

Q1 2010 Earnings Call

Company Participants

- Frederico Curado, CEO
- Luis Carlos Aguiar, CFO

Other Participants

- Joe Nadol, Analyst
- Nick Sebrell, Analyst
- Unidentified Participant, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. And welcome to the audio conference call that will review Embraer's First Quarter 2010 results. Thank you for standing by. (Operator Instructions)

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Participants on today's conference call are Mr. Frederico Curado, President and CEO, Mr. Luis Carlos Aguiar, Chief Financial Officer, Mr. Andre Gaia, Head of IR, and Mr. Rodrigo Rosa, Controller.

I would now like to turn the conference over to Mr. Curado. Please go ahead, sir.

Frederico Curado {BIO 2004589 <GO>}

Good morning, everyone. Welcome to our conference.

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Just starting with some highlights, in this quarter, we delivered our first jets to Gulf Air, a new customer in the Middle East region. We also have the important confirmation of our 20 190s due with Austral, which is in Argentina. That was actually in the first week of April with the succeeding event.

As far as business jets go, the Legacy 450 and 500 program is on track. We have, also early April, the first metal cut of the first prototype. So we continue very bullish on this program. We also celebrated the 100th Phenom, 100 delivered to our customers. We had a delivery of a Legacy 600 to the government of Panama, which was an important customer for us as well.

And in the defense business, we have our first delivery -- actually, our first four aircraft delivered to the Ecuadorian Air Force. And as far as the KC-390, the program is on track. And we are just finishing the final -- finishing the phase of preliminary studies.

So everything is moving on as scheduled on the development and also in contracted deliveries.

In this quarter, we had 41 aircraft delivered, being 21 commercial jets, 19 business jets. And this Legacy to Panama which I just mentioned. We have backlog at \$16 billion. Firm backlog is, roughly, worth a little bit over three years of annual revenues.

And in the quarter, we have slightly below \$1 billion net revenues and a positive contribution to the gross margin coming from the defense and aviation services businesses.

Our EBIT was \$57 million, which is equivalent to 5.8%, which, of course, makes us confident to be able to achieve our 6% guidance in the fiscal year. Our EBITDA was 1.8%, which also gives us confidence about meeting our projection for the year, which is 7.5%.

Important aspect also, despite the slightly negative free cash flow we had, we kept a very strong net cash position of some \$460 million, which, of course, is very important for us to keep going through this difficult moment of the industry.

And finally, our net income was \$35 million, which represents close to \$0.20 per ADS or \$0.05 per share.

As I mentioned, our revenues were a little bit atypically concentrated on defense and aviation services. This, of course, tends to smooth out towards the -- during the year. And we pretty much believe our \$5 billion revenue guidance shall be achieved with the breakdown, which we informed as well. It's not a trend, it's more a mix of this quarter.

As far as gross margins go, we had a good quarter, 21.7% on our gross margin. And this compares, of course, favorably to one year ago, when we still had the weight of extra costs due to the extra labor which we had carried in the company until mid-December last year. It's important to mention that this improvement in gross margin is despite the fact

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that the real, our currency, have appreciated. So we had some headwinds in this aspect. In Brazilian GAAP, the gross margin is 20.7%. And that also is an improvement over last quarter and an improvement over a year ago, First Quarter of 2009.

As far as sales and general expenses and administration expenses go, we had a decrease vis-a-vis the last quarter, although an increase if you compare to the First Quarter of 2009. And the major contributor here, of course, for this increase was the foreign exchange. In Brazilian GAAP, we are below both last quarter and First Quarter last year. \$121 million is what we spent in SG&A in this quarter.

So we had, as I mentioned, \$57 million in EBIT, 5.8%. In Brazilian GAAP, that number goes up to 6.9%, or \$122 million. And our EBITDA is \$80 million in US GAAP, or 8.1%, while, in Brazilian GAAP, it's BRL202 million, or 11.4% margin.

Net income. We had -- This is our classical problem with the income tax calculation, which has no direct cash impact. So we had this very high rate to be applied to our results, which brought the net income down to 3.6%, or \$35 million, or 2.5%, BRL44 million in Brazilian GAAP. Again, this is -- If you take the rate -- The rate is over 40%, which, of course, is not a typical rate. But it is what the Brazilian legislation requests.

