THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

NEMAKA.MX - Q3 2019 Nemak SAB De CV Earnings Call

EVENT DATE/TIME: OCTOBER 18, 2019 / 3:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Alejandro Chavelas *Crédit Suisse AG, Research Division - Research Analyst*

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

Jamie Nicholson-Leener *Crédit Suisse AG, Research Division - Global Head of Emerging Markets Corporate Credit Research & MD*

Marcelo Garaldi Motta *JP Morgan Chase & Co, Research Division - Research Analyst*

Travis Pascavis *Hartford Investment Management Company - High Yield Credit Analyst & Global Macro Strategist*

Vanessa Quiroga *Crédit Suisse AG, Research Division - Head of Mexico Equity Research & Co-Head of the Housing & Infrastructure in LatAm excluding Brazil*

PRESENTATION

Operator

Good morning, everyone, and welcome to Nemak's Third 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 would now turn the call over to Adrian Althoff.

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 up today's call by providing an overview, our 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'll 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 Martínez *- Nemak, S. A. B. de C. V. - CEO*

Thank you, Adrian. Hello, everyone, and welcome to Nemak's Third Quarter 2019 Conference Call.

Our results this quarter represented a continuation of the main effects anticipated in our 2019 guidance. In particular, a less favorable product mix and light vehicle production reductions among certain customers affected volume, which in turn, have an impact on our business performance. Revenues and EBITDA for the period amounted to $963 million and $139 million, respectively.

As you probably are aware, based on recent media reports, we appear to be nearing the end of UAW strike. Now in its 32nd day, the strike has -- had brought consequences for GM's supply change in North America. We have been continually monitoring the situation. While we saw little direct impact in the early days, shipments has started to slow as the strike wore on, leaving certain impact to our business. For the third quarter, lost production associated with the strike total approximately 100,000 equivalent units. However, taking into account what we have seen in October thus far, we estimate a total impact to date of approximately 400,000 equivalent units.

During the third quarter, we also saw effects linked to our plans to close our manufacturing operations in Windsor, Canada. We have included previously anticipated severance costs as well as lost volume and productivity within the Unifor illegal blockade of the plant in September, which represented a mid-single-digit impact to [LBA] in the period. As you may already know, we have initiated an arbitration process with Unifor to which we aim to reach a definitive resolution on next step for winding down this operation. We will inform you in due time upon new relevant developments, which may arise in this result.

I would now like to move on to highlights in the strategy execution, which we include further progress in the ramp of our structural and electric vehicle component business.

At the plant level, we remain focused on bringing to market new battery housing for European and North American customers. Multiple volume launches in this product line [early] to deploying hybrid segment, which is expected to increase as a share of overall electric vehicle production in the coming years. In the short term, plug-in hybrid vehicles could see the fastest growth in Europe. We're adding a battery and electric motor to a conventional power vehicle, represents one of the main levers available to automakers for adopting to new, more stringent CO2 targets to take effect starting in 2020.

During the quarter, we leveraged our technological capabilities as well as the manufacturing footprint to capitalize on this trend. We successfully completed the launch of new [building] assembly battery housings featuring complex castings, along with cutting-edge friction state welding technology. This particular product [goes] into new Daimler passenger car and SUV applications, and we advance as planned with 5 additional battery housing launches spanning Europe and North America, all of which are scheduled to reach series production by the end of next year.

Based on the global business today, we maintain our previously communicated expectation of achieving a 20% share of the market for battery housings for plug-in hybrid applications in Europe and North America in 2020. We also continue to make the drive towards enforcing operations in additional EV applications. During last week, we remain a finalist for the 2020 Automotive News PACE Awards in recognition for our progress to date in leveraging our proprietary CPS casting process, which we have traditionally used in high complexity engine blocks for the production of highly integrated electric model castings. We expect to begin series production of electric motor housings using this technology in 2020 as part of business win, largely to supply parts to pure electric SUVs of European customers.

In terms of the third quarter, we acquire incremental business in the structural and EV components for a total of approximately $30 million in annual revenues. This consisted primarily of new contracts to supply parts to pure electric clients and pick-up trucks of a global OEM. As of today, our total order book in terms of the structural and EV components stands at approximately $640 million in annual revenues. At the same time, we continue to pursue sales prospects in this segment worth $1.8 billion in annual revenues. Year-to-date, we have won contracts across our product lines worth a total of $650 million in annual revenues, 40% of which represents incremental business.

