CONFERENCE CALL TRANSCRIPT

3Q18 EARNINGS

NOVEMBER 6, 2018

Operator

*Good morning, ladies and gentlemen, and thank you for waiting. Welcome to Magazine Luiza's conference call, referring to the third quarter of 2018 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. Mr. Trajano, you may proceed.*

Frederico Trajano - CEO

Good morning, everyone. Thank you very much for participating in our results conference call for the 3Q18 results. The entire Board of Executive Officers of Magazine Luiza is here with me, and I will be presenting today with Roberto Bellissimo, our CFO. After my introduction, Roberto will share details about the results.

Well, in my opinion we had very positive results in a very challenging scenario, which we already expected, as I mentioned in the last conference call. We come from a post-World Cup period, and there's always a hangover after that, like we say in retail, because it's always a quarter of very strong growth, from a seasonal standpoint. It advances some sales from the second quarter to the first, especially in the image line. We also had a scenario of foreign exchange pressure, which I was very concerned about in the second quarter, due to the uncertainties of Brazilian elections. In light of all this, I would like to strongly emphasize our sales growth, considering the fact that last year's third quarter was one of the best quarters in the company's history. We had very strong growth last year, both offline and online, so growing from that in such a challenging scenario is a fact to be celebrated by the company as a whole, and even my original expectations for this quarter were exceeded.

We grew 24% in physical stores, with a significant share of same store sales of 16%. And we are already reaping the benefits of an expansion program we started to accelerate last year, opening new stores. This year we have already opened more than 80 stores, and we expect to keep growing at this pace until the end of the year. The highlight was e-commerce, which also grew substantially both in 1P, an operation that has been growing massively for a long time, and in marketplace, which has already exceeded R$1 billion. That's a very impressive figure, with significant growth from last year. Later on we will also comment on the growth of new sellers, we can emphasize that in the questions and answers. In October we had about 400 new sellers, a record addition for a single month, which shows how we are improving our onboarding process, though still remaining highly selective with the entry of new sellers. We are still the most selective company by far, because for us the service level of 3P needs to be the same as in 1P, meaning an incredibly high level of service.

But what I celebrate the most in this third quarter of 2018 is, without a doubt, the evolution of our customer indicators. We made a commitment and were extremely emphatic about it since the beginning of the year, in all of our conversations with investors, in all of our earning releases, that this was a customer-oriented year, where we would significantly raise the company's bar in terms of customer base growth and, most of all, customer service level indicators. So we were strongly committed to putting together an operation that was truly - not subjectively, not rhetorically - focused on consumers. We believe that the best defense we can have against any current or potential competitor is an extremely loyal and well-served customer base, which would have no reason to change this relationship. So we've been doing that, and for the first time in this earnings release I invite you all to read our message from management, where we comment on that with detail, to make our evolution very clear. We are disclosing a few indicators that we never disclosed to the market before, and I'll be here talking about them because I think it's important that you understand the quarter in terms of the significant evolution in these customer indicators. We raised the bar for customer indicators precisely because we wanted to eliminate the subjective aspect of being customer-oriented. Many organizations in Brazil and abroad claim to be customer-oriented, but few of them truly are. Those that are hardly lose any market, they are always growing and have a much more favorable situation in the long run.

I'd like to point out that we have both quantitative and qualitative customer indicators, and I think both are important because we need to expand our customer base. We had a few years of very high growth without expanding the customer base; it was mainly an average ticket growth, and this year we are willing to significantly increase the number of active customers in our base.

We grew our active customer base by 31%, the highlight being e-commerce, where the active customer base expanded by 61%, an impressive figure that grew far more than any other operation that discloses this indicator to the market. But I would like to stress that we are not growing in e-commerce to the detriment of physical stores. Customer base in physical stores grew 21%, so we are really gaining market share, not only in terms of sales but mainly the share in customer base, both online and off. With regard to the online business, I'd like to emphasize the spots we've been doing not only to expand the customer base, but also increase customer loyalty. We've been doing this in our app - as previously disclosed, 75% of our accesses are on mobile devices, including the app, but also our website's mobile version. We had over 1 million downloads in the quarter and reported a customer base for the app of 19 million.

I'd like to point out that customers from the app shop more frequently, they're more loyal to the base. We offer many advantages to them, such as free shipping for products over R$100. So, we have a number of benefits with the app, a much better shopping experience, where customers can place an order in up to 3 seconds. We're one of the best rated apps on both the Apple and Android stores. In sum, we developed an app that we're constantly improving, but has been resulting in a much more constant relationship, not only in shopping but in access. Our post-sale tracking on the app has improved significantly, so customers who have been using this tool are very satisfied.

The app equivalent for physical stores, as I often say, is credit card, because it's a tool that makes our relationship with the customer more frequent. Our main focus, in addition to expanding our customer base, is to establish a stronger relationship with these customers, which is a huge challenge because historically we used to be a company more focused on low-frequency, high-average ticket products. We have been improving that substantially, increasing the share of light segments and marketplace as well.

Credit card customers usually buy more frequently, so at the beginning of the year we decided to accelerate investments in acquiring card customers and selling the Luiza card. We're currently selling 150,000 cards per month, which is extremely high, 86% higher than last year, and that requires a series of investments, such as discounts for customers who shop using the card. Furthermore, the financial dynamics to account for card results has more of an expense impact than a revenue impact in the short term under IFRS 9, but over time this card tends to help improve the company's results in the long run, as it is very profitable. This means that in the long term, the impact of LuizaCred on the company's results is very positive, for both LuizaCred and Magazine Luiza, because card customers have a higher credit limit and end up buying more products, in addition to a more positive customer lifetime value.

Our investments in the card and app clearly show how in the short term, some of our investments may slightly reduce our margin, but from a value creation standpoint in the long term, the strategy makes a lot of sense. Making these trade-offs was an informed decision, which I will explain in more detail. But we really celebrated the fact that we grew so much.

Just so you have an idea, around 50% of everything we sell in our physical stores today is sold through the LuizaCred credit facilities, especially credit card. It's a very significant figure, which makes the results of physical stores very resilient, because credit customers tend to stay in the channel, they remain loyal to the channel. A significant portion of same store sales growth in physical stores comes from this strategy of increasing the penetration base of credit card in the channel.

