

Q3 2007 Earnings Call

Company Participants

- Antonio Luiz Pizarro Manso, CFO
- Carlos Eduardo Camargo, IR
- Frederico Fleury Curado, President, CEO
- Marcello Rodrigues, Controller
- Unidentified Speaker, Unknown

Other Participants

- Christine Min, Analyst
- Dan Kwiatkowski, Analyst
- Joe Nadol, Analyst
- Rob Pickels, Analyst
- Ron Epstein, Analyst
- Vinicius Canheu, Analyst

Presentation

Operator

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Participants on today's conference call are Mr. Frederico Fleury Curado, President and CEO, Mr. Antonio Luiz Pizarro Manso, Chief Financial Officer, Mr. Carlos Eduardo Camargo, Head of Investor Relations and Mr. Marcello Rodrigues [ph], Controller.

I'd now like to turn the conference over to Mr. Curado. Please go ahead, sir.

Frederico Fleury Curado {BIO 2004589 <GO>}

Good morning, everyone. Thank you for joining our conference. We'll be discussing our Third Quarter results in U.S. GAAP, which were released last Friday, simultaneously with our financial statement under Brazilian GAAP.

Together with me Antonio Manso, our Chief Financial Officer and Marcello Rodrigues, our Controller and Carlos Camargo, our Investor Relations.

Summarizing the Third Quarter, we have shown improvements in the number of deliveries, coming from 25 delivered in the First Quarter to 47 delivered in the Third Quarter, plus one turboprop [ph] which bring up the number to 48, which -- if you would account it.

We also have initiated in a more comprehensive way our internal recovery program, which we called Programa de Excelencia Empresarial Embraer, which is something like the Companies Excellence Program and which, of course, will be with us for many, many years ahead for our business starting with the first phase of the program right now.

As we anticipated in the last quarter, the third shift is about complete by now. And we also have -- as of July we have frozen our labor at the existing level. The training costs also are rapidly being reduced as we go down the road along the year.

During the Third Quarter our production rate for the E-Jet family achieved 13 aircraft per month, which keeps on track towards our goal of 4 aircraft -- 14 aircraft per month by the end of the year as a rate -- as an average rate.

Our backlog reached over, just over \$17b. And as a headline, the 20 aircraft sold to Air France KLM, I think, was an important development in this quarter.

We also had the first flight and the second flight of the Phenom 100 prototype which, in terms of orders in the family, both in the 100 and 300, has accumulated more than 500 firm orders.

We did have an extraordinary event in Brazil in the -- related to a favorable decision to the Company in a tax dispute over the calculation basis of the Brazilian COFINS tax. That favorable decision resulted in the reversal of a provision in the amount of \$156.6m, which was reported in other operating income net.

When we analyze the operating results without that extraordinary event, the operating income would be \$73.7m, \$74m, which would represent an operating margin of 15 -- sorry, of 5.2% for the period. This is an increase compared to the Second Quarter this year when we recorded 2.8%.

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So certainly, the improvement can be partially explained by the higher number of deliveries combined with the results of the internal plan to optimize some of the processes of the Company. But certainly, the major component of this improvement was the higher revenue.

At this time, I will switch over to Carlos Camargo, who can walk you through the results itself and I'll be back in the end for Q&A. Thank you.

Carlos Eduardo Camargo {BIO 20195335 <GO>}

Thank you. Good morning. In the Third Quarter we have delivered 47 aircraft, as announced, totaling 108 deliveries in the first nine months of the year, brought from 25 in the First Quarter, 36 in the Second Quarter. Due to the higher number of deliveries net revenues increased 28.7% [ph] and almost 63% from \$1.1 billion and \$877 million in the Second Quarter of 2007 and in the Third Quarter of 2006, compared to \$1.4 billion in this Third Quarter.

The gross margin was 21.8% compared to 26.2% in the Third Quarter and to the same margin of 21.8% in the Second Quarter of 2007. High industrial costs still affected the Company's results, as previously mentioned. With the implementation of the third shift we, the Company, expected to gradually reduce the costs related to overtime and overtime work and employee training.

