

Y 2019 Earnings Call

Company Participants

- Andre Luis Rodrigues, Executive Officer
- Paulo Geraldo Polezi, Finance and Investor Relations Executive Officer

Other Participants

- Andressa Varotto, Analyst
- Augusto Ensiki, Analyst
- Catherine Kiselar, Analyst
- Fernando Leitaó, Analyst
- Gabriel Rezende, Analyst
- Marcelo Motta, Analyst
- Victor Mizusaki, Analyst

Presentation

Operator

Good morning, and welcome to WEG's Audio Conference to announce the results concerning the Fourth Quarter 2019. We are broadcasting this audio conference, along with the respective slide deck at the following address ri.weg.net. Afterwards the audio track will be available at our website. (Operator Instructions)

Forward-looking statements made during the call about the company's future results, about the perspective of the company's outlook, about operating and financial projections and targets and to the potential growth of company's are based on expectations and assumptions on the part of the company's management and based on information currently available.

Such forward-looking statements involve risks and uncertainties and therefore, depend on circumstances that may or may not materialize. Investors should have in mind that economic conditions in general and in Brazil and in the world, as well as other operating factors might affect the company's future performance and lead the results to different from those expressed in these forward-looking statements.

I would like to remind you that this conference call is being conducted in Portuguese with simultaneous translation into English.

With us today in Jaraguá do Sul, we have Mr. Andre Luis Rodrigues, Chief Administrative Officer; Paulo Polezi, CFO and IRO; Wilson Watzko, Controller; and Andre Salgueiro, IR Manager.

Now, Mr. Rodrigues, you may carry on.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Good morning, everyone. It is a pleasure to be with you once again for the audio conference about the results obtained in the fourth quarter of 2019.

We'll start with the highlights, where our net operating revenue grew by 20.9% when compared to the fourth quarter of 2018. The good performance of our business in Brazil, along with the growth of new businesses such as solar generation, and the growth in revenue coming from GTD and the external market have supported our performance, even in a scenario, where growth is slightly low in Brazil and despite some indications of a slowdown in the global economy. Details about this performance will be presented by Paulo, as we move ahead.

Another highlight was the EBITDA, which showed a growth of 36.1%, reaching the level of BRL666 million in the quarter. EBITDA margin grew by 1.9%, reaching the level of 17.6%. That figure is the result of a favorable combination of the following points: cost rationalization, expense reduction, economies of scale and a favorable mix of sold products.

Lastly, we have another growth of -- growth of return on investment, as we will see going forward, which saw an increase of 2.6% when compared to last year's fourth quarter, reaching a level of 20.2%. The consistency of this number for the last quarters are a result of our improvement in operating performance, as shown by our growth in revenue and the improvement in our EBITDA margin, with a more attractive combination of development strategy with return on investment -- invested capital, along with more discipline in capital use, as shown in our working capital management and the optimization of our investment program.

I'll now give the floor over to Paulo Polezi, who will continue with the presentation.

Paulo Geraldo Polezi {BIO 19468811 <GO>}

Good morning, everyone. Moving now on to slide number five. We saw the evolution of business areas in different markets, where we operate. Starting with electronic equipment industrial in Brazil, we saw another year of -- another quarter of good performance for the short cycle equipment, which has been showing continuous improvement.

The highlight was the modest improvement in the demand of long cycle equipment, automation panels and high voltage motors, allocated for specific segments such as, pulp & paper, oil and gas and mining. It's worth mentioning that higher demand is concentrated in those segments. Despite the fact that Brazil has fewer or few projects of expansion in those areas.

GTD picked up some growth again, despite lower stake or the lower participation of wind projects throughout 2019. Transmission and distribution have positively contributed especially because of products linked to the auctions of transmission conducted in the past years.

Solar generation remains as a big highlight, especially in terms of distributed generation, where revenue has been growing in a consistent way for the past quarters. Part of that performance can be attributed to orders, which were anticipated due to a possible change in the regulation of distribution of -- and generation, which was scheduled for early 2020, but which never materialized.

For motors and for domestic use, we continue to see good performance in revenue, which has been strong [ph] since the early in the year, which is closely linked with an increase in market participation in important segment such as, dishwasher, washing machines and air-conditioning machine.

