

Q2 2019 Earnings Call

Company Participants

- Francisco Gomes Neto, CEO and President
- Nelson Salgado, Executive Vice President, Finance and Investor Relations

Other Participants

- Christine Dong Hee Lee
- Gabriel Cavalcante
- Jeffrey Osborne
- Josh Milberg
- Myles Walton

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call that will review Embraer's Second Quarter 2019 Results. Thank you for standing by. At this time, all participants are in only mode. Later, we will conduct a question-and-answer session, and instruction to participate will be given at that time. (Operator Instructions) As a reminder, this conference is being recorded and webcasted at ri.embraer.com.br.

This conference call includes forward-looking statements or statements about events or circumstances, which have not occurred. Embraer has based these forward-looking statements largely on its current expectations and projections about future events and financial trends affecting the business and its future financial performance. These forward-looking statements are subject to risks, uncertainties and assumptions, including among other things, general economic, political and business conditions in Brazil, and in other markets, where the company is present. The words believe, may, well, estimates, continues, anticipates, intends, expects and similar words are intended to identify forward-looking statements.

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Participants on today's conference call are Mr. Francisco Gomes Neto, President and CEO; Mr. Nelson Salgado, Executive Vice President, Finance and Investor Relations; and Mr. Eduardo Couto, Director of Investor Relations.

I would now like to turn the conference over to Mr. Nelson Salgado. Please go ahead, sir.

Nelson Salgado {BIO 19113798 <GO>}

Good morning, everyone, and thanks for joining Embraer second quarter 2019 conference call. We start with the operational highlights at page 4, with Commercial Aviation. Embraer delivered 26 E-jets in the second quarters and 37 year-to-date. As far as sales activity Embraer signed up to 78 aircraft commitments during the Paris Air Show, including United Airlines for up to 39 E175 including 20 firm orders.

Fuji Dream Airlines ordered 2 E175s to Commercial and Binter signed an order for two additional 195-E2s. KLM Cityhopper's signed an intention to purchase up to 35 E195-E2s. Which we not to include it in our backlog yet. After the Air show, Skywest also signed a firm order for seven E175 Ejets.

In terms of new programs the E195-E2 that was certified in the first part of the year. We have its first delivery to Azul Airlines in the third quarter of 2019. And Azul in preparation for starting the operation of the aircraft signed a contract for a long-term Flight Hour Pool Program with Embraer. And the E195-E2 began also its global demo tour in Asia.

Moving to Executive Jet at slide 5. Embraer delivered 25 executive jets, 19 light and 6 large in the second quarter of 2019, and 36 year-to-date. This volume is around 20% above the same periods of 2018. As far as the new products with the Praetor 600 and the Praetor 500. The Praetor 600, received a triple certification from ANAC, FAA and EASA with the first delivery to a European customer already happened in the second quarter of 2019. The Praetor 500 it was just announced yesterday. Received the ANAC certification out performance on key performance metrics such as range and speed.

In terms of new sales, Embraer had an expressive backlog increase, due to the new sales of Praetor jets and related services. We are very happy with the markets response to the new Praetor. Finally, our Bossa Nova interior won the award for the Best Interior Design at the 2019 International Yacht & Aviation Awards

Next slide, slide 6, we show the highlights for Defense & Security. Starting with the KC-390. The program continued its flight test program with focus on the military missions. Looking forward to the first delivery to the Brazilian Air Force that is scheduled to happen in 2019. Embraer also announced its first export customer for the KC-390. The Portuguese government announced a firm order for five KC-390 and related services. That was a very important achievement introducing the KC-390 in the European market and reinforcing the program success.

Still regarding new products, Embraer and ELTA Systems from Israel signed a strategic agreement to introduce the Praetor 600 AEW airborne early warning, we believe there is a potential for these products and Embraer wants to explore it with the partnership. Finally, our subsidiary Atech successfully completed the delivery of a new aircraft traffic management center in India. And the contractual discussions with the Brazilian Navy for the supply of four sheets of the Tamandare class continued to move as expected.

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Now we move to the financial results. Starting with the backlog at slide 8. We continued our backlog recovery and reached \$16.9 billion by the end of second quarter 2019. This recent increase was driven by demand for our new Executive Jets Praetor 500 and 600 and the continued success of the Phenom family. It is important to say that the recent KC-390 order from Portugal is not included in our backlog yet.

