

Q3 2018 Earnings Call

Company Participants

- Nelson Krahenbul Salgado, Executive Vice President, Financial and Investor Relations
- Paulo Cesar de Souza e Silva, President & Chief Executive Officer

Other Participants

- Audrey Preston, Analyst
- Augusto Ensiki, Analyst
- Cai von Rumohr, Analyst
- Joshua Milberg, Analyst
- Kristine Tan Liwag, Analyst
- Noah Poponak, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call that will review Embraer's Third Quarter of 2018 Results. 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 and webcasted at ri.embraer.com.br.

This conference call includes forward-looking statements or statements about events or circumstances which have not occurred. Embraer has based these forward-looking statements largely on its current expectations and projections about future events and financial trends affecting the business and its future financial performance. These forward-looking statements are subject to risks, uncertainties and assumptions including, among other things, general economic, political and business conditions in Brazil and in other markets where the company is present.

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Participants on today's conference call are Mr. Paulo Cesar de Souza e Silva, President and CEO; Mr. Nelson Salgado, Executive Vice President, Finance and Investor Relations; and Mr. Eduardo Couto, Director of Investor Relations.

I would like now to turn the conference over to Mr. Nelson Salgado. Please go ahead, sir.

Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Good morning, everyone, and thanks for joining our call. We'll start on slide 4 with the Commercial Aviation highlights. Embraer delivered 15 new jets in the third quarter and 57 year-to-date. We anticipate a strong fourth quarter in terms of deliveries and expect to reach the middle of our guidance range from 85 to 95 planes. I would like also to mention that a few E-Jets deliveries is lifted from third quarter to fourth quarter without any impact to the full year results.

Another highlight is the entry to service performance of the E190-E2 at Widerøe from Norway. With 98.5% scheduled reliability and 99.5% completion rate, these are exceptional results for the entry into service of a new aircraft with a new customer.

As far as sales activity, Embraer signed a firm order contract for 12 E190-E2s with Helvetic Airways from Switzerland, another European customer Binter Canarias from Spain acquired three E195-E2s. We want to highlight that we have seen solid sales activity, and we expect to close 2018 with a book-to-bill around 1.5. In terms of product development, the E195-E2 program is on track for certification in the first half of 2019.

Next slide, slide 5, we present highlights of the Executive Aviation business. In terms of deliveries, Embraer delivered 24 Executive Jets in the third quarter and 55 year-to-date. Similar to previous years, we expect higher deliveries at the fourth quarter, yet we believe we should be closer to the low-end of our guidance at 105 planes.

It's important to mention that we have been focused on price and profitability recovery rather than volumes and market share. In the quarter, our Legacy 450/500 family reached a milestone of 100 deliveries including the fifth Legacy 450 to the Canadian operator AirSprint. In terms of new models, Embraer dominated the NBAA Airshow with the launch of the Praetor 500 and Praetor 600. The models are the most disruptive and technologically advanced jets in the midsize and super-midsize segments with unprecedented range in their segments, 3,250 nautical miles for the Praetor 500 and 3,900 nautical miles for the Praetor 600. They have the best-in-class cabin altitude, superior cabin design and ultra-quiet interiors.

As well as full fly-by-wire with active turbulence reduction, and best in-flight Ka-band connectivity. The Praetor's are part of our value strategy to improve profitability using superior service.

Moving to Defense & Security highlights on slide 6, let's start with the KC-390. The KC-390 has achieved an important milestone, and received a certification from the Brazilian Civil Aviation Authority, ANAC, and the first delivery to the Brazilian Air Force remains in

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schedule for the first half of 2019. Also, the KC-390, regarding the KC-390, aircraft number 003 successfully performed its first flight, and aircraft 004 to 008 are already under assembly for deliver to the Brazilian Air Force.

As far as other programs, the Brazilian Air Force's Special Flight Inspection Group received its third Legacy 500 for the I-X Program. The Embraer was shortlisted in the Brazilian Navy Corvette Class Program to provide the combat management and system integration. And third, Embraer received the initial request for proposal for the Light Attack Aircraft Program, the OA-X Program of the U.S. Air Force.

Moving now to the financial results. We'll start at slide 8, with the firm order backlog. Our backlog reached \$13.6 billion at the end of the third quarter. The backlog was negatively impacted by two factors. First, we removed an order from SkyWest's for 100 E175-E2s from the backlog. This order remains effective and SkyWest is committed with the E175-E2. But given the contract's conditionality terms related to scope clause change, Embraer decided to adapt a conservative approach in line with the latest IFRS rules, and removed this order from the backlog.