Commercial aviation segment has increased its relative participation of total revenues in the Third Quarter Of 2007, due to a higher number of deliveries compared to the last year, reaching 69% compared to 64% in 2006. The Company's operating income reached \$230 million and the operating margin was 16.1% in the Third Quarter of 2007, compared to the operating income of \$52.4 million and operating margin of 6% in the Third Quarter of 2006.

In the Third Quarter of 2007 operating margin was 2.8% and the operating income was \$31m. That is the relevant increase mainly due to extraordinary events previously mentioned regarding the tax dispute and improvements achieved with implementation of internal plan to optimize processes.

For the same reason cash generation, as measured by the EBITDA, reached \$247 million in the Third Quarter of 2007. Despite the increase in the numbers of delivered aircraft this quarter, the Company is still in the production ramp-up process of Embraer 170/190 family in order to fulfill its delivery commitments for 2007 and 2008. And additionally, we are investing in the build up of spare parts inventory to support customers -- the aviations services operations.

Embraer's net cash position increased by \$322m, ending the Third Quarter at \$450m, mainly due to the cash generation from our operations. Total debt at the end of this quarter was \$1.8b, representing an increase of \$52 million compared to \$1.75 billion on June 30, 2007.

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The average debt maturity also remains practically stable at 3.7 years, when it was 3.7 years at the end of June 2007 and now is 3.8 years. Of the total debt on September 30, 46.1% is effectively stated in reals and indebted to the TJLP at a weighted average interest rate of 7.93% per annum. The remaining \$92.5 million are accounted for in other currencies, primarily U.S. dollars, with a weighted average interest rate of LIBOR plus 1.63% per annum.

The backlog for the ERJ145 family is at 51 aircraft. Those aircraft produced in our JVR, Joint Venture in China and delivered to that market.

For the ERJ1 -- for the Embraer 170/190 family, since the launch of the E-Jet we have sold 712 aircraft, of which 292 were delivered. Therefore, the firm order backlog for the E-jet reached 420 aircraft at the end of the quarter, as mentioned by Frederico.

The firm order backlog reached the record high level of \$17.2 billion in the Third Quarter and includes orders for our commercial aviation, executive aviation and defense and government segment.

As mentioned, actions taken regarding our industrial and operating capabilities were implemented, with increased deliveries towards the end of the year expected, allowing us to deliver between 165 and 170 jets in 2007.

So thank you. And now we will proceed with the question and answer session.

Questions And Answers

Operator

Ladies and gentlemen. we will now begin the question and answer session. Embraer will answer the questions from the analyst investors first and after that they will proceed answering the questions from journalists.

(Operator Instructions)

Our first question comes from Christine Min of Calyon Securities.

Q - Christine Min {BIO 5802066 <GO>}

Hello. Good morning.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Good morning.

Q - Christine Min {BIO 5802066 <GO>}

You have a very strong competitive positioning in the marketplace with the E-Jet product family, and could you give us some color on what you're seeing in the pricing environment?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Well despite this -- we probably have to separate the E-Jet into two families to answer your question. In the 70 to 80-seater segment, where we have the Embraer 170 and 175, we do have a direct competition from Bombardier and as a result, of course, one can imagine that prices are under pressure.

On the upper segment Embraer 190, 195, despite the fact that there is no direct competitor to those aircraft, we do have indirect competition or, let's say, not indirect but competition in some accounts with the Airbus 318 and 737 600. But most importantly, I'll say we are pretty much in between two very much known segments of the market. The costs of the higher end, let's say, the 737, 700, Airbus 319, 320, those costs and the regional jets' [ph] costs, they are references that pretty much plots where Embraer 190 195 should be in terms of cost.

So there is not (technical difficulty) that people could imagine in terms of benefiting from not having a direct competitor -- competition. So we directly in the 70 to 80-seater market, indirectly in the 100 to 110-seater market, there is pressure on the pricing. And what we've been trying to do over the years is really to manage the growth market share and margin compromise so that we really do not compromise with those for going for our after market share.

