

Q1 2015 Earnings Call

Company Participants

- Paulo Polezi, Chief Financial Officer
- Unidentified Speaker
- Wilson Watzko, Controlling Director

Other Participants

- Alexandre Falcao, Analyst
- Lucas Marquiori, Analyst
- Murilo Freiburger, Analyst
- Ricardo Schweitzer, Analyst

Presentation

Operator

Good morning everyone and welcome to the teleconference to discuss WEG SA 2015 First Quarter Results. As a reminder, this conference is being recorded. And at this time, all participants are connected in listen-only mode. Later we will conduct a Q&A session and further instructions will be provided. (Operator Instructions) To obtain the quarterly results press release or the presentation that will be used in this conference, please go to WEG's investor relations page at www.weg.net/ri.

Before proceeding, we would like to make it clear that forward-looking statements that may be during this conference concerning WEG's business outlook, production and operating and financial goals and also to WEG's potential future growth are management's believes and assumptions as well as information that are currently available.

These forward-looking statements involve risks, uncertainties and assumptions, since they refer to future events and they therefore depend on circumstances (technical difficulty) materialize.

Investors should understand that general economic conditions, conditions of the industry and other operating factors may affect WEG's future performance and lead to results that might differ significantly from those expressed in these forward-looking statements. Once again this conference will be conducted in Portuguese with simultaneous translation into English.

With us today in Jaragua do Sul, we have Mr. Paulo Polezi, CFO and IRO; Mr. Wilson Watzko, Controller and Luis Fernando Oliveira, IR Manager. Please, Mr. Polezi you have the floor.

Paulo Polezi {BIO 19468811 <GO>}

Good morning, everyone. It is a great pleasure to have you all here to discuss the results concerning our first quarter results for 2015. We'll start with a brief overview, where I'll touch upon the performance of our growth in revenue and after that Wilson will be talking about cost, EBITDA, working capital investment. After that we will be available for questions or comments, you may have.

So going straight to page three of the presentation. We have a table summarizing the main figures for the quarter. The main highlights for the first quarter 2015 was obviously growth in net revenues at 19.4% when compared to the previous period. The double [ph] digit growth was reached both domestically and in the external market. The growth in our domestic market was at 14.8% when compared to the previous period with the highlights for the continuous growth in our energy generating system, expansion with our orders already in our portfolio for wind energy.

The external market grew 24.1% driven mainly by the devaluation of the dollar, the valuation of the dollar against the reais that's an important aspect, because the US dollar appreciated when compared to most currencies in the first quarter. That's important for our company because our sales are always made in local currency in our different markets where we operate. For example, growth in revenue in dollars was 2.5%.

As you can see in the chart, but with the compared figures based on local currency that growth will remain at 16% as you can see on page four, 50% of our growth came from external markets.

Moving on to slide number five, we can see in our revenue distribution or breakdown for our different business areas is the fact of the low growth of the Brazilian economy, with the decrease of relatively important in the area of industrial equipment, paints and varnishes. We have noticed for some time now that industrial investments taking basically place in maintenance of installed capacity, expansion investments only occur in very specific cases.

The GTD, generation, transmission and distribution. It stood out with an advancement in the business of PCH business especially and also wind energy. The growth in domestic motors can all be attributed to the consolidation of WEG Yatong [ph] which was purchased by the company.

I'd like now to give the floor to Wilson who will continue the presentation. Please Wilson you have the floor.

Wilson Watzko {BIO 16648037 <GO>}

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Good morning, everyone. Let's now move on to page number eight, where you have a breakdown of cost for the first quarter 2015. Gross margin reached 30% with a drop of 2 percentage points when compared to the first quarter of last year.

