Q4 2018 Earnings Call

Company Participants

- Lorival Luz
- Pedro Parente
- [0BN034-E Lorival Nogueira Luz]

Other Participants

- João Soares
- Lucas Ferreira
- Marcella Recchia

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to BRFSA Conference Call. We would like to inform you that this conference is being broadcast on the Internet at www.brf.br.com/ir.

At this time, all participants are connected in listen-only mode. After the presentation, we will have a Q&A session when further instructions for you to participate will be given. We would like to ask you to please ask one question only.

Forward-looking statements made during this code relating to the business perspectives of the company, projections resulting potential for growth of the company are merely forecasts and they were based on the company's management expectations regarding the future of the company. These expectations are highly dependent on market changes, the general economic performance of the country, of the sector, and international markets, and therefore they are subject to change. I would like to remind you that this call is being recorded.

This call will be presented by Mr. Pedro Parente, CEO; and Mr. Lorival Luz, COO, Executive Global Vice-President.

We would like to give the floor now to Mr. Pedro Parente who will start the presentation.

Pedro Parente {BIO 2058839 <GO>}

Good morning, everyone. We invited you to this call in order for us to talk about our plan operating a financial restructuring plan that we announced in June after at the conclusion of the sale of our operations in Europe and in Thailand.

for the amount of BRL 340 million.

The company de-leverage, which is our priority financial objective, is on a downward trend. Since the third quarter of last year and this year, we will again generate positive cash flow which will bring the operation's contribution, we reached 100% of the initiatives listed in our plan and 89% of our objective for financial result with BRL 5 billion between divestment, the sale of non-core – non-operating assets and working capital and securitization of receivables.

We conclude that all the divestments in Argentina and, of course, some of them have already been signed and other have already been concluded, but we expect to conclude all of them by the end of this month.

And yesterday we signed a contract for the sale of our assets in Europe and Thailand, as we mentioned, for BRL 340 million. These divestitures bring about many positive impacts for the company and, of course, the inflow of cash and the end of non-profitable operations and the release of time and dedication of our management to these operations and a more adequate asset base for our operations and the reduction of depreciations and the other initiatives of the plan. And there, I refer to those beyond the divestituresincluding the securitization of receivables, we reached a global – an overall financial result as – according to the plan.

And as I've said, we closed with 100% of the initiatives already concluded, the one – the plan. And 81% of the financial target with the announcement of the sale of assets in Thailand and Europe of about BRL 1.3 billion, we totaled BRL 4.1 billion as a financial result from the planned initiative. And this financial result has not reached the BRL 5 billion target due to the very adverse conditions in the Argentinian and European markets. And in the case of the European market, relevant uncertainties related – about the conclusion of the so-called Brexit process, that is to say, the exit of the UK from the European community. Of course, everybody is familiar with that.

And our evaluation by our executive committee and the board of directors is to reach 100% of the initiatives and 81% of the financial target established means that the program was quite successful. We've sustained the objective of a downward trend for our net debt/EBITDA ratio, which is as I have already mentioned our main top financial priority.

The result of this program, the financial result together with our comfortable cash position gives us this downward trend in our debt consistent withwhat we said to the market regarding the net maturities of our debt. In the last few months we closed many refinancing operations as well as new loans, leaving the debt service for this year totally under control. The main impact of the financial result, lower by 19% vis-à-vis the plan, is a postponement of about six months in order for us to reach the leverage target that we announced in June that were established for December 31, 2018 and also 2019, having established in our plan a goal of reaching 4.35 times EBITDA at the end of December 31, 2018 and we're talking about the pro forma figure, and about 3 times the 31 of December

2019. And what we see and what we estimate is that these targets will be reached with a lag of about six months.

Now, we estimate that the net database ratio closed 2018 at about five times and that it should close 2019 at about 3.65 times, both in our executive committee and our board of directors. We considered the hypothesis of demobilizing other assets in order to comply with what we had announced in June. But we concluded that with the downward trend of our leverage and the attainment of 81% of our target in terms of financial generation and the comfortable cash situation, and also the debt service for 2019 under control

and the slight delay to achieve the target. A short-term decision of a new divestiture wouldn't be justifiable and it would not be in the interest of the company nor of the shareholders.

