Q2 2016 Earnings Call

Company Participants

- André Nogueira de Souza
- Jeremiah Alphonsus O'Callaghan
- Russell Colaco
- Wesley Mendonça Batista

Other Participants

- Alexander Robarts
- Andrew Carey Callaghan
- Bryan C. Hunt
- Farha Aslam
- Jose J. Yordan
- Lauren Torres
- Viccenzo Paternostro

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and welcome to JBS Conference Call. During this call, we will present and analyze the results for the second quarter of 2016.

Now, I'll turn the conference over to Mr. Jerry O'Callaghan, Investor Relations Officer.

Jeremiah Alphonsus O'Callaghan {BIO 19817115 <GO>}

Hello. Good morning, everybody, and welcome to our second quarter 2016 earnings call. With us here today, we've got the Global President of our company, Wesley Batista. We've also got from the U.S. André Nogueira who is the CEO of our U.S. Operations; Enéas Pestana who is the President of our Operations in South America. With us also is Mr. Gilberto Tomazoni who is the President of our Global Operations; Mr. Tarek Farahat, who is our Global President for Marketing; and also with us today is Russ Colaco who is our new Global CFO.

Before passing you on to our CEO, I would just like to briefly read the disclaimer in our presentation which is available on our website in which we will make reference to as we go through this call today. So just to read through this disclaimer this morning; on August 5 this year, we filed a registration statement on Forms F-1 and F-4 with the SEC and we also filed a request to register as an foreign issuer allied with a BDR program with the

CVM in Brazil. Please refer to those documents for more information regarding the proposed corporate reorganization.

During the course of this call, we will make forward-looking statements. All statements that address expectations or projections about the future are forward-looking statements. Although they reflect our current expectations, these statements are not guarantees of future performance, but involve a number of risks and assumptions. We urge you to review JBS filings with the CVM and the SEC for a discussion of some of the factors that could cause actual results to differ materially.

During this call, we will also refer to certain non-IFRS financial measures. These non-IFRS financial measures do not have any standardized meaning under IFRS and may not be comparable with other non-U.S. GAAP or other non-IFRS financial measures publicly available.

With that, I will pass you on to Mr. Batista.

Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you, Jerry. Thank you for joining us on today's call. Last night, we reported our financial results for the second quarter of 2016. EBITDA was R$2.9 billion, which was an improvement over the first quarter of this year, but below the year-ago period. Net income was R$1.5 billion.

JBS is facing different opportunities and challenges in each of the regions we operate – where we operate. Our results reinforce the importance of our strategy to diversify our business across both markets and segments.

I would like to provide you some of my perspective on the key highlights to the quarter. First, last week, we filed our F-1 with the SEC and launched our consent solicitation for the bondholders in connection with our reorganization. We remain on track to complete the process by the end of this year.

In the U.S., our beef business has seen improved profitability. We expect the increase of cattle availability in the U.S. and improving domestic demand will drive further improvements and profitability. Also, the export market is picking up for our U.S. beef business. We are very positive what this business is going to deliver to JBS in this second half of this year and going forward into 2017.

To talk about our pork business in the U.S., we had another good quarter, and the team – our team has been achieving pretty good progress. When we announced the Cargill acquisition, we announced that we were going to be looking for $150 million in synergies, and we are well on track to capture these synergies and may beyond to this number that we initially projected.

We are seeing pretty good pickup in the export – in pork export, especially pork export to China. As we know, China reduced substantially their herd, their sow herd size last year. The reduction in China was in a magnitude that is equal to all U.S. sow herd size. So, we expect to keep seeing pretty good demand for pork in China. So, we are very positive also what is our pork business is going to deliver in terms of results in the second part of this year and going forward.

Our chicken business in the U.S. and Mexico, Pilgrim's Pride, already reported their second quarter. I'm not going to go through Pilgrim's (06:30) already provided our perspective of the business.

So, moving to South America and especially talking about Brazil, our Seara business was negatively impacted by the increasing – especially in corn price. For you all to have idea, corn price almost – is almost double the price this year comparing to last year, a pretty big increase in corn price and for sure impacted our results in Seara.

Only – the impact in corn represented in the second quarter 600 basis points in margin EBITDA. On top of that – on top of corn, we all are seeing the real is strengthening against to the dollar. Also, this has a pretty big impact in our export revenues.

We are very focused to best price increase in the domestic market, and as well in the export market to offset the increase in corn price in Brazil, and as well to compensate and to mitigate the strengthening in the real. This has a lag in terms of timing, but we are confident that the industry – and we are going to be able to offset this through price increase in both the domestic and export.

We keep investing in our brands here in Brazil, and especially in the Seara brand. We keep growing our customer base. We keep improving our service level, and as well we keep growing in our prepared food business in value – growing our value-added portfolio.

