 50% over last year. Also because of that, LuizaCred's efficiency rate has improved considerably from 46% to 40% in the quarter, one of the lowest operating expense levels in the last few years, with a tendency to decrease as earnings grow.

Lastly, still on LuizaCred, we have the portfolio evolution. Payments overdue for more than 90 days went back to the same level as two years ago, mainly because we currently have many more new customers than we did a year or two ago. As you know, new customers have a slightly higher delinquency level of around 10% compared to old customer delinquency of roughly 7%. Today, the portfolio has many more new customers than two years ago. But delinquency by origination month remains consistent, with a highly profitable outlook as these customers mature. Short-term delinquency is very low at 3.2%, very much under control; coverage is also very high at 68% of the portfolio.

With that, LuizaCred had a loss of R$8 million in IFRS, plus a R$35 million profit in BR GAAP, basically due to excess provisions and limits granted to the best customers in the portfolio. At this pace, it has earned R$70 million in profit in the first half, and is expected to post really good BR GAAP results in the year as well.

These were our main financial comments, and I will now turn the floor back to Frederico.

Frederico Trajano - CEO

Before we open for questions, I would like to share a highlight of the third quarter, fourth quarter, which we will experience now. We will still have a strong comparison basis over the third and fourth quarters, but there is no World Cup, so we will not face the same situation as the one seen in the second quarter. I believe this will have a greater impact on growth indicators for both the third and fourth quarters. Although we did have an exceptional Black Friday in the fourth quarter, so we need to keep planning for this year's Black Friday to be strong in the upcoming fourth quarter.

I would like to emphasize that a winning team needs good players in every position. Our legal team had a great victory. I usually do not talk about this in our calls, but we won, and I think it was a cause not only for Magazine, but for the entire retail industry. We won the cause for temporary workers, which was a new law passed by the Temer administration with significant legal insecurity, because there had been a few losses in lower-court proceedings. We had a unanimous win, and the process was supremely carried out by our team and advisors. The entire retail market was paying attention. Today we have more than 4,000 people working under the temporary model. So, I am very pleased by this victory, and it was a major evolution in labor laws for us to be able to have the right amount of people in retail peak periods. This is why I want to emphasize this work.

Still with regard to people, our teams continue to grow substantially in both marketplace and Labs. In Labs, now with the Netshoes team, we have over 1,000 people in four locations: São Paulo, Franca, Uberlândia and São Carlos. It is good for us to have these four locations for risk dispersion. Because overall, not only in Labs, I feel like the economy has not accelerated yet, but the job market has. Our leaders, our professionals, are being approached constantly, and many of my efforts in the first half were focused on coming up with a robust program of long-term incentives. We have more than 250 people at Magalu who are partners. We have already distributed Magalu shares to the main leaders of Netshoes, and we want to expand this program to other leaders from all levels going forward. Here at Magalu we have many DEVs in the program, and they are not even managers. Despite this acceleration, we had very little personnel losses in the first half, and in July and August. We have a very strong team, with almost 40 officers at Magalu and 15 at Netshoes, whom we maintained with the team, and we want to count on them for our development. For this exponential growth we need many talents in wholesale, not retail. I was very concerned about it in this first half, and I think now we are very protected. It does not mean we won't have any losses, but we are protected in our main positions, it will be expensive to take people away from Magazine Luiza.

I would also like to point out the Netshoes integration plan, which is already in motion. Edu and Márcio will be able to talk about it. In the second half we will develop a plan; there are some low-hanging fruits now, but this is pre-systemic. The heavy, systemic integration should happen next year, after the Black Friday, after the year-end. It would not be wise of us to accelerate this process too much. That said, many wheels are already in motion, and I will let them talk about it in the Q&A.

Thank you very much. We are now open for questions.

