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NEMAKA.MX - Q3 2015 Nemak SAB De CV Earnings Call

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**Juan Tavares** *CitiGroup - Analyst*

**Umberto Garcia** *Barclays - Analyst*

**Karl Martinez** *Interacciones - Analyst*

**Lillian Starke** *Morgan Stanley - Analyst*

**Valentin Mendoza** *Banorte - Analyst*

## PRESENTATION

### Operator

Good morning, everyone. And welcome to Nemak's third quarter 2015 earnings call.

Armando Torres Tamez, Nemak's Chief Executive Officer, Alberto Sada, CFO, and Maximilian Zimmermann, Investor Relations are here this morning to discuss the Company's performance and to 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 Maximilian Zimmermann.

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### Maximilian Zimmermann - *Nemak SAB De CV - IR*

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 our business and financial highlights. Alberto Sada, our CFO, will then discuss key industry trends and our third quarter 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 other.

I will now turn the call over to Armando Tamez.

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### Armando Tamez - *Nemak SAB De CV - CEO*

Thank you, Max. Hello, everyone. And welcome to Nemak's third quarter 2015 results conference call.

During the third quarter our business performance in Europe and North America, our largest markets, continued to drive our results. We delivered solid profitability, posting a 19% increase in EBITDA over the third quarter 2014.

In terms of revenues, we posted a 4% decrease compared to the same quarter of last year, mainly due to the depreciation of the euro and lower aluminum prices.

We see that several industry conditions are creating a significant tailwind for us, particularly in North America where a healthy macroeconomic environment characterized by high consumer confidence, lower interest rates and [temper] of demand is foretelling like typical sales.

Furthermore, we expect that the trends toward increased localized production and decreased inputs will continue; thereby helping us ensure that [typical] production in the region continues to grow.

At the global level, we're effectively capitalizing on the ongoing shifts in the automotive industry towards engines that are more sophisticated and powerful than in the past. These engines require increasingly advanced (inaudible) and, therefore, higher value-added [castings] that we are well-positioned to deliver, thanks to our proprietary technology and our product development and manufacturing capabilities.

So, as those new engines come to market, we are seeing our sales mix (inaudible) improve, which, in turn, is posting our bottom line.

In order to fully reinforce our competitive position, we are also maintaining important investments in our manufacturing (inaudible). During the quarter, we officially [innovated] our first plant in Russia where we are now producing cylinder heads and engine blocks for gasoline applications. And we continue construction of a (inaudible) die casting plant in Mexico where we will manufacture blocks, transmission cases and a structural component starting in the second half of 2016.

In terms of our regions, our capacity expansion plans are mainly being driven by contracts to produce cylinder heads, engine blocks and a structural component for the North America, Europe and Asia markets.

At the same time, our (inaudible) for vertical integration strategy, we are continuing to make significant investments to expand our in-house machining capacity at cost or [lower retails]. These investments, in turn, are enabling us to deliver quality improvements to our customers while reducing our costs and increasing our margins.

I will now like to touch on a topic that has been in the news and which I am sure all of you have top of mind - Volkswagen.

I think it is still too early to tell what, if any, impact this situation will have on us. Taking a step back and looking at their business as a whole, Volkswagen Group [usual] applications account for 0.5% of Nematik's consolidated volume. And the Volkswagen Group represents a total of 6% of Nematik global volumes. This includes the Audi, Lamborghini, Porsche, Saab, [Discover], and VW brands.

We will continue to monitor this issue closely and keep you informed of any possible implications for Nematik.

Next, I would like to talk to you about our rest of the world regions. On one side we have China where we are continuing to ramp up our operations. Notwithstanding the recent economic slowdown, we expect that the volumes in the country will continue to increase. We have signed contracts with OEMs to double our production capacity there in the coming years. And the [Greenfield] facility we opened in (Inaudible) in 2013 is already operating at almost full capacity.

We believe it is important to keep in mind that [IHF] and other leading industry analysts forget that China's level of growth in auto sales over the short and medium term will be lower than in the past, but still at around 4% growth rate. Additionally, they expect China's auto market, already the worst (inaudible) to add 5 to 6 million [people] by 2020. So taking into account the bigger picture, we remain keen on considering selective investments to support our customers' growth in the country.



On the other side of the rest of the world region we have Brazil. As you know, Brazil is experiencing significant economic challenges, including rising inflation, a depreciating currency and a slowing GDP growth. And while this is putting downward pressure on our volumes there, we think it is worth mentioning that Brazil represents less than 4% of our consolidated volume. We would also like to emphasize that we continue to see Brazil, the largest consumer market in Latin America, as an attractive long term growth opportunity.

I would now like to move on to the commercial side of the business.

During the first nine months of the year we were awarded new contracts with global customers worth a total of approximately \$1 billion in annual revenues, around half of which represents incremental [problems]. This includes \$350 million worth of new contracts in the third quarter alone.

