Q3 2018 Earnings Call

Company Participants

- Andre Luis Rodrigues, Administrative Financial Superintendent & Director
- Andre Salgueiro, Investor Relations Manager
- Paulo Polezi, Chief Financial Officer & Investor Relations Officer

Other Participants

- Alexandre Falcao, Analyst
- Lucas Marquiori, Analyst
- Marcelo Inoue, Analyst
- Marcelo Motta, Analyst
- Murilo Freiberger, Analyst
- Rogerio Araujo, Analyst
- Unidentified Participant
- Victor Mizusaki, Analyst

Presentation

Operator

Good morning. Welcome to the conference call of WEG to announce the results of the second quarter -- or the third quarter of 2018. Today we are transmitting this conference call along with a slide deck at the address ri.weg.net, and after completion an audio will be available in our Investor Relations website. (Operator Instructions)

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As a reminder, this conference call is being conducted in Portuguese and you are listening to the simultaneous transmission into English. Today with us in Jaragua do Sul, we have Mr. Andre Luis Rodrigues, Administrative Financial Superintendent and Director;

Paulo Polezi, CFO and IRO; Wilson Watzko, Controller; and Andre Salgueiro, Investor Relations Manager. Please Mr. Andre Rodrigues, please, you may start.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Good morning, everyone. It's a pleasure to be with you once again for the conference call of the third quarter of 2018. Starting with the highlights of the quarter, the first point I would like to highlight once again the strong growth in revenue of 33% in the consolidated results. The growth in domestic market was 36%, driven especially by greater share in our solar generation business by the recent acquisition of steam turbines, TGM, led by the gradual improvement of the revenue from transformers business.

Internationally, our growth was 30%, concentrated on the sales of short cycle equipment. As seen in the previous quarter, we're already seeing some opportunities for projects that require long-cycle equipment. Additionally, this performance was also favored by recent acquisitions and FX variation. Excluding the impact of acquisitions and considering the performance only in local currency, the growth was 6%. The second point was the 26% growth in EBITDA as compared quarter-on-quarter. EBITDA margin closed the quarter at 15.1%, especially stable as compared to Q2 '18, but was below the margin of the third quarter of 2017 because the recent acquisition, new businesses and impact other set variation in cost of material. Paulo is going to show you more detail about this. And in closing, once again, I would like to highlight the generation of operating cash that reached 910 million year-to-date and the growth of ROIC, our main indicator.

Now moving to slide four, we provide more details on ROIC, which presented the growth of 0.6 percentage points as compared to Q3 '17 reaching 17.2%. The growth in the operating profit after tax is explained by the growth in revenue and improvement in operating performance. This growth more than offset the growth of the capital invested that was required to support the business growth, both through recent acquisitions and also by our investment in working capital, fixed assets and intangibles that we made over the past 12 months. The consistency of this indicator along the year is an evidence of our strategy of development of new businesses, which although they have structured in lower margin have an interest in return on invested capital.

Now, I would like to turn the conference over to Mr. Polezi.

Paulo Polezi {BIO 19468811 <GO>}

Good morning, everyone. I'm on slide number five. You can see the evolution of the business areas in different markets. In the area of Industrial Electro-Electronic Equipment in Brazil, the sales of short-cycle equipment keeps a uptrend. On the other hand, the long-cycle equipment sales, especially automation and panels have demonstrated a slight decrease comparing quarter-on-quarter, thereby justifying the growth in this quarter -- smaller growth in this quarter. Solar generation business was the highlight, now that our four recent solar projects added to our portfolio.

Another highlight in GTD was the improvement in performance in transmission and distribution business, which already indicated some improvement with more orders in our portfolio. Additionally, since March, we have been consolidating our TGM operation, the company of steam turbine in this business area. In engines for domestic use, there has been a slight growth in revenue as a consequence of the consumption dynamics in Brazil, which did not show a significant recovery as compared to last year. Our performance in the coatings business reflected the performance of the industrial and consumables market, which presented a recovery in the past few quarters.

Internationally, the highlight is still the area of Electro-Electronic Equipment, where the growth is driven by short-cycle products. Additionally, as we mentioned in previous quarters, we have a project for capacity increase and construction of new factories which also demand long-cycle projects, especially in industries related to oil and gas, pulp and paper and mining.

