

Gaston Bottazzini, CEO of Falabella, on the company's financial results as earnings fell by 86%:

"We are already seeing positive signs. We see the core retail and banking businesses starting to improve"

The company's chief executive explains these results in a context rarely seen before by the company, as several macroeconomic issues affected most of its businesses. However, he already foresees a change in the trend, as the exchange rate is improving and inflation is falling, while domestic investments will soon come on stream, particularly in digital services. "An examination of Amazon, Alibaba and every successful marketplace in the world reveals that these were long-term investment cycles, which produced significant value", he remarked. He states that he categorically does not agree with the risk rating change by Fitch, and believes that the country lacks "much clearer signs of a focus on growth", with security and employment as the main issues.

"There was tremendous pressure on our results during the second half of 2022, due to an unprecedented context", explained Gaston Bottazzini, Falabella's Corporate Chief Executive Officer, after the unflattering financial results of this company were released this week, despite being one of the largest retailers in Latin America. The 86% drop in earnings last year is comparable only to the drop in 2020, in the midst of the pandemic.

In this interview, Mr. Bottazzini starts with putting these results into context. After a period of high consumption and the Chilean consumer enjoying healthy liquidity as a result of pension fund withdrawals, the second half of 2022 encountered very little liquidity in the market. He said that "this was the first issue that affected our performance". Secondly, he mentioned disruption within the logistics chain, which resulted in logistics costs increasing, "in delays and even some disorder as goods arrived in Chile and other countries", which strongly impacted margins and inventories. Then there was inflation, in general in every country, "but it was particularly high in Chile, which also put us under pressure".

Mr. Bottazzini summarized by saying that it was a combination of "supply problems, lower consumption, higher inflation and higher expenses" within the retail business. Higher interest rates in the banking business implied higher financing costs for bank assets and lower liquidity in the market, which meant that customers were less able to pay, and additional provisions were required.

But he added that "there are a number of developments and positive outcomes that are perhaps hidden", and he emphasized two of them. Outside of Chile and especially new countries are seeing a "substantial improvement in their results", he said. Brazil is reaching positive numbers and Mexico is "very close to break-even" in both the home improvement and financial businesses. The second is Falabella's new digital platforms, the launch of the marketplace in Colombia completes the six platforms operating across the region. "So we moved from purely investing in platforms, to a cycle of operating and optimizing them. All of this translates into better growth prospects for Falabella going forward, and some of these are already beginning to appear".

For example, he explained that the marketplace previously was a very small share of digital sales, but it already represents a 25% share and that share grew by 25% in 2022. The bank overcame the negative pressures he described and "improved its position compared to other banks in Chile, and in each country. We are fighting for first position by credit card usage in the Chilean market, and we became the second largest bank in Chile by share of checking accounts", he added.

“All of this translates into better prospects (...) We are already seeing positive signs going forward. More stable exchange rates, inflation decreasing, and the yuan peso exchange rate improving, as most of our imports come from China. If we examine these positive trends, we can already see the core retail and banking businesses starting to improve. This is combined with a very ambitious efficiency plan and with digital platforms that will now fuel strong growth. So, I would like to qualify that these results are the consequence of several short-term impacts, and we are committed to converting them into better results, especially in the second half of the year”.

“We have specific plans to improve our current operation and to grow using our digital platforms, so the combination of these two will produce a very powerful proposal going forward”, he added.

- Is there no mea culpa? Are there situations that could have been foreseen and corresponding measures taken? For example: the bank portfolio is not in UF and you couldn't see the benefits forecast by other banks.

“When you look at what happened in every area and compare that to your plans, there is always a mea culpa. However, I think that it was difficult to foresee the drastic change in consumer behavior that took place in Chile. This affected specific formats and categories more than others, but they had a greater impact on the hard categories where we are strongest. If we had seen that more clearly, obviously we would have prepared our procurement accordingly.

Regarding the banking business, traditional banks are denominated in UF because they sell products in UF. No bank has credit cards in UF. Credit cards within Chilean banks represent a small percentage of their business, because they serve large and small companies and provide mortgage loans, with credit cards as just another product. Whereas we are a people's bank with a particular focus on credit cards and without a significant mortgage portfolio. This relates to the nature of our profile, rather than changing the denomination of our assets, which is the outcome of our products”.

- Based on this experience, does Falabella need to diversify into more defensive businesses, such as supermarkets?

