

Y 2019 Earnings Call

Company Participants

- Antonio Joaquim de Oliveira, Chief Executive Director
- Carlos Henrique Haddad, Chief Administrative & Financial Officer and Director of IR

Other Participants

- Lucas Canteras
- Thiago Lofiego

Presentation

Operator

Good morning, ladies and gentlemen and welcome to Duratex SA's audio conference. Thank you for standing by. At this time all participants are in a listen-only mode, and later we'll conduct a question-and-answer session. And instructions to participate will be given. (Operator Instructions). As a reminder, this conference is being recorded. I would now like to turn the conference over to Mr. Henrique Haddad, CFO and IR Director. Please go ahead, sir.

Carlos Henrique Haddad {BIO 17599460 <GO>}

Good morning, everyone, and welcome. Thank you for listening into one more conference call for the earnings results for Duratex. I'm here with our CEO, Antonio Joaquim and our IR and communications team.

This quarter, I'd like to begin my presentation by telling you about some things that marked the year 2019. It was another year of several structural changes in the company. 2019 was marked by several restructurings and changes in our business divisions. In May, we announced the acquisition of Cecrisa, one of the biggest ceramic tiles companies in Brazil, better known by its Portinari brand, which is a market reference. This acquisition was very important for Duratex, not only because it confirms the company's position as one of the greatest and most important manufacturers of ceramic tiles in the high-end market, but also because of the synergies it has with our Ceusa operation. These synergies have already been captured in 2019 through the integration of some industrial activities, restructuring, commercial and administrative staff, integrating the supply process and the marketing effort to explore the best in the Portinari and Ceusa brands.

It's worth remembering that the fourth quarter of 2019 was the first in which we consolidated 100% of Cecrisa's results. Moreover, in October, we began the new ceramic

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tile line, which increased the division's capacity by six million square meters, which were investments we had approved in 2018.

To speak a bit about the Deca division. In 2019, we continued to optimize our manufacturing park with consistent improvements in productivity. And that's why in July 2019, we announced that the Sao Leopoldo's ceramic units was going to be closed and its assets will be transferred to the other company's units.

In Wood, in September, we announced the definitive closing of the Botucatu wood panels unit, which had its operations suspended for nearly a year. With that movement, we were able to sell our forestry assets in the region, another relevant step in line with our strategy to focus our efforts in operations with higher productivity and a better use of capital.

Last but not least, in the month of December, we approved the creation of a joint venture with Lenzing, through which we will build a new soluble pulp or dissolving pulp unit. With earthworks nearly concluded the project is gaining traction to conclude another major enterprise in the next two years in the state of Minas Gerais. These changes have been essential for the company's strategic positioning and they are improving how its assets are used.

Page 3 discusses the extraordinary events of the year. These events led to an impact in the adjusted and recurring EBITDA in the fourth quarter of BRL290 million and BRL313 million in the year overall, as we can see in the reconciliation details between the total and recurring EBITDA data.

Excluding these effects, Duratex closed the quarter with an EBITDA of BRL278 million for a total of BRL909 million for the year, as we can see on Page 4. An improved economy with more consumer confidence and a slight re-uptake in consumption has favored the company's results in the fourth quarter, especially for the Deca division. It has led the adjusted and recurrent EBITDAs to come to a high of 17.5% this quarter. This year, it grew by 7.1% vis-a-vis 2018.

Although we had an improved result, the biggest highlight in this quarter was the operational cash generation. This was due to gains in cash generation and working capital. As we can see, in Page 5. This year, the company generated BRL460 million in cash, an important evolution in the second half of the year, especially the fourth quarter. And this is not even considering the extraordinary events we saw on Page 3.