Next in slide 9, we show aircraft deliveries in commercial, we delivered 26 planes at the second quarter and 37 year-to-date. This is below last year but in line with our expectations, and we reiterate our guidance of 85 to 95 E-Jets deliveries this year. On Executive Jet, we had a better first half compared to last year. With 25 deliveries in the second quarter and 36 in the first half of the year. We maintain also our confidence to deliver 90 to 110 E-jet this year as we are better sold than last year and has been seeing stronger demand for our planes.

Moving to slide 10, net revenues, we reported second-quarter revenues of \$1,379,000,000 broken by commercial aviation \$631 million, Executive Jets \$297 million, Defense & Security \$196 million and services and supports \$255 million. The total in the first half of the year amongst \$2.2 billion. With the exception of commercial aviation where we have lower deliveries, we presented good revenue expansion, especially on the Executive Jets and defense.

In the slide 11, SG&A expenses. We reported a total of SG&A at \$119 million with G&A expenses amounting to \$46 million and selling expenses to \$73 million. Our SG&A expenses this year has been affected by the activity related to the separation of Commercial Aviation business.

Moving to the operating results at slide 12. We reported second quarter EBIT of \$27 million with 1.9% EBIT margin. The first half EBIT was \$11 million with 0.5% margin. The operating results are in line with our guidance of break-even margin for the year. It's important to highlight that the separation costs associated to the Boeing transaction are all included affecting the EBIT. Year-to-date, we had separation costs of around \$30 million. Breaking our 2019 EBIT margin per business, we have services 12%, commercial 2.7%, executive around zero and defense minus 7%.

Moving to slide 13, we show our EBITDA. The same impact that we explained for the EBIT also applies here for the EBITDA --. We reported in the second quarter \$67 million EBITDA with 4.9% margin. Year-to-date EBITDA is \$98 million with 4.4% margin.

On slide 14, we present our earning. Embraer reported a net loss of \$14 million in the second quarter with margin of negative 1%. Again here, our earnings have been impacted by the low operating results and also higher financial expenses given our increased leverage.

As far as investments in slide 15. We've reported total investment year-to-date of \$200 million broken by research \$21 million, development \$127 million and \$52 million in CapEx. Our investments this year remain concentrated on the E2 program as we enter into service with the 195-E2 and continue the development of the 175-E2.

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At slide 16, we show our free cash flow. Embraer reported a positive free cash flow of \$2 million at the second quarter and a free cash flow consumption of \$664 million year-to-date. As we have been saying, we expect a positive cash flow generation in the second half of the year because of the higher deliveries especially in the fourth quarter.

Finally at slide 17, we show our indebtedness profile. We ended the second quarter with a total cash position of \$2.48 billion and a total debt position of \$3.57 billion, implying a net debt of \$1.90 billion. Our debt maturity remains comfortable with an average of 5.1 years.

With that, I conclude the presentation. And I will pass to our new CEO, Francisco Gomes for closing remarks before we open for Q&A. Francisco, please go ahead.

Francisco Gomes Neto {BIO 16673591 <GO>}

Thank you, Nelson, and good morning, everyone from my side as well. It is a great pleasure to become a part of this highly skilled team, in the year that Embraer is celebrating its 50th anniversary of challenges and achievements.

In my first three months at Embraer, I have visited all of our sites around the world and I'm greatly impressed with the levels of engagement, ethics and teamwork that our Embraer team shares. I am convinced that Embraer is very well positioned for a promising future, through the combination of its state-of-the-art products, continued progress in becoming a more efficient company, the continued support of our customers and the consummation of the strategic partnership with Boeing.

We continue to work on several fronts to ensure that the strategic partnership between Embraer Boeing is successfully concluded and all of our employees regardless of whether they will remain with Embraer or eventually work in Boeing Brasil Commercial are fully engaged with the necessary processes to complete this important transaction.

After what I have experienced in Embraer and in these initial months, I'm convinced that the company will return to its growth path. With our team working in a lean manner, with ethics, unity and oriented by results, we believe Embraer will recover and even surpass its current market value. Our executives defense and services businesses are stronger than ever after a long period of investment and combined with the maturity of innovative programs will bring value for our shareholders.