Operator

*Excuse me, ladies and gentlemen. We will now start the questions and answers session. To ask a question, please press *1. To remove a question from the list, press *2. Our first question comes from Mr. Robert Ford, with Bank of America. You may proceed.*

Robert Ford – Bank of America

Good morning to all, and congratulations on the results. Thank you for picking up my question. Would you please explain the inventory position and the material changes you are making in your inventory?

Roberto Bellissimo – CFO and IRO

Good morning, Bob, how are you? Bob, we made provisions for sale promotions we will have in the second half, focusing on selling low-turnover products. It is a provision for us to accelerate inventory turnover going forward. The turnover is already good. It has always been good, at 60 or 70 days, but we have developed more campaigns for this second quarter to sell low-turnover products and further improve inventory turnover. This is the purpose of this provision, to sell low-turnover products going forward. I did not understand the second part of your question, sorry. Assortment change? I did not get it.

Robert Ford – Bank of America

If you could talk a little bit about how you are using technology to optimize inventories, please.

Frederico Trajano - CEO

Look, Bob, we have many technology fronts, with our own proprietary algorithms, demand forecast algorithms, and we are now using external information. For example, the Google search base, other information for demand forecast, assortment... Definition of assortment and demand forecast. We have also been using, for example, website information for store supply, product searches by city, there is this granularity information by city, so the assortment is getting more accurate. Replenishment algorithms and processes are increasingly automated, there is no human factor. These are all algorithms, and most of them were developed recently with the commercial team for both e-commerce and physical stores, with the Labs team, which is dedicated to this kind of work. This is why we expect to take advantage of the sale promotions. We will have the Independence Day week next month, the website's anniversary, Black Friday at the end of the year, so we chose to build a provision in the second quarter to sell some of these products and make the algorithm work for the new product line more appropriately than in the previous model.

Robert Ford – Bank of America

Very clear, Fred, thank you. Also, loan growth remains high in provisioning, as you mentioned; even higher. What are your plans for LuizaCred and for the sustainability of current growth rates?

Frederico Trajano - CEO

LuizaCred has a very specific factor. Every retail company with a financial operation is required to apply the IFRS 9, which is a different accounting method than the one used by banks, like BACEN GAAP and other models. The IFRS 9 model is very peculiar, and we cannot get rid of it, so we, Carrefour, and every other retail company with financial operations must follow this model. Its characteristic is to advance the long-term provision. The problem is that when you grow too much, you end up allocating too much provision. The advantage is that when you forecast results for 3, 4, 5 years you see that in the third or fourth year profit increases a lot more and you have no surprises. Based on our forecasts, future results are very healthy. Like we said at the beginning of the year, this is a strategic definition for us. We want to focus on growth, even if it comes to the detriment of a short-term accounting factor. We are adopting a strategy of expanding LuizaCred's customer base and portfolio by 40% or 50%, not worrying whether the result will be affected by this provision, because in our opinion this is simply an accounting factor. We are disclosing our results in BR GAAP as well, and looking at it you can see that LuizaCred's results are very healthy, the figure is much higher, and EBITDA margin would be better. But I will not stop growing customer base, or having a tool that significantly increases customer loyalty and purchasing MAU, because my short term is creating an exclusion due to IFRS 9 adoption. We are very confident, with a very strong vision for the period, supported by Itaú itself, which is very excited about the operation and willing to accelerate it, so we will continue to see China-paced growth in our financial operations as well - card, portfolio, and all products and services sold at LuizaCred, like personal loans and payment of bills in installments. In the LuizaCred revitalization process we are already there; our Luiza Card app is one of the most downloaded financial apps, and we have more than 600,000 customers using it. So, this is a very strong trend. The process of selling cards at the stores is also available via mobile. We are making this LuizaCred product more digital, and we believe it will also help us continue to gain customers with the Luiza Card as their main card.

Robert Ford – Bank of America

Thank you very much, Fred, and congratulations once again.

