Q1 2016 Earnings Call

Company Participants

- Andrew Murchie, Chief Executive Officer-Marfrig Beef
- Eduardo Miron, Chief Financial Officer
- Frank Ravndal, President & Chief Executive Officer
- Marcos Antonio Molina dos Santos, Chairman
- Martin Secco Arias, Chief Executive Officer

Other Participants

- Diogo Vaz da Silva, Investment Professional
- Isabella Simonato, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Marfrig Global Foods S.A. Conference Call to present and discuss its Results for the First Quarter of 2016. It's worth mentioning that in compliance with Law 11,638/07, the financial statements reflect the adoption of the International Accounting Standards, IFRS, and has been reviewed by independent external auditors.

The audio for this conference is being broadcast simultaneously through the Internet in the website, www.marfrig.com.br/ir. In that address, you can also find the slideshow presentation available for download.

We inform that all participants will only be able to listen to the conference call during the company's presentation. After the company's remarks are over, there will be a Q&A session. At that time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Marfrig's management and on the information currently available to the company.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Marfrig and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Marcos Molina, Marfrig Global Foods' Chairman.

Marcos Antonio Molina dos Santos {BIO 15363967 <GO>}

Good morning, everyone. Once again, I'd like to thank everyone for your participation in the call. Before I pass the call over to Martin, I want to highlight some points.

Marfrig recently announced its new organizational structure. As the Chairman of the Board of Directors, I believe that this change is in line with the company's goal to have a leaner structure and will allow our executives to manage the business with greater efficiency and agility.

It is important to emphasize that nothing has changed in terms of the company's strategic direction. Our commitment to deleveraging, lowering the debt half, and generating positive free cash flow remains our top priority.

As for the first quarter results, I highlight the continuous outperformance in Keystone and the ongoing strategy in Marfrig Beef, which, despite the challenging scenario in the Brazilian economy, has proven successful in effectively serving the food service segment and growing export.

I will now hand the call over to our CEO, Martin Secco.

Martin Secco Arias {BIO 18098476 <GO>}

Good morning, good afternoon, ladies and gentlemen. I would like to start by thanking everyone for participating in another earnings conference call of Marfrig Global Foods. Today, we will commenting on the results of the first quarter of 2016.

The CEOs of the business unit, Frank, Andrew, Marcelo, are with me and will present the result of their respective units over the course of the call. Eduardo Miron, our new IRO and Global CFO, is here with us. And Roberto Marielo, our IRD (05:24) Director is here as well.

Please go to the slide number three just to begin the presentation. On this slide, I will comment on the main metrics of our guidance for the first quarters of 2016. Consolidated net revenue was BRL 4.9 billion, a lower sales volume affected by the quarter's seasonality, mostly in Marfrig Beef was offset by the higher average sales price in Brazil and the Brazilian real depreciation against the dollar.

Adjusted EBITDA was BRL 443 million, with a margin of 9% in line with our expectation for the year, a solid performance in Keystone and a good operational result in Brazil, combined with our continued discipline in fixed cost contribute to the result compared to the first quarter of 2015. In term of CapEx, the amount invested in the quarters came to

BRL 108 million. Free cash flow was negative in BRL 122 million, which is in line with our expectation for the first quarter, reflecting this period seasonality as I already mentioned before.

It is important to highlight, however, the 28% increase in operating cash flow, which amounted BRL 298 million in the first quarter of the year. I want to emphasize that we remain commitment with the guidance for 2016, focused on delivering on positive cash flow generation.

Before moving to the next slide, I would pass the call over to Eduardo Miron, Marfrig Global Foods' CFO.

Eduardo Miron

Thanks, Martin. Moving now to slide four, I will give more details on the composition of our net revenue. As you can see, Marfrig's net revenue was BRL 4.9 billion, increasing 16% from the first quarter last year. The highlights were the depreciation of the real against the U.S. dollar, the better average sales price in Marfrig Beef Brazil, and the ongoing and successful strategy achieved (08:04) in Keystone to grow its key accounts.

