Q3 2014 Earnings Call

Company Participants

- Alvaro Penteado de Castro

Other Participants

- Juan G. Tavarez
- Paulo Valaci

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call of Duratex. Thank you for standing by. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions to participate will be given at that time. As a reminder, this conference is being recorded.

Now, I would like to turn the conference over to Mr. Alvaro Penteado de Castro, Financial and IR Manager. Please go ahead, sir.

Alvaro Penteado de Castro {BIO 5537843 <GO>}

Hi. Good morning to you in the U.S. Good afternoon for those in Europe. It's a pleasure to conduct this conference call about the third quarter results. You know that this is differently than the other conference calls, a little different because we do on the following day the Portuguese one, which is our most important, is our annual conference call and we do with a public audience. And in the following day, we do in English the same material.

As you downloaded and took notice of it, you will find out that it's a very thick material. I do not intend to go over in detail all of these pages. I will concentrate my discussion in the results, which I think is what is important. But, of course, I will go through this material very fast in those pages. They are more of a qualitative basis. And in the end, if you have questions, you please – you can ask about that, no problem at all.

Starting on page 1, this is well known. We are part of the Itaúsa Group, and they control the company's share between Itaúsa and Ligna. They are part of the control block. We are Novo Mercado, only common stock, one share, one vote, tag along rights, and a dividend policy worth of 30% of the adjusted net income.

On the following slide, page 2, we have here Duratex's history since its foundation, which dates back from 1951. The highlights here are we were born as an open-capital company, already very unusual in Brazil. Part of this history was made of a number of M&A deals. In 2013, we ended a very important CapEx problem, which now give us, let's say, the opportunity to capture momentum as we experience the recuperation of markets. And finally, we conclude that in 2014, our Duratex 2020 Strategic Plan, which give us more in terms of organic and inorganic growth looking forward, and this I will comment further towards the end of this presentation.

With regard to the competitive advantages on page 3, we stated here five differentials very unique to our operation. First operation itself via geographic diversification and integration of processes. Under the product differential we have the diversity of product and the launching of new products every year, and the corporate governance being Novo Mercado only common stock and having a very active board of directors. I think this is an important differential, not only in Brazil, but also when you look into the best companies abroad.

Innovation, we have a pretty important program, very structured to innovate, which is very difficult in our industry. On one hand, we have the panel-making segment, more commoditized. On the other one, Deca. It's difficult to innovate, but we have structural projects, and we believe we've been very successful in this direction. And finally, branding, which is the summation of all of these aspects that contributes for the build branding of Duratex.

Following to that on page 4, with regard to geographic diversification. It is of common knowledge we have the most diversified operation in the Wood division in Brazil with plants located in the very south in São Paulo and Minas Gerais. All of the other competitors are more concentrated either on Paraná or Rio Grande do Sul, no one with this kind of configuration here. And from 2012 onwards, we have an operation in Colombia where we increased our participation, our stake in that operation in the beginning of this year, achieving 80% stake. And from the beginning of this year, we started to consolidate the numbers of Tablemac into our numbers.

The following page, we have the same feature for the Deca division. Here we have operation in the South, in Santa Catarina right north of Rio Grande do Sul, also in São Paulo, Rio De Janeiro, Paraíba, and Pernambuco. Of course, they're the most diversified segment of our existing (05:52) sanitary ware. Here you can read sanitary ware as PetroChina (05:57). You know that because this product is more bulky, more costly to transport, to move around, this is one of the reasons why we have this kind of diversification, which contributes for a better or lower logistic cost to attend this market in the south and northeast and even in the north region of Brazil.

Following to that, with regard to scale, we almost double-folded the capacity in the Wood Division in this last seven years, growing from 2.1 million cubic meters to 4.1. And in the Deca Division, more than double-folded the capacity we had in 2007, reaching 38 million items a year worth of capacity in 2014. Of course, that currently we are running these plants not only the Wood Division, but also in Deca with a minor or lower degree of idleness, which will enable us to capture momentum looking forward.

Slide number 7 brings a couple of information with regard to integration. On the forestry side, this almost 270,000 hectares of land, which is basically half in half, half is zoned own land, the other half is leased land, where we have about or close to 190,000 hectares of planted forests. This kind of forestry asset is good to supply 100% of my wood necessities in the state of São Paulo and is also sufficient to supply future addition of capacity that is on our plants.

