Q2 2017 Earnings Call

Company Participants

- Guilherme Setubal Souza e Silva, Executive Manager-Investor Relations

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. Guilherme Silva, Investor Relations Manager. Please go ahead, sir.

Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Good morning, everybody. Thank you all for coming. We are starting the Duratex results teleconference now, which will present the company's results for the second quarter of 2017. The environment is still unfavorable, with the high unemployment rate and slow recovery of the economic activity.

In this quarter, we had systems disruption to our operations from the political scandals in Brazil, which put the economy in rebounds in doubts (01:10). Thus, we believe that the economic recovery may be further delayed given that the company in this quarter was focused on our internal agenda and cost cutting initiatives.

So, in slide number 2, we will start to discuss the highlights from the period. In the Wood Division, we introduced the price hikes in March and April. However, we have started to face compression on market shares. We will not change our sales policy because this price hike - price increase was leading to boost the profitability. It's very important we will support this price hike that happened in the first quarter and April.

The drop in volumes in the domestic market was partially compensated by an increase in exports during the quarter. It's part of our long-term strategic plan to grow revenues from abroad. Exports are thus expected to grow in 2017 versus last year.

In the Deca Division, the product mix was more favorable in the second quarter compared to the first quarter. On one hand, basic products, products behind the wall like (02:27), for example, had a lower shipment volume. On the other hand, the finished goods show a strong performance due to higher sales of electronic shower. It's important to mention that this is the most recent product we had added in our portfolio and during the winter, sales are seasonally higher. Electronic shower business is performing better year-on-year and it has been a good investment so far.

Finally, the cost cutting and efficiency program that's constituting our internal agenda, the name of the program is Duratex Management System, show a saving of around BRL 32 million during the first half of the year. This has been our main focus and this year we are internalizing methodology and working with (03:20) supporting throughout the business.

Now, let's turn to page number 3 and talk about the consolidated results. We have increased profitability in both division, Wood and Deca. The consolidated EBITDA for the quarter was BRL 178 million and EBITDA for the first half of the year was BRL 326 million. In comparison with the first half of last year, we had improved our EBITDA by 17.4%, achieving a EBITDA margin of 17.5% year-to-date.

We should highlight the savings arising from the Duratex Management System and Zero Based Budgeting program, with a nominal reduction (04:11) of BRL 3.5 million in general in this quarter. The cost cutting initiatives were really important to leverage our performances in a tough demand scenario.

During the quarter, we also had a gain due to a lawsuit that had success in the Supreme Court regarding IPI tax benefit. The positive effect of BRL 33.7 million was accounted for by other operational results. Thus, we ended the first half of the year with a net profit of BRL 17 million. Even though it's important to mention that this result is still below our potential, we can already see some improvement in our operations.

Now, let's move to slide 4 which represents the free cash flow. During the first half of the year, our EBITDA was BRL 84 million higher than the same period of last year. Regarding working capital, we had a cash injection of around BRL 40 million to combat the volatility arising at the end of the quarter. (05:30) levels improved because our sales forecast was higher than actual sales, important despite of the mismatch as part of an unusual provision in such a volatile market.

But it's important to mention that we are adjusting our production plan and our goal of reduction in inventory in 2017 will remain the same. There was also an impact on the working capital horizon from the accounting of IPI tax benefits, which should be compensated in full by the end of the year. So, it's important to mention that this number of BRL 33 million should be compensated over the year.

CapEx remains at the foreign (06:12) cash levels with investment around BRL 200 million year-to-date. This investment related to the (06:19) issue and policy of banks for the implementation of new ForEx (06:25). Although we are working on reduction cost and controlling investment (06:29) in the short term, we have not (06:32) the investment that generates value in the long term such as the development of new ForEx (06:38). We believe we are at the bottom of the economic cycle, and that the operation will recover in line with the economy.

In financial approach (09:50), we consider the cash view (06:51). In other words, of the financial revenues for the period minus the expenses (06:57), therefore, we place slightly higher than the previous year because part of our increase is not based on bank fees, for example, the (07:07).

We also had acquisition effect from the early withdrawal of tax benefit we had in Aracaju in our electronic shower operations in order of BRL 5 million. Consequently, the year-to-date free cash flow is positive with BRL 2 million, higher than BRL 5 million negative since last year. We are working to improve Duratex's cash generation quotation using the following (07:38). First one, operational improvement in our business. Second, reduction in the working capital. Third one, execution of investment to sustainable operation. And last one, liquidation of surplus assets.

Now on the next page, we are going to talk about the total debt. As a result of the cash flow presented to you, we had a slight increase of BRL 74 million in net debt. Our net debt in the end of the quarter was at BRL 2.1 billion and the leverage ratio was 2.89, with a small increase due to a (08:22). Our target is to reduce the leverage to close to 2 times by the end of the year based on everything that I mentioned on the previous slide. The amortization schedule remains stable with a comfortable cash position.

Now, moving on to slide number 7, we will start talking about the Wood Division. In this first slide, you can see a chart regarding the panel market in Brazil, not only Duratex, but the total capacity and the production and sales in the first half of the year. As you can see, the domestic market panels market in Brazil show a downturn according (09:06).