Keystone, which is one of the largest global suppliers of high value protein products, with a production platform located in United States, Asia and Oceania, accounted for 50% of the consolidated revenue, which is 11 percentage points higher than the first quarter of 2015. Marfrig Beef, responsible for the remaining 50% of the total revenue, posted revenue growth of 6.4%, with lower sales volume offset by the higher average sales price.

Regarding currency, note that only 19% of revenue was linked to the Brazilian real, which is 5.3 percentage points lower than in the first quarter of last year. This trend reflects Keystone's continued good performance and Marfrig Beef's ability to take advantage of the good opportunities in the export channels and to prioritize the most profitable channels despite the adverse economic scenario in Brazil. The international operations, Keystone and Marfrig Beef International combined, accounted for 62% of total revenue, up from 58% in the first quarter of 2015, just confirming the high level of internationalization of Marfrig.

Let's not go to slide five, please. On slide five, I will comment on Marfrig's consolidated gross income and adjusted EBITDA in the first quarter of this year. Gross income was BRL 576 million, advancing 21% over the prior-year period, with margin of 11.7%. The main factors contributing to this performance were the depreciation of the real against the dollar, the lower cost of raw material in international operations, partially offset by higher cattle costs in Brazil. SG&A expense as a ratio of net revenue stood at 5.2%, in line with the same quarter last year. In this context, adjusted EBITDA was BRL 443 million or 25% higher than in the first quarter of last year.

The solid performance in Keystone combined with the good performance of the beef operations in Brazil were partially offset by the lower contribution from the operations in Uruguay. In addition, I would like to highlight the increase in Keystone's contribution to consolidated EBITDA that increased to 50%, compared to 39% in the first quarter of last year.

Going to the slide six. In this slide, I will comment on the company's net result. In the first quarter of 2016, Marfrig posted a net loss of BRL 106 million, which represents an improvement of BRL 465 million from the prior period. The main drivers of this improvement were the operational performance and the financial results.

Now, I will hand the call over to Frank Ravndal, Keystone's CEO.

Frank Ravndal {BIO 19230519 <GO>}

Thanks, Eduardo. Good morning, everyone. Keystone had another very strong quarter. Adjusted EBITDA increased 17% compared to the first quarter of 2015, and the EBITDA margin reached 9.1%. This was a record first quarter performance for the company. Keystone's business model executed with financial and operational discipline continues to pay off, generating consistent and sustainable returns. Let's review the overall quarter performance in more detail on slide seven.

As a reminder, all financial data presented for Keystone is in U.S. dollars. Starting with the graph on the upper left, net revenue decreased by 6% compared to the first quarter of 2015. As you know, Keystone's business model includes pass-through arrangements for commodity inputs and some commercial contracts with several customers. Therefore, revenue is linked to meat and feed prices and in the first quarter, we continued experiencing a market environment of lower price levels for these commodities. In the U.S., for example, feed cost dropped by approximately 16% and outside meat costs fell by approximately 15%.

In addition, revenue in APMEA was lower than the same period in 2015 when we saw significantly higher level of promotional activity across the quick service restaurant channel, especially in China, when compared to this current quarter. In terms of volume, the quarter was very similar to year ago levels, showing 1% increase. Continued key account growth in the United States helped to offset slightly lower volume in APMEA, particularly in China, as explained by the lower level of promotions mentioned previously.

Moving to the graph on the right side of the page, you can see the EBITDA and EBITDA margin results. We generated adjusted EBITDA of $57 million in the quarter, up from $48 million in the first quarter of 2015, an increase of 17% year-over-year. This is a record high first quarter.

To give you a quick historical perspective, in the first quarter of 2012, Keystone's EBITDA was $34 million with a 5.5% margin. This highlights the very steady year-to-year increase in margins from 2012 through 2015. This quarter's strong performance is mainly explained by three main drivers; first, better sales mix in the U.S. key accounts and Thailand and Malaysia; second, a positive commodity market environment, which led to a 16% drop in feed cost and also lower outside meat cost; and third, an unrealized mark-to-market gain on grain hedge contracts, representing a positive year-on-year variance of $1.8 million.

