

Q2 2020 Earnings Call

Company Participants

- Marcos Antonio M. dos Santos, Chairman
- Miguel Gularte, Chief Executive Officer
- Timothy M. Klein, President, Chief Executive Officer, Director
- Unidentified Speaker

Other Participants

- Andre Hachem, Analyst
- Benjamin M. Theurer, Analyst
- Isabella Simonato, Analyst
- Joao Soares, Analyst
- Lucas Ferreira, Analyst
- Luciana Carvalho, Analyst
- Thiago Duarte, Analyst
- Victor Saragiotto, Analyst

Presentation

Operator

(foreign language) Good morning, everyone, and thank you for waiting. Welcome to Marfrig Global Foods S.A. Second Quarter of 2020 Results Conference Call. With us here today, we have Mr. Marcos Molina, Founder and Chairman; Tim Klein, Chief Executive Officer of North America Operation; Mr. Miguel Gularte, Chief Executive Officer of South America; Mr. Tang David, Chief Financial and Investor Relations Officer; Mr. Rafael Braz, Investor Relations Director; and Mr. Paulo Pianez, Sustainability Director.

This event is being recorded. (Operator Instructions) This event is also being broadcast live via webcast and may be accessed through Marfrig website at <https://ri.marfrig.com.br/>, where the presentation is also available. Participants may view the slides in any order they wish. The replay will be available shortly after the event is concluded. Those following the presentation via webcast may post their question on our website. They will be answered by the IR team after the conference is finished.

Before proceeding, let me mention the forward-looking statements are based on the beliefs and assumptions of Marfrig Global Foods S.A. management and on information currently available to the company. They involve risks and uncertainties because they relate to future events and, therefore, depend on circumstances that may or may not occur. Investors and analysts should understand the conditions related to macroeconomic

conditions, industry and other factors could also cause results to differ materially from those expressed in such forward-looking statements.

(foreign language) Now, I will turn the conference over to Mr. Marcos Molina. Mr. Molina, you may begin your presentation.

Marcos Antonio M. dos Santos {BIO 15363967 <GO>}

(foreign language)

Timothy M. Klein {BIO 16522695 <GO>}

Thank you, Marcos. Good morning, everyone. Please move to Slide Number 5. In the second quarter of 2020, National Beef posted net revenue of \$2.7 billion, up 19% from a year ago. The coronavirus pandemic significantly impacted our business in the quarter. Unprecedented employee absenteeism due to COVID-19 positive test results and pandemic-related fear resulted in the temporary closure of our Iowa plant for two weeks in April and a significant reduction in throughput at both of our Kansas plants during late April and May. Similar impacts were felt across the entire U.S. beef packing sector, with industry-wide capacity utilization falling to nearly 55% by early May.

For the quarter, industry slaughter was down 17.2%. During the same period, our slaughter was down 14%, allowing us to gain market share in the quarter. The rapid and unexpected decline in slaughter led to significantly lower demand for live cattle, causing a decline in prices. It also led to a much lower supply of beef products, which resulted in a sharp increase in boxed beef prices during the quarter. With seasonally strong demand during this time of the year and the limited supply, boxed beef prices nearly doubled in mid-May.

Now, please move to Slide 6. The decline in cattle prices and the increase in boxed beef prices during the quarter resulted in a significant expansion in the cutout ratio and industry margins. For the quarter, we posted a record adjusted EBITDA of \$635 million, up 170% from a year ago. These results include \$48.5 million of additional expenses directly related to the coronavirus pandemic. Most of the increased expenses are related to temporary wage increases and the tenant's bonuses designed to encourage healthy workers to report back to work.

The strong results for the quarter reflect our team's strength and our ability to effectively navigate through an extremely difficult environment. We believe our results for the quarter are among the best in the industry. As we move into the third quarter, industry slaughter rates and margins have returned to pre-COVID levels. However, due to the reduced slaughter levels in the second quarter, it is estimated there are approximately 700,000 head of cattle backed up on ranches and in the feed lots. With the industry already running at full capacity, this should provide ample supplies of cattle for the second half of 2020 and well into 2021.

Our top priority continues to be the safety of our employees. We're diligent in our efforts, not only in providing a workplace environment and the safety equipment needed to

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protect them from exposure to COVID-19, but also in seeking out best practices across the manufacturing industry. We believe the steps we have taken so far have been effective. At present, we're only experiencing a handful of positive COVID cases in our plants each week, with no impact on throughput or efficiency.

Now, I'll pass to Miguel. Thank you.

Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Unidentified Speaker

(foreign language)

(foreign language)

(foreign language)

Questions And Answers

Operator

(foreign language) Thank you. The floor is now open for questions. (Operator Instructions)

(foreign language) Our next question comes from Mr. Andre from Itau.