In the quarter, the domestic demand for panels decreased 5.5% compared to second quarter of last year and fell 1.1% year-to-date, although exports grew 34.8% in the first half of the year. But it's not enough to offset the overcapacity of the industry (09:27). The main negative is the MDP, which is running so far with idle capacity of around 36%. This environment reflects the economic cycle that we are currently going through, which negatively impacts our operations.

On the next page, we'll look at the performance of the Wood Division in Duratex. As you can see, shipment in the Wood Division was lower in the quarter due to one-off loss of market share. As you know, we increased price at the end of the last quarter and in a oversupply market, we lost volumes from the immediate (10:17) customers.

Despite this, our pricing strategy will not change and we'll retain the price hike implemented. Furthermore, we are making some adjustments to increase price of some specific product lines like MDF white. We had already noted in July this important information, a balance in the market share with the volumes returning to their regular levels.

We had also been able to partially offset the falling volume if including (10:49) exports. We are growing our volumes in export in this year by 50%. The declining volumes, due to the restructuring market and the loss of market share results a low level of capacity utilization in the quarter. We ended the quarter when 55% of capacity utilization, with a greater (11:14) in MDP that is only around 50%.

Excluding Itapetininga unit, which temporarily shut down, our capacity utilization was 70% in the second quarter. Revenue fell less than volumes due to a price hike implemented. The combination of these factors resulted in EBITDA of BRL 101 million, that represent a EBITDA margin of around 18%.

I emphasize here the positive effect of the IPI tax benefit that we mentioned before, which we spoke about in the beginning of the presentation. If you will exclude this effect in EBITDA on the Wood Division, the EBITDA was BRL 84 million with the margin around 50%, in line of the first quarter of the year. The low capacity utilization continues to undermine our profitability, due to a inefficient fixed cost dilution in a capital intensive (12:16) business. So, that's it from the Wood Division.

Now on page number 10, let's talk about the construction material segment, the ABRAMAT and after that Deca Division. The ABRAMAT index, which measures the performance of the construction material industry, has reduced 7% in the first half of the year. This graph shows the difficult steps we are facing in an industry which (12:48) for our demand. The association has revised the estimates for the year, which previously indicated a flat number and now we're indicating a 5% drop. Despite these results, I'd like to reinforce here that Deca's performance is better than the average of the industry, as you can see on page number 11.

The performance (13:20) in Deca were slightly below our expectations, mainly due to a low shipment at the end of June. However, I'd like to say here that the first months of the year, the volumes grew 9% over the same period of last year, despite the (13:40). We found this quarter was compensated on the segment of basic products, which is hopefully what goes behind the wall like (13:52), for example. We also noted a good performance of electronic showers, which was the last acquisition of our portfolio and we have been performing well in this business.

Revenue grew in the quarter, benefiting from the price increase and better mix, with a higher share of finished goods. Moreover, the mix of ceramic business was better than the previous quarter. Thus, Deca's EBITDA was BRL 77 million in the quarter, with an EBITDA margin of 22%. But if you exclude the effect of IPI tax benefit as we did in the Wood Division, the EBITDA would have been BRL 61 million with a margin of 17.2%. We are already seeing a slight recovery in Deca Division, driven mainly by the strength of the brand and of the sales and marketing initiatives that we have carried out.

And now, let's move to the last slide, which is the message from our senior management. In the Wood Division, we will retain the price hike increase that were implemented at the end of the previous quarter. We believe that it is the right decision and we have already noticed our market share recover in July and in the end of the quarter. The price hikes were helpful for the recovery of the profitability of the Division.

If the pace of the recovery is slower than expected, we are expecting out our efforts internally to reduce more costs. We have approved an additional cost cutting plan, which could bring a reduction of BRL 100 million more than the original budget. In CapEx, our investments will continue to focus on sustaining our operation. Our expectation is to invest something around BRL 420 million this year. Half of this is the formation of new products and half (16:15).

The cash strategy and the leveraging remain the same. We are concentrating our efforts to adjust the company's working capital. We had already seen a constant improvement in the payment terms from around 10 days to close to 60 days. And our initiatives to adjust our inventories continued in our agenda. We are investing time and focus on the better production plan and our new (16:43) will be crucial to achieve this goal.

And finally, we are consolidated the goodwill transformation of Duratex. June was a key momentum in this program because we trained all of our more than 11,000 employees on this new cultural model. The managers lead this process and the feedback that we are receiving is very positive. This project will take the company to another level.

I close here my presentation and I'm willing to answer any questions you may have. Thank you very much.

Q&A

Operator

Ladies and gentlemen, we'll now begin the question-and-answer session. This concludes today's question-and-answer session. I would like to invite Mr. Guilherme Silva to proceed with his closing statements. Please go ahead, sir.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Thank you very much for all to coming for this teleconference. And like to emphasize that myself and Felipe (18:41), we are able to answer any of these questions that you have ahead. Okay. Thank you very much for your time. See you next time. Thank you.

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.