Q2 2019 Earnings Call

Company Participants

- Eduardo Miron, CEO
- Marco Antonio Spada, Chief Financial Officer and Investor Relations Officer
- Marco Spada, CFO
- Marcos Antonio Molina dos Santos, Chairman
- Tim Klein, Head, North America

Other Participants

- Analyst

Presentation

Operator

Good afternoon, ladies and gentlemen. At this time, we would like to welcome everyone to Marfrig Global Foods SA Conference Call to present and discuss its results for the Second Quarter 2019. The outlook for this conference is being broadcast internally through the Internet in the website, www.marfrig.com.br/ri. In that address, you can also find the slide show presentation available for download.

We inform that all participants will only be able to listen to the conference call during the company's presentation. After the company's remarks are over, there will be a Q&A period. At that time, further instructions will be given. (Operator Instructions).

Before proceeding, let me mention that forward-looking statements that are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Marfrig management and on information currently available to the company.

Forward-looking statements are not guarantees of performance based on the risk and 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 Marfrig and could cause results to differ materially from those expressed in such forward-looking statements.

And now a message from your -- from Mr.Marcos Molina, Founder and Marfrig Global Foods Chairman. Please go ahead.

Marcos Antonio Molina dos Santos {BIO 15363967 <GO>}

(Foreign Language). Good afternoon, everyone. I'd like to start by thanking you for attending another Marfrig earnings conference call.

(Foreign Language). It was a strong quarter with strong results in which once again on a pro forma basis we improved from our prior quarters, reinforcing our strategy of focusing on beef protein and on higher value products.

(Foreign Language). In North American operation. During the quarter, we concluded the acquisition, which we carried out jointly with the other shareholders of national beef of the Iowa plant, which not only will expand our operating capacity but also demonstrate the commitment of all shareholders to the growth and profitability of the business.

(Foreign Language). Another highlight is the agreement with ADM for the joint development of a plant-based product. We are going to produce a 100% vegetable burger with a flavor and texture that mimics the animal protein burger.

(Foreign Language). As the world's largest beef patty producer, we would like to give consumers the power of choice, and we have already closed a deal with Burger King with sales starting in September.

(Foreign Language). Before I hand the presentation over to Marco Spada, who will go into more detail on the quarter's results, I want to talk about the sustainable bond that we recently issued.

(Foreign Language). As you know, sustainability is a key value at Marfrig. We recently created our sustainability committee, whose members include Roberto Waack, which is an expert in this field; and we also recruited an officer, Paulo Pianez, who will be responsible for all matters related to sustainability.

(Foreign Language). Working together with the financial team, this team was responsible for the first sustainable bond operation in Brazil, which is not just a Green bond but a bond that goes beyond environmental aspects to include social economic dimension.

(Foreign Language). The bonds were placed with the lowest interest rate ever obtained by the company, which reflects the market's recognition of Marfrig's sustainability actions.

(Foreign Language). I want to thank everyone for a solid quarter, and again, I'd like to thank you all very much.

Eduardo Miron

Thank you, Marcos. Good afternoon. I want to start by thanking everyone for attending this another earnings call from our Marfrig Global Foods that we will be commencing -- commenting on the results of the second quarter of 2019.

With us today are also Marco Spada, the CFO and Investor Relations Officer; Miguel Gularte, CEO of the South American Operations; Tim Klein, CEO of the North American operations by phone. And we invited Paulo Pianez, our Director of Sustainability, to join us this time.

I'd like to start saying that we are extremely happy with the results achieved in the quarter. They confirm our positive view for the year and on the financial pillar and also is in other strategic pillars, like sustainability and product and customers.

Let's start on Slide 3 with the quarter's financial highlights. For the third straight quarter, we posted positive net income, which this quarter surpassed BRL86 million, which is an excellent result compared to the net loss of BRL582 million in the same quarter last year. Net revenue was over BRL12.2 billion, setting a new record for the company, while adjusted EBITDA was also a record at BRL1.1 billion, with margin of 9.1%.

As Marcos touched on, we concluded the acquisition of Iowa Premium, which added 1,001 thousand heads per day to the processing capacity of our North American operation, which now amounts 13,100 heads per day. The acquisition price was approximately $150 million, with each partner contributing proportionately to their interest, which in Marfrig's case, was around $75 million. We also carried out transactions to reduce our debt cost, issuing a $1 billion bond maturing in 2026 with a coupon of 7% per year, improving our average cost and average term.