In summary, this is a great way to start 2016. And I would like to take the opportunity to thank the entire Keystone team for the strong result. Andrew Murchie, CEO of Marfrig Beef (14:58).

Andrew Murchie {BIO 18098471 <GO>}

Thank you, Frank, and good morning, everyone. On slide eight, I'll comment on the result of Marfrig Beef, which is swarmed (15:12) by the operations in Brazil and (15:16). Net revenue in the first quarter of 2016 was BRL 2.5 billion, increasing 6% on the same period last year. The lower sales volume influenced by the lower cattle supply Brazil was basically offset by the better average price in Brazil, which reflects the better sales mix, focus on serving more profitable channels such as exports, food service and small retailers and also by the depreciation of the real against the dollar.

Between the periods, I like the (15:51) growth in export share in both divisions, which accounted for 54% in the units revenue in the first quarter versus 48% in the previous year. In the specific case of Marfrig Beef Brazil division, export accounted for 50% of the unit revenue, reflecting the company's flexibility to serve the best markets during this adverse moment in the Brazilian economy.

Also in the Marfrig Beef operation Brazil, I want to highlight the ongoing and successful strategy to expand sales in the food service channel, which accounted for 40% of Brazil domestic market revenue during the quarter. In the quarter, adjusted EBITDA amounted to BRL 222 million, up 3% on first quarter 2015.

The lower sales in – in volume in Brazil and the weak performance of the Uruguayan operation affected by the price decrease in international market were offset by the better sales mix and the real depreciation.

Before moving on to the next slide, I will pass the call back over to Eduardo Miron.

Eduardo Miron

Thank you, Andrew. We – the slide now – nine shows Marfrig liquidity and debt maturity schedule. We ended the first quarter of the year with cash and equivalent in an amount big enough to cover our debt through 2018. Although we acknowledge that this is a conservative position, we saw it as necessary given the overall condition of the Brazilian market. In that regard, we continue assessing the market and the best alternatives to move forward with our Liability Management process.

On March 31st, gross debt stood at BRL 11.7 billion, decreasing 3% and 13% versus fourth quarter 2015 and first quarter 2015, respectively. Measured in U.S. dollar, gross debt stood at $3.3 billion. Marfrig net debt closed at BRL 6.5 billion, decreasing 8% and 39% when compared to fourth quarter 2015 and first quarter 2015, respectively. In U.S. dollar, net debt stood at $1.8 billion.

In the first quarter 2016, the company's leverage, measured by the ratio of net debt to adjusted EBITDA, excluding the positive effect from the capital gain on sales of assets sold in 2015, was 3.47 times or 0.5 times lower than the previous quarter. The average cost of the debt was 7.64%, 24 basis points lower than the 7.88% posted in the fourth quarter 2015. Regarding debt maturity, the average term was of 50 months, in line with the previous quarter.

Let's go to the next slide, please. On this slides, I will comment on the cash flow in the first quarter of the year. The cash flow from operations before interest and CapEx was BRL 298 million, impacted by seasonality of the beef industry during the quarter. Working capital had a small but negative impact of around BRL 9 million. Regarding CapEx, we invested BRL 108 million in the first quarter to keep the high operational efficiency of our facilities.

Financial expenses amounted BRL 312 million, affected by the average exchange rate of BRL 3.91 per $1 versus BRL 3.84 in the fourth quarter of 2015 and BRL 2.86 in the first quarter of 2016. The concentration of the low season in the beef industry, together with the continuity of the investment plans and the interest expense explained above, led to a negative free cash flow of BRL 122 million during the period.

I would like to finish saying that our financial and operating discipline, which led us to deliver our guidance in 2013, 2014 and 2015, remains one of the main strategic drivers for the company. I reaffirm our full commitment to achieve this year's guidance.

Before moving to – moving on to the next slide, I will pass the call back to Martin.