Two points to highlight here that drove those results. First was an increase in raw material costs which were referenced in the US dollar, a higher volatility in cost is always harmful and the volatility in the currency exchange was also high in the quarter. Secondly, there was a change in our product mix with a growth in wind generation systems where we have part of the systems which are manufactured by third parties and re-sold by us. Margins there are lower of course, but the return on capital is similar. On page nine, we see the main variations in the components count for EBITDA, this first quarter EBITDA grew 16.3% when compared to the previous year and margin reached 16.4%. In other words, 0.4%, down from the first quarter of 2014. It's important to note that we managed to recover part of that drop in gross margins with a stricter control and sales expenses, general and administrative expenses.

On page number 10, we have the breakdown of working capital, as a percentage of net revenues throughout the last year. An increase of the need for working capital in the last quarter most clearly in this first quarter for 2015 is driven mainly by devaluation of the Brazilian currency especially on inventories and receivables, the initial impact of the consolidation of acquisitions that were made, as well as, the investment needed to enter the long generating business.

Higher effort in the external market where we seek to capture growth opportunities, which were made available by the devaluation of the real. Our financial flexibility allows us to tap those opportunities. That's one of the reasons why WEG is able to maintain growth rates stable throughout time.

Lastly on slide number 11, we have organic investment and capacity expansion throughout 2014 and also in the first quarter of 2015. Main investments in expansion are taking place in our new production units for electric motors in the Mexico and in China. For 2015, we foresee investments at BRL478 million and expansion and modernization of our productive capacity.

We have managed those expenses with close attention trying to avoid accumulation of idle capacity as well as the addition of assets and business which were more affected by the world economic activity in some markets.

I'll now give the floor back to Paulo to carry on with the presentation. Please Paulo, you have the floor.

Paulo Polezi {BIO 19468811 <GO>}

Thank you, Wilson. Before we move on to the Q&A session, I'd like to reinforce a few important points. We started 2015 filling the signs of a challenging year, important adjustment measures announced by the government, the economic performance of the country has been feeble (inaudible) made 2013 [ph]. However WEG has kept good results

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when compared to the Brazilian industry as a whole and its main global competitors that reflects our business model which gathers verticalization, diversification, modular expansion, global presence and also what we call financial flexibility. This first quarter reinforces our trust in growth opportunities for the company and we will carry on executing the necessary actions to take advantage of all those opportunities.

I'd like to close now and we can start the Q&A session. Please, operator, you have the floor.

Questions And Answers

Operator

Ladies and gentlemen, we will now start the Q&A session. Once again, this conference call is being conducted in Portuguese with simultaneous translation into English. (Operator Instructions) Our first question comes from Ricardo Schweitzer from Banco Votorantim. Mr. Ricardo, you may carry on. Next question, Murilo Freiburger from Bank of America.

Q - Murilo Freiburger {BIO 17385357 <GO>}

Good morning. I have a question concerning the comes turning the GCD [ph] more specifically about the winds generating system and also biomass which been observing the fast three auction to sell -- A minus 5, A minus 3. I'd like to ask you if any of the partners of WEG has participated in the auction. And if you have the chance to sell more equipment because of those auctions and also some perspective going forward for the GCD and their wind segment concerning your production capacity what can we expect in terms of growth, capacity expansion and that's my question. Thank you.

A - Paulo Polezi {BIO 19468811 <GO>}

Good morning, Murilo. Thank you for the question. Actually we do have, if you options is gathered for this year. Actually, the first one happened last Monday, the 27th alternative process option, they sold thermal and wind energy systems. For the thermal sources as far as we could sell it was basically existing capacity, it was somewhat smaller auction always focused on existing capacity where we see a mapping out the winners, but apparently there will be no need of major added investment. As for the wind system auction we did not participate in those. We'd like to remind you that we have a limited capacity right now, we are paying close attention to the upcoming auctions before we make a decision.

We have -- there is another auction taking place today the A-5 auction, this is a more interesting auction for us, especially concerning the hydraulic segment or the water segment or a few PCH projects, which have been accepted to participate in the auction. Reason for the higher -- the larger PCH they are not that big, so they are interesting for us.