“Falabella is a highly diversified company. For example, real estate is more defensive than department stores. Home improvement moves in different cycles than department stores and fashion. We have a smaller share of the supermarkets market. Obviously, if we had a larger share, as in Peru, then we would be more anti-cyclical. The bank also operates a cycle that is different from the rest of the business. Traditionally, this diversification has worked in our favor. If you look at Falabella's history, it is rare that several businesses are simultaneously impacted. Events over the last few months are unusual and rarely seen in Falabella's history, with various macroeconomic challenges affecting the majority of our businesses. But the real estate business will be the first to start reversing the trend in our results. Also, the bank is experiencing short-term difficulties at the moment, but will reverse this trend as it has a very solid commercial position not only in Chile, but also in Colombia and Peru, and this will not simply sustain its customer relationships but will reinforce them too. We are being very proactive in our dealings with customers who have payment problems”.

- Falabella's market value has been hit the hardest over the last three years, compared to its retail peers such as Cencosud and Ripley. It has been severely punished. Why does the market no longer believe in Falabella?

"I don't think that the market doesn't believe in Falabella, but rather that Falabella has changed its business development profile. We see this as a long-term and sustainable change. The company is undertaking a profound digital transformation, which requires an enormous investment and this affects our short-term results. I understand what we are seeing as market impact in two ways. Firstly, the market wants to see the fruits of this change, which is not only transforming the nature of our business but also the company's culture. It currently doubts whether Falabella will be able to successfully transform, and this translates into a lower market value. When we examine the global context, we can find companies that have successfully achieved this transformation but the statistics are not in our favor. They indicate that many retail companies that have tried to transform have not succeeded. Now if Falabella had not transformed, if it had not heavily invested in e-commerce, payment platforms, tools that capture data to understand customers, and loyalty systems, then I believe that we would probably be much worse off with little hope of achieving success. Falabella has been in the market for 130 years and its long-term strategy has always been to support its customers. Obviously, we care about how the market reacts to what we do, but we care far more about our strategy of genuinely supporting our customers. The only way to achieve that is to adopt the big trends that our customers expect, which are developing our capabilities with regard to digitization, marketplace, data processing, digital banking and payments platforms. Not only did we promise all these capabilities three or four years ago, but they have now been implemented and are fully operational. It only remains for them to start contributing to growth, and this is starting to happen".

- What answers can you give or promises can you make to investors?

"The promise is that our strategy is based on an analysis of what is happening in the world to support our customers over the long term. And that this will result in a sustainable organization".

- In other words, Falabella invested during this cycle and now we are going to see the results? Couldn't both have been achieved at the same time, like walking and chewing gum?

"Ideally, that is correct. And much more could have happened in parallel had each traditional business not suffered from the difficulties that I described earlier, but the reality is that investment takes a while to complete. You cannot build a marketplace and make it successful in three years. An examination of Amazon, Alibaba and every successful marketplace in the world reveals that these were long-term investment cycles, which produced significant value. These are not unsubstantiated promises. The promise of value is real".

Investment: "It will continue its downward trend".

- What do you expect for 2023? Is it going to be substantially better than 2022, the same, or worse? Are forecasts being recalibrated following the January Imacec (Monthly Economic Activity Index) that gave new and slightly more positive signals than the expected terrible recession?

"We believe that in 2023 our results will initially come under similar pressure to that experienced towards the end of 2022, but there will be a gradual improvement towards the end of the year. An inversion of 2022. 2023 will start off weak and will gradually strengthen towards the end. How much better or worse will it be? Well that depends. Clearly, yesterday's signal (the Imacec released on Wednesday) is good, even if it does not directly affect the retail business today, as improvements may appear faster than we expect. This is a data point for one month, but obviously economic growth in general translates into retail growth".

- Should 2023 produce a substantially better bottom line?

“It should be better”.

- Sensitive indicators for you at the moment, consumption and delinquencies?

“We do not see delinquencies improving, yet not continuing to deteriorate. We see consumption under a lot of pressure, but in a different context for us. We are entering 2023 with prudent inventories and expectations, which means that even if 2023 is similar to 2022 our results should be better, because we were better prepared at the start of the year. We will no longer have inflated inventories that impact our margins. We are also trying to bring down total expenses and this is already bearing fruit. Our expenditure was high in 2022 and this year it is already well below inflation”.

- A US\$ 664 million investment plan has been announced. This is the lowest in years...

“This is due to the nature of our investments. Historically, Falabella opened 26 to 30 stores in all countries. Now we are selectively opening stores in a couple of countries, with a strong focus on Brazil and Mexico, and these are home improvement stores rather than multiple formats. The second change is that we are switching from investment to expenditure, because everything that involves digitalization creates expenditure on logistics and technology. This lowers total investment, which will continue to trend downwards, although this will not necessarily translate into lower company growth. Investing in digital platforms is far more scalable than investing in stores”.

- How are you going to finance it?

“With the company's retained earnings and borrowings already earmarked for this purpose. We do not need to increase our debts to finance investment”.