The second fact was that we (00:08:19) JetBlue given the recent fleet renewal decision from the company. It is important to say that Embraer is working to finalize the important deals that were announced during the Farnborough Airshow, and we are confident as I said before to finish 2018 with a book-to-bill around (00:08:47) 1.5. And with that, we expect to recover the backlog.

Moving to slide 9, we show aircraft deliveries. In Commercial Aviation, we delivered as previously said 15 jets, 57 in the year. We expect a strong fourth quarter and anticipate to reach the middle of our guidance range from 85 to 95 jets. In Executive Jets, we delivered 24 aircrafts in the third quarter of 2018, 17 light and 7 large, with 55 year-to-date.

This year again, we will follow historical seasonality with higher deliveries at the fourth quarter; however, we expect to end 2018 closer to the lower end of our guidance at 105 deliveries.

Next slide, we present net revenues. Consolidated revenues reached \$1,152 million, which were broken by: Commercial Aviation, \$382 million; Executive Jets, \$312 million; Defense & Security, \$223 million; Services & Support, \$233 million. As far as consolidated revenues, we had a relatively lower level, primarily because of Commercial Aviation deliveries. I mentioned before that a few aircrafts was moved (00:10:38) from third to fourth quarter and we expect to recover that in the fourth quarter within the year.

We maintain also guidance of \$5.4 billion to \$5.9 billion in revenue in the year, broken by: Commercial from \$2.3 billion to \$2.45 billion; Executive, \$1.35 billion to \$1.5 billion, in the Executive, we'll be closer to the lower end of the guidance; and Defense, from \$800 million to \$900 million; and Services & Support, from \$900 million to \$1 billion.

Moving to slide 11, SG&A expenses. SG&A expenses reached \$118 million in the third quarter, with G&A at \$44 million, below the same period of 2017, and selling expenses at

\$74 million, above the same period of last year, that was due to the Airshow that this year took place in July, third quarter, and last year took place in June, second quarter. Embraer remain focused on reducing SG&A expenses through our efficiency process.

Next slide 12, adjusted EBIT. We reported EBIT of \$45 million with 3.9% margin in the third quarter. Our year-to-date EBIT reached \$181 million with 5.3% margin. Looking at third quarter margins per business: Commercial Aviation was 1.1%, here we had in fact of relatively lower deliveries and a bit of mix as well; Executive Jets, 4.1%; Defense, 3.4% (00:12:43), Services & Support, 10.7%. We reiterate our 2018 EBIT guidance of \$270 million to \$355 million with margins from 5% to 6%.

Next slide, slide 13 represents adjusted EBITDA. Embraer reported EBITDA of \$105 million in the quarter and \$9.1 million (sic) [9.1%] (00:13:14). Year-to-date, EBITDA was \$366 million with an EBITDA margin of 10.8%. Similar to EBIT, we reiterate our EBITDA guidance of \$540 million to \$650 million with 10% to 11% margin.

Moving to slide 14, we highlight adjusted net income. Embraer reported a net loss of \$29 million in the third quarter. The net loss is driven, first, by lower operating results which we expect to recover in the fourth quarter and higher financial expenses. Regarding financial expenses, we had a \$20 million increase in the quarter due to, first, the \$10 million in residual value guarantees recognition which we expect to (00:14:29) in the next quarter, and \$10 million from mark-to-market 2019 hedge operations - we had to mark-to-market with 2019 hedge operations. And what happened here was that, there was a big volatility of the real against the dollar in this last quarter that led to the recognition of accounting losses that we expect to revert in the future as we have a more stable FX.

Moving to investments at slide 15. The net investments reached \$158 million year-to-date, broken by \$29 million in research, \$75 million in development, and \$54 million in CapEx. It is important to note that we have received \$120 million in contribution from suppliers. If we consider that, the gross amount of the development investment would account to \$200 million and the total to \$283 million. We expect to end 2018 below our current guidance of \$550 million. All programs are on track despite the lower investments.

Next slide 16, free cash flow. Embraer reported negative free cash flow of \$166 million for the third quarter and minus \$549 million year-to-date. The negative free cash flow year-to-date is mostly driven by higher inventories as we prepare for higher deliveries in the fourth quarter. With those higher deliveries, we expect to revert a very good portion of the negative free cash flow. But we expect to be at the lower end of our guidance regarding cash flow, which is around minus consumption of \$100 million this year.

