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Fourth Quarter 2020 Earnings Conference Call

February 11, 2021

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

Marcelo Motta, *JPMorgan*

Alejandro Azar, *GBM*

Augusto Ensiki, *HSBC*

Mario Appelbaum, *First New York*

Valentin Mendoza, *Banorte*

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

Operator

Good morning, everyone, and welcome to Nemak's Fourth Quarter 2020 Earnings Webcast.

Armando Tamez, Nemak's CEO; Alberto Sada, CFO; and Adrian Althoff, Investor Relations Officer, are here this morning to discuss the Company's business performance and answer any questions that you may have. As a reminder, today's event is being recorded and will be available on the Company's Investor Relations website.

I would now like to turn this conference over to Mr. Adrian Althoff. You may begin.

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 2020, as well as our outlook on 2021. 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 Fourth Quarter 2020 Earnings Webcast. I would like to begin with an overview of 2020 results and initiatives before moving on to our 2021 guidance.

Our efforts to manage and successfully emerge from the COVID-19 pandemic were instrumental to our solid performance in 2020, marking a new chapter in our growth and transformation journey. Based in large part on our experience in China, where we witnessed firsthand the effects of the initial spread of the virus on the global automotive industry, we leveraged best practices across our operations to protect the safety and wellbeing of our people, while maintaining business continuity amidst the health crisis.

Simultaneously, we took steps to support the long-term sustainability of our business, including the implementation of operational efficiencies to optimize costs, expenses and cash flow, and the use of credit lines to reinforce our liquidity positions. Thanks to these efforts, in the first half of the year, we weathered effects of historic industry-wide production stoppages and achieved a smooth restart of our global operations, ensuring a stable supply to customers. Moreover, we subsequently capitalized on the improved demand to post record-breaking results in the second half of the year.

Starting in June and continuing through the end of the year, the global automotive industry experienced sustained recovery in both light vehicle production and sales. Similarly, our volume showed a positive trend across our regions. Volume in North America and Europe approached pre-COVID levels in the second half of the year, while rest of world benefited mainly from the Chinese market's relative outperformance starting in the second quarter.

On the one hand, effects of the spring lockdowns resulted in production stoppages of approximately two consecutive months at all our facilities worldwide, which in turn put a damper on our results in the first half. On the other hand, for the second half, volume and revenue were down just 3% lower year-over-year on sequentially stronger customer demand.

Moreover, we harnessed cost reduction efforts to drive EBITDA to $328 million, or 21% higher compared to the same period of the previous year. In turn, this enabled us to achieve our best-ever EBITDA per equivalent unit. Additionally, these efforts helped us to deliver a 5% beat on the fourth quarter EBITDA result implied in our revised 2020 guidance published last October.

I am also pleased to share that we made further progress on deleveraging in the fourth quarter, repaying most of the credit lines we had drawn early in the year to reinforce our liquidity during the pandemic-related production stoppages. As a result, notwithstanding the extraordinary headwinds we faced in the first half of 2020, we finished the year with a similar level of net debt compared to the end of 2019.

Moving on to our sales and marketing activities. Throughout the year we continued to work in tandem with our customers to support their lightweighting and electrification strategies. This includes harnessing our design engineering, simulation and casting capabilities to deliver tailor-made solutions to support crashworthiness and thermo-mechanical requirements of new electric vehicles, while at the same time reducing their weight and therefore increasing their driving range.

During the fourth quarter, these efforts culminated in us being awarded a new contract with an OEM customer in North America to develop and produce aluminum battery housings for an iconic, full-electric premium vehicle. We believe that this project represents a breakthrough in our efforts to reinforce our leading position in this new product line in the region.

At the end of 2020, our total order book in our E-Mobility and Structural Applications segment amounted to approximately $850 million in annual revenue. We also saw positive developments in our order intake on the Powertrain side in the year, winning contracts to supply cylinder heads and engine blocks in all our regions. This included incremental business to supply these parts to an Asian OEM customer in Europe and South America worth a total of approximately $80 million annually. For the full year, we won new contracts worth a total of approximately $700 million annually across our product lines, half of which represented incremental business.

In recognition of our efforts to anticipate and meet customer needs, we once again received important industry awards in the year, including the General Motors Supplier of the Year and the Volkswagen Group Award in the Launch of the Year category.

Regarding our manufacturing operations, we saw increased activity in E-Mobility and Structural Applications. In particular, the main highlights include: initiating series production of battery housings for the full-electric Ford Mustang Mach-E in North America; structural applications for a new all-electric sedan in Asia; and battery housings for new plug-in hybrid electric vehicles of Stellantis in North America, as well as Daimler and the Volkswagen Group in Europe.