- Minister Mario Marcel referred to the Imacec when he called on businessmen to invest. Will you pick up the gauntlet?

“I believe that there needs to be much clearer signals of a focus on growth, in order to increase investment in Chile in particular. Not only this government but also previous ones have focused on distribution, which is very important for Chile, but providing incentives for growth has received less attention in relative terms. Furthermore, security within our particular industry is affecting our capacity to grow and develop. A more forceful security plan is needed. We now have greater stability in terms of legal certainty. We are preparing a constitution based on principles that are consistent with the major global democracies, and volatility is lower than was expected from the previous preparation process, but there are still many issues on the table. For example, laws that affect labor relations and financial business dealings, which trigger a degree of uncertainty. So, removing uncertainty is also very important for encouraging investment”.

- Is there no legal certainty surrounding investment in Chile at the moment?

“I believe that steps are missing. Some depend on the authorities, but Chile lacks certainty in some of these areas for investment to really grow”.

- There have been robberies and shootings in malls. Do you believe that the responsibility for improving security is being largely shifted to the private sector?

“We have absorbed a lot of security improvements and we have invested”.

- But do you believe that the responsibility of the State is being transferred to the private sector?

“The private sector and the company cannot absorb all that responsibility. We believe that it is a shared responsibility and that the authorities need to emphasize this issue”.

- Is that your biggest concern?

“I would put labor issues and security issues on the same level. Everything else comes second”.

- What do you think of the Labor Minister's announcement to move forward with sectoral negotiation?

“All these announcements point to the fact that the future is becoming uncertain”.

- But do you believe that this is feasible for the retail sector?

“Sectoral negotiation exists. When we look around the world at countries with sectoral negotiation like mine, which is Argentina, we can observe its negative impacts. You don't have to look far. You cannot see across the Andes Mountain range, but you can read the newspapers and discover the negative impacts of a policy such as a sectoral negotiation, and I'm talking about my country in particular. The basic problem is a loss of identity during negotiation”.

- What about the 40-hour project?

“It is a feasible project and we are prepared to implement it, but it obviously impacts our productivity. It must be complemented by other measures that support it. It is good to focus on distribution and improve people's conditions. This company serves people, so what interests us most is that people's conditions improve, but this must be supported by focusing on how to improve productivity, and Chile has failed to improve its productivity in many sectors”.

- The Retail Brands Association has called on malls to open an hour later. Do you think this is possible?

“We are analyzing all the possibilities, and clearly this is one of them. We are considering all our options”.

- The DT has challenged polyfunctionality, which is merging positions within the role of 'store operator'....

“This is an example. It reduces working hours while restricting the opportunities for people to fulfill various functions. Fulfilling various functions offers greater productivity, so one benefit would be offset by another. If it were favored, then it would help offset the 40 hours. The world is moving towards multi-functionality, as it requires people who can perform more functions and who want to perform more functions, because this offers them a higher salary or a richer working experience”.

- Speaking of uncertainty, you also mentioned laws that affect financial business dealings.

“There are two issues. Firstly, the regulations governing interchange fees that focus on lowering the cost for businesses, without taking into account the penetration gap in Chile and its scale. Rates have been proposed that would be the lowest in the region and these would make bankarization and innovation very unattractive to those trade segments that are currently excluded from the system. Secondly, the regulations governing consumer credit risk provisions that would make offering loans less attractive. This is counter-intuitive while the country isn't growing”.

- Do you agree that tax reform should increase corporate income tax instead of wealth tax, as proposed by the CPC? Do you see room for this reform, and that it could be a better solution to not affect investment?

“The question should be: what is the best tax reform formula to encourage the investment and growth desired by the government”.

- You will celebrate five years as CEO of Falabella in June. Does the exhaustion lead you to think about stepping aside?

“My commitment to Falabella is closely linked to the company's digital transformation. My goal is to complete this project before thinking about new projects”.

Box

FINANCIAL RESULTS

“I would like to qualify that these results are the consequence of several short-term impacts, and we are committed to converting them into better results, especially in the second half of the year”.

Fitch downgrade: “We do not agree with the change in our rating (...). The company's capital structure has not changed”.

- While Fitch affirmed Banco Falabella's AA rating and stable outlook on Friday, it did downgrade Falabella's rating a week ago, saying in its report that it is concerned about its leverage metrics over the next two years, its inability to pass inflation on in prices, its inventories, and ultimately that it appears to be weaker than other retailers. How are you going to address these challenges?

