

Q3 2015 Earnings Call

Company Participants

- Eduardo S. Couto, Director of Investor Relations, M&A and New Businesses
- Frederico F. Curado, President & Chief Executive Officer
- José Antônio de Almeida Filippo, EVP, Chief Financial & Investor Relations Officer

Other Participants

- Cai von Rumohr, Analyst
- Darryl Genovesi, Analyst
- Derek Spronck, Analyst
- Joshua Milberg, Analyst
- Myles Alexander Walton, Analyst
- Peter John Skibitski, Analyst
- Stephen Trent, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen, and welcome to the audio conference call that will review Embraer's Third Quarter 2015 Results. Thank you for standing by. This conference call is being held during the Embraer Day in New York with the presence of investors and market analysts. At this time, the company will present its third quarter 2015 results. As a reminder, this conference is being recorded and webcasted at www.ri.embraer.com.br.

This conference call includes forward-looking statements or statements about events or circumstances, which have not occurred. Embraer has based these forward-looking statements largely on its current expectations and projections about future events and financial trends affecting the business and its future financial performance. These forward-looking statements are subject to risks, uncertainties, and assumptions including, among other things, general economic, political, and business conditions in Brazil and in other markets where the company is present. The words believe, may, will, estimates, continues, anticipates, intends, expects, and similar words are intended to identify forward-looking statements.

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conference call might not occur. The company's actual results could differ substantially from those anticipated in the forward-looking statements.

Participants on today's conference call are Mr. Frederico Curado, President and CEO; Mr. José Filippo, Chief Financial Officer and IRO; and Mr. Eduardo Couto, Director of Investor Relations.

I would now like to hand, to turn the conference over to Mr. José Filippo. Please go ahead, sir.

José Antônio de Almeida Filippo

Okay. Thank you, and good afternoon, and thanks for joining the Embraer third quarter 2015 earnings results. As we normally do, we will go with the presentation, then we'll be open for questions.

So, starting in page three with the corporate highlights, we were listed for the fifth or the sixth consecutive year on the Dow Jones Sustainability Index. Important for us that - very much in terms of sustainability initiatives. Also, regarding management excellence, we received Magna Cum Laude recognition from the Brazilian National Quality Foundation, which is equivalent to the Malcolm Baldrige Quality Award.

And also in relation to people management, we received important recognitions in Brazil and Latin America. Next page, page four, in terms of highlights for Commercial Aviation, we had the delivery of 21 E-Jets in the third quarter of 2015. We have now accumulated 68 aircraft delivery this year. And also, we were able to record 20 new firm orders, accounting now for 146 to-date.

These 20 orders, we like to break this, highlighting in SkyWest order of 18 E175s that will fly for United Airlines, and also two undisclosed orders for E190s. Also, in terms of orders, the highlight of the firm orders for 19 E175 also from SkyWest that will fly for Delta Airlines. This was announced after the closing of the quarter in October 2015.

Confirming the good commercial performance, we achieved the ratio of book-to-bill above two times over the first nine months of 2015. And finalizing these highlights, in relation to the development of the E2 program, it was initiated, the final assembling of the first E190-E2 prototype. This was showed to the market last week, actually.

Okay, next week, oh next page, sorry, going to page five, the highlights of commercial, of Executive Jets business. We had a delivery of 30 executive jets in the third quarter, broken by 21 lights and 9 large aircraft, and we account now for 57 light and 18 large year-to-date.

In relation to the Phenom program we had in the third quarter, the delivery of the Phenom 300 number 300 is important milestone in this program. And also, as far as the Legacy

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500 and 450 program, important information related to the certifications of the Legacy 500 in Mexico and in China, and also the Legacy 450 in Brazil, USA and Europe.

In relation to the quality and customer perception, we are also ranked by important magazines. At this time, we show here the first place in the global executive jet industry ranking by the Professional Pilot magazine

Next page, page six, and now the highlights of Defense & Security business. We start with the information that contract with the Gripen program became effective. We actually have currently a group of engineers already in Sweden preparing for this program that is starting now. And also, regarding the KC-390 program, we had a resumption of the flight test campaign, with a second flight that actually happened yesterday. In relation to the LAS program, we had the delivery of two aircraft in the third quarter of 2015 to the U.S. Air Force. And now, actually today to-date, we have 12 already delivered, which includes two additional ones that happened after the end of the quarter.

