Q1 2017 Earnings Call

Company Participants

- Andre Luis Rodrigues, Managing Director
- Paulo Polezi, Finance and Investor Relations
- Unidentified Speaker, Unknown

Other Participants

- Joao Noronha, Analyst
- Lucas Marquiori, Analyst
- Marcio Prado, Analyst
- Rogerio Araujo, Analyst
- Unidentified Participant, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. And welcome to WEG S.A. 2017 First Quarter Results Conference Call. Thank you for standing by. As a reminder, this conference is being recorded. And at this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session and instructions to participate will be given at that time.(Operator Instructions) We are simultaneously webcasting this conference and the accompanying slides available at WEG's Investor Relations page www.weg.net/ir . We'd like to remind you that we are recording this conference and after its conclusion the audio will be available at our Investor Relations website. Journalists should direct questions to our press office at 55-4732-767295. Any forecasts contained in the document or statement that may eventually be made during this conference call relating to WEG's business perspectives, projections and operating and financial goals and to WEG's potential future growth or management beliefs and expectations as well as information that are currently available. These statements involve risks, uncertainties and the use of assumptions as they relate to future events and as such depend on circumstances that may or may not be present. Investors should understand that the general economic conditions, conditions of the industry and other operating factors may affect WEG's future performance and lead to results that may differ materially from those expressed in such future considerations. We would also would like to remind you that this conference will be conducted in Portuguese with simultaneous translation into English. With us today, Jaragua do Sul, we have Mr. Andre Luis Rodrigues, Managing Director and Financial Superintendent; Mr. Paulo Polezi, Finance and Investor Relations Officer and Mr. Wilson Watzko, Controller Officer. Please Mr. Rodrigues, you may continue.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Good morning, everyone. It's an honor to be here with you for this conference to discuss the results of the First Quarter 2017. We're going to start highlighting the three most important points. The first highlight is the performance of the net operating revenue that dropped 11.7% in this quarter in comparison to the First Quarter of 2016. Even with this drop, the performance in domestic markets continued improving presume at a gradual process of normalization, that is to say after a long and deep recession, the different segments are responding at different paces. With the serial product, short cycle in the first half, expectations are positive but the process is still in the beginning, investment in expansion of capacity for example haven't resumed yet. And the external market, we continue experiencing a low growth environment as a result of reduction in CapEx in important segment such as oil and mining. We managed to grow but the negative effect in the exchange rate in the external market is very important. If we show the conversion of the currencies, we would report growth in consolidated values and there are recurring results on the operation -- movements we made in the last quarter. This is very hard moment but -- as everything is time aware [ph] to preserve the margin and we also need to be ready for any resumption in a recovery. We have to make adjustments but we have to preserve our reaction capacity. Along last year, our concern was -- is to stop the drop in margin. So in the middle of the year, we needed to normalize the margins and all the returns that accompany the normalization of the market. This process continues in the First Quarter of 2017, the EBITDA margin reached 15.5% and the net margin was 12.1% with a positive evolution in relation to the First Quarter 2016 which is the relevant comparison. And the third highlight was the continued discipline in the use of capital which is part of our effort to make adjustments because without the focus on the increase in productivity and efficiency. The working capital management has been one of the highlights of this effort showing gains even in the beginning of the recovery of the Brazilian market. I'll turn the call to Paulo Polezi for him to continue the presentation.

Paulo Polezi {BIO 19468811 <GO>}

Thank you, Andre. Good morning, everyone. Now, on slide 4, we can see the pace of the behavior of the revenue in different markets for the quarter. I start from Brazil. We continue in the modernization process in the market in a slow and gradual manner. We see that the industrial products of short cycle and the serial product continue in the process of recovery especially for more dynamic market such as agriculture and the processing of food. This market continues their natural process when each market responds differently making the diversification of value is a -- to be a relevant model. Demand of engineering product that depend on CapEx is still very limited because they depend on the resumption of investment. Outside Brazil, the global market of electric industrial product shows no growth. In the local currency, we have managed to grow with the entry into new market or with the gain in participation in the market share. In the First Quarter of 2017, the revenue showed a drop in relation to the First Quarter 2016 at 19.6% in real, 22.9% organic growth in real and a growth of 0.1% in dollars and also growth of 1.9% in their respective local currencies. As for electronic-electronic equipment in industrial area, the low economic growth and the downturn in industrial investments limited the performance. Some segments of our business such as mining and oil have shown a small response in relation to the recovery of the commodities. But there is no growth in the market.