In the area of GTD, the main contribution was the transformers business, which presented a growth in all our operations overseas with a highlight for the consolidation of the new transformer company in the United States. In domestic use engines, revenue has presented a slight drop especially because of fewer orders being made in a local market in China added to the weak performance of the operation in Argentina, which is suffering the consequences that their local economy is dealing with. In coatings, our revenue international market also reflected difficulties in the economic scenario in Argentina, our main market outside Brazil.

On slide number six, you can see the evolution of the business in Q3 '18, where the highlight was the growth in revenue. EBITDA grew 25.6% as compared to Q3 '17, with a margin on 15.1%. As Andre mentioned, the performance was practically stable as compared to Q2 '18, but was below the margin that we had in Q3 '17, especially as a consequence of impacts of the acquisition of WEG Transformers in USA and the fast growth of new businesses such as solar generation, which has lower operating margins and also the impact in short-term effects volatility on the cost of materials of our long-cycle project.

Finally, on slide number seven, we show the investments of recent quarters. In Q3 '18, investments amounted to BRL105 million, 44% allocated for Brazil and 66% meant for our manufacturing units overseas. We should highlight that the recovery of the market behavior gradually requires more and more disbursement for the expansion and modernization of our production capacity.

Now, I finalize my part and I turn the conference back over to Andre Rodrigues.

Andre Luis Rodrigues {BIO 17964192 <GO>}

Thank you, Paulo. Before we move to Q&A session, I would like to highlight a few points. First of all, as we've recently mentioned in our call, ROIC is one of our main drivers for 2018 along with revenue growth. In the foreign market, the recovery of sales is consistent. The industrial production has been growing in the main global markets. Additionally, important industries continue their trajectory of recovery with the emergence of opportunities and projects involving long-cycle equipment.

In Brazil, on the other hand, the solar business -- solar generation business acquisition of TGM, recovery of the economy will continue to contribute for our growth in revenues in 2018. Lastly, we continue to pay attention that short-term oscillations where recent acquisition, new businesses and short-term FX volatility may impact our profitability, but then on the other hand, the improvement in our mix of sales and the gradual recovery of economic activity in Brazil, they have a positive impact in our mid-term businesses.

Now, we're moving to our Q&A session.

Questions And Answers

Operator

Ladies and gentlemen, we are now going to start our Q&A session. (Operator Instructions) Our first question comes from Lucas Marquiori from Safra Bank.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Good morning. Thank you for the call. I have two questions to ask. The first is the portfolio of solar products, could you give us an update of the value -- the current value of this portfolio and when we're going to start seeing the delivery of solar products domestically? I would like to have more detail about the size of this portfolio. Second point, as Polezi mentioned, domestic or home appliances, and I would like to understand more about China. I don't think it's very clear that the fewer orders that you're getting from China, is it related to President Trump, commercial war, what is it?

A - Andre Salgueiro

Hello, Lucas. Good morning, this is Andre Salgueiro. I will answer about the solar business and then will answer about the home appliances market. In solar business, as we said from the beginning of the year, we expected revenues to be between BRL500 million and BRL600 million. I think we are more closer to the high, closer to BRL600 million. In terms of solar farms, there was a new project -- a new solar farm that was added. This is a new project added to our portfolio and we're looking to an amount of BRL240 million, BRL250 million in the portfolio for solar farms, about BRL80 million more or less possibly this year and the rest for next year.

And I think that the additional information is that here we're only talking about solar farms. In addition, we have distributed solar generation, which is more recurrent and this keeping the same key tone with a significant growth as compared to last year.

Q - Lucas Marquiori {BIO 17907247 <GO>}

How big is the distributed portfolio? Can you share that with us?

A - Andre Salgueiro

Well, it's really a short-term portfolio. They come in all the time, so it doesn't really make sense looking at it, but because it's a very short-term portfolio. What we estimated earlier this year is that revenues from distributed solar would be around BRL100 million for this year. It's closer to BRL150 million and it's growing.