By reducing maintenance CapEx, given the restructurings that we went through and improved working capital, we improved our cash generation as we can see on Page 6. Analyzing working capital, we can see there was a reduction of 20 days in the cash cycle in comparison to 2018. A highlight here was the reduction in the amount of time clients took to receive products and an increase in their -- in our suppliers' payment dues. This improvement is the result of a group of efforts made by the company aiming to have better operational cash generation and reinforcing our commitment to generate more value in our operations. I'd also like to highlight the results from the asset optimization strategy reflected in our forestry OpEx as well as the reduction of our maintenance

CapEx. This was due to the restructuring we mentioned before that were carried out in the last years.

With that, the total CapEx for the year was BRL454 million. When we exclude the effects related to the expansion projects, we notice that there was an important reduction in comparison to the previous year.

Now to talk about debt management, we move on to Page 7. With a greater cash generation and by receiving from the sales of lands and forests our company's leverage reached 1.9 times net debt-EBITDA. It's important to remember that these results already consider the consolidation of Cecrisa's liabilities of around BRL440 million. Another important highlight was how the company's debt was restructured over the year. The average due -- payment dues went from 2.1 years to 3.7 years, keeping competitive costs.

Now to talk about the results for each business, we will begin by talking about Wood in Page 9. The wood panels market had a retraction of 6.5% in the fourth quarter and 3.3% in the year, overall. It's important to remember that in the fourth quarter of 2018, volumes were very positive, given the expected improvement in the economy for 2019 then. MDF volumes had the worst performance in the market for the year and for the quarter.

On the other hand, in the MDP market, we see some stability versus the previous quarter and a small reduction versus 2018, which gives a sign that the furniture market is improving. Another important point was an increase in the cost of international shipping, which led to a reduction of 16% in the exported volumes this year.

Now focusing on the Duratex Wood business on Page 10, even though our volume performance was affected by the market, Duratex has been increasing its share in higher added value products. And that mix improvement, with a rigid cost control, has led to an increased EBITDA margin of 24.1% in the last quarter of 2019, which was still in line with 2018. We are still focused in differentiating our products and having better commercial discipline and productivity.

Now to talk about Deca, we move on to Page 12. The construction sector has had an improvement in the fourth quarter. The year was closed with a higher -- with an increase of 2%. And the expectation for 2020 is a growth of 4%, which is a good number considering our recent history.

In 2019, we had a great year for Deca. Despite the challenges we faced with this slow economic recovery, we were able to present significant improvements in our results. The improvement presented by the Brazilian Association of Building Materials in the fourth quarter was also reflected in Deca volumes, which increased 16.1% versus the fourth quarter of 2018, partially offsetting a reduction of 6.5% presented until September 2019. Therefore, we concluded the year with volumes very close to what we had last year. The company's premium position has made our unit revenue increase by about 7.7% in 2019, even in a scenario with retractive volumes.

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In the quarter, this growth was a bit under the yearly average, given an increase in sales and products that had a smaller value added. During 2019, the division directed its efforts in seeking more logistical and operational efficiency, which has resulted in a continuous evolution of our gross margins, which reached about 29.7% in the year disregarding the expenses with closing Sao Leopoldo. It was a 1.8 percentage point gain versus the previous year.

Now the next page, we'll discuss our Ceramic Tiles business. This business had an accumulated growth of 3.1% over the year, with a slight reduction in the last quarter. Page 16 shows further details on our performance in that segment. The biggest highlight in the Ceramic Tiles business was that in the last quarter, we consolidated the Cecrisa results and that impacted increased volumes, revenue and EBITDA. Since the comparison is impacted by the consolidation of the operations, we'd like to focus on how synergies were captured.

We're far along in our capturing process with important activities, both on the operational side, such as closing factories, standardizing processes, managing our suppliers, but we are also restructuring our administrative and commercial staff. These movements, although they're just beginning, are already showing some results. The EBITDA margin has been 2 percentage points above what we presented the previous quarter. Another important highlight was the start of the new ceramic tiles line, which increased by 6 million square meters the division's capacity. It's worth highlighting that this new line is for bigger sizes, which will make it more competitive for our Ceusa and Portinari brands in this segment.

