# Q2 2015 Earnings Call

## Company Participants

- Andre Luis Rodrigues, Managing Director and Financial Superintendent
- Luis Fernando Oliveira, Investor Relations Manager
- Paulo Polezi, Finance and Investor Relations Officer
- Wilson Watzko, Controller Officer

## Other Participants

- Alexandre Falcao, Analyst
- Cassio Lucin, Analyst
- Lucas Marchiori, Analyst
- Murilo Freiberger, Analyst

## Presentation

### Operator

Good morning and welcome to the conference call of WEG to discuss the results of the Second Quarter of 2015. We inform you that this conference call is being recorded and that at this time all participants are connected in listen-only mode. Later, we will begin the Q&A session, when further instructions will be given. (Operator Instructions) To obtain the release about the quarter or the presentation used in this conference call, please go to www.weg.net/ri.

Before proceeding, we would like to clarify that any forward-looking statements that may be made during this conference call relating to the company's business outlook, financial and operational targets and the potential for future growth of WEG are based on the assumptions and beliefs of the company's management and on information currently available.

These forward-looking statements involve risks and uncertainties as they have to do with future events and therefore depend on circumstances, which may or may not occur.

Investors should understand that general economic conditions, industry conditions and other operational factors may affect the future performance of WEG and lead to results which differ materially from those expressed in such forward-looking statements. We would like to inform you that this conference call is in Portuguese with simultaneous translation into English.

Today with us in Jaragua do Sul are Mr. Andre Luis Rodrigues, Financial and Administrative Superintendent; Paulo Polezi, CFO and IRO; Wilson Watzko, Controller; and Luis Fernando Oliveira, IR Manager.

I will now turn the floor over to Mr. Andre Rodrigues.

## Andre Luis Rodrigues {BIO 17964192 <GO>}

Good morning to all. Thank you all very much for attending. It's a great pleasure to be with you today to present on the results of WEG for the second quarter of 2015. We are going to follow the usual presentation and make a brief presentation, where Paulo and Wilson will talk about the numbers and we will have more time for the Q&A session.

Before turning the floor over to Paulo, I would like to highlight two points in this quarter. I would first of all like to highlight the consistent growth of our net revenue, 29% relative to the previous year and 10.3% relative to the previous quarter. This was driven by two factors.

The first was the performance in generation, transmission and distribution, especially in wind generation and our growth in the foreign market. This was driven by a depreciated reais, the acquisitions and the growth in those markets which we deem strategic.

The second point is that we are now operating in a new environment. It is very different from the environment we saw in the same quarter of last year. Despite that, our EBITDA and net income grew by 13% and 14.4% respectively. For reasons that we are going to explain, the margins have dropped relative to Q2, 2014.

I now turn the floor over to Paulo.

## Paulo Polezi {BIO 19468811 <GO>}

Thank you so much, Andre. Good morning to all. Moving on to page four, we can see that in this quarter 55% of our revenue was obtained outside Brazil, the greatest percentage ever in our history.

It is interesting to note that this took place at the time when the growth in internal market, in the domestic market was also robust, 16.8% quarter-on-quarter. We highlight the growth in wind energy generation systems, a new product for us.

The growth in the foreign market was 40.9%. This has to do with the depreciation of the reais vis-a-vis the American dollar and this has deepened an effect that we have been observing for some months now.

Another important aspect is that the US dollar continues to appreciate against practically all the currencies. Since the sales of WEG are always in the local currency in the different markets where we operate, we see that on average, our business in these currencies has been growing steadily, but we have less dollars.

In this quarter, revenue grew 14.8% in local currency and 2.3% in dollars, as you can see in the release and in the presentation.

Moving on to slide five, we can see a sustained trend in our last few results. The weak performance of the economy in Brazil makes so that industrial investments are now focused on maintaining the installed capacity that is investments to expand capacity which generate additional demand and growth are taking place only in very particular cases. This explains the relative decrease of the share of equipment for industrial use and varnishes and coatings.

The growth in the area of motors for domestic use has to do with the consolidation of WEG Yatong in China. And finally the generation, transmission and distribution business area now has a greater share, as we see an increase in the business in generation in general and wind generation in particular.

I now turn the floor over to Wilson. Please.

