Q3 2018 Earnings Call

Company Participants

- Eduardo de Oliveira Miron, Chief Executive Officer
- Marco Antonio Spada, Chief Financial and IRO
- Marcos Antonio Molina dos Santos, Chairman
- Timothy M. Klein, President & Chief Executive Officer

Other Participants

- Alexander Robarts, Analyst
- Botir Sharipov, Analyst
- Leandro Fontanesi, Analyst
- Teo Lasarte, Senior Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Marfrig Global Foods' S.A. Conference Call to present and discuss its results for the third quarter 2018. The audio for this conference is being broadcast simultaneously through the Internet in the website www.marfrig.com.br/ir. In that address, you can also find the slideshow presentation available for download.

We inform that all participants will only be able to listen to the conference call during the conference presentation. After the company's remarks are over, there will be a Q&A session. At that time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Marfrig's management and on information currently available to the company. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties, and assumptions because they relate to the future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Marfrig and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I will turn the conference over to Mr. Marcos Molina, Marfrig Global Foods' Chairman. Please, Mr. Molina, you may now begin the conference.

Marcos Antonio Molina dos Santos {BIO 15363967 <GO>}

Good morning. Good afternoon, everyone. Before I hand the call over to Miron who will comment on this quarter results, I'd like to make a few comments.

I consider this a special quarter because it is the first one that includes 100% of National Beef, and with record of revenue and EBITDA. And more importantly, we resumed our positive cash generation. It also shows a strong net revenue in U.S. dollars which provide us a natural hedge. Even with a strong appreciation of U.S. dollar, our indexes remain stable.

We will continue to focus on the execution of our strategic plan with organic growth, value-added products, and therefore creating sustainable value for our shareholders. I'd like to congratulate the entire Marfrig team for the results achieved.

I will now hand the call over to Eduardo Miron who will begin the presentation.

Eduardo de Oliveira Miron {BIO 15427272 <GO>}

Thanks, Marcos. I want to start by thanking everyone for participating in our earnings conference call of Marfrig Global Foods. Today, in addition to commenting on the results for the third quarter of 2018, we also will provide an update on the strategic fields. With me today are Marco Spada, CFO and Investors Relation Officer (sic) [Investor Relations Officer] (00:04:28). And given the important moment of our company with the ongoing transition, we also have with us, Tim Klein, CEO of the North American Operations; and Miguel Gularte, CEO of the South American Operations.

Let's turn please to slide number 3 where we will begin today's presentation. As for our strategy, as we presented in our conference call on Marfrig's new structure, we shared with you the five pillars that will support the creation of sustainable value for the company. I want to reinforce this with a diversified production platform spanning the Americas and access to key consumer markets, our mission is to produce and supply the best quality beef to the world.

To achieve that, we have forged strategic alliances and partnerships with producers, industry associations, and government agencies to ensure best practices for the entire process. Our firm commitment to food quality and food safety is part of our culture and permeates our entire value chain. In addition to operational excellence, we also are focusing on continually improving our capital structure which will help to transform Marfrig into a industry leader with consistent generation of profits and free cash flow.

On the next slide, you can see the status of the actions that will make our global – our goal of creating value sustainably a reality. On the Keystone sale, in addition to the approvals by BNDES and the regulatory authorities in the United States and Japan, yesterday, we announced the approval by the authorities in China. Still pending is the approval by the authorities in South Korea which should occur by the end of this year. Once the transaction is concluded, the funds will be released which will enable us to move forward in yet another phase of our Liability Management process, which is aligned with the goal of ensuring our financial strength.

In the near term, we have the payment of the bridge loan used for the acquisition of a controlling interest in National Beef. Without abandoning our commitment to maintaining a robust liquidity position, given the scenario marked by volatility that persists in Brazil, we also expect to settle other short-term liabilities. More details will be forthcoming (00:07:38).

In the specific case of Marfrig, I should remind everyone of how this year has been particularly challenging. As part of our strategic shift towards growing in the beef market, we had two major projects, with the Keystone divestment now in its final phase. This led to the important transformation throughout the company that, in our view, is just in the initial phase.

