Q4 2014 Earnings Call

Company Participants

- Alvaro Penteado de Castro

Other Participants

- Diogo Miura
- Lucas Ferreira

MANAGEMENT DISCUSSION SECTION

Operator

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

I would now like to turn the conference over to Mr. Alvaro Penteado de Castro, Financial Manager. Please go ahead, sir.

Alvaro Penteado de Castro {BIO 5537843 <GO>}

Good morning, and thank for accompanying Duratex' conference call for fourth quarter results. It's my pleasure to talk about – discuss these results with you, especially because we have a better end of the year, after a very challenging and difficult beginning of the year. Just to do a quick review, first quarter started kind of well, in a more normalized tone. After that, the activity diminished considerably following the negative expectations, given the number of non-working days following the World Cup event.

Because of that, we had to stop the plants to control the output according to the demand in that period, damaging costs and the operating performance of the company. Third quarter was characterized by an environment of softer prices, specifically in the Wood Division, pushing margins down. But fortunately at least in the MDF segment, we had an improvement in performance, which enabled us to push prices up, recuperating the discounts in the first place and after that even increasing prices in the real basis, which contributed to this very positive results we posted in the fourth quarter.

In the end, the performance of the Wood Division kind of offset the performance of Deca, where we made a number of adjustments that I will comment further in this presentation. But starting on slide one, here we bring some highlights, of course the first one is with regards this movement in MDF that I just commented, a better price base contributed considerably to the improvement in margins pushing margins in the W Division in the fourth quarter to almost 32%, which is more of a kind of normalized margin that we used to experience in better times in the past.

So even during this challenging year we were able to maneuver to bring margins backup to a more normalized kind of margin that we're more used to. In a way that the consolidated margin ended the year or the ended the quarter at 25.7%, in the Wood Division, the margin reached again 31.9%.

With regard to the operation, in Deca and given the poor performance specifically in ceramics and given that we added a great deal of new capacity in the end of 2013 with the integration of Queimados plant which added 25% capacity in that specific segment and given that in 2014, volume came below of what we expected. We made an adjustment shutting down forever the unit in Jundiaí II. That was the oldest plant in ceramics. It was acquired back in 2008 from Ideal Standard. So if we compare that kind of operation with existing plants of our – with the other plants, that was much more outdated in terms of equipment and in terms of cost of operation. So we prefer to adequate the output capacity by discontinuing that operation and shifting the production to other units which are more efficient in terms of cost, which will contribute in this year and looking forward to a better operating performance in Deca.

Finally, I'd like to highlight that yesterday the Broad of Directors ruled for a dividend payout of 40%. So you know that Duratex has a policy of a minimum payout of 30%, and extraordinarily they increased the dividend payout by 10%, reaching 40% and the distribution should be done on February 26.

Following on slide number two, we have some highlights with regard to revenues and gross margin. One highlight here is that given the discontinuation of the operations in Jundiaí, we had some extraordinary and non-recurrent events on the cost side of Deca. So when we reach the gross margin – in the slide number two, specifically in the fourth quarter, 29.3% is the recurrent margin. We have BRL31.4 million worth of extraordinary items that we are disregarding for this calculation. Of course that the positive here is revenues almost stable quarter-on-quarter, specifically because you know that during the fourth quarter, seasonally speaking, the quarters tends to be weaker, and we managed to bring revenues almost in the same level of the previous quarter, which contributed for the improved margins that we saw in this last quarter.

Following to that, we have the evolution of equity that reached BRL4.6 billion, unfortunately return on equity still below of what we intend to reach, reaching almost 7.4%. Looking forward, of course that we expect, as the market recuperates, as we are able to capture the benefits of this readjustment in production, we expect to improve these returns on equity.

Page number three, here we separated the Brazilian operations from the Colombian operations, especially because that operation was – or we started to consolidate Colombia in our numbers in 2014. So the comparison basis with 2013 is not the same. So we separated that just to give a better idea to you, where the performance – which one of the countries are contributing with what to the performance.

So on the top table, we see the performance in Brazil, specifically in the Wood Division, there was a diminishment in volume shift by almost 3%. That happened quarter-on-quarter, given the seasonality of the business and also year-on-year given our policies to try to keep prices on more softer periods and speeding up or being the first mover to increase prices and always in these movements, we tend to trade a little market share, but in the end, we are aiming to safeguard the performance of the company and actually we did that, it's very visible in the fourth quarter, when we see the evolutions of margins to 26.1% up from the 22.6% in the third quarter and this is consolidated basis.