We kept our inventories at a low level. We still believe that we will be able to reduce some further volume in our inventories. It was a stable \$2.4 billion or \$2.3 billion from last quarter to this quarter.

Our indebtedness remains with very favorable share of long term and short term. 75% of our debt is long term. And today's average maturity is five years. Our total debt is \$1.8 billion. Our total cash is above \$2.2 billion, almost \$2.3 billion.

We have here our IR people and also our CFO, Aguiar. And Gaia and, also, Rodrigo Rosa, our Controller. So we open it for questions now. And we'd be glad to answer them. Thank you.

Questions And Answers

Operator

(Operator Instructions) Joe Nadol, J.P. Morgan.

Q - Joe Nadol {BIO 3056499 <GO>}

Good quarter. On defense, can you give us a sense as to how -- what the profile of the sales looks like over the rest of the year? There's very strong volume in the First Quarter relative to what you've done in prior years. And I saw you had Super Tucano deliveries and, I guess, a Legacy. How does that look like it's going to flow the rest of the year? And do you think you're going to end up higher than the \$600 million and change that you guided for last month or two months ago?

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A - Frederico Curado {BIO 2004589 <GO>}

I like the "change", \$50 million change. That's a nice change. No, Joe. We still are sticking to our \$650 million guidance. There is some volatility there because defense you have some -- part of the revenues are counted as progress accounting. And part is actual deliveries. So for example, these Legacy jets delivered in the First Quarter bumps the number up on the defense side. So basically, we do not expect, at the same level, revenues for the next three quarters. So \$650 million is probably a good number for you to work with.

Q - Joe Nadol {BIO 3056499 <GO>}

Okay. Then, was there anything else in the overall gross margin besides mix? I mean, your productivity is improved. You noted the labor. But that affects, obviously, the First Quarter comparison. If we look at the rest of the year last year, it was clean. How are you feeling about gross margin for the year? Typically, your operating margin improves a lot throughout the year. You're already at 6% in the First Quarter. Do you think that can --? Can you give upside to that number?

A - Frederico Curado {BIO 2004589 <GO>}

Well we certainly hope so. But at this stage, I think it's too premature to indicate anything above that. Gross margin -- We have headwinds as far as currency goes. Brazilian currency is already in a very uncomfortable level, BRL1.75 or BRL1.74. We expect that number to be at least BRL1.8 or more. So that's a headwind.

Structurally, we continue absolutely focused in our cost control and the productivity of our company. So on the cost side, I think the only, let's say, wild card there would be foreign exchange rate. Although we -- I mean, it's hard to believe that it can get much worse. But who knows? It's an election year. Who knows?

On the pricing side, for the year, pretty much, you have firm contracts. You know, pressure from competition is there, clearly, but I don't think materially to -- impacting our projections. So probably, you can -- we'll be able to sustain gross margin at this level.

Q - Joe Nadol {BIO 3056499 <GO>}

Okay. Fred, how was the gross margin mix in the commercial segment this quarter? Was there anything unusual? Was it average? Was it better than average?

A - Frederico Curado {BIO 2004589 <GO>}

Commercial sector?

Q - Joe Nadol {BIO 3056499 <GO>}

Yes, the gross margin mix in there. I mean, you don't break the numbers down for us. But was it an average sort of mix by customer and mix just within the commercial aircraft deliveries?

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A - Frederico Curado {BIO 2004589 <GO>}

Well not particularly, I think. No, we don't have any exception on this, Joe.

Q - Joe Nadol {BIO 3056499 <GO>}

Nothing unusual? Okay. Then, Fred, I guess just two more for you. One is, Could you just comment on the changes in management since the analyst meeting? You made some moves. Just a little color behind what you're thinking was there.

Then, secondly, if you could just comment on how, over the last month or two, the order environment has evolved. Thanks.

A - Frederico Curado {BIO 2004589 <GO>}

Okay, Joe. Well we -- Just last week was my -- I just ended my third year. So I'm now -- It's been three years that I took the helm of the company. And I really dedicated a lot of my efforts and time in those first three years to streamline, to improve, to enhance operations, people, morale, et cetera. Of course, the crisis caught us -- caught the whole industry off guard. But I think we were fortunate that we were fast and agile to react to that.

