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NEMAKA.MX - Q2 2019 Nemak SAB De CV Earnings Call

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## CORPORATE PARTICIPANTS

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## CONFERENCE CALL PARTICIPANTS

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**Guilherme G. Mendes** *JP Morgan Chase & Co, Research Division - Research Analyst*

**Héctor Maya**

**Mauricio Serna Vega** *UBS Investment Bank, Research Division - Analyst*

## PRESENTATION

**Operator**

Good morning, everyone, and welcome to Nemak's Second Quarter 2019 Earnings Call. Armando Tamez, Nemak's CEO; Alberto Sada, CFO; and Adrian Althoff, Investor Relations Officer, are here this morning to discuss the company's performance and answer any questions that you may have.

As a reminder, today's conference is being recorded and will be available on the company's Investor Relations website. I will now turn the call over to Adrian Althoff.

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**Adrian Althoff** *- Nemak, S. A. B. de C. V. - IR Officer*

Thank you, operator. Good morning, and welcome, everyone. We very much appreciate your participation. Armando Tamez, our CEO, will lead off today's call by providing an overview of business and financial highlights from the quarter as well as an update on strategy execution. Alberto Sada, our CFO, will then discuss our financial results in more detail. Afterwards, we will open up for a Q&A session.

Before we get started, let me remind you that information discussed on today's call may include forward-looking statements regarding the company's future financial performance and prospects, which are subject to risks and uncertainties. Actual results may differ materially, and the company cautions not to place undue reliance on these forward-looking statements. Nemak undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. I will now turn the call over to Armando Tamez

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**Armando Tamez Martínez** *- Nemak, S. A. B. de C. V. - CEO*

Thank you, Adrian. Hello, everyone, and welcome to Nemak's second quarter 2019 conference call.

During the quarter, we continue to leverage efficiencies to counter effects of less favorable industry conditions in our main markets, finishing in line with our expectations. On the one hand, our results reflected the volume trends embedded in our 2019 guidance. We also saw an impact from exchange rate effect in the period. On the other hand, we benefited from further progress in our execution of cost reduction initiatives, particularly in our European plants. Altogether, revenues and EBITDA amounted to $1 billion and $174 million, respectively.

I would now like to touch briefly on the announcement we've made these past few days regarding our decision to cease manufacturing operations at our plant in Windsor, Ontario, Canada by mid-2020. This basically came down to cost and capacity rationalization. The phaseout of an export program to China representing more than 90% of the plant revenues, yielding its capacity utilization down to less than 10% by next year, making the operation financially unsustainable. The customer, Shanghai General Motors, decided to replace this program with another one which will be produced locally in China, prompting our decision to close the operation. We [have owed] this category to strong and dedicated team in Windsor, and we are deeply grateful for the many contributions they have made to our company.

Turning to strategic execution. We maintained our strong focus on ramping up new product launches as well as on pursuing new opportunities in our structural and EV components business. This included static test production of our company's first battery housing for complex electric vehicles, which will be supplied to a North American OEM. We plan to begin this production of these parts by early next year at the new facility, which is under construction at our site in Monterrey, Mexico.

We also continue to advance (inaudible) processes related to our structural and EV component business. Taking into account [nascent] products in these discussions, which are occurring across most of our OEM customer base, we are confident that we will substantially grow our order book in this segment in the coming months.

Year-to-date, we had won contracts across our product lines worth a total of $410 million in annual revenues, 40% of which represents incremental business.

Regarding the second quarter, the main highlights included a volume increase representing $10 million in (inaudible) revenues for existing business to supply battery housing for mass-market plug-in hybrid applications for a European OEM and contracts to produce complex cylinder heads and engine blocks using our patented casting technologies.

I am also pleased to share that this past May, we received the GM Supplier of the Year award for outstanding performance. This marks the 15th time that we've held this yearly honor, making us 1 of the 10 most recognized suppliers in the award's 27-year history, out of more than 20,000 suppliers worldwide.

Building on our commitment to drive value creation for our stakeholders, we are also -- we doubled our efforts to strengthen our sustainability practices. This past May, we are not -- [completely] committed through design-based target initiative to set greenhouses emission reduction targets in the next 24 months. To date, Nemak is the only company from the automotive supply sector in Latin America that has committed to this initiative. Through action like this, we aim to contribute to overall efforts in the automotive industry that will promote sustainable human mobility.

With this, I conclude my remarks, and I now will hand off the call to Alberto.

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**Alberto Sada Medina** - *Nemak, S. A. B. de C. V. - CFO*

Thank you, Armando, and good morning, everyone. I will share some additional information on our performance during the quarter and expand on Armando's comments regarding industry trends and financial results.

