

Q3 2015 Earnings Call

Company Participants

- Andre Luis Rodrigues, Superintendent, Financial and Administrative Director
- Paulo Geraldo Polezi, Chief Financial and Investor Relations Officer
- Wilson Jose Watzko, Controlling Director

Other Participants

- Alexandre Falcao, Analyst
- Renato Mimica, Analyst

Presentation

Operator

Good morning and welcome to WEG's Conference Call to discuss the results of Q3, 2015. We would like to inform you that this conference call is being recorded and at this point, all participants are connected in listen-only mode. Later, we will begin the Q&A session when further instructions will be given. (Operator Instructions).

The press release and the presentation that we are going to be using during this conference call, please go to WEG's IR page at www.weg.net/ri.

Before proceeding, we would like to clarify that any forward-looking statements that may be made during this conference call relating to the company's business prospect, financial and operational targets, and the potential for future growth of WEG are based on the assumptions and beliefs of the company's management and on information currently available. These forward-looking statements involve risks and uncertainties as they have to do with future events and therefore depend on circumstances, which may or may not occur. Investors should understand that general economic conditions, industry conditions and other operating factors may affect the future performance of WEG, thus conducting to results which differ materially from those expressed in such forward-looking statements.

This conference call is being done in Portuguese with simultaneous translation into English. Today with us in Jaragua do Sul, (inaudible) Andre Luis Rodrigues, Superintendent Director, Financial and Administrative Director; Paulo Polezi, CFO and IRO; Wilson Watzko, Controllershship Director; and Luis Fernando Oliveira, IR Manager.

Mr. Rodrigues, the floor is yours.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Good morning to all and thank you very much for attending this conference call. It's a great pleasure to present the results of Q3, 2013 [ph] and we will be very brief in the presentation. We will focus on the relevant points to allow for more time for the Q&A session.

On page three, we see the main highlights. The first one is the net operating revenue, no news. The conditions in Brazil, as everybody knows, are very difficult and in the foreign markets are lots of uncertainties. But thanks to our business model, which can develop and tap business growth, we are following the same trends in the previous quarters, a growth of 24% quarter-on-quarter, 2.5

billion in revenue and 8.4% relative to Q2 in this environment which is very challenging, we were able to maintain profitability. Our EBITDA was 395 million and margin is also above last year's, 15.5%. Wilson will tell you more details in the next slides.

In the last line of our bottom line, we had 254 million in net results, in net income with a 10.4% margin. This margin was impacted as we said before by an accounting effect of financial exposure that had to do with a marking to market of our swap operations for our dollar operations. Paulo is going to tell you more about it later.

At the end of the quarter, we invested 334 million in the first nine months of the year. Our expansion program continues, especially abroad. We are modernizing our industrial plants. And the last highlight is the acquisition of Autrial, a manufacturer of industrial electric panels, one more acquisition that generates value and contributes to our internationalization, Autrial is located in Spain.

Now moving on to slide four, we are going to talk about growth. And I would like to give you more details about what we have been able to do this quarter. In the domestic market, we grew 9.4% quarter-on-quarter, and the growth was mostly in GTD. Our business model, and I would like to highlight that, is based on production flexibility. And this is extremely important when we look at the current scenario in Brazil.

We still see great opportunities in the foreign market, which accounted for 57% of our revenue. Despite the 37.4% growth in the foreign market having been impacted by the ForEx, devaluation of the real, we still see a very healthy growth in local currency. Our products are not commodities with international prices in dollars, our products have a high tech content and our brand is the main factor that drives decisions. So in local currency, the growth was 7.4%, it is fundamentally organic and is in line with the last few quarters. The drop in revenue in dollars has to do almost exclusively with the appreciation of the US dollar relative to all the other currencies.

I'll now turn the floor to Wilson.

Wilson Jose Watzko {BIO 16648037 <GO>}

Good morning to all. I would like to present more details about the main impacts of costs in this quarter. We see a similar environment relative to Q2. The main impact in this quarter were the addition of provisions that we have to make. They are detailed in the explanatory notes, and as we said before, this doesn't mean a structural change in our business model. This effect should taper off in the next few quarters, thus becoming normal in 2016.