In the paint and varnishes division, the good performance in the quarter was driven mainly by the increasing participation in markets and with strategic clients such as maintenance projects and important segments, including oil and gas. In the external market, our performance in industrial electronic equipment was also positive despite the lower pace of growth when compared to previous quarters because of changes in the macroeconomic scenario, which have been pointing to a slowdown in the global markets.

On the other hand, long cycle equipment, such as, high voltage motors, automation panels continued to display good performance. Projects in important segments for WEG such as oil and gas, mining, water and sanitation were the main destination -- destinations for those types of equipment.

In the GTD area, the biggest contribution came from transformers, especially due to synergies already observed in our operations in the US and Mexico, with new orders for transformers for renewable energy hubs in the US and new projects in Mexico.

As for motors for domestic use, the slow performance in China in the past quarters along with uncertainties in Argentina have affected the numbers for this quarter, despite the good performance shown in the operation for our commercial motors in the US. And the paints and varnishes, the growth in revenue is a result of the constant search for new clients and also an increase in market state in Latin America.

Slide number six shows the evolution of our EBITDA in the fourth quarter last year, where we saw a growth of 36.1% vis-a-vis the fourth quarter of last year -- of 2018, sorry. The EBITDA margin closed at 17.6%, an increase of 1.9% when compared to the fourth quarter 2018. Reasons for that improvement include, this gain in margin in some businesses in Brazil, especially in automation and generation products; the better profitability abroad with a highlight for our T&D operations in the US and in Mexico; and also to a favorable mix because of a higher participation of our more mature businesses on top of a better revenue stream coming from wind generation.

Slide -- lastly on slide number seven, we have our CapEx investments for the past quarters. In the fourth quarter of last year, investments reached to level of BRL180.3 million, 38% of which allocated in Brazil and 62% allocated to production units abroad showing an increase -- an increase when compared to the fourth quarter of 2018, especially driven by the expansion of our motor facility in -- motors facility in China, and the conclusion of our unit in Mexico.

Now, I give the floor back over to Andre.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Thank you, Paulo. In conclusion to wrap up and before I move on to Q&A, I'd like to reinforce some of the accomplishments that we have met last year and our outlook for 2020. As we mentioned early 2019, our main drivers for the year were profitability and return on invested capital. With the numbers just shown, we have this feeling that we have managed to reach our objective. Return on invested capital reached the highest level of [ph] last years and our EBITDA margin showed another -- yet another year of evolution, even if we discount the effects of IFRS 16, which positively impacted our margin by 0.5 percentage point in the year.

Additionally, we would like to highlight that the efforts that the company made to maintain revenue growth close to historical levels despite the lower level of revenue forecast for early in the year for GTD. There was an initial concern because of a lack of projects in wind generation, but throughout the year, we are able to find avenues to minimize that impact. The good performance in solar generation and distribution and transmission are good examples of the efforts that helped us minimize such impact.

We also announced in January the 1st, agreement to supply wind turbines of 4.2 megawatts with Alianca Energia. The agreements contemplate the construction of 4 wind parks, made up of 43 wind turbines, totaling 180.6 megawatt of installed capacity. The revenue will reach about BRL590 million and deliveries should start in 2021 and extend throughout 2022.

We also announced just now in January, an agreement to -- for the acquisition of one of the transformers factory of TSEA (sic) located in the city of Betim, in the State of Minas Gerais. Built in

2013, the factory has 32,500 square meters and has state-of-the-art equipment in place. The transaction is still under the approval of the CADE, the authorities.

As for our outlook for 2020, we have the expectations to have yet another year of growth in revenues. The indications of improvement in the Brazilian economy, where projections that the GDP will grow above 2% and the expected improvements globally should continue to support our growth in revenues. We continue to keep our focus on improving our EBITDA margin and consistent return on invested capital.

The good performance of our more mature business in Brazil and the better profitability of our operations abroad were contributed to our objectives. It's worth mentioning that those -- that outlook does not -- do not include the impact of Coronavirus and a possible slowdown in global growth. As for that -- as of now, we do not estimate relevant impact coming from the virus, but given the level of uncertainties, we cannot state that the same scenario will remain throughout the year.

We can now move on to the Q&A session. Please, operator, you have the floor, once again.

Questions And Answers

Operator

Ladies and gentlemen, we'll now start the Q&A session. (Operator Instructions) The first question comes from Gabriel Rezende from Bradesco BBI.

