Q2 2014 Earnings Call

Company Participants

- Alvaro Penteado de Castro

Other Participants

- Anne-Mette de Place Filippini
- Paulo Valaci
- Thiago Lofiego

MANAGEMENT DISCUSSION SECTION

Operator

Good morning ladies and gentlemen, and welcome to the audio conference call of Duratex. Thank you for standing by. As a reminder, this conference is being recorded. I would now like to turn the conference over to Mr. Alvaro Penteado de Castro, Financial and IR Manager. Please go ahead, sir.

Alvaro Penteado de Castro {BIO 5537843 <GO>}

Thank you. Good morning to all of you who are accompanying the Duratex conference call. Well, it was a tough quarter. As you can see via the releases, it gives me a tough job to discuss this kind of performance. I will try in the next pages.

As you know, the microenvironment in Brazil deteriorated considerably from the start of the year until now. To start, the GDP expectation was reduced and right now we have an expectancy for GDP to grow below 1%. In some houses, this index is already around 0.9%. Also, inflation is playing around the ceiling of the debt, around 6.4% for this year, which is bad for the Consumer Confidence Index, which is in a low level, better only than the Index observed in the year of 2008, which was the peak of the crisis.

We also had seen here a fewer number of working days, given the World Cup event, which hurt the revenues and the points of sales, specifically in the retail of furniture and also in the retail of building materials. The market or the industry indicators, ABRAMAT, and ABIPA ABRAMAT for the building material industry and ABIPA for the panel-making segment, they show a drop year-on-year of 4.6% in the building material segment for the year of 2014, against the year of 2013. And the ABIPA shows a retraction in the domestic shipments of 4.2% during the second quarter compared to the second quarter 2013. So a much different environment of the one we saw last year in the beginning of the year.

Just to remind you, last year the year began in a very good mood in a way that we were able to push price increases right in the beginning of the year. And right then, we did not have much cost pressure so all of that price increase was translated into margins. So far, 2014 and for the rest of 2013, we did not have any price increases and in the year of 2014 starting in June, Duratex had to start giving away some discounts, more specifically in the Wood division. I will comment on that a little further in this presentation. But the combination of weaker volume, more cost and the effects of these economies of scale and some adjustments we made already given the current level of overall occupancy rate in the plant brought down the EBITDA to R$207 million and the margins down to 21.7%.

Net income for the quarter R$58.6 million. We also announced this morning the distribution of the interest on own capital for a total of R$72.7 million, which gives a gross value of R$0.1097 per share, which for the quotation of the other gives an annualized yield of 2.6%.

Following to that on slide number three, we have a picture of the occupancy rates in both divisions, Wood and Deca. We can see that with this kind of occupancy rate, around 60% in the MDF and MDP segments, 60% also on the sanitary ware ceramics, and around 77% in metal fittings. Of course that we have a great deal of inefficiencies at this point, and because of that, we needed to make some adjustments in our operations to cope up with this kind of operating leverage, which means some layoffs.

And on top of that - or if I may rephrase, you know that last year we concluded a great deal of capacity additions. In MDF, we added a new plant of 520,000 cubic meters. In MDP, we finalized the debottleneckment, which added 230,000 cubic meters more and in ceramics 2.4 million items a year more, and in metal fittings 1.2 million items a year more.

So if we disregard all of these additions, the occupancy rates would have been around 80% in MDF, MDP 67%, ceramics 78% and metals 81%. Of course, that was not the picture. We had those additions and unfortunately, the market didn't catch up. So we were bearing the additional depreciation in our numbers, which amounts to something around R$18 million per quarter, which contributes to reduce the gross margin and the bottom line.

Following to that, we have a picture of where the revenues is being generated from. The Wood division in Brazil generated R$554 million during the quarter, Tablemac in Colombia R$65.6 million, and the Deca division R$337 million. One comment here is that Tablemac, for this quarter, we consolidated the months of March, April and May. We are always one month behind the Brazilian schedule. And during the first quarter, since we bought the additional stake, achieving 80.62% participation in that company only in January, we, in the beginning of January, consolidated only January and February. Okay. December was recognized by the equity methodology. But in the end, we can see the variations of the gross margin, and again quarter-on-quarter hurt by this increase in inefficiencies and year-on-year, because of a lack of price increases and additional costs in the system.