I talked a little bit about quantity, now I want to talk about quality, service level. We invested substantially in post sale, especially delivery. We opened two new DCs and invested a lot in express shipment. Today, for more than 30% of what we sell online we promise delivery in up to 48 hours. I think that's much higher than the market average. A great portion of online growth is due to higher conversion of products with fast shipment. Customers often choose fast shipment over price or any other KPI or benefit you can think of. Since we are already offering much faster shipment in around 150 cities, which now have express delivery available, conversion has been increasing. This express delivery model is not only creating higher NPS for the customer, but has also helped us convert more sales and grow so strongly.

The main highlight there was the logistics team, who did a sensational job. We also started to offer sellers the possibility of joining Magalu Entrega, as a pilot, so we want to expand these gains we are seeing in 1P to 3P as well. We have already tested with 10 sellers, for which we reduced delivery time by 60% in the pilot. We still have a lot to do, and we still want to use the Luiza network and make it available to sellers as well. But I think the pilot had a promising start, and as we always do, we achieved very strong capacity to roll out pilots rapidly, as consistently shown over time.

I'd also like to point out indicators that the market doesn't pay much attention to, but are relevant for any retail operation. CSAT, customer satisfaction with our customer service center, improved from 64% to 86%; waiting time in our Call Center is less than one minute, sometimes 30 seconds, sometimes zero. The waiting time to exchange products bought on the website decreased 60%. Formal complaints, Reclame Aqui, PROCON, civil complaints decreased by 40% for every 1,000 orders. Our delivery and service levels are way better than the market's, and improving. So, we're very happy. Today we are the only Reclame Aqui RA1000 operation in the market. We achieved this for physical stores as well, and our website is on RA1000. So, these indicators consistently show that the effort we made this year to improve customer service level and increase the number of active customers and shopping frequency, is showing very positive signs, obviously tending to improve. Physical store NPS improved significantly, and e-commerce NPS remained stable and is evolving. So we are all very satisfied, especially me, with the work our team has done on these indicators and how we're consistently evolving in them.

We have been investing in trade offs to achieve some of these indicators; we recently invested about R$36 million, for a margin decrease of 1 percentage point from the previous quarter. We invested in logistics with two new DCs, significantly increased store supply frequency and delivery base frequency to offer 48-hour delivery. We also expanded logistics, with more people handling goods. We increased store capacity, are increasing Call Center capacity, invested in tools and technology, some of them in OPEX, one of them in CAPEX. We had initiatives to promote customer acquisition, as I mentioned, with the app and the card, and also for customer base acquisition. In sum, we made investments that I believe were key to help us protect the company from any market threats and maintain its position as one of the companies that tends to substantially increase its market share.

Even though we made this informed decision to invest, our conversations, in qualitative terms, of course, with the market... In terms of what we see in other operations, especially online, these investments are irrelevant. I believe other companies that had to make an effort to grow from a specific base experienced a trade off-, though much stronger than the trade off we had this quarter, which goes to show that our growth is completely healthy, with strong focus on creating value for shareholders; our annual ROIC is still at 30%. That's a very high level of return on invested capital. Yes, we are giving up on margin percentage for now, but absolute figures like EBITDA, cash general and net income continue to rise. So, I think this operation was already proven sustainable and healthy, and I think it's the means we have in the market today to capture growth with greater potential to create value to shareholders. So, yes, there is a trade off, but not for rationality. I'd like to emphasize that, because our trade off needs to be positively interpreted. I understand that the company maintains a discipline of creating value for shareholders that has always been our trademark when investing in the online and offline operations.

I will conclude now to turn the floor to Roberto, so he can share details of the financial result. I'd like to conclude with an outlook for the fourth quarter. I'm way less concerned, so to speak, because like I said in the previous call and in news articles, my main concern was foreign exchange pressure, because it makes the process of negotiating with suppliers really difficult. That was the focus in most of the third quarter, and now, in late October and early November, we have a more positive exchange outlook. We managed to close deals for the last quarter, for Black Friday. Evidently, these negotiations already include the first quarter of next year, so we now have a situation of greater visibility, more tranquility, and obviously it still depends a lot on our ability to perform, because retail needs to perform. When a strong quarter ends, you have to be able to perform well in the following quarter, and our comparison basis is only getting worse. Because we did very well in the third quarter of last year, but even better in the fourth quarter of last year.

So I usually say that our greatest competitor is our same-quarter result in the previous year. As such, we have to perform very well, with next to zero margin of error, to be able to present higher results than those presented in the year-ago quarter, as we've consistently done. But anyway, it's always good to stress that this is a challenge for our operation. I believe that, from a macroeconomic standpoint, specifically indicators, we are in a much more predictable situation than we were in the third quarter, with the possibility of preparing for the last quarter and its impact on next year.

I will now turn the floor to Roberto, and then we will be available for questions. Thank you.

Roberto Bellissimo – CFO

Good morning, everyone. I'll go through a few of the highlights very quickly. On page 5, we grew 34% compared to 30% last year, so our biggest growth had been, in fact, last year. Our sales amounted to R$4.6 billion, stable from the second quarter, when there was the World Cup. So, an exceptional sales performance.

Same-store sales of 16% in physical stores, the highlight being new stores, which contributed with 8 percentage points for this growth, with very high productivity since the beginning. Marketplace and e-commerce grew 55%, which was also higher and *accounted for 36% of our total sales, growing 55%, compared to a 65% growth last year. Marketplace grew, multiplied and reached annual sales of R$1 billion in September.*

Our gross margin decreased a little, mainly due to the higher share of e-commerce, which grew by 5 percentage points from the third quarter last year. But we significantly reduced operating expenses by half a percentage point, considering the investment of one percentage point in operating expenses. So, the dilution could have been one point and a half, but instead was half a point, considering all of the investments Fred mentioned. EBITDA increased by 11%, net income by 29%, and we maintained very high cash generation and ROIC.