A - Paulo Polezi {BIO 19468811 <GO>}

Good morning, Lucas, this is Paulo Polezi answering your question talking about home appliances in the international market. As I mentioned in the call, in fact there are two factors, which are not really helping us this quarter. Number one is China. In -- so a little bit more detail about what is going on in China. We are dealing with stronger competition, especially in the Chinese local market and we need to accommodate now our market share in China. To offset that we are trying to develop differentiated products with higher value-added and trying to differentiate our brand in the local market.

At the same time, we also need to remember that there is a devaluation and decreases the competitiveness of our products. And lastly, in China, there's a quite strong trend of globalization of the platforms and also high efficiency of products and we also have the intention of advancing in that direction to mitigate the fiercer competition that we have there. It's not now only, since the beginning of the year also internationally. We should remember our businesses in Argentina. If you're not really familiar, we have a manufacturing plant there for home appliances, especially kitchen appliances engine. So, the combination of these two factors are making our performance more difficult in this area.

In China, it's not related to the limitation of the importing of home appliances by the US from China, we are not yet seeing that, no, we are not.

Operator

Our next question comes from Marcelo Inoue from Citi.

Q - Marcelo Inoue {BIO 17177482 <GO>}

Good morning. Thank you for allowing me the question. CapEx my question is that -- is about CapEx. Your CapEx, your quarter CapEx was around 60, 70, now it's closer to 100 million, a significant increase, almost 50% increase in your CapEx. This level of CapEx reflects your recent acquisition, but I would like to understand how much of this increase was related to the CapEx for the new assets? And could you talk about what you expect for CapEx from now on in terms of region and segment? Thank you.

A - Andre Salgueiro

Marcelo, thank you for your question. This is Andre Salgueiro. CapEx has in fact increased slightly this quarter with two main impacts. Number one is that we have come to the final phase of our casting process in Mexico. So, now we are expecting more expenses for that project and the strong component of FX variation. So most of the CapEx is then overachieved and when we look at it in BRLs, there is an impact of the FX variation that affects especially this quarter. Now looking into next year, we're still in the budgeting phase, so we don't have a final number, but it's natural to assume because the completion of Mexico casting, we are going to have a level slightly above the level that we had this year.

Q - Marcelo Inoue {BIO 17177482 <GO>}

Thank you, Andre.

Operator

Our next question comes from Alexandre Falcao from HSBC.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Good morning, everyone. I imagine you must be working very hard in designing your budget for next year. Could you give us a little bit more color about your mainlines? And if you have a growth that is above what the market is expecting for Brazil? What are you expecting for the growth in Brazil? And could you tell us more about Mexico as your casting plant is -- gets ready in Mexico, so what should we expect in terms of volume and improvement in mix and margin in Mexico? Thank you.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

So, this is Andre Rodrigues talking. So, we are defining our budget, so not everything is precise for next year, especially with everything we are going through in Brazil recently. We are slightly more cautious before we disclose our numbers for next year. But just to give you slightly more color, there are few things we can mention. Number one for WEG matured businesses, so if the economy keeps on developing and everything evolves positively, naturally WEG's mature businesses will be likely to present a better performance that -- than we had this year. Another positive aspect that we were finalizing is that our TNG [ph] portfolio will be better than it was last year as we could see in this quarter as we mentioned this year.

If our TNG portfolio may have a better performance, one thing that is -- always gets our attention is that we need to be careful in a comparison basis for GTD especially in terms of wins, our portfolio in 2017 and 2018 is similar, but we are expecting a reduction of that portfolio. Another point that we need to pay attention to is as new businesses, the solar this year, TGM acquisition (inaudible) that did not have a comparison basis in the previous year will have the comparison basis next year. And so, we need to observe all of this and we are in this process of defining what we can expect for 2019. And then we may have more precise information once we finish that.

As to our casting businesses, the completion of our investment in Mexico, with this investment in Mexico, we are going to get to the last phase of our verticalization strategy in Mexico. So it's much more an investment to increase competitiveness of becoming more vertical and what we expect from that is a better structure for our product cost and optimization that may come from working capital when we talk about inventory because today, engines are produced in Brazil, sent to Mexico and they get to the production. Once we have the casting business in Mexico, we may have that too.