Roberto Bellissimo – CFO and IRO

These are our best customers, pre-approved customers. Our best customers. All activation indicators show improvements in the portfolio, billings, frequency, and operating expenses is improving LuizaCred's efficiency level. This is only temporary and has an accounting nature.

Robert Ford – Bank of America

Thank you very much, Roberto.

Roberto Bellissimo – CFO and IRO

Thank you, Bob.

Operator

Our next question comes from Mr. Joseph Giordano, with JP Morgan.

Joseph Giordano – JP Morgan

Hi, good morning Fred, Beto. Thank you for picking up my question. I actually have some qualitative questions about Netshoes. I would like to understand, in the short term, what are the main measures taken to improve Netshoes's 1P sales and gross margin. I would also like to understand how is your relationship with suppliers after the process, since leverage was making the company struggle. The second question is about Black Friday, and especially Christmas, which is maybe the focus today for Netshoes. Can we expect Netshoes to be leveraged through the Luiza Network? Lastly, back to Magazine Luiza, you talked about investments in new customers. Looking at Magalu, what can we expect to keep seeing in terms of investments in margin and service level to further improve logistics? As for LuizaCred, we have the app to make the card. Why is that not integrated into Magalu's Superapp?

Frederico Trajano - CEO

Thank you for your question, Joseph. For the first part of your question, I will have to ask everyone here. Márcio is here with us today and he will explain to you the ongoing situation of Netshoes, in qualitative terms.

Márcio Kumruian – Netshoes Director

Good morning, Joseph, thank you for your question. I will give you an overview here. First, I would like to clarify that it was Netshoes Brazil that was incorporated into Magalu. Netshoes previously comprised Netshoes Brazil, Mexico and Argentina. We had two M&As before the Brazil M&A; with that, Magalu acquired the most mature and profitable business units of Netshoes, particularly sports and fashion. Secondly, and most importantly, we gained their trust even during negotiations, we realized that the cultures of both companies were very similar. The Magalu team was very welcoming, so I would like to publicly thank them today. With that, Netshoes quickly got into that China-paced growth climate, which helped us work together with Magalu. Another step taken by Magalu was the payment of Netshoes's debt, which helped us regain our confidence. We had a favorable environment, our debts were paid, all during a very difficult process, like Fred mentioned, throughout April, May and June, helping Netshoes recover quickly. With that - and Fred can help me explain this - we have been working on two big fronts. The first front is integration, where we have four focus areas: operations, technology, back-office and business. Evidently, we are also focusing on strong planning for 2020, a systemic execution. This does not prevent us from reaping some of the benefits now, especially for not being public and having a smaller base, as well as expenses under control, because we were already in the ZBB process as reported in our latest earnings releases. Integration is in progress, carried out by two teams and a consulting firm, focusing on full, systemic integration as from 2020. On the other hand, in terms of business acceleration, Netshoes has had a very strong supplier level before, which was one of your questions. Today, 100% of our supplier base understands this new moment of Netshoes. Netshoes's inventory level remains under control and is stronger than ever. We have not had such a strong inventory level in our recent history, and this helped us recover our growth pace. But there is still a lot to be done. For example, we now have a joint campaign with Magalu on the Black App, so our bases have more than 22 million customers, like Fred said, and we are working on this base together. Initially, though, what I can tell you is that everything is OK with suppliers, inventories are healthy and under control, and we have acquired a new pace, slightly higher than the market pace, of around 10%. Overall, like I said, the environment is great, the teams are getting along, and we are building a long-term relationship.

Frederico Trajano - CEO
Edu, would you like to say anything else about the integration process?