On the following page we show the evolution of number of stores. So, we already opened 83 stores in the last 12 months, and are currently investing in dozens of other stores to be launched this quarter. Our CAPEX increased significantly, more than doubled in the third quarter compared to last year, and in the year it also reached R$234 million, of which approximately 50% is in new stores and renovations, and 50% in technology and logistics, in line with our strategy.

On the following page we show the quarterly evolution of sales, e-commerce and growth. IBGE has disclosed that our industry shrunk until August, and E-bit reported 8% growth in the quarter, so we gained a lot of share there in all channels.

On the next page we see the evolution of margins, expenses. Notice how we significantly diluted administrative expenses, which are essentially the company's fixed management expenses, office and distribution centers. We didn't dilute sales expenses due to investments in service level, acquisition of new customers and all that. The equity accounting item shows a reduction in LuizaCred's profitability, which we will comment further later on, but it was basically due to the effects of the growth and IFRS 9 adoption.

On the next page, we see EBITDA evolution. Once again, EBITDA increased as a result of sales growth, e-commerce profitability, and expense dilution despite the investments in customers.

Financial result on page 10 shows that we continue to significantly dilute financial expenses, reducing them by one percentage point. Excluding advances of receivables, we posted financial revenue. This shows our cash generation from working capital. There's a highlight here as well, we still have very healthy average purchase term and inventory turnover. Average purchase term was around 90 days and inventory turnover around 70 days, a very healthy ratio.

As we mentioned, in the second quarter we increased inventories, making advanced purchases to take advantage of prices not affected by the high foreign exchange rate. So, since we purchased in the second quarter what we planned to purchase in the third quarter, we paid for these purchases in the third quarter, because the average payment term of our purchases is usually 90 days. So, we had a little bit more payments than normal in the third quarter, consequently we should have less payments in the fourth quarter. Working capital is seasonal, but this effect slightly reduced cash generation in the third quarter, and will significantly help cash generation in the fourth quarter. Even when we consider these early purchases and the higher investments in fixed assets and all that, we have maintained our net cash position at R$1.3 billion, R$700 million of which in cash, and receivables at R$1.2 billion. I think our capital structure remains strong, as well as cash generation, and guaranteed return is very high as well.

On page 11, we show this evolution. We reduced debt by R$1 billion in the last twelve months and increased cash, with a variation of R$1.3 billion in the last twelve months. Quarterly evolution of profit with net profit margin of 3.3% in the quarter, despite all the investments in customers, and ROIC of 31% in the last twelve months.

Then, on page 12 we show a little bit more information about LuizaCred. We're still investing significantly in the Luiza card and substantially increasing our Luiza card base, which reached roughly 4 million cards in September, growing at an annual pace of approximately 1 million cards. We should grow by virtually 1 million net cards this year, and like Fred mentioned we are selling 150,000 cards per month. Also note that 95% of our customer base is active, meaning that it is shopping or has a payable balance. 65% actually shop, use the card every month, an average of seven times a month. Our card is the main card used by our customers.

That's been very important for the chart below, which shows a growth of around 54% in the Luiza card within Magazine Luiza, significantly helping the growth of physical stores. Another highlight was e-commerce; the Luiza card started gaining share in e-commerce and has also been growing. It's still much lower, but it has great potential and has been growing too.

Total sales of LuizaCred exceeded R$5 billion in the quarter, a portfolio of R$7 billion despite the conservative approval rate of Itaú-Unibanco. The next page shows that NPL 90 dropped from 8.3 to 7.4, reaching one of its best levels ever. NPL from 15 to 90 also decreased to its lowest level ever in a third quarter, at 2.8%. So, we are growing significantly with a healthy portfolio, very conservative approval rate, very conservative provision levels. Here we show a coverage rate of 189%; with the IFRS9 adoption we strengthened our provisions. The short-term impact was on the result. If you look at the BR GAAP result, it's still growing, exceeding R$115 million in the year.

Like Fred mentioned, the trend and potential of the Luiza card and the profitability of this portfolio in the medium and long term are very high, so this strategy makes sense for retail and LuizaCred.

These were the highlights I wanted to comment on. Now we'd like to open for questions.

Operator

*Ladies and gentlemen, now we will 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 Luiz Felipe Guanais, BTG Pactual.*

Luiz Felipe Guanais – BTG Pactual

Good morning, Fred, good morning, Beto. I think the investments made in the platform and in consumer's shopping experience are very clear, but I'd like to understand, in terms of sellers, how can we expect this fulfillment initiative to evolve over the next quarters? My second question would be if you can share with us what percentage of these new active customers you mentioned, Fred, are going straight into the marketplace. Thank you.

Frederico Trajano - CEO

Good morning, Luiz, thank you for your question. As I said, in terms of fulfillment by and use of logistics by sellers, we started the pilot with ten sellers in the quarter and had very positive results. We are now in the roll-out process; we have version 1.0, which I would say is the version where we use third-party contracts for the seller, and in a more advanced version we use our own network. We have been testing Logbee, which is now being considered as our own network, because we acquired it. It's still in an early pilot stage, we plan to start rolling out this quarter and accelerate it over the course of next year. But I won't give you any guidance in this regard. I think we have to... I mean, we're being very careful to do this consistently and offer a positive experience to consumers.

What I can say is that we will do this rapidly, with logistics efforts next year; this year, logistics efforts were focused on express delivery, and next year they will be much more focused on absorbing third-party volume. So, we are very confident that we will be able to bring one of the greatest differentials of 1P to 3P as well. However, although we still don't offer this major differential, marketplace, even with the more basic model where sellers are responsible for the logistics, has been posting very impressive sales growth. I believe the marketplace growth curve is even higher than that of other operations whose figures are disclosed to the public. We can see that these figures are very impressive, with exponential evolution, showing that marketplace is still a greenfield there, with a lot of market to utilize. E-commerce penetration in Brazil is still lower than 5%. So, I think e-commerce is a market to be explored by everyone, there is room for new players and the accelerated growth in marketplace is proof that there is still a lot of room to grow in Brazil in this sense.

As for new customers, Eduardo can comment on the total for the website.