## Wilson Watzko {BIO 16648037 <GO>}

Good morning to all. We are now going to move to page six, where you see the breakdown of the costs for the second quarter of 2015. Gross margin was 28.6%, with a drop by 3.1 percentage points quarter-on-quarter.

This was driven by four causes. First, the effect of the depreciation of the reais on the cost of raw materials, which are denominated or referenced to the US dollar. We want to say it very clearly that it's not possible to pass through these costs to the selling prices. The exchange rate moves a lot faster.

Volatility of costs always hurts us and the volatility of the exchange rate continued high in the quarter. Another point is a change in the mix of products. We now have a greater share of wind generation products and part of the systems are manufactured by third parties and resold by us. The margins of this part of the business are smaller, but the ROIC is similar.

Wind generation is a new business for us and we are still on the learning curve. A third point is the growing share of the businesses we have recently acquired. Some of these are being integrated and some of them also have different margin profiles relative to the overall average of WEG.

And then fourth, we have made some additional provisions in this quarter for labor issues. We now have a more reasonable estimate of the amounts involved and we have also made provisions for any losses with clients or inventories and this is done to address the challenges of the current scenario. Despite that, we have been able to partially recover the drop in gross margin by controlling selling SG&A.

On page seven, we see that in this quarter, EBITDA grew 13% relative to the previous year and EBITDA margin was 15 percentage points, 2.1 percentage points lower than in Q2, 2014.

On page eight, you see our working capital as a percentage of the net revenue in the last few years. With the strong growth in net revenue in this quarter, we see a decrease in almost all the components of working capital. As a result, there is a slight decrease in the total working capital as a percentage of net revenue.

Our discipline in terms of ROIC goes for decisions having to do with investments in working capital and also in CapEx. We use our financial flexibility to take advantage of opportunities for growth that can give us attractive returns and this is one of the main reasons why WEG has been able to maintain growth rates in the long-term.

Moving on to slide nine, we see the organic investments in CapEx in the last few quarters. We continue to execute on our investment program to expand capacity in the new production units for electric motors in Mexico and China.

The expansion of the Mexican unit is already operating and new phases of the project will be implemented in the next few years. In China the first phase should start up in the second semester of 2015. Investments in expanding and

modernizing forecast for 2015 total BRL478 million and are being managed very carefully to use our production capacity in the best possible way. We have flexibility to adjust the pace of execution of these investments.

I now turn the floor over to Andre for his final remarks.

**Andre Luis Rodrigues** {BIO 17964192 <GO>}

Thank you, Wilson and Paulo. Before we begin the Q&A session, I just wanted to stress some important points. There is -- its no news to anybody 2015 is a challenging year. The Brazilian economy has not been performing so well in the last few months, but has been weakening due to uncertainties and adjustment measures.

But WEG has been able to grow and maintain good results in absolute terms and in comparison with the Brazilian industry and our global competitors. This has to do with a robust business model that brings together verticalization, diversification, modular expansion, global presence and financial flexibility. This model and our discipline in executing allows us to cap the opportunities for growth in the market.

We will now open for the Q&A session. Thank you very much.

# Questions And Answers

## Operator

Ladies and gentlemen, we will now begin the Q&A session. This conference call is being conducted in Portuguese with simultaneous translation into English. Our first question comes from Mr. Lucin from J.P. Morgan.

## Q - Cassio Lucin {BIO 16538013 <GO>}

Good morning to all. I have two questions. The first one has to do with revenues estimated. How much of that is linked to the energy market in Brazil?

## A - Luis Fernando Oliveira {BIO 15985519 <GO>}

I'm sorry Cassio, your line is not so good. Can you please repeat the question a bit louder? Its cutting.

## Q - Cassio Lucin {BIO 16538013 <GO>}

Is it better now? So let me go back. This 9.4 billion that you estimated for this year in terms of revenue, how much of that is linked to the domestic energy market, is it just GTD? Are there are other segments? So that's the first part of the question. My second question has to do with WEG's exposure relative to Eletrobras and its subsidiaries in terms of projects, backlog and so on.

## A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Thank you so much for your question. I will take the Eletrobras question first. No doubt the electric industry is very important for us. Any problems that should decrease the capacity of this sector would affect not only WEG, but all the Brazilian economy.