Slide number five, we have a reconciliation, if I might put this way, between the Brazil operations, the Colombian operations to get to the consolidated data, okay. In the end, we can see that volume, although we are about the same level of 2013, and on the consolidated way and then realizing the Brazilian operations standing alone, we can see that year-on-year volumes went down by 8%, okay, remembering that by the second quarter 2013, we did not have the additions of Itapetininga and Taquari.

Also in the Deca division, volume dropped by 9.6%, and again by the end of the year, we had Taquari. So all of these new operations again contributing to increasing depreciation in the system, and more specifically in the month of June as a means to safeguard our market share, we had to give away some discounts contributing to a decreasing margin environment quarter-on-quarter.

On slide number six, we have the picture of demand for MDF and MDP segments. The comment here or the highlight here, negative highlight is on the MDP segment. We can see that on a quarter-on-quarter basis, volume dropped by almost 5%, year-on-year by 16.8% when we analyze second quarter's, and 11% down when we analyze first half year's.

The story here is that we saw during this period and more visibly from the month of April onwards, an adjustment on the inventory level in the retail side of mass production furniture. As we learned, this channel was expecting already softer revenues in the month of June and July, and they postponed the replenishment of their inventories.

On top of that, they gave more focus in the revenues of the white line goods and more specifically, TV sets to accompany the tournament, the World Cup. And furniture was left a little behind, and the information we have so far is that they might put some focus in furniture revenues now in the second half of the year.

It is an expectancy; we have very little visibility at present point, but given that the market, the furniture market was incentivized with the ITI benefit until the end of this year, and given that furniture provides more margin for retailers, we believe that they should focus just with the revenues of such basket outputs in the second half.

The MDF was less hurt. We can see that on a cumulative that year-over-year, first half year, it is still growing, 3.3%, which is good, and probably is translating in our increasing unitary revenue under the analysis we made in our fact sheet. So unitary revenues produced in the Wood division despite we had to give away some discounts starting in the month of June. On top of that, of course, we have an increase on the sales mix of more aggregated value products that contributed also for the unitary revenue increase, but with more cost in the assistance which strained March.

On slide seven, we have all this information. We can see that the Wood division in Brazil generated a gross margin of 28.9% during the second quarter 2014. Lower than the gross margin from the Colombian operation, which in the end generated a 29.3% gross margin for the Wood division as a whole. Recurring EBITDA at almost R$150 million and a margin of 24.1%.

Here again, the speech is the same. We had more cost. We had inefficiencies of scale. We had to adjust our labor force to this new reality. The adjustment was minor, if I may put at present, because we still have this expectancy for a better second half year, so did not make a strong adjustment expecting for the restoration of the market.

Next slide number eight. We have the ABRAMAT Index. Again, this measures the performance of domestic revenues of building materials. June, is accumulative data, so between January and June 2014, the performance was down by 4.6%. So the overall market is experiencing the momentum.

The expectancy for 2014 where you read 3%, we learn that it is already at 2%, so they're even the decreasing the expectancy for the year, following this poor performance of the first half year. Again, here we have, of course, an impact from the number of holidays more specifically in the month of June, but also decreasing number of revenues of real estate during the period.

And this is important because normally the revenue of new and old real estate, they demand remodeling work and since the number of revenues decrease business sector, also the remodeling business, which is very important to us. You know that about 65% of all revenues in Deca are geared by the remodeling business and 35% is geared by revenues towards new real estate.

So when remodeling suffers, of course, the impact on Deca is more strong. Like in the Wood division, we expect the performance in Deca to improve during the second half, more specifically on the remodeling segment, following a more normalized number of working days.

But here, we have also a negative impact coming in, or seen in the margin. You know that labor represents about 40% of the cost of Deca. We had already a number of salary increases during this period, more specifically in the ceramic segment, and this has contributed to push down the margins a little bit. On top of that, like in the Wood division, we did not have a more positive environment to push price increases to compensate for these present cost pressures that we are experiencing.

Now, on to debt on slide number 10, we have the debt profile of the company. Quarter-on-quarter, gross debt remains basically stable, increasing by - or decreasing even a little bit by R$21 million but increasing by almost R$400 million when we analyze the data at the end of June 2013. This increase is basically due to the CapEx during this period and the payment of extraordinary dividends in the beginning of the year.