In September, the senior management of the North American operation National Beef visited some of our industrial sites in South America. They focused on the southern part of the continent which is the origin of the products exported to the United States. They visited our further processing plant in Rio Grande do Sul in Brazil; the Tacuarembo plant in Uruguay; and our portioned, cut, and packed (00:08:43) products plant in (00:08:48) São Paulo. This initial phase supported the creation of an opportunities map focusing on the sales and production areas. For each opportunity analyzed, the company identifies those responsible in each operation and the actions required to transform them into reality.

Some examples include, the expansion of the processed products portfolio for sale in the U.S. market. The other example is the sale of products from South America to Japan and South Korea using the sales team that already existed in North America. And finally, a change in (00:09:33) best production practices across operations from equipment, processes, and training.

Turning to the quarterly results, let's go to slide number 5. I want to commend our team for the exceptional results that we managed to deliver, with new record set for the sales volume, EBITDA and cash flow. This third quarter was only the first quarter in which we consolidated 100% of the results from the North American operations, but it also marks the first quarter in which we resumed positive cash generation.

Free cash flow, even though we were in a scenario in which we did not consider our capital structure normalized, was BRL 271 million. Net revenue despite one fewer week of cattle processing in North America grew 21%, reached a new record level of BRL 11 billion. We also set a new record for the quarterly EBITDA of BRL 1.1 billion which attest the – to the success of our strategy of focusing on beef with geographic diversification.

With the receipt of the proceeds from the Keystone divestment, we will be able to deleverage by nearly 50% and we'll have one of the industry's lowest leverage ratios, 2.57 times if using the last 12 months' third quarter 2018. When measured in U.S. dollar, given our lever of exposure to the international market, the leverage ratio would be even lower at 2.3 times.

So, we are on the path of becoming a simple and focused company with a capital structure adequate to the industry we operate. I will now hand the call over to Marco Spada who will comment on our third quarter results.

Marco Antonio Spada {BIO 20767498 <GO>}

Thank you, Miron. Good morning and good afternoon, everyone. I can let (00:11:59) you to please turn to slide number 7 where we will resume our presentation. On slide number 7, you can see the variation in Marfrig's consolidated net revenue from the third quarter last year to the third quarter of this year. As you can see in the chart, we adopted three basis to show the main factors that led to this variation which are: sales volume, sales price, and exchange rate. And specifically for this quarter, we also eliminated from this analysis the impact from the fewer weeks of results reported in North American operation.

Marfrig's net revenue in the quarter reached BRL 11 billion, representing a growth of 21% year-over-year. The higher volume in sales, which was due to higher slaughter volume in South America, supported a positive variation of BRL 857 million. While the average sales price, which follow market downwards trend, generated a negative impact of BRL 377 million. The effects of the Brazilian real depreciation on exports from Brazil and also on the translation of the result from the international operations had a positive impact of BRL 2 billion. This reinforces the current profile of international expansion that marks Marfrig.

Another important factor was the fewer weeks of operation in the North America operation in third quarter, which was 13 weeks compared to 14 weeks in the same period last year. The difference resulted in a negative revenue impact of BRL 576 million.

Net revenue from North America operation which accounted for 67% of Marfrig's third quarter net revenue was BRL 7.5 billion, a 16% growth compared to the previous year. This revenue growth is explained by the effect of the FX depreciation between periods. In U.S. dollar, net revenue fell by 8% due to lower cattle slaughter volume with the decline explained by the fewer weeks in the third quarter 2018 compared to the third quarter 2017, as I had just explained.

Meanwhile, in South America, net revenue in the third quarter was BRL 3.6 billion, 35% higher year-over-year. This growth is explained by the higher sales volume and local currency depreciation which offset the lower average sales price. Note that despite the challenged political and economic scenario in Brazil, we have posted double-digit sales volume growth in the domestic market of 25%.