We are seeing the industry in Brazil, the chicken and the pork industry in Brazil reducing production more so in this last two months, and we think this is going to accelerate the amount of production – the amount of product that is going to be available in the domestic market, and as well in the export market, and this, we believe, is going to be helpful to put prices where prices need to be, to put margin back where margin was last year.

So, moving to our business in Brazil, quite the same, not so impacted by grain price or corn price, but impacted in the strengthening of the real. The same opportunity that we have is in the export market to put prices back to where price was before. The real was so weak last year. So we see this again as a timing issue in terms of putting prices back to where the price was before, but we don't see any reason that we and the industry is not going to be able to put margins back where margin was before.

So, moving to Europe, Moy Park, you all know, we acquired Moy Park last year. We are very satisfied where we are and the team is very focused and on track to capture the synergies that we announced when we acquired Moy Park and we are already seeing improvement in our margins. And we are comfortable that we are going to be able to capture all the synergies that we anticipate when we acquired Moy Park.

So, mention about Australia. Australia is facing a challenge in terms of cattle availability. The industry is running much less volume this year comparing to last year. Cattle price went up substantially in Australia. So it's a challenge for Australia, but in the other hand, it's pretty good opportunity for the U.S. beef industry and as well for our beef business in North America, U.S., and Canada. So we are seeing export growing quite a lot in Japan, in South Korea, and in some key markets, that is the main players is Australia and U.S., and this is going to be positive for U.S.

Our Primo business in Australia is going well. We are satisfied where we are, even though we keep looking for more opportunities to expand our margin there, and as well grow our volume in our Primo business, especially we see a pretty big opportunity to grow our Primo brand and our business outside of Australia, in some key markets like South Korea, Japan and China.

So, overall, when we see all the segments, all the regions that we operate, I'd like to mention again the importance of our strategy to diversify our businesses across various market and segment, that is playing an important role for our company.

So now, I'm going to turn to Jerry O'Callaghan. He'll go through the numbers and go through each segment. And we are going to be here for the Q&A. Thank you all. Jerry, please.

Jeremiah Alphonsus O'Callaghan {BIO 19817115 <GO>}

Thank you, Wesley. Thank you, all. So I'm going to go through our presentation here and make reference to the page numbers for those of you that are accompanying our presentation on the webcast.

On page six of our presentation, we look at consolidated highlights for the second quarter. Net sales went from R$38.9 billion to R$43.7 billion in the period, up 12.3%, second quarter 2015 against second quarter 2016. Gross profit in the comparable periods went from R$5.87 billion to R$5.27 billion, a decrease of 10.3%. And gross profit margin declined from 15.1% to 12.1%.

Moving on to the next page, page seven, in our consolidated highlights, EBITDA and net income. Our EBITDA for the period, the second quarter 2016, was R$2.9 billion, a reduction of 19% in relation to the same quarter last year, which was R$3.57 billion. EBITDA margin declined from 9.2% to 6.6%. Net income went from R$80 million to R$1.54 million in the comparable period from R$0.03 earnings per share to R$0.55 earnings per share in the period.

With regard to operational cash flow, we had a negative operational cash flow of R$558 million in the period compared with a positive operational cash flow of R$2.97 billion in the same quarter last year. Free cash flow also was negative R$1.585 billion against positive R$902 million in 2015.

Continuing on our next slide, speaking of our net debt that increased marginally from R$48.7 billion to R$49.17 billion and leverage went from 3.84 times to 4.1 times.

Just as a reminder in this second quarter of 2016, we paid out dividends to the shareholders of JBS SA, corresponding to our net income in 2015, 25% of net income which represented R$1.1 billion. We also paid a special dividend at Pilgrim's Pride which was paid out in the second quarter, and of that special dividend, R$570 million went to the minorities and we also had one-off expense in the quarter related to the unwinding of our derivatives position of R$2.65 billion.

Our debt profile on the next page, page 10 in our presentation, 91% of our debt today is in U.S. dollars, 9% in Brazilian reals and the breakdown by source is basically the same as in previous quarters, just under 60% with commercial banks and just 40% in the debt capital market. And by company, almost half of our debt is at SA in Brazil another 43% is at JBS U.S.A., and the balance at JBS Foods.

In terms of short-term and long-term debt, slight decrease in the percentage of our short-term debt from 33% to 32%, when comparing with the previous quarter and in terms of the breakdown of the short-term debt, seeing us, we are very relevant exporters out of Brazil particularly. We use a lot of the (17:23) trade finance lines, which are available in Brazil. So, more than 80% of our short-term debt in Brazil is associated with these trade finance lines, which are rolling lines that we renew all the time, but which are short term by nature.

