

Y 2018 Earnings Call

Company Participants

- Andre Luis Rodrigues, Superintendent Director of Administrative Financial
- Paulo Polezi, Chief Financial Officer

Other Participants

- Bruno Amorim, Analyst
- Felipe Vinagre, Analyst
- Lucas Marquiori, Analyst
- Ricardo Alves, Analyst
- Unidentified Participant

Presentation

Operator

Good morning and welcome to WEG's audio conference on the earnings of the fourth quarter 2018. We are broadcasting this conference call together with slides on our Investors Relations website, ir.weg.net. And after conclusion, the audio is going to be available on the IR website. (Operator Instructions)

Any statements made in this document or made during the conference call with regard to future events, business outlooks, projections, and operating and financial goals, and the future growth potential of WEG are based on the beliefs and expectations of WEG's management that rely on information currently available. Forward-looking statements involve risks and uncertainties, and therefore depend on circumstances that may or may not occur. Investors should understand that general economic conditions, industry conditions and other operating factors may affect the future performance of WEG and lead to results that will be materially different from those in the forward-looking statements.

I would like to remind you that the conference call is being made in Portuguese with simultaneous translation into English. Today with us in Jaragua do Sul are Andre Luis Rodrigues, Superintendent Director of Administrative Financial; Paulo Polezi, CFO and IR Officer; Wilson Watzko, Controller; and Andre Salgueiro, Investors Relations Manager. Please Andre Rodrigues, you may go on.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Good morning, everyone. It's a pleasure to be here once again to release our earnings of the fourth quarter '18. Before starting with the highlights of the quarter on Slide 3, I would

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like to remind you that in the beginning of '18, we said that growth of revenue and continuous focus on ROIC would be the main drivers for the year. With the numbers presented, we see we have accomplished our objective.

Talking about the highlights of the quarter, net operating revenue grew by 16.9% in 4Q, closing the year with growth of 25.7%. Paulo is going to provide more details on the performance around the presentation. And ROIC reached 17.6%, going to levels observed to only before the global crisis of 2009.

The two highlights in the quarter were the growth of 30% of EBITDA that reached BRL490 million with margin growing 1.6 percentage points reaching 15.7%, and increase in the pace of investments, totally BRL170 million in the quarter, including 60% of investments that were made in industrial complexes and other facilities overseas. Going to Slide number 4, we have more details on ROIC who had growth of 1 percentage point compared to the 4Q '17 reaching 17.6%.

The best performance of operating profits after taxes is explained by the growth in revenue and improvements in operating performance. This growth more than offset the more capital invested necessary to support business growth, both because of recent acquisitions and for investments in working capital, fixed intangible assets, performance along the year. The consistency of this indicator proves our strategy to develop new businesses like wind and solar that although have margin structurally lower, present a very attractive return on capital invested.

Now I'm going to turn the call to Paulo Polezi. Polezi?

Paulo Polezi {BIO 19468811 <GO>}

Good morning, everyone. Going to Slide number 5, we show the evolution of our business areas in the different markets. I will start with Industrial Electro-Electronic Equipment in Brazil, where sales of short cycle equipment continue with the trend of growth. Additionally in this quarter, we observed the growth of revenue of long cycle equipment, especially automation panels. We also observed an increase in the search for equipment to expansion project -- capacity expansion projects like brownfields and new investments, greenfields, most of them already being processed but already signing for the beginning of a resumption of this project in Brazil.

GTD has a drop in revenue in this quarter in Brazil. The less projects of wind generation in portfolio are already being concluded, and already recorded a lower revenue along the fourth quarter '18. Additionally, transmission and distribution always contributed to a lower revenue in the quarter showing the oscillation in delivery of projects in the quarter. On the other hand, solar generation continues to stand out and the prospects for the business continue positive, especially in distributed solar generation that has been showing continuous growth with our backlog in recent months.

In domestic use motors, there was a small reduction in revenues, reflects of the consumption dynamics in Brazil for the segment that did not present consistent recovery

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compared to last year. The performance of the Paints business reflected the performance of industrial markets in Brazil that just started to recover in recent quarters. Overseas, Electro-Electronic Equipment continue to grow, mainly driven by short cycle products. As mentioned in previous quarters, we have already observed projects to increase capacity and build new plants, but also demand long cycle products especially in industries connected to oil and gas, pulp and paper, and mining.