The normalization of the Brazilian market is very concentrated inferior products, those with short cycle. Equipments for generation, transmission and distribution of energy the GTD. Starting from generation, there is circles of offer in Brazil that reduces the need of new investments and also orders. We have an expectation from Ag [ph] option that will bring more clarity to the situation of offer in the event of electricity in Brazil. And will pave the way to new options in Brazil. As to transmission and distribution, there is no surplus capacity in the system. The auctions conducted in November and April indeed were successful with new players taking part in the process with positive prospectus reflecting in the portfolio as of next year that may extend up to 2021.

As to domestic use motors, we have seen a stabilization trend continue with -- in line with the consumer good. Abroad, we had some problems with the new fluctuations in the quarter. We have been focusing on developing new processing plant and [ph] market. As for paint and varnishes, we have been focusing on markets and application that we do not -- in which we did not operate, developing products in Latin America, concentrating products that we have already consolidated in Brazil. So we are maintaining our competitiveness with efforts continuing 2017.

On slide 5, we can see the EBITDA evaluation in the First Quarter 2017 and you can see that in spite of the drop in revenues, we maintained focus on the cost and operating expenses. In spite of absolute drop of 3.3% in our EBITDA, there was a considerable increase of EBITDA margins that was 15.5% this quarter. The normalization of business condition in Brazil will provide also the normalization of our margins. Not in a linear manner. But we believe that this will be in a consistent way.

On slide 6, we provide details of the net financial results is part of it in spite of the lower than return period reaching BRL28 million. This was impacted by the mark-to-the-market of derivatives to protect the investments in foreign currency. It has accounting effect because the cash outflow happened only when the settlement of the operation. The positive financial result is a result of the difference between the financial cost with attractive condition and the compensation from investments which was possible because we have -- WEG has a solid capital structure.

On slide 7, we have the analysis of the cash flow. The cash generation from operating activities reached BRL418.8 million in the First Quarter 2017. And we continue gaining an efficiency in management of the working capital that compensate part of this accelerated demand of the market in Brazil. The investment activities reached BRL114.7 million in the quarter. With this, we adjusted the return of investments with expansion and capacity. The financial capacity consumed BRL321.3 million in the period with a net debt of BRL77.7 million in loans and financing.

On slide 8, we can see the capacity expansion in the last quarters. The expansion investment and modernization of -- investment in [ph] capacity reached BRL58.7 million. And 51% was allocated abroad and 49% in Brazil. We estimated that investments for 2017 reaches BRL347.4 million as we announced before. This capacity to adjust the speed of capacity increase has a modular capacity is one of the basis of our business model. We are going to continue monitoring the performance of the market, trying to maximize the ROI. With this, I complete my part and I turn the call back to Andre.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Thank you, Paulo. Before beginning the Q&A session, I would like to reinforce some aspect. As we have said, our expectations for 2017 is that we are going to have a normalized year for the Brazilian economy. That means that the diversification is one of the basis of WEG's model starts to operate again. Those are not still tough, especially in the beginning of this year, we have faced the worst recession in the history of the country and the political uprises imping [ph] the uncertainties. Even so there are reasons for cautious optimism. The second is that there are reasons for optimism as to the industrial electric equipment in the world. There are signs of recovery in the industrial production and the commodities prices are at a high. And our growth has been result of consolidation, we are entering new markets and gaining market share. I would like to reaffirm our confidence in our competitiveness, the growth opportunities will appear in a sustainable manner and we are ready to take them. We can now start the Q&A session. Operator, you may proceed.

Questions And Answers

Operator

Ladies and gentlemen, we are now going to start the Q&A session. We would like to remind you once again that this conference call is being conducted in Portuguese with simultaneous translation into English. (Operator Instructions) Marcio Prado, Goldman Sachs.

