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Q2 2017 Earnings Call

Company Participants

- Edison Ticle de Andrade Melo e Souza Filho, Chief Financial Officer
- Fernando Galletti de Queiroz, Chief Executive Officer
- Unidentified Participant

Other Participants

- Lauren Torres, Analyst
- Marcelo Inoue, Analyst

Presentation

Operator

Good morning, ladies and gentlemen and thank you for waiting. At this time, we would like to welcome everybody to Minerva's Second Quarter of 2017 Results Conference Call. Today with us we have Fernando Queiroz, Chief Executive Officer; Edison Ticle, Chief Financial Officer; and Eduardo Puzziello, Investor Relations Officer.

We wish to inform you, that this event is being recorded and all participants will be in a listen-only mode during the Company's presentation. (Operator Instructions) The audio and the slide show of this presentation are available through a live webcast at www.minervafoods.com/ir and MVIQ platform. The slideshow can also be downloaded from the webcast platform in the Investor Relations section of the website.

Before proceeding, we wish to mention that forward-looking statements may be made during this presentation relating to Minerva's business prospects, operating and financial estimates and goals. They are based on the beliefs and assumptions of Company management and on information currently available.

They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Minerva, and could cause results to differ materially from those expressed in such forward-looking statements.

I will now turn the conference call over to Mr. Fernando Queiroz, CEO, who will begin the presentation. Mr. Queiroz, you may start the presentation.

Fernando Galletti de Queiroz {BIO 15387377 <GO>}

Thank you, and good day to everyone. Thank you for participating in Minerva's conference call on the results for the second quarter of 2017. Before addressing the results of the second quarter, I would like to mention that on July 31st, we concluded the acquisition of the operations of JBS Mercosur in Argentina, Paraguay and Uruguay.

As we will detail later on this acquisition increased our capacity by more than 50%, boosting the Company's strategic and geographic diversification and the advantage in South America, the most competitive region to produce beef in the world. And allowing us to finally begin operating in our country where we have the -- wanting to operate for a few years and has great potential, which is Argentina.

It's worth to remember what I said on the conference call about this acquisition that, this moment anticipate in around five years, our growth strategy here in South America. As we have always adopted a more conservative approach to acquisitions. However, we are extremely committed to ensure that this major step is aligned with the Company's strategy of the process of creating value and integrating the operations.

We think this process, we have three fronts that we are working on the integration. The first team is focused on the key operational process, what is vital for the Company to keep operating with efficiency. The second team is dedicated to the due diligence for us to have a full understanding of the assets. And the third team is focused on the integration process. This team is responsible to share the pillars -- of the three pillars of Minerva. That's how the risk management processes is sharing our experiences and benchmarker for the units and the commercial channels that the Minerva operates.

Now let's move on to the presentation of the results for the second quarter of 2017. Let's have a look on the slide two, to start. In the second quarter of 2017, gross revenues totaled BRL2.8 billion and BRL10.5 billion in the last 12 months. Net revenue in turn amounted to approximately BRL2.6 billion in the Second-Q '17 and BRL9.8 billion in the last 12 months ended in June 2017. These figures give the Company, an all-time quarterly revenue record.

The second quarter EBITDA totaled BRL277.3 million, another quarterly record figure accompanied by the margin of 10.8%. While exports accounted for 61% of the total revenues, we directed almost 40% of the revenues to the local market, what leaded that to a volume growth of 20% over the First Q '17 and 9% over the same period in 2016. This reflects the efficient execution of our strategy to meet our demands for markets which are more resilient in times of crisis, such as foodservice in the small and medium sized retailers.

Combining demand from the domestic and export markets contributed to our sales growth by almost 16% quarter-on-quarter and by more than 10% over the Second Q '16. In the second quarter of 2017, Minerva operating cash flow totaled BRL57.5 million, while in the last 12 months ended June operating cash flow came to BRL398 million. In the Second Q '17 return on the invested capital reached approximately 22% once again, a figure which maintains Minerva as the benchmark on its sector.

Due to the non-cash impact from the foreign exchange variation in a quarter as we will explain later, the Company recorded a loss of BRL55.6 million in the second Q '17 versus an income of approximately 7 million in the last 12 months. In terms of our capital structure, leverage measured by the net debt -- versus the last time 12 months EBITDA ratio is stood at 4.1 times in the second Q '17.

