

Q1 2017 Earnings Call

Company Participants

- Eduardo S. Couto, Director of Investor Relations, M&A and New Businesses
- José Antônio de Almeida Filippo, Executive Vice President-Finance & Investor Relations (CFO)
- Paulo Cesar de Souza e Silva, President & Chief Executive Officer

Other Participants

- Bruno Amorim, Analyst
- Cai von Rumohr, Analyst
- Derek Spronck, Analyst
- Joshua Milberg, Analyst
- Myles A. Walton, Analyst
- Noah Poponak, Analyst
- Peter John Skibitski, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the audio conference call that will review Embraer's First Quarter 2017 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 risk and uncertainties and assumptions, including, among other things, general economic, political and business conditions in Brazil and in other markets where the company is present.

The words believe, may, will, estimates, continues, anticipates, intends, expects and similar words are intended to identify forward-looking statements. Embraer undertakes no obligations to update publicly or revise any forward-looking statements because of new information, future events or other factors. In light of these risks and uncertainties, the forward-looking events and circumstances discussed on this conference call might not

occur. The company's actual results could differ substantially from those anticipated in the forward-looking statements.

Participants on today's conference call are Mr. Paulo Cesar de Souza e Silva, President and CEO; Mr. José Filippio, Chief Financial officer and IRO; and Mr. Eduardo Couto, Director of Investor Relations.

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

José Antônio de Almeida Filippio

Okay. Thank you. Good morning, everybody, and welcome to Embraer first quarter 2017 earnings conference. I would like to start with the presentation as usual, then I will have Paulo Silva do his initial comments, and then we'll be open for a Q&A session. So with the presentation, starting on page three, with corporate highlights, with information that last week Standard & Poor's published an update now rating - reaffirming the investment-grade status.

Also in terms of Embraer liquidity situation, we issued in January a 10-year bond of \$750 million with our debt average maturity increased to 6.3 years from 5.3 years. And closing the corporate highlights, the comment of the creation of Embraer Business Innovation Center to explore opportunities in the future of air transportation. As part of that, we announced last week an agreement with Uber to explore the concept of potential development of small vertical takeoff and landing vehicles.

Next page, page four. Now starting the highlights of business units, starting with Commercial Aviation. We delivered 18 E-Jets in the first quarter of 2017. And as far as sales activities, we announced a new order of four E175 to American Airlines. And as already mentioned, the names of the launch operators for E2 generation, which were Widerøe - with a large operator of E190-E2 and Azul with the E195-E2.

In relation to the E2 development, the E190-E2 fourth prototype joined the first (sic) [flight] test campaign and the milestone of the first flight of the E195-E2 both ahead of schedule.

Next page, moving to Executive Jets highlights. We delivered 15 executive jets in the first quarter of 2017, being 11 light and 4 large aircraft. Including on that was the first Phenom 100EV with new avionics and engine performance improvement. Also in the deliveries of the quarter was the Phenom 300 number 400 to a new customer, Elite Jets.

In terms of sales activities, as already mentioned, Phenom 300 was the best-selling executive jet across all segments in the fourth quarter, a fourth consecutive year of last year. And finalizing the highlights of Executive Jets, in the first quarter, we appointed Michael Amalfitano as the new CEO of business unit of Executive Jets.

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Next page, page 6, highlights for Defense & Security, starting with information of the delivery of two Super Tucanos to the U.S. Air Force, which will be commissioned to Lebanon. In terms of the KC-390 development, it continues to advance with tests of aerial refueling and cargo handling. On service and support contracts, we signed new contracts with Panama, Mexico, Colombia and India for aircraft maintenance and parts.

In relation to our subsidiaries' activities, Atech inaugurated the Air Traffic Command and Control Center in India. And Savis and Bradar announced a cooperation agreement with Rockwell Collins to evaluate business opportunities.

And finalizing highlights for Defense & Security, the information of the launch of the Brazilian satellite that was postponed to the second quarter and is now scheduled to happen later this week.