On the other, hand of course, we cannot lose track of our market position. So it is really targeting our cost side that we intend to keep our competitiveness.

Q - Christine Min {BIO 5802066 <GO>}

Okay. And it might still be early, but are you seeing any impact from the new jets that are coming out from China, or Russia, or being designed from out of Japan?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

No. It is really early. Those airplanes will not be in the markets. Assuming all the development programs are successful, they will not be in the market for a few years. So the answer to your question is, no, we have not seen that although, of course, we acknowledge their presence, their growing presence in terms of markets and marketing activity, but not really disputing sales at this stage.

Q - Christine Min {BIO 5802066 <GO>}

Okay. Thank you.

Operator

Our next question comes from Joe Nadol of JPMorgan.

Q - Joe Nadol {BIO 3056499 <GO>}

Thanks. Good morning.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Good morning, Joe.

Q - Joe Nadol {BIO 3056499 <GO>}

Fairly quick, could you just give maybe some, a few more comments on how you are tracking on the recovery program, manufacturing recovery program? Any numbers on overtime that you can provide?

Then what do you think your Q4 gross margin and operating margin might look like?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Well Joe, I think we are initiating a long road of recovery, as we had the chance to discuss. We have seen a deterioration of our results over some time and it would be unrealistic to expect a sharp reversal of that. Although it is good to see some positive trend, even if we discount, and we should for that matter, this extraordinary event or extraordinary operating profit in the Third Quarter our margin in the year -- in the quarter, I'm sorry, is going up. It's around 5% and we see it going up.

You mentioned about overtime. We are still at a high level of overtime. I can certainly not anticipate any sizeable reduction of that in the near term, because we're definitely focusing in making sure that we do deliver our aircraft this year, the guidance, not only to meet the guidance but also because we have commitments with our customers to do so.

On the other hand, training is already being reduced. I'm sorry, I do not have numbers here with me, but it's definitely being reduced. As we have not hired people since July so, of course, the three months' training they are reduced. But you understand as the counting of those -- of that labor affect aircraft which were already in production some time ago, there'll be some time before you see the full benefit of that improvement.

Q - Joe Nadol {BIO 3056499 <GO>}

Okay.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

On the pressure side, we do have every year in Brazil our legal adjustments of salaries, which happened in September. That of course put additional -- a bit of additional pressure on wages, on real, on the wages dominated in reals.

These, of course, don't help very much this declining exchange rate. I do not mean to blame the exchange rate but the reality is that another 3, 3.2 -- 3.5% devaluation in the quarter itself and that goes -- and that's another additional headwind that we have in our recovery. But I think we are progressing steadily towards that.

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Q - Joe Nadol {BIO 3056499 <GO>}

One might think that going from Q4 into Q1 that you will have reached your 14-a-month rate in Q4. In Q1 your deliveries are probably down a little bit sequentially, so maybe the overtime pressure abates as you head into the New Year. Is that a fair comment?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Hard to say at this stage. We cannot lose track that to meet the delivery guidance of 2008 we can't have too much of a dip in -- during the First Quarter or ever. So our position has to be more and more a continuous flow. So I do not see a -- substantial drop in the overtime. I see a gradual decrease in overtime.

Q - Joe Nadol {BIO 3056499 <GO>}

Okay.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

I do not have specific numbers here but that really moulds [ph] future business.

Q - Joe Nadol {BIO 3056499 <GO>}

Okay. On the tax dispute that was settled in your favor during the quarter, did that result in a cash payment to you in the quarter?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

No. It did not.

Q - Joe Nadol {BIO 3056499 <GO>}

That was non-cash?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Purely economical [ph].

Q - Joe Nadol {BIO 3056499 <GO>}

Okay. Then finally, Fred, if you could give a brief update on the development programs, the Phenom 100 and the Lineage, how those are progressing according to their schedules.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Sure. Well actually we have three programs on both the Phenom 100 and the Lineage 1000 scheduled for next year, and the Phenom 300 scheduled for 2009, all three programs on track. There is no aircraft program [ph] that I know of that's not under timing pressure but we are indeed on time on the programs.

