

Q4 2017 Earnings Call

Company Participants

- André Luís Rodrigues, Managing Director Financial Superintendent
- André Meneguetti Salgueiro, Manager-Investor Relations
- Paulo Geraldo Polezi, Finance and Investor Relations Executive Officer

Other Participants

- Alexandre Pfrimer Falcao, Analyst
- Felipe Vinagre, Analyst
- João Noronha, Analyst
- Lucas Marquiori, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen and welcome to WEG's Fourth Quarter 2017 Results Conference Call. We would like to inform you that this conference call is being recorded and all participants are in listen-only mode. Ensuing this, we will conduct a question-and-answer session when further instructions will be given to participate.

We are simultaneously webcasting this conference and the accompanying slides at our site ir.weg.net. A reminder, we are recording this conference and after the conclusion, the audio will be available at our IR website. Journalists should direct their questions to the press office at the number 47-3276-4295.

Any forecast contained in this document or statements eventually made during this conference relating to WEG's business perspectives, projects and operating and financial goal, and WEG's potential future growth or management beliefs and expectations and are based on information currently available. These statements involve risks, uncertainties, assumptions and they depend on circumstances that may or may not occur. Investors should understand that the general economic condition, industry conditions and other operating factors may affect WEG's future performance and lead to results that differ materially from those expressed in such forward-looking considerations. We would like to remind you that this conference call will be conducted in Portuguese with simultaneous translation into English.

With us today in Jaraguá do Sul, we have Mr. André Luís Rodrigues, Managing Director Financial Superintendent; Mr. Polezi, IRO and CFO; and Mr. Salgueiro, Investor Relations Manager.

You may proceed, Mr. Rodrigues.

André Luís Rodrigues

Hey. Good morning to all of you and it is a pleasure to be with you to release the results for the fourth quarter 2017. We have now once again reported a double-digit operating growth 12.5% in the consolidated results; 10.2% in the foreign markets. In the domestic market we continued to observe a recovery of a short-cycle products especially in agribusiness and consumption. The long-cycle products had a demand that is below expectations.

The recognition of the revenues of an important solar energy project has contributed to the growth of revenues in the fourth quarter 2017. In the foreign market we observed growth in all regions for the short-cycle products. There is an increase in projects for long-cycle in South America, United States and Australasia and additionally the consolidation of the new transformer business in the USA has helped in consolidating revenues.

We also have an EBITDA margin of 14.1%. We attempted to preserve our margins and returns to guarantee our competitiveness in the long-term and this would have happened were it not for impacts on our margins this quarter. The first impact was in the USA Transformer company, structural adjustments and the processes that we have been implemented since the acquisition. That will also better results throughout 2018.

This impact is normal and considered during the time of acquisition. There was another important impact in South Africa, the low performance of some project, for example, EPC compromised our results for the quarter and the participation of new businesses, especially solar energy have caused greater pressure. It is important to remember that this is a business that is still maturing, it has an attractive return on investors' capital but lower operating margins. Were we to eliminate those results, the margins of 2017 would be similar to the third quarter 2017.

The third highlight is the ROIC growth. We reached 15.4%, the best performance in the last eight years. These results are thanks to our better operating performance during the year and a very careful use of our capital.

We go on to slide number 4, where we have more information on the return of invested capital, with the result of 1.7 percentage points vis-à-vis 2016. The growth of our operating profit after taxes results on a growth in revenue, the control of expenses and an improvement in the other non-operating accounts. This has led to a very good years' of capital employed, that is necessary to allow for our growth. We needed more working capital and for the investments carried out in PPE during 2017.

I would now like to give the floor to Mr. Polezi, who will continue with the presentation.

Paulo Geraldo Polezi {BIO 19468811 <GO>}

FINAL

Hey, good morning to all of you. We go on to slide number 5 to show you the performance in the different business areas. For the first time, we observed a growth of revenues in all areas in terms of electro, electronic and industrial equipment, a better demand in Brazil has been impacted by the short-cycle products. We're selling the OEMs besides having clients that are now changing their obsolete engines with a view to improve their energy efficiency.

GTD had has a highlight, the solar energy that became ever more important in 2017. We had two important solar farms as part of our portfolio, part of the revenues were recognized in 2017 with a positive impact in motors for domestic use. The combination of low inflation, low interest rates and an increase in consumption allowed further growth in several areas especially in the durable goods, the white line, reinforcing our revenue for this quarter.

