Q3 2019 Earnings Call

Company Participants

- Francisco Gomes Neto, President and Chief Executive Officer
- Nelson Krahenbuhl Salgado, Executive Vice President, Finance and Investor Relations

Other Participants

- Cai von Rumohr, Analyst
- Gabriel Rezende, Analyst
- Jeff Molinari, Analyst
- Josh Milberg, Analyst
- Louis Raffetto, Analyst
- Unidentified Participant

Presentation

Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

(Starts Abruptly) total of six different airlines.

Moving to slide five, we show the Executive Jet highlights. Embraer delivered 27 Executive Jet, 50 light and 12 large in the third quarter, leading to 63 airplanes year-to-date. During the third quarter, we delivered seven Praetor 600, including the first Praetor 600 jet assembled in Florida. As far as sales, Embraer had the highest year-to-date sales in Executive Jet in the last five years with the Praetor 600 as a big success and the best super midsized jet in the market. Interest from customers is very high and we had the announcement at NBAA of USD1.4 billion deal with Flexjet for the Praetor jet and the Phenom 300, a deal jet can get to the delivery of around 64 jets. Flexjet also became the Praetor fleet launch customer with first delivery scheduled for first quarter 2019. Finally, in terms of the Praetor Program development, the Praetor 500 received triple-certification from ANAC, FAA and EASA, outperforming on key performance metrics, such as speed and range.

Moving to slide six with Defense and Security business, which continues its transition from KC-390 project development sales to fuel production with special highlights to the entry into service of the KC-390 with Brazilian Air force. First aircraft was delivered to Brazilian Air Force in September and the second is expected to be delivered by year-end. The KC-390 also successfully performed a very important air-to-air refueling test with Brazilian Air Force during the third quarter 2019, and continues to move the certification of critical military missions. Also very important to mention is that Portugal became the KC-390 first export customer with a firm order for five KC-390 and related services. This contract will amount to approximately USD1 billion and it will be included in our backlog in the fourth quarter. Talking about other defense platform, we have sold nine Super Tucanos to two undisclosed customers and the Brazilian Air Force received the fourth legacy 500 aircraft modified for airport inspection operations.

With that, we conclude the business highlights and move to the financial results.

We start with the firm order backlog at slide eight. Embraer backlog reached USD16.2 in the third quarter 2019, which is almost USD3 billion above what we had one year ago. New orders for Executive Jets has been the main highlights in the backlog this year. And on the defense side, the recent KC-390 order from Portugal will be added to the backlog in the fourth quarter.

Next to slide nine, we presents aircraft deliveries. Starting with Commercial Aviation, we delivered 17 jets in the third quarter, a two jet more than what we delivered in the same period of last year. Year-to-date, we have delivered 54 jets. We maintain our guidance of 85 to 95 deliveries in 2019, implying a strong fourth quarter in terms of the deliveries.

On Executive Jets, we delivered 27 jets in the third quarter, three more than what we delivered is in the same period of 2018. A special highlight to you, to the 12 delivering of large jets, produced seven in the third quarter of 2018. From this 12 aircraft, we have five Praetor 600 aircraft. We also increased our guidance of 90 to 110 deliveries in 2019 in Executive Aviation, also implying strong deliveries in the fourth quarter.

Next slide, we present net revenues. We reached revenues of USD1.176 billion in the third quarter, slightly above 2018. Year-to-date, we achieved USD3.378 billion in revenue. These revenues are broken by Commercial Aviation USD408 million, Executive aviation USD363 million, Defense USD164 million, and the sales revenue we had to account for a loss associated with the KC-390 development program of around USD34 [ph] million, and services USD238 million. Moving -- to reiterate, our guidance of revenues from USD5.3 billion to USD5.7 billion in 2019.

Moving to slide 11, we present SG&A. Our SG&A expenses totaled USD108 million, broken by USD37 million G&A, and USD71 million in selling expenses. We continue to reduce SG&A expenses despite the preparation for the separation of the commercial aviation business.