Now the last page shows our expectations for 2020. We are still cautiously optimistic in this year. The economic scenario has been more favorable, and civil construction has had - has been recovering. So we are counting on a growing horizon for volumes. In the Wood division, we are still cutting costs and improving the mix with differentiated products ready to capture the market.

For Deca, we are still continuing our operational efficiency projects. And 2020 will be a year in which we'll focus on our commercial execution, seeking a better brand position and strengthening our relationship with clients.

Capturing synergies by leveraging this Portinari and Ceusa brands are still -- is still the focus for the Ceramic Tiles division for 2020. Teams have already been formed, and we are seeking to optimize our manufacturing areas to maximize our productivity gains. Finally, for dissolving pulp, we are focusing on building a new plant in the next two years. It's an investment of nearly BRL5.2 billion.

This concludes my presentation, and we'd now like to open for questions. Thank you.

Questions And Answers

Operator

(Question And Answer)

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question is from Thiago Lofiego, Bradesco.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Good morning, everyone. Thank you for this call. I have a couple of questions. First, if you can tell us a bit about the scenario for wood panels on the demand side for 2020. We saw that in 2019, it was very volatile. So if you could tell us a bit about your perspective in terms of if the demand will grow by two digits, if that would be two positive in your opinion? And if you could also tell us about what you are thinking about the supply and demand for wooden panels in 2020. Given the scenario, how do you think the supply will change? Can that be translated into price? If you're -- you have a price increase that would be interesting to know as well.

My second question is that we've seen some new residential launches in Sao Paulo. But I think in Brazil, overall, probably less than in Sao Paulo, but we are seeing that new construction is beginning. The first wave was in 2017 with low-income housing, and now we are seeing the mid-high segment going up as well. So when do you expect Deca will start to benefit from this? I understand that it's about 1.5 years for the cycle after your new products are launched. But I'd just like to understand if you are seeing a positive impact regarding that for Deca? That's all. Thank you.

A - Antonio Joaquim de Oliveira {BIO 15358831 <GO>}

Good morning, Thiago, this is Antonio Joaquim. Thank you for your question. So to tell you about Wood, first, of course, we do see this, and this is in our statements that we had a 2019 that still had unbalanced offers and demands. There was a higher supply than the demand. And as a consequence, we had to work with prices below what we needed for a good performance in this sector. At the end of the year, we started seeing some re-uptake, but this is still a challenging scenario. So we believe that at least for the first quarter of 2020, we will still have a bit of a challenging scenario still. We have spent January with some results according to our expectations, but we are not underestimating the short term. We do believe that this supply and demand situation will continue to be off-balance for a bit. We think that might improve from the second quarter on, but for now, we have to wait and see what happens.

We are following it closely and we are having a strong effort to differentiate ourselves. We're trying to improve our supply mix. And if it's a priority company, especially in retail and also furniture companies, on the premium side, then we do believe that our clients are a bit more optimistic. We believe that there is nothing really foreseen in terms of new capacities or additional capacities for 2020. All we have is what already exists. So any recovery of the market we will see, will be later. And I do hope that volumes grow. I'm not as optimistic to say that we are growing by two digits. I don't know, but I think that would be a bit more difficult. But we do expect some growth versus 2019. We are doing very well on the cost side, at least, for this part. We still have some opportunities with occupation. And we're definitely analyzing that this year, we are considering another export increase, we looked into that yesterday, we have some good perspectives on that. And we are

able to export some higher added value products, which are very positive. So the exports should reach in 2020 a very positive volume, very high. So with that, we think we do have the conditions to have a better 2020 than our 2019, at least in the Wood division.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Sorry to interrupt, I just wanted to add something to my Wood question. Exports, we know that 2019 was also a year in which that was reduced. So how was that explained? And how do you see 2020? Sorry to interrupt.