Aside from the EV contracts I just mentioned, the main third quarter highlights were contracts to produce cylinder heads, engine blocks and other traditional propulsion applications for global customers.

I would like to conclude by touching on the recent entry into 2 indices comprised with companies with (inaudible) economic, social and environmental practices, the Dow Jones Sustainability Index and the London Stock Exchange FTSE4Good Index Series. We are honored to have received these recognitions, and we look forward to strengthening our efforts to drive change in our industry alongside our customers towards a more sustainable mobility going forward.

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

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 a mixed light vehicle sales and production trends across our main regions.

In North America, SAAR for the U.S. vehicle sales was 17.1 million units, slightly higher than last year, supported by continued favorable economic conditions. Regarding vehicle production, the third quarter '19 figure for North America was 2.5% better. However, our customers posted a reduction of 3.4% driven by the phase-out of certain passenger car applications as they adjust the product mix to SUVs and light trucks.

In Europe, third quarter '19 vehicle sales SAAR was 20.6 million units, down slightly year-over-year, while vehicle production and Nemak's customer production in the region remain unchanged.

Nemak volumes in North America in the quarter finished 16% lower, reflecting a continuation of the factors embedded in our full year guidance, vehicle production reductions among certain customers, lower exports to China and an unfavorable product mix.

Regarding Europe, lower sales to JLR yielded a 2.9% reduction in volumes in the region. And Rest of the World volumes were down 28% due mainly by lower sales by Ford in China, while South America remained stable.

Consolidated revenue was $963 million, a 16.4% reduction year-on-year due mainly to the combined effect of lower volumes and lower aluminum prices and the depreciation of the euro against the U.S. dollar.

During this quarter, we reflected the nonrecurring financial effect of $33 million for the closure of our operations in Canada. This consisted of a noncash asset impairment charge together with a mid-single-digit impact related to the severance and loss volumes and productivity from the illegal blockade of our Canadian plant carried out by the Unifor in September. Furthermore, lower volume as well as the nonrecurring effects resulted in a consolidated operating income of $43 million, 38% lower than last year. Altogether, these effects more than offset benefits derived from efficiencies across all regions.

As in previous quarters, we continue with our initiatives to adjust our cost structure, focusing on manufacturing, labor cost and discretionary spending on SG&A. Our EBITDA was $139 million, a decrease of 13.1% year-on-year due mainly to the same factors explaining operating income, excluding the noncash asset impairment associated with the plant closure. In turn, EBITDA per equipment unit was $13.1, slightly better than the $13.0 in the same period last year as efficiencies offset the effects of volumes and nonrecurring expenses just described.

Net income have amounted to negative $2 million mainly due to the reduction in operating income mentioned above. CapEx was $74 million in the period, consistent with our investment program to support new product launches. Despite these volume reductions, we continue to have a healthy financial condition supported by a solid cash flow generation, working capitalization optimization efforts and a stable debt balance.

Net debt-to-EBITDA was 1.9x, and interest coverage ratio was 9.3x as compared to 1.8 and 8.4x reported in the same period last year. This quarter marks the 24th consecutive quarter with a leverage ratio below 2x.

Moving on to our regional results. Lower volumes, combined with lower aluminum prices, resulted in a 16.7% reduction in revenues in North America. EBITDA for the quarter was $91 million, 12.5% lower than the same period of last year as operational efficiencies compensated partly the effects of lower volumes and the nonrecurring expenses related to the closure of our operations in Canada.

In Europe, revenues were down 13.2% due to lower volumes and aluminum prices as well as the depreciation of the euro against the U.S. dollars. On EBITDA, the reduction of 18.8% is explained by lower volume, the depression of the euro against the dollar and nonrecurring operating expenses.

Turning to Rest of the World. Revenues were down 25.4% affected by lower volumes in China. However, EBITDA reached $9 million, slightly higher than last year as operational efficiencies more than compensated for volume effects.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Vanessa Quiroga, Crédit Suisse.

Vanessa Quiroga - *Crédit Suisse AG, Research Division - Head of Mexico Equity Research & Co-Head of the Housing & Infrastructure in LatAm excluding Brazil*

The first one is regarding -- your expectation regarding aluminum, aluminum prices and how you expect that to affect your margins going forward.

