Q3 2017 Earnings Call

Company Participants

- AndrÃ© LuÃs Rodrigues, Chief Administrative & Financial Office and Member of Executive Board
- Paulo Geraldo Polezi, Chief Finance & Investors Relations Officer and Member of Executive Board

Other Participants

- Alexandre Pfrimer Falcao, SVP
- Joao Noronha, Head of Capital Good and Conglomerates
- Leandro Fontanesi, Research Analyst
- Lucas Marquiori, Research Analyst
- Samuel Campos Alves, Research Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Welcome to WEG S.A. 2017 Third Quarter Results Conference Call. Thank you for standing by. As a reminder, this conference is being recorded. (Operator Instructions) We are simultaneously webcasting this conference. And the accompanying slides, available at our Investor Relations page at www.weg.net/ri. We'd like to remind you that this conference call is being recorded. And after its completion, the audio will be available at our Investor Relations website. Journalists should direct questions to our press office at 47-3276-4295.

Any forecasts contained in this document or statements that may eventually be made during this conference call relating to WEG's business perspectives, projections and operating and financial goals and to WEG's potential future growth are management beliefs and expectations as well as information that are currently available. These statements involve risks, uncertainties and the use of assumptions as they relate to future events and as such, depend on circumstances that may or may not be present. Investors should understand that general economic conditions, conditions of the industry and other operating factors may affect WEG's future performance and relate to results that may differ materially from those expressed in such future considerations. We would also like to remind you that this conference call will be conducted in Portuguese with simultaneous translation into English.

With us today in JaraguÃ¡ do Sul, we have Mr. AndrÃ© LuÃs Rodrigues, Managing Director, Financial Superintendent; Mr. Paulo Polezi, Finance and Investor Relations

Officer; Mr. Wilson Watzko, Controller Officer; and Mr. AndrÃ© Salgueiro, Investor Relations Manager. You may proceed, Mr. AndrÃ© Rodrigues.

AndrÃ© LuÃs Rodrigues

Good morning, everyone. Once again, it's a pleasure to be here with you to discuss the results of the Third Quarter 2017. I would like to start drawing your attention to what we believe to be important about our results this quarter. The first point is the performance of our net operating revenues, a growth of 8.8% in comparison to the Third Quarter 2016. We'd like to remind you that since August, we have been consolidating the new company of transformers in the United States, the former CG Power USA. But even eliminating the effect of this acquisition, our revenues would have grown 6% in relation to the same period of the previous year.

In the domestic markets, we continue observing normalization in the investor sector after a long recession. Short cycle products continue providing the means to grow in the industrial, electrical equipment area. In this quarter, we have seen the first signs of the motors for household use. The performance wasn't better because we haven't observed any changes in the short term for the business using long-cycle products. Those were high-voltage products as for the GTD business because we still do not have the rebound of the investment in the expansion of capacity in the industry nor in the project of infrastructure. An external scenario, we have seen clearer signs of recovery, both for industrial equipment, when we see more products being placed. And for GTD because we started the process of consolidation of the transformer units in the United States.

The second highlight is the recovery of our margin and EBITDA. This is a result of the growth in sales of short cycle products and operating adjustments that we made in the last quarters, also because we continue the focus on competitiveness in the long term, making operating adjustments to expand the margins and returns.

Our EBITDA margin reached 16%, with positive evolution of nearly 1percentage point in relation to the Third Quarter 2016. Net income has also followed the same trend, with a growth of 21% when compared to the Third Quarter 2016.

I would also like to highlight 2 other important aspects in our effort to preserve our competitive capacity, namely the discipline in the use of capital and our efforts to preserve operating cash generation, with a focus on efficient use of return capital. As you all know, our focus is always to maximize the return on invested capital.

I now turn the call over to Mr. Paulo Polezi for him to continue the presentation.

Paulo Geraldo Polezi {BIO 19468811 <GO>}

Thank you, AndrÃ©. Good morning, everyone. Now on Slide 4. We can see details on the behavior of revenues in different markets. In this graph, we can observe from the growth of the net income along 2017 that the gradual normalization of the market is ever more clear.

In the domestic markets, we grew 1.7% year-on-year. And in international markets, we grew 14.4% in real, 14.6% in U.S. dollars and 17.3% considering local currencies. When we eliminated the effect of the consolidation of the unit of transformers in the United States, we show a growth of 9.5% in real and 12.4% in dollars.