Another known effect is the effect of the greater share of wind generation in our product mix. This is a new product and we are still in the learning curve. The margins are very peculiar. The effect of the depreciation of the real on the costs of raw materials which are denominated or referenced in dollars have been mentioned. And the pass-through of this increase as to the selling prices is a slow process in an economy such as the Brazilian economy. The cost volatility is always detrimental and the volatility of the foreign exchange rate is high in the quarter.

We would also like to highlight the effect of the recent acquisitions in our margins although this effect also should taper off in time. These effects explain the drops in gross margin and EBITDA relative to 2014. But we were able to partially recover the margin and we continued to work on productivity and controlling SG&A as a way to minimize these effects.

I'll now turn the floor over to Paulo, who is going to talk about the financial results.

Paulo Geraldo Polezi {BIO 19468811 <GO>}

Thank you, Wilson. Good morning to all. Moving on to slide seven, it's a new slide that we prepared and that will help you understand the variation of the financial results in this quarter. I would like to highlight an important point in the financial results. It was the effect of the marking to market of our hedging operations. As you know, WEG is an exporter and has access to lines in dollars in very attractive conditions, LIBOR plus 1.5% spread. Since these financing lines are for five years, we hire a ForEx hedge with swaps in dollars with a post fixed rate in reis based on the CDI and despite the swap, the costs are still very attractive.

Given the conditions of these swaps and according to accounting rules, we have to mark them to market and this has to be done using three variables; the exchange rate between the dollar and the reis, the DI interest rate and the ForEx coupon. In normal conditions, these variables are in synchrony and hedge works really well. However, because of the downgrading of Brazil's rating, the ForEx coupon has not been in line with what we expected. The swap was not enough to offset the impact of the devaluation of the debt, as can be seen on the graph on this page.

What is important here is not the explanation, which all of you know, but this is an accounting effect. That is we have not liquidated operations at this point. And at maturity, these effects will be eliminated, that is the effective costs will still be very attractive.

Moving on to the next slide, slide eight, another impact of the real devaluation was on cash flow. Here, we have to also explain a little bit of the accounting method. There was an increase in working capital which you can see in the graph and in fact there wasn't an increase in the working capital that is we haven't increased the terms for our clients, we haven't increased our inventories and our suppliers, have not decreased our payment terms. But the devaluation of the real increased, drove all the values in reis upwards at a greater pace than the cash generated from our operations.

In the next few months, the assets will be realized and will flow back to our cash position. The counterpart of this devaluation of the real in our turnover has to do with the adjusted accumulated for conversion which is higher than the typical investments of the company.

And I'll now turn the floor over to Andre.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Moving on to our last slide, I would like to draw your attention to the investment in expansion of capacity in the last few quarters. And it's no news to you, but we have a unit to produce electric motors in Mexico and China. In Mexico, the unit is already operating and the China plant should start up operations next month. These are modular plants, they can grow a lot and considering what we see in Brazil and abroad, we should reach our forecast for investment and expansion in 2015. We said we would invest 478 million. We are finalizing the budget for investments in 2016 and we will have more information shortly. For the time being, what I can say is that, there are opportunities with an attractive ROIC and also in Brazil and abroad.

And with this word of confidence in our business model, which works even in an economy that is not growing, we have been able to maintain good results in absolute and relative terms. And here, we end our presentation and open for the Q&A session.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the Q&A session. We would like to remind you, that this conference call is being conducted in Portuguese with simultaneous translation into English. (Operator Instructions). Our first question comes from Mr. Renato Mimica from BTG Pactual.

Q - Renato Mimica {BIO 15374054 <GO>}

Good morning, thanks for the call. I have two questions. First, I would like to know something about the increase in provisions that we saw again happen in Q3. There was an increase in Q2 and can you give us an idea of when we're going to see these provisions stabilizing, especially the labor-related provisions? Why was there a more substantial increase in the last few quarters? This is the first question.

The second question, if you allow me, has to do with the tax rates. I would like to understand what you think would be a more sustainable tax rate going forward? I mean what are the drivers behind this decrease in the tax rate in this quarter?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Thank you for your question. Let's talk about the provisions first. In general, we believe that the provisions that we are booking now in the normal conditions, these provisions should go down. And now, let's talk about item-by-item clients. The provision for clients has to do with a situation in the market. We are more conservative than usual because we want to avoid problems in the future. And after the aging of some payments, we make a provision. So, this depends on market conditions. We are very judicious when we grant credit, but we have to make provisions for bad debt.

