Q2 2017 Earnings Call

Company Participants

- André Luís Rodrigues, Managing Director Financial Superintendent
- Paulo Geraldo Polezi, Finance and Investor Relations Executive Officer

Other Participants

- Alexandre Falcao, Analyst
- Daniel Gewehr, Analyst
- Leandro Fontanesi, Analyst
- Lucas Barbosa, Analyst
- Lucas Marquiori, Analyst
- Paulo Guimaraes Valaci, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to WEG's 2017 Second Quarter Earnings Results Conference Call. As a reminder, this conference call is being recorded, and at this time all participants are on listen-only mode. Soon after, we will hold the Q&A session where new instructions will be provided.

We are simultaneously webcasting this conference call and the accompanying slides, which can be accessed by our IR website at www.weg.net/ir. We would like to remind you that we are recording this conference call; and after its conclusion, the audio will be available on our IR website. Journalists should direct their questions to the Press Release Office at 47-3276-4295.

Any forward-looking statements contained in these documents or any statements made during this conference call regarding future events, business perspective, projections, targets, operational and financial result and WEG's future growth potential are assumptions and expectations of WEG's administration, and are based on information currently available. These statements involve risks and uncertainties. And therefore, depend on circumstances that may or may not take place.

Investors should understand that general economic conditions, industry conditions and other factors may affect the future performance of WEG, and results may differ materially from those expressed in such forward-looking statements.

We 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. André Luís Rodrigues, Managing Director Financial Superintendent; Mr. Paulo Polezi, Finance and Investor Relation Officer; Wilson Watzko, Controller Officer; and Mr. André Salgueiro, Investor Relations Manager.

Mr. André Rodrigues, you have the floor.

André Luís Rodrigues

Good morning to everyone. It's a pleasure to be with you in the conference call of the results of the second quarter 2017. As usual, we will highlight the three main points of this quarter. Number one, the performance of the net operating revenue growth of 6.9% vis-à-vis of first quarter this year, although there is a drop of 2.3% in this quarter vis-à-vis the second quarter of 2016.

In the domestic market we saw the opportunity of the stabilization process after a long recession period. The different segments are reacting in different ways and this is possible to see due to repetition of the positive environment of the industrial product growth in the short term that are (3:15) stabilization of maintenance, investment, and the emergence of projects in case of productivity and improvement of profit.

Nevertheless, we do not see a short-term scenario change that will be in the engineered program, like the high voltage motors. This is valid for the business of generation, transmission, and distribution vehicle. We have not recovered expansion and investments in capacity, and industry and infrastructure (3:48) in foreign market the recovery signals are more clear in our main market, but below historic average we face a competitive scenario, but we continue finding opportunities of growth in revenues in the year and create some additional market share participation where we are present, or the development of new markets. With this, we are growing, but the negative impact of the exchange rate and the conversion of revenue to the foreign market is still important.

The second point is the recovery of our margin – EBITDA margin raised out of operating adjustments that we carried out in the past quarters and the recovery of our sales in the short cycle products. We want to preserve competitiveness at long term, with operating adjustments to broader margins and returns.

Our EBITDA margin totaled 16.2% with a positive evolution of 220 bps vis-à-vis. The second quarter 2016 net revenue followed the same trend with a growth of 6.7% when we compare it to the second quarter of 2016 with a margin of 11.9%.

And at last I will like to highlight as the last point the continuity of our efforts to increase efficiency and productivity, our discipline in capital use allow us to maximizing investment capital and continuity in the operational cash generation.

Now Paulo Polezi have the floor.

Paulo Geraldo Polezi {BIO 19468811 <GO>}

Thank you, André. Good morning, everyone. Now, when we go to slide number 4, we see the behavior of the revenues in the different markets during this quarter. In Brazil, as André mentioned we continue observing the continuity of the stabilization process of the industrial sector. The industrial products in short cycle and series are in a recovery process. In dynamic market, this process will follow a natural path with each market reacting their way and the diversification present in our business model will be relevant.