As for Industrial Electro-Electronic Equipment. In Brazil, the equipment in demand was predominantly related to short cycle products and sales concentrated on manufacturers or OEMs, industries related to consumption and agribusinesses.

For customized products of long-cycle, the demand is still very weak. We haven't observed in Brazil any expansion projects for increasing our capacity that we name as brownfield or also new investment, which is greenfield.

Abroad, revenue growth is also propelled by short cycle products. And countries in Europe and Asia showed important growth in the revenues this quarter. The main sales channel continues to be OEM. However, projects to increase the capacity and constructions of new plants, which also demand the long cycle products, start to come up moderately, especially in the industry connected to infrastructure.

As for GTD equipment, generation, transmission, distribution of energy, the main factor for the drop in revenue in this quarter was the new scheduling of deliveries and an important project, also wind power generation for 2018.

For other renewable sources, hydraulic and thermal, the improvement in the orders continues. There is expectation of the strength for the next quarter. However, this is not going to change the dynamics for this year, with few investments in the sector.

In the area of motors for household use in Brazil, there is a gradual recovery in consumption, combined with low inflation, low interest rate and increase in consumer confidence, all reflected in the first growth of revenues in this year.

In the international markets, even though the market indicators indicate a certain stability, revenues we presented dropped, which is a reflection of the strong quarter that we have last year. As for ink and varnishes, even though there has been a decrease in revenues, we observed some equipment in some segments, such as agriculture implements and road equipment as well as the normalization of preventive maintenance in important segments such as oil and gas, mining and naval. We continue to focus on diversifying markets, developing projects with higher-added value in sectors that we do not operate yet, going for new clients, especially in Latin America.

As was mentioned before, our continuous focus has been preserving margins and returns, ensuring the maintenance of our competitiveness.

Slide five shows the EBITDA evolution in the Third Quarter 2017. And the major highlight in the quarter comparison was the growth in revenue. EBITDA grew 14.9% quarter-on-quarter -- year-on-year. And there was an increase in the EBITDA margin to 16%. However, those who attended the WEG Day could observe how our efforts in research and development is focused on the continuous improvement of our products in our production of products, with a focus in continuous reduction of -- in costs and increase of production efficiency. These investments allow us to maximize the growth effect in sales on the margins as we have seen throughout this year and again, this quarter.

On Slide 6, we provide details of the net financial results. Positive, even though it's lower than the Third Quarter 2016, reaching BRL 26.9 million. This result was impacted especially by the lower interest rate that was seen throughout the Third Quarter 2017. We'd like to mention that even though the impact has been negative on our financial results, we believe that a reduction of interest is very positive to the company because it reflects a more stable economic environment, with more trends for consumption and as a consequence, a higher level of industrial investment.

On Slide 7, we have the cash flow analysis. The cash generation in operating activities reached BRL 975 million in the period of nine months ended in September. In spite of the better operating performance, cash generation was below in comparison to the same period 2016, which was a result of the current capital of 2017. This higher investment in return capital is a better result of sales growth. Investment activities consumed BRL 389 million for the quarter, focused on the use of expected capacity. As always, we made adjustments to the rate of the disbursement in investment of the expansion in capacity, that we could maximize the use and return on the capital invested.

The financing capital consumed BRL 709.3 million in the period, especially with the disbursements for the payments of dividends related to the first half of the year that was made in August. There was also an inflow of BRL 131.9 million from notes and finances.

And finally, on Slide 8, we show the investments of the last quarters. In the first nine months of 2017, investments reached BRL 109.8 million, out of which 58% was located abroad and 42% to the production unit in Brazil. We can see that the normalization of market behavior is demanding our gradual growth of this investment in capacity expansion. This positive movement makes us to expect that we should have more consistence in growth. And it may continue in the quarters to come. Then I turn the call back to AndrÃ©.

AndrÃ© LuÃs Rodrigues

Thank you, Paulo. Before starting our Q&A session, I would like to highlight some points. First is that as we have seen in Brazil, the major highlight was the continuity of industrial recovery. We expect that this trend will continue in the quarters to come, especially in relation to short cycle products. The resumption of the long cycle product depends on expansion of capacity and infrastructures, which are not observed in Brazilian yet. On the other hand, the combination of low inflation, low interest rate and higher consumer confidence may impact consumption in the next months and in the average term, may turn into industrial investments.