And with this trajectory of deleveraging with the operations that we have already announced, we intend to start the second stage of our liability management program in order to extend the profile of our debt and the reduction of the debt cost and with the improvement of our operating results and improvements also in our management, consolidating the impact of these improvements over 2019.

Both our executive committee and the board of directors will be evaluating the scenario on an ongoing basis in order to assure the attainment of the reduction of leverage of the company which is our top priority.

Our long-term goal is to have a net debt-to-EBITDA between 1.5 and 2 times, leaving a certain margin for us to deal with the cyclical nature of our business. Besides our top priority financial targets and significant improvement in our operating results is part of our top focus both of the executive committee and the board of directors, totally complying with our objectives of safety, integrity and quality. And as we disclosed in our strategic plan, we intend to revert the drop of margins in 2019 going towards the historical levels in 2020 and exceed them in 2021.

I would like to ask Lorival to help me giving you more details about this information. And he will do this by referring to the presentation that you already have.

[0BN034-E Lorival Nogueira Luz]

Good morning. I would like to draw your attention to the presentations that we made available on our website. And first, I would like to go to page number 2, and the objective is to give you a retrospective and what led us to disclose the plan of BRL 5 billion. And going back in history, going to the first half of 2018, when we had the impact of the restriction regarding our exports to Europe and also the exports to Russia, that happened at the end of the previous year that also the impact of the plans for China.

And this caused an imbalance between supply and demand. And this led us to adapt our structure in our production units, closing some of the units as we have already disclosed, and also some impact on our head count and the restructuring of some production lines.

And beside that, in the first half, we had also the impact of the truckers strike. And all these factors caused the negative impact on the company's results.

On July 29, we published a monetization plan that included the Argentina operations, as well as Europe and Thailand, the sale of assets, other initiatives regarding working capital and securitization of receivables.

And going to the next page, page number 3.

I would like to give you some details. And as Pedro said, 100% of our initiatives have already been put in place and with an amount that was lower as our target, which was BRL 5 billion. And we reached 81%, but they were all concluded. And even in spite of these adverse and some other situations that occurred recently such as all the instability brought about by Brexit situation, we concluded the total divestment of all our units in Argentina.

We have already published that, and the signing has already been done and the closing of the operations have already been carried out. And for the next 30 days we will have the closing of (00:12:47) and with the conclusion of our divestment in that country.

We signed Europe in Thailand yesterday and over this period we made many divestments in real estate on non-operating assets and minority stakes and we are ready tackling this. And in working capital – and I will be detailing of this in the next slide – there was a significant improvement and that not only brings us benefit regarding cash but also the operating management and the costs themselves. And we will have these benefits over the whole year of 2019, and we successfully concluded the receivables investment fund at the end of December (00:13:38).

On the next slide, slide number 4, you can see the details of these amounts

where we have this gap between realization and the expectation was the divestment of assets in Argentina, Europe, and Thailand due to the adverse positions of the macroeconomic scenario and the situation in Argentina, which generated uncertainties and a degree of complexity in the transaction itself, given the structure that we had in Argentina with many different business lines that included since a beef and swine and pork, chicken and margarine, etcetera.

So together with the macroeconomic situation of Argentina, generating a reduction in the appetite of investors. But in spite of all that, we were able to conclude this divestment in Europe and Thailand. Also because of the uncertainties, while we were negotiating the final point, a big uncertainty regarding not only Brexit, but this – and that is quite relevant, but also in the quota regime of Europe, of the European Union and the commercial relationship that Europe could have with the other countries, vis-à-vis our segment.

So with all these adverse factors, we were able to conclude our transaction. And it is important to highlight the sale of assets that have already – we have already had BRL 240 million of cash inflow and the working capital and the reductions that we carried out have already brought about benefits over the last quarter of the year and this benefit will be detailed on February 28, when we publish our results and the securitization of receivables.

results and the securitization of receivables.

