Q2 2015 Earnings Call

Company Participants

- Aurélio Pavinato, Chief Executive Officer
- Ivo Marcon Brum, Chief Financial & Investor Relations Officer

Other Participants

- Isabella Simonato, Analyst
- Ravi Jain, Analyst
- Rodrigo Mugaburu, Analyst
- Viccenzo Paternostro, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and thank you for waiting. At this time, we would like to welcome everyone to SLC Agricola's Second Quarter of 2015 Earnings Conference Call. Today, we have with us Mr. Aurélio Pavinato, CEO; and Mr. Ivo Marcon Brum, CFO and Investor Relations Officer.

We would like to inform you, this event is being recorded and all participants will be in listen-only mode during the company's presentation. After the company's remarks are completed, there will be a question-and-answer session. At that time, further instructions will be given.

Also, today's live webcast, both audio and slide show, may be accessed through SLC Agricola's website at www.slcagricola.com.br in the Investor Relations section by clicking on the banner, Webcast 2Q15. The following presentation is also available to download on the webcast platform. The following information is available in thousands of Brazilian reais and in IFRS, except when otherwise indicated.

Before proceeding, let me mention that forward looking statements are based on the beliefs and assumptions of SLC Agricola management and on information currently available to the company. 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 the company and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Aurélio Pavinato, CEO. Mr. Pavinato, you may proceed.

Aurélio Pavinato

Good morning and thank you for participating in SLC Agricola's earnings conference call for the second quarter of 2015. Let's turn to slide two, where we can start with situation of commodity prices in the period.

Cotton continued to show low price volatility in the international market, remaining within a clear trade range over the past few quarters of between $0.60 and $0.70 per pound. If, on one hand, the significant contraction in the cotton planted area in the 2015/2016 crop year of 6.1% according to the USDA support prices. On the other hand, the market has encountered its resistance at the upper limit, mainly due the high Chinese stocks amassed over the recent years.

The 2015/2016 crop year is in full development phase in the North Hemisphere and weather is still a source of the uncertainty for the cotton market. The impact El Niño over the coming months is another very important factor, since the phenomenon is typically associated with irregular monsoon rains in India and Pakistan, and drier and hotter weather in Australia.

Despite China's high cotton stock, the 2015/2016 crop year ends a sequence of five years of inventory builds. China's cotton stock are from previous seasons, which allows for inferring the year of low quality. While the market has been demanding, cotton was of increasingly higher quality, which is produced in the United States, Australia and Brazil where such area has contracted by 9%, 10% and 3%, respectively, according to the USDA.

Soybean price also underwent a period of at least three quarters of relative stability. Production growth in the United States and South America in 2014/2015 crop year is counterbalancing the very thin big (05:00) demand in the Asia market, sustaining prices in the range of $9 to $10.50 per bushel.

The USDA soybean crop for 2015/2016 is already in the full bloom and beginning of the spot placement phase and conditions so far have been favorable which reinforce the view that price will remain at this level until the definition and development of South America crops.

Meanwhile, international corn price, despite the downward trend during the second quarter, recovered later in the period and over the course of July (05:51) mid level of $4 per bushel. This level combined with the ongoing currency depreciation in Brazil has significantly improved the country's export parity. Compensatory export prices should support the shipment of surplus domestic production to the export market, effectively balancing supply and demand in Brazil.

In short, there were no major developments in the international prices of the agricultural commodities recently. On the other hand, in the last month, the Brazilin real depreciated even further, which in the medium term is favorable to our business.

Let's turn to slide three, please, where we can see figures on the performance of our crops in 2014/2015 crop year compared to the previous crop year and in relation to our initial estimates. The soybean harvest season was concluded with a yield of 3,060 kilograms per hectare, 1.9% lower than our initial estimate, which is basically due to the excess rainfall in April and May at the farms in the State of Bahia where, compared to the previous season, the soybean yield - sorry, however, compared to previous season, the soybean yield was 5% higher.