Eduardo Galenternick – Executive Director of E-commerce

Hi, Luiz, this is Eduardo, how are you? In terms of the impact of marketplace on the e-commerce customer base, it has two main impacts. One is, indeed, the entry of new customers. First, when we look at the share of marketplace, of e-commerce at 13%, when you talk about number of customers, it's more due to the fact that the marketplace ticket is lower. And it does contribute to the entry of new customers, but mostly to increasing shopping frequency. When we compare the shopping frequency of customers who bought a marketplace item to that of customers who didn't buy a marketplace item, it is significantly higher. In the long run, this also impacts the expansion of the active customer base, because you stop losing customers after twelve months. So, I can't go into more detail in terms of figures, but this is the impact, which is already more significant than the sale itself.

Luiz Felipe Guanais – BTG Pactual
No, excellent, thank you very much guys.

Frederico Trajano - CEO
You're welcome, Luiz.

Operator
Our next question comes from Robert Ford, Bank of America Merrill Lynch.

Robert Ford – Merrill Lynch
Thank you, good morning to all and congratulations on the results. Fred, people seem to think that margin pressure in the quarter means that your story is over. How would you respond to that?

Frederico Trajano - CEO
Bob, could you ask again, please? You were breaking.

Robert Ford – Merrill Lynch
Sure thing, Fred. People seem to think that margin pressure in the quarter means that your story is over. How would you respond to that?

Frederico Trajano – CEO
Well, Bob, I think it's only beginning, actually. I think now we're... I mean, if you're a digital operation, and we do have the ambition of becoming a digital operation with physical spots, you must be completely focused on the indicators of digital operations. If you take these operations, the indicators of Amazon, Google and Alibaba are all interaction and growth indicators, they are all indicators of active customer base expansion. These operations are not fully focused on maximizing margin percentage.
So, if you want to be a digital operation, you must play the game of digital operations. We made a decision this year to become a digital operation, and to play the game of digital operation you have to think exponential growth, not linear growth. You can't grow exponentially on any platform in the world. At ramp-up, you grow with an increase in margin percentage. And we've been very clear since the beginning of the year in this regard. We proved that we can grow way above the market with a much lower margin trade-off than we've seen in other online operations in Brazil, given the country's specificities.

I'd like to point out that if there is any company that can replicate online growth in Brazil with some level of... In our case, a high level of return on invested capital - 30%, as I said -, that company is Magazine Luiza. But we chose to become a digital company, not a traditional company. And as a digital operation, we have to grow exponentially in the base, in customer interactions, as well as service level and customer loyalty. So, I think our story is only beginning.

Robert Ford – Merrill Lynch

Thank you, Fred. Same-store sales were extraordinary. What do you attribute this growth to, and how do you look at same-store sales growth?

Frederico Trajano – CEO

Thank you for your second question. I'll begin and then turn the floor over to Fabrício Garcia, our VP of Operations, to talk about physical stores. Once gain, our strategy for physical stores has a very important component for the experience: multi-channel customers are better than mono-channel customers. So, I've always laid my bet on physical stores. We have... We are opening new physical stores, we are renovating physical stores, installing mini-distribution centers and renovating entire stores. But I think we've been effectively investing in technology implementation to make the experience of shopping at physical stores way better than the market average; you can shop in two minutes and pay directly with consumers. Now we're also implementing the digital credit card. It takes two, three minutes. That's the experience of getting a new credit card at Magazine Luiza, as compared to 25, 30 minutes to get a regular credit card, like in the previous model. Today you can do it all via mobile, direct sale with the seller. All of the investments in store environment and technological processes at the store. And in team motivation, team work, evidently the work carried out to support the commercial department, supply the store well and work with the basics of retail, a very well-done "rice and beans" mix, with rupture edition, strong supply, store motivation... We didn't stop doing any of that, because in the digital operation we are strengthening the traditional bases. All of that leads us to strong same-store sales growth, not considering new stores, which are operating at a sales level per square foot that is way better than in previous years, very successfully as well.

We are significantly gaining share in physical stores. I'll turn the floor over to Fabrício, who can give you more details on some of the categories where we are also growing.

Fabrício Bittar Garcia – Vice President of Commercial and Operations

Good morning, Bob, thank you for your question. This is Fabrício speaking. Fred already talked about the reason for store growth, it's precisely that, our digital operation. Our store service level is also very good, we take advantage of our strong investments and store customers also benefit.

In terms of category management we have been doing very well, not only this year. We operate in all categories. We just had a quarter, for instance, where white furniture growth was higher than store growth. Telephony is now growing again. In May, we didn't really feel the post-World Cup impact. And in some categories like games, IT and imports, we have been growing well above the market.
So, the focus on categories, as suggested by Fred, and the success of promotions are making stores grow. In addition to what Fred has already said, which is also a driver of our business. It's a combination of factors.

Robert Ford – Merrill Lynch
Thank you very much, Fabrício and Fred.

Operator
Our next question comes from Joseph Giordano, from J.P. Morgan.

Joseph Giordano – J.P. Morgan
Hello, good morning everyone. Thank you for picking up my question. I want to explore a little bit this growth in the Luiza card. It has been growing impressively, but it's also, in a way, replacing payment slips. I'd like to understand, especially with regard to online operations where we see relevant growth: how much does this Luiza card already account for in the online world? I'd like to understand whether or not you are managing to digitalize the more loyal Magalu customers, or if you're still growing significantly in new customers, who weren't traditional Magazine customers.
Second, I'd like to explore this fulfillment initiative you started. First, I'd like to understand whether it is part of an exclusive regime, meaning that fulfillment only happens within Magazine Luiza's marketplace sales. Second, how integrated will logistics with the sellers be, if seller inventory will be located at their own DCs? What is the model like? Will the store function as a drop location? How can we think about that going forward? Thank you.

Frederico Trajano – CEO
Thank you for your question, Joseph. Beto will answer the first question about the card, then I'll talk about fulfillment.

Roberto Bellissimo – CFO
Good morning, Joseph, how are you? As for the Luiza card, for now most of the growth comes from physical stores, the majority of new cards, for instance, is being produced at the physical stores. We even reported an increase in IPP, as we call it, which is the Luiza card's share of physical store sales, by seven percentage points in the third quarter compared to the third quarter last year. So, for the card alone, as Fred mentioned, we have an approximate share of 50% for LuizaCred, credit card and CC at

physical stores, and credit card accounts for roughly 40% of these 50%, so CC is currently less than 10% of sales at physical stores.