The demand by engineered products that depend on CapEx, expansion in infrastructure investment is shy from its target and depends on investment. Outside of Brazil, the global market of industrial electrical products presents growth in local currency. We have been able to grow with entering new markets with gains in market share.

During the second quarter of 2017, the revenues of the foreign market show that drop vis-à-vis the second quarter of 2016 of 5.8% in real (6:30). Nevertheless, a growth of 2.8% in dollars and 5.9% in local currency.

Now, in industrial electro-electronic equipment in Brazil, we saw a movement, a recovery in the market with the stabilization of new orders, a series product or shorter-cycle products. Abroad, we saw recovery in important markets like the United States, China, Germany and Australia. The stabilization of the market both in Brazil and abroad is still highlighted by series products of short cycle. Now, for customized products of long cycle, the recovery depends on the rebound of investments, and the increase of industrial capacity or infrastructure. The demand in Brazil is weak due to a lack of investment in oil, gas, mining, cement and petrochemical. Sectors of foreign market, we see signals of recovery of this industry by being lower than historic average.

In equipments for Generation, Transmission and Power Distribution, the scenario is still challenging. In Generation, there is a surplus of offer in Brazil. We dropped the needs of new investments and the entry of orders. In Transmission and Distribution, there is no surplus capacity. The auctions in October 2016 and April 2017 gave us a positive perspective with new players in the process. But the reflection on the portfolio (08:12) maybe seen in the next quarter uptil 2021.

Now, domestic motors, we have seen a stabilization, when we closed the consumer goods market abroad. We have been positioned as the main supplier or manufacturer of consumer goods in the world. We have focused on development of new products, clients, and markets.

Now, Paints and Varnishes, although a downturn in the revenue, there is an improvement in some segments like machines and equipments for agriculture. Now, the recovery of preventative maintenance in important segments like oil, gas, mining, and the navy industry. We are focused on market diversification evolving, added value product for sectors where we still do not perform and looking for new clients, especially in Latin

America with Brazilian consolidated products. As André said, our focus on preserving margin guarantee and the maintenance of our competitivity will continue in 2017.

On slide 5, we see the EBITDA evolution in 2017. We can see that despite the drop of revenue, we maintained our focus in the maintenance of costs and operating expenses. Our EBITDA presented a growth of 13.7% vis-à-vis the second quarter of 2016, and there was a significant increase in the EBITDA margin that was up 16.2%. We continue believing in that stabilization of business conditions in Brazil will provide the stabilization of our margin.

On slide number 6, you can see the net financial result and it continues positive, although below recent periods, totaling BRL 9.9 million. This result was mainly impacted by lower interest rate (10:02) throughout second quarter of 2016. Additionally, we had a negative impact of the mark-to-market of derivative operation used to protect the indebtedness in foreign currencies. These operations have an accounting effect once the disimbursement of cash only carries out when we settle the operation. The net financial result that is positive is a result between the difference of financial goal and attractive condition, and the compensation in investment due to the solid capital structure.

On slide 7, we have a cash flow analysis. The cash generation and operating activity totaled BRL 623 million during the first semester. Despite the better operating performance, the cash flow was below 2016. This is the result of working capital in 2017. We would like to highlight that, despite the consumption of working capital; we can see that we maintained our operating indicator.

Investment activity consumed BRL 183.8 million in the quarter, focusing on productivity capacity and maximization of invested capital return. With this, we adopted the disimbursements in investment and capacity and expansion. Financing activities consumed BRL 208 million in the period with net BRL 274.9 million in loans and financing.

On slide 8, we see the investments in the past quarters. During this quarter, the investment totaled BRL 61.7 million, 60% goes abroad, and 40% in Brazil. And we are 25% shy from the results of the second quarter of 2016. Part of this difference is explained by the exchange variation in the investments abroad.