You know that in the beginning of the year, we reviewed this material fact stating two new mills, one of them MDF, another one of MDP, to be located in a greenfield project in the Minas Gerais state. And this project, of course, is currently on hold as we will discuss further. But the forestry asset to supply it is being erected, it is being planted, it is being established, and in the near future we'll be more net on wood,

Another comment here, and, which contributes also to generated excess wood, is the increase in forestry productivity. You can see in the bottom that productivity per hectare per year increased from 20 m^3/ha back in the 1960s to 52 m^3/ha in 2010, and we believe that this may approach 55 m^3/ha, 56 m^3/ha in the next six years. Okay. So, this is also, this improvement contributes for us to generate more wood in the existing land of ours, generating this excess wood needed for the expansion that we are seeing happening in the company.

On the opposite side, we have the resin integration. You know that we erected or we started in 2010 a resin plant that supplies 100% of my resin needs in the state of São Paulo for all the mills. And if we take 100% of my capacity, only this resin plant is sufficient to supply something like 65% of all my needs. It's very meaningful, very important competitive advantage that is translated into lower resin costs or both ways, via logistics and via more tailor-made resin, to our necessities.

Following to that on slide number 8, you have the products for manufacturing woods, MDF, MDP, hardboard, laminate flooring, LVT, which is a PVC type of flooring besides baseboards.

Slide number 9, we have historical of launching of products. Even in this more commoditized segment, we are varying into innovate, release new products, improve the technologies to bring that kind of finishings the closest we can get to the more natural type of woods. These finishings are made of paper, printed paper. And given the advancements in technology, the looks of these panels, they are about the same of natural wood. You cannot differentiate, cannot tell which is what, natural woods or a printed paper today.

On the Deca front, also very diversified. We have on the sanitary ware segment: washer, sinks, tanks, toilet bowls, bidets. On the metal fittings: faucets, mixers, flushing valves, showers, and components. Accessories and Hydra or Hydra now with electronic showers and solar heaters. Also in Deca, here is a big differentiator, the historical launches, no one else in this industry launches as much a products as us. No one has this kind of diversification of items under production. You can see that we manufacture almost 2,000 items in the metal segment, 1,200 in ceramics, and almost 40 items in Hydra.

With regard to corporate governance on slide 12, we have 10 members in the Board of Directors, five of which are appointed by Itaúsa, two appointed by Ligna. Remember, in Itaúsa and Ligna, they compose the controlling block. And we have three independent members, real independent that had one of these supporting committees beside audit, which is headed by Tereza Grossi, which is a specialist in this team, and trading and disclosure, which is headed by the investor relation director.

All the other independent members, they have either the staff governance and nomination committee or a sustainability or transactions with the mandated parties. Being its members of Álvaro de Souza, which is a former CEO of Citibank Brasil; Raul Calfat, Chairman of Votorantim Group; and Amauri Olsen, which is a former CEO of Tigre.

On the corporate governance, we have a sustainability platform with this tripod in terms of focus: dialogue in relationship with third-party staff. Examples of that are stakeholder meetings with suppliers, with community members, environmental management where we have KPIs developed to measure our performance, and business transparency and responsibility.

Under Innovation, we have this program on slide 14, where between January and September 2014, there were presented almost 1,000 project. We have under analysis a little above 200 project, of which we have already implemented 12 ideas. The benefits come from new products, cost reduction, and process improvement.

With regard to branding, we have the traditional brands well-known in the market, a diversified product portfolio with penetration in different market segments, not only premium but also economic. We are or we have the most recognized brands. We'll win all the years the top of mind prizes for bathroom seatings, both metals and ceramics. And we win also or we have nomination even in segments where we are not present, like sink and wash basins made of steel. We've got the fifth place in shelves, ninth place in gas-heating systems, and seventh place in plastic faucets, which, of course, we do not manufacture, but this is important to transmit the brand awareness we have.

Also, an important focus is sustainable products. Deca, we have a complete line of water-saving devices. And in panels, all these panels are manufactured with wood coming from reforestation activity and forest, which are also certified by both ISO 14001 and FSC.

