Q1 2017 Earnings Call

Company Participants

- Eduardo Miron, Chief Financial and Adm. Officer and IRO
- Frank Ravndal, President & Chief Executive Officer
- Marcos Antonio Molina dos Santos, Chairman
- Martin Secco Arias, Chief Executive Officer

Other Participants

- Isabella Simonato, Analyst
- Pedro Leduc, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen. At this time, we would like to welcome everyone to Marfrig Global Foods S.A. Conference Call to present and discuss its Results for the First Quarter of 2017.

The audio for this conference is being broadcast simultaneously through the Internet in the website, www.marfrig.com.br/ir. In that address, you can also find the slide show presentation available for download. We inform that all participants will only be able to listen to the conference call during the company's presentation. After the company's remarks are over, there will be a Q&A session. At that time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Marfrig's management and on information currently available to the company. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions, because they're related to future events, and therefore, depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of Marfrig, and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Marcos Molina, Marfrig Global Foods' Chairman. Please, Mr. Molina, you may begin the conference.

Marcos Antonio Molina dos Santos {BIO 15363967 <GO>}

Good afternoon, everyone. Before presenting Marfrig Global Foods results, I'd like to inform that yesterday, we released a Material Fact announcing that we submitted to the SEC a request for Initial Public Offer, IPO, of Keystone Foods shares. This was made by the submission of the Form F-1, which is the first step of this process.

I will now pass the call to our CEO, Martin Secco, who will begin the presentation of the results for the first quarter. Thank you.

Martin Secco Arias {BIO 18098476 <GO>}

Thank you, Marcos. Good afternoon, ladies and gentlemen. I want to start by thanking everyone for participation in another earnings conference call of Marfrig Global Foods. Today, we will be commenting on the results for the first quarter of 2017. With me today are Frank Ravndal, CEO of Keystone Foods; Eduardo Miron, our Global IRO and CFO; and Roberta Varella, our Investor Relations.

Please go to slide number 3. On this slide, we will go over the highlights for the first quarter of the year. In early-May, we filed with the SEC our registration statement for the IPO of Keystone Foods, which was made via confidential submission of Form F-1, the first official step in the IPO journey. This process includes various step and we just concluded first one, which was submission of the F-1 form to the SEC. As we are in silent period according to the SEC rule, we will not be able to respond any question regarding this operation.

Now, going back to the first quarter of 2017. The political and economic environment we faced during the quarter remained volatile at global level. In Brazil, the economy has begun to show sign of recovery, driven by the super harvest in the agriculture sector, especially in the case of soybean. However, Operation of Weak Flesh with (05:12) in middle March on target of few animal protein producers introduced yet another obstacle into the beef industry as a whole, which was already facing a scenario marked by the lower margin, a stronger Brazilian real, and still recovering demand.

In a similar scenario, we continued to show growing demand in all of our operation regions. Despite the challenge, we remain committed to investing in improving our expansion in assets with growing focus on corporate structure in both the operational and financial dimensions. On the next slide, I will comment in more detail the changes of the operational structure in Beef Division.

On the financial front in March, we continued to make progress in our Liability Management process. Marfrig once again successfully carried out an international bond placement, raising $750 million, a seven-year bond at cost of 7% per annum. The proceeds were used to repay more expensive debts, such as 2018 and 2020 Bonds. Lastly, as I previously communicated in January, the debenture was converted and we made the last interest payment in the amount of BRL 327 million.

On slide 4, I will comment on change in Beef Division. The Beef Division continued with two operations, Brazil Beef and Beef International. Broken into five segments and from now on led by CEOs (07:13) will report directly to me and I continue to serve as the CEO (07:20) of Marfrig Global Foods. With a leaner structure and elimination of our hierarchy level, we expect to be more agile in decision-making process and to have more visibility on the results by segment.