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We have three [ph] prototypes of the Phenom 100 flying so far and it's encouraging that the aircraft do display a high degree of maturity. That translates into a better utilization of the staff [ph] hours and also the de-bugging of the aircraft is smoother. So we remain very optimistic about both Phenoms, and on the cost side as well things are under control. So the programs are on track, both are and the Lineage.

Q - Joe Nadol {BIO 3056499 <GO>}

Okay. Thank you all.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Thank you.

Operator

Our next question comes from Ron Epstein of Merrill Lynch. Please go ahead.

Q - Ron Epstein {BIO 1868102 <GO>}

Yes. Good morning, guys.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Good morning.

Q - Ron Epstein {BIO 1868102 <GO>}

So Fred, when you look at the options backlog there's a lot of options out there for the 170/190 family [ph]; there's 750 some-odd options. How should we think about conversion of those options? How do you guys think about it? When we think about deliveries going forward and order activity, how should we factor in the options?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Ron, I think this question, actually, should be posed to the airlines, not to us. Our position is that we would certainly love to see them converting [ph] and it's very, very dangerous to make any sort of forecast. In the 145 base [ph], for example, for two or three or four years we had 100% of the options confirmed. In the end of the program it was close to nil. So where we are [ph] in this phase it's very hard to make any predictions.

I'm usually very conservative, and usually I like to speak about my \$17.2 billion firm and we didn't even mention the \$24.3b. But as a matter of fact, of course, part of that will irreversibly be converted, but the question is how much can we account for. I would not dare to make any projections in that sense.

Q - Ron Epstein {BIO 1868102 <GO>}

Okay, fair enough. Then, maybe just a couple more follow-on questions. Two of the areas where you guys highlighted there were difficulties were the wiring harness facility and the

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composites facility and I just wanted to follow up on how are the bottlenecks in those two facilities going? How has the leaning out [ph] facility gone and are you seeing meaningful improvement at this point?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Yes. We are, Ron. And if we have to identify one action that explains our increasing throughput is the improvement in missing items [ph]. So there's still a very, very strong focus in those bottlenecks to make sure that the assembly lines or the assembly stations, they are fed with the parts at the proper time. And the harnesses, today, it's a less of a concern than it was three months ago. Everything today is less of a concern than it was three months ago.

So today, probably the composites today is our largest point of focus, as we have a significant ability to outsource some of their work, especially the more simple work to contracting firms in Brazil. And that's what we have been doing for the last few months. We do expect to have, and we are actually having, a fast resolution of the backlog of the parts that we have there. So this is being resolved and in our little panel [ph] this is no longer red; it's now yellow. So we are really making progress as planned.

Q - Ron Epstein {BIO 1868102 <GO>}

Okay, then just one more question for you. I don't know if you can answer this or not, but I'm going to ask it. Of that \$17.2 billion firm backlog, how much of this is business jets versus other?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Let me ask my Chief Financial Officer to reply. Do we answer that? Just one second. Ron, it's in the range of \$3.5b [ph].

Q - Ron Epstein {BIO 1868102 <GO>}

In the range of 3.5, okay, that's great.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

3.5.

Q - Ron Epstein {BIO 1868102 <GO>}

That's great. And I guess one last question for Antonio, as well. The favorable tax decision in the quarter, I thought, was going to be about \$80 million and it ended up being almost twice that. What was the reason for that?

A - Antonio Luiz Pizarro Manso {BIO 1845027 <GO>}

Okay, I'm going to ask Marcello to explain well you about exactly the gap in spend [ph].

A - Marcello Rodrigues {BIO 15823412 <GO>}

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Hello, Ron, it's Marcello.

Q - Ron Epstein {BIO 1868102 <GO>}

How are you?