Now next page, regarding the financial results of the third quarter. And in page eight, we start with the backlog. We reported the firm backlog of \$22.8 billion at the end of September, so basically in line with the figures of the previous quarter.

Next page, page nine, in relation to deliveries, I already mentioned but just emphasizing here. Starting with the Commercial Aviation on the left, 21 aircraft delivered in the third quarter, 68 to-date, actually through the end of the third quarter. And in relation to Executive Jets aviation, we have the 30 delivered, broken by 21 lights and 9 large in the quarter, and accumulated figures of 75 deliveries, broken by 57 lights and 18 large.

With that, we take the opportunity to confirm our outlook for the year, which is in the range of 95 to 100 E-Jets in the Commercial Aviation, and 35 to 40 executive large jets, and 80 to 90 executive light jets.

Next page, in terms of net revenues by segment, starting from the top right, Commercial Aviation reported revenues of \$688 million in the third quarter with a total of \$2.23 billion as of September. Going down to the bottom right, Defense & Security with a total of \$182 million in the third quarter, with accumulated in the three quarters of \$0.61 billion this year. Continuing with Executive Jets business, the total \$402 million in the third quarter, accumulated \$0.97 billion in the year.

The consolidated figures, maybe moving to next page, I think we have the, in reals and in U.S. dollars, total reported of almost \$1.3 billion in the third quarter, accumulated of \$3.8 billion in the year. With that, we also take the opportunity to reiterate our guidance range of net revenues from \$5.8 billion to \$6.3 billion in 2015.

Next page, as far as SG&A, we had a total of \$121 million in the third quarter, broken by \$43 million in G&A expenses and \$78 million for selling expenses. Those figures are the lowest when we compare to the previous quarters 2015, and they represent 9.4% of revenues in the third quarter compared to 12.2% in the third quarter for last year. We would like to confirm our commitment with cost control and reduction.

Next page, now page 13. As far as EBIT, we reported operating profit of \$84 million in the third quarter, accumulated of \$266 million in 2015. Operating margins were 6.6% in the quarter and 6.9% accumulated in the year.

Next page, in terms of EBITDA, oh okay. In terms of EBITDA, we had a total of \$158 million in the third quarter, accumulated \$485 million. Margin in the third quarter achieved 12.3%, with accumulated of 12.6% in the year until September.

Next page, in terms of net results, we had a net loss of \$110 million in the third quarter, accumulated loss of \$43 million in 2015. The main reason for this figure was the negative impact of the deferred income tax in the third quarter of \$181 million.

Without this effect, we would be reporting a net profit of \$71 million in the quarter. And this negative effect is - reflects a non-cash effect, which result from the income tax on the Brazilian local currency gains on the non-cash asset items. Basically, as you can see, we have 28% devaluation of the Brazilian real against the dollar in the quarter, and that return to the Brazilian real's gain on those non-cash items, which we have to record and defer the income taxes; they're non-cash income tax, and that's the way you have to record in terms of the Brazilian Tax Law. The non-currency items, they refer to typically fixed assets, intangible assets and inventories.

Next page, in terms of cash flow, we had a cash consumption of \$115 million in the third quarter, with positive operating cash generation of \$70 million offset by \$76 million of CapEx and \$110 million of developed, both primarily related to the E2 program development. And as of September 2015, the free cash flow accumulated was \$482 million negative, but considering our expectations for the fourth quarter, we reiterate our estimate of the negative \$100 million or better in terms of cash duration in the full year 2015.

Next page, page 17. In terms of investments, we had a total investment of \$334 million as of the end of the third quarter, broken by \$27 million in research, \$165 million - \$164 million for development, and \$143 million for CapEx. The figures for the year are tracking below guidance mainly due to the weaker Brazilian real currency.

Next page, page 18, and finalizing the presentation, regarding our cash and debt position, we achieved a total net debt of \$644 million at the end of the third quarter, which we expect to be reduced by the end of the fourth quarter. Our cash position in the end of the quarter was \$2.75 billion and a total debt of \$3.39 billion. In terms of our debt profile, it is in - it has an average terms of 6.5 years, and 91% maturing in the long-term after 12 months.

