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First Quarter 2020 Earnings Conference Call

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C O R P O R A T E P A R T I C I P A N T S

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Armando Tamez, *Chief Executive Officer*

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C O N F E R E N C E C A L L P A R T I C I P A N T S

Pedro Cardoso, *Financia*

Jamie Nicholson, *Credit Suisse*

Ron Vabina, *MUFG BANK*

Joao Rosado, *Financia*

Marcelo Motta, *JPMorgan*

Maxim Biryukov, *AlphaCare*

Alejandro Alzar, *GBM*

P R E S E N T A T I O N

Operator

Good morning, everyone, and welcome to Nemak's First Quarter 2020 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.

Adrian Althoff

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. 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.

Armando Tamez

Thank you, Adrian. Hello, everyone, and welcome to Nemak's First Quarter 2020 conference call.

In light of the dramatic impact we have seen in recent weeks of the spread of COVID-19 on our industry as well as broader society, I wanted to begin with an overview of the measures we are taking as a Company to safeguard the wellbeing of our people and adapt our business to conditions linked to the pandemic.

Now and always, our top priority is to deliver the highest standards of health and safety for our employees and their families. Under the leadership of a task force comprised of members of top management, as well as health and safety experts, we have been implementing a series of measures designed to minimize transmission of the virus, including checkpoint screenings, facility disinfection, and physical distancing protocols, among others. In this regard, we have been drawing upon our experience at our operation in China, where we successfully restarted production in mid-February following a three-week shutdown linked to the spread of the virus at that time.

The pandemic has put pressure on our communities in ways we had never experienced before as individuals nor as a company. We are acting in solidarity with stakeholders in all regions, including customers, suppliers, non-profit organizations, and government agencies in order to identify and implement additional actions in support of worldwide efforts to combat the virus. To date, this has included using 3D printing and other manufacturing technologies at our Product Development Center in Mexico to help increase health system capacity locally, and donating protective equipment for medical personnel in several regions where we operate.

I am proud of the resiliency our people have demonstrated in the face of this crisis. While it is having an impact on all of us, I am confident that our commitment to take every precaution to keep one another safe while going the extra mile to support our customers will help us to overcome the challenges ahead.

I would now like to move on to measures we are taking to address effects of the virus on our business.

In response to light-vehicle production cuts among certain customers, we are further optimizing costs, expenses, cash flow, and liquidity; key levers include cap ex and working capital reductions, flexible production schemes tailored to customer requirements, executive pay cuts, reduced working hours, rightsizing processes, and temporary production stoppages, among others.

Our experience from the 2008/2009 Great Recession serves as a valuable reference in this regard. Efficiency is part of Nemak's DNA, and we will continue to pursue every opportunity to adjust our cost structure to reflect evolving industry dynamics going forward.

Turning to the first quarter, it is worth noting that we were already making inroads on the cost reduction front prior to the onset of the pandemic. Such efforts helped us to keep business performance at expected levels, partially offsetting the impact of lower volume on our result in the period.

While effects of the virus weighed on volume in all markets in the quarter, they were more acute in China and Europe, where customer plants were idled on average 20 and 14 days, respectively. This compared to 10 and eight days in North America and South America, respectively.

In response to these circumstances, we have been gradually scaling down production across most of our footprint since mid-March; with the exception of China, where volume has been trending higher, we have been affected by a combination of limited customer demand and emergency declarations restricting automotive production in certain locations where we operate.

Given these conditions, we expect to generate only marginal production in April in all regions except Asia. While most of our customers have stated their intention to resume light-vehicle production gradually starting in early May, we are mindful that such plans remain subject to change. Regardless, we will be ready to meet the needs of our customers as soon as they are ready to produce again.

Continued uncertainty over the scope and duration of customer production stoppages has substantially limited our visibility on short-term volume development; this is why, as we mentioned in our earnings release issued yesterday, we have decided to withdraw our 2020 guidance. We plan to provide updated guidance figures as soon as reliable estimates can be determined.