The performance of paints and varnishes continues the performance of consumption growth and industrial equipment with an intensification during the last quarter. In the external market, there has been a growth of revenues in all areas except for motors for domestic use. We compare ourselves with a very strong quarter in 2016. In industrial electronic and electro equipment everything was given first to by the short-cycle products for construction of new plants and a demand for long-cycle products are beginning to appear especially in pulp and paper and infrastructure.

In GTD, the growth of revenues was boosted by the new industry in the United States, WEG Transformers USA contributing with revenues of BRL 84.4 million during the quarter. In paints and varnishes, the increase in revenue reflects that search for new clients especially in Latin America with products that already are consolidated in Brazil. As André mentioned, we have a continuous focus on preserving our margins and return to guarantee our competitiveness.

In slide number 6, you see the evolution of EBITDA in the fourth quarter 2017. The growth of cost was greater than the growth of revenues explained by what was already mentioned by André. EBITDA had a growth of 6.1% vis-à-vis the fourth quarter 2016 and we had a 14.1% EBITDA margin. It is important to highlight that were we to eliminate those affects, the margins will be very similar to those we had in the third quarter 2017.

In slide number 7, we show you our financial results BRL 6.6 million negative. This result was impacted mainly by the lower interest rates that we observed throughout the fourth quarter 2017, as you can see in our yield chart. We also had an impact of BRL 10 million referring to the rate for the settlement of an old financing line with cost above the yield of our financial applications. This work was done and we maximized our financial results in 2018, although the impact was negative financially, the reduction of interest tends to be very positive for the company business as it reflects a more stable economic environment, a greater trend towards consumption and more industrial investments.

In slide number 8, we analyze our cash flow. Our cash flow generation reached BRL 1.290 million (sic) [BRL 1,290 million] (00:10:11) during the year in our operating activities. Cash generation despite this was below the results in 2016 because of the use of working

FINAL

capital in 2017. This is a natural procedure. Even with an increase in value we had an improvement in all of our items. In investments, we consumed BRL 382 million for the quarter to optimize our productive capacity and finally financing activities consumed BRL 1.153 million (sic) [BRL 1,153 million] (00:10:47) during the period. So we are in a greater flow of payment of dividends and also financing.

Finally in slide number 9, we show you our investments or CapEx during the last quarter. In the fourth quarter investments reached BRL 75 million, half of which devoted to the foreign market and half to the domestic market. We can see that the more normal behavior in the markets demands that we gradually increase our disbursement and an increase of capacity. This is a positive trend and we hope that this will continue in the Brazilian market.

With this I would like to conclude and I return the floor to André.

André Luís Rodrigues

Thank you very much, Paulo. And before we go on to the question-and-answer session, I would like to reinforce some points. Once again in Brazil the industrial recovery cycle continued, especially in the short cycle products, the combination of low inflation, lower interest rates and good prospects for business should have an impact on the environment in coming months, which could reflect a new industrial investments and a growth in order intake indicates better conditions for the long cycle products in the long-term. A broader signs of recovery seem to be more consistent, industrial production growth in the main global markets and an improvement in short cycle products is driven by OEMs. There are important industries that begin to demand long cycle products.

Finally, the revenue growth and our focus on return on invested capital will be the main driver for 2018. Revenues should increase because of the industrial improvement worldwide and because of solar generation. Good news to conclude, yesterday, the CADE by unanimously approved our acquisition of TGM, which is an important step in the growth of the group. This will bring about opportunities for new businesses in Brazil and abroad.

We can now go on to the question-and-answer session. Operator, you may proceed.

Q&A

Operator

Ladies and gentlemen, we will now go on to the question-and-answer session. Once again, we would like to remind you that this conference call will be conducted in Portuguese with simultaneous translation into English. The first question is from the Lucas Marquiori from Safra Bank.

Q - Lucas Marquiori {BIO 17907247 <GO>}

FINAL

Hey. Good morning, and thank you for the call. Two important points, the first, you spoke about the return on invested capital. And I think that it is important for market to have this metric. I would like to know which is your view of the levels reported for the quarter, compared to the mission of the company as the economy resumes, will this metric improve, decrease, will there be a nominal value or a spread with a cost of capital. I would like to hear your feeling in terms of the behavior of this new financial metric that you are sharing with us.