The other question that I have is on the margin improvement, EBITDA per unit that we saw in the third quarter year-over-year. Can you provide more details on how this was achieved? What specific measures you took during the quarter that supported this result?

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

Yes. Vanessa, this is Alberto. Thank you for your question. Related to the first part on aluminum prices, as we have seen, aluminum prices have been reducing during the year. But remember that we have already adjusted our formula with our customers, so we don't anticipate any major effect of aluminum prices on our margins.

And the second question related to the EBITDA margin improvement, I think as I mentioned on the -- as I was describing the results, we are very focused, as we have been all year, to improve efficiency at all our operations. So that was very clear. It's something that we perform in the quarter. And as you saw, we see margin improvements, SG&A reductions. And these margin improvements come from both SG&A as well as manufacturing costs and labor costs, which we continue to focus continuously to adjust ourselves to these volume fluctuations that we have seen.

Vanessa Quiroga - *Crédit Suisse AG, Research Division - Head of Mexico Equity Research & Co-Head of the Housing & Infrastructure in LatAm excluding Brazil*

Okay. Okay. And just a clarification on the GM strike on another topic. So you -- can you confirm that you haven't reduced your deliveries or stopped your deliveries to GM? And if not, for how long do you think the strike could continue before you have to stop the deliveries? Or any latest updates that you have regarding the strike?

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

Yes. Thank you, Vanessa. This is Armando. As I indicated in my presentation, we immediately stopped the [sovereign] in some of our American plants and Canadian as well when the strike went on. The plants in Mexico continue requesting volume for a period of time until finally all our plants were down.

As it is already on the past, apparently, the UAW and GM had reached some preliminary agreement subject to ratification by all members. It is expected that the new contract will be ratified with the next few days. We don't know exactly how long it's going to take. We will keep this monitoring very carefully.

Operator

Our next question is from Jamie Nicholson, Credit Suisse.

Jamie Nicholson-Leener - *Crédit Suisse AG, Research Division - Global Head of Emerging Markets Corporate Credit Research & MD*

I just have a follow-up about the strike impact. So you said that the 100,000 unit impact in the third quarter and then 400,000 impact to date, so that's shipment that you were going to make that you have suspended? Is that how to view that statistic?

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

Yes. That is correct, Jamie. Yes.

Jamie Nicholson-Leener - *Crédit Suisse AG, Research Division - Global Head of Emerging Markets Corporate Credit Research & MD*

Okay. And so you're still -- are you still producing the units and then warehousing them? Or have you stopped production in any way?

And then once the GM strike is resolved, how long do you think it will take for them to ramp up production? Do you have any sense of when you will start delivering?

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

Yes. Basically, we have been in close contact with our customers, and they have asked us to be ready to start production as soon as the contract as ratified by the members. And we're ready. We're ready. We have all our production plans ready and available just to start at the green light. So we're expecting that, that should happen during the next few days.

Jamie Nicholson-Leener - *Crédit Suisse AG, Research Division - Global Head of Emerging Markets Corporate Credit Research & MD*

Okay. And do you have any impact on margins? Like what impact does suspension of production have in terms of your EBITDA? Is it in line with the decline in units? Or is it higher than that because you're at lower capacity utilization rates?

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

Yes. So far we have -- so far, Jamie, potential impact between $8 million to $12 million that we still need to quantify. And certainly, we will be making our numbers as soon as we have more information of what is the final impact.

In conversations with a customer, what they are or they would like to do once the contract is ratified by the members is to start production and work over time to try to recover as much as possible during this year and the first quarter next year.

Jamie Nicholson-Leener - *Crédit Suisse AG, Research Division - Global Head of Emerging Markets Corporate Credit Research & MD*

Okay. Great. And then just one final question, if I may. You mentioned in your press release that European volumes were down on lower sales to Jaguar Land Rover. Is -- do you feel that that's related like the Brexit uncertainty? Or was that just something specific with the models? I mean how are you looking at Jaguar Land Rover sales going forward? Is it weaker? Or was it just BRIC down in the previous quarter?

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

Yes. I think, Jamie, that is a combination of different elements. One is definitely Brexit. The other one is these potential concerns about the trade wars and duties on the product as well as we are in the progress of launching new products.