A - Marcello Rodrigues {BIO 15823412 <GO>}

I am great. The point's that when we announced that we would have \$75 million from the operational profit [ph] of the tax dispute, we had an additional \$75 million that would be accounted in a reversal [ph] on the financial results. But after the discussions with the external auditors we accounted that for the operational results, only for the interest for the 2007 period that we accounted as a reversal on the financial expense. Okay?

Q - Ron Epstein {BIO 1868102 <GO>}

Okay. Thank you.

A - Marcello Rodrigues {BIO 15823412 <GO>}

You're welcome.

A - Unidentified Speaker

Thank you.

Operator

(Operator Instructions)

Our next question comes from Dan Kwiatkowski of Schroder's. Please go ahead.

Q - Dan Kwiatkowski {BIO 16655726 <GO>}

Good morning, a couple of questions. When do you expect your overtime costs and training costs to normalize? And at what level do you think margins will stabilize at say, given stable FX rate? That's the first question.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Well we're having in a couple of days a full day Embraer analyst session where we'll be disclosing our forecast for year 2008 and year 2009 in terms of both revenues and margins. So as far as margins go, I'll kindly ask you to wait a couple of days until we can see that.

In terms of overtime it's going to be gradually throughout next year. So it will not be something which will be the results of, I think, an asset [ph] function. But it will be basically a function of a combination of, one, the new labor that we have hired this year to be up to [ph] the learning curve, to the productivity [ph] learning curve.

And two, also as a result of the resolution of missing parts, production really is able to flow more steadily, thus, reducing the need to work on weekends or working overtime to compensate for shortages or things like that.

So it's hard to put a set [ph] date to that, but the trend which was going up is no longer going up, it's stable and slightly coming down. It will come down. At which rate, we still have to determine as a result of making sure we are on time on our commitments in terms of deliveries.

Q - Dan Kwiatkowski {BIO 16655726 <GO>}

Okay. Thank you. And the second question is what percentage of your costs are in reais? And what steps, if any, are you taking to hedge your U.S. dollar exposure?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

We have -- in terms of our costs of sales we have about 15% denominated in reais. If you take the overall Embraer costs about one third, about 30%, in reais out of our total costs.

And we have been really doing a lot of effort in terms of increasing our productivity. We are not exposed to exchange rate losses because our Treasury manages the accounts and the balance sheet to make sure that we do not have big imbalances in our accounts.

But the impact of, for example, almost 12% of devaluation last year which goes straight -- representing 3% to 3.5% in our costs, therefore, to our margins, this is hard to overcome in the short time. So the hedge against the currency in Treasury is there, but the impact of the exchange rate in our costs is something that we have to do over time and that's what we're doing.

But there's no way any manufacturer of airplanes outside the United States can have a quick recovery of this tremendous devaluation of the U.S. dollar vis-à-vis the other currencies, especially ours. It's 100% in three, four years.

Q - Dan Kwiatkowski {BIO 16655726 <GO>}

One last question, if I may. What percentage of your personnel cost is overtime currently?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

I would not know that. People [ph] can tell you (inaudible).

Q - Dan Kwiatkowski {BIO 16655726 <GO>}

What percentage of SG&A, or percentage of anything?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Marcello will try to answer your question.

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A - Marcello Rodrigues {BIO 15823412 <GO>}

Yes. We have something around 18% to 20% of overtime of the operational employees, direct employees. But I can't tell you in the top of my mind in terms of dollars how it would be.

Q - Dan Kwiatkowski {BIO 16655726 <GO>}

Okay. Thank you very much.

A - Marcello Rodrigues {BIO 15823412 <GO>}

Thank you.

Operator

(Operator Instructions)

Our next question comes from Rob Pickels of Manning & Napier.

Q - Rob Pickels {BIO 16153519 <GO>}

Good morning. I noticed you guys have been selling quite a few of the Lineage aircraft. Could you disclose how many you've sold and how you expect margins to be on that product versus, say, the 190 -- the commercial version of the 190, which is the platform?