Moving on now to the business units and starting with Seara in Brazil. We previously named this JBS Foods Brazil, but in order to avoid any confusion with regards to the name JBS Foods, we've renamed it Seara. And in the second quarter of 2016, Seara had revenues of R$4.6 billion. That was up 3.3% when compared with the same period last year, R$4.46 billion in the second quarter 2015.

EBITDA declined from R$789 million to R$382 million, a decline of more than 51%. And EBITDA margin went from 17.7% to 8.3%. We had a growth in revenue due to the increase in sales prices in the domestic market.

As Wesley mentioned in the preceding comments, we had a very relevant increase in corn costs in Brazil. Corn prices practically doubled year-on-year in Brazil, and that caused a compression of our EBITDA margin in about 6 percentage points when compared with those periods. Further price increases will be necessary to offset the increase in the costs that occurred throughout the last year.

We've had relative improvement in our service level, and we've reached the number of active customers has reached 139,000 active customers at Seara.

At JBS Mercosul, the next slide in our presentation, this is our beef business in South America. It's primarily Brazil, but it also includes your Uruguay, Paraguay and Argentina, and also our hides processing business. We had revenues of R$7.2 billion in the quarter, stable in relation to the same quarter last year. EBITDA increased from R$376 million to R$457 million, up 21%. EBITDA margin went from 5.2% in 2Q 2015 to 6.3% in 2Q 2016.

We had an increase in volumes sold into the international markets. Just bear in mind for instance Brazil got approved for exports to China in June of last year. So we had a full quarter of exports to China this year, which we did not have in the previous quarter. We've had a pass-through of prices in domestic market and a reduction in the volume sold in the domestic market in Brazil. An increase in cattle prices and the appreciation of the Brazilian real in relation to the first quarter in 2016 caused EBITDA to decline quarter-on-quarter. And very recently, we had the announcement of the opening of the U.S. market for fresh Brazilian beef and that obviously is interesting for JBS. We have relevant presence in both these markets and capabilities to distribute that product down into the market in the U.S.

With regard to our businesses outside of South America, starting with our beef business in JBS USA Beef as we call it, that includes our Canadian and our Australian business. And here we speak in dollars and not anymore in reals. Our revenues declined 12.2% in the comparable periods from $5.94 billion in the second quarter 2015 to $5.22 billion in the second quarter 2016.

EBITDA margin also declined from 3.8% to 0.5% from $228 million in EBITDA to $27 million in EBITDA. We had an underperformance of our regional units in the U.S., basically where we source cattle from the dairy herd in the smaller regional facilities we have in North America and we had a higher production cost related to the initiation of or the re-initiation of our Hyrum, Utah plant where we made relevant investments to expand that plant with major distribution capabilities across the West Coast of the U.S. out of Hyrum. We restarted that plant recently and we've had expenses associated with the restarting of the plant.

We've seen a reduction in cattle prices in the U.S., particularly towards the end of the first half of the year and that indicates a much better dynamic for the second half of 2016. As Wesley mentioned, cattle prices in Australia remained elevated due to strong cow and heifer retention, which contributed to compressed margins there. Important to remember that the climate in Australia has improved quite a lot, we've seen good pasture, which is a good indication going forward and this, is the reason why we are seeing so much cow and heifer retention in Australia which is causing the short-term increase in cattle prices.

Our pork business in North America, JBS USA Pork, page 15 in our presentation. Relevant increase in revenue years from $795 million in the second quarter of 2015 to $1.364 billion in the second quarter of 2016 a 71.6% increase in net revenue associated with the incorporation of the Cargill Pork assets late last year. EBITDA margin and EBITDA also increased. EBITDA went from $65 million in the quarter last year to $137 million in the quarter this year, with EBITDA margin going from 8.1% to 10%. Wesley also mentioned the capturing of synergies associated with that acquisition, we targeted $150 million and we've already captured in excess of $80 million. We see strong demand for pork products (23:57) international market, particularly China and Asia, and we're also increasing our capacity, our capabilities in bacon production and consumer-ready products and improved results coming from that portion of the business.

JBS USA Chicken which is our Pilgrim's Pride business, which already reported, so not much new to add here. Revenue was flat year-on-year at just over $2 billion. EBITDA declined from a high of $426 million in the second quarter of last year to $283 million in the second quarter of this year. With EBITDA margin declining from 20.7% to 13.9%. We had a reduction here in volumes in this business as a result of the implementation of operational improvements in one of our prepared and convenience facilities in U.S. There was also a reduction in chicken prices compared with the same period last year. And we had a much better performance in our Mexican operations due to lower chicken availability and higher sales prices in that market.