Another change in this international operation was the company management decision to divest the Villa Mercedes unit in Argentina. Despite the important of Argentina market, the sector remains in a recovery phase. And as part of our strategy, we believe that the best decision at this time is to divest this asset.

On slide number 5, we are going to comment the Beef results. The first quarter result reflects both the seasonality of the quarter and the temporary challenge posed by the Weak Flesh Operation that affected Brazilian industry animal protein. On top of that, this result was impacted by the depreciation of the dollar against the real of around 20% versus the prior year period.

As you can see in the chart, on the upper left of the slide, the Beef Division posted new - net revenue of BRL 2 billion, down 17% year-over-year. This result is explained by the average dollar depreciation of 20% between the periods, the lower sales volume, the lower average price in the domestic market, with these factors partially offset by the higher average export price in U.S. dollar.

Specifically, in the case of the Brazil operation, I want to highlight the efficiency shown by our team to rapidly respond to these adverse market conditions. We (09:25) part of our effort to consider (09:29) temporary as well as Brazil domestic markets. In domestic market, the fresh beef sales volumes grew around 9%. The food service and small retailer channels accounted for 42% of Brazil operation revenue, increasing by 240 basis points year-over-year.

Total sales volume accounted (09:56) to 229,000 tons, down 5% year-over-year, mainly explained by the lower export volume, which followed the dynamics of the Brazilian market affected by the Weak Flesh Operation. As you can see on the chart on the top right, adjusted EBITDA was BRL 138 million, with margin of 6.7%, the main factor was the lower export spreads or better export price in U.S. dollar and lower cattle cost were more than offset by the stronger devaluation of the dollar against the Brazilian real.

Before going to the next slide, I would like now to pass the word to Frank Ravndal.

Frank Ravndal {BIO 19230519 <GO>}

Hey. Thank you, Martin. Good afternoon, everyone. Keystone delivered another strong result and set a record adjusted EBITDA for the first quarter. The volume expansion in both the U.S. and APMEA segments reflects our commitment to delivering the highest standards of food safety and quality to our customers and our continuing efforts to expand our strong customer base. Our strategic customer relationships with the world's leading and most demanding brands across multiple channels is what defines our culture and differentiates us from our competitors.

Let's review the quarter's results in more detail on slide 6. As a reminder, all financial data presented for Keystone Foods is in U.S. dollars. Starting with the graph on the upper left, volume was up by 5% from the same period in 2016. We had strong growth in APMEA due to a healthy combination of promotional activity, share increases and incremental demand from important export destinations like Japan. Our operations in Australia, Thailand and Malaysia, all performed very well this quarter.

In the U.S., volume growth was driven by strong performance in the food service and industrial channels, where we added new customers and also saw higher demand for No Antibiotics Ever products. Moving to the graph on the lower left, net revenue in the first quarter increased by 7%. In addition to the impact of higher volume, revenue was positively affected by a better sales mix, with continued solid contributions from NAE products in the U.S. and also by higher prices for dark meat by-product exports out of the U.S.

Moving to the graph on the right side of the page, you can see the EBITDA and EBITDA margin for the first quarter. The EBITDA improvement was largely driven by volume expansion and better product mix, as we've just discussed. We generated adjusted EBITDA of $62 million in the first quarter of 2017, up from $57 million, an increase of 10% year-over-year and a record for a first quarter. EBITDA margin was 9.4%, once again above our 2013 to 2018 target range of 8% to 9%. In summary, Keystone had a really strong first quarter and a great start to the year.

I'll pass the call now to Eduardo.

Eduardo Miron

Thank you, Frank. Good afternoon, everyone. Moving now to slide number 7, as you can see in this chart on the left, Marfrig posted net revenue of BRL 4.1 billion in the quarter, down 16% year-over-year. The lower total sales volume posted by the Beef Division and the effect of the stronger Brazilian real were partially offset by sales volume growth in the Keystone Division.