So I -- Of course, keep in mind always that continuous improvement is a must. So we never reach optimum. So we have to keep -- It's a constant pursuit. But I'm very much comfortable now that the changes which have been implemented in our company operationally speaking are solid ones. And they are there. And the question of really -- keep this continuous improvement moving on. So with that, I felt comfortable to start maybe dedicating myself a little bit more towards the future than I had in the previous three years.

By asking Artur to take over as COO -- Artur is a very, very strong executive and has formidable experience in the whole operation of the company -- will allow me to really dedicate more time to view new businesses and new programs and assuring the perpetuity of the company. So with this trifold, myself, our CFO. And our COO, I probably will have more flexibility and more time to address issues like new programs.

And of course, dedicating (inaudible) to that is also a very clear indication that we are narrowing down our vision about what to do next in the commercial aviation. So it's been -- with the organization as a tool. And we have adapted it to what we think will be the requirement of the scenario for the next few years.

As far as orders activity go, you know me, I tend to be conservative. But there are some reasons for encouragement. We have -- The activity has increased. There is more dialogue now with the airlines. There are some campaigns actually going on. Of course, the confirmation of the 20 airplanes for Argentina was something which we had been expecting for some time. And finally, we got it. And hopefully, we'll be able to have some more deals executed during the year. Cautiously optimistic would be probably a good way to define the way we see the scenario now, less so in the business jets. But in commercial jets, yes, there is some activity there.

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Q - Joe Nadol {BIO 3056499 <GO>}

And regionally, Fred, just finally, on the commercial side? Is it Asia, Middle East? Are you seeing any perking up of interest in the US?

A - Frederico Curado {BIO 2004589 <GO>}

Not quite in the US. There is some activity -- There is clear activity in Latin America, in Asia. In Asia and Middle East a little bit as well. And believe it or not, some option activity -- (inaudible) options in Europe. So I would say the US is probably the last one in terms of recovery. Very slow (inaudible).

Q - Joe Nadol {BIO 3056499 <GO>}

Okay. Thanks. I'll let someone else go.

Operator

Ron Epstein, Bank of America Merrill Lynch.

Q - Unidentified Participant

It's Elizabeth for Ron. My first question is -- If Boeing and Airbus re-engine, what does this mean -- What would that mean for Embraer?

A - Frederico Curado {BIO 2004589 <GO>}

Sorry, Elizabeth. Could you kindly repeat the question?

Q - Unidentified Participant

Sure. If Boeing and Airbus re-engine their narrow bodies, what would that mean for Embraer?

A - Frederico Curado {BIO 2004589 <GO>}

Well that certainly will put stronger pressure on the top end of our product family. Our 195, our largest aircraft is just below the smallest airplanes, the A320 and 727 families. And so, yes. And of course, we are looking into that movement. And also, we look into our own customers and our own products, evaluating whether or not we should also consider a next step -- a next version of our engine [ph].

Q - Unidentified Participant

Okay. Then, a second question would be -- Are you seeing any sort of competition from the C series?

A - Frederico Curado {BIO 2004589 <GO>}

Absolutely. The C series with the two models -- As I just mentioned, we see the 195 right below the entry-level plane in Airbus family. The C series airplanes, the two models -- they

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actually compete with both Embraer and Boeing and Airbus. The smallest airplane is a competitor to the 195. And the larger airplane is a competitor with the 319, 727, 700. So absolutely. We see the C series as a serious candidate and a competitive aircraft.

Q - Unidentified Participant

Okay. Then, the last question was just -- You talked with Joe about the order level you're seeing. Is there any other specific going-ons with your sales campaigns that you can speak to?

A - Frederico Curado {BIO 2004589 <GO>}

Unfortunately not, Elizabeth. If I cross the line here, my CFO -- he would not be very happy. Sorry about that.

Q - Unidentified Participant

Okay. Thank you.

Operator

Nick Sebrell, Morgan Stanley.

Q - Nick Sebrell {BIO 7321622 <GO>}

The first question is on costs again. I was wondering if you could talk a little bit more about -- Your G&A costs fell. It seemed that part of that might be due to decline of personnel. And I'm wondering how long that decline in personnel might continue. Are these small layoffs that are happening or just mostly attrition to retirements? Or what's the program there? That's the first question.

