

Q1 2017 Earnings Call

Company Participants

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

Other Participants

- Gabriela Benjamin, Analyst
- Karel Luketic, Analyst
- Lucas Ferreira, Analyst

Presentation

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 the instructions to participate will be given at that time. (Operator Instructions) As a reminder, this conference call 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, everybody. Thank you all for coming. We are going to start the Duratex results teleconference now, which we'll review the company's results for the first quarter of 2017. In general, our feeling is that the first quarter of the year present a slight improvement in relation to the beginning of the previous year. The main indicators suggest a more favorable scenario mainly driven by a full inflation, which has enabled for more significant cuts in the interest rates. However, we should emphasize that any recovery in the economy is still in its infancy.

Please turn to page number two, and now we are going to talk about the highlights for the quarter. Duratex had started the year with improvement performance in relation to the first quarter of last year. The main factors driving by -- driving these results have been a slightly more favorable scenario into the sector which we operate and capture of benefits from the internal efficiency program that we have been working on since the end of 2014 with important cost cutting and efficiency gain initiatives, which make up part of the Duratex Management System.

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In keeping with our drive to improve performance since the end of last year, we have incorporated working capital into the Duratex Management System. It's already possible to see the results of this work, whose focus has mostly been on inventory reduction and extension of supplier payment lead times.

In the Wood Division, the main highlights for the quarter was the announcement of introduction of a price increase for the wood panel portfolio. In March, we introduced an increase of around 15% in the standard products and white coated lines and of 80% in April for the other coated lines.

Since the beginning of the year, we have seen a little more discipline in offer on part of the sector as a whole, which has enabled the opportunity for this price increase. The idea is to offset its counts suffered [ph] at the end of last year and to recomposition our product lines to improve the profitability of the division.

Finally, Deca improved its performance in variable ways with a stronger sales performance and more favorable cost base. It has enabled an improvement in the division's margin. A 6% price increase also -- was also introduced across the board in the division.

Following a challenge in 2016, the division show a good progress this year despite the operation in the market that continues to shrink. This emphasize the strength of Deca's offering with a strong brand, high quality products, presence at the point -- the point of sales and a strong relationship with opinion formers.

Now let's turn to page number three and we will take a look at the consolidated results. Page number three, as we previously mentioned, the results from the first quarter was better than from the first quarter last year. We closed out the quarter with around 150 million of EBITDA, which represented a margin of 15.6%, and an increase of almost 4% against the previous year.

This improvement was due to the greater volumes and linear cost in Deca Division added to a recovery in the wood division towards the end of the quarter. General and administrative expenses showed a nominal reduction of BRL4 million, this mean at around 10% lower than the same period of 2016.

These results emphasize our commitment to the extensive cutting -- cost cutting program. Contributing to the financial results was a reduction in the pressure [ph] the interest rates, which adds to an operational improvement resulting in a net recurring results of BRL9 million. Despite the loss for the period, this is an improvement versus the same period of one year ago.

Continue with our strategy for the market diversification, the consolidated income for the quarter include 6% of participation in the external market through our business in Colombia Tablemac plus exports. These results was influenced negatively by the lower exchange rates, lower export volumes and lower revenue from Tablemac. But it's important to mention here that our strategy to increase the business out of Brazil through

Tablemac and exports is the same, right. So the idea is to reach between 25% and 30% over the next years.

Now on to the next page in which we deal with the free cash flow of the company in this first quarter '17. So page number four, as illustrated in the graph, it is we can see an improvement in the working capital position. The main improvement shown was the extension of the payments lead time to supplier, an initiative led by our supply team. The strong efforts are being made to reduce our average stock lead time through our new S&OP (sic) model, whose target is to link the production plan closer to the demand expectation.

We invested around BRL100 million during the quarter, with BRL44 million allocated to the maintenance of the business and around BRL55 million to the Forest OpEx. Our investments are still focused on the sustaining operation with continued focus on the long-term. We wish to position Duratex to gain market share when the market starts to grow again.

In 2017, we expect to invest between BRL400 million to BRL420 million. In line with our strategy to decommission assets as we previously announced, we sold land farms during the quarter around BRL2 million after-tax. It's worth emphasizing that these sales do not present a risk to the supply of wood for our panel lines as these assets have set Duratex needs.

