

Q3 2017 Earnings Call

Company Participants

- Guilherme Setubal Souza e Silva, Executive Manager-Investor Relations

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call of Duratex. Thank you for standing by. At this time, all participants are in a listen-only-mode. Later, we will conduct a question-and-answer session, and instructions to participate will be given at that time. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Mr. Guilherme Silva, Investor Relations Manager. Please go ahead, sir.

Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Good morning, ladies and gentlemen. Thank you for joining us in the Duratex third quarter earnings conference. This is Guilherme speaking. I am the IR Manager of Duratex. I'm here with Philippe (00:50), our IR Coordinator to host this conference call.

As you may see, the presentation is a little bit different to the previous one. We hosted Duratex Investor Day yesterday, and the idea really is to discuss not only the results of the quarter, but also our strategic plan, and what we have been doing to offset the downturn of the economy.

So please move to page number 2. The transformation that we are implementing in Duratex is based on three important pillars. First one, improving what we call Duratex Management System to become a more efficiency company. Number two, our cultural transformation, which is going on to prepare the company for a new growth cycle. And the third one and lastly, we have been restarted our value proposition in the beginning of the year. The new proposition is solutions for better living, apply that over the next few years, we are moving from a traditional manufacturing company for our consumer and solution-driven company. We will present the consolidated financial results in the next page, page number 3.

The more favorable economic environment had a positive impact on our operation. We have been seeing an improvement in the economy activity, inflation below the target and a drop in the interest rate. All of this factors are positive drivers for the industries in which we operate. The net revenue during the quarter was around BRL 1 billion, higher than the previous quarter, due to a higher shipment and a better pricing.

FINAL

Bloomberg Transcript

FINAL

In addition, the EBITDA was BRL 205 million and the net profit was BRL 83 million. We start to see the benefit of all the initiatives of productivity gains and cost cutting that we have been working over the last three years since we had pick up in the gross and EBITDA margins. Last quarter, we have announced the P100 project that aims to reduce a BRL 100 million in cost during the year 2017. Year-to-date, we had already reduced around BRL 60 million. Our commitment is to be more efficient quarter-on-quarter to improve the value generation of our business.

Please let's move to page number 4, where we will discuss the cash flow and the corporate debt. The combination of a better environment and the initiatives that we promoted lead us to a better perspective in terms of cash generation. Year-to-date, EBITDA is higher in 2017 than 2016. We still had some investment in working capital during the quarter due to the higher shipment, which has impact our accounts receivables.

However, the cash conversion cycle in days is lower than 2016. As a result of our discipline in working capital management, we expect to reduce the cash conversion cycle in the following quarters. In addition, the capital expenditure was BRL 283 million, in line and a little bit lower than 2016. It's reinforced our rationalization of investments focused only on sustaining CapEx.

The financial flow was significantly lower than the previous year as a result of low interest rates. Therefore, we already see a reduction on our financial leverage of the company. The net debt to EBITDA ratio in the end of the quarter was 2.8 times versus 3.3 times at the same period of last year, which was the peak of the rate. Our idea is to reduce it to some point close to 2 times, which we feel comfortable.

We are working on the liability management of our corporate debt. And in this month, October, we had BRL 500 million (05:40) in commercial promissory notes. The notes will mature (05:46) in three years, and (05:48) interest rate will be paid in the end of the operation. The cost of this deal was 104.5% of the CDI.

So let's move forward to page 5 to present the results of the Wood Division. The wood panel industry in Brazil has show a slight recovery in this quarter. Domestic demand was 8.5% higher than the third quarter 2016 and exports grew around 30%. Thus the combination of the better demand and the amortization of our market share, which was low last quarter results in higher shipment in the division.

The volume shipped in the quarter was 615,000 cubic meters, the highest of 2007 (sic) [2017] (06:45) quarters. Net revenues were benefit due to a higher volume and grew to BRL 651 million. The gross margin also presents an improvement, as a result of better fixed cost dilution, stable price and low cost. Lastly, the recurrent EBITDA was BRL 152 million, which represents a EBITDA margins of 23.4%, above both the third quarter 2016 and the second quarter 2017.

During this quarter, we had run our operation at 6% of capacity utilization, with a higher rate in MDF wood panels. If we dis-consider Itapetininga's unit capacity that is temporarily shutdown, we have run around 75%.

The main two drivers for the improvement in the results were better volume, above 600,000 cubic meters and the new commercial strategy of the division regarding price and return (07:56) over volumes. The price hikes implemented in the first half of the year (08:01) and we started to see a better balance of supply and demand in the industry as a whole.