I have no doubt that working hard will build a strong, solid and sustainable future for Embraer in the next decades.

So thank you very much, operator. Now, we move to the Q&A session.

Questions And Answers

Operator

Bloomberg Transcript

(Question And Answer)

Ladies and gentlemen, we are now begin the question-and-answer session. (Operator Instructions). Our first question comes from Cai von Rumohr, Cowen and Company.

Q - Jeffrey Osborne {BIO 15017297 <GO>}

Hi, this is Jeff on for Cai. Good morning, and welcome aboard Francisco. Thank you for taking my question.

A - Nelson Salgado {BIO 19113798 <GO>}

Cai, can you hear us?

Q - Jeffrey Osborne {BIO 15017297 <GO>}

Hi, yes. This is Jeff on for Cai. Can you hear me?

A - Nelson Salgado {BIO 19113798 <GO>}

Yeah, very clear.

Q - Jeffrey Osborne {BIO 15017297 <GO>}

Okay. Good morning, and welcome aboard Francisco. Thank you for taking my questions. I'd like to ask about the Boeing partnership, specifically, how the separation activity is progressing? And what is the current view on major milestone dates and cost.

A - Nelson Salgado {BIO 19113798 <GO>}

Well. Thank you Cai the conclusion of the deal has two big fronts one relates to the work with the regulatory authorities of several jurisdictions for E-jet approval. On the front we are not talking about specific regions but we are moving according to what we planned. The other big front is associated with all the steps that we have to do to separate the commercial aviation business. And here most of the activity is associated with the duplication of the IT systems, with the separation of the people that will go into the company, the preparation of infrastructure that we will need in 2020.

After the separation, for example, we will move a lot of people from the main site. Of Embraer today in , which is the existing site, to Eugenio de Melo. That will be the main site of Embraer. And for that, we need to accommodate people there. We are also moving the final assembly line of the praetor jets to Gaviao Peixoto y because today it done at Sao Jose dos compos. So many different activities but we are confident that we are moving ahead as planned to target the transition by the end of the year.

Q - Jeffrey Osborne {BIO 15017297 <GO>}

Okay. Thank you. That's helpful. And is there any update on the actual the cost whether for the tax and the separation cost? I think it was previously supposed to be \$1.2 billion combined what they're about?

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A - Nelson Salgado {BIO 19113798 <GO>}

Yes, because they're now we're not changing that number. That we were expecting related to the separation activities themselves which will add up to the first part of the year \$30 million that we mentioned would be impacting our EBIT.

Q - Jeffrey Osborne {BIO 15017297 <GO>}

Understood. And then one more question, if I can on a different subject here on Executive Jets, it looks like the book to bill was quite strong, but it's difficult to tell exactly what it was, although it looks like it's about one. What was the book to bill in the quarter? And any color on what geographies were strongest? And what type of buyers are most active? Thank you.

A - Nelson Salgado {BIO 19113798 <GO>}

Strong book-to-bill in executive aviation. As we mentioned the certification of the praetor aircraft and first delivery of the praetor 600 in Europe and the first delivery of the praetor 500 already coming. These are having a very good response from the markets. Our book-to-bill was actually around 8.5, but we are not able yet to provide details of where this growth come from.

Operator

The next question comes from Myles Walton UBS.

Q - Myles Walton {BIO 6802513 <GO>}

Thanks, good morning. Welcome Francisco. I was hoping maybe you could start around the cash flow of the business and kind of what your expectation is for free cash flow for the year and or maybe where you think the balance sheet is on a pro-forma basis on the deal closing, if there's any adjustment?

A - Nelson Salgado {BIO 19113798 <GO>}

So we are working towards the outlook that we gave you at the beginning of the year regarding 2019, which is to pay \$1.6 billion in extraordinary dividends to shareholders and stack the Embraer with a net cash position around \$1 billion.

For this year, 2020, we expect the free cash flow to be breakeven -- sorry, for 2020 for next year, we expect cash flow to be break-even. And as we reported in January we had projected revenues of \$2.5 billion to US\$2.8 billion, and EBIT margin from 2% to 5%.

Q - Myles Walton {BIO 6802513 <GO>}

And so, Nelson, sorry, did you say what the free cash flow was for 2019, I understand the cash position but, I just wonder, is this year a free cash flow breakeven or will you be able to recover what's been consumed in the first half?