Again, even with the kind of performance that Deca posted, the Wood Division was able to offset that performance and this is important when we think about Duratex, this is the company diversified business with focus, very important focus on performance.

The performance of the Colombian unit was stable and should be stable in the coming years given that the capacity there is very small when compared to the capacity we have in Brazil. And looking forward we don't have the addition of new capacity not in the next five years or six years because we don't have wood to support such desirable expansion. We are fixing the wood situation there and maybe in the long run we might add new capacity, but this is another story, we don't have nothing (09:41) in the short term that will change the situation in the next years.

Following to that, on slide number four we have the picture of demand of panels in volume for the Brazilian market. The highlight here is still the performance of MDF that year-on-year, 2014-over-2013, increased shipments by 3.4%. And in MDP there was a diminishment of 8.1%. The difference here is that MDF is more geared to mid and high income segment, which are more resilient.

And MDP is more geared to mid and low income segments, which are more exposed to these worries regarding employment levels, unemployment in the case, difficulties in gearing financing. So MDP more exposed to that, is more exposed also to the consumer confidence index which reached a record low in the end of the year. And even in January, the number was released already, and is down even from the lowest point which was January 2009.

Going back to these kind of volume. MDF not only is more resilient internally given the focus in mid and high-income segment, but also is a product that is or has its sales base more diversified. We make floorings, laminate floorings from MDF. We have also products, decoration products made of MDF. We have picture frames, wine boxes, a number of other products that are made of MDF, which gives more diversification. We do not depend upon a sole industry like furniture, like MDP is exposed to, and on top of that MDP more concentration in mid and low segments.

On next page we have the performance of Duratex, the Wood Division and in terms of shipments, when you see these shipments, just watch out because in 2013 we did not have the numbers of Tablemac consolidated in these volumes. So 2014 and 2013 are not very comparable, but in the end this is Duratex, again, we managed to increase volume year-on-year by 4.5%. If we disregard Tablemac, again down 2.9% in terms of volume. Occupancy rate reached 75%, a little down from the third quarter in MDF because of seasonality issues. Just to remind you in the third quarter, occupancy rate was 81% down fourth quarter to 75%, MDP third quarter 69% increased a little bit 71% maybe because increased prices in MDF and there was a shift by clients looking for more inexpensive products.

This is one possible explanation and hardboard performing stable. These are very small capacity we have, less than around 5% of the total capacity (13:37) performance is more stable. When we look at page number six, addressing results already of the Wood Division, net revenues, gross margin, EBITDA and EBITDA margin. The big highlight here is fourth quarter of course, specifically when we talk about operating margin, again EBITDA margin reaching almost 32%, EBITDA reaching BRL 233 million, up by 32% quarter-on-quarter. And on the right hand side, we have some highlights of these, what caused these results. So we had an increase in MDF prices which contributed again for this margin recovery. But still cost is under control, although we have some relief from the commoditized inputs specifically methanol, which price is down year-on-year.

The other inputs are kind of behaving in-line with inflation and we were able to offset that – those pressures via prices in MDF. But when we compare 2013 and 2014, another difference is the consolidation of Tablemac in the numbers of Duratex, which has lower margins and contributed a little to push the margin of the Wood Division (15:17).

On following page we have the performance of the building material industry, given by the ABRAMAT index, which is the one that we follow. Here we can see that the performance of this industry was very poor in 2014, down by 6.6%, reminding that these numbers are on real-terms. So in nominal terms, the reducement of revenues was more close to 13%, a huge reducement year-on-year. And despite this poor performance of this industry, still and comparatively better (16:03), we did not perform that bad. I mean, because of the strength of the brands, because of the diversification of sales base, products, focus on the operations and trying to improve results, being fast in reducing – adjusting production whenever is needed. We tend to outperform the industry. So in the end, we can see that volume on page eight, here was down by 5% year-on-year. Fourth quarter was considerably impacted by this worsening of the consumer confidence index.

You know that the macro environment is not easy, industry across the board, laying off or reducing output level, reducing the investments, waiting for a better macro environment to go back to the growth side. All of that hurts businesses or the consumption of products like Deca which have a higher unit price. And when we talk about remodeling, our acquisition on new home, those are more long term projects that requires the commitment of income for a longer term time of period, which is bad when we analyzed the macro environment. So we are under the situation controlling and addressing these issues to reduce the negative impact of this environment.