At the end of June, 2017, Minerva's cash flow position amounted to BRL4.4 billion, which is sufficient to amortize its debt through 2026. The Company's debt duration at the end of the quarter came to approximately six years. We tepid our 2026 bonds with annual coupon of 6.5% and totaling US$350 million. The proceeds are from the capitalization was allocated to pay for the acquisition of the assets of JBS Mercosur as already announced.

Lastly, regarding other highlights, I would like to reaffirm that the scenario of supply of animal ready for slaughter is becoming increasingly favorable for the industry, especially in Brazil. According to the Brazilian IBGE, that's the National Statistics, Brazil recorded an increased slaughter of females in the previous quarter. This is one of the main indicators of the reversal of the cattle cycle from negative to very positive.

We will now move on to slide three to talk about the industry overview in Brazil. Slaughter volume totaled BRL6 million in the second quarter which means, a reduction by almost 3% over the first quarter, and by 6% over the second Q of '16. This reduction in slaughter reflects the impacts from the Carne Fraca operation, we continue to jeopardize the industry performance in the beginning of the second quarter. Also the high numbers of holidays in Brazil of working days in Brazil were smaller. And the political and sector scenario volatility that took place in Brazil as up to middle of May.

This factor that is the reversal of the cattle cycle and the unstable political sector scenario lead to the strong decline in the average price of cattle from BRL146 per 15 kilos in the first Q '17 to BRL134 per 15 kilos in the second Q '17. This is equivalent that 20% reduction over the previous quarter and on even sharper decline by more than 14% over the average arroba price in the same period of last year. It's important to mention that regarding the cattle cycle, we expect a highly positive animal supply scenario for 2017. In the next two years, we believe that this cycle will achieve its peak in offers in 2019.

Brazilian beef exports volume fell to 8.5% over the second Q '16, remaining virtually stable over the previous quarter. Nevertheless, exports revenue grew by 1.5% over the first Q '17 and inched down by 2% over the second Q '16. This result was made possible. Thanks to the strong performance of some of the main importers of Brazilian beef, and especially, Chile, Russia and Hong Kong. This strong performance positively affected the average, the dollar price of beef by more than 7% increase in the second Q '17 over the second Q '16.

Local market demand was weaker in the second quarter, despite the improvement in some macroeconomic indicators, especially due to the political and sector volatility from the Carne Fraca operations in the first week of April, which reduced the slaughter and consequently beef production in the country. So, this reduced the volumes in the Brazilian local market.

So, now let's move on to slide four to talk about the sector overview in Paraguay. In slide four, Paraguay's second quarter slaughter volumes fell 7% over second Q '16 and remained flat over first Q '17. Cattle prices rose by 15% year-on-year and 6%, quarter-on-quarter. The price of cattle in Paraguay was affected by strong demand from the Chilean market in the second Q '17, especially after May when Paraguay was recognized by Chile as a country free of foot-and-mouth disease due to the vaccination.

As you can see in the lower left chart, Chilean accounted for 44% of Paraguay's exports in the second quarter, which is equivalent to a 15 points increased over the same period of 2016. As a result, Paraguay exports revenue totaled US$282 million in the second Q '17, accompanied by exports volume of 65,000 tons. After Chile, the country's main export destinations were Russia and Brazil, which combined exports corresponds to one-fourth of the total.

It's also important to highlight the operating proceeds improvement in Paraguay end market productivity in the last few years. This evolution can be rated through the exports' constant growth, the frequent opening of new markets and the greater exposure of Paraguay beef in regions such as Chile and Europe. Therefore, we see Paraguay as a country of a strong fundamentals and the future potential to perform even better in the sector.

Let's move on to slide five and discuss, Uruguayan market. In the second quarter of 2017, Uruguay's slaughter volume came to 608,000 heads of cattle, up by 12% in the second Q '16. This figure is a result from the recovery of exports, mainly to China and to the United States, whose combined exports accounted for almost 60% of the country's total. Uruguayan exports revenue amounted to US$394 million in the second Q '17, 19% higher than in the second Q '16 and 5% more than in the first Q '17. Meanwhile, the average price of cattle fell 2% over the first Q '17, closing the quarter at US$161 per 100 kilos.

Let's now analyze Minerva's performance, beginning with exports. In the second quarter, we once again remained among the main exporters in the country where we operate. Our share in the Brazilian exports increased to almost 20%. In addition to the Company shares that was recorded in Paraguay accounting for almost one-quarter of the total country's exports, while our share in Uruguay exports came to 14%.