At slide 12, we show operating results. Embraer third quarter EBIT was negative USD21 million, implying a negative margin of 1.8%. Important to mention that our EBIT included USD66 million in separation costs related to the Commercial Aviation carve out year-to-date and USD35 million in the third quarter alone. Excluding Commercial Aviation EBIT of the businesses that we remain at Embraer was 2.6% in the third quarter and breakeven year-to-date mostly driven by better margins at Executive Aviation.

Our margins business in the third quarter were negative 11% at Commercial Aviation driven by carve out costs and (inaudible), positive 6% in the Executive Jets with the beginning of the Praetor 600 deliveries. Negative for Defense, as I mentioned, impacted by one-off charges of USD34 million in the KC-390, and positive 7% attributable [ph] in support also partially impacted by carve out costs.

Moving to EBITDA at slide 13, Embraer's EBITDA was also impacted by the carve out costs. EBITDA reached USD18 million third quarter, equivalent to a margin of 1.5%. EBITDA year-to-date USD116 million, with 3.4% margin.

At slide 14, represents net income. Embraer reported a net loss in the third quarter of USD48 million, implying a negative margin of 4.1%. Our earnings have been negatively impacted by the combination of carve out costs, same impact that we have in the EBIT and EBITDA and higher financial leverage that we move as we close the deal as together with the debt that we move to the Boeing Commercial Aviation.

Moving to investments. We reached USD314 million year-to-date, broken by USD33 million in research, USD187 million in development and USD94 million in CapEx. Our major investment this year as related to the E2 program development.

Cash flow at slide 16. Embraer had the free cash flow consumption of USD257 million in the first quarter 2019 and USD921 million year-to-date. We expect to recover a big amount of our cash usage in the fourth quarter with meaningful free cash flow generation driven by aircraft deliveries on both executive and commercial that will have a strong fourth quarter. Given that we anticipate a negative free cash flow in the range of USD100 million to USD300 million for the full year of 2019. This negative free cash flow already includes all the separation costs.

As a result of the free cash flow consumption, we show our indebtedness profile at slide 17. Our average debt maturity is 4.9 years. And Embraer ended the third quarter with a cash position of USD2.2 billion and a total debt position of USD3.5 billion, implying a net debt of 1.3 billion.

Moving now to slide 19 [ph], we bring some information about the discussions of Embraer and Boeing partnership. As it was widely published in the press, European Union has recently announced an extension anti-trust decision deadline regarding the partnership until at least to March 2020. Despite that, the carve out of the company commercialization business is starting at the end of 2019. So as we grow in 2019, we will start implementing the carve out of our Commercial Aviation business. It will be separated into another company and it's very important to make clear the Commercial Aviation business will continue to operate normally 100% under Embraer management's until the closing of the operation. We now expect the transaction to be consummated shortly after all regulatory approvals are sustained.

Now we move to our guidance. Given the cash consumption observed in the third quarter, the review of short and medium-term business plans and considering the new closing timeline of the transaction expected to occur in -- at least in March 2020. We updated our 2019 and 2020 guidance. For 2019, Embraer reaffirms deliveries of 85 to 95 jets, 90 to 110 executive jets, two KC-390 and now expects the delivery of five Super Tucanos.

Embraer also reaffirms expectations for revenues of USD5.3 billion, USD5.7 billion, and breakeven EBIT margin while removing the estimates, which were dependent upon closing of the transaction at the end of 2019. We also introduced 2019 free cash flow guidance of our cash consumption from USD100 million to USD300 million in 2019, including here again all separation costs.

For 2020 guidance at slide 22, and this guidance includes all the expected results of executive, defense and related services, that is the scope that will be retained by Embraer after closing. Embraer reaffirms consolidated revenues of USD2.5 billion to USD2.8 billion. EBIT margin of 2% to 5% and breakeven free cash flow in 2020.