I would now close the highlights of corporate and business units and moving to financial results. Now, starting with page 8, our firm backlog in the end of the quarter, that reached \$19.2 billion, slightly below the end of last year. Despite the decline, I would like to comment that Executive Jets business units had a book to bill of 1.5 times in the first quarter of this year.

Next page, page 9, aircraft deliveries, starting with Commercial Aviation on the left side, we delivered 18 aircraft in the first quarter of 2017, slightly below the same period of last year. It is important to say that we are sold out for this year after the recent announcement of the American Airlines order.

Regarding Executive Jets, we delivered a total of 15 aircraft in the first quarter, broken by 11 light aircraft and 4 large aircraft. Seasonally, the first quarter is the weakest quarter of the year. And we see that, particularly, three planes leapt to the initial days of April. For 2017, we are confirming our guidance of deliveries of 97 to 102 aircraft in Commercial Aviation and 105 to 125 in Executive Jets, broken by 70 to 80 light jets and 35 to 45 large jets.

Next page, page 10. In relation to net revenues, consolidated revenues reached \$1 billion in the first quarter of 2017. The reduction compared to the previous year's reflect lower deliveries. The amount of revenues is broken by \$633 million in Commercial, representing 62% of the total; \$226 million in Executive, representing 22%; and \$156 million in Defense, representing 15%. The balance of 1% is related to other revenues.

In case of Defense revenues, I would like to mention that we were frustrated by the postponement of the satellite launch which would have added around \$100 million of revenues in that business. For revenues, we are also maintaining our guidance for 2017.

In next page, regarding sales and general administrative expenses. We reported a total of \$114 million of sales and general administrative expenses in the first quarter of 2017 compared to \$140 million in the previous year. The slight increase in G&A expense is related to the 20% stronger real against the dollar when comparing both years.

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Next page, page 12. As far as EBIT, we reported adjusted EBIT of \$31 million in the first quarter 2017 with 3% margin. This number was adjusted to \$8 million of cost related to the final remaining employees termination associated to the dismissal plan. Reported adjusted margin by business units were Commercial, 13%; Executive, negative 10%; and Defense, negative 20%.

If we had the launch of the satellite and the additional three planes that were delivered in early April, the combined EBIT margin would have increased from 3% to 5.5% in the quarter.

For EBIT, in terms of dollars and margin, we are confirming our outlook for 2017 of \$450 million to \$550 million and 8% to 9% margin.

Next page, page 13, in relation to EBITDA. We reported a total of \$103 million in the first quarter of 2017 with a 10.1% margin. Our EBITDA outlook in 2017, we are confirming the range of \$770 million to \$890 million and margins from 13.5% to 14.5%.

Next page, net income. We reported adjusted net income of \$23 million in the first quarter of 2017 with 2.3% net margin. Adjusted net income excludes deferred income tax.

In Page 15, next page, in relation to investments. We had a total investment of \$72 million during the first quarter of 2017, broken by \$8 million in research, \$31 million in development and \$33 million in CapEx. The total investments in the first quarter was mainly affected by suppliers' contribution of \$86 million.

For the year 2017, we are estimating the total of \$650 million, broken by \$50 million, research, \$400 million in development and \$200 million in CapEx.

Next page, Page 16, as far as free cash flow. We reported a free cash flow consumption of \$199 million in the first quarter 2017. The cash consumption of \$48 million in operation activities is mostly related to the typical working capital requirements in the beginning of the year. For 2017, we are estimating the cash consumption of \$150 million or better.

Next page. Page 17, before moving to Q&A session and Paulo Cesar's final comments, in relation to our cash and debt position, we closed the first quarter 2017 with a total debt of \$4.3 billion. In this amount is included the recent 10-year bond issued of \$750 million, which improved the debt profile to 6.3 years of average maturity.

In terms of our cash position, we had a total amount of \$3.5 billion, which would turn to a net debt of \$806 million as of March 31st.