A - Antonio Joaquim de Oliveira {BIO 15358831 <GO>}

What was happening is this. Right now, our situation is better for exports. We had a bit of a competition in 2019 in terms of exports because of shipping. Henrique Haddad has mentioned that before. You know that with exports, our margins are lower. So we need to fine-tune that operation very well. So it was a bit more challenging this year. We think that in 2020, we have already begun to be stronger. Shipping rates have gone down. So we are already operating at a level that was higher than the levels we saw in 2019. And we are exporting to South America to the Andes, Colombia and that capacity is 100% taken in Colombia. So a huge part of our volumes go there. So we see a more favorable result -- excuse me, scenario for exports.

Regarding costs, prices have been maintained, and they can improve somewhat, but our effects will be better also because of the exchange rate with the dollar. So for the Wood export scenario, we are having a more positive outlook. We should probably see some strong figures in the first quarter, and that's very important because we also, along with other competitors, have plans to export more. So that's good. It also reduces some of the pressure on the domestic market. As I said, we still have a lack of balance between the supply and offer sides. That's for the Wood division.

Regarding Deca, we do see some recovery. We have been growing -- or we have been seeing that until December. We see that Deca is going up considerably. We also have an expectation that in 2020, our Deca operation will be better. We are measuring our ETA [ph] in the long term, and we hope to have it balanced and positive. So we are optimistic about Deca. It was a very consistent market. The recovery of civil construction has been very consistent, not only in Sao Paulo, but for all of Brazil. And I hope that these effects will start showing results soon or more direct effects for Deca from the middle of the year, we hope to see some acceleration. Although there is a higher demand on the market. That's another important point.

Over the last year, many -- there was a very significant movement of clients that reduced their inventory. So they readequated their inventory to a lower level. And now at the end of the year, they're starting to recover their inventory. Let's say that they cut a bit more than they should, and now they're starting to recover it. So now we see that the market is recovering its inventory, especially for retailers. They are adjusting that. So that would be a positive scenario for us. We see that the recovery has two important things in this cycle; first, interest rates are lower. So employment is up, there's more confidence. I've traveled in January and in February to visit clients and overall, especially for Deca and Ceramic

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Tiles, they're very optimistic. So I'd say that the scenario for Deca is quite positive, and I think that we can expect a recovery.

Since we made a strong effort in productivity gains, I'd say that our biggest results in 2019 were due to productivity gains. Right now, we have closed that plant in Rio de Janeiro, we're moving our production to the Northeast, we are full speed in the receiving plants to expand our areas and also in Paraiba. So right now, the biggest challenge we have in Deca is improving all the logistics, how we supply our clients, and we are working strongly on this. We also concluded a cycle recently, where we reviewed our commercial policies. It was a very important effort that was done with the support of some renowned consultancy companies in the market. So we're implementing a new cycle, a new vision in commercial policies and clients have liked them a lot, and this has started in January. So as I said -- I always say that we are cautiously optimistic, and I don't think that -- I think that if we don't have any structural issues that are more serious or anything happening in Brazil, any political situations then the market should behave better in 2020.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Great. Thank you. I'm sorry, if I may -- you mentioned the Wood division. And do you think this year, the prices will be recovered for wooden panels in real terms? Do you have any initiatives to increase prices now in the first quarter?

A - Antonio Joaquim de Oliveira {BIO 15358831 <GO>}

Traditionally, prices do go up in the first quarter. That cycle of price adjustments can go to -- last until March and so on. It will, of course, depend on our competition. We increased the price last year, and then we had to adjust some things at the end of the year. But we have been cautious because if there's any imbalance between offer and -- supply and demand, we might not have enough space to increase prices as we should. We do need to, but it's likely that there will be an increase in the prices in the first quarter. We'll see what happens. And everyone, our competition, is taking a hit from the low prices. If the market recovers, then maybe we'll have some space to do something.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Great. Thank you, Antonio.

Operator

(Operator Instructions). Next question comes from Lucas Canteras from Goldman Sachs.