Taking into account recent progress in discussions with our customers, we believe that we are well-positioned to continue to capture new business to produce these types of parts in the coming months. As of today, we are pursuing new business opportunities in E-Mobility and Structural Applications worth more than $1 billion annually.

I would also like to highlight our progress in 2020 towards improving our performance in globally-recognized benchmarks for environmental, social and governance practices. These include the CDP Climate Change and Water questionnaires and the SAM Corporate Sustainability Assessment, among others. Additionally, we were selected to join several stock indexes comprised of companies that meet relevant sustainability criteria: the newly-created S&P/BMV Total Mexico ESG Index, and for the second consecutive year, both the Dow Jones Sustainability MILA Pacific Alliance Index and the London Stock Exchange's FTSE4Good Index Series.

As part of our sustainable business approach, we follow the universal principles of the United Nations Global Compact, which guides our efforts in areas such as human rights, labor, environment and anticorruption, helping us to provide maximum value to our stakeholders by minimizing the impact we have on our communities and the environment.

I would now like to move on to our spin-off from Alfa. This past December 14, we entered a new phase in our Company's history, following the transfer of Alfa's entire share ownership in Nemak to Controladora Nemak, a new entity that trades separately on the Mexican Stock Exchange. We are confident that this transaction puts us in an even better position to capitalize on demand for sustainable mobility solutions in our industry, while at the same time helping us to improve liquidity of our shares. Moreover, given our experience operating as a standalone business over the years, we are well-prepared to continue driving value creation for our shareholders, now as a fully independent Company.

With that, I conclude my initial remarks, and will now 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 2020 and expand on Armando's comments regarding industry trends and financial results.

Light vehicle sales and production across North America and Europe, our main markets, showed an overall recovery trend in the second half of the year on the release of pent-up demand, as well as better general economic conditions compared to the first half.

Turning to the fourth quarter, annualized U.S. light vehicle sales SAAR was 16.0 million units; that is, 5% lower than last year, but substantially higher than the 14.6 million units recorded for the full year, as this latter figure derived in part from the OEM production stoppages in the first half of the year. Light vehicle production in the region showed an even greater turnaround on a sequential basis than light vehicle sales, finishing only slightly down year-on-year, aided by the ramp-up of post-lockdown restocking initiatives among automakers, but seeing a 20% reduction on a full year basis, again due mainly to the first-half OEM stoppages I just mentioned.

Moving on to Europe, renewed pandemic-related lockdown measures had a greater impact on light vehicle sales in the fourth quarter. However, we saw a similar outperformance trend on the production side, where light vehicle sales decreased 10% but light vehicle production was slightly higher than last year. On a full year basis, sales were down approximately 20%, due mainly to the first half industry stoppages, just like in North America. Meanwhile, the rest of world region saw sustained higher year-over-year light vehicle sales and production due to consistently higher sales and production figures in China, whereas Brazil lagged behind for much of the year, although signs of increased activity began to emerge in the fourth quarter.

Similar to the global automotive industry as a whole, Nemak's volume performance saw a sustained rebound in the second half off the lows during the spring lockdowns, remaining at close to pre-pandemic levels throughout the back half of the year. During the fourth quarter, consolidated volume nearly recovered to last year's levels, as volume increases in rest of the world and Europe almost offset the volume drop in North America.

In this region, volume was down 9.7%, driven by a combination of customer production adjustments, the wind-down of our Canadian manufacturing operations and product mix. However, volume in Europe and rest of the world was 3% and 36% higher, respectively, on the back of stable production levels in Europe and increased customer demand in China. In turn, consolidated revenue for the quarter was slightly higher versus last year, as higher aluminum prices and the euro exchange rate compensated for slightly lower volume.

Moving on to our results; during the quarter, we delivered improved financial performance largely on the back of restructuring initiatives and expenses reductions implemented in the first half of the year, which included enforcing strict cost controls, minimizing discretionary spending and applying right-sizing measures to optimize our cost structure in response to volume trends, among others. These actions resulted in year-over-year reductions of 5% in cost of goods sold and 17% in SG&A for the second half, reflecting a total cost savings of around $250 million for the whole year, which we were able to hold onto from the second into the fourth quarter. We expect that a large portion of our efficiencies achieved in the year will be sustainable over the medium and long-term.

Rounding out our consolidated results, EBITDA for the fourth quarter was $150 million. This is 12.8% higher year-over-year, reflecting the factors I just described. In turn, we reported our best-ever EBITDA per equivalent unit on a six-month period, reaching $16.2 per unit. For the full year, EBITDA was $432 million, slightly higher than our revised EBITDA guidance.