Finally, before we open for Q&A, a quick word about our business in Europe, Moy Park, which we acquired second half of last year. We had revenue here in pound sterling, revenue of £365 million for the quarter, up 1.2% from £360 million in the same quarter last year. EBITDA went from £31.2 million to £33.5 million, up 7.3% and EBITDA margin went from 8.7% to 9.2%.

We had an increase in volumes of fresh chicken sold in the domestic market and of prepared products into the export market. And also, as mentioned earlier, we improved operational efficiencies and a better part of mix. And we see continuous progress in the operational results with increased sales growth in that business.

That terminates our prepared remarks. We would now like to open up for Q&A. Thank you very much. Thank you all.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Farha Aslam, Stephens, Incorporation.

Q - Farha Aslam {BIO 6151888 <GO>}

Hi. Good morning.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Hi. Good morning.

A - Jeremiah Alphonsus O'Callaghan {BIO 19817115 <GO>}

Hi, Farha.

Q - Farha Aslam {BIO 6151888 <GO>}

First question is regarding the launch of your bonds to F-1 and in terms of timing of a potential U.S. listing, do we have any clarity around when that could happen?

A - Russell Colaco {BIO 17952782 <GO>}

Sure, Farha. It's Russ here. So we launched our consent solicitation. We expect that to wrap up early next week. In the F-1, if you do look through it, we do refer to an expectation that we would be trading in the U.S. late in the fourth quarter.

Q - Farha Aslam {BIO 6151888 <GO>}

That's helpful. And then, this is a follow on to the cattle markets. I think, Wesley, you highlighted increased cattle supplies in the U.S., could you kind of share with us your thoughts on the increase in cattle, the pace of the increase, and how JBS's U.S. beef margins, or kind of that division, what's normalized and where can we expect that to go over the next few years?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Well, I'm going to answer part of your question. I'm going to ask André to add on my question. So, we have been talking about U.S. cycle in the beef business. We thought that the cycle was going to come – improve – the better cycle was going come earlier. But we are very positive now that second half we are going to see this positive cycle showing in the results and – showing in our results.

I expect to see, in the second half of this year, margins coming back to a normalized level that we think that is around 4% to 5% margin EBITDA or EBITDA margin. So this is the level – we may can see quarters better than this level, but overall in average, I do see margin coming in these levels.

So about cattle availability, André, if you can answer this part.

A - André Nogueira de Souza {BIO 20244486 <GO>}

Okay. Thanks, Farha. We are (29:02) around 3%. We expect for the second part of the year that will be around that, maybe a little bit more, maybe 3% to 4% in terms of heads that we are going to process, but probably a little bit less weight. I think that we're going to see now the cattle, compared with the same period of last year, a lighter cattle that we saw, maybe even 20 pounds lighter than last year, and from next year 2% or 3%, and another 2% for 2018. So we are just starting the cycle, the positive cycle of cattle availability into the West. We have seen much less production in Australia. So, that's why the exports have been so strong, especially in the last two months.

There's more cattle available in U.S. U.S. beef became more competitive on a global base. In the West, we'll recover and we'll grow exports. So because of more exports and less imports, I don't think that this more cattle available will translate in a much higher domestic availability. I think the domestic availability grew a lot in the last six months, especially. I think that recovered the mark that was very compressed before. I expect that for the remaining of this year and for next year, the net available to be around 1% in U.S.

So a healthy growth and healthy recover, but most of this, the balance will be more exports and less imports.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Only to add a little bit more on that. We are very positive in our beef business second half of this year and going forward 2017, is a combination, more cattle available, less imported products, especially from Australia. And as the cattle price in Australia went up quite a lot, so U.S. is much more competitive in Japan and South Korea. So the combination of export, more cattle availability, declining cattle price, all these things and we are already seeing this translating in results.

Q - Farha Aslam {BIO 6151888 <GO>}

That's very helpful. Thank you.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you, Farha.

Operator

The next question comes from Viccenzo Paternostro, Credit Suisse.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Hi, Wesley. Hi, Jerry.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Hi, Viccenzo.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Hi. Most of my questions on the JBS operations were answered in the Portuguese conference call. I will focus my questions on the financial line. My first question is on the expectation for the reduction in cost of debt going forward, after the corporate restructuring. It seems that it's possible to have much lower interest rates after I mean, I would say in 2018. I don't know if you have any estimate on what would be a fair assumption for the cost of debt in 2018 for instance, for the new company listed in the U.S. I suppose you could have access at a much lower debt – low cost of debt in the U.S. So that was my first question.

My second is on the hedging. You reduced a lot your hedging exposure from R$33 billion to R$0.5 billion only in the hedge. I'd like to know your thoughts on what would be the size of the hedging structuring going forward. Thank you.