Okay, with that, we finalize the presentation. I'd like to turn to Paulo for his initial comments before we turn to the Q&A session. Thank you.

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

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So thank you, Filippo, and good morning to all. So thanks for joining us this morning. A few comments I'd like to make. As you have seen, so the results on the first quarter was a little bit disappointed. However, we are not at all worried about that. So we believe that it was - it came a little bit weaker than expected. But we are very confident to keep our guidance for 2018, and we already have seen certain deliveries of aircraft or events that happened just as we crossed from the first quarter to the second quarter.

We continue to develop the E2 it's on time, so no big issues. Of course, we have regular, normal, topics to deal with, but not at all any big issue. And our plan is to deliver the first E190-E2 on the first half of 2018. So the campaign, certification campaign is moving very nicely, according to the plan. So the same for the KC-390. So both programs - so we are very pleased with the development.

We continue to focus on cost, either by reducing cost or looking ways to gain more efficiency in the company. This is something that I outlined to you when I took over last year, and we implemented - we are implementing our \$200 million mission. A bigger part of it is already done, which was the dismissal of 1,600 people through the PVV (15:10).

And as the budgets for 2017 is being implemented, so we are achieving the targets that we defined last year. And we will not stop here. So we are already looking into new initiatives to continue. It is right. So we believe - we do believe that there are still good opportunities to become more efficient in general.

As far as the business units are concerned and markets, we are seeing a great activity in Commercial Aviation. Our teams are very, very busy globally. So we are quite positive that we can see a demand that will bring us additional opportunities. Of course, it is not - I'm not guaranteeing that we are going to close these deals. However, it's very good - very positive to see the level of activity that we are engaged nowadays.

Of course, 2018 is always - whenever we have a transition from one aircraft program to the other, so I always - there is a more challenge because of the ramp-up of the new programs. So we are working on that, and we may see some lower margins in 2018 or maybe a little bit of less aircraft to be delivered in 2018. But still early to say what's going to happen. So we still have to wait a little bit more in terms of jet deliveries.

However, in terms of margins, I think we should expect lower margins in the Commercial Aviation in 2018 versus 2017, which is being - it's still a very good margin. So double-digit, and we'll continue to have these strong margins in Commercial Aviation.

On business Jets, Michael came on board. Michael Amalfitano, the new CEO. He came on board on March 1. And he is already implementing certain actions that I'm sure will bring better margins going forward and also cash for the unit going forward. I do expect that in the second quarter or max in the third quarter, we are going to see already the different numbers that will reflect more this strategy.

We are really looking even more with higher focus to reduce cost on business jet unit. And our market approach is being to look more at the value that we are offering to our clients

than going for market share. And we are already seeing it slightly improved in the margins for business jets.

On the new business units, servicing and support, so we are taking the necessary actions to implement the unit. So we are almost finalized the organization of this new business unit. And as we move into the second quarter, so we will implement it. So as we have anticipated, when we announced the launch of this new BU, so there's a lot of synergies that we can have gains there by having only one unit looking into that, so synergies - people synergies in warehouses, in inventory. So I'm sure that we will extract a good value from this new business unit.

So, all in all, I think we are set for a good year in 2017. So we are on schedule on everything and keeping our guidance. So looking forward to have a new call with you guys in July when we analyze the second quarter results. Thank you.

Q&A

Operator

Our first question comes from Myles Walton with Deutsche Bank. You may begin. Myles Walton, your line is open. Please check your mute button.

Our next question comes from Pete Skibitski with Drexel Hamilton. You may begin.

Q - Peter John Skibitski {BIO 6760095 <GO>}

Hey, good morning, guys. I guess just on the satellite launch, I think you said it would happen this week. Should we conclude that, just on your comments, José Filippa, that the second quarter will be your highest revenue quarter for the year in Defense? Is that a fair assumption?