Q - Lucas Canteras {BIO 20909160 <GO>}

Good morning. Thank you for taking my question. I'd just like to understand a bit better how the integration is going between Ceusa and Portinari, which used to be Cecrisa. I know there was a NVP -- guidance of BRL450 million. And I think that now that you have been running operations in plants, you have a better idea. So if you could give us some color on that, if you could give us an update on the estimates, that would be great. Thank you.

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A - Antonio Joaquim de Oliveira {BIO 15358831 <GO>}

Lucas, in terms of Ceramic Tiles, we are very optimistic, not cautiously optimistic, but rather very optimistic. We're doing very well, but I'd like to say two things; first, we were able to do something very quickly, which was to consolidate all the important movement we had in merging Ceusa and Portinari. From -- or until December 31, and I remember that we took over in July 31, we had five months. So in these five months, we reviewed all the teams, we got important synergies from this team model, especially M&A gains, administrative costs were reduced, we had, of course, a second quarter in which we invested a lot to reduce the team, to reduce the number of sales reps, to adequate our structure. So I'd say that all boxes have been ticked and everything is in line with our expected model -- or this was the case by the end of 2019. So it was actually faster than we imagined. We had a lot of collaboration from our employees, all the people involved, it was a very important group effort. I don't think we have ever had such a faster and successful merge as this one. Right now, we're working on systems and so on. We are reviewing our go-to-market with clients, channels, we are structuring the service model, per channel, I think that's going to be very positive. So I'd say that besides that, we concluded the expansion of the Ceusa capacity, it nearly doubled. With the new plant, it was the first 4.0 factory for this industry in Brazil, an automated line, with cutting-edge equipment. So it is the most modern plant for bigger sized products, which is a unmistakable trend in the market. So we're very excited.

Regarding synergies, we have been working with a synergies scenario above what we expected. So we are optimistic. We have certainly been seeing higher results than we expected. And this is what we want to say for now. But what I can tell you is that synergies are very important and they are above what we expected. So what do I believe for -- what will happen in 2020 for the Ceramic Tiles sector? It's what I mentioned in the last conference last year. We received a lot of questions. Of course, Portinari was -- had an EBITDA margin below Ceusa's. So we did that. And we do expect in 2020 to capture the most important part of the synergy process. And in 2020, we should go back to the previous margin levels. This is what we expect. So throughout 2020, we still have two important events because we had two points; first, there was some luck on of the timing, in the moment in which the merge took place. Because Ceusa was launching a new line and obviously, there was ramp-up for the new line, which was expected considering only Ceusa.

With the merge, we manage to transfer a lot of the Portinari production to this line. So now we no longer have Portinari and Ceusa. We have four plants and the four plants manufacturer, whatever is best. So industrial synergies were much higher than we expected. For example, the new line is already basically running full-time after two months of operations. So that's going to help. And we have some industry changes. We closed the Minas Gerais unit, and we brought the equipment from Minas had to be modernized. And that's going to affect or increase one of the Portinari plants. Then we also had some equipment from an unactivated plant in Goias. And again, the equipment will always be modernized and will help to work with more Portinari lines. So we separated the industrial side into two chapters; first, ramping up the new line; and secondly, investing around BRL60 million or so into modernizing the Portinari lines. So for the second half, we should have all of our assets up-to-date and modernized. So we should be capturing some important synergies. I think we're going to be able to have a turnaround in our results for

Portinari and we hope to be able to have a very interesting marriage between the two operations very quickly.

Q - Lucas Canteras {BIO 20909160 <GO>}

That's great. Thank you.

Operator

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

A - Carlos Henrique Haddad {BIO 17599460 <GO>}

Once again, I'd like to thank you all for listening in. And we are open to any questions you may have if you need further information. Thank you, and we'll see you next time.

Operator

That concludes Duratex SA's audio conference. Thank you very much for listening. Have a good day, and thank you for using Chorus Call.

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