A - Russell Colaco {BIO 17952782 <GO>}

Yeah. It's Russ here. I'll tackle the first question on the cost of debt. While we expect that will be included in the developed market, high-yield indices and we will start to have a trading range in line with U.S. listed peers and rates in line with U.S. peers. It's very hard to predict what those will be in 2018. You might look at what other high-yield companies that are similarly rated in the U.S. have in terms of yields, now that might be an appropriate expectation, but hard for us to forecast that far out. And, Wesley do you want to talk about the hedging policy on a go-forward basis?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Yeah. Basically, the hedging position and policy, look, actually we don't have any hedge today in Brazil. This position that you mentioned is not any hedge in Brazil or hedging the real against the dollar. This position is just in the U.S. a little bit in grain that Pilgrim's Pride has a little position in grain. So, our position today, we are completely un-hedged. We don't have any hedge. And you all know we have – last year, we were fully hedged, as we thought that the real was going to depreciate, and we put 100% hedge, against to our exposure.

And in the beginning of this year from January to April, we took all the hedge out, because the scenario changed completely. And we think that the real does not make sense to put any hedge on the real today due two fact, one is the cost of this hedge does not make sense, and the perspective in Brazil is getting better every day, in terms of the political situation here, the economy, and the fiscal debt, all these things. So, it does not make sense in our view to put hedge. So, this is one thing. The other thing is that as we complete our reorganization and reporting our earnings in JBS Foods International and we now reported in dollars, this is going to take our necessity to being placing hedge against the real. So, we don't have any plans to put any hedge in place now or going forward in the scenario that we are seeing in the marketplace.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Perfect. Thank you very much.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you.

Operator

The next question comes from Lauren Torres, UBS.

Q - Lauren Torres {BIO 7323680 <GO>}

Yes. Hi. Good morning, everyone.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Hi, Lauren.

Q - Lauren Torres {BIO 7323680 <GO>}

Hi. My question is on pricing at Seara. You mentioned that the corn price hike was too big, I guess, off that (36:37) was pricing so far and that there is room for further pricing so curious as to (36:40) your perspective on what type of pricing we should see. I know, there has been a strong margin stories, but just curious on how you're thinking about, I don't know, if this is second half story or we should start thinking about next year as far as recovering some margins and if that's price led and by how much pricing you have to take to get there?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Lauren, basically this is going to be a moving progress. So we are going to see the prices in the domestic market as well in the export market, recovering during this second half of this year, and hopefully, we can get all the price recover by year-end and we can see 2017, a stable price dynamic and margin back to where margin was before. As we all know, when you think about – we have two major and very relevant impacts in our Seara business. One was corn, today it's worth double the price compared to a year ago. And it's a Brazil issue and we think that is going to improve going forward, as Brazil is importing more corn and as well, we are going to get in the new...

A - Russell Colaco {BIO 17952782 <GO>}

Cycle.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

...cycle to be able to see more corn available. And as usual, when you have corn in the price that it is now in Brazil, this will stimulate a lot to increase the size of the planting area. So, we think that we are going to have a better scenario in the corn market for next year.

And in the export, this is the biggest – on top of the domestic market, but in the export market, is the largest opportunity in terms of translating price increase into results, and why? Last year, as the real went to four by the end of last year, everybody increased a lot export and put much more product in the export market. For you have idea, Brazil was exporting 300,000 tons per month and went to 400,000 tons per month, because it got very attractive with the real at four.

And the velocity and the magnitude that the real appreciated so – was much faster than the industry was able to put price back where price was before. The real was so weak last year. But this is a question of time. We don't have any doubt that we are going to see prices back where price was before when the real was at three last year, but is a lag. The corn and the real, the real appreciated and the corn went higher very, very fast. And price is going to catch up. My view, we think we are going to end up 2016 without the price recovery implemented.

Q - Lauren Torres {BIO 7323680 <GO>}

Thanks. That's good to hear. And if I can ask one unrelated question, the U.S. opening for Brazilian beef, I guess this is becoming now more of a reality. So just curious to get your perspective on what this could translate into for you as far as incremental and maybe the opening of other markets. How are you thinking about the benefit of this flowing through once it does fully occur?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Look, this is mid-term and also short-term. Mid- and long-term is very, very positive for the Brazilian beef business, not only to be able to access the U.S. beef market, but also to foresee future expansion in terms of market opening to Brazil or other markets opening to Brazil. I think this is the first step for Brazil being able to foresee another important market opening to the Brazilian beef industry.

And think about – we are the company that has the best structure in the U.S. to be able to distribute and to sell Brazilian beef products in the U.S. market. So we have knowledge, we have very sizeable operation, we know the customers, we have the vision, we have sales team. So we are very positive in terms of what this is going to bring to the Brazilian beef business. And in the other hand, it's not going to jeopardize in any regard in our view the U.S. beef business, given the fact that Australia – the amount of production in Australia is well below last year and Australia is shipping much, much less product to the U.S.