Following to that, on slide number 10. We have here revenues year-on-year going down by only 1.8%, remembering that on real terms ABRAMAT index posted a diminishment of

6.6%. So here we outperformed the market by much showing that our position or the way we do things here tend to post or provoke more positive reactions or results. The operating result was more difficult to control because we had all the inefficiencies given these economies of scale plus inflation and the salary increases running around inflation plus the real gains. And you know that 40% of the cost in Deca is related to labor, so in Deca we have a much bigger exposure to this inflation situation.

And because of that we did our homework here readequating the production to try to overcome these short-term difficulties. Given that we still have in Brazil a very young population, I mean the real estate segment, we see this very positively, still we are looking for ways to increase our participation in the building material industry via diversification of products and so forth is just a short-term situation that we know will go away as the macro environment improves.

Following to that on slide number 10, we have CapEx. In 2014, we ended the year with investments totaling almost BRL 610 million. A highlight here is that we have, including in this number a BRL 150 million invested to increase our participation, our stake in Tablemac, in Colombia, and another BRL 50 million in cash that we paid for the Caxuana asset. The remaining a BRL 100 million was paid here land that we gave as part of payment for this forest that we acquired from Caxuana. So if we disregard, the BRL 200 million paid for Tablemac and Caxuana, CapEx for 2014 was already very close to the maintenance level which we intend to keep for 2015.

Okay. I'll repeat. Reminding that the most important project including the Queimados plant in ceramics, Itapetininga, MDF, and Taquari is the debottleneckment in MDP, all of these projects are completed. They are already ready to run, if demand permits. So now is just a matter of time to occupy these capacities, and we know that the capacity we have is good for the mid-term and short-term demand pattern that we expect to have.

Following page shows an evolution of capacities throughout the years, 2007. And the company started a big investment project. Again, if we revisit the previous slide, we invested more than BRL 4 billion during this period. So if we check the capacity evolution here, between 2015 and 2107, Wood Division capacity almost double folded. And at the same thing as in the Deca Division considering already the discontinuation of the ceramics plant in Jundiaí.

Following to that, even after the very long period of investment. We were able to keep the debt level very low or very manageable, net debt to EBITDA reached 1.81 times, a little down from the kind of level, we ended September 2014. And up from the level we ended in December 2013 given the acquisition and investments we made in an environment of decreasing EBITDA. This is the reason why.

On top of that, we also paid an extraordinary dividend in the beginning of 2014, which contributed to consume cash in that specific moment. So still the debt is very adequate for the size of Duratex We are cash generators, you can see that even with all of these difficulties in 2014, we were able, we managed to finished the year with an EBITDA close to BRL 1 billion, which is very, very okay for this kind of operation we have today.

If we take into account, the amortization schedule. We can see that, we ended the year with almost BRL 1.1 billion in cash, which is enough to pay the whole debt maturity of 2015, if we desire to. Of course that we are negotiating, some of these debt maturities possible to review. We are working on that already. So we don't see any major challenge in terms of these maturities.

When we talk about foreign denominated debt which we have, that's not a preoccupation on our side, given that a 100% of this debt is hedged. So our function of currency is reals.

Finally, on slide 13, we bring some takeaways from this presentation. Of course, that 2015 the focus will be on the operation itself, both in the Wood Division and in Deca as a way to improve our competitive advantages when analyzing these competitive environment we are in. So when we talk about Deca, given the number of plants we have, we were able to discontinue the more inefficient ones. So we expect to capture some benefits by concentrating production in more efficient plants looking forward. We don't expect to lose revenues given that the new plant in Queimados added a great deal of capacity, which should be good to attend the demand for the mid and short run.

When we talk about cost, here this is something that the management is entirely focused on. We have internal actions here to control general and administrative expenses. If you address our numbers you will see that these kind of expenses stayed or remained pretty much stable during the year even in an inflation environment of 6%, which shows a very intense control of such kind of expenses. The logic to building our budget was not to increase such kind of expenses for the year of 2015. So we have a major focus looking forward to keep this line under control.

When we talk about CapEx again, we tend to keep it close to the maintenance level, which is BRL 400 million. Reminding you that something around BRL 170 billion to BRL 180 billion are directed to the maintenance of our timberland operation, plantation plus maintenance. And the rest is geared to not only the plants, but some minor investments that we always have to do remodeling some plants, some equipments and adequating our operations to legal standards.