A - Nelson Salgado {BIO 19113798 <GO>}

Yeah. We generally, the second half is looking stronger than the first, that's typical in our cycle. Both executive and commercial they have a-- and defense they have a stronger second part of the year in terms of cash generation. And we expect that these results for the first quarter especially will be recovered. And with that, we remain in line with our guidance of a \$1.6 billion dividend and to stack Embraer with around \$1 billion net cash position. We did not give expenses guidance to 2019.

Q - Myles Walton {BIO 6802513 <GO>}

And then in terms of the delivery of the KC-390 to the Brazilian Air Force what are the milestones ahead there? Is there any required further testing, or is it generally paperwork at this point just in terms of getting that delivered?

A - Nelson Salgado {BIO 19113798 <GO>}

Actually the first KC that we believe it to be delivered to the Brazilian Air Force was the aircraft that we presented in the Paris Air Show. And as soon as it came back from the Paris Air show the delivery process for the Brazilian Air Force started. This is the first delivery of a brand-new type to its first customer. So the processing takes long, so because there are lots of things that have to be verified by the customer. And we expect that the delivery will happen in the third quarter of 2019.

Q - Myles Walton {BIO 6802513 <GO>}

Alright. Very good. Thanks so much.

A - Nelson Salgado {BIO 19113798 <GO>}

Thank you.

Operator

Our next question comes from Ronald Epstein, Bank of America Merrill Lynch.

Q - Christine Dong Hee Lee {BIO 20986130 <GO>}

Hi. Good morning, guys. This is Christine Lee Hogg calling in for Ron. My first question is on Commercial Aviation. Can you walk us through the moving pieces in margin for that aircraft, in your Press Release you mentioned that there are weakness because of shift in mix. So can you discuss what's driving the margins lower for that segment?

A - Nelson Salgado {BIO 19113798 <GO>}

Well. We for some time anticipated that this transition year when we start ramping up the 190 E2 deliveries, or the E2 deliveries, are products that traditionally has a worse gross margin, right? So I think, this as we grow the number of the E2s in the mix, that tends to drive margin down. We are also delivering aircraft U.S. The E75. In contract, we knew also that we would have worse margins than we have previously indicated in the segment. So that basically what is affecting the margin. So it's a bit of higher cost on the E2 relatively to

what we expected in the future, because of the learning curve and more tight margins because of sales prices on the E75.

A - Francisco Gomes Neto {BIO 16673591 <GO>}

Yeah. One important thing, Kristine, too if I add it's important to say that the margins we mentioned about commercial, it includes the separation costs there. So if you remove the separation cost, the margins in commercial would be like three percentage points better. So besides what Nelson mentioned that we're going to have the decline is also related to the separation costs.

A - Nelson Salgado {BIO 19113798 <GO>}

Yeah. I was talking more about the gross margins.

Q - Christine Dong Hee Lee {BIO 20986130 <GO>}

It's really helpful. And when you think about the learning curve on the E2. At what unit delivery, do you expect incremental E2 margins to be closer to parity could what your legacy E-Jet margins were?

A - Nelson Salgado {BIO 19113798 <GO>}

Well it's very difficult to say. We work very hard every day to try to anticipate the reduction of costs. But I would not take the risk of saying a consistent amount of aircraft, right? But it's very normal. There is generally in this learning curve in the first 50 to 80 aircraft we have a faster reduction and then a slower reduction up to 150,200 aircraft. So that's more or less the profiles that we're looking at.

Q - Christine Dong Hee Lee {BIO 20986130 <GO>}

Great. And an Executive Aviation. Can you discuss the demand environment and also the pricing. Are you starting to see pricing improve in executive?

A - Nelson Salgado {BIO 19113798 <GO>}

Well, the market is better, generally speaking, not spectacularly but it seems better all these publications in executive aviation are mentioning that. So we have a more positive environment coming from that. And with the introduction of the praetors we believe we differentiated our offer in the segment even more. With a much bigger range than any other competing aircraft the praetor 500 and also the praetor 600. And we expect that this positioning will allow us to practice a better prices that we'll be working the offer we are providing to the market.

Q - Christine Dong Hee Lee {BIO 20986130 <GO>}

Great. And lastly for me if I could squeeze one more. For the Boeing deal, are there termination costs if the deal doesn't close?

