Q1 2018 Earnings Call

Company Participants

- AndrÃ© LuÃs Rodrigues, Vice CEO, Chief Administrative & Financial Office, IRO and Member of Executive Board
- AndrÃ© Menegueti Salgueiro, Unknown
- Paulo Geraldo Polezi, Chief Finance & Investors Relations Officer & Member of Executive Board
- Unidentified Speaker, Unknown

Other Participants

- Joao Noronha, Head of Capital Good and Conglomerates
- Juan Tavarez, Director and Analyst
- Lucas Marquiori, Research Analyst
- Unidentified Participant, Analyst

Presentation

Operator

Good morning. Welcome to Conference Call of WEG about the Results of the First Quarter of 2018. We inform that this conference call and the accompanying slides are being transmitted on our website of Investor Relations at, ir.weg.net and after its completion the audio will be available at our website of Investor Relations. (Operator Instructions)

Any forecast contained in this document or statements that may be made during this conference call relating to WEG's business prospects, projections and operating and financial goals. And to WEG's potential future growth are based on management's beliefs and expectations as well as on information that is currently available. These statements involve risks, uncertainties and the use of assumptions as they relate to future events and depend on circumstances that may or may not occur.

Investors should understand that the general economic conditions in 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 like to remind you that this call is being held in Portuguese with simultaneous translation into English.

Here with us, we have AndrÃ© Luis Rodrigues, CEO (sic) (CFO); Paulo Polezi, Finance and Investor Relations Officer; Wilson Watzko, Controller; AndrÃ© Salgueiro, Investor Relations Manager.

Please, Mr. AndrÃ© Rodrigues, you may continue.

AndrÃ© LuÃs Rodrigues

Good morning, everyone. It's a pleasure to be with you again for the teleconference to present the results of the First Quarter of 2018.

I would like to start by highlighting the main points of this quarter. First, we had a strong revenue growth, 19.6% in the consolidated results, of which 13.9% in the domestic market and 24.5% abroad. In the domestic market, this growth was driven by the economy's recovery and increasing share of the business of solar generation plant. It is worth mentioning, in the month of March, after the final approval of CADE, Brazil's antitrust agency, we started to consolidate TGM, a steam turbine company acquired in December 26, which contribute to our portfolio of GTD products.

In the international market, growth remains concentrated in sales of short-cycle equipment. But we have already found some opportunities in major projects of industries that require long-cycle equipment. In addition, the consolidation of the new business of transformers in the United States helped in revenue growth.

Second, the performance of the EBITDA margin was as expected, showing an improvement over the Fourth Quarter of 2017 since the one-off impacts of the last quarter are no longer present. But stayed below the First Quarter 2017 margin, impacted by the acquisition of transformers operation in the United States and by the rapid growth of the solar generation business, still maturing and with lower operating margins.

Finally, I would like to highlight again the generation of cash from operations, which reached 492.6 million. And the growth of return on invested capital in the annual comparison, the main performance indicator of WEG.

Going to Slide #4, we have more details of ROIC, which grew by 1.2percentage points when compared to the First Quarter of 2017, reaching 15.1%. The growth in operating income after taxes is due to the revenue growth, improvement in operational performance and other non-operational accounts. This growth more than offset the growth of capital (invested) required to support business growth. But both from recent acquisitions and investments in working capital, fixed assets and intangible assets carried out over the last 12 months.

I now turn the floor over to Paulo Polezi.

Paulo Geraldo Polezi {BIO 19468811 <GO>}

Good morning, everyone. Moving on to Slide 5. We present the evolution of the business areas into various markets.

In the domestic market, we had growth in all business areas. In the area of Industrial Electro-Electronic Equipment, after last year's recovery, we reached the standard level for short-cycle products, especially low-voltage motors and serial automation equipment, which presented lower growth in sales quarter-on-quarter.

The solar generation business was the highlight in GTD, gaining relevance in recent months with 2 major solar projects added to the portfolio and contributing positively to revenue growth this quarter. Additionally, as already mentioned by AndrÃ©, since March, we are consolidating the operation of TGM in this business area.

In motors for domestic use, the recovery dynamics of last quarters continues. But favored by the combination of increased consumer confidence, low inflation and lower interest rates.