This slide also shows Minerva exports in the last 12 months ended June, 2017 by region. Asia remained as Minerva's main export destination despite its 4 percent points declined over the last year and corresponded to approximately one-fourth of the Company total exports. China and Hong Kong were the two main export destination of the region. But, we also had another highlights such as the Philippines, Malaysia and South Korea. South Korea is worth of mention as revenues from exports to that country doubled in the analyzed period.

Another region, worth of note, as a percentage of our exports in the last 12 months ended June was the Americas which accounted for 70% of the total, up by 400 basis points over the same period last year. This result was specifically proved by the exports from our units in Brazil and Paraguay to Chile. A country whose share of the region exports alone grew by almost 30%, remaining as the region's main export destination.

Lastly, it's important to mention, the NAFTA region which is mainly represented by the United States as a share of our exports, the region's share increased by 300 basis points over the last 12 months ended June, 2016 to 7% over Minerva's total exports. The share of the United States as a percentage of the Company's exports is also worth emphasizing, up by almost 80%.

I will now pass the floor on to Edison, who will comment on the financial and operating highlights.

Edison Ticle de Andrade Melo e Souza Filho {BIO 15435343 <GO>}

Thank you, Fernando and good morning to all. We will present Minerva's financial and operating highlights as of slide seven. In the second quarter of 2017, Minerva posted net revenues of BRL2.6 billion, as Fernando has already mentioned, a record revenue figure for our quarter. This result reflects the healthy performance in both the local and export markets due to the efficient execution of our commercial strategy in each of these markets.

Second quarter EBITDA amounted to BRL277 million, increasing by 16% over second quarter of '16 and by almost 40% over the first quarter of '17. The EBITDA margin stood at 10.8%, 160 basis points up when compared to the first quarter of '17. At the end of the second quarter '17, Minerva's return on invested capital reached approximately 22%, again in line with the performance of the Company, the past quarter's performance of the Company and also keeping us as a benchmark in the sector in terms of ROIC.

At the end of June, the leverage was 4.1 times measured by the ratio net debt to EBITDA, although higher than the first quarter leverage. It's worth mentioning, 2 points that explain the current leverage level. The first one was the depreciation of the real that reached almost 5% in the quarter and also impacted our net leverage. And the second is related to the operational side, the Company increased the capacity utilization by more than 5 points from 70% of utilization rate to 75% of utilization rate.

So the Company increased volumes, increased revenues and prepared and more important, prepare the Company to continue growing at very high rates in the coming quarters. These required working capital needs of around BRL280 million that resulted in a cash burn in the quarter of BRL230 million that impacted the net leverage of the Company and resulted in a net leverage of 4.1 times at the end of the quarter.

Let's move on to slide 8 to talk about the Company's net result. In the second quarter '17, the Company recorded a net loss of BRL55 million impacted by the non-cash effect from the FX variation of around BRL130 million. In the last 12 months, net income was approximately BRL7 million and in this quarter, if we adjust the net income result by the FX expense, the Company would have posted a profit of around BRL70 million in the quarter.

Let's move to the slide 9 to discuss the operating cash flow. In the second quarter of '17, operating cash flow was positive by 58 -- almost BRL58 million. The main -- I think the main line that contributed for the operating cash flow was the variation in working capital, as I have already mentioned, that was negative by BRL281 million and is related to the acceleration and growth of our operation.

The working capital line was mainly affected by the receivables line, that in the quarter increased and contributed to this negative effect. Also it's important to highlight that we have just opened -- reopen our Minerva Dawn Farm unit that also required the extra working capital to prepare the unit to start operating in the beginning of July.

And the effect of this reopening of the plant was felt in the working capital, but it has not contributed to the increase in volumes in the second quarter. So let's wait for the third quarter that we will present even more -- even higher growth on volumes and revenues than we showed in the second quarter.

It's also important to highlight that in the suppliers' line, it contributed to the operations positively of approximately BRL74 million, because we were able to reduce the payment in cash for cattles. It's interesting, because Minerva became a kind of safe haven for the farmers during the quarter because of all these stuff related to an important players in the sector.

Let's move now to slide 10 to talk about free cash flow. So as I mentioned, the second quarter EBITDA reached BRL277 million, CapEx with cash effect amounted to BRL65 million from the BRL65, BRL45 was related -- BRL43 was related to maintenance expenses and BRL22 related to expansion of capacity. The financial net result with cash effect was around BRL163 million and the working capital needs as I mentioned was BRL281 million.

So this leave us with a negative free cash flow in the quarter of BRL231 million and BRL555 million negative in the last 12 months. Again, in the last 12 months' figures, the main contributor for the negative free cash flow was the working capital line that required are more than BRL600 million during the last 12 months.