A - José Antônio de Almeida Filippa

Pete, good morning. Not necessarily. I don't think we should consider exactly that be enough to get the best quarter because it depends on some schedules, deliveries and some other things. But, yes, it's confirmed that it's scheduled for May 4. So two days from now, so far. Until we have anything new, that's the original schedule, and then we are confident that this will happen, and definitely I agree with you that it's going to be impacting the second quarter in about \$100 million. That's the milestone in the contract we first established.

But I think we're not guiding that this will be exactly a reason for second quarter will be the best. I think we should now retain on the \$100 million revenues for the satellite launch for the second quarter. And again, it's scheduled for this week. So we - so far, there's nothing that I indicated that's not going to happen.

Q - Peter John Skibitski {BIO 6760095 <GO>}

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Okay. Fair enough. I guess one for you, Paulo. Your comments on the services and support unit, there just seems to be a real parallel with Boeing here in terms of creating a stand-alone services unit. And they have put out a revenue target, sort of a notional revenue target and so two questions for you on that. I guess, number one, would you guys consider putting out a revenue target for that unit as sort of a notional long-term target? And number two, are you guys considering M&A to build that services unit, or will it be just all-organic type of a focus?

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

Well, no. We are not giving an external guidance, right, targets for that. We have internal or a right number that is being already disclosed and the head of the unit last week in Orlando in the MRO conference mentioned about that. So nowadays, we have about 15 of our revenue - about 15% is coming from the services and support across the three BUs. And we want to bring this after one quarter of our revenue in the next four years. So this is, I'll say, is the first target - internal target.

As far as the - how I wanted to grow on the BU, initially so we are targeting to look into more scope in terms of work that we can do. We believe that we can not only enlarge in terms of clients base the services and support that we provide, but also we can increase the number of parts that we touch in the aircraft and do more than what we have been doing. So this is a first initiative. So we can grow in our MROs in Nashville and OGMA, and especially in components repair. So we can do much more. And internally, if there is an opportunity through an acquisition, a small one, that can enhance the new business units, so we will be looking to that as well.

Q - Peter John Skibitski {BIO 6760095 <GO>}

Okay. Very helpful. Thanks, guys.

Operator

Thank you. Our next question comes from Cai Von Rumohr with Cowen and Company. You may begin.

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

Yes. Thank you very much. So maybe give us a little bit more color on Commercial demand because you really have not gotten much in the way of orders so far. What geographies? What models? And give us some help. You mentioned the potential of lower deliveries next year. What percent of your delivery slots? How many delivery slots, maybe a better way to put it, are sold out for next year? And how many would you have to sell to get to about a flat year?

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

Okay. On Commercial Aviation markets, I think the activity we are seeing is really global, including the U.S. So there is a good activity there for the 76-seater with major airlines and also regional airlines. The E190, E195 are also elsewhere. So there is - very - I would say

good activity that we are engaged. So I cannot provide comments more than that, but we are pleased with the opportunities that we are seeing.

For 2018, we don't know yet. I think it's too early to mention anything here, so we would have to wait a little bit more in order to elaborate on how 2018 could be, right?

So, however, in terms of margins – so we can see that our EBIT that we will have a weaker margin in Commercial because of the transition from E1 to E2. And whenever you have a transition like this, you have more inefficiencies, right, in the process. The ramp-up will be such that at the beginning brings a lower margin to us. But we are not concerned on that because, from 2019 and on, we are already anticipating that the margins will improve again. But for a number of deliveries next year, I'd prefer to wait a little more.

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

Okay. And then maybe if you could give us some color on biz jet demand and your production rate. Given that you entered the year with some wide tails, have you pulled that production rate back to get rid of the wide tails? And at what point might you start to pick production up again? Thank you.

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

On the business jet market, it's still weak, under pressure. Last year, total delivery was around 650. I believe this year it's going to be about flat. However, I think that we can have a slightly improve on margins as we work with the new models and with the services attached to it, so we believe that we can deliver a better value to our clients and be recognized for that in the market.