The performance of Paints and Varnishes reflected the performance of industrial and consumer goods market, which have intensified the recovery process over the past quarters.

Internationally, we also had revenue growth into (all) areas with exception of motors for domestic use, where the effect of component inventory adjustment in large global OEMs and the decrease in orders coming from China have impacted performance in this quarter.

In Electro-Electronic Equipment, growth remains driven by short-cycle products and countries in Europe, Asia and Africa, have shown significant growth in revenue this quarter. In addition, capacity building projects and construction of new factories, which also demand long-cycle products continue to grow, mainly in industry relating to mining, infrastructure and production of pulp and paper.

In the GTD area, revenue growth was mainly driven by the consolidation of the new U.S. transformer company. In Paints and Varnishes, the growth of revenue in international market reflects the search for new customers, especially in Latin America with products already consolidated in Brazil.

On Slide 6, we see the evolution of EBITDA in the First Quarter 2018, in which the main highlight when comparing to the quarters was the growth of revenue. EBITDA grew 14.7% in relation to the First Quarter of 2017. And there was a reduction of EBITDA margin to 14.9%. As AndrÃ© mentioned, this performance was within our expectations. And EBITDA margin recovery will happen naturally with the integration of new acquisitions and as the new business in GTD matures.

Slide seven shows the financial -- net financial result in detail, which reached BRL 27.9 million positive, remaining stable when compared to first Q'17. In this quarter, we recognized interest revenue on contract renegotiations with clients, which offset the lower interest rates received on our cash position.

It is worth noting that despite its negative impact on our financial results, the reduction in interest rates is very positive for the company's business as it reflects a more stable economic environment with increase in consumption and consequently higher level of industrial investment.

On Slide 8, we have cash flow analysis. Cash generation from operations reached BRL 492.6 million in the quarter, an increase of 18% compared to the same period of the previous year, resulting from a better operational performance in conjunction with working capital management. Investment activities consumed BRL 218.4 million in the quarter, reflecting a stable level of investment when compared to first Q'17 and considering the acquisition of TGM as well. Finally, financing activities consumed BRL 410 million in the period, reflecting the increased settlement of loans and the greater payment of dividends in the quarter.

Finally, Slide nine shows the investments of the last quarters. In the first Q'18, investments totaled BRL 61.7 million, of which 60% went to Brazil and 40% to production units abroad. It is worth mentioning that the normalization of market behavior requires (request) that we gradually increase disbursements for the modernization of our production capacity and purchase of machinery and equipment in Brazil. For the first time in the last 12 quarters, investment in Brazil was higher than overseas.

With that, I finish my presentation and return the floor to AndrÃ©.

AndrÃ© LuÃs Rodrigues

Thank you very much, Paulo. Before I start the Q&A session, I want to (reinforce) some points. First, as anticipated in the Fourth Quarter's release, growth of revenue and continuous focus on ROIC will be the main drivers for 2018. Revenue should grow organically with increase in global industrial investment with entry into new business such as solar generation and with acquisitions that increase our competitive advantage such as the recent acquisition of U.S. transformers operation, for example.

In Brazil, the diversification of our business will continue its positive contribution to revenue growth. After the recovery in 2017 of the Industrial Electro-Electronic Equipment, in 2018, we have solar generation business and TGM contributing to GTD revenue growth.

In the international market, the signs of recovery are very consistent. Industrial production growth in the main global markets and the improvement in short-cycle products continues to be driven by OEMs. In addition, important industries are beginning to show the first signs of recovery with the emergence of the first opportunities of projects involving long-cycle equipment.

To conclude, I would like to highlight that this morning, we (sent) the (set) date for WEG Day 2018. This yearly event will be held in two days, June 12 in New York and June 20 and

-- June 22 in JaraguÃ¡ do Sul. We will be pleased to see you at one of our events.

We can now start the Q&A session. Operator, you can continue.

Questions And Answers

Operator

(Operator Instructions) First question comes from Lucas Marquiori from Banco Safra.