GTD, the greatest contribution comes from the transformer business that had growth in all operations abroad, particularly for the consolidation of the new transformer company in the US. In domestic use motors, revenue had dropped specially because a lower backlog in the local market in China alights to a poor performance of the operation in Argentina that is suffering from the recent problems that are being faced by the local economy. In Paint, the drop of revenue in the (inaudible) market also reflects difficulties in the Argentinian economic scenario, one of the big markets for this business unit outside Brazil.

On Slide 6, we have evolution of EBITDA in the 4Q '18. The major highlight quarter-on-quarter was growth in revenues. EBITDA grew 30.2% compared to the fourth quarter '17. As Andre mentioned, EBITDA margin closed the quarter in 15.7%, an increase of 1.6 percentage points compared to 4Q '17. This is a reflex of better profitability in overseas operations, gains of margins in some operations in Brazil in addition to a lower revenue of wind generation that has traditionally lower operating margins. Finally, the lower exchange volatility in the period contributed for stability of costs of materials in long cycle projects in Brazil.

Finally on Slide 7, we show investments in recent quarters. In the fourth quarter '18, investments reached BRL170 million, 40% allocated to Brazil and 60% to production units overseas, showing significant growth compared to previous quarters, especially because of an advanced investment in the first foundry outside Brazil of WEG that is built in Mexico in that in this quarter concentrated higher volumes of investments. Additionally, a normalization of market behaviors demands gradually an increase in disbursements to expand our plant capacity and also to modernize our production processes in Brazil and in overseas.

With that, I will close and we'll turn the call back to Andre.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Well, thank you, Paulo. Before we open for Q&A, I would like to reinforce some recent accomplishments and the prospects for the year of '19. Well, the first thing is that we announced last week the acquisition of two new businesses. The first was the purchase of the Storage System of Energy in batteries of NPS in the US that can bring good prospects in the future for the growth of WEG, and insert more synergy to our renewable energy solutions like wind, solar, and also electric traction.

The second, the purchase of Geremia Redutores that will complete our portfolio in the reducer business following on our strategy to offer complete solutions in a large range of

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products. Finally, profitability measured by EBITDA margin and our continuous focus on ROIC will be the main drivers for '19. Even with an expectation of growth, the pace of growth in revenues will decelerate in '19 especially because of a lower project portfolio in renewable generation as wind. As you all know, this businesses have operating margins that are lower and therefore we expect an improvement in the mix of products sold. That together with best outlooks for other businesses will positively contribute to our EBITDA margin and maintenance of ROIC for the remainder of the year.

We are going now to start with the Q&A session. Operator?

Questions And Answers

Operator

Ladies and gentlemen, we'll now start the Q&A session. (Operator Instructions) Our first question comes from Ricardo Alves from Morgan Stanley.

Q - Ricardo Alves {BIO 16840901 <GO>}

Good morning, Andre and Paulo. Thanks for your time. I have two questions, both in GTD. The first is more objective. This level of BRL500 million (inaudible) if I'm not mistaken that you delivered in the quarter as part of already the deceleration, now the drop in winds that everybody is expecting and a bit more volatility in P&V, do you think that we can work with this level along the year? Or from what I understood in your release is to have something of wind that is going through the results, so perhaps we should work with something like BRL400 million, BRL450 million, if it would make a bit more sense? So a bit focus more on GTD for this first quarter. And then about solar energy more specifically, could you please give us a break down in solar for what is distributed? I believe it's going to keep constants, but I just wanted to check on that. And a bit more color in terms of solar farms. If I'm not mistaken, you would deliver them by June and what would be their contribution today? And if you have in your pipeline other projects like this too as of June make up your portfolio once again. Thank you very much.