Despite the slowdown in growth, there is lack of capacity in the electricity industry.

And now specifically about WEG, as I said, this sector is important for us, but whenever we participate we participate in public bids according to the public bidding legislation. And we have also things going on with Eletrobras companies.

So we focus on transmission and system connection equipment. We are not participating in big bids, in big constructions of units. So I think WEG from the point of view of exposure is exposed because the business as a whole is exposed and we have been participating in this business we have always done.

Just as regards the exposure as a whole, what we see is the following. There are four business areas. So the direct exposure to the electricity industry would be in the equipment for generation and distribution of energy. So we allocate that in that business area. I don't think this is going to be very relevant. In this quarter 29% of GTD has to do of course clearly with the generation -- with the electrical equipment that we provide for the GTD business.

## Operator

(Operator Instructions) Our next question comes from Mr. Falcao from HSBC.

## Q - Alexandre Falcao {BIO 5515455 <GO>}

Good morning to all. My question has to do with margins. Can you give us a little bit more color about this, the margin seems to have been more impacted by provisions in Brazil than by raw materials, am I right or can we expect for the next three months?

## A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Thank you for your question, Falcao. You are right in what you said. And first, you have information in the explanatory note number 15, you have the explanations that the results of this quarter were affected by labor-related provisions. We have almost 32,000 employees and its part of the process, we have to review some processes and we have always been very conservative when we make our analysis and when we make our provisions. Again when we talk about clients and inventories, because of the scenario in Brazil, we decided to be cautious and review the processes and in terms of inventories this had to do with our operations abroad. We operate in 27 countries and our good management practices require us to review the inventory turnover in these units.

We want our managers and the people in charge to work hard and we make the provisions accordingly. Whether this is going to happen again or not, I cannot tell you now, it will depend on the conditions of the market and on our policies.

If we have a client and if there are delays we have to make the provisions accordingly, and of course we review these provisions and make any adjustments as may be necessary. Your assumption is right and this is how we have been dealing with the provisions.

## Q - Alexandre Falcao {BIO 5515455 <GO>}

So can we say that you looked at the scenario, it's more challenging scenario, you looked at your receivables and you decided to make this adjustment now, is it an adjustment? My question has more to do with the change in this specific part of the business, is this an impact that we are not going to see going forward if the situation does not deteriorate?

## A - Luis Fernando Oliveira {BIO 15985519 <GO>}

No. I don't want to give you an impression that this is a non-recurring thing. What we did, it was a very, very deep assessment of the economic scenario, of the information currently available and we made provisions. What's going to happen in the future?

Well, it is a new environment that requires caution and we made this provision. We don't want to give you the impression that it's a one-off thing, but I just want to say that we continue to analyze the scenario and then make decisions.

## Q - Alexandre Falcao {BIO 5515455 <GO>}

GTD has a higher margin historically and has also because it is a longer cycle. You are now beginning to operate in the wind energy market, you want to gain market share and you are being more aggressive. I just want to understand the GTD portfolio, when are you going back to this usual margin in the GTD business and drive margins upwards?

## A - Luis Fernando Oliveira {BIO 15985519 <GO>}

Just one thing, this is a concept. We are not being aggressive, of course, when you penetrate a new business area, you have to be aggressive. But what we are saying is that the wind-related products are different. When we sell a small power plant, the revenue for WEG is 20 to 50% of all the capacity of a small power plant. So if we use that as our -- as a proxy for our development in the generation business this is what it is.

In wind generation, we capture 80, 85% of the business. So of all the investments made in a wind farm, we gain a greater share in terms of revenue. But we buy these equipments and we incorporate them into our business, so we don't get all the revenues. So this is why the margin is different.

So it's not like we are going to go pass the learning curve and the penetration in the market and the margin is going to be the same, no, they are different businesses. The margin profile is different and this additional costs and this additional revenues have not required additional CapEx. So the ROIC ends up balancing out these two things. The margin has to do with the return on invested capital and this is offset, so it's an attractive business, although the margin is different.

It's the same comparison for example motors, high voltage motors have more value-add, the margins are different than appliance motors, where the margin is lower. But the point of view of the return on invested capital, these are comparable businesses. This is the main component. It doesn't have to do only with the pricing you see.