Okay, with that, we finalize the presentation and we now open for the Q&A session. Thank you.

Q&A

Operator

Certainly, thank you. Our first question comes from the line of Darryl Genovesi from UBS. Please go ahead.

Q - Darryl Genovesi {BIO 20862546 <GO>}

Hi, guys. Thanks for the time. Filippo, on the adjusted net income number that you provided, when you were just backing out the deferred tax impact, it's actually above the pre-tax income. So, I guess that would imply a tax gain in the quarter. Is that a cash gain, and is that something that's sustainable for some reason?

A - José Antônio de Almeida Filippo

Basically like this is, we have to take all the assets, the known monetary assets, and they are referred in dollar terms. So, when we take the Brazilian real, then we have a gain, a non-cash gain, and we have to record the income tax of that gain. This is a non-cash since a deferred, and the assumption is that those inventory will turn into final good and sometime this will be sold, and then the profit will come. So that's why actually it's an anticipation of that, but this is not a cash item. It's just like a non-current income tax. I don't know it's exactly...

Q - Darryl Genovesi {BIO 20862546 <GO>}

Well, I guess what I am saying is the adjusted number that you provide, the \$71.5 million, compares to \$59 million pre-tax on the income statement in your release. So I guess I'm just trying to reconcile why the adjusted number is higher than the - why the adjusted net income number is higher than the unadjusted profit before tax number.

A - José Antônio de Almeida Filippo

What we did is the only the adjustments for the deferred tax. It's just like a calculation to help you to see without that effect, which we have the current income tax, which was as we reported it, but just the piece related to the deferred piece actually, no.

Q - Darryl Genovesi {BIO 20862546 <GO>}

Okay. And then also, can you quantify the adjustment at the Defense business?

A - José Antônio de Almeida Filippo

Can you repeat there?

Q - Darryl Genovesi {BIO 20862546 <GO>}

Sure. You had in your press release, you talked about a cost base revision for certain contracts in the Defense & Security segment due to the negative impact of foreign exchange variation. Can you quantify that?

A - José Antônio de Almeida Filippo

Yes. It was \$30 million in the third quarter, accumulated \$90 million in the year. That's the effect, again, is the same effect of the currency, which we have to reset the contract, and that we make this adjustment every quarter when we have the valuation. Normally, we used to do this every quarter, but when we had the valuation like we had recently, in recent quarters, this effect is higher. So for the third quarter, it was at \$30 million, and we had the accumulate in the three quarters of \$90 million.

Q - Darryl Genovesi {BIO 20862546 <GO>}

Great. Thanks very much.

Operator

Thank you. The following question comes from the line of Josh Milberg from Morgan Stanley. Please go ahead, sir.

Q - Joshua Milberg

Good afternoon everyone, and thanks very much for the call. I had a couple questions on the Commercial division. The first one is just if you could update us on how you are seeing the 2016 outlook for deliveries and for mix. Also just, how is your visibility on next year? And with the firm backlog as it stands, is it reasonable to expect that we could have a similar level of deliveries next year? I don't know what you can say. Maybe that's not something you're ready to comment on.

A - Eduardo S. Couto {BIO 18009973 <GO>}

No, sure. Glad to answer. No, we are totally sold out of course for 2015. So, always some of course customer finance things to be finished, but we do not see any risk at this stage for the guidance that we have provided, so it looks really, really solid. Same thing probably for next year, I think. As we mentioned in the last quarter, we felt comfortable. We're feeling increasingly comfortable with at least maintaining the current level of production revenues in that market. Of course, we can give you more color early next year. But we are, with this recent sales last year, I mean 2014 was a very strong year in sales and 2015 again. So that really gives us a, I'd say very comfortable position in the years ahead.

Q - Joshua Milberg

Okay. That's great. And then the other thing is just with respect to residual value guarantees and whether the level of provisioning we saw in the third quarter is what we could expect going forward. And also just if there's anything else relevant to highlight on that particular issue.