In exports, we delivered volume growth in all markets. This let our exports volume mix to register a higher share of countries from the so-called general list, which does not require a specific certifications. In fact, a lower sales price. Important to mention that these certifications for the recently reopened facilities are still in the approval process.

Let's move to the next slide, please. Complementing my previous comments, this slide shows Marfrig's global profile. Our geographic diversification enable us to serve the largest and most important beef consumer markets in the world. As you can see, the U.S. domestic market accounted for 58% of our revenue in the third quarter.

China, including Hong Kong, Japan, and these were (00:16:15) combined, accounted for 20% of our revenue. With a production platform concentrated in the Americas, and with daily primary processing capacity of 32,000 heads, Marfrig today is the leading global beef supplier.

Moving to next slide, I will comment on the evolution of Marfrig key operating indicators in the third quarter, compared to the same quarter last year. We have processed 1.8 million head of cattle in the third quarter, 4% more than the third quarter of last year. This growth is explained by the higher process in South America due to the expansion of the production capacity of our Brazilian operation. Another highlight was Uruguay, where we've moderately increased our share of the country's cattle processing to 22%. Note that the global slaughtering growth would have been even stronger if not for the difference in the number of weeks reported from North American operation, as mentioned earlier.

In the third quarter, Marfrig posted consolidated gross profit of BRL 1.5 billion and adjusted EBITDA of at least (00:17:33) above BRL 1 billion, setting a new quarterly record. This performance is explained by the operating result in North America, where margin expansion accompanied by the (00:17:46) industry trend reflecting the positive phase of the country's cattle cycle, and also by the company's global profile, which was benefited from the weaker Brazilian real obtaining results that offset the higher raw material cost in South America in comparison to the third quarter of last year, which will benefit - benefited from factors external to the industry.

Please let's move to the next slide. Here, we show our debt profile and some key financial indicators after the conclusion of the strategic divestment of Keystone. On September 30, Marfrig's net debt, including the figures for Keystone, stood at BRL 16.9 billion, that's 4% against second quarter 2018, influenced by the stronger dollar in comparison period.

Considering the inflow of the proceeds from Keystone sale, Marfrig's net debt stands at BRL 8.3 billion, which represents a decline of nearly 50%. On the same basis, as you can see in the chart on the right side of the slide, financial leverage measured by the ratio of net debt to adjusted EBITDA in the last 12 months, ended the quarter at 2.57 times. It's important to note that this EBITDA of BRL 3.2 billion already excludes the result from Keystone Foods.

Given the company's growing international exposure with dollar denominated revenue in debt accounting for a higher share, we believe that, as of this quarter, a good metric for evaluating financial leverage is to also report the ratio in the same terms. So, calculating EBITDA based on the historical dollar of each quarter, the company's leverage ratio would be even lower at 2.3 times. In other words, after the recent strategic transactions, Marfrig will become the Brazilian company in the sector with the lowest leverage ratio.

Moving to the next slide, I will comment on cash flow. Important to note that beef (00:20:15) in the first quarter, which reflects National Beef results in full (00:20:18) for the three months and the transaction was – as the transaction was concluded early June this year. I also would like to note that this does not consider the cash flow from Keystone. On this basis, Marfrig's operating cash flow came to BRL 804 million, reflecting the strong performance of its operations in a more normalized environment for working capital following the negative impact from the truck drivers' strike in second quarter 2018.

CapEx, which came to BRL 198 million, was influenced by the effect from Brazilian real depreciation on the international operations and by the investments in maintenance in the new projects, such as expanding the further processed and portioned products portfolio.

Interest expenses amounted to BRL 336 million with sharp (00:21:25) appreciation in the U.S. dollar against the Brazilian real of 10% and the non-recurring increasing in the line of interest arising from expenses (00:21:33) with the bridge loan for the acquisition of control of National Beef in the amount of BRL 77 million were the main factors. Note that we have highlighted this BRL 77 million on the interest expenses in the chart, because it's a figure that should decline immediately after receiving the proceeds from the Keystone sale. As a result, free cash flow in the third quarter was positive BRL 271 million, marking our return to positive cash generation.