Following to that, under brand strengthening, we have the recognition by Dow Jones Sustainability Index and ISE, which is the local sustainability index of Bovespa.

Well, having gone through all of these more qualitative issues, we'll spend some time now, from now onwards, talking about the numbers, the results of the company.

Starting on page 18, I think it's important to highlight the big improvement we had in terms of the results in the third quarter 2014 over second quarter. My guess is that when the second quarter, given the combination of very negative events, the World Cup, the less working days, and movement of the retailers to destock to prepare for more difficult times, all of that together contributed to a very poor performance in the second quarter, which was overcome in the third quarter.

We can see volume increasing very strongly in the Wood Division by 18% quarter-on-quarter. On the Deca front, despite the difficulties faced in the housing segment given the low levels, the low confidence levels that we have in the economy right now in the consuming side, in the industry side, still performing quite well with posting an increase of 4% in volume growth.

With regard to revenue, we see the Wood Division growing by almost 14%. And here, one comment already. The volume increased by 18% and revenues by only 14%. Why? Well, given the very bad momentum we experienced in the second quarter, we have to, we had to give some discounts to recuperate our market share base which we were successful in doing so. But of course, that there was some negative developments on the revenue side. These discounts were up to 5%, and you can see here despite growing by 18% volume, revenue increased by only 14% because of these discounts. On the Deca front, prices were stable, so volume increased by 4%, revenue increased by 4%.

On the EBITDA side, the result of that was an increase by 14%, and we had also a positive development on the margins growing from 21.7% in the second quarter to 22.4%. This improvement is the result of the gains of scale because, or since we took off 5% of the prices in the Wood Division, and still were able to generate margin gains in the period.

Profit increased by 42.5%, totaling BRL 83.5 million for the period. And of course, that we have a couple of challenges looking forward. The first one I think is to increase the occupancy rate in our plants. It is, we showed already that with more volume, the economies of scale come, they appear. So, we need to occupy these plants to take the benefit of economies of scale, given that we pushed a great deal of new capacity in the end of 2013. Now, the challenge is to occupy those.

And the second challenge is to recover our historical level of margins. But to do so, to be successful with that, of course, that we did at this present time, the recomposition of our price base. Today or because of the lack of visibility we have today, it is not, we are not very certain, very sure when that's going to be possible. You know that in our business, we have a, kind of, a seasonality. We are approaching the time when activity starts to diminish, which is the month of December. So, right now, we believe that is not the very best of the moment to try to address this recomposition of prices. But we are analyzing the market, we are very into the demand pattern, and whenever we see the possibility, the opportunity to recuperate those margins, be sure that we will move into that direction.

Following to that on slide 19, we have some information with regard to the revenues. You can see that on a consolidated basis, revenues increased quarter-on-quarter by 10%. Year-on-year increased by almost 3%, the same figures for the cumulative data. Gross margin stayed pretty much flat quarter-on-quarter and down year-on-year, basically because of this cost pressures that we are facing. It seems the last time we were able to increase prices, which was in January 2013. Since then, we are bearing not only the increasing cost in the inflation, but also via these economies of scale since recognition, again, new capacity more towards the end of 2013, which contributed to increase depreciation, contributed for a higher number of employees in the plant and so forth.

On page 20, this is how we are presenting the information, given that we started to consolidate the Colombian operation. So, on the top, we have volume, Deca, Wood, EBITDA, recurrent net income and return on equity only for the Brazilian operation. Then we have the Colombian operation, and finally, in the bottom, the consolidated data.

Colombia is contributing with a volume of 54,000 cubic meters for the quarter out of the 763,000 that we did on a consolidated basis. EBITDA was BRL 13.5 million. Total EBITDA consolidated, BRL 237 million. EBITDA margin, a little below the margin in the Brazilian market, 20% as opposed to 22% in Brazil and recurrent net income, BRL 7 million, okay? Following to that, we have the performance of the panel market in Brazil. We can see here that still the MDF segment is the one that is contributing best for the performance of panels. MDF increased shipments by 6% cumulative data 2014, as MDP decreased by 8%, okay?