And as regard to labor-related provisions, we have to make provisions for the proceedings. These are actions that are very defined. These are not contingencies for the adjustment of our staff. These are very detailed suits. So, these labor suits have to do with the claims, especially -- and this is always the case for companies, especially at WEG. I mean we have more than 31,000 people working for us.

And then, as regard to the inventory provision, we have been focusing abroad, especially in those slow-turnover items and at end of this year, we should put an end to this provision. So, we expect that in the future, this could be normalized.

Let's talk now about the income tax rate. We are internationalizing and trying to grow abroad, and we are now using our operations in Europe to export to the rest of the world with the exception of South America and the Caribbean. With that, because we are exporting from Europe, there is a difference in the effective tax rate, and this has to do with the difference in tax rates because of the income we have abroad.

Q - Renato Mimica {BIO 15374054 <GO>}

Thank you very much for your explanation.

Operator

Our next question comes from Mr. Falcao from HSBC.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Hi, Hello. We hear you, Mr. Falcao.

Q - Alexandre Falcao {BIO 5515455 <GO>}

I actually wanted to follow up on Mimica's question relative to the tax rate. So, if a new law, if the benefit that you have from the law of good is eliminated, how are you going to go about in terms of planning your taxes? And can you tell us what would happen, when you start to sell more abroad, what is going to happen to the effect caused by the dollar? And then, speaking of the domestic market, GTD sales dropped very substantially. And in the beginning of the year, you expected a flat performance. So what has changed and what is going to change in your budget for

2016, which would be a near, that won't be better than 2015? So how are you going to address this drop in revenue?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

As regards the income tax rate and the law that grants us benefits, this law allows us to invest and develop --

Q - Alexandre Falcao {BIO 5515455 <GO>}

No, no, no, this was just -- I understand the effects of this law, but what I wanted to know was about the decrease of the tax rate?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

There is nothing we can do. There is a provisional measure in place, the tax benefit that we have today, I mean we are going to continue to maintain the investments in R&D, even if the benefit is eliminated. There is no short-term alternative to offset that. If the provisional measure is going to be approved, is it going to be approved as it is, there is nothing we can say at this point, you see.

And as regards the new method, this is what we are going to do. We're going to work with this new method established by the law. The tax rate is what it is. It has to be sustainable. There are lots of talks about changes in the tax system and we have to follow the law as it is. But within the legislation, we have been able to use this law the best we can. And speaking about the future and about the market, our vision today, I mean, we don't expect the scenario to change substantially in the near future.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Assuming that this scenario holds, we must think, well, okay, GTD didn't perform so well?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

The GTD growth will be lower for two reasons. First, the higher base of comparison for wind energy. This year, we have a comparison base. Also, the power market is consuming more and this has an impact in our business. But more important than talking about our expectations is to talk about the things that we are doing now.

I would like to highlight also what is going to happen with ForEx. This has an influence on our growth. Our expectation, if things don't improve, is to continue to grow abroad. Thanks to our investments, we have a new plant in China, which will start up in the middle of next month. I mean, WEG has a very strong business model. We can always grow and this improves our bottom line. We are a diversified company, we have enough flexibility to address the difficulties ahead of us and tap the opportunities when they come up.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Thank you very much. And so the Brazil market saw a drop by 10% in the GTD segment?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Yes, the GTD business, especially the industrial segment, is lower than we expected, slightly lower. We have been saying that, this is a market where we see investments in maintenance, very little has to do with new projects to expand capacity. And it's very difficult for us to see a more relevant growth.

Operator

Our next question comes from (inaudible).

Good morning to all. I actually have three questions. I would just like to go back to the provisions. You have explained very well the provisions, but my question is, looking at the history of WEG, this level of provisions increased sharply in Q3, provisions for inventories and also provisions for clients for bad debt and provisions for labor suits. Do you expect this to go back to normal in Q4?

I did the math very quickly here. And this would generate an impact on margins by 1%. This hurt the margins in Q3. Can we expect this to go back to normal in Q4 or should we expect that only for 2016?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Okay, let me take the first question, okay. So we can address your question very accurately. We make the provisions as they are needed. In Q2, we said something important. These provisions are additional provisions, which reflect very clear cases. So these situations have a beginning and an end. We cannot say when they're going to end, but this hasn't changed our business for the future.