With this, I finalize my part, and I give the floor to André.

André Luís Rodrigues

Paulo, thank you very much. Before we start our Q&A session, I would like to strengthen some points. One, as we have mentioned, our focus continues being preservation and competitiveness at the long term, carrying out operating adjustments for better margins, and (12:26) adjustment in the last months have long-lasting effects. And we are ready to make the best of the opportunities of sustainable growth that starts emerging. Another point in the diversification, that is the base of the business model will continue positively contributing throughout the stabilization process.

Point number two, in Brazil, the recovery of economy is gradual and slow, although there is continuity of recovery of short-cycle products. We depend on investments and expansion of capacity and infrastructure for the recovery of long-cycle products. We're facing the worse recession of the country's history, and uncertainties with political crisis. They are reasons to continue believing we're on something that recall during the first quarter of cautious optimism.

In the core market, we see recovery signals. Although we're below historic average, we see the recovery of new orders of short-cycle products and for oil and gas and mining projects that have emerged. We announced on June 23, the acquisition of CG Power USA, a company specialized in manufacturing transformers of distribution and power with very relevant in the market of transformers, the U.S. market; and together with our productive platforms in Brazil, Colombia, Mexico and South Africa will allow us to make progress quickly in our internationalization in business transmission and distribution project.

We will now start our Q&A session. Our operator may proceed receiving questions.

Q&A

Operator

Our first question from Mr. Daniel Gewehr, Santander.

Q - Daniel Gewehr {BIO 6544306 <GO>}

Good morning to everyone. I can see that you have significantly improved your cost control, expense control and gross margin. Now, how much of this control is there? Is there space for improvement to increase your margin realization? Now, the second question is your EBITDA grew more than your EPS. How do you see in (15:11) the growth rate in EBITDA or your rate of growth? I would like to understand this effect.

A - Operator

Thank you, Daniel, for your (15:31). Well, I'll start answering the margin. You saw if there is room for improvement in our margin. Let's analyze the following. There are factors that allow us to understand that there is room for improvement, and there are some factors that may go against us here. And I believe that in the future, we will have to observe which one of them will prevail.

Now, the factors that are favor will, from here on, mainly during the second semester, favorable seasonality. We tend to observe the recovery of short cycle product, something that we have already observed. Now, these cost adjustments that you mentioned in your question, they were implemented properly until today. And they have a long-lasting effect. I believe that they will help us because of the operating leverage and all the indexes that I have just mentioned. These are the factors that may help us to improve a bit more our margin. Nevertheless, we have to remember two factors that are very important that can go against us. One would be, well, we are carrying a very significant gap of backlog energy TD.

The windmill is stable, until next year, but the other business units have relevant backlog. And also, a process have strongly helped us last year, this year didn't helped us that much. And it was present that was (17:12) emission. It is being valid until July. But during the second semester, we will not see this.

In a nutshell, we have to set two factors here. The positive and the negative, and we have to observe the trends. There are more positive than negative factors. Nevertheless, we have to pay attention to them from here on.

Now, regarding the second part of your question is we will have a detachment of the net income and EBITDA margin, well, yes, as your EBITDA margin grows, your net income will follow it. Something that we saw this quarter. I believe that the question is the financial result. Although, we have a highly competitive structure with very attractive financing lines and good cash position, the financial result changes quarter after quarter, and this can detach a little bit. If you see former years and this is the flow and gradual effect. I believe that this effect will be cleared as of the year 2018.

Q - Daniel Gewehr {BIO 6544306 <GO>}

Thank you very much.

Operator

Next question, Alexandre Falcao, HSBC.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Good morning to everyone. Two questions, one would be regarding the labor reform. I don't know if this will affect your results. What can happen in your enterprise, if for example, these new changes in labor union, how can they affect you? Do you see this reflecting on your results?