And also prices are at an interesting level for us. So in today's auction is an auction we will be paying close attention to. On top of that, there are another three auctions happening this year May, in August, in November and A-3 auction taking place in July. So many

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things happening this year in terms of auction and as we see prices are at a very attractive level. So we see there are a lot -- significant investments in wind systems and we would like to see a more balanced industry.

We think all renewable sources can contribute. We think the market will become healthier if all sources are taking into account in those auctions. In other words, if we have a balanced market, that market will suffer less when we have significant climate change. Then the market seems to be go in that direction.

As I said before, we haven't made any decision in terms of our capacity expansion. But if things continue following that direction we made quickly make that decision in the near future.

Q - Murilo Freiburger {BIO 17385357 <GO>}

Great. So just to confirm looking forward, so if there is an interesting pipeline as you described. So you may have some upward review in terms of investments looking to increase capacity?

A - Paulo Polezi {BIO 19468811 <GO>}

Probably not for this year, Murilo when we participate in the A-5 auction, we would be delivering the equipment in three to four years. So they would saw dispatching energy in five years. So we have a certain leeway, a certain comfort zone to plan and make decisions concerning those investments. We do not need to rush.

Q - Murilo Freiburger {BIO 17385357 <GO>}

No, I understand. Exactly, because of that you have time to react. So if the market continues looking positively, you would be able to adapt and take part in the auctions.

A - Unidentified Speaker

Exactly that's how we feel.

Q - Murilo Freiburger {BIO 17385357 <GO>}

Okay. Thank you Luis.

A - Unidentified Speaker

Thank you Murilo.

Operator

Next question Lucas Marquiori from Banco Safra.

Q - Lucas Marquiori {BIO 17907247 <GO>}

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Good morning everyone, Paul, Luis and Wilson. (inaudible) segment I'd like to understand a little bit the negotiations you have been doing with suppliers for the pieces of equipment, you do not manufacture. Is there any risk in terms of supply and could that affect your working capital. That's the first question. I have a second one, I will ask later.

A - Unidentified Speaker

In fact, we have a full capacity, especially for the wind segment, which is a newer market for us. We have just entered that market. For the other energy sources, we have a good quality portfolio for this year. We're not at full capacity yet, but for the wind segment specifically we are manufacturing a complete system, clients demand a full-fledged system.

So that somewhat limits our delivery capacity on a monthly basis. But generally we do not see any difficulty going forward in terms of suppliers, we see it very comfortably, we have everything planned out in a gradual way. So none of the parties are stressed because of the supply problem. We have a shared planning process with our suppliers. So our risks -- that kind of risk is highly manageable.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Okay, thank you. And the second question -- year-over-year growth of the external markets. So what segments, what areas are now proving growth upwards. Maybe it fall in the US or what could be the industry which is calling your attention in terms of growth and also a feed back on your investment in China and Mexico.

A - Unidentified Speaker

Okay. Starting with China and Mexico we are moving ahead at the projected pay. We estimated Mexico and China, the Mexico actually little before we should start seeing the first motors coming -- we are rolling out of the first unit soon.

We have two projects happening at the same time in Mexico, we have a motor assembly unit and we also have the verticalization of that plant, it's a new foundry area, this new manufacturing plant will be thought producing motors this year, of course there will be a ramp up in the coming years. And for the foundry unit, we are just starting now.

As for China production we will start later this year from the third to the fourth quarter, we also ramp up process going forward. So both projects are moving ahead as planned of course there is a higher concentration on investment in the first two years. We are in the second year of investment, for those two projects but both will start producing in the second half of 2015.

Outside of Brazil, there is no major news or piece of news, end markets where we are more diversified and where we are exposed through what we call OEM, the equipment manufacturer. That diversification places us in a very comfortable position. For example, when I talked about the US industry as a fact there are areas related to oil and gas, which will suffer more because of our drop in prices.

But that's the most diversified market that we operate and there are many players who are being benefited by the drop in oil and gas prices. In other markets, for example mining, specifically in Australia for example as a good example and we've been talking about this impact for some time now. It is a more difficult situation to get around but as a whole, we do not have any major piece of news as I said for that, in mature markets we carry on expanding our product line and that's been a successful measure.