Now, let's present our capital structure at the end of the quarter -- on the slide 11. So, we ended the quarter with net leverage of 4.1 times as I have already mentioned, it is again important to highlight that the FX at the end of the quarter was -- has depreciated almost 5% when compared to the same rate -- to the same exchange rate at the end of the first quarter. This contributed with a non-cash expense of around BRL130 million in the quarter.

Important to highlight, the capital structure in terms of liquidity, Minerva kept a high liquidity in the quarter, it was affected by the retap of the 2006 -- 2026 bonds concluded in June. So we had cash position of BRL4.4 billion around US$300 million were used to pay for the acquisition of JBS assets in the 31st of July. So, if we adjust the cash position by the acquisition of the assets and the adjustments of working capital, our net cash would be today around 3.1 billion. Important to highlight also, that we kept our long-term duration within our debt profile, the debt ratio was around 6 years and 75% of Minerva's total debt was exposed to the dollar variation.

Let's move now to the last slide of the presentation, to present our current food ingredients, South America, especially after the acquisition of JBS Mercosur assets. So on the slide 12, but that's included in this slide at the end of the presentation to remind you of the current structure of our operations, our current footprint, especially after the acquisition. We can see that after the transaction, we greatly improved what we believe to be one of the Company's unique features. It's well sided scale and geographical diversification in South America.

Minerva's daily capacity -- daily slaughter capacity increased 52% from 17,000 heads per day to more than 26,000 heads per day. Important to highlight that now we are operating in a new country which was already part of our business plan that is, Argentina and also -- and now also as part of the Company's geographical diversification strategy, Brazil now account for 45% of our total capacity and the other regions in South America 55%. This compares to the share of Brazil of 70% before the acquisition.

So we took a step forward into diversification in order to diversify and protect the Company, even more against sanitary risks in the region. Moreover this will grant us more operational flexibility because we will reduce exposure and avoiding depending on -- only one region. In addition, this move also allows us to take more advantage to the arbitrage opportunities that we see in the market, especially in the export market.

I would now pass the floor on to the operator to begin the Q&A session. Thank you.

Questions And Answers

Operator

Thank you. We will now start the question-and-answer session for investors and analysts. (Operator Instructions). Mrs. Lauren Torres form UBS, would like to poll the question.

Q - Lauren Torres {BIO 7323680 <GO>}

Yes, hi, everyone. If I could ask two questions, first on the working capital. I think you mentioned that you'll continue to increase production in the third quarter and then it normalizes in the fourth quarter. Just curious, was this what was anticipated going into the year. I'm just curious to get your perspective on, based on what you see in respect of the cattle cycle list, you see the investment and the spend is higher than you anticipated, and if there is a chance that you may need to ramp it up in the fourth quarter as well?

And the second question relates to the JBS acquisition. You mentioned significant synergy gains. So I don't know if it's a little bit early to talk about this. But curious to get any framework on what the amounts of these synergy gains could be? Thank you.

A - Edison Ticle de Andrade Melo e Souza Filho {BIO 15435343 <GO>}

Lauren, the increase on working capital needs in the second quarter, they basically guarantees another increase in terms of capacity utilization, in terms of increasing volumes in the third quarter. So, our expectation is that the growth in the third quarter will be even higher when compared to the second quarter. You can have an additional working capital need in the third quarter, because -- especially, because of the operation of the new plant.

However, I think, it will be done in the third quarter and in the fourth quarter, we expect the working capital changes in the quarter to be normalized, because again, we will increase the volumes, we will increase the operation into a new level and we will stay at this level in the coming quarters.

A - Fernando Galletti de Queiroz {BIO 15387377 <GO>}

Regarding the JBS acquisition, Lauren. The first one starts with the cattle supply, by not having one competitor, this increased our pricing power, but especially in Paraguay where we are by far the leading Company, this gives us lots of synergies in terms of using our structure to supply more efficiently. A lot of synergies as well on the commercial approach, best practices to be shared between our plants and their plants. Well, there are things that we will learn, there are things that we will teach. So, there are best practices to be shared.

There will be some synergies on the administrative parts, especially in Paraguay and Uruguay and one of the basis of Minerva that we saw that we will be implementing there is the risk management tools that we have in our Minerva operations. So, the combination of all these -- of works done in all the sectors will allow us to extract much more synergies from the operation.