In the case of cotton, 50% of the planted area has been harvested to-date. As in the case of soybean, the cotton first crop suffered from the heavy rains in April and May in the State of Bahia and Goiás, which caused cotton bolls to rot. As a result, we have reduced our yield estimate to 1,649 kilograms per hectare, which is 5.6% lower than our initial estimate.

The cotton second crop, however, which is planted later than the first crop benefits from the rain just in maintenance. As a result, we had to revise upward our yield estimate to 1,667 kilograms per hectare, which is 7.5% higher than our initial estimate.

For the corn second crop, which accounts for 88% of the company's corn planted area, with 80% of the harvest is already completed, we estimate a yield of 7,116 kilograms per hectare, which is 4.1% higher than our initial estimate. Therefore, despite the shortfall of 44% in the corn first crop compared to the target, the total corn shortfall would be only 3.8%.

Let's move on to slide four, which shows the variation in our production cost per hectare in relation to the previous season which increased only 3.6% despite the weaker local currency and higher inflation in the period, which demonstrates the company's focus on meticulous cost management to strengthen the efficiency pillars of our business, which are low production costs and high yields.

I should also emphasize that as per the notes to the market published last Tuesday, we signed a lease agreement for areas on Pioneira Farming in the State of Piauí. Our (09:50) strategy of consistently expanding the scale of its production unit, reducing fixed costs and capture operating efficiency gains. Since we are currently unable to expand the scale of Pioneira Farming, we decide to leave this area.

I will now hand the call over to my colleague, Ivo Brum, our CFO and IRO, who will comment on our financial results in the period.

Ivo Marcon Brum {BIO 16639894 <GO>}

Good morning everyone. Let's go to slide five, which summarizes our income statement. Net revenue posted year-over-year growth of 19.1% in the quarter and 11.9% in the year-to-date. Net revenue growth was basically driven by the higher volume of soybean prices and by attribution of biological assets, which reflects the expectation of the high margin in 2014/2015 crop year compared to the 2013/2014 crop year.

Gross income grew by 101.8% compared to the second quarter of last year, basically due to the higher attribution to the revenue of the biological assets, which reflects the higher margins in the current crop year compared to the previous one. In the year-to-date, gross income advanced 34.8% on the same six-month period last year. Adjusted EBITDA was BRL 93.2 million, up 5.8% from the BRL 88.1 million reported in the second quarter of last year, driven mainly by the higher EBITDA from soybean.

In the year-to-date EBITDA come to BRL 143 million, down 13.9% year-over-year. The main factors contributing to the variation were the lower EBITDA from cotton invoiced, due to the lower prices in the comparison period. Note, however, that for 2016, we expect higher EBITDA than 2014 since over the last few quarters of the year, we invoiced cotton from 2014/2015 crop year with higher margins, driven primarily by local currency depreciation.

Net income in the quarter posted strong growth of BRL 37 million from the same period last year. Net margin in the quarter expanded 9.3 percentage points to 11%. Net income growth and net margin expansion in the period were driven by gross income growth, which is explained mainly by the higher crop margins in the 2014/2015 crop year compared to 2013/2014 crop year, as reflected by the attribution of biological assets and by the higher volume of the soybean invoiced between the periods.

In the year-to-date, the net income also amounted to BRL 76.3 million due to the similar effects that impacted that in the quarterly comparison.

Let's go to slide six, which show the breakdown of our net debt. Our adjusted gross debt was stable toward the period standing at BRL 1.4 billion. The main variation were due to the amortization of the Constitutional Funds line and contracting of the working capital loans to cover cash needs after Joint Ventures. And the contraction of Rural Credit line for 2015/2016 crop year.

The ratio of adjusted net debt and adjusted EBITDA increased to 3.6 times in this quarter. We expect this ratio to decline by the end of the year, driven by improvement in the adjusted EBITDA.

Thank you. And we will now start the question-and-answer session.

Q&A

Operator

Thank you. Ladies and gentlemen, we will now initiate the questions-and-answer session. Our first question comes from Isabella Simonato of Bank of America Merrill Lynch. Please go ahead.