The second point refers to the bonus that was announced along with the results. It would be wonderful to hear from you, which is why this movement was carried out, if you're simply trying to improve the profits of the company or if this boils down to a simple remuneration. Thank you.

A - André Luís Rodrigues

Hello Lucas, this is André Rodrigues. Thank you for question. Let's speak about the return on invested capital and Salgueiro will speak about the bonus. Nowadays, the ROIC is the main company indicator. This is how we measure the management performance and in the last quarter of year, we had the best results in the last eight years for ROIC.

In 2017, we had anticipated that we would focus strongly on improving the ROIC. After two years of crisis, we maintained our resiliency and even in the worst moment of the crisis, we maintained the figures of 215, but 2017, was a year for improvement and we reached a growth of 1.7 percentage points and our focus going forward is to improve and develop this indicator further. Of course this will depend on our business mix. At some point in time, we may have to make investments that in the short-term will have an impact and reduce the indicator. We can revert this quickly and we also have potential acquisitions abroad but the focus continues to be the same and we're working towards improving the indicator.

A - André Meneguetti Salgueiro

This is André Salgueiro. Carlos (00:16:24), in terms of the increase of capital, according to the new law, the profit reserve cannot go beyond the amount of the company stock. Considering the forecast of results for the coming 12 months or perhaps a longer period, we would be very close to overcoming the shareholders equity and because of this we have some options one was to pay out dividends and another was to increase shareholders' equity, which is the option that was deliberated by the board of management. This is a proposal that will have to be ratified at the shareholders assembly.

And we're going to - instead of issuing new shares, we are working with this bonus. We increased the number of shares and we increased the liquidity of our securities. This is an indirect effect that should also benefit the liquidity once it has been approved.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Thank you very much.

Operator

The next question is from Mr. Noronha from Santander Bank.

Q - João Noronha

Hey. Good morning to all of you. Thank you for the question. I would like you to further explore your vision of the evolution of the impacts that have hampered your EBITDA margin in the fourth quarter? How these will evolve throughout 2018? If you could give us more color on this, I think it would be interesting?

A - Operator

Thank you, João. Let's speak about these impacts and how they happened. The first refers to the acquisition of TGM that took place in June of last year. We had anticipated that the level of profitability would be below our expectations. This of course was considered in the price. And now WEG along with the operation in Mexico have very interesting and synergic opportunities and we're trying to develop a commercial and operational aspect to increase the profitability of this business. Throughout this year, we hope to improve this and to be very concrete. In the second quarter, this is a quarter where we will be able to revert this situation of deficit, and through time what we expect is to allow profitability reach the profitability that we have at other transformer units in Brazil and abroad, were been very objective.

This has been carefully measured. The action plans have been developed. We have a team of Brazilians that remain one month in Mexico with a specific goal to be able to reverse this situation and we are very confident that we will be able to leave this deficit behind us.

In South Africa, perhaps we should understand the our business environment for in that country between the marketing of electrical motors and electro-electronic components. We also set up automation (00:19:52) transformers, substations, and then industrial, electrical installation of an average and large size. We work with this in South Africa.

In the last quarter of 2017, we had an increase of cost that was not expected in some of the projects, especially, an EPC and the automated panels because of their characteristics, they are very large, they are very complex. And because of the geographical location of Sub Saharan Africa, which are the measures we have taken so that this will be a one-time event. This was an unexpected bent in the project. We carried out a scan to avoid the recurrence of this problem and additionally, this impact was concentrated on a more relevant and more complex projects. This is not the characteristic of the other projects that are being developed.

The next question is from Felipe.

Q - Felipe Vinagre {BIO 19282922 <GO>}

Hey, good morning to all of you. I have two questions. The first refers to solar energy. You have this new endeavor that seems to becoming stronger with the - if you could compare

this with the beginning of the wind farms, which are the differences in these two large markets that are very recent markets for you? Do you think that the solar energy has a better foundation than the wind power and how would you compare the ROIC and the margin? And which will be the scenario of these two markets for 2018 and 2019, if we keep in mind the auction? This is only my first question. I will then ask the second one.

A - André Meneguetti Salgueiro

Felipe, good morning. This is André Salgueiro. I will speak about solar energy, and I would like you to confirm the backlog for solar energy. Solar energy is something relatively new for WEG and not only in Brazil, it's something that's gaining movement in the last few years. Comparing this with wind power, the great difference is that we're going into a period that is previous to this cycle when we decided to enter this. The main player were already in Brazil and WEG has to come up to part was Wayne Power (00:22:43). We worked on substations, transformers, the inverters, and all of this was part of our portfolio. What we have done in the last year was to add more services and offer a full package to the client.