Q - Gabriel Rezende {BIO 20589376 <GO>}

Good morning, everyone. Going back to solar energy in the domestic market, as ANEEL plans to review subsidies in solar energy and so discussions will extend a little more, well, how will that affect you in that. Can we expect a slowdown in growth because of that.

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

Hello Gabriel, this is Paulo Polezi. Thank you for your question. We did have -- I'll start by saying the following. I'll backtrack a little. We had a very good performance in solar in the fourth quarter. Distributed generation, it came out above our expectations. And of course that positions the company in a good place because of our network, our position in the market with national coverage, a very broad coverage.

Now, the regulatory change to your point never materialized, never happened. As of now, it is hard for us to say anything about that because we do not know what -- how much was anticipated; we don't know how much of that amount was anticipated. So we'll have to wait and see. There is no fixed date for that. And without that date, we expect demand to continue consistent as it has been the case so far. So we cannot say anything about that now. What I can tell you is that as long as we do not have a final set date, the trend is for the market to continue to behave in a positive manner, as it has been doing.

Q - Gabriel Rezende {BIO 20589376 <GO>}

Okay. Thank you. But could you give us a breakdown of your backlog now early in the year in GTD?

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

Our GD backlog is short, distributed generation, GD. But as I said, our network is national. We have national coverage. We have been bringing in -- bringing in new entrants to our base. What I can tell you in terms of backlog has to do with our solar plants. Just as a reminder, we have a very interesting combination of solar plants. Last year, we had a prevalence of distributed generation.

We had two new solar farms, right delivered Esmeralda and Sobrado in the second half. And for this year, we will continue our project in the State of Paraiba which will also contribute to the numbers in the first quarter of this year. So that's the backlog in terms of plans that we have.

However, there are other projects out in the market, which we are looking into, and we might have other solar plants coming in throughout the year. So as we have the agreement signed, we'll update you on a quarterly basis.

Q - Gabriel Rezende {BIO 20589376 <GO>}

Okay. Very good. Thank you.

Operator

Once again, our next question comes from Marcelo Motta from JPMorgan.

Q - Marcelo Motta {BIO 16438725 <GO>}

Good morning. Still going back to the Coronavirus impact if you could tell us the status of operations in China. I can imagine the operations in China have been affected. Are they back in full capacity after the New Year celebrations. And what do you expect in terms of supply chain, we see in newspapers that there is a risk of some inputs never making it to China. So what kind of impact can we expect, should the problem extend for some more time?

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

Thank you, Marcelo. So we'll talk about Coronavirus in two fronts. Number one, operations in China. The impact is concentrated in the four production units in China. If the situation worsens, we have just to let you know, we have a daily follow-up on that. If things move ahead according to what we expect, we'll not see major material impact on the numbers of the company, which have been consolidated already.

And in terms of operations, as we had announced early last year, the different units went back into operation. We are not operating at a 100% yet because there are restrictions for people to move around, not all WEG associates leaving the area, many travel because of New Year celebrations. And those who traveled need to wait for the lock down to be able to come back to work. So we need to wait for that to stabilize, to see in the coming days what will happen as those employees come back to work. And of course that also goes for raw material, input that are expected. Our suppliers are going through the same experience we are. Then we are in compliance of course, with everything the Chinese authorities have asked us to do. And as I said, should that situation go back to normal, as we expect whatever losses we may have now will be recovered throughout the year.

Outside of China, we also have some concern and that of course is related to the supply chain as you mentioned. And the main problem would be focused on the automation division. China is the main supplier of electronic equipment in the world, as you know, and we also are supplied by them. And also on top of automation, solar panels. Several suppliers have not recovered full capacity yet, and we do not have a final word as to when they're going to be back to work.

What we have in concrete terms. Our inventory level or levels will keep us working throughout the first quarter. If we have any glitch, any problem in supply for those inputs, for those raw materials, we'll only feel the effect at the end of the second quarter. So when we announce first quarter results, we'll have a better update concerning the coming months.

Q - Marcelo Motta {BIO 16438725 <GO>}

Thank you. If I may, I have a follow-up. Any impact on the cost of those inputs that you envision. Do you expect in terms of solar equipment, solar components, do you see any impact in cost that might impact first quarter results?

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

Well, there is going to be an increase, no doubt. I'll give you an example. At our motors unit, we import fewer components, and we saw a slight increase in cost. But nothing major, nothing that will entail serious impact on the company's consolidated numbers in the first quarter.