As mentioned on the previous slide, we have still [ph] more favorable financial results, mainly due to a decrease in the interest rates in Brazil. The majority part of our debt is linked to the CDI around 90%. Thus this reduction in the interest rates results in improvements to our bottom line.

Finally, the cash flow generation this quarter was BRL32 million. When you compare to one year ago, it was positive -- this quarter, the BRL32 million when you compare to one year ago was negative in BRL126 million, it's important to mention that the first quarter of last year, half of that was the acquisition of part of the shares of Tablemac. But when you compare year-over-year without Tablemac, we can see a good improvement in our working capital lines.

On the next page, we are going to talk about our corporate debt. So in this chart, you can see our corporate debt composition long-term and short-term. An important point in this quarter was the reduction in the company's leverage to 2.81 times net debt-to-EBITDA. We are working to reduce this indicator, which reached 3.3 times in the third quarter of last year. Over time, we are expanding to improve the EBITDA and reduce our net debt.

In fact, we can see -- we can already see a reduction in our net debt. We consider our net debt profile to be appropriate with competitive rates, an extent average terms, mainly stemming from the issue of CRA last year. As mentioned previously, the fall in the interest rate is advantage to Duratex and if the market projections for a further reduction in the CDI materialize our results, so we will receive a boost.

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So having reviewed the main points regarding our consolidated results, we shall move to review our results for the Wood Division, it starts on page number seven. On page number seven in this chart, you can see the panel market in Brazil, not only about Duratex, but the panel market as a whole. The wood panel markets in Brazil showed a slight growth in terms of volumes during the quarter with a domestic growth of around 3%. There was a drop of 1% in MDP market compensated by a 6% increase on demand in MDF. Exports in the sector also grew in the period by around 40% year-on-year. These results illustrate the greater discipline in the offering by the sector. Despite the marginal growth during the quarter, the scenario of oversupply continues to be a challenge for the all companies in the sector.

On the coming page, we are going to look at the performance of Wood Division in Duratex specifically. So right now, on page number eight, here we have the performance of the Wood Division in this first quarter '17. During the quarter, we noticed a drop in volume shipped, which reflected our strategy not enter into a price war and retain profitability, as the base price at the beginning of the year was unfavorable. Despite the volume shrink by 2.5, our net income was virtually stable.

Our EBITDA results show BRL92 million, resulting a margin of 15% and grow up almost 30% in relation to the last year, the same period, first quarter '16. Capacity utilization was 56%. If you consider the capacity of Itapetininga, right, so if you consider the capacity of Itapetininga, the capacity utilization is 56%. If you consider the capacity available currently, given that Itapetininga is currently down, the number is 71%. Also during the quarter, we had a number of care [ph] and maintenance period for our production lines, which impacts this indicator and profitability in this quarter.

The extended proceeds for this time of the year, normally this method happens in the first quarter or in the first semester as a whole. As I mentioned at the start of the presentation, we made the sales of farm within our strategic plan for a decommission assets. In March and April, we implement a price increase in our panels portfolio, the range between 8% to 15%. These were the main points regarding the wood division.

Now we move to page number 10 and the idea is to show the highlights of Deca Division in this first quarter 2017. On page number 10, here we have the ABRAMAT Index. The ABRAMAT Index for the quarter show a fall in the revenues of 6.3%. This result is an indication of the adverse scenario that the construction material sector continues to face. Despite the market continues to shrink in March, there was a sharp slowing of the decline, which partially compensate by -- compensated for the months of January and February.

In the opinion of ABRAMAT, 2017 would be a transitional year after three years of decline. As a company [ph], decline of 6% is the forecast for the first semester of the year with a reversal of this trend in the second semester with 2017 closing at the same level of 2016, meaning no change year-on-year.

Even against this backdrop, Deca has shown improvement performance as we show on page number 11. So here we have the performance of Deca Division. Despite the decrease, we have just seen Deca Division show an increase in the sales volume in both

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basic lines and furnishing, but with greater concentration on the basics, thus the mix [ph] was slightly less favorable, meaning that the net income for the division grew at a lower level than the volumes.

We combined these increasing volumes with a linear cost base arising mainly from the product that compromise Duratex Management System and the adjustments to capacity made by the division in the second semester of last year.