Given Embraer's expected 2019 cash consumption combined with anticipation of the closing of the Embraer Boeing partnership to March 2020 -- March or April 2020. And the potential financial impact of these delays, Embraer now expects a special dividend of between USD1.3 billion and USD1.6 billion to be paid after closing of the transaction in 2020.

With that, I conclude my presentation and we would like -- I would like to pass to our CEO, Francisco Gomes, for his closing remarks.

Francisco Gomes Neto {BIO 19328044 <GO>}

Thanks, Nelson, and good morning to all analysts and investors connected with this call. After six months, as the head of Embraer, I would like to share my impressions with the market. First, we have a great team, and I'm really impressed by the commitment and hard work of our team in the carve out process to separate the Commercial Aviation business into a new company. Of course, the carve out has affected our results in 2019, but we are confident that after the conclusion of this partnership with Boeing, Embraer will be much stronger. Second, while we continue to manage our whole business in the ordinary course will be extensively working (inaudible) losses on a business plan of this new Embraer, and important actions has already been taken. We have presented to the market at the right time, but I'm 100% convinced of the huge gathering we have in executive, defense and services.

With a lot of focus on sales of the great new products we have, discipline in cost control and cash generation, I believe that our biggest opportunity today is to improve these three businesses. No other initiatives will create more value to our shareholders -- shareholders than this. That is the reason my management team is deeply engaged reviewing the business plan for executive, defense and services.

We also continue our focus on the innovation initiatives that will contribute with a future growth of the company. Finally, we recently announced important changes, that Nelson Salgado, our current CFO will now move to operations to increase the alignment of operations team with the financial targets we have.

We also announced Antonio Garcia as our new CFO, starting on January 1, 2020. Antonio comes from ThyssenKrupp and brings a lot of experience in cost control, profitability turnaround and cash generation. I believe we are building the right leadership at Embraer to take the necessary steps that will bring enormous result to our investors in the coming years.

With that, we conclude our presentation and we would like to open for questions.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Cai von Rumohr, Cowen and Company.

Q - Jeff Molinari {BIO 21655488 <GO>}

Hi, this is Jeff Molinari on for Cai. Good morning and thank you for taking my question. So the first question I have is on the Boeing-Embraer JV. This week it was reported that in the EU stopped the clock to review the proposed JV, is this latest development contemplated in your expectation for decision in March? Or how is that -- will that be delayed substantially? And then I have a couple of follow-ups.

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Thanks, Jeff. No, we do not see that there is any additional delays. Actually when the European Commission decided to move the process to Phase II, they decided the deadline that we would be around mid-May -- mid-March. And they requested additional information from the two companies. We are working very hard to deliver this information as soon as possible, but the European Commission started the clock until they receive this additional information. We do not see this as any change in the normal course of this process and don't expect this to be a big delay.

Q - Jeff Molinari {BIO 21655488 <GO>}

Okay. Thank you. And if I can, another follow-up. So the delay caused the decrease in the special dividend range, so -- but you didn't quantify what the impact is on separation costs. Can you talk a little bit about what the expectation is for those costs in 2019 and 2020 or collectively, however you want to frame it? Thank you.

A - Francisco Gomes Neto {BIO 19328044 <GO>}

The separation costs will amount to something bigger than USD100 million [ph], close to USD100 million in 2019, and three may be something left for 2020, but we don't expect that to be significant.

Q - Jeff Molinari {BIO 21655488 <GO>}

And is there an amount in your free cash flow guidance that you're assuming for the free cash flow guidance, USD100 million to USD300 million outflow. What are your assumptions of separation costs within that?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

So the same. That guidance includes already the separation costs in the order of USD400 [ph] million, as I mentioned, too.

Q - Jeff Molinari {BIO 21655488 <GO>}

Okay. I'll get back in line. Thank you guys.

Operator

Our next question comes from Myles Walton, UBS.