Q - Marcelo Motta {BIO 16438725 <GO>}

Okay. Thank you.

Operator

Our next question comes from Victor Mizusaki from Bradesco BBl.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Good morning. Congratulations on the numbers. I have two questions. Number one, Andre you mentioned that for 2020, you will be focusing on of course once again, return on invested capital and EBITDA. Can you talk to us a little bit more about the return on invested capital? Are you talking about any one specific business unit that could be leading that increase in returns. And number two, the electric engines for trucks, when can we expect revenue from that front to come in.

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

Hello Victor, thank you for your questions. As for our EBITDA margins and return on invested capital, we have no guidance. But what I can tell you is that the company's focus has been and will always be to display consistent results both in EBITDA margins, and on return on invested capital.

As for the Oman [ph] project, as far as we know from that venture is that we'll start producing equipment in the last quarter of this year. So we'll have an impact on our revenues, an initial impact of course in the last quarter of this year. In any case, any update on that front will be passed on to you as soon as it comes into us.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Okay. Thank you.

Operator

Our next question comes from Fernando Leitao, XP investments [ph].

Q - Fernando Leitao {BIO 4411017 <GO>}

Good morning, everyone. Thank you for taking my question. I'd like to know the following, you operate in several industries, right.

Operator

Once again, Fernando your microphone is open, you can carry on. Once again, our next question comes from Augusto Ensiki from HSBC.

Q - Augusto Ensiki {BIO 15988025 <GO>}

Good morning. Thank you for taking my question. While, you talked on WEG Day, the impact on those numbers -- in the company's revenues?

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

Augusto, we couldn't really understand your question. Can you please repeat your question. You want us to compare WEG Day with what? Sorry.

Q - Augusto Ensiki {BIO 15988025 <GO>}

The number of solar kits.

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

The solar kits. Okay.

Q - Augusto Ensiki {BIO 15988025 <GO>}

What kind of impact did that have on revenues, the number of solar kits?

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

Augusto, good morning. This is Andre speaking. Actually what we talked about on WEG Day is the following, with an -- with the increase in capacity because of our new distribution warehouse, we increased our capacity to 115 kits a day, so that happened in August. And given the demand and the pace of develop, not the business, you can say that in the last quarter, we are close to 150 kits a day, close to 150. We have still keep an eye on the market and see how that plays out and then think about new investments on that area.

Q - Augusto Ensiki {BIO 15988025 <GO>}

Okay. And what would be the contribution of that segment to the revenue stream, solar kits.

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

We do not have that breakdown. That's under GTD. The release makes it clear that we're talking about solar growth, as a whole. It's -- it is a norm of the company, which has been growing in importance, which has the best performance in Brazil under GTD, but we do not have a breakdown per segment. But since last year when solar matured it is seen by the company just as the other business, the company operates. It is under GTD, but we do not provide a broken down figure.

Q - Augusto Ensiki {BIO 15988025 <GO>}

Okay. Okay. Thank you.

Operator

(Operator Instructions) Our next question comes from Catherine Kiselar, Banco do Brasil.

Q - Catherine Kiselar {BIO 20979709 <GO>}

Good morning. Congratulations on the numbers. My question is the following about the auction contracts going forward. Can you give us some color on that front any changes. And what are the company's expectations going forward vis-a-vis the coming auctions?

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

Catherine, this is Paulo. Thank you for your question. I'm going to talk about the transmission auctions and energy auctions, you did not specify, so I'll address both types of auctions.

For the auctions, which took place for transmission, we won some of them. Our order portfolio is being put together. We haven't reached its maximum level even though auctions have slowed down in pace. But that's one of the reasons that led us to acquire the transformer plant in Betim, as Andre mentioned earlier today.

For the past, our auctions in transmission, there are a few contracts, which are not -- have not been signed. We are still negotiating them. So we expect to have 10% of the auctions is still up open outstanding the market. The last one in 2019 was a smallish auction and some of the participants made very low bids and that might exert some pressure on margins.

For this year, ANEEL has already announced that they intend to conduct two auctions for transmission, one in July and another one in December. Both together should add up to BRL10 billion or BRL11 billion. And then we have different auctions happening in 2022, '23 and so on. So we are now reaching the end of this opportunity, a window for the best auctions, but there are still there -- there are opportunities out there.