Q - Marcio Prado {BIO 15398968 <GO>}

Hello, this is Marcio from Goldman Sachs. I have two questions to ask you. The first question is related to the gross margin that's reported for the quarter. I would like to understand what was the main driver that led to this figures, was it because of head counts, raw material, is there a reduction of any particular cost? And second question is related to the expectations also [ph] increase in revenues. And also EBITDA margin for this year?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Here we go, let's talk about the margin for the First Quarter and the first half of the year impact. It grew in relation to the quarter of last year. So we can view the quarter-on-quarter results as reference. The second factor that we would like to highlight that drove us to reach the margin, first is the normalization. What I mean is the volume of serial product was positive and this helped us and the other aspect was the efforts made to improve cost, like we mentioned some initiatives. First, we re-negotiated the agreement with material supply. The second was a number of productive improvements in the plants, in the shop floor and we continue doing this. And we also reduced the working hours and this is an effort that is still valid to see -- still being applicable for this half of year. But not in all units, this is for the unit of unit and transformers, not so much for motors automation and paints and varnishes. But these are the four factors that drove the margins down. As far as to expectations, I think (inaudible) can say something about this.

A - Unidentified Speaker

We have to make a connection of what happened this half of the year if the Brazilian market continues its normalization process and it is something that we had announced, we had foreseen after a tough period. We expect that this environment is going to bring the market back to normal, the segments are responding at different paces to the economic environment and makes the model of diversification that we have as a fact [ph] be successful. This did not happen last year, since we had a normal period. But this will start working again, we can see that improvement of the serial project of short cycle. However, we do not see any resumption in the capacity expansion environment in the industry or the infrastructure and there was a drop in the First Quarters to generation. Still, we believe that this recovery will continue first for the maintenance CapEx and then we are going to expand into products and businesses. And after this recovery, it's normal to expect that along 2017, we can see improvements in the margins. And we also say that we cannot ensure that every quarter, we are going to have a linear growth, a linear improvement but if we have this linearization or if have this normalization, we can say that the margins will be better than 2016.

Operator

Rogerio Araujo, UBS.

Q - Rogerio Araujo {BIO 17308156 <GO>}

I have two questions. The first question is related to the GTD patch [ph] segment. I would like to know if the transmission auction will compensate the drop in generation that has been happening as I see in the results or if investments in generation will have to be cap. So that we can see the improvements in GTD in the future. This is my question. Thank you.

A - Paulo Polezi {BIO 19468811 <GO>}

There are two different things we have to approach, one is the results in area of energy. It's always seen in the income and orders, which is based on a portfolio built last year, the quality of this portfolio is not as -- it doesn't have this high quality and it -- this affects the income this year. And this also affects the T&D auction, the auction was very positive, it was carried out in October and it was very positive. We had easing of new laws, 21 companies took part, the dynamics for the sector is very positive, very good. But the results will not be reflective in the short run. So what I'd say is that one would not affect the other. The energy sector will require recovery of growth, it will depend on the auction of the contraction that will happen in the first half of the year, in the short time. And we also need higher visibility, we may have new auctions after the second half of the year and the dynamics can improve for the energy sector. T&D had those auctions with positive aspects. We have some pre-agreement -- individual pre-agreements and these bring about growth for T&D sector in the years to come as -- we said in the call that can extend up to 2021. It does not have any effect to offset the other segment. Because this depends on the transmission segment in the country.

Q - Rogerio Araujo {BIO 17308156 <GO>}

The other question is related to raw material, we saw the prices of raw materials rose in previous month, especially steel and copper. But in the last week, we saw some drop. So I would like to know what you expect for the next quarters and you also mentioned an increase of prices with the increase of raw material prices. I would like to know how much of the 22% will be reflected in the electric, electronic sector in Brazil? And what was referred to volume and what was referred to price?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

We cannot provide the breakdown of what is price and what is volume. We can later on provide the data to you maybe. But the price is raw materials in general requires a long-term view. When we see the impact on cost, we understand that they refer to raw materials that were purchased months ago. So some raw materials were purchased at higher dollar and the dollar rate dropped along with time and this becomes a positive aspect in terms of cost, regardless of the fluctuations that are happening in the past weeks. We work with a policy of hedge with a main input and we always look in 12 months span and we work within comfortable range. So there is -- operating our business not very sweet or soft -- swift way but sometimes you cannot notice in the short run what are the variations because of the reasons I just explained. So the increase in prices that you mentioned, what I can say is that historically, the company makes annual adjustments and we have already made the adjustments for this year in the First Quarter. And we pass on to the prices the inflation rate and this is part of the normalization process. And these are being at on in a natural way. And this did not happen in the past years. So cost very well controlled. We do not see any pressure from the raw materials because of the policies we have adopted for managing cost of the company and prices are heads on [ph] in a more natural way.