Finally at slide 17, we show Embraer's indebtedness. We ended the third quarter with a cash position of \$3.14 billion and a debt position of \$4.02 billion, implying a net debt of \$881 million, which again as we deliver and complete the fourth quarter deliveries, we expect this position to go back to what it was in the beginning of the year. In terms of average debt maturity, we remain at a comfortable level of 5.5 years.

With that, we conclude our presentation and are available now for questions. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Robert Spingarn with Credit Suisse.

Q - Audrey Preston {BIO 20426628 <GO>}

Hi. This is Audrey Preston on for Rob Spingarn, and I just had a couple questions. So, going back to slide 15 with your investments, even incorporating the supplier contributions, it still looks like you're tracking below where you were expecting for the full year. So, could you elaborate on some of your planned investment opportunities in Q4, and is there any reason why the investments are tracking below expectations? Thank you.

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Change in scope (00:19:03) - oh, sorry, so coming back to investments. As I said, we will be below the guidance in the investments this year without any difference in the product development targets. That is happening mainly because we are being more efficient in our investments with regards from our efficiency program. So, we will be below the level of investments, but with this current development programs without any change.

Q - Audrey Preston {BIO 20426628 <GO>}

Great. Thank you. And then, if we can just take a closer look at the SkyWest orders as well. So, now that you've taken them out of backlog, but there's still no change to the terms and conditions, what is the timeline on these orders and when could we expect to maybe see them go back in backlog? And when can we expect a little bit more certainty around those orders as well? Thank you.

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Well, as I mentioned, we are working very hard to convert the announcements we made in the Farnborough Airshow into firm orders, but we cannot really commit to a date when this is going to happen. We expect it to be as soon as possible.

Regarding the SkyWest order, as we mentioned, it is connected to the change in scope process in the U.S. regarding the E175-E2. And we are not seeing, at this moment, any priority in the airlines in change in scope clauses. However, Embraer has an 85% market share in that segment with our current E175-E1. So, the fact that the scope clauses may change later does not imply any harm to us, on the contrary, we will remain with a very good market share in this segment, because the E175-E1 is by far the best project in the segment.

Q - Audrey Preston {BIO 20426628 <GO>}

Great. Thank you.

Operator

Our next question comes from Josh Milberg with Morgan Stanley.

Q - Joshua Milberg

Good morning, everybody, and thank you for the call. My first question is, if you could give us some additional perspective on the improvement of your Executive and Defense profitability in the quarter, and also the sustainability of the better numbers? You mentioned your focus on price. And on the Executive side, we were wondering if price was the main driver of the better margin and what if any other factors helped? Obviously, better revenues and better fixed cost evolution helped you. That's my first question.

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Okay. Thank you. I think, in Executive Aviation, we've announced that many months ago that we were implementing programs to turnaround the business, with a big focus on value rather than competing exhaustively for market share. I think what we are seeing now is a result of that effort. We have been able to maintain prices that are good for our products which we think deliver more value to the customers. We invested also in cost reduction with the material (00:23:16) and internal costs for our production processes as well.

So, I would say that what the results we've seen so far are the results of these efforts that we've been consistently implementing. As for the sustainability, everything that we are doing is for those results to be sustainable over the long-term. As I said before, we go on investing in new product development. We've just launched two new products which we think will again deliver superior performance and will deliver a premium price (00:23:57).

Regarding Defense business, we have during the year been impacted by losses in the KC-390 program development. As I explained here earlier in our results presentations, the way the revenues and margins of the program are accounted for means that whenever we had something that does not go as planned, we had to recognize an accounting loss, right? And in this year, in the second quarter, we had to recognize \$127 million loss because of the loss of the first prototype. And with that, we had to re-plan the program and we do not expect to have further problems moving ahead. If we manage to skip to the new schedule, we think that those margins that we see now are sustainable. But again, product development of a very innovative and high technology program is something that we know in the industry that you cannot say 100% for sure we're not going to have problems. But if those problems do not happen, we will sustain this kind of results.

Important also to note that as you change phase with this program from product development to serial production, right, our Defense business (00:25:47) because during the last few years of heavy product development of KC-390 (00:25:56), those uncertainty, they bring some volatility to the results. As we enter into serial production and deliveries, once we go over the initial ramp-up phase, we should see Defense business with much better and sustainable results.

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Q - Joshua Milberg

Okay. That's very helpful. And a related question and it's a question that ties into your point about cost reductions and their sustainability. I think that you guys have talked in recent months about being able to rightsize Executive and Defense with the Boeing transaction. And I was just wondering with the work that you've done advancing the deal these last several months, if you have a better idea now of maybe what the magnitude of the opportunity could be to sort of rightsize the businesses as a byproduct of the transaction.