Q - Lauren Torres {BIO 7323680 <GO>}

Thanks. Good to hear. Thanks, again.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you.

A - Russell Colaco {BIO 17952782 <GO>}

Thank you.

Operator

The next question comes from Alex Robarts, Citigroup.

Q - Alexander Robarts {BIO 1499637 <GO>}

Hi, everybody. Thanks for taking my question.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Hi, Alex.

Q - Alexander Robarts {BIO 1499637 <GO>}

Hi. Listen, the first question relates to the JBS Pork business. I thought it was interesting how you laid out the scenario going forward for exports in the Portuguese call earlier, from the U.S. pork. And I want to understand the opportunity, I guess, the sow herd reduction in China is now coming to the point where they just need to import a lot of pork. How does that translate as far as the JBS Pork business, thinking of the second half? I mean, I understand 20% of the industry is exported. Is this an opportunity that could really be an outsize opportunity in the sense that we should expect a lot more of your product to be exported and of the industry?

And as the second biggest player in pork, do you think double-digit margins then in the pork business become feasible for the second half and are you concerned about any kind of supply issues though in the U.S. So, kind of a several pieces of the question, but around this whole idea of the Chinese sow herd reduction and your export possibility.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Alex, I'm going to ask André to answer your question. Please, André.

A - André Nogueira de Souza {BIO 20244486 <GO>}

Alex, US this year, exports growth to China is close to 300% compared to last year. That will give you the size of the opportunities. And (45:09) more production in Cargill that's the norm of the seasonality now and the September more (45:16) production that U.S. pork meat will become even more competitive. So, if you look, the last year or so, and including the first part of this year, U.S. pork meat was more extent (45:30) than European meat. So that was whole with the (45:33) the export. But the U.S. (45:35) are so good in the first part of the year that we could deliver good margin and good performance despite of export not being so strong.

Now, we are in the second part of the year and for next year that U.S. will be cheaper and maybe much cheaper than Europe. So I expect a very strong growth. Who is leading the growth until now? It's China, but I don't think that will be only China. I think that U.S. is in a point of competitive in price that the export will grow beyond China.

Q - Alexander Robarts {BIO 1499637 <GO>}

Right. So...

A - Operator

So, Alex, just to add a portion, so you asked about margin – double-digits to level margin. Yeah. We definitely think that this is doable. And it's going to be, in our view, the case given the fact that we see pretty big opportunity for pork export, and also pretty good pork availability in the market. So, we are seeing – we saw a pretty big decline in hog price. And like André mentioned today, U.S. is so competitive in terms of cost and price that we believe not only in China, U.S. is going to get really good traction in other markets in terms of exports.

So, the combination of these things, on top of that, we believe we have a very, very well-run pork units and pork business, and we are very, very good positioned to take advantage of that.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. Okay.

A - Operator

(47:20) commence that in the first part. And the synergies that we planned, we are capturing the synergies, so we are having big improvements in the operation on the sales of the business that we acquired. So that on top of the – the March condition I think that performance will continue to drive high margins.

Q - Alexander Robarts {BIO 1499637 <GO>}

Fair enough. That's clear and thanks for that. The second question relates to one of the things I remarked on in the documents that we kind of were able to see for the first time, related to the SEC registration and filings.

There is a piece there that talked about related party transactions, and I guess what was interesting to see is that when you look at the cattle purchase agreements that JBS has entered, I guess a million heads, right, is minimum that you have to buy either in Oklahoma or Australia or Canada, but the bulk of that is in Oklahoma.

How are you thinking about these cattle purchase agreements going forward? Is this something that you feel is a competitive advantage versus other players in the industry? I mean, one of the things we've seen in the sharp drop, right, recently of the cattle prices is that we've had these mark-to-market issues that have kind of been impactful on your margins recently.

And I'm wondering, does it make sense to reduce those cattle purchase agreements or amend them, or do you feel comfortable with them? And just kind of maybe giving us a little perspective on these – on this 1 million heads a year that you contracted by through your businesses. Thanks very much.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you. André, please.

A - André Nogueira de Souza {BIO 20244486 <GO>}

Well, this is a big advantage for JBS to have this – a lot of big advantage we have just time of (49:32) local supplier and continue to be a big advantage for JBS. We have this captive supply. We buy at market price, so there is no benefit or negative impact in terms of pricing for JBS. It's just a captive supply. This is in favor of JBS.

If JBS decides to buy any less cattle, I think that for the other sizes, this more than happy to reduce that, but this is a benefit for JBS to have this captive supply of cattle. So, there's no negative. We buy these at market price. It's just a captive supply, and we will work to develop specific programs that will just (50:16) relationship. We have been the largest natural supplier of beef in the U.S., and we have that because of this captive supply.