We are doing micromanagement in terms of manufacturing in cash in the unit. So we are looking to 2017 to really fix the ask and demand – the offer and the ask in the market. And so we believe that this year, 2017, we are going to see a better cash generation in the unit.

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

Thank you very much.

Operator

Thank you. Our next question comes from Myles Walton with Deutsche Bank. You may begin.

Q - Myles A. Walton {BIO 6802513 <GO>}

Thanks, good morning. Sorry about the technical difficulty. There was a big drop in residual value, negative adjustments in the quarter. And I'm just curious, Paulo, can you comment on the backdrop of your E-Jet residual values and 145 values? And if this lack of negativity in the quarter is any indication of it – of a trend going forward that we maybe have a lower run rate?

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A - José Antônio de Almeida Filippo

Myles, let me help to answer that. We don't - the decrease, I think, is natural because of the schedule of the commitment that we have as we get into the moment you naturally reduce (30:18) this. So I don't think this can be different trend. We see prices, okay, not decreasing that much that be affecting like potentially impairment.

So I don't think that could be something that could be taken as a new behavior of that impact. So it's just like a very specific thing that happened in the month or in the quarter. And I would say that mostly related to the schedule of the maturity of each commitment that we have.

Q - Myles A. Walton {BIO 6802513 <GO>}

Okay.

A - Eduardo S. Couto {BIO 18009973 <GO>}

It's Eduardo here Myles. Actually, we have a reduction in provisions for used aircraft in the first quarter. So it's compared to previous provision, our numbers were actually better this quarter.

Q - Myles A. Walton {BIO 6802513 <GO>}

Yes - no, that's what I was implying. It was much better. So I'm asking is it indicative of a trend that your provisions going forward could continue to be better than they have been historically.

A - José Antônio de Almeida Filippo

So, again, I don't think that that means necessarily a different change in the way we should treat a very specific in the quarter, and that could remain the same projection that we used to do.

Q - Myles A. Walton {BIO 6802513 <GO>}

Okay and then in terms of cash flow improvement through the course of the year, 1Q is similar to last year's first quarter probably because of the satellite and also the few deliveries slipping into April and then lighter business jets. But should we expect a substantial improvement in second quarter cash flow? Or do we really have to wait until the very end of the fiscal year?

A - José Antônio de Almeida Filippo

No, no. I think that we should still look the year at a 12-month basis, not specifically in the quarter. We had that comment about the milestone of the satellite launch, but I don't think that could change the profile throughout the quarters. I think we should remain to expect this by midyear to have a better color, better look on how these things go. We're are confident about the estimates we made, the negative \$150 million or better, that we should keep that target going forward.

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Q - Myles A. Walton {BIO 6802513 <GO>}

Okay. All right, thanks.

A - José Antônio de Almeida Filippo

Thank you, Myles.

Operator

Thank you. Our next question comes from Derek Spronck with RBC Capital Markets. You may begin.

Q - Derek Spronck {BIO 17904184 <GO>}

Thank you for taking my questions. Just on the KC-390, have you seen any pickup in interest internationally on the product? And what are some of the biggest pushbacks from customers? I mean, it seems to be a technologically very advanced plane. What would you say is the biggest obstacle that you're facing when you're selling this aircraft internationally?

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

Well, so we are seeing a very good interest on the KC-390 as we move forward, indicating thing, the tasking thing. So this is normal for an aircraft like this, right? So we have to go step-by-step. We are bringing again the KC-390 to the Paris Air Show to Europe. So we will do a tour, a demo flight tour after Paris Air Show.

So we remain very confident that throughout this year we are going to get our first international order, international outside Latin America. So we continue to be very bullish on this program. We are not seeing a pushback on the aircraft. So it's just a question to wait until we move forward step-by-step into the certification of the program, but we remain very bullish.

Q - Derek Spronck {BIO 17904184 <GO>}

Is Boeing providing any sort of benefits with that relationship there yet? Or do you think that will continue to grow?