Q - Alexandre Falcao {BIO 5515455 <GO>}

So, could you talk about installed capacity? If you have demand -- a demand shock, are you ready for that? How much idle capacity you have today to absorb growth and how much investment will it require?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

So another thing that we always mention is that we're modular and this is one -- our competitive advantages. We can accommodate demand without much investment in CapEx. When I talk about short-cycle businesses, we've been disclosing that we are close to the ideal capacity. We are almost full capacity in terms of our industrial, everything that is short-cycle.

And in our long-cycle businesses, we still have some way to go because of everything that happened with the crisis in Brazil. The good news is 2017 was better than 2018 and 2018 is now better than 2017 was. Now expectation excluding once again when we are likely to improve that next year. So short-cycle, when I say that we are almost full capacity for the long-cycle, we are around 70%, 90% depending on what we are talking about.

So, in terms of a better recovery than we were expecting, no problems for short-cycle and neither for long-cycle because we can add capacity very fast without much CapEx investment. So along the recent years, I think we have clearly demonstrated that in the way that we operate.

Q - Alexandre Falcao {BIO 5515455 <GO>}

Thank you very much.

Operator

Thank you very much. Our next question comes from (inaudible) from Credit Suisse.

Q - Unidentified Participant

Good morning, everyone. Thank you for the question. And so talking about oil and gas in Brazil in the recent scenario, do you see good prospect in the domestic market in Brazil because of oil and gas investments?

A - Andre Salgueiro

Hi, (inaudible), this is Andre Salgueiro answering. We had auctions late last year. They were very successful. So we have an outlook of investment in oil and gas in Brazil thinking in a five-year time and since these expense are going to be significant, but they are more mid and long-term opportunities. We're not seeing opportunities for 2019, for example. So it's something for late 2019, 2020.

I think that the only thing that is worth mentioning is the change in the market. In the past there was very strong concentration in local players and now we have international players and we still pay attention at competitiveness and how we are going to take part in those processes. But I think that we have proven along here that we have product technology and competitiveness in terms of cost to be involved in oil and gas projects anywhere in the world. So, if it's in Brazil, this helps us too.

Q - Unidentified Participant

Thank you very much, Andre.

Operator

Our next question is from Rogerio Araujo from UBS.

Q - Rogerio Araujo {BIO 17308156 <GO>}

Hi, thank you. Thank you for the opportunity. I have two questions. The first one requires GTD in Brazil and we have seen a very strong growth, much greater than we were expecting and when we try to do the math of what explains solar, the solar part is less than half. We had 88% organic growth in GTD and in solar, it's half of that and the other half is difficult to explain. You mentioned that wind power had a low cost in the 3Q '17. If you could give us more detail about GTD investment and what explains such a significant growth, this would be very helpful. And that was my first question. Thank you.

A - Paulo Polezi {BIO 19468811 <GO>}

Rogerio, this is Polezi answering. Giving you more details about the numbers in terms of GTD, so we had a record revenue in this quarter with about BRL670 million. And then -- and I'm talking about 97% quarter-on-quarter according to our calculation. And I think that the difference between my number and yours is TGM. So number one, solar plant and also the distributed generation that's part of the growth, 40% is explained by the solar businesses. And number two in terms of relevance. We have the expansion of our sales in (inaudible) about 25%. And then what explains this is an increase in sales especially in projects for renewable energy and then the improvement. We have better orders in our book for power. And then number three, we have wind, it's about 10% for wind. As a reminder, in the third quarter last year, there was an interaction in a project that we were delivering and last 10% TGE that explains part of this growth. And I think would be relevant, we can explain to you the reasons for this significant growth in last quarter.

Q - Rogerio Araujo {BIO 17308156 <GO>}

Thank you very much, Paulo. This is very clear. My second question regards WEG Transformers. Could you tell us about the turnaround, have you broken even? What is the turnaround in future quarters? How much is it contributing for a reduction in margin? And is the pressure going to be relieved over the next few quarters?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

This is Andre Rodrigues answering your question. And so this pressure is going to go down in future quarters, yes. All action plans that we have been developing to improve margin and the growth of the unit, they are in line with what we were developing. And this year what we did not expect was to have an internal inflation that was the highest we had in the US as you've been seeing the higher steel prices and other raw materials.