Q - Alexander Robarts {BIO 1499637 <GO>}

Got it. Okay. Thank you.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you.

Operator

The next question comes from Jose Yordan, Deutsche Bank.

Q - Jose J. Yordan {BIO 1496398 <GO>}

Hi. Good morning, everyone. I just had a...

A - Operator

Hi, Jose.

Q - Jose J. Yordan {BIO 1496398 <GO>}

Good morning. Just a clarification on these regional units and how – what percentage of the total U.S. business that represent. And if you can give us any color about how much money in pre-operating expenses are we talking about in terms of negative impact in the quarter? I mean, I guess, what I'm getting to is what would the second quarter margin in JBS USA Beef, what would it had been, had it not been for these two one-offs that we're talking about here in the press release and the presentation?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

I'll let André hold it.

A - André Nogueira de Souza {BIO 20244486 <GO>}

Hello. We got cut off for a minute. I think we're back on line. Are we?

Q - Jose J. Yordan {BIO 1496398 <GO>}

Yes.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Well, if you want, I can answer the question (51:29).

Q - Jose J. Yordan {BIO 1496398 <GO>}

Yeah, yeah. Go ahead with that. We got cut off here. Go ahead.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Okay. Okay. So, Jose, the size of the business in reals, we have four plants that we call the fat business and have five plants that are smaller plants and regional plants that are called the regional business. In terms of size, the regional business in terms of sales is half of the sales of the fat business, because the plants are smaller plants and these plants will smartly (51:59) process most Holsteins and dairy cows and beef cows.

So, this had been a good business overall for us. They have the seasonality and of course, and now that we saw this retention of cows that we have in U.S., we're processing less cows. The profitability of this business at this moment was in the second quarter lower than the fat business. So push the fat business was the talk of the town.

More important than that, in terms of impact in the quarter was Canada. I explained this in the first quarter. Canada, we have one plant and we process there about Canada (52:39). We have a lot of contracts and (52:42) was very short in U.S. The discount that we normally have in cattle in Canada, you buy cattle $150 per head lower in Canada than you buy in the U.S. That discount disappeared and that's really impact the results of that business in the first quarter and in the second quarter. That was probably in terms of total amount, the biggest impact for us in the quarter.

This is not the case anymore. We already started seeing May, especially in June and now in July, the cattle price in Canada went back to the normal discount level for the U.S., and that's probably the trend, with more cattle availability in the U.S., to go back to the normal trend.

And we have the (53:28) opening of the new fat floor and the new distribution that impact our business. As was already commented, we expect, without these one-offs in the more normal – in the regional business that we're going to see in the second part of this year and the next year, this business is going back to what we call normal margin. We can have a strategic quarter that would be above that, but the normal level between 4% and 5%.

Q - Jose J. Yordan {BIO 1496398 <GO>}

Okay. Thanks for the color.

Operator

The next question comes from Carey Callaghan, American Trust.

Q - Andrew Carey Callaghan {BIO 2035081 <GO>}

Yes. Two questions, if I could. First on the Seara business, I don't want to put words into Wesley's mouth, but I think I heard him say the 600 basis points adverse impact of the corn could be recovered by late in 2017. Looking at the historical EBITDA margin, it was more like 17% to 20%. Do you think you get back there in 2018? Hello?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Yes.

A - André Nogueira de Souza {BIO 20244486 <GO>}

Hello.

Q - Andrew Carey Callaghan {BIO 2035081 <GO>}

Yes, can you hear me?

A - André Nogueira de Souza {BIO 20244486 <GO>}

We've got cut off briefly here. I'm sorry. We had some issue in São Paulo. We've got cut off. We're just reconnecting now. Actually, I'm on a cell phone, but we can hear you well. So, you can take it from here, if you don't mind.

Q - Andrew Carey Callaghan {BIO 2035081 <GO>}

Sure. So the question on Seara was, you might recover the 600 basis points from the corn adverse impact by the end of 2017, but historically, that business looks like it's carried maybe 17% to 20% margins. Do you see getting back to that level in, say, 2018?

A - André Nogueira de Souza {BIO 20244486 <GO>}

Actually, we see a real scenario that this can be back on 2017, not in 2018, not only corn, to recover this 600 basis point on the corn, but to adjust the export price to the level that was a year ago, is going to have the most impact in the result because, again, I mentioned this before, when the real was R$3 last year, prices in the international market was along $500 higher than it is or then it was a couple of months ago, but given the fact that the real went to R$4 in the end of last year, price declined, because Brazil increased a lot of volume to the export market.

So, I think from now or from a month ago or a couple of months ago, that prices starts to pickup in the international market. So I think there's enough time the next five months that to put prices back where the price was before.