## Q - Alexandre Falcao {BIO 5515455 <GO>}

Thank you very much, that was very clear.

## Operator

Our next question comes from Murilo Freiberger from Merrill Lynch.

## Q - Murilo Freiberger {BIO 17385357 <GO>}

Good morning. As regards the production capacity, there was a growth in revenue by 40%. And are you close to reaching your maximum production capacity? And in terms of wind energy, what are the plans going forward? Can you expand this capacity in Jaragua or in any other geography in Brazil? This is the first question.

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

Hi, Murilo. This is Paulo speaking. Thank you for your question. You gave us the opportunity to talk about the investment as a whole. I will give you an overview. When we make investments, we always make investments to avoid idle capacity and to maximize return on capital and we invest in those markets that are more dynamic. We can adjust that as well.

For example China and Mexico, these are full-blown investments. We are expanding our facilities in these two markets as we have been telling you and these are the two main operations outside Brazil. They were also designed to expand our product line and to expand verticalization in the company to better

serve our market. The production capacity in these two places should increase by four times. Here in Brazil, the same rationale goes. We are going to do the same thing. The capacity is adjusted to the deliveries that we have to make and for some years to come and any additional investments that have to be made will follow the same rationale, the same pattern.

So in Brazil, as regards the energy business, we do not have final decision about that. We are observing the market and we are also looking at the auctions. We made a decision very fast, if the auctions prove to be attractive. So growth wouldn't be hurt, I mean it's not lack of capacity that's going to hurt growth, no, no, by no means.

## Q - Murilo Freiberger {BIO 17385357 <GO>}

My second question has to do with margins. By looking at the company as a whole, when we look at the ROIC of the company, there wasn't a contraction, was there. There was a change in mix with lower margins, but the invested capital has offset that. So when we look at the return for the company as a whole, there hasn't been a structural change from the first to the second quarter. So going forward okay, you have provisions in the short term, but going forward with the mix of products, are we going to see a company that has a

lower margin with a similar ROIC?

## A - Luis Fernando Oliveira {BIO 15985519 <GO>}

I think you are right and we always look at the return on invested capital, that's the main metric. It is important to ensure that the margins do not drop, but the margin is one component. What matter is the contribution of the margin vis-a-vis the capital invested.

So you are right in what you say. However, we think that in the future, what is going to happen to the margin is that the margin is going to fluctuate within maybe a wider range than it used to, but it will continue to fluctuate.

When you have a long cycle, the variation of the margins is higher. So in time, if this market heats up the price, we can respond with price very quickly and the margins can rise also very quickly. So we don't have a rule for that, what we can say is that our concern is to ensure the ROIC and its impacts. We are looking at the two things in a combined fashion. We don't focus just on one of these two things.

## Q - Murilo Freiberger {BIO 17385357 <GO>}

Thank you so much Luis and Paulo.

## Operator

(Operator Instructions)

## A - Luis Fernando Oliveira {BIO 15985519 <GO>}

There is a question that came through the web. Mr. Saraiva asks about the fulfillment of the targets from the strategic plan. We continue to execute those actions which are required to allow us to achieve our strategic plan targets. We have been performing well and considering the context we have been achieving intermediary targets.

And the strategic planning was not based on macroeconomic variables. We didn't say like world economy is going to grow X, the Brazilian economy is going to grow Y and we are going to grow Z, no, we assessed the business opportunities at hand in every business area. Each business area pursued its opportunities, very clear

opportunities with sound fundamentals.

Our business model is very robust. It includes verticalization, diversification, financial flexibility, global presence, the capacity to expand in a modular fashion and this allows us to achieve the targets for 2020. We are happy with the way the company has been performing so far.

## Operator

Ladies and gentlemen, our next question is from Mr. Marchiori from Banco Safra.

## Q - Lucas Marchiori

Hi. Just wanted to discuss some points with you. As regards components in GTD, you are verticalizing, you are buying components from third parties. Was there any increase in price of these components? Have suppliers driven prices upwards? That is the first question.

And then I would like to understand the capacity in China which is coming online. What percentage of the plant should start operating? Can you give us an idea or capacity, volume, revenue that we can expect for the second half of the year?