It's a new market that is growing and Brazil has an enormous potential for this. We have mentioned this before. In the worst place of solar radiation, it is 30% better compared to Germany when it comes to solar farms.

Q - Felipe Vinagre {BIO 19282922 <GO>}

And what about the generation Brazil? What do we have in terms of generation?

A - André Meneguetti Salgueiro

We have the wind power that is practically stable. These are the 2017 and the projects we have in backlog, the level of revenues was BRL 600 million last year, and then we should see this again in 2018. We still don't have any visibility of a project for 2019. We're looking for these opportunities in the market. We have no project in our portfolio for 2019. And for solar farms, we have the projects announced in the last quarter, the project of Coremas with BRL 400 million. Part of this project came into operation in the last quarter 2017, the rest will come into operation in 2018 and other projects that add up to BRL 250 million.

Q - Felipe Vinagre {BIO 19282922 <GO>}

Very good. My second question is on the evolution of the loss of price and commodities. Now either new opportunities for projects, new revenue opportunity because of the commodities and in the short term, will this have an impact on the fourth quarter? And if this is the context, what will happen with the price transfers especially in the foreign markets, where your leadership position tends to be lesser than in Brazil?

A - Paulo Geraldo Polezi {BIO 19468811 <GO>}

Felipe, this is Paulo Polezi. Good morning. When it comes to the commodities and their impact and what happens with our business, I'm going to respond to this in parts. In the domestic market, a very minor impact, we still have not observed the impacts that take place traditionally in mining, oil and gas, which are traditional segments for WEG. We still

do not see a reflection or an improvement and this is what we have mentioned in our releases.

On the other hand, we begin to see more mature markets in our European operations. There is an entry of orders that seems to be more consistent and clients that are traditionally from these sectors that made maintenance orders only are now placing orders or more complex and larger products. This is what we have observed in the more mature countries.

Another highlight, moved away a bit from commodities and is part of the long cycle and it refers to China. China is fostering an important expansion program in infrastructure, the One Belt One Road program that is very well-known and we feel that there is an improvement, a significant improvement.

Another economy where we have enhanced our position for long cycle commodities is India. We have observed an improvement there as well, which means that gradually the conditions are improving. All of this driven by that improvement in the price of commodities. We should remember nevertheless that this effect extends to everybody to WEG and to all (00:27:01). We don't manage the prices. We don't control them. High commodities are good for short cycles and what we observed now should be the trend going forward. Thank you.

Q - Felipe Vinagre {BIO 19282922 <GO>}

Thank you very much.

Operator

The next question is from Alexandre Falcao from HSBC.

Q - Alexandre Pfrimer Falcao {BIO 5515455 <GO>}

Good morning to all of you. I have two questions. The first refers to your cash and your ROIC, is there something else that you can do to revert what you are doing? I'm imagining your levels of EBITDA and CapEx. The second question refers more specifically to Brazil. Which is the indicator that you believe are going to see more when it comes to the short-cycle and long-cycle products?

A - Operator

Thank you very much. Hello, Falco. [Technical Difficulty] (00:28:36) to our cash situation, we tend to say that our financial flexibility is one of the foundations of our business model, because we are able to invest when opportunities arise regardless of the economic situation. In the last years, we have preserved our liquidity and our strength. We make sure to preserve our cash position. It's normal to say that now that we have a more normal market we once again explore growth possibilities both organic and non-organic, [Technical Difficulty] (00:29:16) stability and any surplus cash doubtlessly will be paid out to the shareholders, especially if it goes beyond the level that are normal at WEG.

FINAL

Now your question about having an indicator, we follow industrial (00:29:37) and growth, the growth of economy. It is what is going to determine, what will happen with these two previous points and what will happen in the near future. Now, I would like to remind you that for short-cycles and we have always said this, we can see this in a more consistent way in Brazil but in the Rest of the World as well. The order intake cycle, the more consistent sale, we always spoke that we needed to recover maintenance to then be able to take investments in greenfield.