And the conclusion of this very important stage brings about many benefits, the cash inflow and the closing of the non-profitable operations mainly in the second half of last year and the first half in Europe. We still had shipments of the first quarter and the merchandise had already been shipped and we were able to make these sales within the second half of 2018.

We already had a negative EBITDA in this context of what we call discontinued operations, which is the way you will see this described in our balance sheet on February 28 because we have already signed the sale process. So we have this cash inflow and also the reduction of the negative EBITDA.

Another important factor is the reduction of complexity of management releasing both the time and the dedication of our team in order to focus on what we consider more important, the Brazil, the Halal market and the chicken export market, which is the focus of the company.

Just to give an idea, in these divestments that we announced, we will be – have 13,000 people that we will no longer be managing. So this brings about a reduction in our complexity, and of course, the asset base becomes more adequate. There is a reduction in depreciation that has a direct impact on our net income and besides with this cash inflow, we have

the payment of our debt that will be made and thereby reducing the financial expenses of 2019.

On the next slide, slide number 5, it is important to make clear to you what we are talking about and that we are calling our trajectory. You can see since 2015, the initiatives and the deterioration of – the operation deterioration mainly because of the increase in the cost of grains and also the cost of production vis-à-vis commodities and also the effects of the external market and the payment of dividends and the buyback of shares and the acquisitions that we made during this period, you have an increase in our leverage, and in the third quarter of 2018 reached 6.74x.

And now what we estimate for the end of 2018 pro forma because we are including the inflow of funds in the first and the second half of this – quarters of this year, we so estimate to 5 times. And for the end of this year, 3.65x is our target. This means that a postponement of about six months, vis-à-vis our original plan in terms of deleveraging. But we are very comfortable and we are very firm in the trajectory that we are building for this year in some details that give us comfort regarding this trajectory.

On slide number 6, I would like to highlight the debt profile of the company. Part of these initiatives have already been carried out at the end of last year. And including this, we will be publishing our balance sheet with cash around BRL 7 billion which is quite sound, quite strong. And refinancing and other operations already in 2019 – and already quite under control.

And now we have the beginning of the second stage of our liability management that will be extending the debt profile for 2020, 2021, and 2022 because in 2019 as you will see in the next slide, we have about BRL 4.2 billion concentrated in the first half of the year. And the message here is the following. The trajectory that we have in terms of deleveraging and our operating results and the inflow of cash from these divestments makes the company very comfortable in terms of not needing additional cash in 2019.

And mainly now that we have Ivan Monteiro on board, and you all know him very well, and I do not think I have to mention all his qualities and also his experience in liability management in Petrobras and the relevance of all his achievements. So his first challenge, his first task will be to work hands-on on liability management for 2019, 2020, and 2021 to extend our debt profile

in order to bring even more liquidity to the company. And given the divestiture of these assets, that would bring in about a negative cash generation, the expectation that we have and what we are planning in terms of free cash flow generation for 2019 is positive. So together with what we are doing, this helps us to further reduce our leverage.

Now going to the next slide, slide number 7, and making it clear the way we are doing this and with a lot of transparency and there is no additional cash need for the company over 2019. Our focus will be on liability management, only mainly with the coming onboard of Eva (22:33). So about BRL 7 billion in cash and some funds of the receivables investment fund, the FIDC, and investors have already contributed, but this has not happened up to December. So this will be in our cash in January. So we have the transactions that were signed over January and they will be coming in in the first and the second quarters.

So in blue, you can see what is being built in terms of cash, and 100% of our debt that matures in 2019 plus the refinancing that have already been signed and contracted and that are being done in the first quarter of this year. We will be closing our cash for 2019 with about BRL 5.8 billion, also higher than the minimum necessary cash that we need in order to – which is about BRL 5 billion in order

to have the adequate management. So it's a very robust cash position. And this is why we are saying that we will not need to make any additional divestments in order to have this robust cash position in our trajectory for deleveraging reaching 3.65x by the end of 2019.