Then, a second question is -- The United/Continental merger -- does that have any meaningful impact for you guys if it goes through?

And a third question is -- We've seen in the local press here Azul talking about making another large investment and another large expansion. I was wondering if there might be another follow-on order from them or if the money that they're talking about was already in the order book.

A - Frederico Curado {BIO 2004589 <GO>}

Well yes, Nick. On costs and labor, we -- No. It's basically attrition. We do not have, let's say, a plan to lay off X number of people every month, nothing like that. But we're trying to take the opportunity of attrition and trying to avoid replacement of people, both at direct labor and also at overhead. I would say, mainly, it's overhead. But it's more like a cultural thing than a target. I do not have any target or any goal of reducing X number of people. Those days are gone, hopefully, forever.

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Of course, we have to do something like that because, as you know, in Brazil, there is this automatic inflation replenishing. There is this, let's say, inertia [ph] inflation in Brazil that, every year, we have a certain bump in our payroll, which is a legal constraint. So we have to follow, period. So that has to be balanced also. So we cannot just keep our payroll going up. We have to control that. And the exchange rate, of course, puts more pressure on us in that sense. But I think we are managing that very, very acceptable way and keeping a very high morale in the factory, which is very important as well.

United and Continental Airlines' potential merger? I do not see an immediate (inaudible). Negative? I think it's -- With no order in the US for two or three years now, it can't be more negative than that. But I think those things are so large that -- I kind of see this wave flowing -- If it ever happens, larger aircraft -- (inaudible) at a certain stage.

So of course, we have both 145s and 175s as one of the main features [ph] the main feature for Continental and one of the main features for United. So we'll be very close to whatever happens there to see if we can seize any opportunity. But at this stage, I think it's very, very premature to be optimistic about (inaudible).

And as far as Azul goes, they have -- They're doing quite well both as a company. And, also, the airplane, I think, is performing to what everybody expected, very high reliability. And passenger acceptance is just phenomenal. There is nothing new there as far as I know. But they do have a large number of options. So hopefully, that statement will translate into a confirmation of option to us. But we do not have anything firm at this stage.

Q - Nick Sebrell {BIO 7321622 <GO>}

Okay. Understood. And one follow-up, if I may. The announcement of a decision for a new version of the 190 or a re-engining -- I remember you mentioned that during your investor day. Is that still 12 to 18 months off?

A - Frederico Curado {BIO 2004589 <GO>}

Yes, pretty much. I'll say -- you know, maybe before -- to the end of the year, Nick. I think -- As, of course, more focus on that issue, as we also see movements from Boeing and Airbus, I think it's no secret that -- at least, it's all over the press that Airbus may do some sort of announcement in Farnborough. So I think one of -- As soon as some of these moving pieces in the puzzle become fixed pieces, that's probably going to help us to converge to a decision. Of course, I have to build a business case and bring this to the board. So we cannot underestimate the size of things that you're talking about in term of investment. But I will say probably before yearend would be my bet -- yes -- at this stage.

Q - Nick Sebrell {BIO 7321622 <GO>}

Okay. Frederico, thank you very much.

Operator

(inaudible), Santander.

Q - Unidentified Participant

My question is a follow-up question on Joe's question about the costs. You mentioned labor was one of the sources for cost savings this quarter, which led to an improvement in your gross margin. But was only labor --? How did raw materials behave? Did you have any other part of your costs that has been reduced for any reason?

A - Frederico Curado {BIO 2004589 <GO>}

When I mentioned labor, I was trying to convey that, last year in the First Quarter, for 50 days out of the 90 days of the quarter, we had in excess of over 4,000 people, which obviously led us to the layoff on February 20. So that was my comment.

I think the cost side is the continuous improvement and is not specific to labor. But if you compare year over year, we have that chunk of costs, which, in the First Quarter of last year, really was upon us for most of the -- 60% of the quarter, which really brought our margins way down a year ago.

Q - Unidentified Participant

Okay. But what about raw materials? How are the raw material prices behaving?