We believe that our balance sheet and liquidity position, together with the efforts I just described to reduce costs and spending, will help us to weather effects of the virus. As you may have already seen in our earnings report, we took significant cash preservation measures in the first quarter, tapping into a portion of our existing credit lines to finish the period with a total of US$772 million in cash and cash equivalents. Moreover, we remain focused on evaluating potential additional steps to maximize liquidity and financial flexibility in the face of uncertainty around the pandemic.

I am confident that we have laid a solid foundation for ensuring business continuity in the current environment. At the same time, I want to emphasize that we remain intensely focused on pursuing new opportunities aligned to our strategy, as demonstrated by our continued progress in winning business in e-mobility and structural applications. In the quarter, this included a new contract worth approximately US$70 million in annual revenue to produce battery housings featuring complex castings and assemblies for plug-in hybrid sedans and SUVs of a European OEM. We will harness existing high-pressure die casting capacity along with our expertise in leading-edge welding processes to deliver the required solution to the customer.

More broadly, this project represents another milestone in the growth of our business in battery housings in Europe and North America. In Europe, in particular, we continue to see strong customer demand for applications tailored to the plug-in hybrid variety. Taking into account our track record supplying these parts to all major German OEMs, we believe that we are well positioned to make further inroads in the product segment in the coming years.

Rounding out our sales and marketing highlights, we also reinforced our customer relationships in structural castings, winning business to supply these parts to sports car applications of a North American OEM, as well as the premium sedan applications of a European OEM.

For the quarter, we won contracts across our product lines worth a total of approximately US$190 million in annual revenue, 90 percent of which represented incremental business.

Altogether, our order book in e-mobility and structural applications stands today at approximately US$820 million in annual revenues.

On a concluding note, I would like to emphasize our commitment to do what it takes to keep our people healthy while continuing to adapt and innovate as an organization to meet customer needs in these extraordinary times. This is not the first time in a downturn in our industry, and we know that we have the capabilities required to get through it and emerge as a stronger Nemak.

With that, I will hand off the call to Alberto, Nemak's CFO.

Alberto Sada

Thank you, Armando, and good morning, everyone.

I will share some additional information on our performance during the first quarter and discuss ongoing actions to manage our financial position amid the COVID-19 pandemic.

Light vehicle sales and production across all regions declined due to the impact of the coronavirus outbreak on overall economic activity.

In North America, on an annualized basis, light vehicle sales decreased 11%, mainly due to the implementation of lockdown measures during March, while light vehicle production recorded a reduction of 12%, as automakers implemented temporary manufacturing stoppages and production cuts in response to the general contraction, as well as production restrictions in certain jurisdictions where they operate.

In the case of Europe, light vehicle sales dropped 11%; however, production declined over 21%, as automakers implemented production stoppages earlier than in North America.

As Armando mentioned, most of our customers in these regions continue with the stoppages as of today, and plan to resume operations in early May.

Nemak's total volume was 10.5 million equivalent units, a 13% decrease on a year-over-year basis during the period reported, primarily attributed to the effects of the COVID-19 pandemic on customer production in all regions.

On the revenue side, our sales were $907 million, an 18% reduction versus last year, due to the lower volume and lower aluminum prices.

Cost of goods sold declined almost 18% year-on-year, primarily reflecting a lower manufacturing activity and operating efficiency improvements.

In the quarter, EBITDA and operating income were $142 million and $65 million, respectively, 19% and 20% lower year-on-year, mainly due to the volume reduction just mentioned, and to a lesser extent, exchange rate effects.

We continue to accelerate efforts to make our cost structure as flexible as possible in response to evolving conditions, including accessing short-week government support programs in Western Europe and the U.S., implementing executive pay cuts, and reducing working hours in Mexico. These measures help us to maintain flexibility with our labor force to resume operations once customer demand materializes.

Additionally, we remain focused on keeping a rigorous control of our full range of manufacturing and administrative expenses.

During the quarter, reported net income was negative $14 million affected mainly by the reduction in operating income I just described, together with a negative non-cash effect of $52 million caused by the effect of the appreciation of the U.S. dollar on assets denominated in foreign currencies, in particular the Mexican peso and Brazilian real. As you may recall, at the holding level our functional currency is in U.S. dollars.

Absent this extraordinary effect, net income would have been $38 million.