A - Nelson Salgado {BIO 19113798 <GO>}

Yeah. I don't know the details here. But depending on the reason for a potential we have part. It's important to emphasize that this scenario. We don't even consider. We're working very hard to get regulative approval and internally working very hard to make all the activities that we have to make and complete before the separation starting in the end of the year.

Q - Christine Dong Hee Lee {BIO 20986130 <GO>}

Thank you very much.

A - Nelson Salgado {BIO 19113798 <GO>}

Thank you.

Operator

The next question comes from Josh Milberg, Morgan Stanley.

Q - Josh Milberg {BIO 19336060 <GO>}

Hey, good morning Francisco, Nelson Salgado. Thank you guys for the call. My first question is a follow up on the question about your cash flow. In the first quarter call, you had highlighted that the \$100 million of delayed payments from the Brazilian government and that apparently did not reverse in the second quarter. So I just wanted -- to see if you could give us a little bit of a better understanding on what's your basis for anticipating a normalization in the second half of this year? That's the first out.

A - Nelson Salgado {BIO 19113798 <GO>}

Yes, The budget problems that the Brazilian government have been facing they are affecting our result. But we have great confidence that the Brazilian Air Force will manage to sort it out before the end of the year.

Q - Josh Milberg {BIO 19336060 <GO>}

Okay. That's helpful. And then my second question is on the KC we recognize that the sales to Portugal did represent a big milestone for you guys, but we had thought that deliveries might have started a little earlier. Could you guys comment on the timing that timing and on what penalties could apply if a future Portuguese government decided to cancel or delay the orders. And then if we also think about other potential KC orders from abroad, do you think that 2023 is a reasonable assumption for the earliest when those other orders might start delivering?

A - Nelson Salgado {BIO 19113798 <GO>}

I understood the question completely. Let's go part. Regarding. The contract with Portugal it is indeed a very important milestone because it's the first export customer for the product. And This is always a very important achievement for these products. But the time for the delivery of the first aircraft is more driven by the need to develop the latest version of the aircraft. So there is some product development associated contract which

may just delay the first -- not delay, but it will mean that the first delivery will not happen before 2023. And with the other deliveries happenings up to 2027.

Because parallel to those deliveries, we knew we have already a delivery of around two aircraft per year by the Brazilian Air Force. So that's the delivery time for the KC. I think the piece that you're missing is that there is this product development for that we have an aircraft to the green dragon to operate in the meantime in that environment. Which by the way is very good because we will have opportunities to look customers in all that have the same needs after that.

Q - Josh Milberg {BIO 19336060 <GO>}

Okay. That was the exact explanation that I was looking for just a better understanding of what was behind the 2023 timing. But the other doubt I had raised was if you could just comment and maybe this is something that you don't disclose but, what the contract with the Portugal government, stipulates with respect to eventual decisions to either cancel or delay the order?

A - Nelson Salgado {BIO 19113798 <GO>}

Yeah. Already contracts has provisions if obligations are not fulfilled by either party. But again, we're not contemplating that. We simply have a very strong contract. We have everything in line we have the product development that we service relevant have to do and the first delivery in 2023.

Q - Josh Milberg {BIO 19336060 <GO>}

Okay. Thank you very much.

Operator

(Operator Instructions). The next question comes from Gabriel Cavalcante, CTM Investments.

Q - Gabriel Cavalcante

Good morning, guys. Thank you for picking my question. And it's just about the dividends. We know that in the United States dividends are taxed differently from what they are in Brazil. I just want to know if there's any type of initiative coming from Embraer, maybe working with somebody else to maybe put a different situation for the American investors that are receiving this dividend. And it's just about if they're going to be taxed the same way they're taxed on regular dividends or there's something that are going to help these investors to get taxed differently. Thank you.

A - Nelson Salgado {BIO 19113798 <GO>}

No. There is no different treatment for any investor we will pay the dividends to everyone the same way.

Q - Gabriel Cavalcante

Okay. Thank you.

Operator

This concludes today's question and answer session.

Sorry, the next question comes from Cai von Rumohr. Sorry.

This concludes today's question and answer session and conclude our Embraer's audio conference for today. Thank you very much for your participation. Have a good day.

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