And on slide number 8, we have a summary of the effect of this context that we have for 2019 that reinforces our trust in the initiatives and the result. We have reinforcement of programs that are fundamental principles with safety, quality – integrity and quality. The benefits that will be captured and a strong reduction in the level of inventory of raw materials and frozen raw materials, and that bring about not only a positive effect on our cash but also in our expenses regarding our operations. And we also have and we'll have the benefit of all the adjustments that we made last year regarding balancing supply and demand.

And likewise, we have a price level for chicken and for pork. And if you look at the ESALQ level where you have all the details for pork and chicken, you can see that the price this year is 50% higher in the case of chicken than when we had this impact last year in March and May of last year. And likewise, pork given the effect of Russia. So it already has an increase of 20%. Brazil of course, we expect growth in our GDP that could generate and has the opportunity to generate internal demand

- a higher domestic demand in BRF with these products and with its coverage, is more than prepared in order to tap into all these gains. And we have the management initiatives that are also being implemented. The Operational Excellence System covering all our production lines, all our initiatives are being implemented and the results will be captured over 2019 and 2020. So we see these results being tapped in and we have focus on commercial improvements that are being implemented.

OTIF and other, beside the evolution of our process, management process of the company with the implementation of ZBB and the PMO that we are also carrying out, and also MBG, Management by Guidelines.

And then go into the last slide, these reinforces and gives us consistency regarding what we published regarding our strategic plan that 2019 is a year of change of reversal in our drop in margin and that 2020 we'll be going up to the historical levels of margins. And as of 2021, we intend to be above historical levels of margins with consistency of our initiatives and our long-term view in order for us to build the results of BRF continuously, sustainably and growing profitably.

So this was the message that we wanted to convey to you. And now we would like to open for questions.

Q&A

Operator

Ladies and gentlemen, will now start the Q&A session.Operator: Our first question is from Lucas Ferreira from JPMorgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Good morning, everyone. I have two questions, but I will ask only one and ask the other one at the end if we have time. My question it this, you did provide us a good update on the business so far up to the divestiture plan. I would like to hear from you from two different angles. Do you have room for a better domestic market in 2019? Do you see a room for improvement in prices and margins in addition to what you already mentioned?

And also, on the international side, we have seen China removing the anti-debt measures they had for some Brazilian products. And I would like to know if you have room for better talks with Europe to reopen that market to you some time during this year? Thank you.

A - Pedro Parente {BIO 2058839 <GO>}

Okay. I will answer part the question and I'll allow Lorival to make his comments as well. About the international market and especially China, and also if we consider the Asian flu – the Asian bird flu actually, we are in contact with the authorities so that in the moment and the right time we can seize this opportunity. As you all know, There is a work that list the plants. We have had an excellent conversation with the new Ministry of Agriculture team. And they do know about the needs to operate with this listing process of our plants in a way that is as fast as possible. That's not something that we can do by ourselves, that there's a joint work done with the authorities. But in our situation, in our case, we are ready. When that happens, we'll be able to make the most of it, the most of the situation.

Saudi Arabia, as we have already mentioned, we have there a plant listed to – that are enough to meet the demand of that country. We need to make a few adaptations in our plants. And as we have already announced, those could take three months after the date of that announcement. But we expect that we could bring down that period of time. This is not a commitment, this is not guidance, but we are working with these initiatives so that we can start shipping again at least to the past levels. And we expect to increase them as well.

Now, about Europe, we do have that understanding that it would be needed to go back to exporting to them. We do know that the Ministry of Agriculture also wants to act faster, but once again, it's not in our hands. And we do hope that this happens and as we said last year, and at that time, we believed thatat least two years would be needed so that we would have a positive sign. And I hope these two years do not take that long. We expect that this period of time is shorter.

About the domestic market, Lorival is going to help me.