What we have seen at least in China is that they are having some partial recovery on some of the sales, and we're expecting that Jaguar Land Rover will start recovering slowly. This is a good customer for us. And certainly, we wish them that they have the product line available. And certainly, once we have more clarity on the Brexit situation that potential sales will recover there going forward.

Operator

Our next question is from Alejandro Azar, GBM.

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

I have several questions. The first one is related to the impact from the closure in Canada. Those $30 million, are you expecting more? I remember you said, I mean, back in last call about $40 million from an impairment and severance payment.

And the other question is regarding the European industry, if you can give us more color between the strong numbers on sales in August and September, if you can relay that to the impact on the WLTP that we are seeing a more stable market going forward.

And last one is related to your guidance. Back in February, you mentioned that based on the 12 to 11 months released from OMs, you have seen increasing volumes of mid-single-digit in 2020. Are you still seeing a -- the recovery in 2020%? Those are my 3 questions.

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

Sure, Alejandro. This is Alberto. Thanks for your good questions. Related to the more details on the Canada impact. As it was highlighted, the -- we have recorded gross of $33 million worth of effect due to Canada, and that comprises both the effect of the expenses that we have incur during the closure as well as the impairment of the assets that will be written off as we proceed with disclosure. The first part is a mid-single-digit amount, so that's still to be at the end finally computed but should be around that level.

So you had a second question around WLTP in Europe, and that's something that obviously what we saw in effect last year. I think this year, our customers were much better prepared to deal with the regulations that this new rule imposes. So we're not seeing, at this point, any major effects on production or WLTP of -- production of new or the second phase of the WLTP in this year.

And last, related to the 2020 guidance, that's something that we're still working on. As you see, we're working on (inaudible), and we will certainly give guidance once that's concluded, and this is scheduled to happen during the conference call in February for the end of the year.

Operator

Our next question is from Travis Pascavis, HIMCO.

Travis Pascavis - *Hartford Investment Management Company - High Yield Credit Analyst & Global Macro Strategist*

Some of my questions have been answered already. But just wanted to maybe delve into the 2020, maybe a little bit more. I mean if you take a step back, some of the challenges currently is the phase-out of some of the vehicles, some of the cars in North America. Some of these are likely to be coming to a close. Do you see these elements lingering in into 2020? And can you kind of give us high level overall thinking around some of these effects that have dragged revenues down? And how -- do you still see them as more temporary? Or do you see them as kind of a long-lasting?

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

Yes. Travis, this is Alberto. Yes, this issue was, let's say, the mix changing of vehicles is something that we also last year. Remember FCA took that same decision to phase out vehicles to favor SUVs and light trucks in general. So Ford announced late last year to do the same. So we're experiencing that effect as well in this year as we have anticipated in our guidance. And definitely, this is something that takes a little bit time for the OEM to be fully aligned with the new lineup of vehicles. So we expect a little bit of this effect to carry over in 2020. And gradually, they will make up with the introduction of new platforms in the small SUVs, mid-SUVs and pickup trucks. So certainly, it's something that will carry over next year, but that will be gradually be fully replaced by the new vehicle introduction from -- in particular from Ford, which is what we saw this year phasing out.

Travis Pascavis - *Hartford Investment Management Company - High Yield Credit Analyst & Global Macro Strategist*

Okay. Great. And we -- just tariffs have come and go in terms of the news and kind of what's out there now is just some discussion around potential tariffs on European vehicles that might come to the U.S. and have a tariff placed on them. Any thoughts around that and how it might impact the business? And in particular, exposure to EU exports of vehicles to the U.S. that you might have, have you thought about that at all?

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

Yes. Travis, this is Armando. Certainly, we are watching. As I indicated before, there is a certain risk on potential tariffs on different regions. Europe is certainly one that potentially could be affected. In the meantime, I think they are making efforts from the European Union and the U.S. to negotiate certain agreements to try to reduce or eliminate this potential additional tariff. I think it's too early to tell. We have, as you may know, a production capacity in Europe as well as in North America to adapt to these potential changes and revelation related to tariff or duties on vehicles. I think it's too early to determine if an impact is going to affect us or not.