The recurring EBITDA was BRL57 million, a figure 12.2% higher than for the same period of last year and represents a EBITDA margin of 16.5%. In terms of capacity utilization, the units operate at 75% of utilization. We still have important challenge to expand the capacity utilization mainly in the sector of bathroom wares in which we are operating with a lower numbers of lines. We would like to highlight Deca's strong performance displaying all the potential of the brand and the quality of its products.

On the next slide, we will talk about our participation in the Revestir, the furnish fair. So here in slide number 12, we have some pictures from our brands, Duratex, Durafloor, Deca Division and Hydra. Revestir, the furnishing fair took place here in Sao Paulo and the main fair for the construction and architecture segment in the country. We were present displaying our brands and products to the public highlighting the several important new launch.

We are able to show once again our capacity for innovation with new technology and design. This type of event is very important for us, as it strengths our bonds with important stakeholders even more. Relates to this topic, we will now talk about our sustainability strategy on the next page, page number 13. Here we have our sustainability strategy and the targets for 2025.

At our Optimech [ph] in the third quarter of last year, we presented this new strategy and the launch in our annual report of the targets and commitments taken on for 2025. There are 44 -- 45 targets, which we'll review on an annual basis. In this slide, we have shown some examples of targets that we are tracking for the main pillars of this strategy. For more details, we can access our annual report and sustainability website. So we will finish the first part of this earning presentation with a message from the Board and the Management.

Please right now turn to page number 14, message from the management. We are hoping that 2017 will continue to be a year of adjustments with a challenged scenario. Thus our focus continues to be on Internal Agenda and development of Duratex Management System. We still have the potential for a significant cost reduction and our priority remains improving the efficiency of the company.

As we've mentioned previously in this new cycle, we have included working capital as a variable and we are working to reduce this on an ongoing basis. Duratex investments are directed towards sustainability to the operation, given that we operate, we face peer [ph] capacity in both of our business division. We are going -- we are not going to ignore the

long-term and we continue to invest in the growth of forest and operational mandates [ph].

Our strategy for decommission assets will continue for the next five to eight years adapting our asset base to the company's ongoing needs. It is important for deleveraging the company and contributing to an appropriate return on our investments.

Finally, all of these initiatives are a structure within a major program of cultural transformation that we are experiencing. We are adapting our organizational (sic) culture to the strategic objective that we are pursuing. In this medium to long-term projects, our target is to take Duratex to the next level. The idea is to make Duratex even stronger and better prepared for the challenge that we all anticipate in the years ahead.

That's the end of the first part of this presentation. Now we are open to fill any questions you may have. Thank you.

Questions And Answers

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Karel (sic) Luketic with Merrill Lynch.

Q - Karel Luketic {BIO 16467278 <GO>}

Good morning, gentlemen, thank you for the questions. I have two questions. The first one is, if you can please try to quantify what the potential impact can be of the price hikes implemented over the end of the first quarter. It would be great if you could comment on the evolution of results among the first quarter and what you're seeing already in the month of April versus the average that we saw in the first quarter, that would be great? And the second question is on working capital, we already saw an interesting reduction in the first quarter to almost 25 million. Can you please comment on what you see of total potential here on working capital cuts that would be great? Thank you.

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

So regarding the first question, Karel, thanks for that. I mean, if you analyze the evolution of the first quarter, we can say that the first two months of the year was a very bad year in terms of profitability, specifically in the wood division, okay, due to a price that we -- that faced a discount in the end of the year, okay. However, in March, we have a good combination, right.

So first of all, it's important to mention that we implemented the price increase in March for the standard products, that's the majority of our volumes represents 50% of our volumes. So in March, we had 50% of our volumes with a new price of 15%, and we announced to April, the increased price for the coated lines that's why we had more volumes -- volumes more favorable in March due to the situation.

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So we can state that January plus February together was the same results of March alone, okay. So March we had a very good results, right. And the challenge for the company in this specific on the wood division right now is to implement this price increase in April and May. I can say that so far so good, right, so -- but May, if some -- one month with less working days due to holidays, but so far so good. I think the main challenge will be in May to maintain this price increase implementation, okay.

So regarding the second question about the working capital, we are working hard in two specific sectors, the payments, the supply payments, right. So we have increased price in the average seven days when you compare with the first, the last quarter, right and to reduce the inventory, right. So to reduce the inventory level would be our challenge for this quarter. Basically the idea with the implementation of this S&OP is to link the production with the demand, right.