This quarter, we saw softer production among our customers in the main markets where we operate and consistent with our guidance. In North America, we mainly saw a combination of, first, the phaseout of passenger car platforms from uncertain customers; and second, a tough comparison for FCA, which last year had a higher production rate due to new product launches. Europe production was also down. This year, we saw a normalization of production rates versus last year when customers increased production output prior to the start of new emissions testing standards, not to mention a softer overall macroeconomic environment.

In the quarter, SAAR for U.S. vehicle sales was 17 million units or 1.2% lower year-on-year. Regarding vehicle production, second quarter '19 figures for North America were down 6.7% and 2.3% from Nemak customers and the industry as a whole, respectively. In Europe, second quarter '19 vehicle sales SAAR was 20.2 million units, down 2.9% year-on-year. And for the reasons I just mentioned, vehicle production and Nemak's customers' production in the region decreased 6.7% and 6.4%, respectively.

Nemak volumes in North America in the quarter finished down 15.6%, mainly due to the primary factors, consistent with our full year guidance. First, an unfavorable product mix associated with an increase in smaller as opposed to larger engine applications; second, lower exports to China;

and third, lower volumes with FCA, which has seen delays in launching a new engine we will be supplying. Regarding Europe, the industry factors I just outlined were the main cause of the 9.8% reduction in volumes in the region. And Rest of the World volumes were down 23.1% as we continued seeing the effect of lower sales by Ford in China, while South America remained stable.

Consolidated revenue was $1.0 billion, an 18.5% reduction year-on-year due mainly to the combined effect of lower volumes, the depreciation of the euro against the U.S. dollar and the lower aluminum prices. In turn, consolidated operating income was $90 million, 33% lower than last year. The main reason was the lower volumes I just highlighted. Additional factors included currency effects and the normalization of depreciation expense, which together more than offset positive effects of efficiency and a nonrecurring gain in Brazil.

Our EBITDA was $174 million, a decrease of 15.9% year-on-year due to the same factors explained in operating income. EBITDA per equivalent unit was $15.5, down from $15.8 in the same period last year as efficiencies partially offset the effect of volume headwinds I just mentioned.

Net income amounted to a $42 million, an increase of 75% over second quarter '18. It was mainly due to a reduction in foreign exchange losses associated with more stable exchange rate, along with a nonrecurring interest income in Brazil. Together, these factors more than offset the lower operating income.

CapEx was $76 million in the period, consistent with our expectation of the CapEx reduction for the full year.

Our financial conditions remains healthy, characterized by a solid cash flow generation, strong financial ratios, no meaningful short-term debt maturities and a stable debt balance. Net debt-to-EBITDA was 1.9x. Interest coverage was 10x as compared to 1.8 and 8.2x reported in the same period of last year.

Moving on to our regional results. Lower volumes combined with lower aluminum prices resulted in an 18.8% reduction in revenues in North America. EBITDA for the quarter was $100 million, 23% lower than the same period last year. This was due primarily to a combination of lower volumes and incremental expenses of approximately $6 million related to the launching of new products at our operations in the U.S., where we experienced above normal manufacturing expenses on several launches.

In Europe, lower volumes and aluminum prices as well as the depreciation of the euro against the dollar brought revenues down 14.6%. However, the continued effect of operational efficiencies enable us to mitigate this headwind. Excluding the exchange rate, unitary EBITDA in the region would have been slightly higher.

Turning to Rest of World, revenues were down 14.6% (sic) [28.7%] affected by lower volumes. However, EBITDA reached $16 million, aided by a nonrecurring gain of $8 million associated with the favorable resolution of a sales tax dispute in Brazil, which was a continuation of the federal tax effect we had back in the second quarter of '17.

Last, I would like to provide additional context on financial implications of our decision to close our plant in Windsor, Canada by mid-2020. During the next quarter, in the third quarter of '19, we'll be recording a low single-digit severance effect on EBITDA, and we expect a noncash effect of approximately $35 million to $40 million due to the impairment of the asset. This effect do not imply a change to the EBITDA guidance for the full year.

With that, I conclude my comments, and we'll now open the call for Q&A. Operator, please instruct the participants on how to place their questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from Guilherme Mendes at JPMorgan.

**Guilherme G. Mendes** - *JP Morgan Chase & Co, Research Division - Research Analyst*

My first question is related to your 2019 guidance. So looking to the first half numbers, you're tracking below it. I'd just like to have some color in terms of what we're seeing for the second half and if you restate your guidance or if you see some downside to it.