On top of that, normalizing the corn price, we strongly believe that 2017 is the year that margin can recover to the level that it was before, that it was last year.

Q - Andrew Carey Callaghan {BIO 2035081 <GO>}

Thank you. And just quickly to follow-up on Jose's question, I think you mentioned 4% to 5% margins in USA Beef. Is that 2017 or 2018?

A - André Nogueira de Souza {BIO 20244486 <GO>}

Second half of this year and 2017. This is our view.

Q - Andrew Carey Callaghan {BIO 2035081 <GO>}

Okay. Thank you.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you.

Operator

The next question comes from Bryan Hunt, Wells Fargo Securities.

Q - Bryan C. Hunt {BIO 1530288 <GO>}

Thanks for your time. I was wondering if you could just provide a little bit more color and given the circumstances on the U.S. beef side and talk about maybe how July and August is going relative to that 4% to 5% target. Are you within that range already for the beginning of Q3?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Yes.

Q - Bryan C. Hunt {BIO 1530288 <GO>}

Yes. And is it the fact that the Utah startup isn't in the numbers any longer as well as the normalization of pricing in Canada, that is really driving that?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Yeah. It's a combination, it is higher on Canada and a better dynamic in the U.S. market. So, growing export, so André can give you an idea. In July, export went up how much, André?

A - André Nogueira de Souza {BIO 20244486 <GO>}

Our exports went up more than 20% in July, our exports. We don't know the industry number.

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Yeah. Our volumes. So higher – 20% higher in July compared to last year, our volume. On top of that, André mentioned, our cattle price in Canada, historically, the basis – the difference, the price difference in Canada comparing to U.S., you can see that it was much higher, the price difference. U.S. was higher than Canada. And last year, in this first half of this year, the spreads brought almost none, so price in Canada was almost the same.

Now, July and the whole part – the rest of this year, our cattle price is back to the normal level that it was historically in terms of the base in Canada. So Canada plus (01:00:18) plus better dynamics is putting (01:00:23) us enough confidence to say that we believe margin is going to be and like the U.S. So we know our July numbers, and we know where we are in the third quarter, our results. And we are there or even more.

Q - Bryan C. Hunt {BIO 1530288 <GO>}

And switching gears and looking at your fat or your regional plants, excuse me, that has Holsteins and dairy cows, every cow is raw material for those facilities. Dairy prices have dropped precipitously in the last year, yet there hasn't been a liquidation of dairy cows in the U.S. or at least we haven't seen the beginning of it. What's your outlook for supply of animals for these regional plants?

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

A - André Nogueira de Souza {BIO 20244486 <GO>}

Right, Bryan. You're absolutely right. Despite of the dip in the milk, we are not seeing any strong liquidation in dairy. That's why, we are just looking at the mix on this plant and they process a little bit less cows and more Holsteins. If this change, if we see a liquidation of dairy, that will be very positive for this business. We're not seeing this yet. We do not anticipate this for the second quarter of the year.

We are running with less cows that have been much less profitable than the fat and run more of Holsteins. If that change, we'll adjust our mix. These plants are very well located, very well-invested plants. We grow a lot in ground beef on these plants. We are in pork streams and mix with domestic streaming, that's been great for us. And if these plants change, yeah, this business will run above the normal fat business, if we have a liquidation in there. But we're not seeing that. We're not anticipating that for the second part of the year.

Q - Bryan C. Hunt {BIO 1530288 <GO>}

And then, my last question is on value added. Part of the story is you all continue to move your mix on whether it's U.S. pork or U.S. beef to higher value-added mix. Can you talk about the actions you took in Q2 to drive an increase in value-added products. Thank you. That's all for me.

A - André Nogueira de Souza {BIO 20244486 <GO>}

Bryan, nothing new. It's just a continuation of the investment that we did. Our volumes in ground beef, case-ready ground beef this year compared to last year is 40% higher. Our volumes in the CCA continue to grow, both in beef and pork. We will continue to invest that. We think that could be, in the future, will be a big part of our mix.

And of course, we have the change in the regulation in U.S. that's coming on in October for the retailers in terms of the grind that they do in the back of the store. That probably will be a big bust for more case-ready ground beef.

Q - Bryan C. Hunt {BIO 1530288 <GO>}

Thank you for your time. I'll hand it off to somebody else.

Operator

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

A - Wesley Mendonça Batista {BIO 15243148 <GO>}

Thank you. I'd like to thank you all for being in today's call and to thank you all for the interest on our company, and looking forward to the third quarter earnings call to be with you again. Thank you.

A - André Nogueira de Souza {BIO 20244486 <GO>}

Have a good day.

Operator

This concludes today's JBS audio conference. Thank you very much for your participation, and have a good day.