Q - Isabella Simonato {BIO 16693071 <GO>}

Good morning everyone, Ivo, Aurélio. My question is regarding the working capital for the quarter. We saw that that it was more negative than what we expected, mainly because of the account adjustments from clients. I wanted to understand if you expect a normalization of that account in the second half of the year and if you maintain the expectation of generating positive free cash flow in 2015. Thank you.

A - Ivo Marcon Brum {BIO 16639894 <GO>}

Thank you, Isabella for this question. This quarter, you basically finalize all the costs from the crop 2014/2015. So you have now to sell the invoice, all the cotton and the corn second crop. So (15:37) certainly will increase our EBITDA and consequently our cash flow. This is the main reason. So it is, as usual, you have this situation in the second quarter.

Q - Isabella Simonato {BIO 16693071 <GO>}

Okay. Thank you.

Operator

Our next question comes from – on the webcast. It says where do you see Brazil plantings of soy this fall in terms of hectare increase versus fall 2014 given increase in soy price in real terms? This was a question from online.

A - Aurélio Pavinato

Don (16:41), good morning, Don (16:42). Brazil has a strong real depreciation over the last semester so deciding price in real in Brazil, you can say is at good level. But Brazil producers are facing a strong difficulty to get loan lines, actually the interest rate in Brazil increased a lot and has not been easy for the farmers to get money and the money is expensive.

So we don't believe that considering this soybean price level, international pricing of between $9 per bushel and $10 per bushel, that the Brazilian producers will be much rich (17:41) to expand the planted area because to expand is more expensive. Normally the new land, the yield per hectare is lower, so the cost per bushel, the cost per bag is higher and the money to do these investments is expensive and not easy to get. So this is the reason we don't believe that Brazil is going to increase maybe a few hectares, but in our view, Brazil is going to keep the planted area for the next season.

The idea is now changing between corn and soybean, corn first crop. Brazil is increasing a lot its corn as a second crop and reducing corn as a first crop, and where it reduced the corn as a first crop automatically increase soybean. So maybe a small increase (18:51).

Operator

Thank you. The next question comes from Rodrigo Mugaburu of Morgan Stanley. Please go ahead.

Q - Rodrigo Mugaburu {BIO 20980025 <GO>}

Thank you. Hi, everyone. I have a question on the lease agreement that you announced early this week. I wanted to understand better the rationale why with the current grain prices leasing land to develop. I know that the cost of the lease is cheap, but still in developing land – leasing land to develop. You're not getting the benefit of the land appreciation doing this in Piauí. And I wanted to understand a little bit better why at this point.

A - Aurélio Pavinato

Good morning, Rodrigo. Rodrigo, first of all, I think I have to say we leased the Pioneira Farm because it's a small scale farm and for the operation of the company, it's not interesting to continue to operate that farm. We are working hard to increase the size of our farms and to get the benefit of the scale and to try to increase the efficiency. That means to reduce the production cost per hectare, per bag produced.

The neighbor who leased our farm would like to lease all the developed land, the 5,000 hectares that was developed land. To lease almost 3,000 hectares that was not developed, it was a condition. We gave it to him to lease the other. Actually, for us, we can say it's a very good business to lease the undeveloped land because he's going to develop it for us.

We are going to receive a small amount of leasing payment of this land, but in five years, we are going to have these 3,000 hectares developed and we are going to capture all the land transformation on these 3,000 hectares. So actually, for me, you were not clear then – your understanding about the leasing is in fact the opposite. For us, it's a good view to lease undeveloped land to someone.

Q - Rodrigo Mugaburu {BIO 20980025 <GO>}

Thanks. Yeah. Now, I understand now. Sorry, I misunderstood that. And then as a follow-up, if you have to think SLC portfolio of land moving forward in the growth, would you rather balance it more to states like Mato Grosso, Mato Grosso do Sul, those states where weather seems to be more stable rather than Bahia or the northeast?

A - Aurélio Pavinato

We have a clear strategy to have a balanced portfolio. So for us, Mato Grosso is very good. For us, Maranhão is very good. So good at Mato Grosso. Bahia, in some region has been so good there Mato Grosso. We like Bahia actually.