So we decided to leverage the company a little bit up. The debt level is still very adequate for our size, in our view, representing only 41.6% of equity. And when we analyze net debt over EBITDA in last 12 months, we can see that it reached 1.76 times basically because of softer EBITDA; not that much because of the debt level as we can see quarter-on-quarter.

The amortization schedule is very okay in 2014. We have some concentration in 2015, but most of all of this maturing debt is renewable. We might revolve this in lines between two and three years, if not a little longer as the less lines that we got ranging even five-year time. The origin of the debt, only 2% in Colombia, foreign-denominated currency 22% fully hedged, and the rest is basically domestic taken debt.

Next, slide 11. We have the CapEx during these last years, last six years. If we consider what we spent during 2008 and 2013, R$3.8 billion, one remark that I would like to make right now is that the company is absolutely prepared in terms of technology capacity to capture momentum. As a cyclical business, like industrial businesses in Brazil, we believe that we are going through a period of adjustment of a weak period, given this macroenvironment that should pass eventually in the short run.

One thing that we know is that revenues for our wood is not something that you decide from one day to the other and if you don't do, you lose the revenues. No, this is a more structured kind of pay us for our product, so whatever we didn't sell in this first half, we believe that we'll capture momentum in the quarters to come.

We have capacity. Again, we have a business model that is very integrated with a lot of competitive advantages when comparing to our competitors in both businesses within Deca. So it's a matter of time for us to start capturing such momentum.

On the CapEx for the year of 2014, we made already some adjustments. First quarter, we had an expectancy of investments around R$700 million. This was revised down already to R$650 million. Of course that we are reanalyzing all of this CapEx still, and this number eventually might come down a little bit but we don't have a more fresh information to pass to you.

Of the highlights of what we've already spent. We have the R$151 million for the acquisition of that additional stake in Tablemac, R$58.8 million for the acquisition of the Caxuana forest. All of those happened in the first quarter, and all the minor investments, R$156 million. For debt, CapEx of R$1.3 billion that we announced in the first quarter for the erection of two new mills in the state of Minas Gerais. What we have to say up to this point is that we are analyzing the macroenvironment. And up to this point we have total flexibility to push that investment more down the road, if we see a more tough market in the years of 2016 and 2017.

Up to this point, we're still with a short visibility for that period. The original schedule for that investment would have been start seeing disperse in cash around the first quarter next year, so we still have some time maybe to give more color to you in the coming conference calls. But up to this point, I'd like to make clear that we have total flexibility towards that investment.

Following to that on slide 12, this simply wraps up what I just said. We have the capacity. A lot was done between the years of 2012 and 2014. You can see here that we are not including any more the timeframe for the two new mills, waiting for a more clear view on the future.

And finally, I would like to finish this presentation stating that we have a balanced capital structure, which might enable us to explore many opportunities. This is no news. We've been telling this for the last 2, 3 years, 4 years that we are very geared to grow the Duratex, both ways organic and the M&A. Organic, you saw and you see what's been done in the company. M&A, we had some opportunities in this year past. This year, we acquired the majority stake in Tablemac. We acquired also additional forestry assets that will contribute to supply new additions of capacity in the future, but of course that we want more.

We have a number of possibilities on the table, but nothing concrete at present. Okay. We have again a high degree of timberland integration with excess wood supply ability to meet future expansions. I'm talking specifically about the Minas Gerais project. We might postpone, but this is a project that will come to the market. It has clear competitive advantages via low cost of supplying wood to the mill and this mill is to be placed in a very, or very close to important consuming centers, which is translating the next bullet: Proximity to customers with geographic diversification. And finally a trained, focused and motivated team.

With that, I finalize my presentation and I now open to the questions 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 Mr. Thiago Lofiego, Merrill Lynch.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Hi. Good morning. Thank you for the question. The question is more on the strategic side, so what kind of a leverage level do you consider for you to be comfortable before you take on new investments or acquisitions? I know you mentioned, of course, with a more cautious scenario, you have flexibility, but I just want to understand what kind of leverage that would you not be comfortable on taking on. You know growth decisions or acquisitions in the next couple of years. And then the second question if you could confirm the CapEx budget expected for this year and for 2015, please.