Q - Andre Hachem {BIO 20209966 <GO>}

(foreign language) Hi, Tim, thank you for taking my questions. I'd like to ask -- my first question would be in regards to second half of this year. So during this quarter, you had exceptional results. You had a lot of cattle availability, which drove to lower prices and you had higher meat prices. How do you see the outlook for the second half of this year? So how should we think firstly about cattle availability looking for the second half of this year? And then, secondly, how should we think about meat prices? We're seeing the industry going back to normalized levels. Recession could be around in the U.S. So how should we think about the outlook for the second half of this year?

A - Timothy M. Klein {BIO 16522695 <GO>}

Well, first of all, the industry in the U.S. came back to full capacity by the end of June, first part of July. So the margin spread, the cutout ratio became more normal for this time of year. As I look at the second half of the year, I would look at last year's second half, and that would be what we would call normal although we did have a Tyson fire in there that impacted results for a few weeks.

The one thing that's different this year, though, in the second quarter, there's 700,000-plus cattle that did not get processed, that will be backlog. That will add to the supply that

was already projected for the second half of the year. So we will -- and it will take six months to a year to work through that because of our industry is already operating at full capacity.

Beyond that, looking at the overall beef demand, what we found in past recessionary cycles is the demand for beef continues to be strong. The consumer chooses to buy the cheaper cuts, the chucks and the rounds and less of the middle meats. But overall, the cutout level and profitability for the factor is not impacted all that much.

Q - Andre Hachem {BIO 20209966 <GO>}

Perfect. Very clear. And congratulations on the historical results. (foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Andre Hachem {BIO 20209966 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Andre Hachem {BIO 20209966 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Andre Hachem {BIO 20209966 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Operator

(foreign language) Our next question comes from Mr. Lucas Ferreira from J.P. Morgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

(foreign language) So Tim, my first question is to you. So I wanted you to discuss, if possible, how you see the profitability of your cattle suppliers? We discussed this during the peak of the crisis and we knew that the profitability of the ranchers were quite impacted by COVID. So wondering how sustainable it is right now, if you can comment on

this. And then, also on more sort of needs to long-term discussion on the cattle cycle, which point we are right now, some of the indicators of this sort of cycle indicators are showing that there might be some reduction in the cattle availability more towards, let's say, next year or the year after. So I'm wondering if you can comment on how long this cycle could last and how long could we see margin going back to sort of a long term level? (foreign language)

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A - Timothy M. Klein {BIO 16522695 <GO>}

Okay. First of all, to answer the first part of that question, the segments of our industry, the first segment is the cow-calf operation, the ranchers. Although calf prices did decline, they are still profitable at the cow-calf level. So there is no incentive for them to liquidate their herd beyond what they normally would. So we don't see any impact because of COVID on the liquidation of the cowherd or sending heifers to the plants. So that remains intact. The segment most impacted by COVID was the feedlot sector, where we saw a decline in cattle prices that they felt the brunt of. As we paid less per cattle, they were hurt there. Those cattle turn over every 150 days or so. And replacement margins right now are much, much better. And in fact, cattle prices have recovered fairly significantly from the lows mid-May.

So overall, we don't see any change to the overall cattle cycle. Everything that we look at still points to peak supplies in 2022. The situation we have right now with the 700,000-plus cattle that need to be processed is going to just continue to roll forward. It will take us many months to work through that backlog of numbers. And again, that should provide some tailwind for margin structure for the packing industry.

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Lucas Ferreira {BIO 16552031 <GO>}

Thank you.

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

A - Timothy M. Klein {BIO 16522695 <GO>}

I might add to that a lot of cattle feeders hedge their cattle when they put them in the feedlot and the hedgers did very well during this time period because we had a very favorable basis that that provided protection for them, and in fact they would have netted profitable numbers on the cattle even at the low point in the price.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Thanks, Tim. (foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Lucas Ferreira {BIO 16552031 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Operator

(foreign language) Our next question comes from Mr. Ben from Barclays.

Q - Benjamin M. Theurer {BIO 17248534 <GO>}

(foreign language) And good morning, Tim. So my Portuguese not good enough. So I'll keep it with questions for Tim. So first of all, congratulations on the results during the quarter. So wanted to go back and look a little bit on the overall protein industry in the US and get a little bit of your sense, what you've been seeing in domestic demand within the different proteins where you compete with and on the export markets? Because it seemed like you gained some relative share on the export market, at least with volume going higher, but the industry actually going lower. So if you could share some additional color about your export markets and what's the benefit of it.

And then looking a little bit beyond 2020 and the benefits you've mentioned about the 700,000 cattle somehow backlogged. What would you expect in terms of a new normal from profitability for beef, just considering that the industry has not been adding capacity and is unlikely to add capacity? So should we assume there's going to be a new normal beyond what was the disruption of 2020?

A - Timothy M. Klein {BIO 16522695 <GO>}

Well, to answer the first part of your question, we've seen lower prices for competing proteins, pork and poultry, in the U.S. It has not affected demand for beef at the counter. So we feel like beef somewhat resilient to competing proteins, competing meats. Retailers love the feature beef, brings customers in the stores. So we don't really feel the impact of cheaper-competing proteins in our market.