Operating income for the fourth quarter was $55 million, 67% higher than the same period a year ago, driven by the factors supporting EBITDA. Meanwhile, net income was $14 million, affected by the noncash effect of exchange rate movements in financing expenses and higher taxes. During the fourth quarter, positive free cash flow generation enabled us to reduce net debt from $1.4 billion to $1.2 billion. In addition to the positive developments in our business that I just described, our disciplined approach towards operating cash flow and capital allocation made a difference in this regard. As for the latter, we recorded a Cap ex of $81 million, which is $16 million lower than the same period last year.

In line with our ongoing focus on prudent financial management, in the second half we repaid approximately $530 million of the credit lines we had drawn earlier in the year, including the entirety of our medium-term committed credit lines, as well as a portion of our short-term uncommitted credit lines. As of today, all of these credit lines remain available. At the close of the fourth quarter, our net debt to EBITDA ratio stood at 2.8 times. However, adjusting for the impact of the severance payments and other COVID-related expenses of the year, this figure would have been 2.5 times.

Looking ahead to the rest of 2021, assuming industry conditions remain stable, we'll continue our deleveraging efforts in coming periods, with the aim of bringing our net debt to EBITDA ratio back down to pre-pandemic levels.

I would like to conclude by summarizing our regional results. As we already discussed, the combination of restructuring efforts and sequentially higher volume represented the main catalyst of our consolidated EBITDA in the second half of the year. In North America, our EBITDA for the quarter was 13% higher than the same period of last year, despite the fact that volume was 9.7% lower. In Europe, our EBITDA finished 14% higher even though volume saw only a small increase, reflecting efficiencies achieved in the region. Regarding rest of the world, higher volume was not enough to compensate for effects of a less favorable product mix and launching expenses, as EBITDA was $1 million lower than last year.

With that, I would now like to hand the call back to Armando.

Armando Tamez

Thank you, Alberto. I would now like to provide an update on our outlook for full year 2021.

Regarding strategy execution, we expect that key milestones will include the launch of new products for electric vehicle applications of European and North American customers, the continued adaptation of existing capacity spanning Europe, North America, and Asia to support production of these parts, and the ramp-up of new, more complex powertrain applications in all regions. At the same time, we will continue to monitor potential effects associated with the global pandemic, which remain the main risk for Nemak as well as the automotive industry as a whole.

I also want to emphasize that we will continue to implement a variety of initiatives aimed at capturing new opportunities in E-Mobility and Structural Applications, delivering best-in-class manufacturing performance with a focus on new product launches, and keeping our organization lean and agile. Additionally, we will maintain a flexible approach to investment, characterized by an intensive focus on existing assets, to target growth opportunities across our product lines. With this context in mind, our guidance for 2021 is as follows: for volume, we expect 38.8 million equivalent units; revenue of $3.6 billion; EBITDA of $552 million; and cap ex, $380 million.

As you can see, compared to 2020, we expect increases of 11% and 14% in volume and revenue, respectively. These figures derive in part from our view on the prospects of continued recovery in global light vehicle production for the full year. In turn, we expect to deliver a 28% increase in EBITDA, mainly on the back of a combination of volume, operating efficiencies and a richer sales mix across our product lines.

In closing, given the progress that we made in 2020 to reinforce the long-term sustainability of our business, we are confident that we are well-prepared to capitalize on the ongoing recovery in our industry, while laying an even stronger groundwork for tapping into secular growth opportunities linked to lightweighting and electrification.

With that, we conclude our presentation and would now like to move on to open the call for questions.

Operator

At this time, we'll be conducting a question-and-answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two to remove your question from the queue. For participants using speaker equipment, it may be necessary for you to pick up your handset before pressing the star keys. One moment while we poll for questions.

Armando Tamez

Thank you. We will now take questions on Nemak and Controladora Nemak.

Operator

Our first question comes from the line of Marcelo Motta with JPMorgan. You may proceed with your question.

Marcelo Motta

Hi, good morning, or good afternoon, everyone, depending where you are. Regarding guidance, I mean, just wondering if you guys were already incorporating the whole situation that is happening with semiconductors. We are seeing now that several OEMs are delaying production, given the shortage of raw material. One is if this is included on the volume guidance, and also if you are expecting the first quarter to be a little bit weaker than the other quarters of the year?