Q - Louis Raffetto {BIO 6504202 <GO>}

Good morning, everyone. This is Louis Raffetto for Myles.

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Hi, good morning.

Q - Louis Raffetto {BIO 6504202 <GO>}

Just wanted to sort of follow up on that. So what was the driver to the change in the dividend? I think previously USD1.6 billion, now it's USD1.3 billion to USD1.6 billion. And is there a change in the amount of leakage you guys expect from the deal as well?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

No. That is driven mainly by the cash flow consumption in 2019 and also by this delay, the change of the closing from early 2020 to around March. Right. So in the light of the cash consumption, we thought it would be better to change the guidance for the dividend.

Q - Louis Raffetto {BIO 6504202 <GO>}

Okay. Thank you. And then a follow-up. So I think now you're saying there's -- I think five Super Tucanos. I guess I thought, previously, were you expecting a few more than that this year? Or is that --

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Well, five of them were postponed to the beginning of 2020.

Q - Louis Raffetto {BIO 6504202 <GO>}

Okay. Great. Thank you very much.

Operator

(Operator Instructions) Our next question comes from (inaudible) Global Capital.

Q - Unidentified Participant

My question is about the business jet orders. Wondering if you could provide a little bit of description on how that went for Q3?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Sorry. Are you asking about business jet orders?

Q - Unidentified Participant

Yes, correct.

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Yeah, business jet orders, as we mentioned in the call, we're at the highest level in the first nine months of the year from the last five years. So it's been a very good results. And within those orders, we had this USD1.4 billion orders from Flexjet, which is very important as Flexjet becomes the launch customer of the Praetor 500. So it was a very big year so far to business jet sales.

Q - Unidentified Participant

Thank you. And just a quick follow-up. Can you -- are you able to discuss backlog for Q3 business jets specifically?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Yeah. As a consequence of the sales, backlog is at its highest for executive aviation as well. But I don't have here the figure for executive aviation backlog, but it is the highest ever of.

Q - Unidentified Participant

Okay. Thank you.

Operator

Excuse me. Our next question comes from Cai von Rumohr, Cowen and Company.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Hi, thanks for the follow-up guys. What is your new expectation for net cash position if the deal were to close in March time frame? Thank you.

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Well, Cai, this depends on exactly when the deal closes. As you know, as we move by during the year, in our industry, it's normal to have cash consumption in the first months of the year because of the seasonality. So the amount of cash that -- the liquid cash that we - - the net cash that we will have at closing will depend on the moment the -- when the closing was planned to happen coincidentally with the year-end where we have our -- normally our best cash position because of the situation. Now with the closing -- moving closer to end of the third quarter this year, then it's difficult to predict the net cash. It will depend on the operational performance and cash consumption of the first month of the year.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Okay. That makes sense. And then how is the separation activity progressing? And you're on track for internally separating by fiscal year-end? What still needs to be done between now and the next month-and-a-half?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Cai, you know this is a complex problem. We had many, many projects going on to be able to do that separation. Right now, we have closed the integrated test for the separation of the ERP system, which is one of the biggest step that we have to do. And with that, we considered that most of the activities are finished. So our plan was to have finished most of the significant activities by beginning of December, and that is very much on track. So what we do now as we closed 2019, we will enter a blackout period because we had to shut down the current system so that we could start the operation as two different separate components. So we expect to take the first two to three weeks of January in that process and when you come back from that we will already operate as two separate companies. The company that will in the future becomes bonded with commercial and Embraer with the commercial business carve out. As I mentioned in the presentation, from this point until the closing, Embraer will continue to operate Commercial Aviation as we've always done. The only difference is that now internally it will be in a separate company but same management, same leadership.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Understood. Thank you.

Operator

Our next question comes from Josh Lorico [ph] Morgan Stanley.