A - Lorival Luz {BIO 16180455 <GO>}

Lucas, let me add to that. Yes, we do believe we have a positive expectation about the domestic market. We see that prices started the year in a more robust fashion when compared to the impacts that we had in grains in the past year. So I believe that we start the year at another level.

And also, another aspect that is very important and we have to do our management in a balance of supply and demand, not only for Brazil but also for the international market. And there, we will find the impacts of the African swine fever that once again, could have an impact and there is nothing to find yet. But that could be impacting the demand in China obviously, also considering the consumption of Chinese.

And now, differently from the situation that we had when Russia closed the imports, the market and ourselves are not working with a high level of supply. So what tends to happen is once again to have a balance between supply and demand and that is going to be happening in scarcity management and also in a pricing packed on the light side of the demand.

And then, in the positive side, as it happened with Russia, we had a lot of supply that was abruptly interrupted. So in that scenario is totally from the swine.

And another point, Lucas, that you should highlight is that over this year, we do have a benefit. You have seen that in December of last year, we have concluded once again the merging and the integration of an entity that had been created of One Foods into BRF. The company was called in Brazil SHV. This company over the year was a separate company, separate from BRF and it did have its deficiencies operating and tax wise and we concluded the process at the end of 2018 in a way that the benefits of that transaction will be seen in 2019.

Q - Operator

Thank you very much.

Our next question is from João Pedro Soares from Citi.

Q - João Soares

Good morning, everyone. I have two questions. The first one is about working capital. Do you believe the room this year, two years more working capital considering that you are increasing your policy to retain grains and increase inventory levels?

And second would you be able to unlock that working capital but do you have an expectation to generate organic cash this year and this target of 3.5%? Is there any possibility of generating organic cash?

A - Operator

Good morning. About the working capital for all the lines, the company will follow working with severity there. And for 2019,considering the initiatives from 2018, we will not see a gain in cash as we had in 2018. So it's not – our cash generation is not going to come from working capital. It will come in an organic fashion, in free cash, and coming from a better operating result thanks to the initiatives that we are rolling out, also coming from a severe discipline in our CapEx, and not maintenance CapEx but the CapEx needed for the company and the lower investments in new units or expansions. This is going to be done very rigorously because our objective is to deleverage and also bringing down our debt. And in consequence we will have a lower expenses with these data (36:31) in the longer term. And yes, then there we expect a positive free cash flow over 2019.

Thank you, Lorival. Thanks.

Next question is from Marcella Recchia, UBS.

Q - Marcella Recchia {BIO 19113462 <GO>}

Good morning, Pedro and Lorival. Thank you for this opportunity. I have one question about investments. You say that you expect to reverse the margin drop in 2019 to reach a historic level in 2020, and go over that historic level in 2021. What level of investments do you believe will be needed so that you can meet that target?

A - Operator

Well, in regards our organic CapEx it is already forecasted in our projections for these three years. We understand that we should have inorganic initiatives that is structural growth initiatives by acquisitions or partnerships, as we have already mentioned, especially in Saudi Arabia and Turkey.

If we are to do that only with our own funds, yes, in fact, we should wait for 2021. But we do understand it's possible to think especially by the means of partnerships and to anticipate those project. And so, we are open for that. And Patricio who is our international officer, he is really working on opportunities and initiatives that might benefit the company in a no-cash-deal vision to anticipate this initiative.

So in terms of CapEx, in summary, what is organic maintenance CapEx and plant improvements that we need to make for instance in order to enable our plants to export to Saudi Arabia. These are already contemplated in our projections. And for those that are inorganic and that depend only upon us, they will happen starting in 2021. But we are working to try and anticipate that by the means of partnerships.

Let me understand that better. For these three years of CapEx, do you see an increase in investments for these next three years?

A - Pedro Parente {BIO 2058839 <GO>}

Well, we do not have any estimates for investments that are not, as I mentioned, in the – that are not in our maintenance CapEx and operating improvements. This is what we have planned in our CapEx curve. I don't know if Lorival wants to add anything.