The comment here or the reason why of this performance, is that MDF is more geared to tailor-made furniture and, which tends to be more resilient even in more difficult times as the one that we are experiencing. This is to also in the quarterly review, we can see third quarter 2014 over 2013, the performance of MDF was even higher than the one seen in the cumulative data, increasing by 12% and, on a quarter-on-quarter basis, increasing even more by 24%. So, this market is really showing resilience. Our decision-making to add the new MDF facility in Itapetininga was proven right, even though this plant arrived in a more challenging momentum. We are very optimistic with that. We believe that, looking forward, we will have the ability to occupy this capacity quite fast.

On the MDP, though, the market is more difficult. This kind of panel is more geared to low-income furniture. This segment, of course, is more exposed to the macro environment situation. Consumers of this kind of furniture, they tend to have less savings. They are more exposed to the macro environment. So, we see the activity there more challenging, but looking forward, we are optimistic with the recuperation of it.

Following to that, we have some information of more of the decision here in terms of shipments. We can see that consolidated shipment increased by almost 11% year-on-year, 18% quarter-on-quarter, and cumulative data by almost 5%. Of course, that here we have the volume from Tablemac contributing with 50,000 cubic meters in the year of 2014. If we disregard that, there was no growth basically in shipment, which is pretty much aligned with the GDP expectation for the year, which will be very close to zero.

Since we have a correlation with this kind of market, this is expected. This was pretty much expected. What we did not anticipate was the deterioration of the Brazilian economy during the year. We started our budget to 2014 with an expectation of GDP more close to 2.5%, which, of course, would be impossible to achieve. Again, it will be more close to zero, and this kind of volume is aligned, is more or makes more sense with the kind of macro environment that we are facing.

In the bottom, we have the levels of occupancy rate. Here, basically, is performance third quarter over the available capacity. And again, MDF showing a very interesting occupancy level, above 80%, lagging is MDP with only or close to 70%. One comment here, that during the fourth quarter, at least the month of October, currently, MDF is running at full capacity, okay? MDP improved a little bit, but it's still below 75% occupancy rate.

Following, we have performance net revenue and gross margin, and on the bottom, EBITDA, EBITDA margin. Some highlights here, which contributes to explain this kind of performance in 2014. Of course, the lower price base contributed for the recovery of share. You can see that on the volume side. Gains of scale and a more favorable cost contributes to the improvement of margins in the quarter. This is very visible here. Recurring EBITDA margin for the second quarter was 24% and in the third quarter, 25%. Even the gross margin improved a little bit from 29.3% to 30.4%.

So, in the Wood Division, gains of scale contributed a great deal to this improvement and, of course, that we had some help coming from a more strong real during the period that contributed to ease a little bit the cost pressure and the commoditized goods, such as resins.

Following to that, on the Deca front, situation is still very difficult and you can see that via the analysis of the ABRAMAT index, remembering that this index measures the performance of revenues in the domestic market of new building materials. You can see that from January to September 2014 over the same period last year, the performance was minus 6.5%. For the year, there is an expectancy for this index to be minus 4%. So, really the building material industry is experiencing a more challenging environment given the low degrees of consuming confidence. It's very difficult for someone to compromise themselves in this kind of environment with a very, very little visibility. You know that a unit ticket in a remodeling project or in the acquisition of a real estate are higher than some other baskets of consumer goods. And the terms offered or the terms used to finance these goods, they tend to be long term for acquisition of a house or very short term for a remodeling. So, we see consumers more, not so much into starting a new project in this direction. This is, of course, contributing to take a little momentum from that right now. But again, we believe that this division is pretty well-positioned. It is the brand, the strength of brand or the Deca brand is to contribute for a fast recovery when we see or start seeing the improvement of the macroenvironment of this division.

On page 26, speaking of revenues and EBITDA and margins, we can see an important recovery in the sense that there was an improvement in revenues quarter-on-quarter by almost 4%. And on a consolidated basis, revenue stayed or remained stable year-on-year.

On EBITDA front, despite all of these difficulties, we can still see that the margin is flat, it's stable. We credit that to the enrichment of the sales mix and a little gain of scale. And even though we see some cost pressure, diluted by that cost pressure coming from the increased capacity, these economies of scale with the inauguration of the Queimados plant and the rebranding of Hydra that also contributed to increased selling expenses in this division.