And the second question, the GTD. You said that there is a gap of windmill technologies. And what should we expect for you to gain more? What sectors could emerge again and could help you to regain more productivity?

A - Operator

Let's start with the labor reform. We are still understanding the aspects of legislation that were changed. This is going to be a positive not only for WEG, but for all industries in Brazil because changes will allow us to flexibilize. We will be able to offer more jobs and we will be able to recover the economy. It's too early but we're still analyzing, but I believe that the results is positive, the provision authorization. Now, the negotiation with labor unions are following their normal flow. We believe that we will not change our position. So everything is very normal.

Now, your questions about the new opportunities on windmill technology, with the portfolio that we have of generators, our portfolio goes until the middle of 2018. And very recently, the contraction was (20:50) bid that we won in (20:54) that will allow us do this transition until the market would recover, and there was a decontracting.

So, what can we say right now about this? Point number one, that pack is properly positioned with good products, competitive products. We continue exploring export opportunities. And we're mapping available opportunities at the free market in Brazil that is a bit lower. And it is very important to remember that in the recent past, we witness rigorous cycles, where we're very important. We can talk about mining, we can talk about sugar and alcohol factor. And we found paths to grow.

An example of a pathway of growth that we're exploring that can help us while the windmill sector is undefined is solar energy, for example. Through WEG, more and more is a supplier of solar energy project with photovoltaic energy products. The solar complex of (22:16) in Paraiba that will add 93 megawatts-peak with a revenue of BRL 426 million between 2017 and 2018. It still doesn't compensate, but I believe this is positive.

And an important message to convey here is that in situations like this, our model of business diversification with the vertical integration allows us to make these adjustments of vital capacity to see segments that are rising connected to series and short cycles, until the market goes back to normality in the future.

Okay. Does this answer your question?

Q - Alexandre Falcao {BIO 5515455 <GO>}

Thank you very much. Could you – about the provision, the law has changed. Do you believe that things are going to change?

A - Operator

I would like to elaborate on the provisions. The information that we have does not justify changing our criteria. Let's see this detail that will come from this reform. But as this is something from the past, the trend does not change, but we are going to follow this up in detail. We are going to raise this information, and then, we will send this information to you, because we don't have this on the top of our mind right now.

Next question, Lucas Marquiori from Safra Bank.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Good morning to everyone. Two questions here. The first one regarding the purchase of CG Power. I would like to know the major opportunities that you see in the U.S. market that is your biggest market in addition to Brazil. I want to know where you can grow more markets/products that you are targeting in the U.S. market. This is my first question.

And my second question, if you could update the information, how much from your local production is being exported? What is the percentage of your revenue is being exported and what figure would be the natural figure for this?

A - Operator

Lucas, thank you for your question. Let's start with the CG Power. We announced on June 21. I would like to explain this acquisition. It's a company that produces (25:29) transformers. There are three industrial units in the U.S.; two productive, and one of service. And during the last year, the revenue was $128 million. And it is totally aligned with our GTD strategies. We wanted to find a good asset and this asset emerged.

Together with strategic alignment, you asked about products and areas. This product is the leader in segments where we still did not have a leadership that is transformers. They are leaders in windmill, solar and it's very relevant. Another positive point is, it will allow us to have good synergy with our Mexican plant in a number of areas. It has complementary lines with the Mexican units. Mexico for example have a strong presence in dry transformers.

Today, it will allow us to increase our market share in (26:50) transformers in the U.S. Our market share is one digit, and we want to have our one digit high market share and allows us to mitigate an eventual Trump risk. And this can allow us to mitigate the situation with this risk. So, I believe this was a very important acquisition. We are very reassured, because we believe we will grow in the U.S. market. We already have a good presence in low voltage motors. Now, exporting hasn't changed a lot. We continue with the same trend that we announced during the last year.

Next question from Paulo Valaci, Citibank.