We -- I mean, we don't have the specific number for working capital, but we can say this, we will improve the working capital over the next quarters. We will see a better results in the second quarter, a better result in the third quarter when compared to the second quarter and so on, okay. This is one -- two that we are working very hard and we will see some specific improvements basically and the reduction on inventories and extend payments to the supplier, that's it.

Q - Karel Luketic {BIO 16467278 <GO>}

That's great. Thank you.

Operator

Our next question comes from Lucas Ferreira with Bank JPMorgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Hi, Guilherme. Good morning. Thanks for the call. I have a first question on the conditions of the wood panel market in Brazil. If you were constant on the implementation of the recent price hikes and you know if -- do you still see some chances of maybe further hikes in the second quarter or in the second half of the year, if this is possible?

And second on Deca, I like you to explore a bit more the strong volumes where have you been seeing, is it you're gaining market share over your clients or you see somehow a recovery of -- and demand, how can you explain this strong performance in volumes for Deca?

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

Just one second, thanks for the question, Lucas. Of course, Lucas, there is a risk to this price hike implementation. However, we are confident that we can implement with Ceusa [ph], this price hike implementation, okay. So far so good. So we are in the end of April and the price hike was implemented with Ceusa. And as I said before in Karel's question, I think the main challenge will be in May, right.

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So May would be a important month to see that this implementation will be okay or not. We are very confident, right. So we are seeing a small recovery in the economy, right, so, but as we said before, it's just a small sign, as more recovery in the sell-out, right, but it's early to say that we are seeing a real recovery. But it's important information, I would like to reinforce the message that we are confident in this price hike implementation, right.

And in our view, the main challenge will happen in May, next month, okay. So regarding the second question, regarding Deca, I mean, we are seeing strong volumes there as you can see in the first quarter, right. We are gaining market share obviously when you compare to our competitors in the segment, we can see the difference, right, so the segment is decreasing and we are increasing volumes, right. Basically due to -- in our view, the brands, we had a very strong brand, we maintain our advertising, the sales point and stuff like that, right.

And specifically in the refurbishment segment, we are seeing small signs of recovery (sic), right, so we have increased volumes to the home center than the retailers, right. So in this first quarter and during this first part of the second quarter, okay. Thanks.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Thank you very much.

Operator

Our next question comes from Gabriela Benjamin with NFL.

Q - Gabriela Benjamin {BIO 21064822 <GO>}

Hi, yes, I have two questions. The first one is on the idle capacity you mentioned here, you say 19% -- or 18% idle capacity for panels in the Brazilian market for you guys. Is that considering the plant you guys shutdown and if it's not, what would the number be if we consider that capacity?

And then the second question is regarding Deca in the volumes similar to Lucas' question just now. But I remember in the first quarter of last year, the volume was very low for Deca, because there was about BRL30 million that spilled over into the second quarter. So I'd like to know if that's why -- why we saw such a big volume increase and what you guys are seeing already in the second quarter, if that kind of reversed effect in the second quarter?

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

Thanks, Gabriela. Just one second, please. Regarding the idle capacity, so, if you include Itapetininga, that's one asset that we have. We reported 56% of capacity utilization, without Itapetininga, because Itapetininga is not available due to the re-shutdown in the end of '15, the capacity utilization is around 71%. It's important to mention that our estimation is that the average of the sector is higher than that. The sector is around 80% of capacity utilization, okay.

However, as we are the only player that release this capacity utilization for the market, but our estimation, I mean, analyze the impact, the sales of the first quarter, analyzing the capacity utilization of each competitors, the average of the segment probably will be around 80%.

Regarding Deca, I mean, it's important to mention that the first quarter of last year, we had one issue specific about the deliverable -- the delivery of the products, right, so due to a issue in the end of the first quarter, okay. However, without this issue, we are seeing yes a improvement -- a increase in terms of volumes in Deca Division, right. I can say that it's a little bit surprise for us, but I mean, this is in line with our expectation for the rest of the year. Thank you.

Q - Gabriela Benjamin {BIO 21064822 <GO>}

Great. Thank you.

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>}

So again, thank you very much everyone for coming in this conference call. I'm available for answer the next questions if you have, and Phillip is also with me and we are available to do that, okay. Thanks 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.

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