Having said that, giving some color or showing that the market is really more challenging, we accomplished a number of investments in these last years. Investment was consistently above the minimum for maintenance, we're using around BRL 300 million, BRL 350 million per year. Every year in this history, we posted investment above that level with a record level in 2008 where investments reached almost BRL 900 million. 2012, another heavy year in terms of investments; almost BRL 840 million. And specifically in 2014, since we started to see the deterioration of the scenario, we took our foot from the gas pedal. We valued some organic growth projects and decided to focus on maintenance and finished some more the investments that were going on, approaching the investments for this year to the maintenance level.

Highlighting that, we accomplished a couple of acquisitions that added to BRL 210 million to the expected of BRL 650 million. So, if we disregard the acquisitions, investments for this year would approach the BRL 400 million level, a little above the minimum for maintenance, which should be the size of the CapEx for 2015 at least for now given, again, the lack of visibility. Of course, that on top of the maintenance CapEx, we might increase investment if there's an opportunity on the M&A front. Besides that, we will aim to the minimum.

With regard to the highlight in terms of concluded projects in 2013, again, the plant in Queimados ceramic ware, we added about 25% capacity in that segment with this plant. In Itapetininga, we accomplished this new MDF plant with an effective capacity of 520,000 cubic meters. Remembering that with the addition of this capacity today, we have something like 4 million cubic meters worth of capacity.

So, the addition of this new plant represented a great increase in terms of capacity for the Wood Division, an increase when we take the aggregate level of capacity of 15%. Likewise, we accomplished the debottleneckment in the Taquari plant, adding 230,000 cubic meters worth of effective capacity for MDP.

With all of that, still the debt level is very okay. You know that we have, by policy, kept in terms ofdebt, we cannot go beyond at that EBITDA of 3 times. We are at 1.8 times, almost 1.9 times. And you can see that the leverage increased not because of the debt, because net debt is still at BRL 1.8 billion, even a little lower than the net debt posted in June 2014. But of course, because of the weaker EBITDA generation. Okay?

On the bottom, you can see the amortization schedule, very okay. Even with this billion reals maturing next year, we are already negotiating the revolving of these lines. We don't believe we will have any difficulty in that front. We are very comfortable with the situation. And then you have the debt origin, where you can see that even the foreign denominated debt is, which accounts for 22% of the total is fully hedged. So, in the end, most of our debt is in reals.

Following to that, we have some information of the macro environment. And here, of course, we bring not only Brazil but also Colombia, where we have a plant, also we have an induced operation. And here, you can clearly see the differences between these two economies, which emphasizes our focus in growing our participation in that market, which is outperforming the Brazilian market. You can see that in terms of GDP growth, you can see that in terms of savings, in percentages of GDP. You can see interest rates. How more friendly they are in terms of the Brazilian one. And also inflation, which is much more under control under the Colombian environment.

Following to that, on page 30, we bring a little more color with regard to our strategic planning. Here, we bring a little part about this, Duratex 2020 plan of ours, which was completed in the beginning of the second half of this year, and was formally presented to our board of directors. Here, the growth, better will follow both ways. Organic (37:37), including the conclusion of all these projects that I mentioned already in 2013, and of course, that we have new projects just waiting for an improvement of the macro environment.

And here, the big highlight is that project of ours in Minas Gerais, again, for an addition of 1.4 million cubic meters worth of panels for an investment of BRL 1.3 billion. Of course, that this investment, whenever we decide to take this or to go forward with that, will not take place at once. Normally, it takes between three and four years for you to disburse all of this amount of money, so there's not going to be an important or a relevant concentration of CapEx, even when we decide to go forward with that. Currently, this project is on hold.

In the inorganic growth path, we have some ideas, of course. We have a primary focus to grow our operations abroad in the Latin America region like we did in Colombia with Tablemac. And also, we have a bias to grow our product portfolio by diversifying further. You know that some examples in this end, there are actually two examples. We have Thermosystem, the shower business that we acquired in 2012, and MIPEL, the industrial valve company that we also acquired. Both are examples of what we should see in this path.