As for generation, which is the flip side of the business for WEG, the last October have -- the last auction happened in October, the A minus six that auction was important for our industry because it indicated an increase in demand for energy in the country. So it added 2.9 gigawatts of installed capacity equivalent to BRL11 billion of investment. For WEG that means new opportunities, including hydro projects, hydropower plants, which we hadn't seen that happen in the past years, big opportunities like that and also opportunities in wind and solar.

There are auctions already scheduled for 2020 for April, for energy, the A minus four, for natural gas and coal, which is not really our portfolio. Then that in May, we have another A minus four, focused on hydro, thermal, solar, wind and biomass. And in that case, we have a complete portfolio to participate in those auctions. So in summary, we have a very positive outlook in terms of auctions for 2020.

Q - Catherine Kiselar {BIO 20979709 <GO>}

Okay. Okay, excellent. Thank you. And if I may, a second question. If you could comment on costs and expenses in the period. I'd like to hear from you on that respect? Thank you.

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

Catherine, this is Paulo again. We did mention something about costs in our materials released. But in summary our main cost issues concentrate on copper and steel. As for copper and the London Metal Exchange, we're talking about quarter-on-quarter, fourth quarter '18, fourth quarter '19, copper saw a reduction of 4.5%. But when we normalize that vis-a-vis the exchange rate, which is what really impact our results. The US dollar appreciated by 8%. So in the end, there was an increase in BRLs for copper.

But WEG, just as a reminder, the way we work with our raw materials, copper specifically, we do not feel those short term changes because we have future purchase already scheduled sort of a hedging mechanism, which provides us some stability and helps us minimize the impact of those variation. So as of now, we have not been impacted by that slight increase in BRLs in copper. The same goes for the next quarters, this hedging mechanism.

As for steel, we had an impact because of a drop of 13% [ph] quarter-on-quarter, and that will of course favor us in new negotiations. Likewise, we had a good level of inventory. So in the short run, the impact was not important. We had very competitive price because of that. But that's an important question and it's good for us to be able to have the chance to reinforce that we're highly dependent on those metal raw materials, and WEG works around those issues, always trying to seek long term policy, so that we can hedge against long term volatility.

Q - Catherine Kiselar {BIO 20979709 <GO>}

Thank you very much.

Operator

(Operator Instructions) Our next question comes from Andressa Varotto from UBS.

Q - Andressa Varotto {BIO 20092249 <GO>}

Good morning. Thank you for taking my question. Going back to domestic GTD, which is a very significant growth in the quarter. If you could please give us some more color on the contribution of that as compared to the T&D equipment? Thank you.

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

Andressa, good morning. When you say pre-buy, we had this pre-buy effect, especially for solar and GD because of the potential regulatory changes, which have never happened. So the demand for solar came from that. But as a whole for GTD, the number was very good. The growth was close to 43% quarter-on-quarter. We were very, very happy about it.

And what were the highest contributions? Solar, number one as I said. Distributed solar generation had the highest growth in the period. It more than doubled in terms of revenue for solar and GD for -- when compared to 2018. We also had solar farms contributing with a lower stake, as I mentioned before.

Then number two, the transmission and distribution businesses in Brazil, with an important contribution especially in those products related to the transmission auctions. So those are orders, which were made in the past two years that will be starting to be delivered and invoiced now.

Number three in that list, in terms of contribution to our increase in revenue, generation as a whole. We are now showing [ph] or collecting or picking up the results of those good numbers in this quarter. For example, operations such as steam turbines and hydraulic turbines both areas saw an important increase in this quarter something we had not seen before. And lastly, wind also contributed to the final number at a lesser stake, but still better than 2018.

So with all of that GTD came out really strong and positively surprised especially because of solar, I'd like to emphasize. Going forward T&D, we'll maintain the same pace; generation, the same; solar, we cannot guarantee you that, that pre-buy demand will be maintained with.

Q - Andressa Varotto {BIO 20092249 <GO>}

Okay. Thank you.

Operator

We now close the Q&A session. I'd like to turn the floor back over to Mr. Rodrigues for his final remarks. Please, Mr. Rodrigues, you may carry on.

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

Thank you, everyone. I wish you all a good weekend, and I'll see you all next for -- in our next conference call.

Operator

WEG's audio conference is now over. Thank you all for participating, and have a nice day everyone.

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.