This positive free cash flow corroborates Marfrig's strategy of maintaining a diversified production platform focused on beef protein. Today, we are a company with a better capacity to generate cash and with an asset portfolio capable of serving our debt costs which remain high. Once the Keystone transaction process is concluded, in addition to repaying the bridge loan and other short-term liabilities, we also will have the challenge of reaching an adequate debt cost for this new company. In other words, one of our goals is to continue improving Marfrig's capital structure by reducing our average debt cost.

I will now hand the call back to – over to Miron for his closing remarks.

Eduardo de Oliveira Miron {BIO 15427272 <GO>}

Thank you, Marco. Today, as you know, we have a simpler, more focused business model with a production platform that is diversified geographically to serve the world's key consumer markets. With an ample supply of cattle and driven by strong demands in both the domestic and international markets, the U.S. beef industry has delivered record results. And the expectation is for the cycle to last at least for the next three years.

In Brazil, the outlook for the beef cattle cycle is also positive, and the country's importance as a platform for serving growth – growing global demand is reputable (00:23:43). And to add to this scenario, the expectations for the Brazil economy to resume its structural growth with rising consumer confidence and growing consumption of beef.

In this context, as I commented at the start of our presentation, our focus will be on the quest of operational excellence and sustainable value creation. And once again, I will emphasize that the one thing that will not change is - in this entire process, is our non-negotiable commitment to the financial discipline.

That concludes today's presentation. So, let's go now to the Q&A session. Thanks, everyone.

Q&A

Operator

Thank you very much. Ladies and gentlemen, we'll now begin the question-and-answer session. Our first question comes from Leandro Fontanesi, Bradesco BBI.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Hi, good morning. Thanks for the opportunity. So, I have two questions. The first one is specifically to (00:25:02) the first quarter where we see the results really reflecting the new Marfrig, post the transactions that you did. I was just wondering if you could comment in terms of the cash flow, if it makes sense to assume at the similar level that we saw on working capital consumption and also CapEx for the following quarters?

And the second question is if it makes sense for us to assume that we could see some improvement for the Brazilian market in terms of margins, given we could see some improvement in supply/demand dynamics with the recent lifting of the Russian ban? And also, you have been mentioning some potential new markets that could open, like China and Europe for new plants, if it makes sense for us to assume that we could actually see an improvement for Brazilian operations? Thank you.

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

Leandro, thank you very much. So, let's see if we move step by step. So, in terms of cash flow, yeah. So, we believe that we will continue generating positive cash flow. Certainly, the FX is a component (00:26:14). So, for example, we mentioned this quarter that our CapEx is a little bit higher because there is a conversion of the investments made in the U.S. to reals and therefore, I mean, we always have this type of impact.

In terms of working capital consumption, after all the issues we had in the second quarter, we believe that we are moving more towards a normalized level of working capital. Our target is (00:26:48) always to have a flat impact, but as you know, it changes depending on a specific inventory view being (00:26:54) that you have to do, for example, if you are putting some inventories for the end of year to meet specific demand so that we can have some volatility, but we don't expect any major fluctuation in this item.

And we - back to the margin, in terms of EBITDA, we continue looking at the margins at the range that we mentioned before, between 8% to 10% (00:27:23). This quarter was a very positive one with a margin towards the end of this range. But we believe that this range will be - is not - should not be changed. So, we continue expecting results on those levels.

So, the other question you have about – was about potential improvements because of new markets or new destinations that we could have, you mentioned Russia and then in Asia in (00:27:59) China. Russia is not a material destination for us. Just to give you a little bit of information, we have less than 2% of our sales when this market was open for us and even in Uruguay, where we can support that business, it's less than 5%. And certainly, it's not a market that provides the best profitability. But we always want to have more markets open, so don't take me wrong.

