

Q4 2018 Earnings Call

Company Participants

- Felipe Saraiva, Investor Relations Coordinator
- Guilherme Setubal Souza e Silva, Executive Manager-Investor Relations

Other Participants

- Arthur Suelotto, Analyst
- Juan Gabriel Tavarez, Analyst
- Ricardo Monegaglia, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call of Duratex. Thank you for standing by. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions to participate will be given at that time. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Mr. Guilherme Silva, Investor Relations Executive Manager. Please go ahead, sir.

Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Good morning, everyone, and thank you for joining us for this quarterly presentation of Duratex results. My name is Guilherme Silva, and I am the IR manager of the company.

So let's begin to presentation on slide 2 with some highlights from the 2018. 2018 was a special year for our organization, with a structural change to every aspect of our business. This change hasn't come about in isolation that represents the fruits of all of the work that has been carried out on infrastructure over the last few years. And in particular, the development and implementation of Duratex Management System which is delivery the culture transformation at the same time as you review of our long-term strategy which we call Duratex 2025.

For the Wood business, it was a year of a major restructuring. At the beginning of the year, we announced we were leaving the hardboard business (00:01:47) an asset exchange with Eucatex which has been just finalized in the fourth quarter of the year.

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Next, we announced the operation with Suzano to sell significant forest assets and land (00:01:59) in the state of São Paulo which was surplus to our panel requirements. In April, we reopened the panel facility in Itapetininga, which had been on shutdown since December 2016. In the middle of the year, we announced a partnership with Austrian group Lenzing, as a part of new business, the name is DWP, dissolving wood pulp.

Finally, we had temporarily shut down the MDF facility in Botucatu in the countryside of São Paulo. This line, our least productivity MDF line, will undergo retrofit that will cost in order of BRL 100 million and should be back online once we have completed the upgrade and we consider there is a space in the market. Due to the shutdown, we are going to increase production at our other lines, especially in Itapetininga.

In the Deca business, we are undergoing a strategic recognition called Duratex Strategic Growth Agenda. However (00:03:08), guided by this new plan, we made some significant adjustments at the end of the year. First of all, we closed the Hydra operation at Tubarão facility. We've made electronic showers and consolidate all showers manufacturing at Hydra facility in Aracaju. Production capacity will maintain that the operation under more efficient model. We optimized Hydra structures and reduced the size of Duratex force - workforce, particular in P&D and planning areas.

Since January, we have been capturing the commercial synergy that was on the table. Integrated the sales team in Deca business metal and ceramic wares with the Hydra business electronic shower. Finally, we have delisted around one-third of the Deca's portfolio. This change (00:04:05) offer greater agility and simplicity to our operations, bringing the expectation of improved productivity and the release of working capital.

This change (00:04:16) reflect the benefits arising from the growing maturity of Duratex Management System and the journey of Cultural Transformation with the exemption (00:04:25) of activities and release the surplus assets. We have generated positive cash flow for the year which has contributed to reducing the debt burden on the operation. Thus, 2018 produced a stronger financial performance which contributed in generation of profit in the periods.

Now, let's turn to page 3 where we'll take a look at the impact of this change (00:04:53). The table illustrates the non-recurrent impacts on both EBITDA and net profit, quarterly and annually. It should be pointed out that the impact on the cash flow of this restructuring was limited, given the size of our organization. There was impact on the cash flow around BRL 30 million split between BRL 10 million impact in the Wood operation and around BRL 20 million impact in Deca business. From this restructuring activities, we have (00:05:30) on improvement in the results in the order of BRL 40 million per year beginning this year 2019.

With all of the restructuring carrying out in the operation, the new business from that we opened this year, in particular DWP is still going on hold (00:05:48) and expansion of Ceramic Tiles and with the improvement of the economic scenario, we have increased the level of returns we expect from the current assets, which is reflected in our analysis of intangible assets for the year. Thus, we have recognized impairment of BRL 224 million in

intangible assets on the panels, sanitary wares and electronic shower businesses. There were also some lesser impact which are detailed in the financial statement. We have no recurrent adjustment on EBITDA totaling BRL 560 million and another BRL 160 million (00:06:24-00:06:31) on the net profit. In order to better understand the operation, we are going to present a pro forma of our financial results to-date, excluding the effect of these adjustments on income cost and expenses.