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Yeah. Although, the negotiations for the deal are going on, the manager (00:27:06) of the company is not taking those into account. So, actually, everything that we're doing in Executive Aviation and Defense is just regular course of business. We're just managing the company, looking at the way it's used to be, and all the results that we are seeing comes from this. There is nothing here that accounts for any benefit that would come from the deal.

Q - Joshua Milberg

Okay. That's great. Thank you very much.

Operator

Our next question comes from Ronald Epstein with Bank of America.

Q - Kristine Tan Liwag {BIO 21935865 <GO>}

Good morning, guys. This is Kristine Liwag calling in for Ron. So, my first question is the timeline about your deal with Boeing. If you already have government approval from the current administration, why not complete the deal now? And even if the new administration seems supportive of the deal, it seems like postponing the timeline adds unnecessary risks.

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Hi. Good morning. This is Paulo. So, thanks for your question. We are still in the final stage with Boeing to finalize the last details. And as soon as we materialize this final agreement, we'll bring the deal to be approved or appreciated by the government, the current administration. It is already public information that the current administration will share our request with the new government, with the team, that will be a transition to the new government. And after that - so, when we have the go-ahead from both - so, the current government and the transition team - so, we will call for a General Assembly, which still is our expectation that this will occur anytime in December. So, it's difficult to say now which day of December, but our expectation is that this will happen still in December. And after that, upon approval of our shareholders, so we have the antitrust (00:29:42) which will bring us into 2019, more likely the second half of 2019 for the closing of the transaction.

Q - Kristine Tan Liwag {BIO 21935865 <GO>}

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And if I recall, when you guys first communicated the timeline, the expectation was that you only needed approval of the current administration. So did something change that you now need new administration? Can you talk about other factors that may have come in, in the past few months?

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Well, I think basically regarding the administration, this is being said now by the current government that they would like to share detail, our request this transaction with the new administration. So that was not 100% clear a month ago, but now it's been very clear. So that Mr. Temer would like to share our request for this deal - approval of this deal with the new administration.

Q - Kristine Tan Liwag {BIO 21935865 <GO>}

That's very helpful. And switching to Executive Aviation, how many firm orders and letters of intent did you receive for the Praetor family at NBAA?

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

We do not disclose that information.

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

There has been a lot of...

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

There has been a lot of interest in the new products at the Airshow, right? And there's a lot of activities that we will not disclose the amount of orders we received.

Q - Kristine Tan Liwag {BIO 21935865 <GO>}

Thank you very much.

Operator

Our next question comes from Cai von Rumohr with Cowen.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Thank you very much. And so, could you give us some color in terms of where the Commercial deliveries may be next year? What part is sold out today? I mean, in terms of how many deliveries you have for 2019? And then maybe comment on the impact of sort of this the Boeing JV has - the fact that you're negotiating for one has had people completing orders. Has it been a plus or waiting until it's completed to really finalize and place their orders? Thank you.

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

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See, regarding the last part of your question, no, we are not seeing any difference, because of the deal with Boeing, so we continue to operate business as usual. So, we are closing deals. We have made very good announcements in Farnborough. We are now working to have this quotas (00:32:39) confirm until end of the year, and is going well in this regard. So, we will have a very good year this year, book-to-bill probably above 1, more likely above 1. And this regardless the negotiations that are going on with Boeing. Your other question was, sorry, the first part?

Q - Cai von Rumohr {BIO 1504358 <GO>}

How many orders do you have for 2019 right now? I mean, obviously, what you expect for?

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Yeah. It's early to say, right? So, it's early to say, because we still have few months to go until we can have a clear view. But I could, if you anticipate more or less the same level that we will see in 2018.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Thank you. And the last question would be, I believe your bizjet book-to-bill was a little bit below 1. Could you give us some color on bizjet demand, is that a function of stronger pricing? And what do you see for book-to-bill in the fourth quarter? Thank you.

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Book-to-bill will be around 1, no big changes here. And as I mentioned before, we have been seeing steady growth in prices, which are starting to show up in our P&L, like we expect the trends to continue in the next month.

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Touching a little bit on (00:34:23) information on this topic. So, the launch of the Praetor 600 and Praetor 500 at the NBAA was very successful. So, we are seeing a great interest in this aircraft. I believe the positioning of these aircrafts is obvious what the competitors are offering. So, the clients are telling us that this will be a very demanded aircraft.