Q - Rogerio Araujo {BIO 17308156 <GO>}

If you could provide a follow-up on cost. There was an increase in the useful life of the assets, the depreciation rate and amortization dropped. I would like to know if this reduction will be valid for the quarters to come? And this was one of the reason was the gross margin increase.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Yes, Rogerio. That's right. That we analyze the situation, it was the change that we made in the First Quarter. If we see there is explanatory note providing all the details of all the fact that company review the supplies of the company's asset and this is something we did in 2016 and that led to the increase of the use of life and the average of our permanent assets. And the impact was very positive about BRL50 million. And the effect may be similar in the next quarter each one with a BRL60 million [ph] positive results for 2017. It has no impact on the fiscal aspect. Again, in summary, these are the impact and your analysis is correct.

Operator

Lucas Marchiori, Bank of Safra.

Q - Lucas Marquiori {BIO 17907247 <GO>}

I have two questions. First is related to the announcement I think that you made to enter in the Indian market. Paulo, what can you say about it from -- and this is from your message is, it's a plant that you already have there to the manufacturing of aero generators. My question is, is it more worthy to manufacture your aero generators in India because of the power of the brand. So could you explain why you made this change? And the second question is that recently, you announced that you're going to work with solar farms. I would like to know, what's the profitability in relation to the wind power farms? They would be -- there my two questions.

A - Paulo Polezi {BIO 19468811 <GO>}

I'm going to start from the India plant. And let me know if you need more details. So our motivation to enter the Indian market, we announced our plans to manufacture the generators, we already have a plant for long type of products basically generators and high-voltage motors and it made sense to manufacture generators there. We saw this different market abroad and the choice of India to start the wind power business had some motivations. First, it's a large market in expansion, that is fourth largest market in the world. It's a very big market. There is a demand of local requirements, which is very limited and since we have a plant there, this is very positive for us. So we are going to locally produce the product, the generators and the hubs as well. The other components the towers were each [ph] purchased from third parties. Another reason why we chose India as an important market for us are the prices of agreements of energy $35 [ph] per megawatt and also the manufacturing cost which are very productive in the Indian market. With that, we are going to have our plans prepared to start production as of 2018. We do not have any agreements already executed. We took part in the main fair of wind power energy and the idea is to be ready to provide to the Indian markets. So these are my motivations to working with wind power outside Brazil. Second question related to solar power. Here, we are talking about the first major project of WEG. When we -- the contractor of a large solar energy farm, 31 megawatt are the size and we have two units including substation and transmission lines in the State of Paraiba. The project foresee the construction of a third solar energy. No. That will be delivered at the end of 2016. This is our expectation. And for the two -- we already have an agreement. And the third unit has a process which is a bit delayed. And this is going to be an investment of BRL426 million altogether. Your question about the margin, it's margin -- which is very similar to the margin that we see today in the wind energy for the mature market. We started in the wind market in a more limited margin and the solar initiative is comparable to the more mature phase of the wind power activities.

Operator

(Operator Instructions) Rogerio Araujo, UBS.

Q - Rogerio Araujo {BIO 17308156 <GO>}

If you could make two follow-up, please. The first one is related to the external market that we saw in North America and South America market in general. We saw the flat revenues in dollar but in Europe the results were weak. If you could comment on the regions and why we have this large difference between Americas and Europe and then I'll ask my second question to you.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

For the external market, the trends are still the same. We didn't notice any changes in this environment and we can see that the recovery is slow globally. So the world is growing slowly with little investment in capacity investment. And what has been WEG be doing in relation to the growth as Paulo explained in his presentation. We were able to grow more than 2% in local currencies outside Brazil. We search for this growth by being present in market shares. And we develop new markets in the places where we already consolidated. We know -- understand that the recovery of the prices of commodities will reflect in the future. We have to be careful. But I'm going to be -- to give you some examples. In this fair market as far as oil and gas, we saw a little recovery in the sector. As for mining, we also saw some recovery especially in the beginning of the year. Above all, in our branches where those segments are more exposed such as Africa and Australia -- Australia. And what we have seen is that the manufacturers of equipment, engineering companies are looking for labor to meet the demand. So this is a good sign. Other region that we could mention, I believe that I have already mentioned in the last call that last quarter of last year some European countries were reacting positively. And this continued in the First Quarter of this year. The United States and Mexico also continue with a positive trend and they become more competitive depending on the currency and their appreciation. What we can see is that there is a slight recovery. And we want this to materialize, let's wait and in the – that [ph] is known in the market especially as for oil and gas. We cannot forget China. We started new unit in industrial motors in the beginning of 2016. And this plant is working at full capacity. The good news is that those 2% of growth in local currencies that are reported somehow are well distributed when we consider or where we do not take into consideration the exchange rate when we consolidate the results.