Turning to cap ex, we invested $97 million over the quarter, primarily, to ramp up our product launch pipeline in all regions where we operate, while at the same time advancing plans to reduce investment over the remainder of the year.

In the face of increased uncertainty around the pandemic, we have also adopted a number of key initiatives to preserve liquidity levels and increase our cash position, including working capital improvements and tapping into additional sources of financing.

We drew a total of $493 million in the quarter from credit lines, bringing our cash position to $772 million. We expect that these funds will give us sufficient flexibility to manage through these uncertain times.

At quarter-end, our net debt to EBITDA and interest coverage ratios were 2.1 times and 8.1 times, respectively.

Moving on to the regional results, North America saw volume and EBITDA down 14% and 17%, respectively. Operating efficiencies and enhanced cost management helped us to mitigate effects of less favorable conditions in the region.

Europe recorded 14% and 31% contractions in volume and EBITDA, respectively, primarily reflecting effects of the rapid spread of the virus in the region in March as well as unfavorable foreign exchange fluctuations.

Rest of the World recorded a positive EBITDA generation of $5 million compared to a negative $1 million in the same period of last year. This mainly followed efficiency initiatives and a better product mix in Brazil, which helped us to offset the impact of lower volumes in China.

As Armando mentioned in his remarks, given the difficulties inherent in assessing the extent and duration of the impact of the pandemic in markets where we operate, we are taking a prudent approach to our business. This means focusing on realigning our cost structure and investments in response to the downturn in our industry, while remaining attuned to customer needs.

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.

Operator

Thank you. If you would like to ask a question today, please press star, one from your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, while we poll for questions.

Thank you. Our first question comes from the line of Pedro Cardoso with Financia. Please go ahead with your question.

Pedro Cardoso

Hi, good afternoon. Can you please provide some color on the maintenance cap ex for the current year and what other steps to bolster liquidity are available? Thank you.

Alberto Sada

Yes. Hi Pedro. The maintenance cap ex for the year, I mean, we're currently revising because as we indicated we will be changing our guidance for the year, but in general terms we are investing in maintenance between $60 million to $70 million as of full year. That's distributed on a quarter-by-quarter basis by one quarter.

Related to your second part of the question, related to liquidity, as we highlighted, we drew from our existing credit line to raise our cash position to $772 million, and we still have further possibility to increase our liquidity. We still have around $150 million worth of additional credit lines that we can draw upon if needed.

Pedro Cardoso

Okay, thank you very much.

Operator

The next question is from the line of Jamie Nicholson with Credit Suisse. Please proceed with your question.

Jamie Nicholson

Hi. Thanks so much for the call. I'm wondering, you mentioned that you're only executing marginal production in April and that you've implemented some flexible work strategy. Do you have any estimate, given that your very low production expectation in April and probably going into May, what your cash burn is like? In other words, how much have you been able to reduce fixed cost or overhead? Also, are you seeing an increased usage in working capital in the second quarter? Just given that the auto OEMs have stopped production, are you seeing a buildup in your own working capital? Thank you.

Alberto Sada

Yes. Hi Jamie. I'm going to start first with your second question, related to your second question, working capital has been not increasing but to the contrary. With the reduction in activity, we see overall a reduction in working capital. We're managing that extremely closely and that's a combination of both our ability to contain the effects on the supplier base, as well as how we're following the receivable side. On the working capital we believe it's going to be a little bit favorable or positive.

Related to the cash burn, that's something that obviously we are also taking a very close look at what we need. We're managing that very closely, As you know, we have taken all these flexible measurements that help us deal with the expenses that we would otherwise be having if we were operating. On the cash burn, we'll be, let's say, on a varied basis, but we expect that we'll be using somewhere in the neighborhood of $100 million to meet the needs for the next—for this month and the following month.

Jamie Nicholson

Okay, that's $100 million you expect for the next two months or is that $100 million per month?

Alberto Sada

Well, no, that's according to what our view is. That's for the month of April, and as we speak we're hearing from our customers that there are plans to restart in May, early May, so certainly if that doesn't continue—I mean, if they don't restart we will continue using around that amount per month.

Jamie Nicholson

Okay, got it. Thanks. That's very helpful color. Thank you very much.