Then, on aluminum prices, of course there is a pass-through to customers when aluminum price increase, but it brings some volatility to your margins. When we look at gross margin across the year, what you are seeing, how the aluminum pressure could impact the first half compared to second half? Thank you.

Armando Tamez

Thank you, Marcelo.

Related to the first part of your question, related to the semiconductors, we are seeing, as you are indicating, certainly some customers that are turning down some assembly plants. It is expected that it will have an effect of about 1% to 3% for global markets. Our customers are confident that they can recover a significant portion of this volume loss in the second half of the year. We are expecting that this is going to be minimal. We have not seen, as we speak, on the Powertrain side, any effect yet related to these potential constraints that our customers are facing related to the semiconductors.

Alberto Sada

Marcello, this is Alberto. Related to your question on aluminum prices, and I think as we have shared in the past, remember that we have pass-through arrangements with our customers where we translate those effects of aluminum. There is also potentially a temporary effect because of (inaudible), so that effect has been with the adjustment that we did on our (inaudible) being reduced recently.

Yes, we (inaudible) how the aluminum prices behave, we don't anticipate a strong effect at this point in our results because of that impact.

Marcelo Motta

Perfect, thank you very much.

Operator

Our next question comes from the line of Alejandro Azar with GBM. You may proceed with your question.

Alejandro Azar

Hi, good morning, Alberto, Armando and Adrian. I have several questions, if I may. The first one is, the volume guidance is 38? My second one is, from that guidance of $3.6 billion in revenues, how much would that be from the Structural and Electric Vehicle component? I'll then follow with the other two.

Armando Tamez

Yes, thanks, Alejandro.

In our guidance, our volume is 38.8 million equivalent units, and we're expecting to reach approximately about $350 million worth of the new product lines, which include EV and Structural Components. That's what we are expecting for this year.

Alejandro Azar

Perfect. If I may, that would result in EBITDA per unit of around very similar levels to 2019? Are you accounting for cost reductions or, in my point of view, with your new cost structure, we should have seen greater EBITDA per unit compared to 2019. I don't know if my math is correct.

Armando Tamez

Yes. Alejandro, your math is correct. Certainly, we developed last year a significant effort to improve our cost structure, and we will continue with that type of discipline. This is why, in spite of the fact that we are seeing less volume on utilizations, we are expecting to increase our performance relative to bottom line. That is basically correct.

Alejandro Azar

One more if I may; what's the percentage that you are machining in-house, currently?

Armando Tamez

Yes, good question, Alejandro. We have internally made significant investments to machine where we see good value, and we have approximately, to-date, very close to 70% of all of our products are machined in-house, and the rest, 30%, is outsourced. We will continue looking at every opportunity, where it makes sense, to invest internally, or select reliable suppliers on the outside.

Alberto Sada

Alex, one just original comment related to the EBITDA per unit, just to complement what Armando just highlighted, I think it's also relevant to mention that the volume is quite different between what we had in '19. As volume continues to ramp-up, we should be able to see more economies of scale, and therefore be able to see an increased EBITDA per unit going forward in the future. Even though it may look slightly higher than what we had in '19, in '19 we had $14 per piece, now we have $14.2, but with a volume which is substantially lower than what we had at that time. We're expecting that this is going to be gradually coming back to levels that we have given in the past of our ultimate objective, so EBITDA per unit.

Absent of all of the activities we've done to reduce cost, this EBITDA per unit for 2021 would have been something closer to what we saw in 2020.

Armando Tamez

Excellent. Thank you both for the comments, and congrats on the results.

Armando Tamez

Thank you.

Operator

As a reminder, if you would like to ask a question, please press star, one on your telephone keypad. One moment while we poll for questions.

Our next question comes from the line of Augusto Ensiki with HSBC. You may proceed with your question.

Augusto Ensiki

Hey, good afternoon. A quick question on your depreciation for the quarter, noticed that it ticked up quite a bit sequentially. What was the main driver for that higher depreciation, and is this the level that we can expect going forward? Thank you.

Alberto Sada

Yes, Augusto. The level of depreciation that we have, we expect that to be, in the year, a level of close to $320 million, altogether with depreciation and amortization. There are some intermediate activities that take place, especially, there are some adjustments on the asset side that affect a little bit our depreciation on a sequential basis. But the normal levels that we will be able to see on a yearly basis is close to $320 million, $330 million.

Augusto Ensiki

Perfect. Thank you so much.

Operator

Our next question comes from the line of Mario Appelbaum with First New York. You may proceed with your question.

Mario Appelbaum

Hi, gentlemen, thank you for being available.

My first question is about the merger. If you could talk a little bit about the timing and some of the complexities, or the processes that were required to merge the two, the holding Company and the underlying?