Q - Lauren Torres {BIO 7323680 <GO>}

So, I guess that maybe just too early to talk about what the magnitude of those benefits could be?

A - Fernando Galletti de Queiroz {BIO 15387377 <GO>}

We, in a conservative way, we estimated 250 basis points as increase on the EBITDA margins on that. I would say that at least 100 basis points are coming from the cattle supply between 50 and 100 from the sales side, and from 50 to 100 on the best practices, administrative and risk management tools at least are being very conservative.

Q - Lauren Torres {BIO 7323680 <GO>}

And that's over what timeframe. I mean that's not immediate, that's over a time period?

A - Fernando Galletti de Queiroz {BIO 15387377 <GO>}

We normally will have that in a 12 months, but some of them will be felt in much earlier.

Q - Lauren Torres {BIO 7323680 <GO>}

All right. Great. Thank you.

Operator

Mr. Marcelo Inoue from Citibank, would like to poll the question.

Q - Marcelo Inoue {BIO 17177482 <GO>}

Hi, Fernando and Edison. I have a question, focusing on the expense side. We saw that despite the maintenance works in the Varzea Grande plant there was overall SG&A expense dilution in the quarter. But I wanted to get a sense of the impact of the stoppage of that plant and that I see that G&A expenses increased BRL25 million quarter-on-quarter. And I wanted to understand how much of that increase is due to these planned stoppage. And if we should see the G&A line going back to normalized levels in the third quarter? Thank you.

A - Fernando Galletti de Queiroz {BIO 15387377 <GO>}

It is one-off, on Varzea Grande plant, we stopped the plant for a period that there was a low volume to be supplied, and we increased our (Technical Difficulty) capacity taking out of (Technical Difficulty) in that plant. So, that was the goal but just reaffirming, it's one-off.

Q - Marcelo Inoue {BIO 17177482 <GO>}

Okay, thank you.

Operator

(Operator Instructions) Mr. (inaudible) from Insight Investment, would like to poll the question.

A - Unidentified Participant

Good morning. The first question is, can you -- kind of the JBS acquisitions. Can you give us an idea of how your balance sheet would look in terms of leverage adjust for both the additional debt as well as the additional earnings?

A - Edison Ticle de Andrade Melo e Souza Filho {BIO 15435343 <GO>}

When we concluded the acquisition, we released the presentation to the market that considering a conservative scenario of extracting synergies in the next 12 months, considering the additional leverage coming from the acquisition, we expect the leverage to go down to a level of between 3 and 3.2 times in a 12-month period, in the next 12 months period.

Again this assumes that FX around 3.20. So obviously it will depend on the FX, but to have other a better sense of what would be the leverage in the next 12 months. But considering the additional leverage in the conservative scenario of extracting synergies from the new operations, we would come back in the 12-months period to a level around 3.2 times.

A - Unidentified Participant

Okay, and in terms of working capital, would you expect, I mean, on an annual basis, if we look at all of the 2017, given these additional assets. I mean how should we be thinking about your working capital flow for all of 2017?

A - Edison Ticle de Andrade Melo e Souza Filho {BIO 15435343 <GO>}

In the third quarter, we should have another pressure coming from the working capital because we are in the middle of accelerating the operation, the volumes, however in the fourth quarter, things will be normalized and we don't expect any additional needs of working capital. So, third quarter probably will have a negative cash flow in the working capital line. However, we expect revenues and margins to continue improving and growing in the coming quarters.

A - Unidentified Participant

Okay. And the benefit from lower cattle prices in Brazil, do you see that continuing in Q3 and Q4?

A - Fernando Galletti de Queiroz {BIO 15387377 <GO>}

The normal seasonality that has put in a bit of pressure on the cattle at the moment, but definitely we are seeing a recovery of the Brazilian local market as well. So, we see that the gross margins that they shall remain stable.

A - Unidentified Participant

Okay, thank you.

Operator

This concludes the question-and-answer section. At this time, I would like to turn the floor back to Mr. Fernando Queiroz for any closing remarks.

A - Fernando Galletti de Queiroz {BIO 15387377 <GO>}

I would like to end this conference call. Thanking once again Minerva's entire team for their dedication and the extraordinary efforts to conclude, not only the integration process, but to be able to be agile in a very volatile scenario. Also these teams have skills that are positively reacted to the market changes. So, the performance that we are having is due to the team that we have. We also thank you all for the interest in the Company and we remain at your disposal for any question and clarifications. Thank you very much.

Operator

Thank you. This does conclude today's presentation. You may disconnect your line at this time. Have a nice day.