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

Hi Thiago, thank you for your questions. Addressing the first issue of yours, leverage. We have a policy, internal policy approved by the Board which defines the ceiling of three times net debt to EBITDA. Okay? So we are geared by this policy. Right now we have 1.676 times increase quarter-on-quarter again because of softer EBITDA generation. We don't have a target for an optimal capital structure. What we did in the first quarter was leverage the company a little better, distributing more dividends and disbursing cash in the acquisitions we made following more or less a demand of the market to leverage the company a little bit up and work with a more suitable financial leverage ratios.

With regard to an M&A possibility, we might – if there's a big one, we might even go above the ceiling, but of course that we would need the approval of the Board and that must be something functional, okay. If not, of course, it's three times, we will have to add this potential target leverage condition to the overall leverage condition of the resulting company. But three times is an issue ceiling for us; it's a guidance for us.

With regard to the budget. In the beginning of the year, as I said before, we had an expectancy of R$700 million. We did our first homework here. We reduced already this CapEx to something more close to R$650 million. And we are still working on revisioning these numbers to see if we can push this down a little further for this year. Right now, I don't have a better number, R$650 million is the one so far. I think that was it, right, if I did not forget anything?

Q - Thiago Lofiego {BIO 16359318 <GO>}

Yes, that was it. Thank you, Alvaro.

Operator

Next question comes from Mr. Paulo Valaci, Brasil Plural.

Q - Paulo Valaci {BIO 18268142 <GO>}

Alvaro, thanks for the follow up here. My first question is on the sales mix in the Wood division for the remainder of the year. I was wondering how we could look at the portion that is in exports. We saw a rise in the export mix in the second quarter and that impacted a little bit of your selling expenses. I just wanted to see if there's an expectation already established for the remainder of the year, where you see that going.

And then the second question is on the M&A discussion that was initiated in the first call and extended here. If you could comment on the size of the sort of M&A that you guys are considering over the – for your next growth step.

If there will be sort of those bolt-on acquisitions that Duratex is known for or if something larger will be even considered strategically. Even beyond the discussion of leveraging, if there's anything like an asset that's strategically important for you guys in that discussion. Those are the two questions. Thank you.

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

Hi, Paulo, thank you for the question. Well, with regard to the sales mix, specifically in the Wood division, we have more revenues of MDF, okay, with a better unitary revenue when compared to MDP. And also, if you analyze the material we released, the fact sheet, you will see that the volume of coated products was much higher or performed better than the revenues of standard products.

Just to translate that into numbers, quarter-on-quarter the revenues of standard products decreased by 2.3%, and the revenues of coated products increased by 7.9%, okay. On a cumulative data, six months, standard decreased 0.4% and coated increased by 4.2%, okay.

So that contributed to push unitary revenues up, okay. This is the reason why you don't see a reduction in this indicator, given that we had to give away some price discounts starting in the month of June this year. Again, since we have a very short visibility right now, we don't expect at present to recompose these prices, at present. We need a little more follow-up from the market to see how revenues perform during the second half, to see the possibility or not to recompose this price base.

With regard to exports, yes, we are exporting more. Export revenues now account for something more close to 7% than 5% in the last quarters. The main regions where we are exporting to are Colombia, to complement our product line in Tablemac. You know that we have a capacity constraint there. We have only two plants, very small. In total, an output capacity around 250,000 cubic meters in that market, total MDF plus MDP. It's very little when compared to, for example, the last plant that we had at Itapetininga, that standing alone has a capacity of 520,000 cubic meters, okay, so more than double of the total capacity that we have in Colombia.

So we are complementing our product line in that market and we are also taking advantage of the recuperation of the real estate market in North America, exporting more to that region.

Looking forward, we might expect revenues to increase a little further, but that should not be something very meaningful. I don't see exports reaching at present something like 10%. I don't see that happening presently, because those markets also face competition from other markets, okay. When we talk about the North American market, we are facing competition from the already-assembled furniture coming from China. We face competition from within the domestic markets from other producers and also from Canada.