Q - Lucas Marquiori {BIO 17907247 <GO>}

The first question about solar energy. Could you specify from a solar context, how much equipment do you provide -- (you did) transmission system? What type of equipment. And how -- what percentage of a CapEx of a solar plant does WEG account for in terms of the potential of equipment provided by WEG? Just for us to have this figure in mind. And the second question, something that Paulo mentioned caught my attention. The fact that 60% of investments were made in Brazil after a long period that you invested more abroad and also the nominal drop in CapEx abroad, I would like to understand how we should interpret that? If you plan to, maybe, grow that in other geographies, if you could just explore that a bit more?

A - AndrÃ© Menegueti Salgueiro

Lucas, thank you for the question. This is AndrÃ© Salgueiro speaking. I will answer the solar question. Then, Paulo will talk about CapEx.

As for solar, we started selling equipment to the solar energy market. The main is the frequency inverter. But we also have solutions of substation and transformers for solar complex -- for solar plants. Some new accounts in our portfolio that joined the portfolio recently, we (sold) the entire -- we started to operate it as a turnkey provider since August. So we develop equipment sold by WEG. We buy the rest, which we don't make, which is solar panels for example. And we delivered the full package to customers. So these 2 major projects that we are recognizing the revenue this year, we are building a 100% of the projects, including the parts that are purchased from other providers. But if the customer wants, we can (only) sell part of the equipment such as the frequency inverters or substations and transformers.

Q - Lucas Marquiori {BIO 17907247 <GO>}

These components, these inverters and transformers, who much do they account for in the CapEx of solar plant?

A - AndrÃ© Menegueti Salgueiro

Well we believe, it's about 45% equipment and services from WEG and 55% from other providers. This is pretty much the breakdown.

A - Paulo Geraldo Polezi {BIO 19468811 <GO>}

Lucas, I will continue with the question about CapEx. Yes. After a long period of many quarters, this year, the CapEx is more local after long period of investments abroad. So this year, we estimate to invest 370 million. Of course, it may be a bit lower. This is the goal of CapEx investment. It may be a bit lower than that. But the main reason is the end of a cycle in investments in Mexico and China. In China, investments have been completed last year. The plant is producing at a full stage, at a full capacity almost. And in Mexico, we had 2 stages of investment. First, to increase the production capacity of the plant, which was completed and the other investment was significant or even more significant was another project that ends at the end of this quarter -- of this year, I'm sorry. But we still have some investment; about 20% of this budget will be invested still in Mexico. But the most capital-intensive investment abroad ends this year with Mexico. And from now on, we will see what the market -- where the market goes and WEG wants to invest to increase productivity and make the most of all opportunities available.

Operator

Next question comes from Joao Noronha from Santander.

Q - Joao Noronha {BIO 17451608 <GO>}

I have 2 questions. First, regarding margins. I remember that in discussions in 2017, the main message was that you were developing margin every quarter. It was running close to 16%. And now looking at the scenario for 2018 and considering the deliveries, it's complex to think about the company going back to reaching this 16%. How do you see the development of margins quarter-on-quarter for 2018? And the second question, if you could give some more color on the closing of projects and sales as of April 2017?

A - AndrÃ© Menegueti Salgueiro

This is AndrÃ© Salgueiro speaking. In terms of margins, what we have mentioned since the last quarter of 2017, that the consolidated margin for 2018 should stay at a very close level of the consolidated margin for 2017, which closed at 15.5%. We also said that given the higher concentration of solar project deliveries in the first half of this year and also the impact of U.S. transformers operation on results. And since we expect to improve the profitability of this operation throughout the year, it's natural to forecast that the first half of this year will have a margin that's a bit lower than that level and a slight recovery in the third and Fourth Quarters of this year. As you know the company well, we have a wide variety of businesses. So these estimates are based on the figures that we have right now.

A - Paulo Geraldo Polezi {BIO 19468811 <GO>}

This is Paulo speaking. I would like to give you an update on research and development for T&D. We had 3 transmissions auctions, 12 billion in October 2016 and then in October -- and then in '17, December '17, BRL 9 billion. So our vision is that all the auctions were very successful. And they brought new players to the process, which brings us good business prospects for everyone actually. We're very confident as people are working on the market, looking for new orders. WEG is already participating in contracts for substations. And we continue focus -- focused on obtaining new orders on our transformers as well. But even without any new pre-agreements, we had a big one and then we didn't get (any one). But even without these pre-contract, there are still players in the market that have not yet signed this pre-contract with anyone. So there is still opportunity available in the market. And we're going after them. Also, we're working in other fronts such as selling equipment directly to those who want the auctions, which provide good business opportunities as well as selling to other providers and all the lot. So it's a long process. We know it takes longer, because projects will become effective in coming years and -- but they are happening quite intensively, I would say.