This 40% share of credit card in physical store sales used to be 4% on the internet, now reaching 6% and approaching 7%, 8%. It has been evolving month after month, and we still have a lot to do. We're doing a lot of things that will be available on e-commerce soon, improving customer experience with "custom" offerings, so to speak, for pre-approved customers, such as experience, promotion, discounts, etc., with the possibility of shopping immediately with discount, in installments and without interest, and a series of benefits for e-commerce customers as well. This card was developed for physical stores customers, and we're adapting the offering for e-commerce customers. We believe there is still significant potential to increase the card share in e-commerce, and we're also working on developing a new card, focusing specifically on e-commerce customers. There are many opportunities to be explored, for us to turn e-commerce into the success that the Luiza card already has in physical stores.

Frederico Trajano – CEO

As for fulfillment by, Joseph, what I wanted to say is that once again, one of the assumptions of our marketplace strategy is that everything we did for 1P we will do for 3P - absolutely everything. That includes all of the Pickup at Store functionalities we are offering. We see the store as a shoppable distribution center, so we are already adapting all stores, renovating stores... We renovated 44 stores until September, and will get to 100 by the end of the year. All the new stores are already being launched with this new capacity, with 30% of the area allocated for storage, supply and inventory handling. All of that will be made available to sellers in a simple manner. So, website purchases for Pickup at Store will work for both 1P and 3P. In the future, the stores will also serve as collection points. Sellers will be able to deliver the product at a store, and then the product will be taken to a distribution center, to be shipped to another store or even the customer's home. We see our almost 900 stores now as distribution and sale centers. They will be fully operational for the marketplace, and this is is a long-term vision. We obviously still have the entire implementation process to go through, which we are carrying out very diligently. It is everyone's goal and target, including the technology, logistics, operation, back-office and legal teams, to make it possible. We now have the go-ahead from our legal team to operate for third parties - because it also involves an approval process; it was a goal of the legal team and they met it. So, the wheels are in motion, we are very excited. We won't share any guidance about the roll-out, but just like any other roll-out we ever did, and as we mentioned in the call, we have always had an enormous capacity to accelerate and evolve.

I think as soon as we implement this vision - and I've always firmly defended an omnichannel approach to retail and 1P - I think it will be just as strong and powerful for 3P as well, giving us significant edge compared to pure marketplace operations. I believe it will be, if not the greatest, one of the greatest differentials of our 3P model compared to the market's standard proposal.

Joseph Giordano – J.P. Morgan

Prefect, thank you very much Fred and Beto. One more question, if I may. Within this strategy of getting sellers and customers involved, we can already see massive digitalization in terms of consumer credit. I'd like to understand what the company thinks about that. There were many services being selected for sellers, but the maybe reasoning would be to offer credit to these sellers and maybe try and trap both ends with a payment platform. I'd like to understand what you think about this. Thank you.

Frederico Trajano – CEO

Yes, now obviously the first stage of Magalu Pagamentos is to advance receivables, which is a risk-free operation for the company. At the same time, it is vital for the seller, because most of their credit needs are met with advanced receivables. And our new process is frictionless for sellers, with better rate than the market average; one of the assumptions of marketplace is to be the best option for the seller. We won't tie down the sellers with logistics or payment, we will be the best option for them. To me, a seller is a customer. I often say that when you're in a 3P operation, a two-sided market with two customers, you have the end consumer and the seller as a customer. I see sellers as customers, so I don't want to extort the seller. Our mission here is to give them the best option, not tie them down. I want them to be positive that Magazine Luiza is the best operation for them to work with. I think the digital companies I like the most in the world are those with a more open mind. If you look at China, or even the U.S., I mean... It's not about limiting the seller's options, but about giving them the best options.

What we're doing in the short term that I can disclose is the roll-out of Magalu Pagamentos, which is in full motion. We will accelerate this even more, and soon we will have most sellers operating it, if not all, but without pressuring them, without tying them down unnecessarily. We have to tie them down with the best service, not with a strategy of preventing them from working with a competitor. We are confident that we will be the best option for sellers, and we are working on that. This is our strategy, this is the Luiza way of doing things.

Joseph Giordano – J.P. Morgan

Perfect, thank you very much.

Operator

Our next question comes from Thiago Macruz, Itaú BBA.

Thiago Macruz – Itaú BBA

Hey, everyone, thank you for picking up my question. My question is about the investment you made in customers per se. There has been, in fact, a positive response, all of your operational KPIs are pointing North. And in the earnings release you mentioned four aspects - logistics, service, app and Luiza card. I'd like to have a better idea of the size of each, and whether it would be reasonable to expect a portion of these recent investments to be diluted in the coming quarters. Meaning that we wouldn't see the same size. This is my question, thank you.

Frederico Trajano – CEO

Thiago, we won't distribute this investment. This is obviously not an information disclosed in the earnings release or any other figure published by the company. What I can say is that the majority of this investment was made in logistics, mainly express delivery, fast delivery, which we believe is the hardest differential for the market to beat. So, investments in new DCs, capacity, automation, Logbee, Logbee expansion, supply frequency, and conversion of stores into shoppable distribution centers. The greatest beneficiary of this whole investment is the logistics department, Décio and his team. We do believe that Brazil's worst structural bottleneck lies in logistics, and standard market operations are weaker. We're also investing in the expansion of Logbee within the Luiza network. So, I'd say the majority of our investment is in better logistics, express delivery, higher return rate, better experience for Pickup at Store, and we're already there, working with the store inventory for Pickup at Store. The ship from store next phase. We are focusing mainly on investments in logistics, which indeed requires investments.

It's not so much a marketing investment, which I think is something you invest in for a year and then you have to invest again the following year. In terms of logistics, to the extent that you have a route, you can increase frequency; you start with lower capacity, lower density, and as you begin to offer faster delivery to customers, density increases and idle capacity of the routes decreases. We really did accelerate the frequency in routes, such as staff in the first routes made available for fast delivery, then as customers grow these routes are optimized.