In terms of the overall outlook on industry, I believe that, as we've talked before, because of the relationship that we have today between supply of cattle and capacity to process those cattle, with no new capacity coming into the industry, I think we would move to a new level. And we've talked about that. The industry would move to a new level on profitability compared to other cycles that we've had in the past.

So, as we look at it, we don't think the COVID is going to have any impact in moving to a different plateau on margins other than the impact of these additional cattle that our backlog will have on at least for the next six to 12 months.

Q - Benjamin M. Theurer {BIO 17248534 <GO>}

Okay. And on the export side?

A - Timothy M. Klein {BIO 16522695 <GO>}

Exports -- for us, our primary markets are Japan and South Korea. We look at the export markets as value add. So we sell products that we can sell for more in those markets. And there are a lot of products that -- they don't bring the same level of demand here in the US. So we have not seen any change from any of our customers in either of those countries during this COVID pandemic. They continue to buy month in and month out just as they always have and follow the market up and down.

Q - Benjamin M. Theurer {BIO 17248534 <GO>}

Okay. Perfect one, Tim. Thank you very much and (foreign language).

Operator

(foreign language) Our next question comes from Mrs. Isabella from Bank of America.

Q - Isabella Simonato {BIO 16693071 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

A - Unidentified Speaker

(foreign language)

(foreign language)

Q - Isabella Simonato {BIO 16693071 <GO>}

(foreign language)

Operator

(foreign language) Our next question comes from Mr. Joao Soares from Citibank.

Q - Joao Soares {BIO 17386703 <GO>}

(foreign language) So Tim, you mentioned that you see peak supplies going all the way to 2022, and you see limited possibility of new capacity going into the market. So I'm just wondering maybe what could be the growth alternatives for the North America business. Is it strictly going into non-organic once you have all the balance sheet equation, which is similar and only minimum leverage? So I just wanted to understand if now maybe you're thinking about going more into focus on growth again? (foreign language)

A - Timothy M. Klein {BIO 16522695 <GO>}

In terms of -- do you want me to answer? Hello?

A - Miguel Gularte {BIO 20767495 <GO>}

Yes. Yes. Go.

A - Timothy M. Klein {BIO 16522695 <GO>}

Okay. Our strategy on acquisitions has always been to really focus on what our core business is, which is beef processing. That's what we're really good at. So we're not going to get too far away from that. So we look at businesses that would allow us to add value to some of the products that we have -- that we sell as commodity today. For example, TRIM, where we would look for opportunities to perhaps build a ground beef facility to produce patties and bricks and so forth. So we're looking at those types of expansion opportunities. Another one would be case-ready where as retailers move to that, take labor out of the back rooms, that would be an area that would fit perfectly with our strategy. So we're always looking for opportunities like that. But again, we're not going to get too far away from what our core business is.

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Joao Soares {BIO 17386703 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Operator

(foreign language) Our next question comes from Mr. Thiago Duarte from BTG Pactual.

Q - Thiago Duarte {BIO 16541921 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

A - Marcos Antonio M. dos Santos {BIO 15363967 <GO>}

(foreign language)

Q - Thiago Duarte {BIO 16541921 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Operator

(foreign language) Our next question comes from Mr. Victor from Credit Suisse.

Q - Victor Saragiotto {BIO 19504427 <GO>}

(foreign language) (technical difficulty) all the cattle that was, let's say, not slaughtered in the second quarter, obviously, increases the availability of cattle for the coming months. Margins are super strong and remains in a good shape in July, in August as well. One of the reasons that we heard in the past that we didn't see new capacity entering this market was related to high unemployment rate. Now the unemployment rate in the U.S. is higher, right? So first question is, do you -- let's say, is it a concern for your new capacity entering in this beef market?

A - Timothy M. Klein {BIO 16522695 <GO>}

We pay close attention to that. We do not see any new capacity coming into the industry. There's two major hurdles. Number one, as you said, is the labor availability. That's one issue. And as -- long term, that's always been a significant issue for our industry. The second is finding a community willing to allow a packing plant to come in, given the issues with environmental and so forth. And the third is just the cost to build a facility. To duplicate an efficient operation like one of ours would cost \$750 million to \$900 million. So it just -- and the timing would be -- at this point, if you started today, it'd probably be three or four years before you're processing cattle. And you're going to be in the other side of the cycle at that point. So we just don't see that as a risk.

Q - Victor Saragiotto {BIO 19504427 <GO>}

Thank you. Tim. (foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Victor Saragiotto {BIO 19504427 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Operator

(foreign language) Our next question comes from Mrs. Luciana from Banco do Brasil.

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Q - Luciana Carvalho {BIO 18724665 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Q - Luciana Carvalho {BIO 18724665 <GO>}

(foreign language)

A - Miguel Gularte {BIO 20767495 <GO>}

(foreign language)

Operator

(foreign language) Excuse me. This concludes today's question-and-answer section and does conclude Marfrig Global Foods S.A. conference call for today. Thank you very much for your participation, and have a nice day.

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