Finally, we made or we're starting to make a very important movement towards the northeast region of Brazil. We recently had the approval of CADE liberating us to start the establishment of this joint venture we made with Usina Caete in the northeast region to plant around 14,000 hectares of eucalyptus forest. And in the end this forest will serve to feed a future MDF plant in that region. So again, we are not – we're very worried of course with the short term adequating our operations to the realities that presents to us, increasing or decreasing our output capacity, but always looking long term to the sustainability of the operations to aggregate value to the business, diversifying further our sales base, be more close to our clients, reducing our logistic cost, this will effect (28:22) this how we think.

And thank you very much for listening to me. Now, I open this session to the Q&A that you may have. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Lucas Ferreira, JPMorgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Hi, Alvaro. Good morning. My question is related to this decision to stop the Jundiaí line. Could you give us any guidance in terms of how operations will improve in Deca on the back of this decision. I mean, imagining similar sales mix, volumes, how much does addition in capacity utilization and reduction fixed costs of that line will improve results moving forward. Can you give us any color on how much EBITDA or margins can improve on the back of this decision?

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Hi Lucas. Thank you for your question. Well, 2015 is challenging, right. We're still at the very beginning of the year surpassing that seasonal moment which is normally weak and this January was not different than any other January, I would say. We have still a big expectation to learn what might be the measures will be released by the government to cope up with these inflation issue and the fiscal situation of the government. So in our view, it's still very soon to make any predictions on the year. I would say that up to now there is not much change from what we saw form the performance of last year, despite that a more positive tone on our side, okay. This more positive tone comes from the MDF segment, which is showing more resilience, okay.

And on the back-up front, of course, some improvement given that we reduced our output capacity cutting already some cost, reducing our labor force, so this should generate some cost savings, some more operating improvement looking forward. But we're not disclosing yet this number because this will depend much on the level of activity because if the market recuperates, we'll have to hire more people to cope-up with this for possible demand increase. If activity diminishes further, we'll have to make further adjustments. So it is too soon to quantity this number.

The message, I'd like to leave with you and the investment community is that the company is very aware of its responsibility to improve the returns on a company. You know that the management is remunerated on performance. So we are very into this cost control, addressing these issues to improve the operational performance.

Q - Lucas Ferreira {BIO 16552031 <GO>}

All right. In terms of your CapEx, could you break it down in terms of what is recurring, what is non-recurring, so we can understand what is the level of our maintenance CapEx that we should see from now on?

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Lucas, this BRL 400 million, we believe is recurrent. You know that we are always doing something here, something there. With 2015 plans, with this size of the operation, I think BRL 400 million is a good number to work looking forward. Including in this number, there is no acquisition of new coaching equipment or new capacity, it's only the maintenance of whatever we have.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Right. Thank you very much.

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Thank you.

Operator

. Our next question comes from Diogo Miura, Goldman Sachs.

Q - Diogo Miura {BIO 17360784 <GO>}

Hi. Thanks for the call. Could you please explain how you source your water and what risks you see in the case of a potential rationing?

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Hi, Diogo. Thank you for your question. Very updated issue. Well, in our case despite the plant in São Paulo of metal fitting here in the city of São Paulo, all the other plants we have or we depend or we rely more on wells, okay. The dependence on water is more for the maintenance of the plant, washing the plant, cleaning the plant for the bathrooms down to the production. And even in the plants outside São Paulo we have stations to treat the water we use to reuse it in this maintenance process. So the dependence is very low and we have contingency plans in case of water shortage. So right now we don't see let's say a direct impact on our operation, given let's say a potential water shortage because we can fulfill the necessity with the acquisition of water from third-parties, these EPA (35:35) trucks. Okay. We have already contacted some of these companies. We have already some of them in our watch list in case of needs, just calling and getting this water supply.

In São Paulo we are relying already on these deliverances. But the water, again, is used more in the maintenance of the plant, not the production of products. I think this water shortage issue is more important for the overall economy. And if we have it, in fact, what would be the impact in the economy as a whole. I think this is the issue. But taking Duratex of this context, directly for the production itself, the risk is very low.

Q - Diogo Miura {BIO 17360784 <GO>}

Great. Thank you.

Operator

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

A - Alvaro Penteado de Castro {BIO 5537843 <GO>}

Well, thank you again for accompanying our conference call. I'd like to put myself and the IR team, which is now led by Guilherme Silva, available for potential questions that you may still have. Okay. Thank you. Have a great morning and afternoon for those of you in Europe.

Operator

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