A - Lorival Luz {BIO 16180455 <GO>}

Yes, Marcella. I think that's it. The main objective of the company is deleveraging. So we will be monitoring that over the next few years. And then, if there is a possibility of doing anything that is inorganic or some opportunity that comes up, we can always consider that – seeing it that this is not going to change the deleveraging trajectory of the company, which is our main priority right now, without letting go of any other opportunities that might come up.

Operator

Our next question is from Lucas Ferreira.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Pedro and Lorival, I would like to know if you have any updated estimate of how much EBITDA all these assets that you have sold should you have in an annual basis. You said that Argentina was losing money, it was a negative EBITDA. What about Europe and Thailand? I remember that – in the last year you talked – you said that these assets would represent around 10% of 2017's revenue. I'm not sure if this was the figure, but I would like to know if you have an updated estimate of how much Europe and Thailand will remove in terms of EBITDA of the company. Thank you.

A - Operator

Lucas, let me give you an idea of what you will see when we publish the balance sheet of these discontinued operations. In the top line and then I'm talking about revenue and volume, these operations that we are selling, they have an impact in reducing our top line in 11% to 13%. Now when we turn to our EBITDA, the impact is much lower, it's a reduction of 5% to 6%. So you can see that we lose revenue but these are operations that are not that profitable. And they are profitable and they had a very positive result in the first quarter of last year, especially in the first quarter of last year when we had all the shipments to Europe running at 100%.

So what I can tell you was that basicallySo what I can tell you is that basically, almost 80% of the results that these units had throughout 2018, the results came basically from the first quarter of this year, and especially Europe.

In the second half of the year, they had a negative EBITDA. So the consolidated of those operations for the second half of the year was negative. And considering the market conditions, both for Argentina and also the situation in Europe, and the challenge we face in Thailand with the grain prices that they have in that country, that was something that we were also facing 2019.

So to annualize it, to do – If we work with 2018, we have to separate the results from the first and second quarters, the negative results of the second half of the year which would be the situation that we would face in 2019 anyway.

Thank you, Lorival. It's very clear. If you allow me another quick question. Pedro, you talked about the perspectives on the European market. Well, when you're selling Invicta Foods, then I believe that is important for your logistics and to have access to that market. How do you expect to go back into Europe? Which distribution channels will you be using? Do you think this will hurt your strategy? When you need to go back to the European market, how are you going to do that without having Invicta?

Well, what is important here is that in this agreement with Tyson, we also have an agreement of supply which is good for both companies. Because Brazil and BRF

have a competitive advantage in the quality of the products and the cost of the products as well, and for Tyson to have access to these products is also important so that they can use that fully in the operation that they have acquired.

So we have here, although we have sold that, we developed a partnership relationship that is very strong with Tyson and it allows us to have access to the market by Tyson's operations. And if we did not have that demand coming from Tyson, we can also use other channels.

So the way that the transaction was held, it was positive to both companies and it allows us to have that type of access to the market.

Thank you very much.

Now the Q&A session is closed. We would like to get the floor back to Mr. Pedro Parente.

A - Pedro Parente {BIO 2058839 <GO>}

We thank you very much for your attention. And our investor relations department will continue to be at our disposal should you have any additional questions. And I would like to turn the floor over to Lorival for the closing remarks.

A - Lorival Luz {BIO 16180455 <GO>}

Thank you very much. And I would like to say that we will be publishing our balance sheet at the end of February, more precisely on the 28th of February. And we will also be giving you details about the

discontinued operations, the operations that we have already sold and signed the selling contracts and all the accounting effects regarding the write-off of these assets and also the impacts on the company's net income will be tackled in this balance sheet.

And the investments made before and over the years have an impact regarding the goodwill that has been accumulated and also the impact of translation regarding the currencies, and that will generate impact as a negative impact in the result of the discontinued operations that will be published at the end of February. So I wanted to mention this so that you may pay attention to this material that will be published in detail.

Thank you very much, everyone.

Operator

BRF SA conference call is closed. Thank you very much for participating and we wish you a good day.