A little before finalizing, I would like to stress that we are positioned to grow. We have a good corporate governance at our not only Board of Directors but executive levels. Both bodies are very aligned, very compromised to grow the operations. We have a well-balanced capital structure to take the advantages that might approach both ways in terms of organic growth, in terms of inorganic growth. We have a unique situation that, with plans that were already accomplished. They were already finalized. They are ready to capture momentum as demand presents itself. We have also a unique situation. No one else has this situation in the industry, a forest integration dimension to attempt an increase of capacity of 35% which, of course, includes the Minas Gerais project that is currently on hold.

And finally, I would say that we are focused on sustainable and long-term value generation. We are facing a very short-term disfavorable situation, but we are pretty much positioned to capture momentum as Brazil improves its performance.

Finally, market recognition number of prices that we want. And with that, I finalize my presentation, and I put myself available for the questions and answers that you may have. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Paulo Valaci with Brasil Plural.

Q - Paulo Valaci {BIO 18268142 <GO>}

Good morning, Alvaro. Thank you for the opportunity. I have two questions. The first one is about the competitive environment in the originally wood panels market. I was wondering if you could outline where you see total capacity, wood panel production capacity in Brazil going in the medium term? That would be very helpful.

And then, if I may a second question, is about capital structure. Given the recent delay of the company's medium-term growth initiatives, do you think some form of an extraordinary dividend or a share buyback would be possible in the medium term? Those are the two questions. Thank you.

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Hi, Paulo. Thank you for your questions. Starting with the first one, with regards to the competitive environment in the wood division. What we see is a market that is much more rational than we saw in the past, okay. I think the big difference today is, with regard to one of our Chilean players that is much more rational, is much more focused in improving its performance. It was an important change in management a couple of years ago. And after that, we saw more rationality in that company.

Of course, since it takes two years for you to accomplish a new organic growth project, this is the amount of time for you to erect a new plant. All of these news that were commissioned in 2011, they were thought in, sorry, they were accomplished in 2013. They were thought in 2010 then, which was a very good year. Even in 2011, with that odd year, the competitors pushed a little bit further down the road. This CapEx, okay, is trying to inaugurate to commission in new capacity on more favorable environment which, unfortunately, did not happen because these lines arrived in the verge of a turning point, given the World Cup and the number or the fewer number of working days, and on top of that, of course, elections that normally has a neutral effect on performance.

This specific election this year, as it brought a possibility of an important change in terms of the conduction of the economic policy (44:08). Everybody stops. The business environment stopped to wait the outcome, which, of course, now is known. We took the part of this uncertainty out of the way. My guess is that the market will go back to a more normal kind of growth. And the reality of this new government, which should be a little above 1%, my guess, okay, total personal guess, which is good. I mean, at least, we will start growing again and demand should present itself.

With regard to the competitive environment and the addition of future capacity, what I have to say is that, of our knowledge, there's only one new mill coming to the market probably more towards the end of next year which is a plant from Berneck. Berneck decided to do two plants, one of MDF, which was accomplished by 2012, mid to end of 2012. And in the sequence, they started to do these MDP plants that should be ready by the end of next year. Of course, the Berneck in our view, they are already postponing their assembling process to bring this new mill in a more favorable environment. But of our knowledge, that's what's going on in the market today. And of course we have this CapEx of ours that is currently on hold and we will wait until we have a better stance, a better feeling on the best time to bring this capacity to the market.

With regard to the second question of yours, with regard to the capital structure, what I have to say is that, well, dividend is of a decision making of the board of directors, okay. Since we are reducing our CapEx to a minimum, of course, that will generate a great view of free cash flow next year. Is it possible to increase dividends? I guess, yes. It is possible. But we have to wait a little bit to see what the board thinks about it. We have to see a little bit if they are not thinking in a bigger project, speaking of an acquisition.

We have to wait a little bit to have more color on what they will decide to do with this excess cash that probably will start generate.

Buybacks, I would say that is secondary. It is not our primary focus. I would say that either way, we'll be increasing dividends or acquisitions, okay?

Q - Paulo Valaci {BIO 18268142 <GO>}

All right. Thank you.

Operator

Our next question comes from Juan Tavarez with Citibank.