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So, let's turn to page number 4 where we'll review the results summary. So on slide number 4, we continue to see strong sales, especially in the panels segment, supported by a consistent pricing policy producing net sales of nearly BRL 1.3 billion. For the full year, we saw income growth of 17% (00:07:12), (00:07:16) impact of the sales to (00:07:18) excluded.

EBITDA for the quarter was BRL 237 million with a margin of 18.7%. This result represents a progress on previous quarter and was led mainly by the price environment for panels and a slight improvement in the operation cost as a whole. Recurring net profit was BRL 151 million for the last quarter 2018 and BRL 271 million for the year. There was a 50% increase in net profit compared to the previous year, which reflects the progress that's been made with the operations and improved in the financial performance.

So, now, turn to page 5 where we can review the headlines with the relation to cash flow and corporate debt. The main headline here is the reduction to the financial corporate debt which reflects the organization to commit to this goal (00:08:27). The net debt to EBITDA index has showed steady fall reaching the level 2 times in the end of the year. The actual level of net debt is BRL 1.5 billion. It's important information, BRL 400 million lower than the end of the previous year. In our Wood, Deca and Ceusa operation, there has been positive cash flow generation. Releasing of surplus assets contributed to these results.

In the fourth quarter, we received the final installment of the first round of payment in relation to the transaction with Ceusa, with the final payment was approximately BRL 375 million scheduled for the end of the second quarter of this year 2019.

I should mention here that in December, the senior board proposed a distribution of earnings of BRL 546 million in the form of JPC and dividends. This payment will be made in two tranches; the first one in February 21, and the second in the end of the year.

Moving to the next slide, we will take a look at the headlines related to working capital and investments on slide number 6. In 2018 (00:09:47), we saw a steady reduction in the (00:09:51) of working capital employed in operation. But it should be emphasized that it is just the beginning. Our cash flow conversion cycle fell by 23 days on a full-year comparison, driven mainly by the expansion of the average payment lead times to suppliers and a slight reduction in the average inventory lands.

Investment levels are slightly below initial expectation, totaling BRL 442 million for the year. The focus of investments remain on the sustaining manufacturing and the forestry operations. In 2019, we will be investing expansion of capacity at Ceusa with

approximately BRL 94 million of investments, following investment of just BRL 10 million in 2018. We will also be investing in the new DWP business, which may require operating cash injection spend of the progress of the new inventory and its needs for capital.

Please now moving for page number 18, we'll take a closer look at the Wood division. In 2018 the wood panel market in Brazil showed a significant upturn, meeting our initial expectation and reflecting on better capacity utilization in the country. As you can see in the chart, on slide number 8, we saw improvement in both MDP and MDF, the reduction of the spare capacity.

So in slide number 9, we'll review our performance in the sector, the performance of the Wood division of Duratex. So sales continue to be strong with a volume of 765,000 cubic meters in the quarter, an increase of 40% versus the last quarter of 2017. For the full year, the volumes grew 14.5% tracking the growth and the demand for panels in Brazil. With the market share growing for some lines. Capacity utilization is satisfactory given the current state of the market with our operations 75% which resides (00:12:21) on the average of the year.

We have consolidated price increase for the panel sector during the quarter which has led to income growing by 22% to BRL 847 million. For the full year, (00:12:40) impact of the sale of forest (00:12:41) Suzano, our income grew 30% totaling yearly BRL 3 billion. The recurring and adjusted EBITDA for the division was BRL 170 million of the quarter with a margin of 20.3%.

The price adjustment and the slight improvement the cost performance have put us in a strong position than the previous quarter when the margin were 60.7%. For the full year, EBITDA grew 19% to around BRL 6 million at the margin of 20.1%. So this is the position with the Wood division.

Now, let's go on to Deca division on page number 11. After four consecutive years reached the construction material sector had shrunk. The ABRAMAT Index report a modest growth in 2018 of 1.1%. The association also forecasted moderate growth in 2019 of around 2%.

Now, turn to page 12 where you can see the headline Deca division. Now on slide 12, we can see Deca's performance. 2018 was clearly a very challenging year for Deca division. The market for construction materials showed a slight improvement but still present significant challenges. We saw a slight increase in cost driven by the cost of dollar denominated materials and a currency depreciation with good pressure on the results over the year.