Eduardo Galanternick - Chief E-commerce Officer
Just to give you a little bit more color on the integration process: we basically divided it into three stages. The first stage was the zero hour, focusing on protecting Netshoes's key people and implementing a very clear communication process, which we have already concluded. The second stage we are calling "capturing non-operating synergies," meaning synergies that do not pose any risk to the operation, with joint contractual negotiations and an understanding of back-office structures. This is ongoing, and a consulting team is supporting us. In this second stage, there is still an aspect of capturing joint business opportunities, so the Black App operation, which is a very important date for us, has already been implemented together with Netshoes, with very strong results in the last few days. During this time we are also focusing on planning the business combination to be carried out next year, from a strictly operational point of view. When we say operation, it is basically logistics and Customer Service. As for your question regarding the use of Luiza Network by Netshoes on Black Friday, probably not; we are still not operating it, it is unlikely that we use it, especially because it requires many systemic integrations that could put the operations of both companies at risk during such an important time. All of this will certainly be very well-planned, to be executed in early January, taking as little time as possible over the course of next year. That is pretty much it.

Frederico Trajano - CEO
I would just like to add that I think there is a characteristic of acquisitions... During integration, we were careful to make the best process prevail. There are many great

things Netshoes used to do that we want to use at Magalu as a whole. They had a long-haul air courier work that we did not have, transferring goods from São Paulo to the Recife DC by air. We did not have that. They have positive last-mile delivery costs in some cities, some even better than ours. Their whole DC automation work is more evolved than ours was, so there are many things there that we want to use for us too. It is key for us not to be in a hurry with this integration, so that we can learn from them. Then we can choose the best process - if it is Magalu's, that will prevail; if it is Netshoes's, that will prevail instead. And all of us, not only me but the entire team, believe there are many great things inside that structure. As for your question about investments in customers, etc., we have been focusing on service level, especially delivery. Why does that require investments? Because we are increasing inventories in regional DCs and the frequency of truck supply, expanding Logbee to 100 cities, and increasing the number of people working at DCs to hand in the goods. We are making strong investments in automation for the second half. We are focusing on investments within the SNA. Gross margin was mainly impacted by Lei do Bem, as well as the higher 1P share, than actual aggressive prices. We are not traditionally aggressive in prices. But there was the impact of Lei do Bem, which ended up affecting margin, and there was no pass-through in the first half. We did not invest to increase the number of customers, we simply did not pass the margin through in order to keep our growth pace. But it was not a strategic decision. Our investment in customers is very strong, especially in terms of service level. I always said that we have been investing a lot in growing the app's customer base, so a lot of the investment is allocated to the app, as well as LuizaCred customers, in which we invest through product discounts and awards to employees who sell the card. Both the app and the customer who shops using the card have higher CLT, or customer lifetime, so this is a smart investment for the long term, not the short term. These are appropriate investments, we are not desperate to buy customer base with no return; we want to increase shopping frequency, which is one of the metrics we would like to advance the most in the next few years; it is not only the active base, but the annual shopping frequency. As for the Superapp, our priority was to integrate the Netshoes and Zattini catalogs, as well as all the sellers arriving with new products. We are very focused on #MagaluHasIt, meaning a significant expansion in categories. After we get that, with all categories, we can move on to financial services, card, another type of service that for me is part of the app's process. Our app is mainly a shopping app; other services will help our DAU and MAU. But our focus is to have the best shopping app in Brazil. That is what we are executing now with discipline; we cannot do it all at the same time, we need pace.

Joseph Giordano – JP Morgan

Perfect, thank you very much.

Operator

Our next question comes from Richard Cathcart, with Bradesco.
de Rubem Couto, Santander.

Richard Cathcart - Bradesco

Good morning, everyone, I have two questions. The first one is, I would like to understand the speed at which you will be able to scale cross-docking for marketplace sellers. I would also like to understand if it makes sense to extend that to all sellers, or part of the sellers. Secondly, I would like you to comment on marketplace assortment versus Magalu's 1P operation. I would like to understand if the marketplace growth is fully incremental or if there is any cannibalization from 1P to 3P. Thank you.