This internal inflation that was higher led to a result that was below our expectation, but what we're doing in concrete terms, we're renegotiating prices and together with all actions that we are already implementing that in the future that we will be able to refer slightly faster our performance. And then we were expecting that it happened more strongly this year.

Q - Rogerio Araujo {BIO 17308156 <GO>}

Thank you very much.

Operator

Our next question comes from Marcelo Motta from JP Morgan.

Q - Marcelo Motta {BIO 16438725 <GO>}

Good morning, everyone. I have two questions to ask. Number one, when we look at your margin and we mentioned during the presentation that there was some pressure because of devaluation of the currency, raw material prices, how much is the impact of the effects of the mix? And how much of that do you think you will be able to reverse in the fourth quarter because the FX appreciated? The second regards new projects that can go in many lines with many different products, electronic products, engine, electrical vehicles; is there any line that could surprise us in terms of other fast growth next year?

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

So let's talk about margins. One point that we always mention and we pay close attention at in terms of the variation in margins quarter-on-quarter, it's driven by many different factors. Here specifically something that we always alert is that when there is significant volatility in FX rates, usually one -- you can see a stronger impact in one quarter and this is what happened, a strong volatility. Other factor in this, in the third quarter, had a relevant impact in the margin for this quarter. And this is because for long-cycle products we have developed along one year with pretty fine prices. And sometimes the fluctuation that impacts the margin in that quarter, so that added to the problem that we found in value to (inaudible) led to a drop in margin, a margin that according to reports was slightly lower than the market expectations.

In terms of what we see for the future, it's difficult to see how much that is going to be translated into growth for WEG. So, in terms of storage, we have closed a supply in US, I think in Vermont if I'm not mistaken, for storage unit that we are going to deliver it something new for our company and this is reflected in countries such as Brazil. And we believe that this is a business that is likely to grow.

Another thing that we announced recently everything will be to the 4.0. Industry motor scanning is a product that we're also launching. We expect to advance in those front too. So, let's think of TGM where we already have businesses. TGM was the unit here in Brazil that's concentrated most sales in South America and in Europe through a joint venture that we have there, but in some markets where they already had commercial and structural presence such as South Africa and United States and Mexico, there were markets where TGM did not have in the list of suppliers for those markets. We are developing that too and we are using this trend of WEG structure and brands to develop those markets. We have also been talking about electric traction that WEG is following closely. And then -- and also Volkswagen in terms of urban delivery that the prototype is already being tested in Sao Paulo and the schedule we have -- I don't know the details, but we are going to go into a process of marketing as of next year. And we are trying to develop a small bus with electric traction and there are many lines where we are trying to advance in order to diversify so that we may grow alongside.

Q - Marcelo Motta {BIO 16438725 <GO>}

Thank you very much.

Operator

Our next question comes from Murilo Freiberger from Bank of America Merrill Lynch.

Q - Murilo Freiberger {BIO 17385357 <GO>}

Good morning, everyone. Thank you very much for allowing me to ask a question. Actually I would like to hear a comment about two things. Number one, I would like to hear about long-cycle, do you see any improvement? So you see the quotes in terms of wind and that is going to go into the results of 2019, 2020. And in terms of distributed generation and they are segments that aren't really surprising us in terms of growth that is bigger than expected. So how is the segment within solar businesses this year? And what you are expecting for next few years in terms of distributed generation?

A - Andre Salgueiro

Hi Murilo, good morning. This is Andre Salgueiro. As to long-cycle projects outside Brazil, the first observation that we must make is that WEG's exposure to long-cycle outside Brazil is not relevant and it's never been as relevant as it used to be relevant in Brazil in the past. We have some exposure to that, but now our main focus of sales in most of our sales still come from short-cycle outside Brazil. That's said, as part of the operations that we have outside Brazil and also in terms of exports, we have seen an improvement and as we mentioned in our press release some important industries because of recovery of commodity prices, oil and gas, especially mining pulp and paper, we have seen some projects there in our operations outside Brazil which deal with long-cycle projects, especially electric machinery in the US and WEG India. They have a quite robust and strong order growth portfolio and a significant growth as compared to last year and we expect to grow from this year to next year. So, it depends on the market. This is very much focused on the US market. So we have shale gas, pulp and paper and in India, it's more focusing on infrastructure generation and water movement like sanitation, irrigation. This is what we meant in Mexico.