A - Eduardo S. Couto {BIO 18009973 <GO>}

Yeah, that's an important question. Thank you. There has been recently, there has been a revision by all the appraisers in the whole industry. And in general, there is a reduction of expected values over time of commercial airplanes in general. So it is possible that we have an impairment in the fourth quarter. We estimate that this stays something in the

range of \$30 million, so it's, that's something which is possible. And that would be, if that is confirmed, will be a downside risk to our guidance, but that's due to be confirmed.

Q - Joshua Milberg

Okay. Great. Appreciate that.

A - José Antônio de Almeida Filippo

Okay. We'd like to put on hold the questions remote, please, to have, give a chance for people inside here to ask a question. Myles.

Q - Myles Alexander Walton {BIO 6802513 <GO>}

Could you touch on the margins by segment, Eduardo? And also, in terms of the non-recurring FX charges in Defense of about \$90 million year-to-date, obviously presuming those don't recur into next year, what's the outlook for Defense from here? Are we kind of bouncing around the bottom kind of in a breakeven situation, and are you able to contain the cost to keep it there?

A - Eduardo S. Couto {BIO 18009973 <GO>}

Yeah, just to give the EBIT margin breakdown by business, we had third quarter Commercial Aviation, 12%; Business Jets, around 5%; and Defense & Security, negative 11%. So the consolidated margin was 6.6%.

A - José Antônio de Almeida Filippo

Yeah, the Defense, while - as he said, these impacts of the exchange rate on negative there, we'll have to do this every quarter. This is not the first time we do in this year because we saw that the currency in Brazil has been losing, especially with the higher rates, but if that comes - stays stable in the fourth quarter, we shouldn't see this in the next quarter. This is too much exposed to this effect. So this is basically reason why the Defense business had negative margin.

A - Eduardo S. Couto {BIO 18009973 <GO>}

But if I may add my answer, if I got your question completely, that business was hit by two major, I'd say, trucks, randomly by two major trucks this year. They're impacted by the currency at 50%, that's specifically the Brazilian denominated revenues, a 50% devaluation in the year, 28% alone in the last quarter. So that goes from the top line and, of course, everything downwards. But also, financial problems with our main customer in Defense, which is the Brazilian government, which they had - they have cash issues, so that having impacted our cash flow and also our revenue. So 2015, I think a good way to look at what happened is an adjustment.

I think we are now at a different level. There's a step function downwards as far as the size of the programs. The KC-390, as we have already divulged, is being delayed by a year. The smaller programs also have been all adapted to the new reality of the ability of the government to pay us on time. I mean, we're not planning to fund those programs on

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our own, so we prefer to adjust it to the capacity of the real - the real capacity of the customer to pay it. So it's a year of transition. I think as Jackson will get into more detail in his presentation, but I think he did a great job in rapidly adjusting the business to the new reality. What I expect for next year in Defense is something of a similar level as far as activity. Maybe some upsides because there is increasing activity in export, but certainly, a return to profitability, hopefully to the levels where we were before. So that's the kind of a macro vision.

By the way, if I may add, just anticipating maybe a question about the KC-390. I heard some questions about, well, why did it take so long between the first and the second flight. And the answer is that, well, that coincided, of course, with this whole commercial discussion about the new pace of the program. So strategically, what we decided was to do two things; one, to go and do all the ground vibration test on the airplane, the GVTs; and now, there was to have a full layup of the airplane to the state of the art of our engineering design. So that we will significantly increase the efficiency of our flight test campaign. So from now on, we're going to see the airplane flying much, much more than the last several months.

Q - Peter John Skibitski {BIO 6760095 <GO>}

Hi. It looks like the fourth quarter has - is going to be a really strong cash flow quarter for you to hit your guidance. Can you talk about the puts and takes there? Is it lower development expense because of the real or are you expecting cash advances, or just other puts and takes that are going to lead to a really strong quarter year-over-year?

A - José Antônio de Almeida Filippo

The strong quarter, of course, the typical - the seasonality of the business brings this fourth quarter as a strong quarter. But regarding investments, that's correct to your point. We had, early this year, contributions from a partner that reduced some of this. We don't expect to see that mostly now in the end of the year. Also, engineering was the major piece of investment until then. Now, we're entering the phase of more certification and other tests that brings more like dollar-denominated costs, so we expect to see this increasing. But they are not probably to meet the levels that we expected before. I think we end up the year with a better position in terms of cash consumption without affecting any of the schedule of the program. Program is on schedule completely as expected, and going forward, that's how we expect.