And my second question is related to capital allocation. So you're running at lower investments and low level of leverage, what can we expect in terms of dividend payments?

**Alberto Sada Medina** - *Nemak, S. A. B. de C. V. - CFO*

Yes, sure. Related to your question about the guidance, we don't have any changes yet. I mean so far, I think we are in line with what we had assumed for the year. So the second half will be consistent with the numbers we have for the full year guidance that we guided there during this year, so there is no change.

And your second question, could you repeat?

**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

Related to the dividend, we are committed, and certainly, we will continue with the -- paying the dividends as it was stated at the beginning of the year.

**Operator**

Our next question comes from Héctor Maya, Santander Bank.

**Héctor Maya**

Just wanted to know if the case you mentioned for General Motors [present] to change its production to China, do you have any other places in other regions where you could see another risk like that?

**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

No. No, I don't -- we don't see that coming, at least not to our knowledge. But that was a decision basically by Shanghai SAIC, which is the partner of GM, to, let's say, build another engine in China. And -- but we don't see that effect, at least not to our knowledge, in any other region at this time.

**Héctor Maya**

Got it. And in China, what do you expect forward in the next year? Maybe you could share with us how the mix stands now for Asia, Brazil and the Rest of the World division?

**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

Yes. We are seeing certainly a softening of the Chinese market, mainly related to these trade -- dispute or trade wars. We are seeing a reduction in volumes overall. This is the second quarter that China is selling at approximately at the rate of about 24 million to 25 million units. We were expecting a little bit higher than that in the range of about 27 million. But as Alberto indicated, we will continue again with the same guidance that we stated at the beginning of the year.

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**Héctor Maya**

And just sorry, last one because my line is going down a little bit later. I could not hear very well, but you mentioned structural and component business, you had mentioned something about the coming months. Could you repeat that, please?

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**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

I couldn't follow you, Héctor. Can you repeat the question again, please?

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**Héctor Maya**

Sorry. I was mentioning that if you could repeat the part where you said something about the structural and component business, something that you are seeing about the coming months but I couldn't hear it.

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**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

Yes, certainly. What I mentioned related to the EVs, we were awarded a new case on existing contracts. One of the things that we are experiencing right now, especially in Europe, is that customers, OEMs, in order to comply with the most strict regulations, they need to adopt electrification at a much faster pace than originally anticipated. So contracts that we have already in -- awarded, what we are seeing and that we are reporting right now is an increase. We recently got this increase for a mass production vehicle or set of vehicles of a German OEM. And we are seeing additional requests from customers to, let's say, expand some of our existing contracts there. I think it's very important to clarify that we will see more hybrids at least for the next 4 to 5 years in order for the European customers to comply with the new regulations.

I think we need to clarify that some of the European customers were counting on diesel to be, let's say, more relevant now after the VW scandal. We are seeing that the only way that they can meet the strict regulations is by going into at least hybrids and then electric. So this is the potential that we see. We, as I indicated, bought an extension to our contract with a volume increase. And as we speak, we had been receiving from different customers additional request for expansion of existing contracts plus a very strong pipeline of quotes that we are preparing, and I think it's important for me to clarify it as well that we are trying to be very selective with what -- with few customers that we trust most and also selecting products in which we can differentiate and achieve better the profit margins.

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**Héctor Maya**

Got it. But just to clarify, you said something out of that, that was reflected in the outlook increase for this quarter.

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**Alberto Sada Medina** - *Nemak, S. A. B. de C. V. - CFO*

No. That's included in the $210 million that we described in the press release.

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**Héctor Maya**

Yes, but only that was just for powertrain?

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**Alberto Sada Medina** - *Nemak, S. A. B. de C. V. - CFO*

Yes, it was -- with that -- out of that, $10 million was for structural components and EVs.

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**Operator**

Our next question comes from Mauricio Serna, UBS.

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**Mauricio Serna Vega** - *UBS Investment Bank, Research Division - Analyst*

Just a few on -- first on the Canada plant that was closed. Is there any other plant current -- that is currently operating also at a very low capacity utilization?

And on the other hand, if you could comment a little bit more about your expectations regarding WLTP issue and regulation. I've heard that there's going to be like a second phase for the testing, and that has been clearly a bottleneck issue for production for the European OEM. So just curious on getting your thoughts on that.

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**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

Yes. Thank you, Mauricio. The question that you're asking us, do we have any plans in similar situation as the Canadian operation? The answer is no. We don't have any other plant in our system that I -- expecting to be at the same level as Canada at this stage.