When we see the last 15 years in Bahia, actually the last four years were the worst in terms of weather pattern, weather behavior. We had less of rains in the last four years in Bahia. We know that well. We know big farms in Bahia, they grew there, they developed all of their business there and they are facing problems today because this is not a good weather we had the last four years.

So our strategy is to keep the portfolio well spread between the regions that give you – in a long term give us more stable production in terms of amount and in terms of the quality. We have in the past some years where Mato Grosso, the quality of crop, for example, was not good because it rains too much during the last time. And in Bahia, we had a very good quality.

So for us, to have farmers in – now, we divide in three regions, Maranhão is one region for us because it is on Northeast region, but the weather is so good there as in Mato Grosso. So, we divide in three regions; Maranhão, Bahia, Piauí together and visually, Mato Grosso, Mato Grosso do Sul together. So, we intended to keep this portfolio in all these regions. Actually, when we grow in Bahia, we intend to grow Mato Grosso together, not increase so much in one specific region.

Q - Rodrigo Mugaburu {BIO 20980025 <GO>}

Understood. Thank you very much.

A - Aurélio Pavinato

Welcome.

Operator

Our next question comes from Viccenzo Paternostro of Credit Suisse. Please go ahead.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Hello, everyone. Thanks for the question. Well, my first question is regarding planted area for next season. We have seen soybean price reais per bag at a very attractive level in Mato Grosso. Do you plan to expand planted area this year? Have you acquired fertilizer to do so? So, just trying to understand the strategy of planted area for next year. That would be my first question.

My second question is related to the potential impact of El Niño. It seems El Niño is materializing, right? So, I'd like to understand how do you see the impact of El Niño mainly in northeast of Brazil that usually, we have a drought in this region when El Niño takes place. So, that would be my second question. Thank you.

A - Aurélio Pavinato

Good morning, Viccenzo. Viccenzo, the expansion for next year, we are working on our plan for next season. As we mentioned sometimes in other conference, our intention for this year is not to expand our planted area because, as you know, as I said before, the expansion is expensive because the capital is expensive today. So, we are maximizing the areas that we are planting. We try to do more second cropping. This will be our strategy that we are discussing now and as defined in our final numbers as to the beginning of October.

And as I said sometimes, over the years that SLC Agricola grew a lot. In the last three years, we grew 50% of our planted area and now is the time to increase and to generate cash flow. So, we had this real depreciation, so some inputs increase the value in real so it takes money from our cash. We continue to pay these inputs.

So, today, we need more money to support the cash flow of the company compared used to be one year ago, when the dollar was BRL 2.2 or BRL 2.3. Today, we need more money. So, we had to consider all these numbers on the decision to expand, not to expand and why to expand.

El Niño, normally El Niño year for grains, it is good for production in general in the world. In Brazil, it doesn't affect so much than Middle and Northeast regions. There is no big difference between El Niño and La Niña here Bahia, in Maranhão. In Mato Grosso, normally during El Niño, it rains a little less than normal and for Mato Grosso, it's good to rain less than normal.

And for South Brazil and Argentina, El Niño year normally is a good year for production. This is the reason the market is forecasting, a very good production again in South America next season.

For cotton, the cotton is our main business, actually. Normally, El Niño year is not good for cotton. Normally in India, the monsoons delay and goes not so frequently. So last year India received a little less rain than normally, but was not so bad. Last year, how good or how bad will be this year. So maybe El Niño can cause some damage on cotton production in India and Pakistan.

In Australia, Australia needs water to irrigate its cotton and there's less water. As they had less water – they received less water last year so they reduced again because no water. So if not so good rain this year, they are going to reduce again next year. And Australia is a strong competitor against Brazil because they produce very good quality cotton and they export 100% of their production.

So for cotton, the El Niño is more rich in terms of production than soybean.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Okay. Perfect. Regarding the expansion, how do you see profitability for soybean this year because we – I mean soybean price is close to BRL 60 per bag in Mato Grosso, so it seems a very attractive level. I totally agree with you that credit is a risk, but just trying to understand the profitability. How do you see profitability for next year given this very high soybean price in reais in Mato Grosso?