For the next quarters, we will continue to focus on these investments, but we won't give you a percentage guidance. All I can say is that this operation will focus more on growing absolute figures and less on margin percentage. This is the Company's North: high growth, accelerated growth, and lower margin percentage, because as a matter of fact all the best digital operations in the world are guided by the same KPIs. So we will maintain our discipline in this sense. In our case, without losing a discipline of return on invested capital. So, once again: less margin, more absolute sales growth, margin mass, result, cash generation.

Thiago Macruz – Itaú BBA

Great, Fred, thank you for the answers.

Operator

Our next question comes from Maria Paula Cantusio, BB Banco de Investimentos.

Maria Paula Cantusio – BB Investimentos

Good morning, everyone, thank you for picking up my question. I'd like to follow-up on the previous question. How much do you expect to invest next year? Next year we will have a pressure on gross margin due to the end of the Lei do Bem law, so I'd like to understand how we can look at your EBITDA margin for next year.
Then, I'd like a little bit more color on exponential growth, which is what you're focusing on from now on, and I believe marketplace would be very important in this regard. I'd like to understand how you're looking at the criteria for including sellers in the marketplace. Will you achieve exponential growth even though you are so careful? Or do you think that as soon as you have a more complete service platform you'll be able to loosen up the criteria to bring more sellers into your platform? Thank you.

Frederico Trajano – CEO

Good morning, thank you for your question. We're not sharing guidance, I will continue to emphasize that the company's focus is on expanding the customer base, customer interactions, customer service levels, without straying from our discipline of cash generation and shareholder return generation. Less focus on margin, more focus on overall growth.
You are right to say that the company's main growth driver will be marketplace, without a doubt, because of all the channels marketplace is the one with the highest potential for exponential growth, since you depend on less working capital investments, investments in other issues. We say this is a market with the same dynamics as a platform, and everywhere in the world it usually represents higher growth. We have already been growing it on top of a well-established investment base in logistics, as I said, which we will be sharing with them.
It has better dynamics of return on invested capital than both 1P and physical stores, so I think this is a characteristic that will support the growth forecast with value creation to shareholders in a very clear way. Again, despite our selectivity in absorbing new sellers, last month we reached a record 400 new sellers. There's still a lot to improve in all processes. Let's not forget the platform is only two years old, we have already reached R$1 billion in the quarter with less than two years of operation. There are so many onboarding processes to be improved yet. Even seller approval is something that can be improved. We already reduced approval time significantly, the time to introduce a new seller. We think there's a lot of people who have yet to enter the market, even amateur

operations; we're talking 16,000, 35,000 sellers among millions of millions of corporations registered in Brazil to sell online who are not selling yet. We still have a huge market to grow in and our ambition in terms of having sellers within the platform is a huge ambition. But the sellers must be formal, they must comply with the laws and ethics of Brazil, and above all they must provide the same level of service we provide to our customers, with or without our logistics platform. I don't think we will grow to the detriment of our service level. The KPIs and customer targets are as high as seller growth and active user targets.
So, there is no shortcut here. We will grow while maintaining a very high bar of service level. Evidently, sometimes the sellers won't provide a good level of service because they don't have a good logistics system available. To the extent that they get ours, they will benefit from it. But, I repeat, I won't tie them to my logistics. I'll give them the option, so they can make the best choice for them, because we believe a platform company must be an open-minded company. I hope I answered your question. This is pretty much what I wanted to address.

Maria Paula Cantusio – BB Investimentos

Thank you, Fred. Just to make it clear, next year you will continue to invest in service level just like in 2018?

Frederico Trajano – CEO

Yes, we will continue to invest in service level. The impact it has on PNL will largely depend on growth, on sales gains. We won't share any specific guidance in terms of profitability, but the customer is not a one-year investment. We will really maintain this strong focus. Because, once gain, we believe digital companies, which is how we see ourselves today - a digital platform with physical spots - must be assessed using this criteria: customer base growth, customer interactions, sales growth and cash generation as well. We will be very focused on maintaining cash generation. We will focus less on margin percentage, which is how the retail market is traditionally evaluated. A digital company cannot be evaluated as a traditional retail company.

Maria Paula Cantusio – BB Investimentos

Very clear, thank you, Fred.

Operator

Our next question comes from Richard Cathcart, Bradesco.

Richard Cathcart - Bradesco

Hello, good morning, everyone. Two questions. The first one is a follow-up on Maria Paula's question about Lei do Bem. I'd just like to know your opinion about the end of this agreement next year. Secondly, looking at future growth of e-commerce and marketplace, etc., one of the retail segments with very low penetration in e-commerce today is apparel, we all know it's a very difficult category to operate in. So, I'd like to know if and how you are preparing the company and its logistics to build on this category's potential in the future. Thank you.

Frederico Trajano – CEO

Well, Richard, thank you for your question. Good afternoon. As for the first question, what can I really say about Lei do Bem? It's very hard to predict what will happen, because Lei do Bem will change for the entire market, that is, 100% of our competitors, both online and offline, so everyone who currently benefits from it will have to pass this new tax cost through to prices.

What I see historically is that the market usually passes it through, because if you look at the results of market operations, I don't think anyone can afford to give up on margin like this. So I imagine, and this is my interpretation of what I see in our competitors and the entire market whose results are made public and that we have access to, everyone will need margin and won't be able to give up on margin, so I believe almost the entirety of this tax will be passed through. But we can't be sure, so conservatively I think we should consider that it won't be 100% passed through, especially in the first quarter of next year, which is a quarter of stabilization. This is what I think we're worrying about the most, and in our budgets we're not considering full pass through to prices. I believe the situation will return to normal over the quarters.

But again, I'm not a psychic, I don't know what's gonna happen and how the market will react. The situation is obviously something we need to monitor closely, and we will make it as clear as possible in our results and public interactions with the market, in a completely transparent manner, like we're used to. What I mean is that I don't think anyone can absorb... I mean, our margin is higher than the market average, way higher, we're one of the few profitable operations out there, both online and offline. Online, we're virtually the only one. So I don't think anyone will be able to absorb a market decrease, I think it will be passed through. But we never understand the market, I mean, every competitor has a different strategy, I can't anticipate anything in this sense about Lei do Bem.