As to GD [ph], this is a market as we say that is important and it's becoming more and more important. In fact we announced BRL50 million of revenue for distributed generation and this year our expectation was to double that number and now we have more than BRL150 million for this year and this in fact demonstrates an improvement and how this market has been performing in Brazil. So the expectation is quite positive and there is a trend for growth. But it's difficult to tell how much the market, even how it's going to evolve.

Our business model has been working well for small project that we call retail distributed generation, small homes, small commercial facilities, we have integrators, they are trained in WEG and they're responsible for a certain region to work and sell installation and technical assistance. And this has been working and we have the smaller projects which are not like a solar farm, but sometimes we get them and we do them with companies that we hire with our engineering team.

And I think that in terms of market, and as we have said that a few times before, Brazil is one of the main countries in terms of solar radiation, we have mentioned that. The worst place of solar radiation in Brazil is still 30% better than the best in Germany. And although China has been investing a lot, Germany is one of the countries that the most developed in terms of solar generation. So our expectation for the next few years is quite positive.

Q - Murilo Freiberger {BIO 17385357 <GO>}

Thank you very much for your answer.

Operator

Our next question comes from Victor Mizusaki from Bradesco BBI.

Q - Victor Mizusaki {BIO 4087162 <GO>}

I have two questions. The first is a follow-up on Murilo's question about distributed generation. Can you somehow map that market share in the segment, especially considering that WEG is the only company that has national distribution for this segment, what is your market share? Can you tell us more about that? And the second question is about transmission. In your last call, you said that we were getting more sales in this sector where many of the auctions in other project would start the contracting process. Could you give us any numbers in terms of backlog and how you see this segment?

A - Paulo Polezi {BIO 19468811 <GO>}

This is Polezi answering your question. So talking about the GND [ph] market, it's a number very difficult to give to you. I don't have it available right now. The comment I have to make is that we have many different models in the market, there are many different companies working in this segment. WEG, undoubtedly is one of the most relevant companies in this market in terms of relevance and science. So, our protection is that we are leading this market, but there are many different models. There are integrators or investors that do them that do it alone; others outsource everything; others sell part of the equipment, so I don't think that information is so well structured in the market. Maybe in the future we can address it in more depth and disclose more in future calls, but what we can see from our portfolio and demand, in fact growth, as Salgueiro mentioned, we are strongly represented in distributed generation market, okay?

A little bit about transmission and distribution, giving you an update about this process. What we have been saying that we keep this message, it is a market where supply is working two models, both pre-contract and also investors. They do not work with contracts, but in terms of those who prefer pre-contracts, we mentioned before we had some pre-contracts, some won and others did not. Our customers won two lots and we are working to deliver those lots.

And there are several outstanding contracts in the market, many of them have not yet finalized choosing their suppliers and we are negotiating with other players. These are ongoing processes, but thing is that has been improving gradually since October 2017 and we are now talking about these negotiation and we can see that it starts with smaller pieces of equipment that gradually evolves towards bigger pieces of equipment. And finally, also in this area, we are working on other fronts such as the sale of equipment directly to the winners of auctions or other suppliers in other lots. So in the markets also common for you to supply to other suppliers and have more than one brand in just one venture. So, this is an overview of the market for you, Victor.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Thank you very much.

Operator

We are now closing our Q&A session. I would like to turn the conference back over to Mr. Andre Rodrigues for his closing remarks. Please, Mr. Rodrigues, you may start.

A - Andre Luis Rodrigues {BIO 17964192 <GO>}

Once again, thank you very much for attending our conference call and we'll meet for the release of the earnings of the fourth quarter and this is going to be next year. So have a good afternoon.

Operator

The conference call has now ended. We thank you all for your participation. Wish you a good day. Thank you.