Let's turn to Slide 4, please. Here, it shows our strategic highlights now. For the seventh straight year, our compliance with the Public Committee of Amazon Cattle Ranching was confirmed by an independent Norwegian International consultant firm, DNV-GL. The audit analyzed our cattle purchases in 2018 and confirmed that all our units in the region complied with all procedures required by the commitment undertaken in 2009.

We also issued the first sustainable transition bonds in Brazil for -- in the amount of $500 million for 10 years with a coupon of 6.625%. This is the longest duration and the lowest rate ever obtained by the company. The proceeds will be used exclusively to buy cattle in the Amazon biome. The issue is important symbolically since it's attached to Marfrig's ongoing efforts to promote sustainability and financial discipline.

Let's go to the next slide, Slide number 5, continuing with the strategic highlights. We recently announced an agreement with ADM for the joint development of plant-based products starting with burners. Under the agreement, ADM will provide the ingredients while Marfrig will produce, sell and distribute the products. Our initial idea is assigning the food service channel, as already published. We will be producing burger -- producing burger skins and vegetable burger.

And in Brazil, we must launch the Marfrig retail brand until the end of the year. And then after that, we think about the export market. So we'll start with the food service, where we have a lot of good relationship with a number of players; move to the retail with our own brand; and finally, expect to export. And so based on the performance of this business and -- we feel extremely positive about it.

Let's go now to -- I'll pass now to Marco Spada, who'll comment on the operational results in more detail. Please, Marco.

Marco Antonio Spada {BIO 20767498 <GO>}

Thank you, Miron. Good afternoon, everyone.

Let's continue the presentation on Slide number 7. Here, let's look at the performance of the North America operation, which once again delivered robust results. To facilitate the comprehension of variations, all amounts here are expressed in U.S. dollars. In the second quarter, the operation posted volume and revenue growth, with revenue reaching $2.247 billion. This increase is explained by the continued firm demand in the domestic market which continues to support higher prices. Volumes were also driven by the expansion of the Moultrie unit, which allow us to increase sales to an important supermarket chain.

Gross income, which came to $288 million, was stable year-over-year. Although the cutout ratio, which is the ratio of the average beef price to the average cattle price, rose from 1.85 to 1.86 in a year-over-year comparison. Margins were slightly pressured by the reduction in carcass yield. The lower carcass yield was due to the severe winter of this year.

Let's turn to Slide number 8, please, which shows the results of the South America operation. Net revenue from the South America operation grew by 8.8% on the second quarter of last year to nearly BRL3.5 billion. Revenue growth was driven mainly by the solid growth in export sales volume, especially to Asia, led by China and also to the Middle East. Remembering that we are the company with the most plants in South America authorized to export to China, as expected, export volumes to the country began to grow in the quarter.

Based on average for the period, Uruguay's and Argentina's export to China as the share of their total exports reached 62% and 46%, respectively. Brazil, which has limitations in terms of plant authorizations, shipped 31% of its exports to China. On a consolidated basis, 18% of the total group's revenue in the quarter came from the sales to China. Another factor benefiting revenue was the impact from exchange variation based on the average exchange rate in the period, which increased by 8.7% compared to the same quarter last year.

The operation's gross income was slightly lower than the second quarter of last year at BRL395 million. Gross income was affected by the lower sales volumes, while gross margin, which stood at 11.5%, was affected mainly by the higher cattle costs both in Brazil and Uruguay. In Brazil, the average cattle price compiled by Esalq was 8.9% higher than in the second quarter of last year. In U.S. dollars, the cattle price remained stable. This price increase reflects the pressure due to the local currency depreciation and higher export sales. In Uruguay, the cattle costs went up by 6.8%, explained by the historically low inventories due to exports of live cattle and growing Chinese demand.

Let's move now to Slide number 10, where I will comment on the company's consolidated performance. All indicators you see here posted improvement in comparison with the same quarter last year. Given the company's international presence, the depreciation in the Brazilian real played an important role in the consolidated results. The effects from currency translation, combined with growing domestic sales at the North America operations and growing export volumes at the South America operation, supported net revenue growth on the prior year period of 9.8%, totaling BRL1,220 billion. With this performance, EBITDA grew 13.3% to BRL1.1 billion, setting a new record for the company, with EBITDA margin of 9.1%.

Lastly, for the third straight quarter, we delivered positive net income now of BRL87 million compared to the net loss of BRL582 million in the second quarter of last year, supported by the solid results of the North America operation.

Let's move on to the next slide, where I will comment on cash flow. Considering the net profit I just mentioned and adding non-cash items and adjustments to working capital, the operating cash flow was BRL876 million. Cost of recurring CapEx, in other words, funds allocated to maintenance and minor improvements, totaled BRL191 million. Interest expenses came to BRL277 million, impacted this quarter by additional costs from the issue carried out in May. As a result, free cash flow generation before M&A activities and distribution of dividends was BRL480 million compared to a cash burn of BRL1.1 billion in the first quarter of this year.