As for the fashion industry, it still has very low penetration in Brazil, with huge potential, since it's highly representative in many countries. In China, it has penetrations of over 20%, the main sales channel in the industry. I think this industry has huge potential, and we want to be a full category operation, we want to operate in all categories, and we will have to develop competence, as we have already developed for CPD product deliveries, consumer goods. We will penetrate all categories; our ambition is to become a full commerce operation, full category. So, we will prepare to enter these categories, which are highly important within a context of higher shopping frequency, as they substantially help our very high long term targets for customer indicators, frequency and utilization.

Note that Logbee was an acquisition that provided the company with huge potential to run the last mile of delivery of products with lower value added, lower cubic volume. Our Luiza network... Even Logbee is very good in delivering items with higher cubic volume, so Logbee helps us a lot in terms of serving this type of category. The storage issue is very specific, but it’s nothing we have never faced before with other challenges.

Richard Cathcart - Bradesco
Perfect, thank you Fred.

Operator
Our next question comes from Franco Abelardo, Morgan Stanley.

Franco Abelardo – Morgan Stanley
Hi, good afternoon everyone, congratulations on the results. Two questions. The first one is regarding gross margin. I’d like to understand: was this margin decrease solely due to the mix, or was there an investment of gross margin by channel, meaning physical stores or online? And should we expect to see any positive contribution from marketplace to the gross margin, or if there was, does it help offset the lower gross margin in the quarter? This is the first question.
The second question is regarding working capital. We noticed that inventories and payment terms were slightly worse. Roberto mentioned that some purchases were advanced in the second quarter, and I’d like to understand, looking at the fourth quarter, if we’re going to see working capital returning to normal levels or if if it’s expected to be worse year on year. Thank you.

Frederico Trajano – CEO
Hi, Franco, thank you for your question. With regard to gross margin, I think the main factor regarding gross margin in the quarter was obviously the exponential growth of e-commerce, which has been growing from a very high comparison basis; we always say that gross margin in e-commerce is lower, but offset by lower expenses. In this case, we didn’t see a stable EBITDA margin because we did invest in logistics in the quarter, as I mentioned. But as e-commerce gains market share in the company, it reduces the company’s gross margin, but ends up offsetting it with lower expenses, which results in stable EBITDA.
Since we invested mainly in all of these factors we mentioned - new DCs, higher shopping frequency - we ended up having a decrease in EBITDA margin as well, but obviously in line with our planning and maintaining the same high level of return on invested capital. So, that’s it. There was a little bit of an exchange pass-through in the quarter, in July we had the impact from 15 days of World Cup, but margins within the categories are behaving well. I think it’s more of an impact from the e-commerce mix,

which wasn't as offset by expense dilution due to the strategic investments, which I'm absolutely positive are correct.

Roberto Bellissimo – CFO

Good afternoon, Franco. With regard to working capital, as I explained, inventory in the last twelve months increased by roughly 35%, and suppliers grew around 25%. If they had grown at the same pace, there would be a difference of around R$200 million, with the suppliers item being higher. Why isn't it higher? Because these R$200 million were bought in June and we paid them off in September. If we had bought it in July or August, we would be paying it off in October or November. So, what should happen now is that we have an appropriate inventory of 70 days, on average. In e-commerce it's even better, so we're prepared for the increase in sales in the fourth quarter. And the average purchase term is also appropriate at around 90 days. What happened specifically was that we advanced purchases from the third quarter to the second, and as a result the payments were moved from the fourth quarter to the third, in the amount of approximately R$200 million. In theory, what will happen in the fourth quarter, since we buy with a payment term of 90 days, is we will have the same supplier balance we had in September. Since it was lower than normal, because we had already paid it off, cash generation this quarter tends to be R$200 million higher than it would. Cash generation in the fourth quarter is usually very good, and this quarter, due to this advance, it should be even better. Also, there will be no changes to the year-end positions. We should end the year with the same turnovers and terms - inventory turnover and purchasing terms - we expected before. This was only a factor because of the U.S. dollar appreciation in the middle of the year, which we took advantage of, but it's non-recurring, not quarter-on-quarter. It doesn't change anything in the year.
And the focus on working capital management, the focus on cash generation, like Fred already mentioned, remains the same.

Franco Abelardo – Morgan Stanley

Very clear, thank you Roberto. If I could just follow up on the first question about gross margin. As marketplace increases its share in total sales, shouldn't we see an improvement in gross margin? Maybe as a result of Lei do Bem and 1P e-commerce as a whole having grown even faster, there should be more pressure on gross margin growing forward? Thank you.

Frederico Trajano – CEO

Franco, good point, I forgot to mention that. Once again, Lei do Bem is a question mark, we don't know how the market will behave. Let's consider, hypothetically, that the market passes through 100% of the tax to prices; theoretically we would have no margin losses next year. The marketplace ramp up definitely tends to improve the company's gross margin, especially in e-commerce. As e-commerce gains share in the company as a whole, it tends to help prevent total margin drops, with a highly positive impact on gross margin.

But obviously we have to bear in mind that next year there will be other factors, and gross margin will be, one, a combination of e-commerce and physical stores, and two, the level of pass-through by the market after Lei do Bem. So all of that will have to be taken into account. If we set the variables apart and specifically consider marketplace, we operate marketplace with high profitability, it's a positive business, we're not making related take rate promotions. For us, since we have always operated with 1P, marketplace is also a rational operation. We trade off if it makes sense for the company's long-term cash generation, not when it doesn't. It currently has an impact on gross margin; hadn't it been for marketplace, gross margin would be way worse. I think, as it gains share in e-commerce and in the company as a whole, the result tends to improve. Bear in mind that we cannot predict what will happen with the Lei do Bem law.

Franco Abelardo – Morgan Stanley

Very clear. Thank you.

Operator

Our next question comes from Tobias Stingelin, Citi.

Tobias Stingelin – Citi

Good afternoon, Fred, Beto. I know you've had a lot of questions specifically about margin. Congratulations on the results, I think the strategy is very clear, with a specific focus on growth. What I wonder now is, what could be considered a fair growth? I also know you won't say exactly what you think is fair growth, but just so we can get more color, Fred, how should we think about it, in terms of a limit, since you are capitalized and could accelerate your growth? What metric should we look at - minimum return on invested capital, cash use, breakeven cash generation? I'm trying to find the right conditions for us to better understand how you're looking at this trade-off in terms of profitability increase. Forget margin, but just thinking about growth per se.