Q - Rogerio Araujo {BIO 17308156 <GO>}

And my second question is relation to the fact that is you recorded -- you resumed the activities of research and development. So we saw a history of 44, 45 [ph] when the governance started to make difference to amend the law. And we saw that the investment dropped by half and this recovery in investing in research and development is sign in fact that the government will not provide the fiscal benefit. I would like to know how had been the negotiations with the government in terms of this process of getting the fiscal benefiting relations to the research and development expenses for the next quarters. And what can we expect from this investments or can we expect the same levels or will expect anything from the government in investments of T&D -- research and development, sorry.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

There have been no changes. It's all the same. What can be some variations quarter-on-quarter in the Second Quarter, last year, we reduced the working hours of our employees and this impacted on the result. But for this First Quarter, the research and development is stronger than last year. But there is nothing to report in relation to changes – that [ph] in relation to the government.

Q - Rogerio Araujo {BIO 17308156 <GO>}

From your viewpoint, the government is still providing the incentives?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Yes, no changes have occurred. No changes in our processes in relation to what we had in the past.

Operator

(Operator Instructions) (inaudible) HSBC.

Q - Unidentified Participant

Very quickly about India. In terms of CapEx, how much of the total amount is going to be allocated to India and what -- where the rest will go to?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

CapEx is in the line of others. 40% of this amount is going to be allocated in Brazil and 6% abroad, 40% in Brazil, 31% in Mexico, 14% in China and 15% [ph] in other countries. This is our plan. India is included in the others item as Paulo said, with this initiatives of producing generators in India, we understand that the investment in CapEx will not be so large.

Operator

(Operator Instructions) Joao Noronha, Santander.

Q - Joao Noronha {BIO 17451608 <GO>}

I would like to talk about the transmission auction of Monday, looking the performances of large companies in the stock market, it seems that the market was a bit surprised with the level of discounts that were offered in the auctions. I would like to understand your views on this? What do you expect the reflects of this will be for product, substations and other items that you sell?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Let's talk about the auction, if fact there this deduction that was lower than expected but the analysis that we do of the auction as a whole is that the auction was very positive, quite successful, Joao. It were 31 batches [ph], BRL2.7 million invested. And even with the deduction, it still very successful. From our viewpoint, this process of placing orders, we understand what are the cost of the equipment, the players are well prepared when they submit their proposals, they know to which point they can negotiate. So this is something that we see in a natural manner. And of course if there is any additional competition issue in relation to CapEx, the company will be prepared to deal with that. I'd like to remind you that we made different adjustments in our product line, we have a very competitive product range and we are prepared to negotiate, we are ready to face the scenario that we see in front of us. So we are going to focus on more quality product and we are prepared for this to happen.

Operator

(Operator Instructions) (inaudible)

Q - Unidentified Participant

I would like to take the opportunity to go back to what Rogerio said in terms of research and development, is business model around that more than 1,500 people are working in this area?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Both time equivalent -- people -- 1,000 peoples are fully dedicated to research and development. And this is part of our idea to continue to grow. This is part of our strategy. In the past five years, 60% of revenues, the company comes from products that were developed in the past five years. So we do not depend on benefits to continue this initiative.

Operator

This concludes today's question and answer session. I would like to invite Mr. Andre to proceed with his closing remarks. Go ahead, Andre.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

I would like to thank you all for taking part in this audio conference. We would like to say that we are going to continue the sources in preserving our competitiveness in the long term. The effort to preserve margin returns are going to continue to be a priority to all businesses and we maintain our expectations that the business conditions will normalize. And with this, we will be able to present revenue growth, results and improve our ROI. Thank you very much and see you in the next opportunity.

Operator

This concludes the audio conference for today. Thank you very much for your participation. Have a good day. And thank you for using Chorus Call.