The chart on the top right shows a break-down of net revenue in the quarter, with Keystone Division accounting for 51% of the total company's revenue. Adding Beef International operations, 61% of Marfrig's total revenue came from operations located abroad. In terms of currency exposure, in the first quarter, 79% of revenue was bagged (14:19) to currencies other than the Brazilian real.

Let's turn to slide number 8. On slide 8, I will comment on Marfrig's consolidated gross profit and adjusted EBITDA. Gross profit in the first quarter was BRL 460 million, down 20% year-over-year, with gross margin reducing 60 basis points to 11.1%. The overall profit was driven by the margin compression of the Beef Division, which followed market dynamics, and was partially offset by the Keystone Division performance.

Adjusted EBITDA in the quarter was BRL 334 million, with margin of 8.1%. If you look at the chart on the lower right, you can see the contribution by division to the consolidated EBITDA, where Keystone accounted for 59% or 9 percentage points more than in the same quarter last year.

I will now turn to slide number 9. As you know, we continue focused on the search for solutions to reduce our financial cost. In January, we concluded the conversion of the debentures, which will bring interest savings to Marfrig and will improve our free cash flow during 2017. We already discussed this topic in our last call, but I'd like to reinforce given its importance. Still, during the first quarter, we concluded a new debt issue, taking advantage of an interesting opportunity for the company.

Once again, we successfully achieved our Liability Management goal of reducing cost and extending terms. Despite the uncertainties in the global scenario, in March, we concluded an issuance of $750 million bonds maturing in 2024. With the demand three times higher than the initial offering, the bonds were placed with an interest coupon of 7% per annum, with a spread over Treasury of 170 basis points better than our previous issuance of May 2016, which clearly reflect a better risk perception of the company by the market.

The proceeds were used in a tender offer, which partially retired the 2018 and 2020 bonds totaling $346 million. This was followed by the company's exercise of its call option of the outstanding 2020 bonds in the amount of $204 million in May. If you look at the chart, you can see the pro forma curve of the new maturity schedule for the bonds, which shows an increase in the average term to around five years.

Let's go to the next slide, please. Slide 10 shows Marfrig's liquidity and debt maturity schedule. As you can see in the chart on the lower right, net debt in U.S. dollar, which is our main metric, stood at $1.9 billion. In Brazilian real, the net debt was BRL 6.1 billion. In U.S. dollars, gross debt was $3.7 billion, 9% higher than in the previous quarter, which reflects the proceeds from the new bond issuance, which were partially used in the period and I just commented on the previous slide. In Brazil real, gross debt stood at BRL 11.8 billion.

The balance of cash and cash equivalents ended the quarter at $1.8 billion or BRL 5.7 billion. The leverage ratio measured by net debt to the last 12 months adjusted EBITDA ended the quarter at 4.08 times from 3.64 times at the end of 2016, reflecting the lower quarter EBITDA. As a highlight of our Liability Management process, I'd like to call your attention to the reduction of our average cost of debt to below 7%. Compared to a year earlier, the average cost of debt improved by 70 basis points.

Let's go to the next slide, please. On slide 11, I will comment on cash flow in the first quarter. Before going to the details, I wanted to point out that the first quarter cash flow is usually the weaker of the year even in a stable business environment. Lower business activity, inventory building, sales planning and CapEx acceleration are normally the reasons for that. Back to the first quarter, beside the seasonality aspect, we had two additional factors. First, the U.S. dollar devaluation against Brazilian real of 20% year-over-year, and second, the negative environment due to the Weak Flesh Operation in Brazil.

Moving to the chart, you can see that even in this very challenging scenario, the operating cash flow was BRL 80 million positive, materially impacted by the exchange variation aforementioned. In the Beef Division (20:24) for example, this exchange variation impacted the Brazilian export spreads, and in the case of the international operations, it impacted the conversion of the results from local currency, essentially dollar, to the Brazilian real.