These funds were used to settle the last installment for the acquisition of Varzea Grande plant in Brazil of BRL25 million, and to settle the acquisition of our share of the Iowa Premium in the United States in the amount of BRL280 million, which results in a free cash flow after M&A of BRL103 million.

Let's move on the next slide, where I will comment on our debt and our leverage indicators. As you can see, net debt was $2.6 billion, 6% higher than first quarter, which was driven by the variation of the cash flow after M&A that we saw in the previous slide, added by the payment of dividends to third parties of a total of $151 million. In the second quarter, we paid dividends to the minority shareholders of National Beef, whose amount referred to the first quarter of this year. As you'll recall, there was no payment in this previous quarter, referred to the second quarter of this year as well, and also to a surplus cash related to fiscal year 2018, and also an extraordinary payment paid in advance in order for them to pay the Iowa acquisition.

The improvement in our EBITDA, supported by the continued advances in our operations, is lowering our leverage ratio which fell once again, this time reaching 2.65 times. With the liability management exercise that we carried out in May, we reduced the cost of our debt and extended the average term, which stands at 6.73% per annum and 4.49 years, respectively. With these efforts, we continue to lower our cost of capital and to reduce our borrowing costs.

Let's go now to the next slide, where I will comment on our guidance for 2019. Based on the results delivered in the first half of the year and on our positive outlook for the second semester, we reaffirm our guidance for the full year. The improvement between the first and second quarter is clear, as you can see in the charts, and we have other factors that reinforce our projections. Talking about the revenue, we need to talk about the exchange rate as well. The scenario of a stronger dollar against the Brazilian real, given our international presence, we -- in our forecast of BRL3.9 per dollar is becoming realistic and recently even shy.

About the EBITDA, I would like to recall that due to seasonality, the second semester EBITDA is usually stronger than first semester. In terms of cash flow, a few important points to consider. Our investments in working capital were all made in the first half of the year. Recurring CapEx should decline slightly over the coming quarters. Cash flow in the second half of the year should be higher due to seasonality. For example, bonus payments are made in the first half of the year; operations, to mention, despite payment terms, which happens at the end of the year, are recovered in the first quarter; and also due to some a typical market factors. And last, we continue to reduce our interest rates.

So given all this, we reaffirm our guidance for the year and we are confident that we will achieve those targets.

I will now return the word to Miron for his closing remarks.

Eduardo Miron

Thank you, Marco. I'm now in the final slide for today's presentation. And here, the idea is to reinforce our commitment to a sustainable value generation. This is our goal, which is supported by five main pillars, strategic pillars that we demonstrate in this slide and are same one that we announced at the beginning of the year. I will go over the items as we somehow highlighted them, the main ones during this call.

So we only summarize here some actions and examples, even more important, that show that we are making progress in our strategy. So we are very happy with the second quarter results. I believe it demonstrates our performance and delivery capabilities, innovation and strengthen our commitment to a sustainable value generation. We believe the second semester of this year will be much better. Our teams in all regions we operate are engaged, optimistic and focused, and I'd like to finish thanking them all for their work in this journey.

With that, I would now suggest we move to the Q&A session. Thank you.

(Question And Answer)

Operator

Thank you. (Operator Instructions) Our next question comes from Bryan Hunt, Wells Fargo Securities. You may proceed. Mr.Brian Hunt, your line is open, you may proceed.

Thank you, very much. Sorry, I was on mute. One of your competitors lost a plant to a fire. It's probably going to be down more than a year, is our estimate. Can you talk about your ability to adjust your production schedule to maybe grab some of that industry volume that may be spread around amongst the competitors?

Eduardo Miron

Hi, Bryan, this is Eduardo Miron. As we have here with us our CEO for North America, Mr.Klein, so I would ask him to address your question. Tim can you do that?

Tim Klein {BIO 16522695 <GO>}

Yes. Bryan, to answer your question, the plant that Tyson lost due to the fire represents about 6% of the industry slaughter of Fed cattle. We believe that Tyson internally with their other locations will more than likely offset about half of that. And then with the balance of the industry, we think that the net effect of the fire will be rather than a 6% industry capacity loss more like a 2%.

As you know, the US industry has been operating at almost full capacity, so there's not a lot of gas pedal left with the rest of the industry, including ourselves. We do expect to increase production levels as much as we can without compromising preventive maintenance programs in our plant and employee welfare.