In Brazil, we see that there is a recovery in maintenance. Clients are trying to invest in energy. And this is improving the short-cycle scenario. In the long-cycle, in the case of Brazil, we need to have more patience. Due to the crisis that Brazil faced, it's natural that the short-cycle be the first and it will bring up the situation [Technical Difficulty] (00:30:46) cycle. When we're speaking about the long-cycle, we have had an order intake that was more positive in the last year, and the prices of commodity are one of the indicators of the global situation of [Technical Difficulty] (00:31:05) and this will have positive reflex for WEG, will lead to a price increase and so on and so forth.

Q - Alexandre Pfrimer Falcao {BIO 5515455 <GO>}

Thank you very much. I would like to know if you're planning on making change in the United States. If you could do for example what is done in the United States in terms of the billing or invoicing, I believe that was the question.

A - Paulo Geraldo Polezi {BIO 19468811 <GO>}

Falcao, this is Paulo Polezi. Your question to the recent reduction of (00:31:58) in the United States that went from 34% to 31%, what do we have in terms of an update, we're following very closely on what is happening. Now this change is quite recent and we need to carefully analyze it before taking any action. What I can say is that we have been involved in this, we have specialized consultants that are working on there and we hope to conclude this work in mid-year. On that day we will be able to offer you an update on the impact of this.

At this point in time, I can say the following. From what we have seen, we have perceived Falcao that this benefit will not be integral. It will not represent 31% fully, because there are several alterations, when it comes to the calculation of income tax. We believe that for most of the companies the (00:33:03) will be between 21% and 34%, but it will remain at 21%, because there are other alterations that will be included. Perhaps in the coming quarter, we will be able to give you a clearer impact - clear update on the impacts for WEG and the measures the company will adopt. Thank you very much.

Operator

The next question is from Marcello Silva (00:34:32).

Good morning. About news that was printed in the (00:34:42) yesterday, about the shares, I would like to know if there is any from the company?

Hello Marcello (00:34:52). This is something that pertains at the holding company. It will have no impact on our operations.

Thank you.

The next question is from Alexandre Falcao from HSBC.

Q - Alexandre Pfrimer Falcao {BIO 5515455 <GO>}

Thank you for the follow up. What can we think about going forward, what are you going to do with your budget as you are beginning with solar energy, if this will have a negative impact on your return on invested capital, simply to gain a better understanding of what you are thinking about in terms of ROIC? Thank you.

A - André Meneguetti Salgueiro

Falcao, this is André Salgueiro. The ROIC metric has been disclosed for some time and is at the level of 15% or 17%. Some years, we have fallen below that especially in years of crisis. We don't have a long-term metric but the target for 2018, 2019 is to remain at that level perhaps with a slight increase when it comes to your comments and important issue, wind power and solar energy, often times ended up causing pressure on our EBITDA margin.

We work based on our model of an integrator where we produce part of the equipment. We add services but we also purchase equipment from third parties. This caused us pressure on our EBITDA margin but our ROIC tends to be similar or somewhat better than other activities. This should not cause any pressure on the ROIC products, minor pressure on the EBITDA margin.

Q - Alexandre Pfrimer Falcao {BIO 5515455 <GO>}

If you allow me to ask a last question about what you are doing in China and Mexico, at what level are you're at presently and when we began, you mentioned that you had very good capacity in China that you were creating a critical mass there?

A - Operator

Falcao, let's begin with Mexico. In Mexico we're making investments in the last stage of verticalization, 2014 up to present. This is a project that should end by the end of this year and then Mexico will be able to produce its own carcasses (00:38:22) and will have a full verticalization process in this cycle. Subsequently, we will be planning minor expansion, depending on the market in Mexico and the USA.

In China going forward, the investment was made and it doubled. The production capacity of WEG Motors at the end of 2015, beginning of 2016, this increase of capacity has been fully consumed. Plants are operating at full capacity and now we will continue to invest in capacity increases more on a one-time basis. If one day, we observed the need of having a special foundry for China, we will make that additional investment as well.

Q - Alexandre Pfrimer Falcao {BIO 5515455 <GO>}

Thank you very much.

Operator

At this point in time, the question-and-answer session end here. We would now like to return the floor to Mr. André Rodrigues for his closing remarks. You may proceed, sir.

A - André Luís Rodrigues

Once again, thank you very much to all and until our next meeting, when we will speak about the results of the first quarter of this year, I hope to see you soon.

Operator

The conference call for WEG ends here. We would like to thank all of you for your participation and have a good day.

This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2022, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.

FINAL

Bloomberg Transcript