On the flip side, the Chinese market is the material – is a very important (00:28:43) market and we are – and it's a very important for the South America. We have (00:28:50) participate in a material way for our – in our sales from that region. We have a visit to Brazil from Chinese group. And we are pretty excited and we expect to have more plants open for that market. And with that, yes, we could potentially see improvements in our marketing (00:29:28), as we mentioned this quarter, because of the growth and because we did not have all the invitations (00:29:37) for – from all the markets that we want to have, prices are a little bit lower. So, therefore, when you have those limitations (00:29:46) so we would – we clearly have better margin in the business. I hope I was clear in my answer.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Thank you. It was very clear. Thank you very much.

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

You're welcome.

Operator

The next question comes from Alex Robarts, Citigroup.

Q - Alexander Robarts {BIO 1499637 <GO>}

Yes. Hi, everybody. Good morning. I had a clarification and then a couple questions on Uruguay. You said earlier this morning on the Portuguese call that with the National Beef business you are expecting or you're looking for a lower margin in the fourth quarter sequentially to the third. And just wanted to clarify if that was purely about seasonal reasons or were there some elements that you were seeing either the export market or the domestic market that would explain your cautiousness for the sequential quarter margin there?

In Uruguay, you talked about the mapping of opportunities and such, kind of between the Latin business and the U.S. business. And I guess, as you've done more work on the possibilities and opportunities, Uruguay has kind of been really exporting fresh beef into the United States through, I guess, the sales force associated with Keystone or perhaps its own small sales force. Now, with National, it seems that that's going to be a very interesting opportunity medium-term. I'm wondering if you can give us some color about the dimension of that and the timing of getting more fresh Uruguayan beef in through the National Beef sales force. And then, the second piece of the Uruguay question is, you've talked about, perhaps, you mentioned Japan opening up for Uruguay, and I'm wondering what could the timing be there in that potential dimension of that opportunity? Thanks very much.

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

Okay. A lot about the Uruguayan. Let's go step by step. So, Tim is - Tim Klein is the CEO of North America, is on the line, so I'll ask him to maybe talk a little bit about the opportunity from Uruguay. But let me tackle most of the - of your questions. So, if you don't mind. So, the first thing is related to the performance in Uruguay in the third quarter, so that is seasonal. So, we always have lower margin in the third quarter in Uruguay, given the climate. So, there is a - it's not unique. It's something that happens over and over. So, that was our reference about the Uruguayan result. Yes, we expect the next quarter to be better than this third quarter. So, that's what normally happens.

In terms of the potential to Japan, yes. So, things are moving pretty fast, and we absolutely expect this to happen in the short-run. Hard to define a specific date, but we believe that is going to very, very soon.

Still about Uruguay and the map, opportunities map. From our perspective, and I mentioned this during my speech was, National Beef visited the south of Brazil and the south of South America, meaning Uruguay because there is already corporations trading between those regions to U.S. National Beef has a very strong position, commercial operations over there, so we truly believe that we can take advantage of this, and therefore, do more business together. And we expect to add to National Beef portfolio products that they currently don't have. For example, the organic and the grass-fed products from Uruguay.

And we expect from our industrialized business into south of Brazil, we - where we have a dedicated plant in the south, that we can avoid brokers and have direct sale using the commercial strength of National Beef. So, having said that, I will ask Tim to provide some inputs as well.

A - Timothy M. Klein {BIO 16522695 <GO>}

Yes. Thank you, Miron. The demand for U.S. beef - for organic beef in the U.S. is the fastest growing segment. So, there is a significant opportunity to leverage the supply of organic cattle from Uruguay with the demand we have here in the U.S. with our existing customer base of National Beef. So, we're exploring what those opportunities are and we believe that this will continue to be a significant growth opportunity for our business in North America on the organic beef.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. Thanks a lot.

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

Thanks, Tim.

Operator

Our next question comes from Botir Sharipov, HSBC.

Q - Botir Sharipov {BIO 16759043 <GO>}

Good morning and thank you for taking my questions. Two questions for me. One, if you could maybe clarify for us your – what do you think the sustainable CapEx and sustaining CapEx (00:36:11) going forward for the consolidated business (00:36:15) still quite a bit of noise still in integrating National Beef? Is BRL 200 million is sort of the runway we could assume or do you expect it to come down in the next few years?