Q - Josh Milberg {BIO 19336060 <GO>}

Hi, this is actually Josh Milberg from Morgan Stanley. I was hoping -- I wanted to ask if you could give a little more color on the issue of your commercial profitability in the third quarter? In addition to the issue of separation costs, you mentioned that it was affected by ramp-up of the E2. Could you talk a little more about that effect and how you see that effect evolving into the fourth quarter and into 2020? I realize, of course, that if all goes as planned, you won't be managing the Commercial business as of next year, but I thought you still have some perspective.

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Okay. So results of Commercial Aviation in the quarter, they were negatively affected by the separation costs. According to the methodology that was defined, the Commercial Aviation business exceeds almost all of the separation cost together with some part of the services businesses that is also with the Commercial Aviation. So that explains a part of the results that we had in the quarter, and this is a transitory effect. We don't expect to have, as I mentioned, big separation costs moving into 2020. The other part of the results explanation related to a mix of margin in the E175 E2s -- E1s, sorry, that we have given this year. And costs above expectations in the E195 E2s. So we are working with the learning curve of these products. So we are reducing costs first, but it is affecting the results as we start working up these two new projects.

Q - Josh Milberg {BIO 19336060 <GO>}

Okay. And then on the E175 E2s [ph] that you mentioned. Could you elaborate a little bit on that? Is that because it's the special configuration version of that aircraft, which we had understood in the past had a lower selling price?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Yeah, that's right. So the configuration and the effect of this was associated with these orders drive -- so this is -- drive these margins down.

Q - Josh Milberg {BIO 19336060 <GO>}

Okay. Thank you very much for that explanation.

Operator

Our next question comes from Gabriel Rezende, Bradesco BBI.

Q - Gabriel Rezende {BIO 20589376 <GO>}

Hi, thank you for taking my questions. Actually I have two questions following up on Josh's question regarding margins. So can we affirm that the impact on margins came more from the E2 than the E175? And another question, if you could provide any detail regarding the profitability of the Praetor, it would be great. Thank you.

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Well, as I mentioned, there are three components to the commercialization margin. So E175 E1s, [ph] the E190 and E195 E2s [ph] are ramping up and then incurred and the carve-out costs, which as I mentioned are impacting almost totally Commercial Aviation. The other thing --

A - Francisco Gomes Neto {BIO 19328044 <GO>}

The margin on the Praetor was --

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Okay. The margin on the Praetor, we had in the quarter a 6% positive EBIT in Executive Aviation with the delivery of the initial Praetor 600. We are not disclosing individual margins for products, but definitely, the Praetor have parts to play in these better margins in Executive Aviation.

Q - Gabriel Rezende {BIO 20589376 <GO>}

Okay. Thanks. That's great.

Operator

(Operator Instructions) Our next question comes from Leonardo (inaudible) CTM Investimentos.

Q - Unidentified Participant

Hi, this is Leonardo from CTM Investimentos. I would like to ask you guys, what are your main peers doing in terms of prices in order to achieve the costs and performance of the Praetor business jets?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Sorry, I did not understand the first part of the question. What is the --

Q - Unidentified Participant

What are your main peers doing in terms of prices to achieve the cost and performance of the new Praetor jets. I mean, are they giving more discounts to achieve the Praetor price?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

No, we believe very strongly that with the Praetor 600, we found a fixed cost in terms of positioning, products that have a similar performance are a much -- have a much higher prices, so it's very difficult to have price reduction that would get these products to compete with the Praetor 600. And so we do not see that this kind of reaction will cause us a big problem in the Praetor 600.

Q - Unidentified Participant

Thanks. And can you say something about the business jets used market? Is it getting better?

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Yeah. It is going well. No special points here.

Q - Unidentified Participant

Thanks.

Operator

Excuse me. This concludes today's question-and-answer session. That does conclude Embraer's audio conference for today. Thank you very much for your participation and have a good day.

A - Nelson Krahenbuhl Salgado {BIO 19113798 <GO>}

Well, thank you very much for joining the call.