Operator

The next question is from (Tiago) from CrÃ©dit Suisse.

Q - Unidentified Participant

My question is about the GTD domestic market revenue. Despite the year-on-year strong growth, there has been a decrease when we look quarter-on-quarter. Is there any type of seasonality? And if so, should we expect a stronger quarter if we exclude the consolidation of TGM?

A - Unidentified Speaker

Tiago, to understand your question better -- well, first good morning. You refer to the drop in GTD in the domestic market quarter-on-quarter. If you look at the First Quarter against the Fourth Quarter of last year?

Q - Unidentified Participant

Yes. This First Quarter against the Fourth Quarter of 2017.

A - Unidentified Speaker

Just a minute please. (Tiago), actually, the figure that we have in this quarter is higher than the Fourth Quarter of last year. I don't know if you referred to the table we published in the release and it's a percentage basis. But nominally speaking -- in nominal terms, we are bigger, 407 million in 2017. And the First Quarter of this year was 446 million. And this growth is linked to solar energy.

Q - Unidentified Participant

Okay. I'll take a look at the figures later.

Operator

The next question is in English from Juan Tavarez.

Q - Juan Tavarez {BIO 15083199 <GO>}

So my first question is just to touch a little bit on your new businesses that you mentioned that are in the early stages. I'm curious what would be the impact on your margins and your ROIC today if these segments were operating with normalized profitability? Will it be an expansion of 50 basis points on your margin on ROIC? And also when would you expect these projects to kind of reach those normalized levels? And my second question just touching on GTD. What's the size of your backlog for wind, because I saw you mention that those are sales for those projects are likely going to end in the Third Quarter of this year. And also, what's the size of your backlog in solar? And maybe putting that in context of how different is the visibility of your backlog today within the GTD business versus what it was this time last year or even last quarter?

A - AndrÃ© LuÃs Rodrigues

This is AndrÃ© Rodrigues speaking. We will answer in Portuguese. But then there is a simultaneous translation to clearly explain to you in English. So as for the acquisition of WEG transformers in the United States, your question was how would be the margin of WEG in this quarter excluding the impact from solar (inaudible)?

Well it would be slightly higher than we had in the First Quarter of last year. I think I'll take this opportunity. So before talking about how we expect to improve it, is to say what we have been doing since the acquisition process that happened in the Third Quarter of last year. We optimized industrial processes using the synergy with the Mexican unit and whenever had a chance of talking about the acquisition, I said that it's a very strategic acquisition given the opportunities of synergy with Mexico.

And today, we're actually producing some components in Mexico to optimize cost. And we also developed a single supply chain management, which allows us to make annual purchases of packages and single prices for raw materials that are used in common that has been implemented. We also define the adequate portfolio of products for each industrial plant.

What needs more optimization is made in Mexico and what should be done in the U.S., this is ready. And we also made some changes in the organizational structure of the company. We expect that in the Second Quarter of this year. So now, we will be able to present positive operational results. This is what we're focused on now. And we expect this, yes, to happen in the Second Quarter of this year.

Juan as for your second question about backlog, we don't usually give (this) guidance on backlog for every quarter. The backlog for the revenues of wind power this year will be at the same level of last year, pretty much, BRL 700 million. And this BRL 700 million will be distributed linearly throughout the year. So based on that, you can have an idea of what the revenue from the First Quarter was and what we estimate for the coming quarters of the year.

As for solar, specifically, what we have for 2018, a total for the year, BRL 15 million. In solar, we do have a greater concentration in the first half, BRL 100 million in the First Quarter. And the second part will be in the second. And the third and then the Fourth Quarter would be a bit lower.

Operator

(Operator Instructions) There is a question in English from Juan Tavarez.