A - Paulo Polezi {BIO 19468811 <GO>}

Okay, I'm going to start with wind GTD and then Andre is going to complement. Wind alone, well, we have to talk about GTD as a whole in Brazil. As you very well mentioned, we have about BRL520 million. Winds have a considerable share in this amount. It will reduce along the year. This is the information that we have been providing and will continue until next year. We prefer to you to look at WEG GTD for the year of 2019 in consolidated numbers. Mature businesses and other sources of energy, biomass, hydro plants, they will continue to grow along 2019. And so this is a positive trend. So when you look at GTD in Brazil, you have to consider at distribution and transmission that recovered sales along the year of '18. This recover will continue along 2019. And finally solar, that we can answer in separate. But it's important for you to see the whole thing. We tend to see GTD along the year as growing. Of course, there is going to be a step along the year because of wind coming out, but we expect a recovery. It's hard to give you a hard number, if it's going to be below BRL520 million. We started the first quarter of this year with BRL470 million. So we are going to have some volatility. But we wished you looked at

the WEG's GDP as a whole, not only wind alone, and the trend is of growth along the quarters.

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

And this is Andre Rodrigues. One thing before answering the question on solar is that, in recent years, we have given great visibility in terms of quantities for new businesses in renewable energy, wind and solar. They were new businesses that contributed for the growth of revenue significantly. Now, we are going to disclose information as we do with all WEG's businesses. So let's talk about solar plants and distributed plants. We signed four large projects, six solar farms; four delivered in 2018 and two are to be delivered in the first half of '19. We are almost completing the negotiation of a third project so far this year. Because it is the beginning of the year, prospects are positive we can say because there are still projects from auctions of '17 and '18 in the market that may bring positive prospects for the future. When we go to a distributed generation, you will remember WEG has been in the market since 2011 and we are expanding our network of certified stylers, we have more than 300 now. And the demand for this project has excelled our expectations we have been saying. So we have very good prospects for the coming years. And differently from solar plants is that margins here are very good and compatible to other WEG's businesses. So this is what we have today for the portfolio and what we can say about solar.

Q - Ricardo Alves {BIO 16840901 <GO>}

Okay. It's very clear. Thank you, Andre. Thank you, Paulo as well.

Operator

Our next question comes from Lucas Marquiori from Banco Safra.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Hello, everyone. Good morning. And thanks for the call. I have two questions. First, Andre, in your presentation, you talked about the two acquisitions of last week. I would like to know a bit of your strategic views. First in the US for the storage of energy and batteries, is this an application more for urban mobility, electric cars? Is it more for hybrid energy, solar farms together with wind energy or is it -- and is it something more directed to Brazil or more of a global product? And Geremia Redutores, well, you have a very large portfolio of reducers today. So, is it something to get to a group of clients that you didn't have before? So I would like to understand a bit more about the two acquisitions. And the second, if you could give me the percentage of domestic production that is exported, so how much of Brazil's total production is being exported? These are my two questions.

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

Hi, Lucas. Thanks for your question. Okay, let me talk a bit about strategic views and I'm going to start with the battery stored energy system, NPS. This is a strategic value and the opportunity that this business brings for us to be a relevant player in a business that is just starting to develop worldwide. What is important is that right now numbers are not really

significant. This is a project that is so under development. It's a new reality that's starting first abroad to be implemented later on in Brazil.

So for now, I already answered part of your question. Our view is that this is not going to be a local business, but rather WEG's global business. Today, the market that is most evolved is United States. Last year, we announced a supply in the city of Vermont. Vermont is a city that is conducting a project on the storage based on batteries and we have then a small portfolio to develop new project so far in the United States.

The applications of the storage business are quite complementary to what we have been developing in terms of renewable energy. For example, solar, you have solar generation, but the sun is not shining all the time, the wind is not blowing all the time. So you can store this energy and use it at peak times or peak consumptions.

So you already mentioned electric cars. And as I said, you can work with intermittent sources like solar and wind, and you also have a safety system for the distribution and transmission system. So the project that we are developing in the US is that. An electric traction is very important because the use of a fast charge station. In the beginning, we know that networks are not going to be in place and the solution can help. And another thing that is very important is that this type of application finds a solution of what to do with electric car batteries. You know that they have a useful life of five to seven years, but they can be reused for another 10 to 15 years in battery energy storage. So it is a business that is complementary to what WEG's offers, but it's more long term and it will start outside Brazil.