Armando Tamez

Yes, Mario, thanks for the question.

Certainly, we made a spin-off from Alfa. It was announced that eventually, the two companies will merge into one. That needs to be presented to our Board of Directors for their approval. Once they approve that concept of merging the two companies, Nemak and Controladora Nemak, it will be presented for approval in our shareholders assembly.

Mario Appelbaum

Any comment about when that may happen, or why it might happen earlier or later?

Armando Tamez

We're in the process of solving that, Mario, but we believe that it is going to be this year. We will make the necessary announcement once our Board of Directors gives the green light to continue with that process.

Mario Appelbaum

Okay, thank you.

Then my second question, more on—what are your plans for working capital this year? Should we expect to consume cash or to generate cash? A follow-up of that, have you thought up a new dividend policy with the one that it's more an independent company, or if you don't have a policy yet, when should you—do you have any idea of when it might be communicated to the market? Thank you again for being available.

Alberto Sada

Mario, to respond to your first question on working capital, we have been actively working on improving our cash flow generation on multiple fields. As you saw, we are very prudent on capital expenditures and also working capital, which is very important. We had improvements this year, we expect to have similar levels in 2021, probably a little bit of investment in working capital as we see volumes ramping up.

But to be honest, it's not going to be a substantial change versus what we saw in 2020, other than just the effect of adding additional volume and the corresponding positive—or, let's say, investment in working capital that we need. From a capital perspective, full year basis should be not too much large amounts.

Armando Tamez

Related to the dividend policy, what I can tell you is the following. Over the last six years, we gave, in dividends, approximately $710 million worth of dividends to our shareholders. Last year, unfortunately, due to the pandemic crisis, we were forced to stop the dividend on the second, third and fourth quarters. We have an obligation as Management. Certainly, we will look for opportunities for growth, and certainly, we will continue providing the proper dividends to our shareholders.

I think we will be in the process of evaluating what should be a proper dividend policy, to be presented and approved, first by our Board of Directors and second by the shareholders.

Augusto Ensiki

Okay, thank you very much.

Armando Tamez

Thank you.

Operator

Our next question comes from the line of Valentin Mendoza with Banorte. You may proceed with your question.

Valentin Mendoza

Hi, good morning, Alberto, Armando. Thank you very much for taking my questions and congratulations on the results.

I just had one question, and it has to do with dividend distributions for 2021. In light of this recovery—again, Armando, you're confident in your guidance. I was wondering if we should expect to having back dividends for shareholders in 2021, or what is the strategy on this side? Thank you very much.

Armando Tamez

Yes, thank you, Valentin.

Certainly, we will evaluate what will be the proper dividend, and that, as I indicated, needs to be presented for approval, first to our Board and second to the shareholders assembly. That will be evaluated and presented at a later time.

Valentin Mendoza

Very well. Thank you very much, Armando.

Armando Tamez

Thank you, Valentin.

Operator

As a reminder, if you would like to ask a question, please press star, one on your telephone keypad. One moment while we poll for questions.

Our next question comes from the line of Alejandro Azar with GBM. You may proceed with your question.

Alejandro Azar

I'm sorry, I'll take advantage of—as I'm seeing no questions. How is your capacity utilization in China? With all the growth we are seeing in the region, are you planning, or within this cap ex of $308 million, are you seeing capacity expansions in that region?

Armando Tamez

Yes, thank you, Alejandro, good question.

As we sit, we are seeing rich (phon) volume in China. Actually, we are operating close to 85%, 87% of our install capacity, which is, I would say, operating at maximum capacity, according to our operating policies that we have implemented. We will have some small portion of additional investment for that region. Most of the cap ex that we will be using, especially on the strategic side, for the first time—we'll also pass the cap ex, or the new cap ex for EVs and Structural Components, it will be higher than the Powertrain side for the first time. That is preparing the Company for the new contracts we have been awarded. We expect to continue getting additional new orders in the next coming months.

Alejandro Azar

If I understood correctly, Armando, and I'm sorry for this, from the $308 million, more than 50% is for the Electric Vehicle and Structural Component business, right?

Armando Tamez

Alejandro, out of the $380 million, we have a portion that goes into maintenance as well as developing expenses. For the strategic portion, more than half will be invested to support new programs on the EV side and Structural Components.

Alejandro Azar

Excellent, Armando. Thank you again.

Armando Tamez

Thank you.

Operator

There are no further questions at this time. I'd like to turn this 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 event. Please feel free to contact us if you have any follow-up questions or comments, and have a good day.

Operator

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