There was a modest fall in volumes sold in the fourth quarter of 2018 caused mainly by a high inventory levels (00:14:43) environment. Even so, the volumes remain stable when compared to 2017. Deca's net income was BRL 368 million in the quarter and BRL 1.5 billion for the full year. In the quarter, we saw an improvement internal in the gross margin versus the same period of the previous year on pro forma basis. This improvement reflects the benefit capital from the programs to maximize the productivity and raised

price (00:15:24) the results report at the beginning of the year. But still not sufficient to compensate from the deteriorating margins accumulating throughout the year.

The recurring and adjusted EBITDA for Deca was BRL 52 million for the quarter and BRL 204 million for the full year despite the decline (00:15:49) versus 2017, it's very important to mention here, we finished the year strongly and more optimistic that the series of program ongoing Deca division, we will lead to the significant improvement in 2019.

Now, let's move to page number 14 which discuss results for the Ceramic Tiles division. Here, you can see the ANFACER numbers. ANFACER, the National Association of Ceramic Manufacturers reported a growth in the demand in 2018, but the level of utilization the factory remain unchanged. The average export capacity in the ceramic sector was in the order of 28%.

Turn to page 15. You'll take a look at the performance in the division. So we're now in the slide number 15. You have the performance Ceusa business, other Ceramic Tiles (00:16:54). The performance of Ceusa operations remain satisfactory which reaffirms our belief and the value that the acquisition of this business represented.

Following acquisition, we had made some investments to support the ongoing needs of the business and we have unblocked some bottlenecks in the production process. We have led to improvements in the volume shipment.

In the quarter, we shipped 1.3 million square meters, almost 9% more than the (00:17:29) the same period of previous year with the full capacity utilization. Net sales was BRL 48 million for the quarter and almost BRL 200 million for the full year.

During 2018, we achieved some productivity gains which partially compensate for the inflation in the material cost seen during the period especially with respect to the cost of natural gas, an important raw material. Also this quarter, we saw reduction in the comprehension (00:18:05) provision which boosted the results. The recurring and adjacent EBITDA for the quarter was BRL 13 million, for the full year EBITDA was BRL 47 million at the margins of 14.1%. It's important to mention here that this number was above our expectations.

Now let's turn to the last slide in which we take a look at our prospects for the short term perspective. Now the last slide, slide number 16, we can see the short-term perspective. Our short term view is quite optimistic. Our structure is now linear, more agile and more productivity which reflects all of the restructuring we have made over the last few years. We can now already see a positive signs of recover in the market which we operate. And 2018 showed an increase in demand in yearly (00:19:15) of all of our business.

The expectation for 2019 is for the strength to continue. In all the division we continue our sales policy with sustaining the profitability of our operation without any impact in the market share. We will continue to work on the depreciation (00:19:37) with Wood Panel business, be it through the product or level of services. In our medium-term, we should start to have the rewards for these initiatives. For Deca, the focus is on the strategic

growth agenda. In this initial phase, we are focused on efforts to improve the efficiency of manufacturing in the logistic operation with several (00:20:06) initiatives, I mean, at boosting productivity.

For Ceramic Tiles, we are aiming to consolidate the project to expand manufacturing operations to enhance production capacity in 2019. The expansion would be carry out in phase, so not all of the additional capacity will come online this year. From the middle of the second semester, we hope to be able to ramp up the production of this new line of Ceramic Tiles.

Finally, we remain committed to fulfill all of the requirements necessary to start building the new (00:20:51) Wood facility. This closely controlled products remain on track and soon as we'll be able to announce the date for the construction to begin.

That concludes the presentation. We can now open up the floor to questions. Thank you.

Q&A

Operator

Excuse me, ladies and gentlemen. We will now begin the question-and-answer session. Our first question comes from Arthur Suelotto with Bradesco BBI.

Q - Arthur Suelotto {BIO 20443361 <GO>}

Thank you, gentlemen. Just two follow-up questions from the Portuguese call. The first one regarding the Wood Panels division, you mentioned that you could be trying to implement new price hikes now in the first quarter of 2019, I just want to know if you could share some additional details regarding the potential magnitude of these hikes? And also, if you could also give us some more details regarding the plans for Botucatu. I know that you mentioned that the plant could be restarted if market conditions required additional volumes. But if not, what should we expect for the plan (00:22:10) and when the final decision regarding the revamp could come?