Geremia Redutores is a company that was founded in '73. It is a reference in its market in terms of portfolio and quality products, and it really comes to expand the offers of WEG's style. WEG's style has small reducers, motor reducers, but its focus is more mid and large industrial reducers. And with Geremia, we include that mega reducers. Geremia works with smaller reducers as well. So it's complementary. It comes to strengthen our presence in the reducer market. As I mentioned again, complementary to our portfolio and it will increase our competitiveness compared to global players that are already in Brazil. So, I think they were acquisitions that are very important for the Company's strategy as a whole.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Okay, very clear.

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

The second part of your question of the percentage that in the end of the year was produced in Brazil and exported, so just as a reminder the number was 28% compared to net revenue earning '18. Of course, there was a major impact of the exchange variation. So the number gets an increase that is proportional to what we saw in the external market, but we have a balance of what is produced and sold in Brazil, especially in GTD, and produced and sold oversea because an increase in capacity. Altogether considered, we went up to 30%, so slightly better but almost flat compared to the previous year.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Okay. Thank you, Paulo and Andre.

Operator

Our next question comes from Bruno Amorim from Goldman Sachs.

Q - Bruno Amorim {BIO 17243832 <GO>}

Good morning, everyone. I have two questions that are follow-up really in terms of the splits of energy. I would like to understand what would be the impact of deep reduction in revenue coming from wind project? I understand that the segment has lower margins, lower invested capital, ROIC is good even with lower margins because they have low invested capital. But can you mobilize the capital that is invested in the business because you are going to have a drop in revenues that is significant? And second, what can you say with regard to the ROIC of the wind division, if it's similar to the average of the Company or is it not? I understand you have lower margins and lower capital investment, but in the end of the day is the ROIC the same, higher or lower than the average of the Company?

A - Paulo Polezi {BIO 19468811 <GO>}

Okay, Bruno. Well, wind energy, we have always mentioned that the return on capital invested is above company average because WEG didn't have to make strong investments to work with the business. Now if the share of wind will have a negative impact to the company, well, we always work for the other businesses to offset any drops. Along the time, this is something that we have been proving. There were times that other segments were more relevant in the past and because of specific drop of one segment, the other segment kind of step up for us not to affect our numbers. So even with the reduction of wind for 2019, we don't see anything that is really going to change our trend of showing appealing numbers in terms of return on capital invested.

Q - Bruno Amorim {BIO 17243832 <GO>}

Well, thank you. Just a follow up thinking of the Company as a whole; we saw since the (inaudible) and we have been seeing growth in the Company's top line for the last two years. And I suppose that operating leverage has contributed for your ROIC go from 13% to 17.5% that you delivered in '18. Do you still have room for expanding your ROIC and margins as a whole by means of operating leverage or are you already using your full capacity given the strong growth of recent years? What can you say about that?

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

We want to continue to have an appealing ROIC as it was this year in line or even above the objectives that we had within the Company.

A - Paulo Polezi {BIO 19468811 <GO>}

You ask if there is room to develop. Well, we always work very hard to work with working capital. Sometimes we have to invest. We are growing aboard. We have to invest a bit

higher to support our growth. There are always opportunities to improve margins, and we are going to continue working on that. But our objective is to maintain interesting levels as we delivered this year. I think it's going to continue to be attractive to everyone.

Q - Bruno Amorim {BIO 17243832 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from Felipe Vinagre from Credit Suisse.

Q - Felipe Vinagre {BIO 19282922 <GO>}

Good morning, everyone. I have two questions, changing topics about revenue. First revenue overseas, you grew 14% in local currency and you also talked about the gain of share. I would like to know what you expect from now on. You are with a good backlog? Are you going to continue at the levels of the fourth quarter? And in transmission, the last news after the auctions that we had recently is that you already had a backlog of BRL500 million. If you can say if this has increased and what kind of ramp up we are going to have in terms of revenue for 2020?

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

Hi, Felipe. We have the prospect in 2019 to continue grow at the pace of 2018 overseas. And why are we saying that? Well, first there are two segments that we always talk about as being relevant for WEG outside of Brazil, oil and gas, and mining, that are in the process of recovery. And we see signs that there is a resumption in still pulp and paper and energy generation abroad. And we never stop. We are opening other operating fronts and commercialization in other countries in Asia, in Africa, Middle East. For instance, PGM has a leading position in South and Latin America, but we still have opportunities in the rest of the world.