So, we are very bullish. So, I think it's fair here to anticipate that we may have a good year for new sales, because of these two new products. So, the price point is excellent. The attributes of the aircrafts are great. So, the range and the performance. So, we believe that it will be a very successful aircraft. So, having said that, 2019 maybe a better year than 2018 in terms of sales.

Q - Cai von Rumohr {BIO 1504358 <GO>}

Thank you very much.

Operator

Our next question comes from Myles Walton with UBS.

Good morning. This is actually (00:35:55) for Myles. How are you?

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Fine. Thank you.

Q - Operator

So, I just want to make sure the Commercial Aviation margins again, what were those in the quarter?

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

1% EBIT margin in the quarter.

Q - Operator

Okay. And so, do we think that this is the bottom or is there more pressure going into 2019, I guess, as the next aircraft begins to ramp up?

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Well, I think as I mentioned, the margin in the quarter will be tested by relatively low deliveries than we expect, and we expect to have the deliveries go to up to normal level, the margins will recover.

Q - Operator

Okay. And how do you guys see going into fourth quarter, the gross margins were positive or were good in the quarter. Any way you guys break those out as well?

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Yeah. We have around 15% gross margin in Commercial; Executive Jets 17.5%; Defense around 14%; Services & Support around 29%.

Q - Operator

Okay. Great. Thank you, guys.

The next question comes from Augusto Ensiki with HSBC.

Q - Augusto Ensiki {BIO 15988025 <GO>}

Hey. Good morning, guys. Thank you for taking the question. Regarding the E2, now that you guys have been producing it for most of this year. Has there been any challenges or difficulties in the ramp-up of the E2 production? And then when you think about that going into next year, what kind of mix can we expect for E1 versus E2 delivery? Thank you.

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A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Well, we have not problems with the ramp-up of the E190 or the E2s. And so, everything is moving smoothly, and we are not disclosing so far the (00:38:16) for next year. We do that later on when we have the guidance.

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

So, can you just add and go back to the one of first information that Nelson gave about - on the highlights. So, it's a - the schedule reliability of the E190-E2s are really great. So, we are seeing 98.5% schedule reliability for a new program. So this is fantastic than others. So we delivered the first E190-E2 in April. (00:38:52) is flying quite a lot with these aircrafts, many cycles, so it's not flying many hours but also many cycles. So, the aircraft is really going and delivering very well. So I think this is a point to be noted.

Q - Augusto Ensiki {BIO 15988025 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from Noah Poponak with Goldman Sachs

Q - Noah Poponak {BIO 16071528 <GO>}

Hey. Good morning, everyone.

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Good morning.

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Hi, Noah.

Q - Noah Poponak {BIO 16071528 <GO>}

Hey. So, I mean, I guess are you still expecting eventual scope clause change that allows you to sell and fly the E2-175 (sic) [E175-E2] (00:39:41) in the U.S. or should we really be looking more at the legacy aircraft-type backlog there?

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Well, Noah, as we said before, we do not see any movements right now on priorities from the airlines to change scope clause. But for us, that is a comfortable situation. The E175-E1 remains with a market share around 85% in that market. So, if the scope does not change, we will remain selling the E175-E1s. If it does change in the near future, we will have the E175-E2 ready. But there's nothing we can say at the moment beyond that.

Q - Noah Poponak {BIO 16071528 <GO>}

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Okay. And is 2019 sold out at the current production level, the 85 to 95 you're expecting for 2018? Are there still some spots open?

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Noah, the Commercial Aviation as I mentioned we are seeing very good order this year. And a part of this order will be for the next year. So, I think we are very comfortable with the level - more or less at the same level that we will deliver this year for next year.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay.

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

So, maybe even no upside.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay. When does Republic start to take deliveries of their recent order?

A - Paulo Cesar de Souza e Silva {BIO 17023173 <GO>}

Republic, if I'm not mistaken, we will have to confirm this to you, but delivery is 2020.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay. Got it. And then, final question, at the total company adjusted segment operating margin, are you expecting that to expand, stay the same, contract 2019 versus 2018?

A - Nelson Krahenbul Salgado {BIO 19113798 <GO>}

Well, it's still a bit too early to talk about margins in 2019, and we will give that guidance when the time comes.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay. Thanks so much.

Operator

This concludes today's question-and-answer session. And that does conclude Embraer's audio conference for today. Thank you very much for your participation and have a good day.

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