Q - Paulo Guimaraes Valaci {BIO 18268142 <GO>}

Good morning. You mentioned that your backlog is windmill. How much of the revenue does this represent? And when this backlog will change according to profitability in the future quarters? Well, CG Power last year, you invested a lot that compromised your cash flow. Could you talk about your asset turnaround strategy? Will we have a positive cash generation in CG Power this year or next year?

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

Paulo, good morning. Well, backlog – and André can answer CG Power. From our backlog, there was a misunderstanding. This backlog of windmill technology is in the future. Today, our backlog is very low in high-voltage motor generation and transformers. This is where we have our backlog. This in Brazil and abroad, these sectors are suffering a lot. This is something that comes from the past since last year. This effect was stronger this year. Now, the auctions that generate a great deal of demand for these sectors, they did not take place during the last year, they took place in 2015 and this is the main reason why we have a weak backlog.

We do strategically – it is not convenient to give you the figures in terms of backlog, but what I can say that they are around 20% below history. It's going to depend on the performance of the second semester. We are working below the historic average. Reminding you that we are reducing labor hours to Friday last month within our unit of GTD ex wind. So, this is the current situation. I believe this situation will remain during the second semester and if we do not have new options, it may continue next year.

A factor that may mitigate this is the industrial recovery. A number of orders in the industrial sector started emerging and this may help us to mitigate this effect. But what is important, our options, this is low and we believe they will continue low during the quarters.

Now CG, the expectation is improvement especially during 2018, especially because we will redistribute our product portfolio from one unit and another, and the synergy that we will have with our plant in Mexico. And we expect these results to be reflected on 2018.

Operator

Lucas Barbosa, UBS.

Q - Lucas Barbosa {BIO 20412168 <GO>}

Good morning, André, Paulo. Thank you for answering my question. First question, regarding labor hours reduction. How did this help you in your margin and what about the agreement with your labor union? This is my first question, then I will pose a second question.

A - Operator

Rogério (31:40), good morning. The impact of labor hour reduction is very little in margin. I believe that the effect is more on plant occupation. It affects more the assets. Last year during the second semester, the entire company in Brazil, all the units, Santa Catarina, São Paulo, Espírito Santo, Manaus, all our units reduced labor hours, working hours. Everybody, corporate, administrative.

This year is different. This year, our units are connected to GTD ex wind. These are the transforming units and the power units. These units are less representative in web. Nevertheless, the effect on the EBITDA margin is very low. We do not have this figure on the top of our mind. It is not very relevant. It is very low and we believe that it will not have a major effect during the second semester. If this is your concern of margin, no, the agreement with your labor union is that you can do this six months a year, yes. We have already taken up this period. Now, it ends at the end of July.

Q - Lucas Barbosa {BIO 20412168 <GO>}

And my second question, just a follow-up regarding the backlog, we will like to confirm. You mentioned that your backlog is 20% below in GTD or would this be your backlog by and large? And if it's in GTD, how would the backlog be in the entire company with historical comparison? What about PCH sales in India and your sales of transformers in the U.S.?

A - Operator

Well, backlog is for long cycle products that are in the GTD. Now, motors and automation of short cycle, well, we do not have a backlog problem. So, this is regarding GTD specifically so this is abroad, Brazil. It's stronger in Brazil and lower below. So, the average between two would be around 20%.

Could you please repeat the question about India?

Q - Lucas Barbosa {BIO 20412168 <GO>}

What about the development of the products that you want to sell in the markets in India, the PCH generator, what the market is in India like?

A - Operator

The Indian market is a market that is a good market. It is growing and demands a lot of investments in this market, the power and infrastructure and the main driver would be water pumping. Water is very relevant in the country. The main driver is along these lines.

Now, PCH also exist, but it's not very representative in our portfolio. The great volume in business in India is connected to water, water pumping. And there are actions that we're carrying out and we want to work in the – with wind farms in India, we still have nothing contracted. This is a movement that will bring benefits in 2018, more specifically 2019. Well, these are the two very important sectors, but water pumping is very important in India.