A - Luis Carlos Aguiar {BIO 20815106 <GO>}

We have long-term contracts with those suppliers. Right? I cannot say that our -- let's say, the reduction of our expenses is coming from raw material suppliers. No, not at all. But we have -- On the other hand, we have been renewing our contracts with what we call non-aircraft materials. When you buy from suppliers of our day-by-day, administrative expenses -- for instance, there have been -- We're still reducing our costs on that. And we have taken all of the opportunities when we are renewing or we are bidding a new supplier in order to reduce the costs. Okay? That's basically it.

Q - Unidentified Participant

Okay. Thank you very much.

Operator

(inaudible), Morgan Stanley.

Q - Unidentified Participant

Just another question on commercial revenue. Is there any comment you can make as to the decline in commercial revenue relative to the previous quarter? I mean, yes, there were fewer planes. But the mix compared to Fourth Quarter was similar. And yet, on average revenue per delivery, there's a noticeable difference there.

A - Frederico Curado {BIO 2004589 <GO>}

Well I do not have any specifics on that. Maybe more 170s than 190s, probably, because we had (inaudible) 170s. It's probably -- I mean, I'm not 100% sure. But it's probably right --

a balance between 170s and 190s.

Q - Unidentified Participant

Then FX would also play into that?

A - Frederico Curado {BIO 2004589 <GO>}

Say it again, please.

Q - Unidentified Participant

And FX would also play into that?

A - Frederico Curado {BIO 2004589 <GO>}

Foreign exchange? It hurts on the cost side. I'm not sure about the question. But it hurts, of course, on the labor side, which, on the cost of goods sold, is about 20% or 30%. But I'm not sure I answered your question.

Q - Unidentified Participant

I'll look into it again. Thank you very much.

Operator

(Operator Instructions) (inaudible), Santander.

Q - Unidentified Participant

Only one more question. On the new -- How are you seeing the demand for the new Legacy you launched recently? Do you believe the new Legacy will repeat the same success you had with the Phenoms when you launched the product?

A - Frederico Curado {BIO 2004589 <GO>}

Well the airplane is doing relatively well. And I say relatively because the business aircraft segment as to the Legacy in terms of size, which is a super, mid-sized segment, is just suffering relatively -- suffering from lack of demand. And the activity has picked up more on the ultra-long-range segment, for, like, the Gulfstreams, the Falcons. And the Globals. Below that, where we are, the Legacy and downwards, we still see a very dry market there.

So (inaudible) we have been -- We have so many 650s already. We start delivering them in the second half of this year. But it's hard to compare. And with the Phenom, it was launched in the very booming market in 2005, so, with huge wait lines, et cetera. In terms of absolute numbers, of course, we expect to have a brighter future than what we have now. But relatively speaking, the airplane is doing okay.

Q - Unidentified Participant

Okay. Thank you.

Operator

(Operator Instructions) (inaudible).

Q - Unidentified Participant

I wanted -- I may have missed this because I got on the line late. But you talked about possible new aircraft. Are you still considering or are you not considering the possibility of a turbo prop that would be a larger turbo prop?

A - Frederico Curado {BIO 2004589 <GO>}

I'll say we are less bullish on turbo prop at this stage. We, of course, looked deeply into it. And the market demands size, despite the fact that, of course, oil prices are still up and probably will go up. We are not very enthusiastic about investing in a new turbo prop.

Q - Unidentified Participant

You had mentioned that you might do something by the end of the year -- about a new derivative or a larger aircraft. As you have spoken to you customers. And you have a lot of them, what is it that they're looking for?

A - Frederico Curado {BIO 2004589 <GO>}

Well actually, what I mentioned was maybe some re-engining or some new version of the E-jets, not necessarily a larger aircraft. And we are actually -- We are talking to our customers as we speak. And again, I think, in the next few months, you'll be to consolidate all that and aim probably -- aim to a decision before yearend.

Q - Unidentified Participant

All right. Thanks.

Operator

(Operator Instructions) This concludes today's question and answer session. I would like to invite Mr. Curado to proceed with his closing statements. Please go ahead, sir.

A - Frederico Curado {BIO 2004589 <GO>}

Thank you, all again for participating. I think it was a quarter as planned, which is good. No big surprises. So just hang on. And let's see what the future prepared [ph] to us. A little bit more optimistic on the commercial landscape. And, hopefully, you'll have increasingly good news from now on. Thank you very much. Have a great weekend, all.

Operator

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That does conclude Embraer's audio conference. Thank you very much for your participation. And have a good day.

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