Frederico Trajano - CEO

Edu will answer the second question. The first question, Richard... First of all, good morning and thank you for your question. We are focusing on Magalu Deliveries now, in the more standard context, where we use this market carrier contract, not the network model. It is a major, significant systemic development to integrate 3P deliveries into the Luiza Network. We started with Logbee, which already has an interesting share of the total, and we want to roll it out to the network as a whole, including Pickup at Store, over the next few quarters. I do not have a deadline for you, nor will I give you guidance, but I can say that this is one of the main goals of the Labs team, the logistics team and the business team, also shared by some people from physical store operations. It is a big target, and it is important for us, because we have a very high share of express delivery in 1P. Today we cannot offer this to 3P, and I think this is going to be Magazine Luiza's greatest differential in the future. But, I repeat, this is a complex implementation, and we even had to create an entirely different legal entity for logistics to be able to operate this. It has been done already. But I think I will be able to share our progress on these fronts with you in upcoming quarters, compared to this year. Now Edu will answer your second question.

Eduardo Galanternick - Chief E-commerce Officer

Hi, Richard, this is Eduardo, how are you? Thank you for your question. With regard to 1P and 3P assortment, we definitely expect incrementality. Not only incrementality of number of categories in new types of products, but even in categories we operate in the long tail. This is actually what we have been seeing in the last few years. So much so that our 1P sale continues to grow strongly. I cannot guarantee that there is no cannibalization. What we want to do is mitigate that, mainly focusing on product exposure and distribution, complementary lines, and most sales naturally have incrementality. OK?

Richard Cathcart - Bradesco

Great, perfect, thank you very much.

Eduardo Galanternick - Chief E-commerce Officer

Thank you.

Operator

Our next question comes from Luiz Felipe Guanais, with BTG Pactual.

Luiz Felipe Guanais – BTG Pactual

Good morning, everyone. I actually have two questions. The first one is regarding new customers in the platform. Could you give us more color, Fred, on how many of these customers are already going directly into the marketplace? Also, can you see any cross selling between customers from the Netshoes platform and customers who shop for both 1P and 3P products at Magazine Luiza? And my second question, also regarding logistics: you said Magalu Deliveries is already serving 60% of the sellers on the platform. What is the Logbee penetration for these sellers right now? Thank you.

Roberto Bellissimo – CFO and IRO

Luiz, I will answer your questions. First, regarding Magalu Deliveries, what we can say is that out of these 60% we have two Magalu Deliveries modalities: one is shared contract and the other is through our network; 25% of everything goes through our network. 25% of Magalu Deliveries is through our network, and growing. This growth comes naturally with the expansion of Logbee. As for the Magalu cross sell, we began by analyzing the bases, identifying intersections, which parts are new and which parts they both have in common. Now we are working on that business unit I mentioned, the business plan and implementation, thinking of a way to implement this correctly, with data protection but also capturing the best result from this base unification. This is incipient, it is starting now. As for new customers, we have a share of new customers in the marketplace. Early on, the marketplace depended on customers that were mostly recurring customers. This has changed. Now we have a higher rate of new customers in marketplace than in 1P. I think, overall, these are the main points.

Luiz Felipe Guanais – BTG Pactual

Great, thank you very much.

Frederico Trajano - CEO

Just a quick highlight, the figure we disclosed, of 22 million, is for single customers. We do not include repeated customers in the 22 million. I think it is good to have this very clean base, it gives you a good outlook.

Luiz Felipe Guanais – BTG Pactual

Thank you.

Operator

Our next question comes from Mr. Ruben Couto, with Santander.

Ruben Couto - Santander

Good morning, everyone. I would like to go back to investments in acquiring new customers. Could you give us a little bit more color on the share of marketing expenses in selling expenses, and how much of your marketing costs is currently divided between offline and online media? And, if possible, still on this topic, can you explain how the dynamics of Magazine Luiza's marketing profile compares to Netshoes? Just to give us more color on how this line could change as Netshoes is integrated into the company as a whole. Thank you.