Q - Lucas Barbosa {BIO 20412168 <GO>}

Thank you very much.

Operator

Good morning. Next question Leandro Fontanesi, Bradesco BBI.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Good morning. Could you elaborate on the domestic market? You mentioned products with low demand. Could you mention products with a higher demand vis-à-vis last year because here we can see there was an improvement?

And the second point, Mexico investment. Could you give us an update of the investments in these countries?

A - Operator

Leandro, good morning. Yes, we will recap and we try to be specific in our speech. We will give you details of the domestic market. And André then will talk about China and Mexico. We repeat this constantly, we have the continuity and the recovery processes. It's very obvious in the series and short-cycle products. This is clear.

We have also observed a number of markets that are more dynamic right now. Which markets are these? One, agriculture; two, food processing; and also the part of beverages. So, these markets are gaining momentum right now, especially during this quarter. Although there is a lack of greenfield project, expansion problems, the stability of orders in small and series products have been consistent in the past quarters. And this shows that the maintenance CapEx is re-emerging again. This is something that we have to register.

And on our side, we also continue trying to expand and to gain market. So, the dynamic of Brazil is more or less along these lines. GTD is difficult as we mentioned when we answered the other questions, and I believe will continue difficult. We are expecting new auctions, one, power decontraction and one of power generation, and I believe that now André can answer.

A - André Luís Rodrigues

Let's start with China, China positive result. We announced a new capacity at the end of 2015, beginning of 2016 without our motor capacity of low voltage and we are investing to increase our capacity and the expectation is then in 2020 we will have our existing capacity. Our plan to running – and our expectations of increase of capacity have materialized.

Mexico, let's see the internationalization process of Mexico and horizontalization the positive in both companies, low voltage motors. They're a good Mexico presents good quality and labor and a cost that is very competitive. And Mexico now, we are working with low voltage motor and we are in the last stage where we can see verticalization. That this is an investment to have a smelting plant that will end by 2018.

Now, both countries have promising results and with promising future. And it is following our strategy of expanding our action in these countries. And we are focusing our investments on China and Mexico when it comes to investing in foreign markets.

Q - Operator

Thank you very much.

We have a number of questions that came in written. I would just like to strengthen a point. And this was a question that came from Santander regarding net revenue and financial results.

I would like to highlight something. Although we observe a stabilization in interest rate and a drop in the long-term, the main message is that at the end, this is very positive, an environment where you have a lower interest rate. It goes hand in hand by a growth environment.

So at the end, the net income of the company is better because it means that the economy is growing. So the scenario, then a drop of (41:21) interest rates is positive for that than negative. I just wanted to strengthen this message.

There is another question here from (41:37). He asks what is the percent of market share in windmill technology.

This is strategic information, very important for the development of our business. Unfortunately, we cannot disclose this. Now, the class entities have a statistic data and I believe that they can show you their representativity of Brazilian players and what their market share is. I do apologize, this is the piece of strategic information and we cannot disclose this.

There's another question from Sérgio (42:20). Is WEG prepared to supply and what kind of equipment and auto parts are they willing to – or they can supply for the automobile industry?

Especially now with electric cars, we have technology and we have prototype of electric vehicles in WEG, and we have around 250 buses running with solution of electric engine and frequency (43:00) inventers. We have technology, we have the capacity. And now, I'm talking about the burden, now when we – we talk about buses, but the light vehicles well, this is the trend.

This is going to become a reality and we are maturing the technology and the company, and company is investing times and resources on this type of technology.

We bring our Q&A session to an end right now. Mr. André Rodrigues will make his final remarks. Mr. André?

A - André Luís Rodrigues

Thank you very much for your participation. We expect you during our next conference call with the earnings results of the next quarter.

Operator

This conference call has come to an end. We thank everyone for your participation and have a very good day.