A - Eduardo S. Couto {BIO 18009973 <GO>}

Peter, I think to your point, you see - we will see a reduction in inventories. So that's going to help the cash, and the activity, of course, all the income from the deliveries. So that would be twofold, more deliveries, cash inflow and reduction in inventories. I think that's a major contribution for the cash flow in the fourth quarter.

Q - Derek Spronck {BIO 17904184 <GO>}

Great. This is Derek Spronck at RBC. Have you changed your hedging policy at all?

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A - José Antônio de Almeida Filippo

No, no. We do hedge, all the balance sheet is hedged in all the time. Our cash flow hedging position, the policy established that we do this every year. So we're now in the process of contracting the 2016 hedging for the cash flow position. So we didn't change our hedging position.

Q - Derek Spronck {BIO 17904184 <GO>}

If the real stays at current levels, would the Defense division, going forward on a quarterly basis, then be producing positive gross margins?

A - José Antônio de Almeida Filippo

Yes, it tend to be positive because most of the effect was the adjustment on the currency. So as we have the program stabilize in terms of currency impact, it tends to be profitable and returning margins, definitely.

Q - Derek Spronck {BIO 17904184 <GO>}

Okay. And just one more quickly. Your reduction in SG&A, could you break that out between how much of it was FX related versus cost controls that you've implemented?

A - José Antônio de Almeida Filippo

I don't think we have this number available at this point. But we can make some - we can inform you later.

A - Eduardo S. Couto {BIO 18009973 <GO>}

Yeah. One thing I think we can say now is that we control that by currency, at least in reals, and we are below budget in both currencies. So we are also being leaner in reals. It is not 100% currency. So that much I can say.

Q - Derek Spronck {BIO 17904184 <GO>}

Do you have specific cost reduction programs that you are implementing?

A - Eduardo S. Couto {BIO 18009973 <GO>}

You bet.

A - José Antônio de Almeida Filippo

Yeah.

Q - Derek Spronck {BIO 17904184 <GO>}

Okay. Great.

A - José Antônio de Almeida Filippo

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All right. Cai.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Excuse me.

A - José Antônio de Almeida Filippo

Please.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Yes. Thank you, José. So this year you got caught short because of the big decline in the real in terms of your cost collar. I think it's around BRL 3.40. Can you tell us kind of preliminarily, what kind of a range or cost on the cost collar of the FX you would anticipate for next year, or at least your approach to that issue?

A - José Antônio de Almeida Filippo

If we stay in this level of the currency - maybe I should say in a different way. We keep on the 25% of the cost associated to the real-denominated. So, this is the benefit that we have. Part of this benefit of course goes into the deferred assets, which is development of the programs, and a part to go into the cost. But you have to take into account that to benefit from that, this cost has to go through the inventory, and then when we deliver, there's a cap. There is a delay about two or three months to have a full capture of this effect.

But going forward, maybe we should think that the currency shouldn't be increasing that much. We expect to see this more stable. What we saw this year was more a volatile approach from the currency. We will still continue to benefit because we are not increasing the costs, so we're keeping, retaining this in dollar terms, the piece of the real cost that we have.

A - Frederico F. Curado {BIO 2004589 <GO>}

But if I may add, Filippo, you're asking about the hedge?

Q - Cai von Rumohr {BIO 1504358 <GO>}

Yes exactly, about the collar, yes.

A - Frederico F. Curado {BIO 2004589 <GO>}

If the labor cost if we already have a zero cost collar in place for next year?

Q - Cai von Rumohr {BIO 1504358 <GO>}

Yes.

A - Eduardo S. Couto {BIO 18009973 <GO>}

We do.

A - José Antônio de Almeida Filippo

Yeah, we're starting to do. And what we've been doing so far is we have a cap of above BRL 6, and a floor about BRL 3.5, BRL 3.4, BRL 3.5. That's how we're working on it.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Terrific. Thank you.