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

It continues to- we continue, of course, to work with Boeing. But as I said, it would be a step-by-step growing interest of the KC-390 as we move forward into the campaign. But the partnership with Boeing will be very helpful, and - so it's a combination, right, of product and marketing, international marketing in this case, that will bring the success, right, on this program.

Q - Derek Spronck {BIO 17904184 <GO>}

Are you comfortable with the pricing of the product in the marketplace?

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

Yes, we are. Definitely.

Q - Derek Spronck {BIO 17904184 <GO>}

Great. And one more just - I guess, not as material, but you announced a partnership with Uber Elevate. How big of a market do you see that growing into? Is that a recognition that sole ownership of the business jet may be moving more towards a partial or an Uber-type of model?

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

No, I wouldn't go that far at this stage. So I think the announcement is an initiative to put us more into this kind of situation, new business model, new technologies and things like that. So since (36:07) will be electric vehicles, so it is our interest in developing or understanding much deeper the electric aircraft or hybrid aircraft. So this is a good fit for us at this stage.

So how big is the market? I think the market is very big. But the bigger question is, will the stakeholders, the ecosystem, achieve these markets or not. So there's a lot to happen. We need the certification, we need the authorities to approve flying in big cities.

We need to find a good solution for the battery and for the recharge of battery. So we have to solve the logistics, right? For instance, in big cities, in order to have these vehicles taking off and landing, so there's a lot to be right done in order to achieve what we anticipate is a huge market.

So when we talk to Uber, so the numbers are really big, and the efficiency of the system, if implemented, will be a success. I have no question about that. If you look at that nowadays, Uber is in 75 countries, 450 cities. And there are 60 million people, 60 million people that monthly require Uber car. So we can imagine the huge demand for this service.

Q - Derek Spronck {BIO 17904184 <GO>}

Okay. Great. Thanks very much.

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

Sure.

Operator

Thank you. Our next question comes from Noah Poponak with Goldman Sachs. You may begin.

Q - Noah Poponak {BIO 16071528 <GO>}

Hi. Good morning, everyone.

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

Good morning.

A - José Antônio de Almeida Filippo

Good morning, Noah.

Q - Noah Poponak {BIO 16071528 <GO>}

Can you tell us, with the - with regard to the \$200 million cost plan, where were you running on that, I guess, on an annualized basis as you entered the quarter versus where you exited the quarter? And, I guess, what's in the full year EBIT guidance from the \$200 million?

A - José Antônio de Almeida Filippo

Okay, Noah. I think that we are, as we planned, most - remember, maybe coming a little bit back on how we break the \$200 million. Most of it, about \$130 million, will be coming from the head count reduction, which was actually achieved by the dismissal plan that Paulo mentioned about the 1,600 employees that left. Of course, there's a schedule for that to left. Actually, in the first quarter, we just announced that the remaining group was - left the company basically because of the function that those employees performed. So we have to wait some of them until we adjusted the processes. And to that - so still - I think now it's over, the most of this target there.

Then the balance would be coming from general expenses related to travel expenses primarily, which is one important item for us, and also some like consultancies and general expenses. So I would say that we're there in terms of the targets, the - like I said, the head count reduction was achieved. And then everything else was already budgeted, and the leaders have in their new targets already considered that.

The benefit of that will be still coming throughout the year. We understand that mostly we still - will go this year, 2017. By the end of the year, we're going to that stage in full. This year, still some way to get there, but we already achieved that. You saw that some impacts that we cannot control about like exchange rate that sometimes can impact for one direction or the other. In this quarter, we had the opposite expected ways after Brazilian real strengthened against the dollar. But this is a function of (40:57) things. We speak that this is not enough to affect the plan. So in summary - in summarizing to the question, we are okay. And most of the \$200 million reduction will be seen in 2017 and after that in full implementation. That's basically how we see that.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay. So the \$450 million to \$550 million EBIT guidance has something close to the \$200 million in it?

A - José Antônio de Almeida Filippo

Correct.

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Q - Noah Poponak {BIO 16071528 <GO>}

And what does it have in it for FX going against you?