Sales of furniture in the retail segment has started to pick up, as we have experienced a turning point in the retail index. We've seen that things are getting better and we may have touched the bottom of the cycle in the past.

Now let's move to page number 6, where we'll present the initiatives that we are performing in Wood Division. In the panel business, the priority of the division is on having more discipline in the management operations. The target is to maximize the returns through cost efficiency, a better plan of the operations and sustaining the price increases that were implemented.

Duratex Management System is a crucial tool to leverage our operations and deliver better results. We can already see the positive impacts of the cost restructuring in our results in this third quarter 2017. However, we had been working on research and develop for a few years. Commonly, the wood panels are compared to a commodity dynamic (09:27), because the products from any competitors are similar. However, we have developed new technologies and partners (09:36). New technology in resin to assimilate the demand from the end consumer. We are also offering more complete solution for our clients, work on factors such as lead time, periodicity (09:49) and et cetera. We aim to be the trend-setter of the wood panel industry in Brazil.

Lastly, one of the main points of our agenda is the logistics aspect. We have restructured the S&OP model of the division. We have already active some improvements. The idea is to continue improving the system to benefit our service level and productivity. In addition, we are adapting the mix of production among the units that we have. Our footprint with five different sites is a competitive advantage of our operations, so we are working to get the most from it.

In the next page, we'll show the scenario for the forestry business. Duratex is a six years old company that holds a lot of expertise in the forest management. We are benchmark in forestry productivity, cost of harvesting and cost in forestry development. Although the pulp and paper business as such more intensive in forest than the wood panel business, the positive - this position creates for several opportunities to get more value from our forests, which we are always looking for. The location of our forests in Brazil is also our advantage. The majority of our forests are located in São Paulo and (11:23), which create a lot of - lots of opportunities for the operations.

Now, let's move to page number 8, and right now we start discussion about Deca Division. Deca Division has outperformed the industry average another quarter. The ABRAMAT index which measures the performance of the civil construction material industry has decreased 5.3% year-to-date. The estimate of the Association is to drop 5% in the end of 2017, in line with the year result so far. It demonstrate that the downturn in

FINAL

the demand and negatively affects our operation. Although this negative forecast will pace off the drop as a result in the past month, this tough scenario that (12:17-12:24) could grow volumes, reaffirming the potential of the business.

The shipment in this quarter was 6.7 million items, which represents a net revenue of BRL 368 million. The gross margin has improved due to a better fixed cost dilution, better mix of products and cost cutting initiatives. The EBITDA was BRL 52 million with a slightly decreasing margins. The main driver for this decrease was a higher cost in our SG&A figures, especially because of marketing costs that happened during the quarter. We still have some challenges to expand the capacity utilization of our operations. The current utilization (13:14) is 72%, impacted negatively by the ceramic business which is running with more idle capacity.

On the next page, we will represent the initiatives that we are performing in the division. One of the main points during this year is to get closer to our clients and to the end consumer. We are managing not only the sell-in our products, but also the sell-out of our clients. The target is to be more strategic in our sales, avoiding high inventory in the supply chain. Innovation is one of the drivers of value for Deca Division. The product launch during this year had a strong uptick and as I may highlight some examples in the both business, metal ceramics and electronic showers. It is an important step to continue developing products that fit the needs of the end consumer and set trends in the industry.

Lastly, we escalated some marketing initiatives using digital tools. We are promoting our brand in the social medias and accelerating our operations in some (14:35) that presented good results so far.

Deca Division is conducting an intense agenda to offset the downturn in the demand. The combination of brand recognized by the consumer and solid relationship with architects and specialists, the quality of the products and the extensive portfolio once again will drive Deca Division for a better results, even despite the difficult period that the industry is facing.

Move to number 10, represent Duratex Management System. Briefly, we have started Duratex Management System in 2015 and have already delivered around BRL 150 million in cost cut initiatives over the last two years. The system was developed with us of a consulting firm and it's based on the PDCA methodology.

During 2017, the consulting is doing the handover of the operation for a kind PMO offices (15:50), which was structured in the (15:54). Our internal team is going to be responsible for now and beyond to continue the operation of the Management System. Since the pickup in the Brazilian economy was lower than expected, we have announced in the last quarter a contingency plan to save an additional BRL 100 million.

We call this project, as I said before, P100. It has already delivered BRL 60 million in saving, as we presented at the beginning of the call. As we speak, we are working on the budget for the next year. All the budget is built using SGD system as a important assumption. Therefore, we continue to reduce costs in the next years.