And my second question is on, I guess, division by division EBITDA margins. I was wondering if once you complete the deal with Keystone and release your Q4 result, it should be disclosed in a separate segment data for each division? Thank you very much.

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

And thank you. So, regarding the first question, the CapEx, we made our comment that our – the number for the whole year for CapEx was between BRL 550 million to BRL 600 million, that was the number that we've been working with. When we talk about reals, it will always have a little bit of exposure and volatility because it can fluctuate a little bit even with this developing of the FX (00:37:26). But we are still on or the same (00:37:28) range, so we are not changing. So, we should not expect any major impact in this fourth quarter for the CapEx.

For the coming years, we are not providing (00:37:41) any forecast at this point. I'd like just to take the opportunity to answer your question to mention that we, as we mentioned before, we will get together and, at the beginning of next year, to have our Marfrig Day where we are going to discuss the five-year plan and provide a little bit more disclosure on our plans for the businesses. And so, at this point, we cannot comment on that, on what kind of level of CapEx we have for these coming years or next year.

Regarding the breakdown, we know that there is an expectation from the market to have these breakdowns between the South and North American businesses. As we mentioned in the past, we are at the beginning of this transition, we are studying and making sure that we don't make any mistakes in terms of what to be disclosed and how to disclose this. We understand the demand from the market but we thought that for this year, it would be something that we need to spend a bit more time to fully – to deep dive and fully understand before we provide this breakdown. So, it is something that is in our top priority list in terms of analyzing and – but at this point, we are not ready to provide.

Q - Botir Sharipov {BIO 16759043 <GO>}

Okay. Thank you.

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

You're welcome.

Operator

Our next question comes from Teo Lasarte, Insight Investment.

Q - Teo Lasarte {BIO 15017626 <GO>}

Hello. Good morning. First of all, I was wondering if could you tell us your expectation in terms of the Keystone sale? You might have mentioned this before in the call, apologies if I missed it. But are you still expecting the entire process from the (00:39:40) proceeds from the sale could come through by the end of Q4 or to early 2019, when do you expect it to happen?

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

Yeah, no, thanks for the question. As we – you remember that when we closed the deal, we had the expectation to have this done by the end of the year. That was our initial estimation, our initial forecast. And we still believe that it will happen in the fourth quarter of 2018. As you noted, we have had most of the approvals. Yesterday, we released the information regarding China. So, therefore, in terms of antitrust approvals, we just had South Korea. So, therefore, we are still positive that it can be done until the end of this year.

Q - Teo Lasarte {BIO 15017626 <GO>}

Okay. And given the liabilities you have next year, I'm referring to the 2019 bonds, I mean, is it the case that you would expect to redeem it only when you've finalized the sale of Keystone or is there a possibility that you would redeem this bond before the actual closing to come in (00:40:50)?

A - Marco Antonio Spada {BIO 20767498 <GO>}

Hi, Teo. This is Spada speaking. Well, regarding the call back (00:41:00) from 2019, we also addressed that, (00:41:03) the situation regarding the cash position. We are holding the cash due to the uncertainties regarding the Brazilian current scenario here that – the termination (00:41:18) from our board. We are waiting. So, we've actually – before (00:41:25) including Keystone sale, we will not be doing anything other than that (00:41:31).

Q - Teo Lasarte {BIO 15017626 <GO>}

Okay. Thank you.

Operator

Excuse me, ladies and gentlemen, This concludes today's question-and-answer session. I would like to invite Mr. Eduardo Miron to proceed with his closing statements. Please go ahead, sir.

A - Eduardo de Oliveira Miron {BIO 15427272 <GO>}

Well, first of all, thanks for you all for attending this call and for supporting the company. We continue committed to generating sustainable growth. It was, again, a special quarter and we look forward for the next one. Thanks a lot.