The second point is that in this new market, recovery signs are consistent. We observed recurring growth in the order placement for short cycle products, especially in Europe and Asia. And some projects are of long cycle products in South Asia -- South America and Europe and Australasia. And some events that we expect to happen in the next month may bring some visibility to GTD. What is the niche and carrying of the deliveries? Also windmill energy for 2016 -- 2018, as Paulo commented, that's bringing some impact in the revenues for 2017. But that equated a gap that was expected for 2018. Considering the new production expansion rate, the portfolio of wind generation will extend up to 2018. Next quarter, we'll have the beginning of the recognition of the revenue of the major projects of solar energy.

Additionally, the Brazilian electrical sector announced 2 new auctions of new energy. Their offer of energy, especially for auction A-4 will be concentrated on renewables, especially wind and potable and safe energy, markets that we have been both in position in the past years. The volume of the auction have not been announced yet. The number of projects have been quite significant, showing the confidence that -- of companies and investors in the markets of electric energy generation. And this can bring positive perspective in the medium and long terms. We can now start the Q&A session.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Joao Noronha, Santander.

Q - Joao Noronha {BIO 17451608 <GO>}

I would like to get more light on the change of trend or this strong trend that the market has been showing, though I saw a slight growth of 3%. And compared to last year, we had a drop in dollar terms. And this strong number of 12.4% is the same basis in comparison to last year. Was there any important sale? And how can we look at the quarters to come? Could you say that this is a growth in dollars that we should expect considering the improvement that you showed according to your perception of external markets?

A - AndrÃ© LuÃs Rodrigues

Hi, Joao. This is AndrÃ© Rodrigues speaking. Thank you very much for your question. Well what can we say about it? But our revenue growth has been pulled by short cycle products. Important countries in Europe, Germany, for example, have been having good performance. We added France, Italy, Belgium and also China and some countries in Latin America. The main channel of sales are still the OEM. And some projects also that we think about, constructing new plants. And also some long cycle products that started to come up, especially in Europe and in China and in Australia, when we talk about mining activities. And some GTD deliveries, especially some PCHs of Latin America. When I talk about the long cycle products, in comparison to short cycle products where our presence is more intense, we have more opportunities than challenges in this process. So you also asked what we expect in the future? So what have we been observing? Last quarter, we had reported that the entry of orders was a signal of the market system's recovery in the international markets. We believe that this trend is likely to continue for the next quarter, not as we have seen in this quarter because it's important that -- we have to mention that the Third Quarter 2016 was weaker in comparison to what is happening now. And also, we have to mention some important projects in Latin America and Europe and Australasia for this quarter. But our expectation is that this process is likely to continue in terms of recovery.

Q - Joao Noronha {BIO 17451608 <GO>}

Okay. I have another quick question. If you could give us an update of the competitive dynamics for winning the orders in the auctions.

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

Hello. Good morning. This is Paulo Polezi speaking now. I'm going to answer your question about the auctions. Auctions for us is good news to us, however, it's difficult to predict the results. The number of projects that have been registered is very large. So we have to monitor it to see if the distributors will have enough demand. And this is likely to be clear in November. So we are going to monitor all this demand. On the other hand, we'd like to remind you that we have A-4 and A-6 auctions. And the beginning of the supply agreement is relatively long. And this can increase the risk of those who signed the agreements with -- at low prices. This is how we see it. The rational perspective that we can have is that the auction A-4 has a lower demand in relation to A-6, maybe as a result of the -- a reflection of the economy that may be slow in the short term. This is what we can say. There's another fact that came to my mind now. And this is also good news. The NDS is going to maintain the finance with the rates to JLT to close, that will include transmission activities to win. Another point and is recent news is that the government announced 2 auctions for the beginning of 2018. So all these movements of auctions is starting to resume. But we still do not have a definite date. As for T&D, we'll have 2 important auctions, last year and this year. And there's a third that has been announced to have for the future. And this is all very good news, very positive. And it's going to bring very good dynamics to all of us.

Operator

The next question comes from Lucas Marquiori, Banco Safra.

Q - Lucas Marquiori {BIO 17907247 <GO>}

I have 2 questions. The first question is about the size of the solar energy project. So could you give us an idea of the magnitude and how much of revenue would be generated? And the second question, if you could give us an idea how the EBITDA margin will be in the next quarters and since there are some effects downwards and some upwards trends related to automation. And in that term, how do you see the margin for the quarters to come?