When we talk about Colombia, we see competition from Chile, from Peru, from Ecuador, where – or who are traditional exporters to the Colombian markets. Finally, when we talk about M&A, again, our strategy here when we think about Brazil, we are more open. We have more possibilities, because we can explore not only core businesses, speaking of panels, ceramics, and metals, but we also can explore synergical businesses. Businesses that complement our product line via a new kind of product like we did with thermal system adding to our product portfolio, electric showers and solar heating systems. But you know that we are eager to enter in other businesses. Of course, this willingness of ours is more linked to the construction industry, so if something happens or we have more chance to see things happening on the Deca front.

When we think about core businesses, then we are linked. Or when we think about core, this is what we look abroad. Abroad, we are not looking for anything synergical, only panels, metals, and ceramics. We are more limited when analyzing possibilities in Latin America, North America, or even Europe. It's difficult to say about potential sizes. What I can tell you is that management has already mapped the potential targets that we would like to see in our portfolio. We know the companies that would like to sit with us on board.

But you know that on the M&A discussion, it depends on a lot of things to be successful in the bidding or not. You know that in the past, we were interested in some big possibilities like a Grohe that unfortunately was acquired by Lixil, a Japanese company. So we don't have a limitation. We are more eager to see the opportunities, participate in deals that make sense for the creation of value in the end.

Q - Paulo Valaci {BIO 18268142 <GO>}

Thank you, Alvaro, very clear.

Operator

Next question comes from Mrs. Anne de Place, Burgundy.

Q - Anne-Mette de Place Filippini {BIO 17688973 <GO>}

For this call, my question is around sort of just how you may or may not be impacted by potential energy rationing or shortages leading into the second half of the year.

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

Hi, Anne. Thank you for your question. You know that we have energy contracts. So when we think about this issue via contracts, at least we have the price of energy safeguarded. Of course, that in the event of an energy rationing, which is less likeable right now than in the beginning of the year, if that comes, the impact we believe will be more intense in competition because – this is only thoughts, okay. There's not a certainty at this point or more clarity in this discussion, because we don't know the terms of a potential ration. We don't know what the government might demand some companies to do.

But in our case that we have a number of plants, we might shut down more inefficient plants and run other plants with a higher degree of occupancy rate, and in the end not lose revenues for the point of view of output capacity. Okay. Of course, that we have to analyze the impact on the chain to see a potential impact in demand.

But when we analyze the way Duratex is structured and the way our competitors are structured, we believe that we might be better off than competition. For example, there are some companies that have only one line of MDP or one line of MDF. And these companies, if a rationing comes, they might have to operate these lines in a more inefficient way, causing additional inefficiencies than ours.

So right now, the discussion is more on a qualitative basis, not much on a quantitative basis, because again we don't have any clue of how the government might demand, if they should demand a rationing situation.

Q - Anne-Mette de Place Filippini {BIO 17688973 <GO>}

Okay, thank you. Alvaro, could I ask a follow-up question just in terms of capital expenditures for next year, so 2015, absent of any acquisitions of course?

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

Well at present, we develop our budgets on a yearly basis and we should start the process for 2015 around the end of September or mid-September to have more color on what should be the picture of this team more towards the month of November or beginning of December. Right now, what I can tell you is that with regard to the maintenance CapEx which is around R$230 million, this should be capped. This is a recurrent kind of CapEx to keep the plant in the state-of-the-art. So my belief is that we should not reduce this maintenance CapEx even in a market downturn.

So the question remains about additional CapEx. The most important project at present is that one of R$1.3 billion that if we should keep the schedule, about 20% of that should be spent in 2015. So it's an additional R$260 million. That presently is on hold, okay. We are analyzing the market, analyzing the macroenvironment, trying to figure out what the market will be by the year – by the end of 2016 beginning of 2017 to see if we keep the original schedule, or if we postpone a little bit. If we decide to postpone this R$1.3 billion CapEx, then of course, the expected CapEx for next year should be considerably reduced approaching to the maintenance CapEx level, okay?

Q - Anne-Mette de Place Filippini {BIO 17688973 <GO>}

Okay. Thank you.

Operator

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

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

Well, thank you for accompanying our call. I make myself available and the team for the questions that you may have. Sorry to bring you such bad numbers up to presently, but we are working here to improve or to go through this difficult macroeconomic environment in the best way we can. Thank you so much and have a great day.

Operator

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