A - Unidentified Speaker

Excuse me, Rob. Just a second, Rob, let me just double check it. (foreign language). Okay, Rob, regarding the Lineage we have disclosed at the end of Third Quarter we had 11 per month [ph] (inaudible), okay?

Now, at the Dubai [ph] Show we disclose a new contract, I just don't have the total to give you yet. But in terms of margins, of course, we do not disclose margins for each product across each segment, but I can tell you that the margin for the Executive Aviation is better than the Commercial Aviation and other segments of the Company, right? But specifically for each product, we do not disclose the margins.

Q - Rob Pickels {BIO 16153519 <GO>}

Is it fair to say the margin on the Lineage will be in line with the other executive products?

A - Unidentified Speaker

Yes, pretty much close, yes.

Q - Rob Pickels {BIO 16153519 <GO>}

Okay. Thank you.

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A - Unidentified Speaker

Thank you.

Operator

Excuse me. Our next question comes from Mr. Vinicius Canheu with Credit Suisse.

Q - Vinicius Canheu {BIO 6300903 <GO>}

Hello. Good morning, everyone. Just after looking at your numbers, I would like to understand in the line of other operating income if we exclude the provision reversal, probably, what would be left would be a net expense of about \$15 million to \$20m. I'd like to understand what is the reason for such as expense?

And I'm sorry if you're already answered this question, but can you detail what was the impact on your gross [ph] margin of the currency appreciation in the quarter?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Part of this increase, actually, is not that we have in the last quarter, in the Third Quarter last year where we had, it was not a gain, but it was also a reversal of debt [ph] expenses when we entered in the FEIA [ph] which we had a reversal of interest and fines [ph] tax that we were introducing [ph] around \$50 million -- around \$40m. So partially the explanation is that we had a decrease the last couple of years because we are only going to this increase [ph] for this quarter. And some other effects [ph] are moulds [ph], like Fred mentioned, that -- due to the exchange rate dip [ph]. The majority of our expenses are real-denominated really [ph].

A - Unidentified Speaker

If you take -- within [ph] the math about 3% in the quarter applied to 15% of the cost of sales, it's about half (inaudible).

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Yes. But if you compare to --

A - Unidentified Speaker

Gross [ph] margin.

A - Antonio Luiz Pizarro Manso {BIO 1845027 <GO>}

-- between the years -- comparing the Third Quarter of 2007 and 2006 we have close to 4% [ph] of valuation of the real. That, if you take it to the 15% [ph] of the exposure is between 1.5% and 2% in our gross margin.

Q - Vinicius Canheu {BIO 6300903 <GO>}

Okay.

Operator

This concludes today's question and answer session. I would like to invite Mr. Curado to proceed with his closing statement. Please go ahead, sir?

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Well first of all, I appreciate everyone's attention and time to attend our conference. Of course, the results of the quarter were outstanding but, rather than celebrate the very large number, which of course is the merit of the Company as a whole, because the recovery of a tax dispute is a merit to the Company. But I would just like to emphasize or reiterate that our focus is really to be centered into a pragmatic recovery of our efficiency and, of course, assuring that our growth is achieved, as planned.

So there is a lot of work to do. I think the initial actions, the initial results, bleeding probably the [ph] impact of measures, I think they have shown positive results. And we remain positive about the numbers that we have been telling [ph] the market in terms of deliveries. And we'll be revising those numbers. Actually, we have revised and we'll be announcing those numbers and discussing them in a couple of days in terms of [ph] discussing with (inaudible).

So I thank you all for taking the time to follow Embraer and hope to talk to you in a couple of days. Thank you.

A - Carlos Eduardo Camargo {BIO 20195335 <GO>}

Thank you very much.

A - Antonio Luiz Pizarro Manso {BIO 1845027 <GO>}

Thank you.

A - Frederico Fleury Curado {BIO 2004589 <GO>}

Thank you, all. Goodbye.

Operator

That does conclude Embraer's audio conference for today. Thank you very much for your participation. Have a good day and thank you for choosing Chorus Call Results [ph].

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