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

Lucas. Good morning. This is Paulo speaking. I'm going to provide information about the solar energy project. I'm going to give a general idea of the solar project. We are prepared to offer the services as providers. And we are going to offer a complete solution and also supply the distributed energy. We have a company that we hired that will install the solar modules. So we have 2 different fronts. And the 2 sides are covered. And you asked about volume. The first supply, which was major and that was signed in the beginning of the year, was in Paraiba. And with 3 solar energy, with 3 megawatts of a generation substation and generation line. And the delivery is likely to be in October 2018. The 3 power plants will bring BRL 420 million as revenues. And according to the delivery schedule -- schedules, we will have about BRL 100 million for 2017 and the rest, for 2018. We confirm the second project as a contractor for other solar farms in the city of Malta. These projects are a bit smaller than what I mentioned now. It will generate BRL 250 million in revenue. And the delivery will be in the second half of 2018. And this is how we see solar energy initiatives. And we also would like to remind you that these came from auctions that happened before 2015. So it took a while to move away from the planning. Is it okay in terms of solar energy?

Q - Lucas Marquiori {BIO 17907247 <GO>}

Yes. Yes.

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

And AndrÃ© is going to tell us the other part of your question.

A - AndrÃ© LuÃs Rodrigues

Talking about margins, we do not work with the guidance in terms of margins. We say that it's very normal to have fluctuations of margins quarter-on-quarter. The important point to mention is that our company has a long-term vision in its way of managing. And our eyes is always on return on invested capital. When we start a project, such as wind energy, the more integrated we are at a certain level of activities, you may have a lower margin, lower. But with the return on invested capital which is higher. With wind energy, this is going to happen in the same way.

Operator

The next question comes from Alexandre Falcao, HSBC.

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

I have 2 questions, the first one is related to the delay of GTD orders to 2018 to close the gap. Well about this, I would like to understand whether you're going to have a gap for 2017 because you're delaying this for 2018. So I would like to understand this magnitude and how much of revenue in that side you will still have for 2018. In relation to international markets and your competitors, if you look at the activities in investment in CapEx, this was planned for the other quarters. And this is the only quarter when you are able to catch up in terms of volume. Why did that happen? Is this what we are going to expect in terms of growth in the future? Or is there any other reason?

A - AndrÃ© LuÃs Rodrigues

Hi, Falcao. Good morning. This is AndrÃ© Rodrigues speaking. I'm going to say your question about wind energy and then the international markets will be completed by my colleagues. It's very natural in the longer cycle to have some new scheduling. And this is what happened in this specific project that you mentioned. You know that we do not give the disclosure of a standalone revenue about windmill energy. What we can say to you is that we do not have new revenue. What we did is to redistribute this revenue along 2017. And the remaining amount was left for 2018. For windmill energy, it will stand at the same level that we had in 2016. And for 2018, considering the projects that we have in our portfolio, without considering any new potential project, the revenue remained at the same level or a bit higher, considering the OEM revenues that are starting to come in that were delivered in the past. So this is the distribution. And this is why we say that the revenue was equalized. We decreased the gap because before this reprogramming, we were working with the delivery of product up to May next year. And now we have a portfolio which will last up to October next year.

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

Falcao, I do not know if we quite understood your question. But I'm going to include some points and make yourself comfortable if it's not very clear. First, our expectation is to have some recoveries in some segments abroad. We were observing some -- a moderate recovery in the oil and gas and the mining segments. That has -- stands out. And markets didn't change a lot for short cycle products. And this is what we have seen lately and we are probably going to follow the trend that we saw in the United States and in Europe. In the United States, we see that there is a flat performance, there's no loss in market share. But we don't see an increase as we saw in Europe. So we are monitoring this evolution in the key markets, especially Germany, Europe, in general. And our sales channel, especially for short cycle products, are the OEMs. So it's very difficult for us to measure where the products are being delivered. You sell it to the OEM manufacturers. And they distribute it themselves to different sectors It's difficult to make these kind of measurements. And for long cycle products, it's more related to where we are positioned and how is the country being developed. For example, as to GTD, our position is quite relevant. In Mexico, in the United States and Central America, it has been very difficult. Yesterday -- last year was a very good year. But this year, we are facing problems. And we hope that next year, we'll recover this production. When we think about how the high-voltage motors is doing well in India, because of the characteristics of products that are sold in Indian markets. So for long cycle products, we think about the regions where we have a stronger presence because our exposure is not as relevant as we have with short cycle products.