Martin Secco Arias {BIO 18098476 <GO>}

Thank you, Eduardo. On the last slide, we will comment on Marfrig's priorities for 2016. The macroeconomic scenario remains challenging. However, the expectation is for developed countries to maintain their moderate expansion with GDP growth rate of 2.4% in the United States and 1.5% in the Eurozone according to the latest IMF report.

In the case of China, despite growth being below its historical average, partly influenced by the lowest commodity price, its development policy remain focused on domestic consumption which should continue to drive growth for the fresh beef and frozen products.

In Brazil, the economic scenario remains negative, which will continue to affect domestic demand. In this context, we remain commitment to the strengthening Marfrig by focusing on profitability by capturing operational efficiency and productivity gains, prioritizing grow in value-added channels at Marfrig Beef and droving (23:04) on its capacity to continue growing in the international markets as well the improvement in the Uruguayan operation, continuing to expand Keystone food service business in both United States and Asia and maintain our strong focus on financial discipline controlling cost and delivering. And in this scenario, our expectation is that Marfrig will continue delivering good result, and we remain commitment to delivering this year – the guidance of this year announced in last February.

Our presentation – we would like to begin the question-and-answer session where me and my team will be available to take your question. And thank you again for joining us in this call.

Q&A

Operator

Thank you. Our first question comes from Fernando Ferreira with Bank of America Merrill Lynch.

Q - Isabella Simonato {BIO 16693071 <GO>}

Good afternoon, everyone. This is actually Isabella Simonato. I have two questions. First, on the beef side, if you could give us more color on how you're seeing the outlook for Brazil and Uruguay in the short term, in the next few quarters, and how to expect profitability if we assume FX stays closer to BRL 3.50 (25:01), how that changes your view for the year?

And second on Liability Management, what are the next steps that we can expect on that? I mean, you did important asset sales last year and also buyback of some bonds. What can we expect from now on? Thank you.

A - Andrew Murchie {BIO 18098471 <GO>}

Isabella. Hi, Isabella, it's Andrew. Isabella, in terms of catalysts in Brazil, we see normally the first semester of course is the most challenging one. The type of negotiation that we have with farmers is open-pasture animals. So it's normally to have a little bit more of difficulty in terms of volumes. But there was a lot of rain by the end of last year and in the first trimester. So we expect to have a lot of regular, let's say, offers in terms of availability of animals for the second trimester.

That will be the break between the open pasture to feedlots where we also expect to have stability. The capacity installed in Brazil is quite in line with the availability. The cycle of capital is still very – on the positive side, let's say, there's still being retention in terms of cows, and we expect that this massive volume should be coming. This end of the cycle should be in 2017. So we expect normal offers during 2016 and a higher volume coming by the year of 2017.

Yeah, Isabella?

Q - Isabella Simonato {BIO 16693071 <GO>}

Yeah. Thank you. And what about Uruguay?

A - Andrew Murchie {BIO 18098471 <GO>}

Regarding Uruguay, it's not the lowest season in Uruguay, normally. The normally lower season in Uruguay is over September and October, but we really have a very bad time in Uruguay regarding the – the weather was very, very surprised in the last two months. We have a lot of raining that was unexpected on Uruguay. And the offer of the animal are very – very – very low. But today, the situation was absolutely normal. We are going to the biggest slaughter time in the year, that is mean May, June, July, this is our strong season in Uruguay. For that, the business in Uruguay is absolutely normal now.

Q - Isabella Simonato {BIO 16693071 <GO>}

Thank you. And my second question was on the Liability Management.

A - Eduardo Miron

Okay.

A - Frank Ravndal {BIO 19230519 <GO>}

Isabella?

Q - Isabella Simonato {BIO 16693071 <GO>}

Oh, sorry. No, I thought you heard me first. The Liability Management, I would like to understand what are the next steps from now after you did the asset sales. And the beginning of the Liability Management just started last year. What are the next steps from now on?