Let's move to page number 11. This slide has illustrated our focus in the cost efficiency in every aspect of the company. It represents our environmental performance, which is important for ESG aspects and for cost cutting. If you'd like to know more about it, we have plenty of information disclosure in our Annual Report.

Right now, let's move to page number 12. In addition to the previous slide, here we have info about the social aspects of the company. I'd like to highlight the initiatives that we are being conducted to develop a higher engagement with stakeholders, especially the local community.

Now, please turn to page number 13. So here is finish off the first pillar that we are discussing about the Duratex, the SGD, Duratex Management System, very focused on results.

Now, I'd like to present in the page number 14, our cultural transformation process. We started last year after broad discussion in the board, a program to change the corporate culture of Duratex. In my opinion, this might be the most important initiative that we are working on. The new culture is based on four pillars: people, process, clients and results. The world has changed. The client needs are changing. The people are changing. We are preparing the company for a new growth cycle. Therefore, it could be an important milestone in Duratex history, and lead us to another (18:53) of success.

Let's now move to page number 15. We had already talked about the results and culture. Now, we are moving to the last step of my presentation, a new value proposition - solutions for better living. Let's start on page 16.

We have reviewed our strategic plan and defined four avenues that combined with the new value proposition are going to be the way of growth in near future. The first one, digital transformation, based on three aspects, getting closer to the client and the end consumer, generating new business opportunities, and improving efficiency with new tech. Number two, environment solutions. We are going to offer more complete portfolio of solutions, leveraging our brand. Number three, water solutions. Improving heating systems and consumption management of water, which is a scarce resource. Lastly, forestry solutions. We believe that there is a lot of value in our forest, due to our forestry expertise, as we said before and location of the land. Therefore, we work on maximizing the value of the forest with the new business opportunities.

Please turn to page 17, where we present the Ceusa acquisition deal. Pursuing (20:45) a new business that fits the solutions for better living, value proposition, we have acquired Ceusa in August. Ceusa is a ceramic tile (20:55) company that has a strategic fit with our operations. We had been looking (21:03) for value at least five years. During this time, we have evaluated a few companies and we believe that Ceusa was the most appropriate entry for this new business.

The industry has felt the negative effect of the crisis and the shipments have reduced year-on-year in the sector. Currently, our estimation suggests that the industry might be running 70% of capacity utilization. However, it's important to mention that Ceusa was

improving volumes and profitability during the crisis, and it's currently running 90% of capacity utilization. The EBITDA margin of Ceusa for instance is close to 20%, was higher than Deca Division on the last year.

This deal wasn't only about acquired capacity, the most important aspect that I'd like to raise here for us, was the Ceusa's business model. The value proposition of the company is based on innovation. As a driver of value, they have really talent team and caught our attention. Their research and develop can read the trend of the market and develop products that fit the needs. Moreover, we believe their portfolio has a lot of synergy with Deca and we can unlock some value.

With this acquisition, we are offering to the final consumer a more complete solution which has more than half of the average ticket (22:49) in the bathroom, for example. The deal was approved with no restriction by CADE, the Brazilian authority last week, and it was officially ended.

Now, turn to the now the last page, page number 18, where we present the final message from our management. Although we had reviewed our strategic plan for the future, we still have a lot of challenges to face in the short-term. The management is focused on this short-term issues as a priority. First of all, we are working to simplify the organization. The target is to be more responsive for the market demands and more agile. The cultural transformation is the most essential tool for this (23:42).

Secondly, we continue focus on resuming growth. As soon as we started to see volumes pick up, we might see profitability getting back on track. Initiatives that we have been doing regarding cost savings are going to support this process.

And lastly, the cultural transformation ongoing might be halfway. There is still some room to improvement. However, the project is achieving that was expected. It's already possible to feel the difference in the way of working and in the relationship of the stakeholders. The program might be a step change in Duratex history.

Now, this is the end of my presentation and I'm available to answer any question you may have. Thank you very much.

Q&A

Operator

This concludes today's question-and-answer session. I would like to invite Mr. Guilherme Silva to proceed with his closing statements. Please go ahead, sir.

A - Guilherme Setubal Souza e Silva {BIO 20114864 <GO>}

Again, thank you for joining this conference call guys. Myself and Philippe (26:15), we are available to answer any new questions forward, okay. Thank you very much. Have a nice day.

Operator

That does conclude the Duratex audio conference for today. Thank you very much for your participation. Have a good day and thank you for using Chorus Call.

FINAL

This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2022, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.

Bloomberg Transcript