Q - Stephen Trent {BIO 5581382 <GO>}

Thank you. Good afternoon gentlemen, Steve Trent from Citi. Just two questions for me, if I may. I noticed in the quarter, if you look at current and non-current receivables, in 3Q there was a small sequential decline versus 2Q, which I thought was intriguing. And when you dig into that number, is there any sense you can give us as to whether the flow from the Brazilian government was in line with your expectations or below or above, or receivables turnover was much stronger in a particular area than you'd anticipated?

A - José Antônio de Almeida Filippo

Yes. What we've been, as Fred mentioned, we already reviewed that contract, especially the main customer, which was something that led us to increase these accounts receivables. So we currently are experiencing the balanced situation. Well, with expenses are the same what we, revenues are related to the payments, so we keep seeing that. The variation is primarily due to some exchange variation affect on some part. There is local currency, but basically, we are continuing to receive what we've been expensing.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. Got it. Thank you. And just wondered, a general question. When you look at your campaigns for Commercial Aircraft, and other people are, other companies are showing up in these RFPs, what are you seeing in the competitive environment? More of Mitsubishi, less of other competitors? If you could give us a sense as to what that looks like.

A - Eduardo S. Couto {BIO 18009973 <GO>}

Sure, Steve, be glad to. If we separate into two different markets artificially in the regional pure like 75-seater market, typically regional feeder market and the mainline market. So well, currently, in every campaign that we have, we have ourselves. We see Mitsubishi and we see of course Bombardier there. We have been successful in, especially after the enhancements to our E175, which we introduced last year, have been successful in seizing all the opportunities, or almost all opportunities which are there.

So I think on that front, we feel very comfortable. And on the mainline side with E190, E195, we have less of a concentrated demand, but there are several campaigns out there. We just mentioned two undisclosed orders, which are not the United States. And if I may add one, let's say, one possible positive prospect, of course, this is something which is ways from being a reality, but can happen, is major airlines in the U.S. discussed with their

pilots and possibly flying 100-seaters at mainline level. So if that happens, of course, that's a plus to everything that we're doing. So between the E2, D1, the E2, which is on time, by the way, absolutely on time, you saw the picture, and Paulo will go into details, we feel that we're covering from the 70-seat to 130-seat markets pretty well, and comfortable that we keep being the dominating player there.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. Very helpful. Thank you.

A - Eduardo S. Couto {BIO 18009973 <GO>}

Thank you.

A - José Antônio de Almeida Filippo

Let's take the two rounds question here so we will be ready for the - to cut this part of the event and continue the presentation.

Q - Operator

Thank you. I guess my question is on next year, on the Commercial Aviation segment, obviously, you have the skyline pretty much filled up for the year. So you know where the pricing is going to be and the real is going to be a tailwind here as well. Is it fair to assume we can see a decent increase in margins next year for the Commercial Aviation segment?

A - Eduardo S. Couto {BIO 18009973 <GO>}

It's possible. We'll see where the currency will stay. Of course, it's - let's say, it stays at level of BRL 4, that's a tailwind for us. So everything we are doing is still keep - maybe if we go back probably two years ago, when we said that we were seeing at that time that the mix of aircraft, E190s, E195s versus E175, which historically tends to have a lower margin, we saw the mix changing significantly over the next several years, but we thought we could have resilience in holding, maybe not exact same margin, but kind of a low double-digit margins.

And I think we have demonstrated that in the last 18, 24 months. So this is pretty much the story. So yeah, the exchange rate helps in that as there's some (36:39) of larger contracts. Same configuration, that helps; more scale, dilute more fixed costs. So it's a good momentum in that sense.

Q - Operator

So there is nothing in the pricing that should be extremely worrisome for there?

A - Eduardo S. Couto {BIO 18009973 <GO>}

No, there is pricing pressure. We're seeing pricing pressure, there is one competitor in particular. We've been very, very aggressive in both Commercial and Executive Jets segments. And of course, to say that this is really irrelevant, not true. It is relevant. You have to react to that. And we have maybe felt that a little bit - we are feeling that a little

bit more in the Executive Jets segment. On the Commercial, we have been able to really sustain a certain level, the value of the air products really differentiates itself and help us to sustain a healthier price, and therefore, margin. But on the cost side, it's a relentless effort.

Q - Operator

Thank you.

That does conclude Embraer's audio conference for today. Thank you very much for your participation. Have a good day.

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