And then in Brazil, we see that there are no major investments in the industries, but what about exporters? Have you seen an improvement that could give us an idea about what the industrial equipment industry is going to look like in 2016?

## A - Luis Fernando Oliveira {BIO 15985519 <GO>}

Thank you so much for your questions. I will take the first question. The capacity in China is going to come online in the second half of the year, but there is going to be a ramp up in production. We start slowly and little by little we are going to ramp up production.

We will have the construction works ready and then we have to occupy the shed with machinery gradually according to the demand, that is we get the orders and then we place the machinery accordingly.

We don't expand capacity to have idle capacity, so we only put equipment online once we have the orders. We know how to do that, that's the way we always do it. We ramp up very gradually. You are not going to see a big leap because of the coming online of that operation, you are going to see that in time, in three, four years. Once the Rugao plant is working in full capacity, but it's going to be something that you are not going to see very sharply quarter-on-quarter.

In Mexico it's the same.

We have started the operation in Mexico and the impact is not so big. We go step-by-step. Then the impact has to do not specifically with GTD components, but with raw materials, resins, electronic equipment, electronic components, copper, steel, there are a lot of components that are denominated in US dollars. So it's not one specific component of a system, it happens across the board.

And then relative to the industrial sector in Brazil, we haven't seen any major changes in the scenario. It is exactly what we have described, very slow growth, very weak and you see that on the macroeconomic data on industrial production. The impact of the exchange rate for exporters in those who have the capacity to export comes later, it's slower. Industrial goods are not so sensitive to prices, you have to have a presence abroad, you have to have developed your clients, so their response to the exchange rates comes a lot slower.

## Q - Lucas Marchiori

And just coming back to the components, we know that you are very good in managing capacity, but maybe the suppliers are not as good, the capacity of the supply chain may not be able to follow the growth of the pipeline in wind energy.

## A - Luis Fernando Oliveira {BIO 15985519 <GO>}

We don't have problems with wind energy. When we assume capacity, we already have the contracts, so for the backlog these has been sorted out. For new orders, this is a discussion that we have to have, just as we discuss internally and this has to do of course with the auctions. We have to make a decision about our own capacity and we also have to talk to the suppliers to say whether we have the capacity or not, whether we can take on new commitments or not. But for our backlog and for the orders we have, this has been sorted out.

## Operator

Our next question comes from HSBC from Mr. Falcao.

## Q - Alexandre Falcao {BIO 5515455 <GO>}

Thanks for allowing this follow-up question. I would just like to understand something about your GTD capacity outside Brazil. Are you -- you have one third of your GTD outside Brazil and is it being supplied from Brazil? I just want to understand what is going to happen in the second semester. What happens with your working capital once you become more verticalized abroad? Does this

improve your working capital?

## A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Let's talk about the working capital first. Yes, this is going to improve. It is part of what we do every day, we analyze the ROIC and working capital is very important. We have been using this flexibility relative to working capital to develop new business and we have got it right, but now with our growth abroad and with the internationalization, we will gain with the verticalization abroad.

As regards to the countries, we have seen growth in Mexico, but our rationale is the following. We talk a lot about flexibility, but flexibility also has to do with assessing what the best decision is, when we are going to bring these assets into operation, which countries we are going to invest in. So when there is a growth in the market and we have a strategy to focus on the North American market. So this allows us more flexibility in the way we produce, and this also allows us to increase our share in Mexico.

If the economic conditions allow Brazil to be an export base, we are going to focus on Brazil as an export base and develop it. The same goes for China, where we have also grown. So there isn't a rule. The strategy is clear and as I said before, we are very disciplined in executing, but we are flexible enough to analyze the best time to make changes. I talked about China and Mexico, but we also have Colombia and two acquisitions in Africa to expand GTD, a company in Colombia and a company in South Africa.



## Q - Alexandre Falcao {BIO 5515455 <GO>}

Thank you.

## Operator

The conference call, the Q&A session of WEG is now ended. I would now turn the floor over to Mr. Andre Rodrigues for his final remarks.

## A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Once again thank you all so much for attending this conference call. Thank you all so much for your questions. Have a nice day and I hope you will follow our next call. Thank you.

## Operator

WEG's conference call is now ended. Thank you all very much for participating. Have a nice day and thanks for using Chorus Call, Brazil.