Q - Juan G. Tavarez {BIO 15083199 <GO>}

Hi. Thank you. Good morning, everyone. Just a quick question on inventories, if you can give us a sense on the process supply chain. How are you seeing inventories both for your customers and competitors?

And then my second question is around pricing. I know you mentioned that in MDF, the market is quite tight, and you're recuperating some of the discounts that you were given earlier in the year. But I'm curious if on MDP, you're still seeing some pressure, and then looking into next year, how do you see the dynamic? Do you see the possibility to pass prices in line with inflation, or do you see it a bit more challenging?

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Hi, Juan. Thank you for your questions. Well, with regard to the inventory level, when we talk about our customer base, the inventory level tends to be low. We don't see much inventory formation in our client chain. Specifically, when you divide the kind of clients, you know that we sell to tailor-made furniture manufacturers, which in big numbers probably accounts for about 30% of our revenues, and the remaining 70% goes to mass production furniture. When we assess these two segments, I would say that the tailor-made furniture segment works in adjusting time fashion. If the client puts the order, then we'll react and put the order on the industry. So there's no inventory there.

But when we talk about the mass production furniture, I would say that probably you should have, on a normal period of time, about 30 days' probably worth of inventory on the manufacture, and probably up to 30 days on the retailers, up to, it's less than 30 days. During this destocking level that took place between April and June, I would say, these inventories, they dropped to a very critical level. The information we had after July was that some clients in the retail, they even lost revenues because they did not have the products in inventory. So, the industry or the chain got to a very critical level of inventory.

Of course, that today or after we started to see the recuperation of shipments, the first movement probably was to recompose part of this inventory. But, and probably this started to happen in July. But the movement we saw in terms of shipments already in August, September, and even October, this shows that the market is pretty consistent and more consistent even in the MDF segment.

The reason why we started to take off the discounts granted already in the month of, in the end of the month of September, so this is not yet present in the numbers that we posted. This new situation will be more seen in the fourth quarter, even with the possibility of a little improvement on the margin side, okay. Of course, that we depend on few or more information of what's going to be in the month of November and even the month of December when traditionally the activity starts to diminish, but the expectation is there.

With regard to prices, again, the last time we increase prices was in January 2013. After that, we see a number of efforts. We started to address the cost issue reducing where we could, reviewing CapEx, doing our homework to adequate the company to this new reality. And right now, what I can tell you more firmly is that the discounts in the MDF segment are gone, okay? And even in some specific segments of MDF or some kinds of finishing, we even increased prices already. But this reality is not seen at least for now in the MDP segment, which is lagging.

You see, when we're talking about an occupancy rate around 70%, 75% right now in October, there is too a lot of idle in the industry, and this is best specifically for those players with only one client of MDP. For example, not that they are doing this but when you see Eucatex with only line of MDP, when you take (52:09) only one line of MDP, examples of the situation, these guys have to run their plant with the highest degree of occupancy rate possible. And for doing that, sometimes, they push a little bit or give more resistance to price increases in this specific momentum since this product is very commoditized.

Looking forward, again, we don't see room presently to move prices up. We need a little more color on the demand better specifically looking forward how we will pass through first quarter 2015 which seasonally will tend to be weak as every first quarter to start thinking about or having more information about what's going to be the second, third and looking forward, what's going to be the rest of the year of 2015.

There are still a lot of uncertainty towards who's going to be the finance minster, who's going to – what's going to be the policy to fight the inflation, which is running, as everybody knows the (53:22) of the band, which is very bad specifically when we talk about cost pressures specifically on the labor front that every year you have to sit with the union as we renegotiate salary terms. This means a lot in terms of cost pressure specifically when we talk about Deca Division. So, there is, we still need more information to decide when the best momentum to readdress pricing, but for sure this is not the right time.

Q - Juan G. Tavarez {BIO 15083199 <GO>}

All right. Thank you.

Operator

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

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Well, thank you all for company conference call. Myself and my team, we are available to address the further questions that you may have. Thank you so much and hope to talk to you soon. Okay. Bye-bye.

Operator

That does conclude the Duratex conference for today. Thank you very much for your participation. Have a good day. And thank you for using Chorus Call.