In other markets, we are carrying on penetrating with motors specifically and there is always an impact from local currencies, because we do business in local currencies in some markets, even though our growth is higher in local currencies when you convert that to dollar. So the US dollar, that growth loses a ground, but that is impossible to get around that, and the fact of life if you will.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Okay, Luis, Paulo, thank you.

Operator

Next question from Ricardo Schweitzer from Banco Votorantim.

Q - Ricardo Schweitzer {BIO 17931515 <GO>}

Good morning, everyone. Can you hear me now.

A - Paulo Polezi {BIO 19468811 <GO>}

Yes, Ricardo.

Q - Ricardo Schweitzer {BIO 17931515 <GO>}

Sorry for the disconnect question. First, I have two questions, the first one you mentioned the program CapEx for 2015 is 478 million. I'd like to make sure I understood that that CapEx encompasses expansion and maintenance and if you could please give us some color of the breakdown for that number between investments in Brazil and abroad.

My second question has to do with the wind systems, I'm trying to understand a little more, if you could specify the issue of the working capital, special increase in inventory and receivables and what could be attributed to other factors rather than the wind generating systems?

A - Paulo Polezi {BIO 19468811 <GO>}

Okay. Starting with the first question, Ricardo. The 478 million is our organic investment. In other words, our expansion and investment in our installed operation and as for maintenance that's somewhat complex concept for us. We are a growth company, we've been growing at double-digit [ph] for some time now. So investment in maintenance cannot make that much sense. What we do is we invest to maintain those assets at the same level.

Anyway it's not -- we are talking about here is the organic, the total growth -- the total investments in growth including expansion and modernization. You can expect to maintain the same standard at about 30%, maybe a little more, maybe a little less both in the external market and 70% dramatically that tends to be the trend for the year as a whole.

Q - Ricardo Schweitzer {BIO 17931515 <GO>}

Okay.

A - Paulo Polezi {BIO 19468811 <GO>}

Ricardo concerning the working capital question -- you asked. Going back to what Wilson just said the main affects is driven by the currency exchange variation. When you compare our numbers to the first quarter last year, there was a 21% impact coming from the currency exchange and that affects directly inventory and receivables in different currencies and that happens across our pipeline and that's not surprising, we expect that to happen.

Now we also have our new business align including acquisitions and the wind generating systems that growth will require an increase in working capital if we compare that to last year, we had barely started. We started delivering the wind systems in the second half of last quarter. So in the first quarter of last year we were practically at a zero level. So the impact was significant.

So once again, when I talk about working capital lead to reinforce the message. It varies for WEG and we are paying close attention to that, a change in working capital for us is also seen as an investment, which will allow us to expand our business and I know if I address your question.

Q - Ricardo Schweitzer {BIO 17931515 <GO>}

Yes. Yes, you have. Just one quick follow-up concerning the CapEx plan. Could you please give us a breakdown for the currency range, when you made the plan, it was a very lower level than we have today?

A - Unidentified Speaker

In terms of currency exchange, we do not have a specific forecast for exchange. We use the numbers that we have for September-October, that's the figure we use, two point something.

Q - Ricardo Schweitzer {BIO 17931515 <GO>}

Okay, thank you.

Operator

Next question, Alexandre Falcao from HSBC.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Good morning, everyone. I have two questions. The first one concerning the auctions, which are taking place. Now A-3 and A-5, it seems to be an incentive for biomass, which is a significant -- I'd like to comment is that in your plan. How much was that represent in terms of added revenue which you decide that there is enough available megawatts for that investments.

And my second question, you also mentioned last year for (inaudible) in terms of smart grid, voltage elevating substations, what would we needed for Brazil to gain efficiency in the system. How was those things moving ahead are we close to seeing as a reality and when can we see that happening, if at all.