Q - Juan Tavarez {BIO 15083199 <GO>}

Sorry, just 2 more questions, if I may. First, on tax management. I noticed that this quarter, you had one of the lowest cash taxes that you've had in a long time, which helped your ROIC. I'm curious if this is the level that we should be seeing for the coming quarters as well? Is there anything specific that you are able to monetize on your tax asset side that's facilitating this lower tax cash levels? And second, maybe just to touch on short-cycle. You mentioned that in Brazil you've reached a normalized pace of kind of demand for short-cycle products. So is this segment back to precrisis levels now in Brazil? And maybe, on the long-cycle, how would you categorize the gap today versus precrisis levels?

A - Paulo Geraldo Polezi {BIO 19468811 <GO>}

This is Paulo speaking. Your question about taxes. Okay. Today, the tax rate in the First Quarter was 13.8%. The same rate was 11.5% in the First Quarter of 2017. So these -- the levels are close. What we can say from -- for the future in terms of tax rate is that, we believe, it will be around 10% to 15% based on the 3 main benefits that the company obtained. First, paying interest on equity, which is still in force and it helps. There is also the difference of tax rate in operations abroad, which also helps. And finally, the incentives, the tax incentive for Lei do Bem, which is give donations. So with the 3 benefits, we believe, tax rates will be from 10% to 15% for the next period.

The second question about industrial equipment. And the behavior now has been normalized. Yes. In fact, we may say that, yes, we have noticed a return to precrisis activities. So to speak. But Juan, for short-cycle equipment, for low-voltage motors, automation and serial equipment, we can say with some comfort that, yes, we have returned to precrisis levels. What's still lagging or lacking is the new orders for long-cycle, because in Brazil, we have not seen anything yet for that. But in the external market, we export a lot, right, from our Brazilian operations. And we have seen some orders and small invoices for long-cycle. So in summary, short-cycle, yes, we are back to levels of precrisis. But in long-cycle, no.

Q - Juan Tavarez {BIO 15083199 <GO>}

Paulo, just to clarify one thing on the tax side. I was actually talking more about the cash taxes that you report in your cash flow statement, not so much the reported tax on your income statement, where in the cash taxes where I saw that it's almost half the level of (where your reported) taxes, (so which is) really low compared to even previous quarters. I'm curious if there's anything in terms of how we should be looking at monetization of some tax assets that you have on your balance sheet? Or anything like that, that should facilitate a lower cash tax in the coming quarters? Not so much the reported tax line. But more about the tax (cash) in your cash flow statement, which is in the end what impacts your ROIC in total. So I'm curious if you have any guidance on that side?

A - Paulo Geraldo Polezi {BIO 19468811 <GO>}

Just a second, Juan. Please hold. Juan, we have the numbers here with us. We don't see a material difference in numbers. I don't know exactly what you're referring to. But in a way, we prefer to talk to you shortly afterwards. We can address this question in detail. But however, we have not noticed any higher taxes in our cash flow. But we can get into more detail with you shortly after this call. Okay?

Q - Juan Tavarez {BIO 15083199 <GO>}

No. It's okay. Thank you very much.

Operator

The next question comes from Lucas Marquiori from Banco Safra.

Q - Lucas Marquiori {BIO 17907247 <GO>}

It's a quick question on my side. You said that solar comes as a percentage of completion. These 2 major projects that now you have in your portfolio, how much of them have you made. So that -- or realized. So that we know how much more is still to go?

A - AndrÃ© Menegueti Salgueiro

Lucas, I just mentioned this before. But we don't give details about that. But just for you to have an idea, we have built slightly above BRL 100 million this quarter for solar projects. So in the backlog, (about) 500 million for the total of the year. This is what we have done so far up to March.

Operator

(Operator Instructions) This ends the Q&A session. I would now like to turn the floor over to Mr. AndrÃ© Rodrigues for his final comments. Mr. AndrÃ©, you may proceed.

A - AndrÃ© LuÃs Rodrigues

Well once again, thank you very much for attending the call. There are some questions sent by webcast that will be answered by e-mail throughout today. So see you next call. Thank you very much.

Operator

The conference call of WEG has now ended. We thank you very much for attending. Have a good day.