“To begin with, we do not agree with the change in Fitch's rating, as the company's capital structure has not changed. We have not increased debt or reduced equity, as that structure is the same and the leverage ratio that they are looking at is mainly linked to short-term pressure on the company's EBITDA. We have experienced short-term pressure on EBITDA several times in the past. Our current leverage is no different to where it was in 2009 after the Lehman Brothers collapse and no different to where it was during the pandemic, when it reversed as EBITDA recovered. We believe that the current trend of lower inflation and a better exchange rate will help our core businesses to improve their performance. Secondly, we are implementing an efficiency plan, which will help us to improve performance. Thirdly, our investments in technological platforms will be lower going forward because the majority of that investment is already behind us. Therefore, we expect that these major factors of improvement in the macro context, implementation of our efficiency plan, and acceleration of our digital platforms will help us to turn this situation around. We do not have an EBITDA problem over the medium term and our liquidity obligations are covered, so we do not have a liquidity problem, as the company's debt profile is mainly long term”.

- Did you discuss this with Fitch?

“Yes, of course”.

- When do you expect the situation to reverse and the rating to change?

“The problem with rating agencies is that once they make a decision, they require a consistent improvement over a long period to reverse it. I cannot speak for them as to how long this will take, but I expect that by the end of this year we will see a substantial improvement in EBITDA that will bring our leverage ratio down from where it is today. While remembering that our capital structure has not deteriorated”.

REGULATION OF INTERCHANGE FEES

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SECTORAL NEGOTIATION

“When we look around the world at countries with sectoral negotiation like mine, which is Argentina, we can observe its negative impacts. You don't have to look far. You cannot see across the Andes Mountain range, but you can read the newspapers and discover the negative impacts of a policy such as a sectoral negotiation”.

The next IKEA stores to be opened: Bogota at Mallplaza NQS this year and Mallplaza de Cali and Viva Envigado in Medellin during 2024

Gaston Bottazzini explained that Chile will receive approximately one third of the investment plan, specifying that most of the logistics and technology investments are in Chile, which provides services to the rest of the region.

Eleven stores will be opened in total, where three will be in Chile with two being Sodimac and one Tottus. The home improvement markets with room for growth are Brazil and Mexico, as penetration is very low.

- Do you see any opportunities for inorganic growth there, or can you launch other businesses in Brazil and Mexico, as they only have the home improvement format?

“We are looking at expanding our presence in these two markets (...). But we have not prepared a specific plan for 2023. Inorganic growth is less likely in the short term. With the reason being that we haven't found any attractive opportunities”.

“However, we have been investing in companies that accelerate our development through Falabella Ventures. This aspect of inorganic growth is progressing, as we already have five investments in Falabella Ventures, two in logistics, two in data management and one in the payments segment”.

- What has been the impact of IKEA? Were your expectations met?

“We have two stores. They have already received more than 11 million visitors, which is very high compared to our expectations. They attract a huge flow of customers with excellent sales dynamics. We have yet to entice customers to the furniture part of the store, which is consistent with IKEA's

experience on entering every market. E-commerce already accounts for 30% of IKEA's sales, which means that we sell 70% in these two stores and 30% on the platform”.

- What is the precise store opening schedule?

The next three are all in Colombia. The first in the fourth quarter of this year, September-October, at Mallplaza NQS in Bogota. The second at Mallplaza Cali and the third at Viva Envigado in Medellin (an Exito Group mall) both in 2024. Peru will most likely follow, but there are still no specific construction plans for what would be the sixth store. The next store under consideration in Chile would be Concepción in 2026”.

- Have you explored expanding the IKEA franchise to other countries after Chile, Peru and Colombia?

“We are not currently contemplating any other countries. We have an open dialog with them, but the priority is to ensure that the first three are successful”.

- Is Falabella interested in Ripley's stake in Nuevos Desarrollos?

“If they decide to sell their stake, which would depend on its valuation, we would buy it.

- Why did Falabella agree to the interlocking agreement with the FNE? Was there any untidiness?

“No there wasn't any untidiness. We do not agree with that accusation. We believe that the law was respected both in form and substance. It is an accusation that arose from a change in the interpretation of the law. And our agreement was due to the visualization of a highly complex and potentially politicized process.

- What is the Net Zero investment about?

“During the last year and a half we progressed from analyzing the impact of each business on climate change to analyzing our impact as an entire company. This encompassed refrigeration in Tottus, air conditioning, procurement and logistics. The aim was to reach a commitment to become carbon neutral not just by business, but for the Falabella Group as a whole. Net Zero requires limiting green bond purchases to 10% of our mitigation measures. This requires that 90% must be actual mitigation measures, such as reducing our energy, lighting and cooling requirements. We developed a plan to achieve Net Zero over the next 12 years, with an intermediate target of a 65% reduction by 2030. This positions us in a league with very few other retailers worldwide. We want to be regional leaders”.