So for a development of PGM out of the market in which we are leaders, we might have opportunities to grow. Another example is that we are doing very well in low voltage motors in China. We have a new plant. We started to produce in Rugao in 2016 and now we are making new investments to increase the capacity of Rugao's plant. China is growing more than 20% in dollar. That shows our successful strategy outside of Brazil. That's why we believe that 2019 may bring good prospects for growth in the external market

A - Paulo Polezi {BIO 19468811 <GO>}

Felipe, good morning, this is Polezi. As for backlog, we have to look at what our profile was like in this area and what is going to be from now on. In last years, we had always had a balance between revenue from generation of energy and other parts for the industry and another part for renewable energy. Last year, the share of distributors has gone down significantly. The main player in the market is less active, especially state-owned companies are a lot less active. On the other hand, it was renewable energy that took this vacant space.

WEG has solutions of substations and transformers in many of this project. For 2019, we see the same process to go on, growth and the addition of new orders because of the auctions. So this is already starting to appear along the year as more specifically in the second half. And with all that, we are going to have a bit more robust growth in the level of two digits in the area of T&D. So what is really different is the auctions that we already had and orders are going to start more to the second half of this year.

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Q - Felipe Vinagre {BIO 19282922 <GO>}

If you allow me, just a two very quick questions, the interest rates and income tax. I see that with prefixed rates, interest rates are going down. Do you think this line is going to get better or worse? And in terms of income tax, if you think you are going to keep the levels of '18 or even better because you are increasing your mix overseas compared to the domestic mix?

A - Paulo Polezi {BIO 19468811 <GO>}

Let's talk a bit about the financials. I always like to start by saying the following. WEG is quite different from other companies. That helps our business units which is our financial flexibility. What's that? We have a solid balance sheet with cash liquidity and this is a must to us. The opportunities that we have to raise credit below market costs are no longer available. On the other hand, especially in Brazil, we are having the best time in terms of low interest rates in history. All that together, we still have access to the main structures for financial leverage and we are going to probably continue that cash ratios that are suitable or positive and will support the Company's growth.

That's on the one hand. The downside is leverage in debts overseas. We also saw an increase in interest rates in emerging markets and in mature markets. LIBOR, for instance, went up and we had some leverages in Mexico, South Africa and Colombia; All that gives us a bit more financial expenses. Along the year, we are going to work to reduce this leverage in the external market, so we are working today with the best case scenario of having a neutral financial results along the year. We don't know when we are going to be able to 0 the debts abroad or change them in for cheaper debt, but we are working to have a breakeven point in 2019 or a neutral point in 2019.

And just to add in terms of income tax, we do not have expectations in changing any of the benefits that we have interest on capital or others. There is always this mix between Brazil and overseas. So you might have minor changes, but in the basic scenario, we are not going to show anything much different in terms of effective rates for 2019.

Q - Felipe Vinagre {BIO 19282922 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from (inaudible) from HSBC.

Q - Unidentified Participant

Well, thanks for taking my question. I have a quick question about non-recurrent numbers of BRL26 million. In the material fact, you had mentioned BRL46 million. Has the amount changed or you are going to have an extra BRL20 million for the next quarter?

A - Paulo Polezi {BIO 19468811 <GO>}

Hello, good morning. This question has to do with our announcement of November. The total agreement was BRL46 million divided in two installments -- two parts. One part is what is non-operating expenses about BRL20 million. It was already entered in -- booked in the results of the fourth quarter and BRL26 million is the monetary correction. Since it started to be calculated back in the '90s, that was booked into financial result and that's why we had unfavorable financial results. So BRL46 million altogether, BRL26 million in financial result and BRL20 million in the line I mentioned.

Q - Unidentified Participant

Okay. Thank you very much.

Operator

(Operator Instructions) We are now closing the Q&A session. We are going to turn back the call to Andre Rodrigues for his final considerations. Please Mr. Andre, you may go on.

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

Well, once again thanks very much for joining us in this conference call. Even starting the year with the drop in the wind portfolio, we have the expectations of growing our business in Brazil and overseas. With that, we are going to improve our operating margins and we are going to keep return on capital invested as WEG has been presenting with an attractive number for 2019 as well. Good morning, everyone, and see you in our next audio conference.

Operator

WEG's audio conference is now closed. We thank you very much for joining us and wish you are good day.

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