Frederico Trajano – CEO

Well, Tobias, it's very hard to answer your question without giving guidance, so I'm going to step on eggshells here and try to answer it as qualitatively as possible for overall clarity, but without breaching any CVM regulations.

As for our vision, I'd like to clarify once again that since the beginning of the year, when we anticipated that we would adopt the strategy of growing above the basis, with simultaneous improvement in service level - and growth is not just focused on GMV, but also on increasing the number of active customers, because we had three years of flat active customer base, from 2010 to 2014, almost four years at a base of 10, 11 million active customers in the year... We understood that in order to become a major digital operation, we would have to significantly expand the customer base. So, it's not just about growing GMV, it's about growing the active customer base, and increasing interactions with these customers - meaning the number of times we connect with them both financially and in terms of utilization frequency and such (MAU, DAU). We will focus a lot on CLV; all of the investments we made were focusing on customer lifetime value. We invested heavily, working with a consulting firm in the first quarter and identifying which customers provide the highest return in the long term, meaning customer lifetime value - you extrapolate the history based on the customer profile... And we saw, for instance, that credit card customers, app customers and other segments I won't disclose here are customer segments and profiles that tend to become more profitable for the company in the long term, with a stronger repurchase profile.

We specifically accelerated the investments in these customers, so I'm sure that over the years the Company's results will justify these investments and we will maintain a high level of return on invested capital, especially because our investments compared to the market's investments in growth, have much higher return. Considering new customers, active customers, additional sales on the invested amount in terms of margin or even CAPEX, today we have a machine that is generating growth with much lower investment cost than we normally see in the market. So, this is the idea, it won't change. Now, specifically, margin percentage for these impacts would be guidance, we won't be sharing that. What I can say is that we won't... We believe Brazil can't... What can we absolutely not accept? It is the increase of indebtedness, we can't accept lower return on invested capital in a way that is not rational, and we can't accept loss. We have never intentionally operated with loss. The company has always been extremely focused on rational growth. Our rationality now is in the long term, not the short term, because I think this is how the world's best work operate and how we will work.

Tobias Stingelin – Citi

Great. Perfect, thank you Fred.

Operator

Our next question comes from Rodrigo Cuestas, Goldman Sachs.

Rodrigo Cuestas – Goldman Sachs

Hi, good afternoon everyone, thank you for picking up my question. In terms of physical stores, you mentioned a very strong return in terms of technology at the stores. But in new stores we see that you once again improved productivity quite significantly. Does it make sense for us to expect the same maturation curve in stores to be opened in the future? I mean, has maturation curve been accelerating, or was this strong pace driven by some non-recurring aspect, like a stronger push from cards? My second question is regarding consumer finance. You estimate that more than one quarter was affected by the adoption of IFRS 9 last year. So, considering this high level, when does it make sense for us to see a more normal level of result? Would it depend on maturation of new cards, etc? Thank you.

Fabrício Bittar Garcia – Vice President of Commercial and Operations

Thank you for your question, Rodrigo, this is Fabricio. In terms of new stores, we have been asking ourselves why we are performing so well, and I think the first thing that happened with new stores this year is that our strategy was extremely on point, and its execution also has to be very disciplined. Which is what we are doing. So, we were very successful in identifying markets to enter, investments in stores, cost of occupation, and the sale volume they would generate. And we entered all of the identified markets strongly. Today we are entering a new market, offering our digital operations and very good service level. We opened two warehouses to serve this new market, with product unity, promotions... In sum, the brand's strength. So, these stores did perform better than even we expected. But I think they still have some maturation time left, and next year they should definitely perform better than this year. We still have a lot of room to grow in these stores. And we actually entered two new markets, Maranhão and Goiás, so our market share there is in its early stages, and it's much lower than the market share we have in more mature markets. Because of that, and considering the markets we chose to enter, I think we have a lot of room for growth, and they should mature in two or three years. I think that complements the fact that we have a very good strategy for sustaining sales at these new stores. This is the strategy for new stores. As for the second question...

Roberto Bellissimo – CFO

Good afternoon, Rodrigo. Regarding cards, whenever the card portfolio grows intensely, it usually struggles a bit in the beginning, both because of cost of sales, which is high in card operations, and IFRS 9, where you have to provision even for the credit available, whereas customers are often not using the entire credit limit like older customers do, which is why older customers are much more profitable. In this sense, the portfolio is a bit newer this year, because it has more new customers in the base, so they are a little less profitable. But I repeat, from a customer lifetime value standpoint, it's very profitable. And we're adding a lot of new customers and keeping default at a very healthy level - and you know how conservative Itaú's approval rate is, it's extremely low at around 10%, just so you have an idea.
So our expectation is... This year was marked by strong acceleration in growth, we were keeping a pace, and we're selling 150,000 cards per month; last year we sold around 75,000 cards per month, 80,000, so we doubled the expansion pace. Issuance costs are having a somewhat negative impact on the result of LuizaCred, both in BR GAAP and IFRS 9, and the new criterion for additional limit provisions only applies to IFRS 9. The

trend is for these results to converge and improve in the medium and very long term, as the portfolio matures and investments are made in the customer base.
But we will keep investing in further expanding this card base, because of the strategy of previously mentioned. The new card strategy has had little positive impact on retail and LuizaCred, but it makes a lot of sense from the point of view of return on invested capital in the long run. So, the investments are definitely profitable.

Rodrigo Cuestas – Goldman Sachs
Perfect. Thanks, guys.

Roberto Bellissimo – CFO
Thank you, Rodrigo.

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. Please, Mr. Frederico, you can go ahead.

Frederico Trajano – CEO
Well, I'd like to thank you all for participating in the call. And also the entire team and all of the partners who helped us achieve a very positive quarter, despite the many uncertainties and struggles in the market. Thank you very much.

Operator
Magazine Luiza's conference call is closed. We thank your participation and have a nice afternoon.