Operator

And how many additional head per day do you think you could get by maybe running an extra shift on Saturday or just tweaking schedules?

Tim Klein {BIO 16522695 <GO>}

Well, we're not putting the numbers to it yet, but we think somewhere between -- somewhere in the range of 500 to 800 per week.

Operator

Very good. I appreciate your answer. My next question would be your leverage is low. You just made an acquisition. The second half is going to be better than the first half. What are your priorities for free cash flow in the second half of the year and going forward?

Eduardo Miron

Well, our leverage -- we are -- let me start saying that we are convinced that we need to keep our leverage at a low level. So that's a key top prior for the company. We -- our focus for the next six months is to extract the right profitability from the business. We believe that our EBITDA for the rest of the year shall be better than the first -- the average of the first half of the year. And we will continue our discipline in the other components of the cash flow.

We mentioned that in terms of CapEx, we should not have -- we should lower the CapEx for the rest of the year. We should benefit from lower interest rates in our interest line given the exercise, the effort that we have made in this area. And we believe that we are -- in terms of working capital, we will continue our discipline with the working capital solution. I expect any major variation in the working capital. So we are committed to our guidance for the year, and that's our top priority, as we speak.

Operator

And just one point of clarification. When you say low leverage, is there a number you would associate with low leverage? Is it below 3 times or 2.5 times?

Eduardo Miron

Yes. What we have already mentioned to the market and the other producers that -- we should expect something around this level that we finished 2018, which is around 2.2 times, 2.4 times.

Operator

Thank you very much. I will hand it off to somebody else.

Eduardo Miron

Thanks.

Operator

(Operator Instructions). Our next question comes from.

Analyst

Hello. Thank you very much for taking my question. Just as a follow-up. I would like to ask about the leverage. In other opportunity you have said that the leverage will be around 3.5 times. Has this has changed?

Marco Spada {BIO 19715083 <GO>}

Hi, Catherine. This is Spada who is speaking. Our target was -- there was a target in terms of leverage that was put in place back in 2013 for the end of 2018 which was 2.5 times leverage. We have reached that in the end of last year, and going forward we didn't put any further targets in terms of leverage. What we have said in the market, and this might have caused some confusion, is that we do have an internal agreement -- the shareholders' agreement of Marfrig. There is a new limit between the shareholders set to be at 3.5 times going forward.

Why this decision? In the past, this limited used to be 5 times. Now with the new situation of the company, it makes much more sense to do a financial review of this as -- it is an agreement between the shareholders. There's this internal limit of 3.5 times, but this is not a target or a goal to be achieved. I mean, we are way below this. Our intention is to keep the leverage in the company. And as Miron just said, the intention is to finalize 2019 level, at least equal to what we finalized in 2018, maybe even lower than that.

Analyst

Okay, thank you very much for the clarification. -- And regarding dividends to minorities, which are your expectation for the whole year because we have seen an increase on those in this second quarter?

Marco Spada {BIO 19715083 <GO>}

The numbers -- what happened is that in the second quarter, there was a concentration of payments, basically. So this -- as you can see, there was no payment in the first quarter. Usually, you see every quarter there is a payment related to that. So as we have already said in previous opportunities, 54% of net revenues are distributed as tax distribution or dividends for the shareholders every quarter. So in this quarter, there was a concentration of payments, and that's why the number you see is higher.

Analyst

So you do not expect any more dividend for the rest of the year?

Marco Spada {BIO 19715083 <GO>}

No, every quarter, you should expect -- I mean, you should expect in the third quarter more dividend payments. In the fourth quarter, more dividend payments as well but much smaller than what you see in this quarter.

Analyst

Could you give us like a sense of the total amount, please?

Marco Spada {BIO 19715083 <GO>}

It depends on the revenue projection for each quarter, so I cannot anticipate this to you.

Analyst

Okay. And if I may, please could you confirm your CapEx for the rest of the year? You said it will be below the first half?

Marco Spada {BIO 19715083 <GO>}

Yes, our expectation is that CapEx -- the recurring CapEx should be something around BRL600 million to BRL800 million for the whole year. So that's why we see that this should be lower than it was in the first half of the year.

Analyst

Thank you, very much.

Marco Spada {BIO 19715083 <GO>}

You're welcome.

Operator

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

Eduardo Miron

Well, I'd like to thank everyone at this time to listen to our second quarter earnings call. Thank you all for your support in the company, and we will continue very focused to deliver our objectives for the year. Thanks. Thanks again.

Operator

Thank you. That does conclude our Marfrig's conference call. Thank you very much for your participation, and have a good, nice day.