Travis Pascavis - *Hartford Investment Management Company - High Yield Credit Analyst & Global Macro Strategist*

Yes. It's highly uncertain. I do totally understand. And just as you think about some of the management changes that you made recently, any kind of high level, strategic sort of overview of how that fits in with what's going on?

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

No. We are not, again, seeing these. We see this, Travis, I said, potential temporary situation in volumes, but I think the fundamentals that we have are solid. And we have also -- we speak, in our opinion, a very solid footprint with the operations in the main -- on different regions, North America, Europe as well as Asia. And we are seeing that, for instance, it's more related to the U.S. MCA. But they will increase the content of vehicles in North America, which at the end, I think, is going to be beneficial for the region.

So I think we are seeing, as we speak, a little bit of movement from some of the European and Asian OEMs trying to develop suppliers in the region to comply with the new regulations that once the U.S. MCA agreement is approved, they will be ready to comply with these rules and regulations.

Travis Pascavis - *Hartford Investment Management Company - High Yield Credit Analyst & Global Macro Strategist*

Okay. And just my final question, it's kind of a technical one. Just on the Rest of World EBITDA margin, improved basically. That's just a direct result of the Windsor shutdown, right? That margin is without the impairment charge, my guess.

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

Yes. Rest of the world is China as well as South America. So there's no effect of the Windsor charges in RoW. The RoW margin improvement comes from efficiencies that have been implementing especially in China, and gradually better mix that we're launching in South America. So that has nothing to do with the Windsor impairment charges.

Travis Pascavis - *Hartford Investment Management Company - High Yield Credit Analyst & Global Macro Strategist*

Oh, okay. Okay. I didn't know if there was shipment from that plant to China that was kind of...

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

Oh, no. On that direction, yes. I mean as you know, the trigger for this move has to do with the phase-out of a production program we had in China. But overall, that's from revenues and the income that we generate in China locally, not export.

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

Yes. I think the bulk of which -- from Canada to China is part of the revenues and EBITDA of the North American region.

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

Yes.

Operator

Our next question is from Marcelo Motta, JPMorgan.

Marcelo Garaldi Motta - *JP Morgan Chase & Co, Research Division - Research Analyst*

Two quick questions. First on the EV and structural component. Could the company comment if there was any impact from those -- what was the impact of those lines in revenue and how much it represented of revenues this quarter?

And also regarding 2019 guidance, the company mentioned on its press release of the results that the guidance is reaffirmed. But for -- in order for the guidance to be reached, I mean this fourth quarter, we need to be very strong, so just wondering if there is any risk to the guidance and how should we think about the fourth quarter, given that the volumes continue to be weak, et cetera. So it doesn't look like it's feasible to assume that volumes will be down only to [8%] on a year-over-year basis.

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

Thank you, Marcelo, for your question. Related to the revenues generated by the EV and the structural component, as we anticipated, we are planning to end the end with approximately $175 million in revenues.

Related to the guidance, as we already announced, we are going to be affected in terms of revenues. However, we determine that we will meet the guidance that we've indicated at the beginning of the year, which is in the $620 million for the EBITDA for the 2019 calendar year.

Operator

(Operator Instructions) Our next question is from Alejandro Chavelas, Credit Suisse.

Alejandro Chavelas - *Crédit Suisse AG, Research Division - Research Analyst*

Just a clarification, so just to have the numbers straight. So you mentioned that the impact during 3Q '19 from the strike was 100,000 units, and for the whole impact so far in the year has been 400,000 units. Is that correct?

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

That is correct, Alejandro. Yes.

Alejandro Chavelas - *Crédit Suisse AG, Research Division - Research Analyst*

Correct. And the second question, what was the positive impact in the quarter of the EBITDA level from IFRS 16?

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

Yes. IFRS 16 -- yes, we have both an impact as we recorded the leases into our debt balance as well as have a credit on our results. So the credit on the result is a mid-single-digit effect, and the effect on that is about $40 million. And that effect on that was recorded in the first quarter, so that was a first effect. And this mid-single-digit number of EBITDA, that's a quarterly effect.

Alejandro Chavelas - *Crédit Suisse AG, Research Division - Research Analyst*

Correct. So excluding IFRS benefit, EBITDA would have been down 18% instead of 13%? Just to understand.

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

Well, you have to deduct between $4 million to $5 million on the EBITDA to make it comparable from year-over-year.

Operator

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 - *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.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you very much, and have a great day.