But to tell you when we're going to put an end to these provisions, I mean this is difficult to say, but as time goes by, the relative importance of these provisions and the provision themselves tend to shrink, but to tell you that in Q4, you're not going to see that happen, it's difficult to say. We are at the end of October. We still have two months in Q4, so the trend is that these provisions will lose importance. Gradually, all the situations that gave rise to the provisions will be sorted out, but there is no way I can tell you this is going to end in Q4.

I understood that. Thank you. Can I move on to the second question then? Looking at your CapEx, we see a trend towards investments abroad. You have increased capacity in China and Mexico, and these projects are in dollars, right. With the volatility in the exchange rate, are you going to reassess your CapEx, your investments given that your operations abroad is so relevant, so what can we expect in terms of CapEx? Are you going to invest more heavily abroad?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

CapEx is in dollars, but the revenue is in dollar as well. So, this is being financed in an equivalent currency. Cash will be generated in the local currency or in dollars. We always review CapEx. WEG is very detailed and we focus a lot on the return on invested capital. We want to optimize that.

Let's take the cases of China and Mexico. We designed a strategy, the strategy is working and there is no signal today that would make us review that strategy. Okay, if the situation becomes more difficult, these are modular investments, you see. So we can hold back, we can export some components from Brazil, but we are executing on our strategy, because it is working.

So the expectation of ending 2015 with 478 million. So this number doesn't really have to do with the exchange rate in Q4?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Exactly. Everything that we had to do for Q4 has been contracted already, but for example, if the real devalues even further, they still have an accounting effect on the conversion. We cannot measure that, but we are very close to this amount.

And my last question, if you allow me, is you made comments about an increase in the degree of uncertainty in foreign markets. The organic growth is healthy 7.5%, but because of the problems with the currencies, there was a drop. So what is your take on the foreign market going forward relative to exports and relative to manufacturing abroad?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

I would like to highlight something very important. The 7.4% growth is compared with Q2 where we grew 14%, that included non-organic growth, which was the consolidation of our operation in China, which was acquired last year. So 14% was actually organic and non-organic growth. So you have to make this adjustment. If you adjust this 14%, we would be talking about a figure that is very similar to seven, virtually the same I would say.

And again, abroad, we have operations that are relatively smaller, so there may be a variability in terms of deliveries. Our operation in the space, for example. We have large machine operations. So if the schedule is more concentrated on one quarter or the other, there is a variation. We expect our concentration in the last quarter of the year for a certain type of machine. What there is, is uncertainty, all this volatility, the volatility in China has an impact on the price of commodities or all these things create uncertainty. It is not a business that is not subject to uncertainty, but most of the times, we have been able to execute our strategy, although the macroeconomic environment may not be the most favorable one, for example, in China.

So in the sense, organically in local currency, WEG has not seen slowdown?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

No, no, no, no, it's exactly as we expected, one digit or two digits, but we feel the impact of some sectors in some specific markets. For instance, take the mining industry. There is a slowdown in the mining industry. So if you look at that, with regard to South Africa, it hurts their growth in other markets. For example, in the North American market, where there is more diversification for us, one thing affects the other, so this is the cool thing about our model, it's based on diversification.

Operator

(Operator Instructions) There is a question here from the webcast from Rusty Johnson [ph]. And he asks about how important it is for WEG, the wind business and what is the risk associated with cuts in the budget for these businesses and since these type of deals are usually subsidized by the government. There is something important here that has to do with the Brazilian wind model. So the prices are always competitive. There are auctions for wind energy and the generators put their bids in. There are no subsidies in wind energy. The government doesn't pay for the energy generated. The generating companies put in their bids and they offer their prices that are going to give them the returns for their investments.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

The wind energy business is very important for us, it's a significant part of our growth in Brazil, but it's a very safe portfolio and for various reasons. First of all, it is very expensive to cancel an order, because we receive advancements from the clients and there are penalties if they cancel their orders. And secondly, because our clients, the generating companies, they have commitments with respect to what they won in the auction. If they fail to build the plant and dispatch energy according to their contracts, they pay significant penalties. So it is very difficult to cancel an order. It is a very safe portfolio.

Operator

The Q&A session is now ended. I would like to turn the floor over to Mr. Rodrigues for his final remarks.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Once again, ladies and gentlemen, thank you so much for attending. Thank you and see you next time.

Operator

WEG's conference call has now ended. Thank you all very much for participating. Have a nice day and thanks for using Chorus Call.

FINAL

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