And the second question related to the WLTP, you're right. Certainly, they will come this September with the new regulations for the WLTP. We have already, Mauricio, adopted that in our guidance. And what we are seeing and talking to all European customers is that now, I think they are very prepared, better prepared than last year. I think last year, to some extent, some of our customers probably believed that they could get some type of an extension for the testing period, and they didn't. So now I think they formed dedicated teams to prepare and schedule the testing of the new vehicles that they need to, let's say, pass this new testing.

So short answer, again, is that it's already embedded in our guidance, and we don't expect major effects. And we are continuing, let's say, committed to deliver our guidance in terms of EBITDA and also dividends and maintaining also a healthy leverage ratio, below 2x.

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**Operator**

(Operator Instructions) Our next question comes from Alejandro Alcaraz (sic) [Alejandro Azar], GBM.

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**Alejandro Azar Wabi** - *GBM Grupo Bursátil Mexicano, S.A. de C.V. Casa de Bolsa, Research Division - Research Analyst*

I'm having a hard time hearing -- my first question is regarding the Windsor, Canada. You mentioned severance payment in the low single digit and then an impairment between USD 35 million and USD 40 million for the third quarter in 2019. Was that correct?

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**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

That is correct, Alex.

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**Alejandro Azar Wabi** - *GBM Grupo Bursátil Mexicano, S.A. de C.V. Casa de Bolsa, Research Division - Research Analyst*

Okay. And then my other question is regarding your backlog. Just -- your backlog on the structural and electric vehicle components would now be around $610 million. Is that correct also?

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**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

That is correct, Alex. And as I indicated also, we have a very strong pipeline of quotes, about -- approximately of about $1.8 billion. And as I indicated, we are trying to be selective in terms of what customers we are choosing to do business with and also selecting parts that are complex and also that would create better margins for our company. And we are committed to achieve the $1 billion sales by 2022.

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**Alejandro Azar Wabi** - *GBM Grupo Bursátil Mexicano, S.A. de C.V. Casa de Bolsa, Research Division - Research Analyst*

Okay. And just another one. The severance payments on the impairment, is that impact embedded on your $620 million EBITDA guidance or not?

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**Alberto Sada Medina** - *Nemak, S. A. B. de C. V. - CFO*

Yes, that effect is too small to change the guidance, but it's already included.

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**Alejandro Azar Wabi** - *GBM Grupo Bursátil Mexicano, S.A. de C.V. Casa de Bolsa, Research Division - Research Analyst*

I'm sorry. So the number on the impairment, the...

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**Alberto Sada Medina** - *Nemak, S. A. B. de C. V. - CFO*

Yes. And remember that the impairment, the impairment is not an EBITDA effect. It's a noncash write-off that we need to do based on the value of the assets, and that will be a depreciation eventually. So it will be an EBIT impact...

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**Alejandro Azar Wabi** - *GBM Grupo Bursátil Mexicano, S.A. de C.V. Casa de Bolsa, Research Division - Research Analyst*

Okay, I understand. Yes, yes. Okay. Perfect. And then the last one, it's on profitability. We are seeing higher-than-expected profitability when I compare this quarter, even excluding the $8 million in Brazil, your margins are above 16% versus your EBITDA guidance below 15%. What can you comment about that? Is that the impact on efficiencies, a mix?

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**Alberto Sada Medina** - *Nemak, S. A. B. de C. V. - CFO*

Yes, yes, Alex, and that's -- what you're saying is absolutely right. Remember that the first semester is traditionally higher due to the seasonality effect on volumes during the year. So normally, you would see higher margin and higher volumes, higher results in the first semester than the second semester.

Having said that, I also need to recognize that we have -- as we have said, we have been working very thoroughly on efficiencies, and that's something that has also had a positive effect on our margins.

So yes, it is a little bit higher, but it's consistent, and again, aligned with our view for the full year to reach the $620 million of EBITDA for our guidance.

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**Armando Tamez Martínez** - *Nemak, S. A. B. de C. V. - CEO*

Adding to what Alberto has mentioned, I think it's important also to mention that we had continue looking for operational efficiencies at every single plant as well as our administration. I think we are now moving into having a unit and a company that has a -- and a structure that it is according to the new market reality.

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**Operator**

(Operator Instructions) There are no further questions at this time, and I would like to turn the conference back over to Mr. Althoff for any additional or concluding remarks. Sir?

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**Adrian Althoff** - *Nemak, S. A. B. de C. V. - IR Officer*

Thank you, operator. I would just like to thank everyone for participating in today's call. Please feel free to contact us if you have any follow-up questions or comments. Have a good day.

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**Operator**

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.

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