Operator

Thank you. Our next question is from the line of Ron Vabina with MUFG. Please proceed with your question.

Ron Vabina

Yes. Hello everyone. Thank you very much for the call. I have two questions. Can you give us a rough idea of the expected volumes in second quarter? Is it going to be down 50%, 75%? Just a rough idea will be helpful.

Secondly, I know there was a question on the liquidity, but just again want to understand the liquidity position better. You said you have $700 million in cash and ability to draw an additional line. What is that additional line capacity? If the situation continues with low volumes even in third quarter or even in fourth quarter, roughly how long will this cash liquidity of $700 million last? Are you comfortable with that through the end of the year? Will you be able to meet all your debt payments, interest payments, etc.? Thank you.

Alberto Sada

Yes, Ron. Related to your second question around the liquidity, as I described previously, we have $772 million in cash available on hand, and further to that we still have committed credit lines of close to $150 million. That gives us, let's say, ample sources of funding to meet our needs going forward. Definitely, it's going to be hard to assess how long—I mean, based on what we're hearing from our customers on a restart in May, certainly it's way more than what we would need based also on the cash burn that we have, so that gives us sufficient room to maneuver and since we have not too much amortizations in the short term, we are, let's say, ready to meet with all the needs that we have in the year as to the question related to interest and debt obligations.

Related to your first question on volumes, at this point it's very difficult to really make a point around how much that's going to be. It's going to depend ultimately on when our customers plan to restart and how quick they want to ramp-up volumes.

Operator

Thank you. Our next question comes from the line of Joao Rosado with Financia. Please proceed with your question.

Joao Rosado

Hi. Thanks for taking my call. I just wanted to get a better grasp on your working capital situation once factories begin to open and whether you're having already discussions with the OEMs about their needs in terms of your product. Once factories start to open in Europe, which is expected end of April, beginning of May, when do you actually expect, for instance, in Europe, to start shipping products to the OEMs, or do they already have enough inventory? Also in terms of your raw material needs, once you have your factory up and running again, do you have enough inventory for a few months? Do you need to start buying inventory as well? Just wanted to get a better understanding of what we should expect in terms of working capital.

Alberto Sada

Yes. Certainly, as we were planning for the shutdowns on the different operations that we're working on, we increased a little bit the level of inventory. That gives us flexibility to ramp up our production as (inaudible) starts increasing next month. We don't envision any issue from the inventory side of it, that we have finished goods inventory, as well as work-in-process inventory, and we also keep safety stock of inventory of raw materials.

From a working capital point of view, we feel fairly comfortable about how to deal with the restart, and we prepare ourselves precisely for that, to have a little bit of extra cushion to prepare as the OEMs—knowing how the ramp-up from the OEMs is going to be so that's going to put us in a better flexible position to meet their demand.

Operator

Thank you. Our next question is from the line of Marcelo Motta with JPMorgan. Please proceed with your question.

Marcelo Motta

Hi. Thank you for the call. Two questions. The first to comment about the Company trying to access government aid both in the U.S. and Europe. I mean, could you please just let us know what exactly could be those aids? Could it be tax deferral, could it be, I don't know, reductions on payroll tax? We're just trying to understand what would be the positive impact of that.

When we look at China, which was the first country to enter and leave the lockdown, how are your current sales to the country compared to your normalized level? I mean, could you say that you are already like 99% back or are you still—they're consuming half of what they used to consume before the COVID-19 crisis? Those would be the questions. Thank you.

Armando Tamez

Thank you, Marcelo. This is Armando. Related to government support, let me just start by telling you that in Europe we have a very strong government support for our operations. Just to give you some examples. For instance, in Germany, our people are getting paid by the German government, as well as the Austrian and the Spanish government to a level of approximately 70% of the wages and salaries. That is not an additional burden for us.

In the States, we were able to lay off people and they are receiving approximately $400 from the U.S. government. We have not seen, unfortunately, any support in Latin America, not in Mexico or Brazil, any support from the government, but at least our operations in Europe, as well as in the U.S., we are receiving some government support and benefits.