A - Eduardo Miron

Isabella, Eduardo Miron speaking. So the Liability Management is a process, and it continues (28:51) following the market. Our bonds, they have reacted positively, so they are performing very well. I think the overall condition seems to become a little bit better, and we'll be ready to take the opportunity as it pops up.

Q - Isabella Simonato {BIO 16693071 <GO>}

Okay. Thank you very much.

A - Eduardo Miron

You're welcome.

Operator

Our next question comes from Diogo Vaz da Silva with Eton Park.

Q - Diogo Vaz da Silva {BIO 17905067 <GO>}

Hi. I just wanted to understand if it's possible - and when you look at the cash flow statement of the company and that at - and you see there's a gap in between what you guys report as EBITDA and what's the cash flow generated. So, for instance, if you just look at the last page of the presentation, can you see what was net income and what were the adjustments for non-cash items? And if you just add those two up, for none of the period EPS even close to (29:54) EBITDA, and I was just wondering what other cash items are there that are below EBITDA line?

A - Eduardo Miron

Diogo, as you know, I mean EBITDA is not necessarily a cash flow. So we have a full reconciliation of this in our report. So you can see exactly what is - what are the non-cash that is shown in the cash flow slide. What we tried to do in this slide is to show - is to have as much as link with the financial report so that you and I (30:38) can fully follow. At the same time that we have the interest expense that is we use the accrual for interest expense. So it's more in a managerial way. So that's the way we present the cash flow for the market and that's been the practice for a while.

Q - Diogo Vaz da Silva {BIO 17905067 <GO>}

Right, I was just wondering, do you have any other big financial expense that is, for instance, not reported as interest. Are - I mean even if it's a big number, if I were to think about cash flow as being EBITDA, then taking working capital, interest, CapEx, and these items, I never get to the same number that you guys report as being your cash - your free cash flow. And so, I'm just wondering what are kind of the other big cash expenses that don't fall under any of these lines I just mentioned now.

A - Eduardo Miron

Yeah. No, I mean, the interest that you have, well, that is our total interest expense, and we've been providing details to the market. So if you are interested, we can give you more detail and a breakdown of this.

Q - Diogo Vaz da Silva {BIO 17905067 <GO>}

Understood. And could you also just - sorry, on a slightly different topic, could you just get into a bit more detail around what drove the fall in volumes in Keystone during this Q1?

A - Frank Ravndal {BIO 19230519 <GO>}

Diogo, hi. It's Frank Ravndal. We didn't have a drop in volume overall. It was about a 1% increase. Where we did...

Q - Diogo Vaz da Silva {BIO 17905067 <GO>}

(32:20).

A - Frank Ravndal {BIO 19230519 <GO>}

...volume was in Asia and of about 4%. So - and really just I think a question like we mentioned of just slightly lower promotional activity across a few markets. I think the biggest of those deltas was probably in China over that period.

Q - Diogo Vaz da Silva {BIO 17905067 <GO>}

Understood. Okay. Thank you.

A - Frank Ravndal {BIO 19230519 <GO>}

Sure.

Operator

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

A - Martin Secco Arias {BIO 18098476 <GO>}

Thank you. In a historically, seasonally challenging quarter for these type of industry, especially in our Beef segment, Marfrig team was able to deliver a good operational result when compared to first quarter of 2015. The continued solid performance at Keystone, the cost discipline, and the pursuit of the better result remain our core drivers.

The continuing improvement of the Uruguay operation, the positive outlook of the global beef industry, and the recovering of the Leg Quarter prices in the international market are positive factor to - positively influencing our business through 2016.

I want to take this opportunity to wish the team much success in their renewed challenge. As you know, we recently announced a change in our organizational structure, which we believe will streamline our company and make it more efficient.

Before closing, I would like once again to emphasize our commitment with the Liability Management process, delivering on positive free cash flow generation. I would like to thank you again, our teams all over the world for the results of this quarter.

Thank you, everyone, to participating today in this call, and I wish you all a good weekend. Thank you.

Operator

Thank you. That does conclude our Marfrig conference call for today. Thank you very much for your participation and have a great day.