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

Perfect. Do you have any possibility of expecting some significant change because of the NAFTA extinction? Is there anything relevant as you saw in Mexico? Do you have a plan B? Do you have anything to share with us?

A - AndrÃ© LuÃs Rodrigues

Our North American growth plan doesn't change. This has always been a relevant market to our company. And the acquisition of CG Power is another is step that will bring our growth appetite to this market. When I mentioned this acquisition, I mentioned the synergy that could be created between production of Mexico and the countries such as the United States. And it's performing well. So NAFTA is over. So what happened? What was the impact? We have a devaluation in Mexico. Mexico became more competitive because of this extinction. So we have to understand that the United States do not have the capacity to meet the demand. Any sort of barrier that is imposed will bring inflation to the American market. You mentioned plan B. What I can say is that it will be difficult to supply motors to Mexico. We can use our supply chain because we are diversified in our strategy. We can make a change of capacity and we can produce more to North America. And we can use Mexico to work with other markets. This is something we can develop. We have already studied this in a deeper manner. And it's something that will be easy for us to put into operation. But as to CG, it will take a little bit longer. And that's why we decided to purchase the company so that we can be protected when something like this happens.

Operator

Our next question comes from Leandro Fontanesi from Bradesco BBI.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

I have 2 questions also. The first one is related to the international markets. You said that you're gaining market share. And could you confirm that and in which markets, if so? And the second point, if you could make comments about the project that you mentioned about electrical trucks, how relevant this could be. And if you have any plans of exporting this product.

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

Thank you for your question. As to market share, what we have seen during the presence that we have in short cycle products. What we have observed in some markets related to Industrial Electro-Electronic Equipment as we have seen throughout the past quarters, there has been some news last week and that was very good news. And before talking about this, I would like to go back a little and talk about the decision that we had to hold at WEG Day this year, focused on innovation so that we could show you that WEG is a company extremely updated, ready to meet the demand that may come up, related to the new technologies. So we showed with a clear example that we have always been prepared and we have always been ready to compete in different markets, using different technological innovations. When some news like this is disclosed, we get very happy because we show the development of -- that we had with MEM, that's a global company. But it's still very soon to talk about the opportunities, to give information because we're talking about the pilot project developed with MEM. And MEM has its own strategy of commercialization and we have to respect how the client operates. And we have the opportunity of developing the project in the domestic markets. And yes, I see opportunities of expansion, all these exports -- initiatives outside Brazil. The electrical traction for WEG is not something new. It's important to remember our first initiative is related to this. It dates back to 15 years ago when we started the developments of transforming a motor into a traction motor. In 2011, we were already a manufacturer using train motors. And we also used -- worked with the motor that runs hopefully on electricity. And the reality is that we have more than 260 buses that are running with the integrated solution by WEG. So this was something that we had. And trucks are an excellent opportunity for us to develop in the urban area. And this is the gain that we see, the great potential because we don't need long distances and there's always an appeal in major cities to reduce the CO2 emissions. And this is very important and it comes in good time. We hope the development that we're going to have, that MEM announced related to the pilot project as of next year with a beverage company that will use this equipment and after 2020, it will be available for sale. So this is very positive and that we're very happy with this development.

Operator

The next question comes from Samuel Alves from BTG Pactual Bank.

Q - Samuel Campos Alves {BIO 18720076 <GO>}

My question is related to the acquisition of TGM that you made at the end of last year. When do you expect results to be consolidated with WEG? And in terms of representativeness, you disclosed the number for 2015. Could you update on those numbers and how much this can add to the revenues and to EBITDA to the company for next year?

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

Hi, Samuel. The TGM process is under study. And we have to respect the agency pace. And if it does not materialize this year, probably next year. Listen, we announced the acquisition at the end of last year. And after the acquisition, we lost contact because we were complying with the rules according to legal reglementations. And we said that it was a company that was ready to add the BRL 250 million in revenues to WEG and would also offer opportunities to develop new businesses in the international markets.

Operator

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

A - AndrÃ© LuÃs Rodrigues

Thank you very much for attending our conference call. And see you in our next conference call to discuss the results of the Fourth Quarter 2017. Have a good day, you all.

Operator

That does conclude the WEG's audio conference for today. Thank you very much for your participation. Have a good day.