And finally, the second question on Ceusa, just if you could give us additional color regarding those expansion of capacity and what do you expect to see in terms of volume growth for 2019? That's it. Thank you.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Okay. So let's start with the pricing hikes that we announced in the beginning of the year. We are talking about the range of 8% to 12% that's over the first semester of the year, so depend on the product line and region (00:22:44), okay? So, the average is between 8% to 12%, okay?

To the second question regarding Botucatu, I mean the decision that we took at the year was to shut down temporarily the plant, right, so after that, the idea is to retrofit the line,

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right, to put this line in more than a way (00:23:09), if I can say that, right? And after that, we'll decide to reopen or not Botucatu, right? So - but probably it will take one year and a half and two years probably, right? So depending on the market condition. But certainly, nothing will happen in this year of 2019.

So regarding Ceusa, so we announced the expansion of the line, right, so of the facility. We had 6 million square meters of capacity, we are adding 5 million square meters, so the addition of 83%. So, the idea is to finalize this expansion in the beginning of the year and start the (00:23:52) part in the second semester of the year, right? So, we are seeing some demands to capture this expansion, right? So, and we are very - I mean, feel very happy with the acquisition of the Ceusa, right? So, the performance is doing very well, right?

So, and you have a good problem in Ceusa, we have a lack of production, right? So, we have higher demand that we can offer nowadays. Okay.

Q - Arthur Suelotto {BIO 20443361 <GO>}

(00:24:21). Just to confirm here. 8% to 12% for the price hikes over - at the end of year, price levels. Is that it?

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Yes. Definitely, yes (00:24:32).

Q - Arthur Suelotto {BIO 20443361 <GO>}

Okay. Thank you.

Operator

Our next question comes from Juan Tavarez, Citi.

Q - Juan Gabriel Tavarez {BIO 15083199 <GO>}

Hi. Thank you. Good morning, everyone. So just following up on the pricing expectations in the Wood Panel Division for the first quarter, I'm just curious if how does this fit within your strategy that you mentioned of not impacting your market share. And so what is your view of the supply-demand balance and the expectation during the year. I guess part of my question is this 8% to 12% eventually sustainable if we start to see more supply added to the market or do you see demand being there to be able to absorb any incremental supply?

A - Felipe Saraiva

Hello Juan. Good morning. This is Felipe speaking. We believe it's sustainable as we have discussed during this conference call. We have our constructive view for the year in terms of demand for Wood Panels. 2018 was an year of growing demand for our panels. I believe we can follow the same trend for 2019.

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There is no deviation. We do not expect any deviation regarding losing market share or anything with these price hikes. What we have actually been seeing in the industry is that Duratex and the major competitors are implementing price hikes in the first moment of this year. To try to avoid any noise or try to (00:26:15) the supply chain of (00:26:18) furniture as a whole, this price hike is going to happen around through the first semester. So, it's not going to be all the hikes in the beginning of the year. It's going happen through the first semester. So, that's the way we are trying to avoid any impact.

I don't know if Guilherme would like to add any points.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

No, that's it. I agree with you.

Q - Juan Gabriel Tavaréz {BIO 15083199 <GO>}

Got it. I'm curious as well just to get your sense here. I know you mentioned capacity utilization at Duratex was close to 75% during 2018. What is your status today in capacity utilization and how does that relate to the overall industry?

A - Felipe Saraiva

Duratex is really at 77% for the fourth quarter. We believe we can increase the capacity for the year. In our updates, the average of the industry varies at some point between 85% or 90% for this year. So, that's why we believe there is room for new price hikes as I mentioned before. It's not just a movement from Duratex, but the competitors as a whole are increasing prices right now in the beginning of the year.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Just important to make (00:27:39).

Q - Juan Gabriel Tavaréz {BIO 15083199 <GO>}

Okay. Thank you very much.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

The 77% is including Botucatu, okay. So if you exclude Botucatu that will not open in 2019, probably you are very above 77.5% (00:27:53) in MDF line, for example, probably close to 90% due to the shutdown that happened in the end of November, okay? It's important to mention that 77% is including Botucatu capacity because it was available in the fourth quarter.