Related also to our Chinese operation, as I was indicating in my speech, we were able to restart three weeks after the shutdown, gradually. We started with one shift and then increased. It took us about two, two and a half weeks to go back to normal. We are operating our Chinese plants today at approximately 90% of our expected volumes, and we don't have any issues, fortunately. I just want to add that in spite of the fact that the virus, unfortunately, was generated in China, so far we haven't had any single case of any of our colleagues or families getting the virus.

Marcelo Motta

Thank you very much.

Armando Tamez

Thank you.

Operator

Our next question comes from the line of Maxim Biryukov with AlphaCare. Please proceed with your question.

Maxim Biryukov

Hello everyone. Thank you very much for the call. Actually, most of my questions have already been answered, but just a few more. Aluminum prices have significantly dropped down like 15% during the last two months. Are you expecting any kind of benefits from this? Also, you released the actual financial statements. There is financing expenses which is six times more than it was in the first quarter of 2019, about—it's almost 10% of total revenues, but the debt hasn't really changed that much. Can you please comment what is behind those numbers? Thank you.

Alberto Sada

Yes, absolutely Maxim. Related to your first question on aluminum prices, given that we are operating with a pack of different alloys, really the difference in price that we had last quarter versus now, the drop in that average bucket of prices translated into relatively small amount. It's really a negligible effect that we're seeing right now and depending on how we move forward it could go in either direction.

Related to your question about the financial expense which was a non-cash foreign exchange loss that we reported in the quarter, that has to do with the exposure that we have to assets, to a net balance of assets and debt in pesos and in Brazilian real, right, and when we are seeing a steep depreciation of those two currencies against the U.S. dollar, since our net position is an asset, we have to record either a loss or a gain. In this case, a depreciation of the peso and the Brazilian real to the dollar generates a loss, and it's about 40% represented from our assets in reals and 60% from an asset in peso. Remember that we have our functional currency at the holding level in U.S. currently. That's the reason why we need to book this accounting effect, it's a non-cash effect, as the assets gets revaluated to the new exchange rates that we're seeing right now. Had the exchange rate been the opposite, that would have been a financial accounting gain.

Maxim Biryukov

Thank you.

Operator

The next question comes from the line of Alejandro Alzar with GBM. Please proceed with your question.

Alejandro Alzar

Hi Armando and Alberto. Thank you for taking my question. If you could give us more color on—this is a follow-up from Jamie Nicholson about the cash burn. Is your cost of turning on capacity or start producing again embedded in that $100 million cash burn? If you could give us more color on those types of costs?

My second question is related to the plant closure in Canada. At what time do you expect to not have operations there? The other one is, what are you expecting to do with that asset? Are you planning to sell the land? Do you have an estimate of a book value on that land cost?

The third one is related to the renewal you've been winning on the structural and electric vehicle components. If my numbers are correct, those are around $150 million. Could you give color on how those contracts are generating EBITDA right now? Thank you.

Alberto Sada

Okay. Sure, Alejandro. Thanks for your questions. I have here the three ones. The first one's related to the comment on cash burn. That will be the amount of $100 million that is a steady state cash burn rate that we will need when we are at significantly low level of production as what we were experiencing in April. That takes into consideration all the costs that we have. That's in round figures where we are not able to collect (inaudible) based on volumes. Obviously, if things would continue lower, there could be adjustments to that level of cash if we were to adjust further our cost structure to (inaudible).

Related to the closure of the Canadian plant, we are on track to meet our plans, which is in the middle of the year, in the summer of this year, of 2020, and so far we have not yet considered any options on what to do with the asset. We're keeping the asset ourselves, so at this point we are not thinking of doing anything with that asset for now.

Third, relating to structural and EBIT (phon) components, for the full year expectation in terms of EBITDA, that's still to be considered once we provide a revised full year figure, once we have a better visibility of how the volumes for the year are going to look like.

Overall, the margin expectations for structural and EBIT (phon) are, as we have indicated in the past, slightly better than the average.

Alejandro Alzar

Okay. Thank you very much, Alberto.

Alberto Sada

Thank you, Alejandro.

Operator

Thank you. There are no further questions at this time, and I'd like to turn the conference back over to Mr. Althoff for any additional or concluding remarks. Sir?

Adrian Althoff

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.

Operator

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