A - Unidentified Speaker

Thank you Falcao. We do not have any formal guidance either for the company nor for the different sectors. Fact of the matter is biomass, thermal industry has being a halt for a few years after the crisis we have only invested in terms of maintaining capacity. We are again monitoring the industry very closely, we have a very strong brand in this industry, we have a very interesting production capacity for that factor. I think it is an important factor, it generates energy which is very close to consumption factors. So it makes all the sense in the world to have that included in our energy matrix in Brazil.

But at the same time they had other problems to face, you know this is better than we do that, the fact that energy, sugar and alcohol. So we have better prices and at the same time we need to improve the other prices so the whole sector may be capitalized as a whole.

We are -- I could say moderately more optimistic concerning that sector.

We think the objective conditions for the sector is to receive the investments again are emerging, for example in today's auction, we're talking about something close to six-gigs in terms of thermal energy. So it's very high volume of course not all we will be sold and part of it comes from biomass. So we are, as I said moderately more optimistic. We think it is a sector that will take some time to resume a good level.

From the economic point of view, it makes all the sense in the world for us to have a biomass in our energy mix with all the transmission auctions scheduled for this year. We'll involve the provision coming from the Madeira River, tens of thousands of kilometers to bring energy which is far located far from the consumption center and this is the bottom line.

We can generate energy close to consumption center. So it makes sense. So we won't have problems in transmission. We have a more straightforward transmission system, each new generation create 5 MVAs in terms of transmission need. Whenever we start generating -- a huge [ph] elevating substation, we also need substations along the transmission line. We also need -- also substations as the energy arrived at the consumption centers. So all this expansions by itself creates demands for CMV [ph].

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On top of that, we have the station's infrastructure in Brazil. That's a fact also, so we now see ahead of us a scenario where needs are clear and I think we are moving towards the right direction. So we will start getting the right signs to investors. Every January for the last three or four years, we have to answer questions coming from investors concerning blackout, what kind of impact a blackout will have and the demand for our products, we would like -- we would like to stop having to answer those questions, and like to start talking about expansion throughout the year. And I think we are moving in that direction now. So as I said, we are more optimistic about the outlook for the sector.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Okay, good. Thank you.

A - Unidentified Speaker

Concerning solar energy, I know that the Energy Minister talks a lot about this, you have any perspective going forward for solar energy. It's for this year, of the three reserve auctions we have for this year. Two are referred to solar energy. In August and also in November, those two auctions will focus on wind and solar. So it's not something we expect to happen going forward, it's going to happen this year.

It's an expansion of our product line and it is a project we have full command in terms of industrial automation, we have to invest in R&D to adapt that product for photovoltaic generation and it is a very promising market for us. We are trying to analyze all alternative we have in terms of offering a full-fledged package, just as we did with wind energy.

And also have to work on the funding of that project. If the NDF [ph] has offered very interesting conditions to finance that type of energy source.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Just one follow-up. There was, if I'm not wrong, a regulatory issue has this hurdle been overcome.

A - Unidentified Speaker

If I'm not wrong, the regulatory hurdle to do with a distributed solar energy and we're not there yet, we're talking about projects to sell energy directly to the grid. And in this case the regulatory hurdles are much simpler to overcome.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Okay, thank you.

Operator

(Operator Instructions) This concludes today's Q&A. I'd like to invite Mr. Paulo to proceed with the closing remarks. You have the floor, sir.

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A - Paulo Polezi {BIO 19468811 <GO>}

So once again, thank you. Just one last reminder, we will be holding -- we have send a save the day notice. And so just to reinforce we have our WEG Day on May 22, the tower meetings with institutional investors and also fund managers. We will send by next week the emails with forms. We have of course limited places, please if you have not received this notice -- if you don't receive this before by Monday please get in touch with us and we will send that to you.

Once again, thank you, Luis. Thank you all for participating in the call and we are available. Have a nice holiday. Have a nice long weekend.

Operator

WEG conference call is now over. I'd like to thank you all for participating. Have a nice day. And thank you for using Chorus Call.

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