A - José Antônio de Almeida Filippo

It's difficult because we don't have that situation. We are - we plan to have - the exchange rate we use for the year is almost what we're having today, about 3.2. We already mentioned that before. So it's hard for us to anticipate if, for some reason, FX would go against us. But we have to compensate. That's normally how we do. We had that situation in years before. Normally, when we face the worst exchange rate in the currencies - in the - expenses in reals, normally, we call the leaders and we review the targets to compensate that. That's normally - I don't think we should consider that any exchange rate change will be enough to affect our target in terms of the expense reduction.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay. But presumably, you must be making some assumption for that in your EBIT guidance because if I just - if I adjusted your margin for 2016 for all the one-time items, I get back to about 8%.

And if I were just assume you were flat on that underlying basis in 2017, if I only added \$200 million to that, I'd get to a much, much higher margin level. So there must be some FX or other offset that you're assuming in the guidance that I'm trying to get to?

A - José Antônio de Almeida Filippo

Yes. I don't want to get into more detail here, but you're right - if you do that calculation you're going to find that. The \$200 million is the comparison with the target that we established last year for that. But of course, if you take, for example, the average exchange rate of last year was about 3.5. And if you take the current exchange rate that we are using, which is 3.2, this is already a disadvantage that we already considered in the guidance that we already have. So this was partially compensated with the reduction, so we're not going to see full, the \$200 million.

If you do this calculation, there are other impacts that we have. There was also a wage increase, like 5%. You remember that we had in September this adjustment with the union with a 5%, so there's a combination of things that we have to face.

But if we focus on the head count reduction and the expense reduction and others, I think we can get to the blended combination, which will turn to the guidance that we have. We'll make it or that we do sometime directly. I don't think but now it's - there's so many comments to make on that. And I don't think it will be worth to explore this now. But considering several pros and cons on that, but focus on the root of the plan which is like head count and general expense reduction.

Q - Noah Poponak {BIO 16071528 <GO>}

Yes. Actually, I guess, also, you achieved some of the plan in 2016, so that impacts the comparison as well, but what - just one more margin question - how should we think

about the margin on the satellite project when that lands in the second quarter? How much of that will drop through the EBIT line?

A - José Antônio de Almeida Filippo

It'll be about like 20%.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay. Thank you.

Operator

[Operating Instructions] Our next question comes from Bruno Amorim with Santander. You may begin.

Q - Bruno Amorim {BIO 17243832 <GO>}

Yes. Hi, guys. Good morning. So two follow-up questions, the first one, given that you were surprised negatively with the results as well, why not revising the guidance downward? Was there margin of safety in the guidance you gave us in March? Or is there something coming better than initially expected and therefore offsetting today's weak results?

And second question, the gross margin in the Executive division was only 8%. So apparently, the weak result in the division was not fully explained by low dilution of G&A. Could you please comment on the pricing and competitive environment? Is it getting worse than at the end of last year somehow? Thank you.

A - José Antônio de Almeida Filippo

Okay, Bruno. I think, regarding the guidance for the year, like we said, first quarter is typically a weak quarter. We comment about two specific postponement of events that affected, which was the slip of three planes in Executive and also the satellite launch. So - but that could be something that we expect to see in the second quarter. I don't think that be enough for us to review the year. We're still confident about the guidance that we sent out, so I don't think we'll be exchanging or having any comment that we shouldn't get there. This is not something new. We already faced that almost every year.

Regarding margin, I think that what you saw in terms of Executive Jets, of course, that's not only necessarily direct margin. There's also some cost that impact the gross margin, which will have a number of deliveries. And you saw that the deliveries were not strong, and that is also something that we can consider.

We don't see a change in the market that we saw before. It is not improving, neither worsening. I think that we still have a very competitive and very challenging market. We're facing this market with the value proposition on the projects, avoiding more aggressive low-margin deals. I think we still going in the direction, and we don't see that there will be something that will change the way we're expecting. I think that we may see definitely an

improvement in the margins objective just going forward, which is the same that we saw in previous years. So basically, that's my comments on your question.