Frederico Trajano - CEO

More than half of our marketing investments today is in online media, because the online base is growing more. It does not mean we are spending less in analog media, we really believe in network TV, we have contracts with Faustão, Luciano Huck, Maísa, Faro, we are strong in the Globo network, but of course we have been growing more online than in physical stores, capturing a little bit more share in the total. More than half is online, and its share of sales is more or less stable; despite the growth we are not pushing marketing investments to gain customers. It is simply not diluting because we are strongly focused. We moved away from marketing investments to generate revenue and are focusing on marketing investments to generate new customers. This is slightly different from traditional marketing ROI, return on investment, which usually focuses on revenue or contribution margin. We have been focusing specifically on customer base. But this is still a process. We have been considering this in our marketing decisions. It is not just about bringing in revenue from existing customers, but also bringing new customers to the base. We cannot really compare to Netshoes, because it comes from a different category. The marketing percentage in fashion is for the segment as a whole, higher than electronics, and the average ticket is lower, so there is not much to compare for this analysis. I believe we will help them generate many sales, since their entire catalog is available at Magalu, also improving our search algorithms and indexing our active base. We will generate a lot of sales for Netshoes, and we are charging much less than Google. So, I believe this will generate many new customers for

Netshoes, but still, electronics will always require a higher investment base in ROI, because of the segment's nature. But the percentage of marketing investments is also lower.

Ruben Couto - Santander

Got it. So, initially, is it more likely for us to see cross-selling between the platforms than an effective acceleration in marketing investment capacity at Netshoes?

Frederico Trajano - CEO

I believe there will be both. We will accelerate investments there. Last year, Netshoes reduced its marketing investments significantly, because the situation required this decision, since they were tight on cash, etc. Márcio actually had a great campaign there, with both the Black App and the promotions marathon earlier in the month. It had been a while since I last saw a Netshoes full banner on Uol, in the big sports marketplace. It was great to see Netshoes come back, delivering sales in August and July as well. But apart from that, one does not have to grow to the other's detriment. We want to achieve China-paced exponential growth through both the synergy and stand alone channels.

Ruben Couto - Santander

There are now 22 million customers. If you work well on this base...

Frederico Trajano - CEO

We can grow in the base too. But I want to gain new customers as well. If you think about it, this is 22 million customers among 150 million economically active consumers. So there is a lot more to grow in terms of customer base. We only have 2% of the Brazilian online and offline retail. It was 15% of online and offline durable goods, and we have only 2% in the first quarter, which is online/offline retail. There is a lot of room to gain market share, and we will make the most of it, because Magalu's goal for the next few years is growing. And I will be saying this constantly in the upcoming quarters. That is our priority.

Ruben Couto - Santander

Very clear, guys, thank you.

Operator

Our next question comes from Thiago Bertolucci, with Goldman Sachs.

Thiago Bertolucci – Goldman Sachs

Hi, everyone, good morning and thank you for picking up our question. We have three questions. The first one is about the volume of non-recurring items in the quarter. Could you comment on the nature of that? I think there is some tax effect here. How should we look at this line's evolution during the year? The second question is about Netshoes. Could you comment on, and update us on, the best store model you are thinking of? And the third one, if I may... In his opening remarks, Fred talked about a potential regulatory shift to increase marketplace formality. Can you share more details on what kind of shift you are expecting in this regard, as well as the timing? Could this happen in the next few months? Thank you.