Q - Juan Gabriel Tavaréz {BIO 15083199 <GO>}

Great. Now that's very helpful. And maybe just my last question, if you can just touch a little bit on sales mix and the second would be (00:28:19) between MDF and MDP market. I mean any color you can share with us there in terms of which segment may be easier to pass through some of these price increases right now or do you foresee a shift in your sales mix of what you delivered in the fourth quarter into the first quarter.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Sorry, Juan, can you repeat the question, please, the (00:28:41) question?

Q - Juan Gabriel Tavarez {BIO 15083199 <GO>}

Sure. Just on sales mix, I'm just curious - in the Wood Panel Division, I'm just curious how you foresee that sales mix shifting into the first quarter in terms of the MDF versus MDP or export and domestic. And also if you can maybe give us some color on which segment is stronger or weaker in terms of trying to pass through some of these price increases, if MDF seems like it's a tighter market (00:29:09) increases with MDP. I mean just curious if you have any color there on sales mix in those end markets.

A - Felipe Saraiva

Okay, sure. For the beginning of this year, we believe we can have a slightly better mix of products because during December and during January, part of our clients that are furniture manufactures, those guys traditionally acquired MDP lines, fiberboard (00:29:37) lines, and those guys shut down for vacation. So right now in February, we are seeing those guys bringing back the production that was shut down in December and January. So for the beginning of the year, it's tradition that fiberboard lines performed a little bit better, but for the whole year we believe that fiberboard (00:30:03) lines are going to be the main driver for volume growth. Those lines of products, they usually supplies low-weight furniture industry, and this is the industry that you see more fundamentals to grow in 2019.

Q - Juan Gabriel Tavarez {BIO 15083199 <GO>}

Great. Thank you very much.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Thank you.

Operator

Our next question comes from Ricardo Monegaglia, Santander.

Q - Ricardo Monegaglia {BIO 20701786 <GO>}

Hi Antonio, Henrique. I have two questions regarding the Ceramic Tiles segment. First one, Ceusa has been delivering very solid and resilient operating margins. With the capacity expansion that you mentioned to come, do you believe Ceusa will be able to maintain these healthy margins? Or do you think more production capacity would implicate Ceusa's margins to convert to the industry average, which is below what Ceusa has been delivering?

And my second question. Due to the recent appreciation of the BRL, what does the company view about increasing the threats from imports of ceramic tiles for the short-term? Those are my questions. Thank you.

A - Felipe Saraiva

Thank you, Ricardo, for the questions. So regarding margins in Ceusa and what is our expectation after the Expansion Project, we believe actually that it can increase a little bit our margins when you have the new lines (00:31:32) impact. The main reasons that this line is going to enable us to produce different size and the better mix of products. So, the idea, with the expansion in capacity in Ceusa, is to benefit the mix of products of our Ceramic Tile operation as a whole. So, there's (00:31:49) of increasing margins with these expansion.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

One point here, I'm mean add what Felipe is saying is that the size for - to put this line was available, so we can't put the line without any significant increase in SG&A (00:32:10) for example, right. So, we can dilute more efficiency that could have fixed cost of the facility, right, so that's why we can't add margins plus what Felipe said before.

A - Felipe Saraiva

Regarding your second question, on the depreciation of BRL and the impacts on imports of tiles, this might not be an issue. Ceusa is still a tiny competitor in the industry as a whole. So, Ceusa, as this represents 0.6% of the industry and with expansion it should be 1% or 1.1%, something like this. So, it's a pretty low-capacity share.

And we believe the products and the channels that we have to distribute Ceusa products they are pretty well defined. So, we might not feel (00:33:05) that compares to that competition so much. At least, that's what we are expecting. I believe other players who could share (00:33:17) a little bit more than Ceusa and we still have the advantage of synergies back in terms of channels to distribution and so on, so that's the plan (00:33:27) for the business.

Q - Ricardo Monegaglia {BIO 20701786 <GO>}

Very clear. Thank you.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

(00:33:34).

Operator

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

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Thank you for joining this conference call, everyone. So, myself and our IR team, Felipe and (00:34:07), we are available to answer any question over the day. Okay. Thank you very much.

Operator

That does conclude the Duratex audio conference call for today. Thank you very much for your participation. Have a good day and thank you for using Chorus Call.

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