Q - Bruno Amorim {BIO 17243832 <GO>}

Thank you.

Operator

Thank you. Our next question is a follow-up from Cai von Rumohr with Cowen and Company. You may begin.

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

Yes. Thank you so much. So KC-390, what do you still have to do to certify it and get it really into production? And what sort of risk do you see of kind of having to take a reserve as you go through that process?

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

So we have flown more than 1,000 hours with the two aircraft that are in certification process – are in the test campaign. We believe that we are moving nicely, right, into this certification. So we are not anticipating at this stage any big hurdle or any big issue. So far, so good, I would say. So it's really going very well. So the first delivery is being forecasted for next year for the Brazilian Air Force. In the next month, we are going to do refueling testing. We are going to do an operation in the ice. So it's part of the process, of the certification process. So, as I said, so we are – gradually in step by step, moving forward nicely in the program.

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

And roughly, when do you expect to certify the aircraft?

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

So the initial certification towards the end of this year.

A - José Antônio de Almeida Filippo

And the full certification.

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

And the full certification, mid next year.

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

Got it. And last question, you had large losses in both business jets and the defense business for the year. What are you now looking for margins approximately for those two sectors?

A - José Antônio de Almeida Filippo

Yes, Cai, we're not disclosing guidance specific for business units, but I think we're keeping the same level that we - remember, when we announced the guidance for the year, which is about like a mid-single-digit for both Executive and Defense, with expectations to be a little bit better than that, but that's what we plan.

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

Thank you very much.

Operator

Thank you. Our next question is a follow-up from Noah Poponak with Goldman Sachs. You may begin.

Q - Noah Poponak {BIO 16071528 <GO>}

Hey, Paulo, when you mentioned the potential for a little pressure on the Commercial margin in 2018 versus 2017, would you then expect that to be true for the total company, or can that be made up or more than made up elsewhere?

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

It's early to say, Noah, because we are, as you know, in the business jets, so the cycle is much shorter than in Commercial, right? So we sell a lot during the year for delivery in the same year. So it's too early to say. So it still depends upon the - how the business jets markets will develop in the next quarters. On Defense, I believe we can have more or less same margins. So it's really more on the Commercial Aviation that we are anticipating our margins that will be slightly lower than what we have today.

Q - Noah Poponak {BIO 16071528 <GO>}

Okay, thank you.

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

Sure.

Operator

Thank you. Our next question comes from Josh Milberg with Morgan Stanley. You may begin.

Q - Joshua Milberg

Good day, everyone and thanks for the question. Just another quick one on your expectations for some pressure on your Commercial profitability next year. I think you attributed that to - just to the ramp-up of the E2, and I was just wondering if some of that pressure could potentially come from lower E1 pricing.

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A - José Antônio de Almeida Filippo

Josh, no. That's exactly how you perceive that. It's more related to the transition between one model to the other and the capacity to do really do a number of deliveries. We don't see - we don't work with the different prices as (53:04) we are operating today. It's basically because of the transition year.

Q - Joshua Milberg

Okay, great. And then just with your current E1 backlog, could you just comment on whether you see potential for a meaningful percentage of that backlog converting to E2?

A - José Antônio de Almeida Filippo

No, from E1s to E2s, no, we are not anticipating that. So we believe there is a demand now for E1 as well as for the E2, so depending on the market, depending on the application of the aircraft, as you know, so we have three models, right, on the E2. Three models - four models on the E1. So U.S. is a strong market with a different dynamics when compared to other markets. So it's - I mean, we are not anticipating this.

Q - Joshua Milberg

And do the contracts give that flexibility? Or is that something that, in most cases, the customer really doesn't even have that option?

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

No. In general, there's no this option to go from E1 to E2. It could be in one or two small cases, but it's not relevant.

Q - Joshua Milberg

Thanks very much.

Operator

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

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