Regarding CapEx, you can see that we invested about BRL 134 million in this quarter, a 24% increase in comparison to the BRL 108 million invested in the first quarter 2016. It is important to mention that the majority of this was in U.S. dollar and mainly in Keystone. So, investment is even more relevant considering foreign currency 20% lower than last year.

Another positive highlight was the reduction of around BRL 100 million in interests this quarter in comparison to last year. This improvement occurred mainly due to the debenture conversion and the consequent interest saving from January on (21:25), and the foreign currency translation impact that positively affected the interest line. Beside these two factors, we had interest reduction as a consequence of the ongoing effort in our Liability Management process.

Before moving to the next slide, I will now pass the call back to Martin.

Martin Secco Arias {BIO 18098476 <GO>}

Thank you, Eduardo. Before starting the Q&A session, I want to remind everyone that in 2016 earnings call, I commented that we were in the final phase of the construction of our 2021 Vision and that I plan to share it with you shortly. And because of the fact that Marfrig management decided to launch the Keystone IPO process, in compliance with the SEC rule (22:25), we are not currently – we are currently in silent period, and thus, prevent from giving long-term figures or projection for the company. So, we will return to this topic once Keystone IPO registration process is concluded. I thank everyone for your understanding, and the rest assured that we remain focused on our commitment to keep building a more solid and profitable company.

We are now ready to go to the Q&A session.

Q&A

Operator

Excuse me, ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Isabella Simonato with Bank of America Merrill Lynch.

Q - Isabella Simonato {BIO 16693071 <GO>}

Good afternoon, everyone. Thank you for the call. My question is on the beef operations. I understand that this was a tough quarter, especially because of the Carne Fraca investigation. How can we think about Q2? What sort of impacts we should continue to see because of this investigation? And how are you looking for beef prices in the international market going forward, I mean beyond Q2, more looking to the second half of the year in dollar terms? Thank you.

A - Martin Secco Arias {BIO 18098476 <GO>}

Thank you, Isabella, for the question. What we can share with you today is the situation of Carne Fraca happened was absolutely normal today in the beef sector. All the markets are already open and normal. The market for the cattle purchase is absolutely normal. We are in full May and June of slaughter plants. It was a huge problem at the end of March and at the beginning of April. We are also receiving this – during this month two important visits for the external sanitary authorities like U.S. and the Community – European Community that they are checking all the Brazilian system. But for the comment that we received, because also we received some visit in our factories, the situation is absolutely normal and under control.

Q - Isabella Simonato {BIO 16693071 <GO>}

Great. Thank you very much.

Operator

Our next question comes from Pedro Leduc with JPMorgan.

Q - Pedro Leduc {BIO 16665775 <GO>}

Hi, everybody. Thank you for taking the question. A bit more on the results itself. From what I'm seeing, this quarter had a little bit of a still abnormally high net financial expenses, if you can give us what was recurring and whatnot? And still on this line, how much deleveraging do you think you need to achieve in order to be returning to a net profit basis? And so, just trying to understand lower rates (26:05) will do the job or really how much cash you're looking to – that will be needed for that? Thank you.

A - Eduardo Miron

Hi, Pedro. Thanks for the question. As you know, I mean, our target is to continue reduce our costs and I just mentioned previously, all the activities that we have done in the first quarter of the year. So, it shows how focused we are on this. Obviously, the current level of interest, the way we see is supposed to be reduced. We expect this number to be in the range of BRL 350 million overall to BRL 400 million. And – but that's just a part of the equation. So, I think the most important thing is that we need to have the business performance improving. And with that, I think we'll have a positive cash flow at the end of the year.

Q - Pedro Leduc {BIO 16665775 <GO>}

Okay. Thank you.

Operator

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

A - Martin Secco Arias {BIO 18098476 <GO>}

Okay. I would like to thank everyone once again for joining us on the call, and we are going to keep in touch with you in the next days, if you have other questions than today. Thank you.

Operator

Thank you. That does conclude our Marfrig's conference call for today. Thank you very much for your participation. You may have a nice day.