Roberto Bellissimo – CFO and IRO

Good morning, Thiago. I will begin with the non-recurring items. They are non-recurring, so we have no outlook for these items in upcoming quarters. The main one is tax credit, related to a lawsuit we won to exclude ICMS from the PIS and COFINS calculation basis. This is a currently known lawsuit, we had gains of approximately R$1 billion on this line. Then we had the inventory provision that we mentioned, with tax provisions and expenses, as well as fees related to the tax gains as well, all included in tax expenses. We also had the acquisition expenses. Like we said, it was a very complex acquisition, involving domestic and foreign lawyers, banks, auditors and so on, so we had a series of expenses related to the acquisition itself. There are also some Netshoes results in these 14 or 15 days that we did not include in our results, for purposes of comparison with the same quarter last year. These were the main operating effects in the adjustments. We also had non-recurring impacts on our financial results. The tax credits were updated, so the monetary restatement of these credits, which is included in the R$1 billion I mentioned, is accounted for as financial income. Then, as incredible as it sounds, we have PIS and COFINS on PIS and COFINS, taxes levied on the tax credit restatement. We also had financial expenses related to the acquisition, mainly swap and hedging for the acquisition, which was in U.S. dollar, and card advance expenses to pay for the acquisition and debt on the closing day, June 14, and other smaller expenses. The tax effect on all of this, between positives and negatives, resulted in a positive impact of R$291 million, almost R$300 million, on the Company's total result. But, I repeat, these are non-recurring events for us, so we disclose our earnings focusing on recurring results. Of course, these are positive non-recurring events. These tax credits will become cash in the next two or three years, so these are positive events for our results and for cash generation in future quarters as well.

Frederico Trajano - CEO

Specifically with regard to regulatory risks, my take on the issue is that, with regard to marketplace, we made the decision to anticipate any potential regulatory risk. I really believed marketplace would have a huge absolute revenue volume in Brazil, really high penetration in total retail transactions in the country, both online and offline. All marketplace operations are growing considerably. And I believe the Departments of Finance, the governments and authorities who receive taxes, will no longer accept operations that fail to control whether the sellers are issuing invoices or not. It is very simple to demand sellers to issue invoices, to check those invoices and require formality from sellers in the platform. I do not have any insider information from governments. What I know is that many public agencies that monitor tax payments and formality have been discussing this issue, not only in the Executive branch but also in the Judiciary branch. I think the conversation will gain momentum soon, because the numbers are becoming quite relevant and authorities will not allow it. This happened abroad. Amazon, for example, did not pay VAT in the United States until recently. Then it got too big, the states realized it was not paying taxes and demanded the company to pay taxes in all states. Amazon received an unfavorable decision from the U.S. Supreme Court. It has not been easy there since 2011, 2012. Since the company lost, shares more than doubled, because the tax difference compared to deficit by was too big, especially in electronics. I think there will be a big phenomenon in Brazil soon. So at Magazine Luiza we chose to assemble an operation that anticipates regulation, avoiding regulatory risks. This is important because our shareholders do not have to worry about us specifically, since we are taking precautions to be prepared for this change, preparing our structure and growing on a solid basis. In addition to the regulatory issue there is an ethical issue. It is not right for a company to promote products from tax evaders and smugglers. We would not feel comfortable doing that, even if there was a breach in the law, because we have always been law-abiding, we always grew while paying taxes for all the brands. This is a very important aspect for me, a sine qua non condition for my Board to authorize the marketplace launch. My Board would never let me work differently, regardless of there being a breach in the law.

Márcio Kumruian – Netshoes Director

Thiago, this is Márcio. With regard to Netshoes, the main focus now is for us to become a super seller with Magalu. Like we said, integration will take place next year, but some basic integrations are already in place. At this time, our focus is to accelerate again and put Netshoes in the same position it used to be in the past. We will calmly and strategically discuss new business models, new stores, new possibilities. This is the time to reap the benefits at hand and seize current integrations between Magalu and the sellers, making Netshoes a big seller here. The biggest.

Thiago Bertolucci – Goldman Sachs

Perfect, guys, thank you. Thank you.

Operator

We are now concluding the questions and answers session. I'd like to turn the floor over to Mr. Frederico Trajano for his final remarks.

Frederico Trajano - CEO

Thank you once again for joining the call. Have a great week.

Operator

Magazine Luiza's conference call is closed. Thank you all for your participation, and have a nice day.