A - Aurélio Pavinato

We are forecasting the number for next year will be better compare to this year. The cost increase versus the price increase is much more than the cost. So the profitability will be better than this year. This is our view today. So the...

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Perfect.

A - Aurélio Pavinato

The expansion probably will not happen because of the credit the lack of money and the cost of money, the lack and the cost of money.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Perfect. Thank you.

A - Aurélio Pavinato

Welcome.

Operator

Our next question comes from Ravi Jain of HSBC. Please go ahead.

Q - Ravi Jain {BIO 16135293 <GO>}

Hi, thank you. So I had two questions. So following up on the inputs, fertilizers and chemical prices. With the devaluation of the BRL, do you expect the input prices in dollars to go down? Do you see some pressure on fertilizers and chemical prices?

And second question is, what would be the plan for the positive FCF generation? Would it be to purchase land and expand more or would it be to deleverage? What would be your plan on the FCF generation? Thank you.

A - Aurélio Pavinato

Good morning, Ravi. Thanks for the question. The input price on the international market, the fertilizer price. They did change so much over the years. Actually, urea – nitrogen last year it came down then went up again. So one year ago, the nitrogen price was high, $100 higher than today. So it came down compared to last year.

Phosphorus price reduced a little bit. So the phosphorus price like the (32:49) last year was $520 per ton. Now it's $470, $480. So it is still expensive, the phosphorus on the international market.

The potassium, the potassium are still supplied. The price came down last year when they finished the cartel, Russia left the cartel, then the price went up again. And now the price came down again. So the price today is around – a little lower than $300 per ton on international market.

So in general, fertilizer, the price in dollar is a little lower than last year. And we bought almost all our fertilizer for next season and we're happy we bought when the price was a little lower than today. So our price in dollar will be between 12% to 15% lower in dollar.

Chemical price, Chemical price normally we're dealing in dollars and as the chemical – they have been manufacturing in Brazil, but normally they work in dollars. As they (34:21) their costs that is in reais, so they were able to give us a discount. Something like similar of the fertilizer price, a discount. So for next season, we're going to get a reduction on our cost in dollars, the input cost.

The other costs that are in reais, the cost in dollar will be much lower because of the real depreciation. So this strong real depreciation we had last year, last semester, we can say very good for our business in Brazil because our production cost in dollar per bushel on the part and dollar per pound (35:14) dollar per pound cotton. On the part next season will be lower than this season.

And about the cash generation, as I said before, we intended to work on the direction to leverage the company because we have spent a lot to increase our leverage. This real depreciation, as we had 25% of our debt in dollars, so $110 million, this amount of dollar increase our net debt as well. So, more than our – we were forecasting at the beginning of the year, we can say, and this was one of the reasons we're spending our money to pay the chemicals in the first semester compared our forecast in the beginning. So we intended to use the money and we're going to generate and we are forecasting better a bit for next year compared to this year and we intend to use it to reduce our debt.

Q - Ravi Jain {BIO 16135293 <GO>}

Thank you. That's helpful. One quick follow-up. What would in your view be a sustainable long-term leveraged net debt to EBITDA? What will be your target in the medium to longer term?

A - Aurélio Pavinato

We consider 2.5 times net debt to EBITDA,. 2.5 times for us is a very comfortable situation. Actually, when you see our company, as we headed to buy all inputs to plant, to have and then to sell, so our production cycle in the areas almost a year. So, most of this debt are 100% or almost 100% of this debt, we use it to support our next cycle productions. So our debt is not a CapEx debt; it's OpEx debt.

So in our view, 2.5 times this year is a comfort. Not so big debt. And as we work on next business and we know that we have this volatility mainly due to the supply volatility, the production volatility, we have the price volatility as well. So we have to be prepared on a low commodity price like this year that can go to 3 times or 3.5 times.

On a very good year in term of price and you have to wait for that in the future, on near future, the net debt can come to 2 times. But in a long-term view, we intend towards 2.5 times.

Q - Ravi Jain {BIO 16135293 <GO>}

Thank you so much.

Operator

And this concludes our presentation for today. You may disconnect your line at this time. And have a nice day. Thank you.

A - Aurélio Pavinato

Thank you.