I am also pleased to have that, for the third year in a row, [KIA] selected for operation in Slovakia was a world top productivity plant. We see [KIA] as an important partner for our global expansion plans. And this quarter, we are especially proud of our team in Slovakia for this well-deserved recognition of the work that they are doing to reinforce our relationship with them.

Lastly, I would like to emphasize that we expect to continue delivering good operational growth and reinforcing our core competitive advantages going into 2016.

As you may have read, this past August the rating agency, [MODIS], raised our credit rating from BA2 to BA1, a single notch below investment grade. This upgrade is a reflection of our strong credit metrics, solid profitability and leading industry position.

I will now hand off the call to Alberto Sada, Nemak's CFO.

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**Alberto Sada** - *Nemak SAB De CV - CFO*

Thank you, Armando. And good morning, everyone.

Let me start by sharing relevant industry data that sheds light on our results.

During the quarter, the seasonally adjusted annual rate for vehicle sales in North America was up 5% from 3Q14 in line with both vehicle production in North America and Nemak North America customer production. In Europe, the seasonally adjusted annual rate in the quarter was up 2% compared to the same quarter of last year, driven by western Europe's recovery which more than compensated for lower sales in Russia.

Vehicle production increased 5%, and Nemak's customer production increased 7%, driven by increases in market share and exports from several Nemak customers.

Now, let me move on to discuss our results.

Volume in the quarter was 12.4 million equivalent units, a 3% increase from the same quarter of last year, mainly due to higher volumes in Europe and Asia.

I will now turn to our financials.

Revenues were \$1.1 billion, 4% below the same quarter of last year due to the depreciation of the euro compared to the U.S. dollar and lower aluminum prices.

As you may be aware, 30% of our revenues are generated in euros. This translates to approximately a \$50 million decrease in our top line. On a currency neutral basis, consolidated revenues increased 1% in the quarter.

In terms of aluminum pricing, we had a negative effect of approximately \$60 million in the quarter due to a 16% decrease in average aluminum prices. It is important to highlight that we have pass-through arrangements of aluminum prices in all our contracts with (inaudible).

Gross profits increased 22% to \$193 million. Several factors helped us increase our gross profits in the quarter; the most important, being a better sales mix.

Let me give you more details on what I mean by improved sales mix. Our customers continue introducing more sophisticated engines with higher value-added [castings] and better (inaudible).

In addition to mix, we continue to improve our operating efficiency across our regions. Furthermore, we benefited from external factors, including the depreciation of the Mexican peso, lower energy costs and metal price [lag].

Let me just clarify that last factor. As indicated before, our aluminum factory arrangements have monthly adjustment formulas that, from time to time, generate variation of results, which we call metal price [lag].

Now, let me move on to our bottom line.

Income from operations was \$121 million, a 34% increase from the same quarter of 2014, mainly due to the improvements in gross profits, which I just mentioned.

EBITDA for the period was \$193 million, a 19% increase compared to the third quarter of last year. This increase was due to the increase in gross profit. EBITDA per equivalent unit increased 15% on the same period to \$15.60 per unit.

Net income increased 33% compared to the third quarter of last year to \$81 million in the period. This was driven by higher income from operations and a lower effective tax rate, which more than compensated for the foreign exchange loss.

In terms of our balance sheet, as of the end of September, we had a net debt position of \$1.2 billion, \$70 million lower than December of last year.

Cash and cash equivalent amounted for \$100 million.

Now, allow me to give you some details on our regional results.

Our volume in North America remained stable. Revenues decreased 6% mainly due to the lower aluminum prices, which, as indicated before, are a pass through to our customers.

In terms of EBITDA, North America increased 28% compared to the third quarter of 2014, mainly due to an improved sales mix, the depreciation of the peso, the beneficial metal price lag efficiencies and lower energy costs.

Moving on, we are very pleased with the financial results achieved in Europe. Volume increased 7% in line with our customers' production volume. Despite the 16% devaluation of the euro, revenues and EBITDA remained stable compared to the same quarter of last year.

On a currency neutral basis, revenue and EBITDA both increased 19%. That is, we have posted double-digit growth in both top and bottom line in Europe.

In the rest of the world operations, our volumes increased by 10%, mainly driven by the launching of new products in Asia. Revenues and EBITDA decreased mainly due to the depreciation of local currency.

And, with that, I would like to open the call for your questions. Operator, please instruct the participants on how to place their questions.

## QUESTIONS AND ANSWERS

### Operator

(Operator instructions). Patrick Archambault of Goldman Sachs.

### Patrick Archambault - Goldman Sachs - Analyst

Thank you. Good morning. And congratulations on a good quarter.

I wanted to just follow up, actually, on the [diesel] comment. Thanks for helping put some parameters around that. But one of the questions I had was just on the overall content for a diesel engine. Forgetting about Volkswagen, just as the mix shifts from diesel to gas, is there a big content differential? And for you is that maybe even an opportunity given I feel like you have a bigger share in gasoline than diesel?

Armando Tamez: Thank you, Patrick. Related to Nemak, in general terms, diesel applications also represent about 12% of our total revenues overall. As I indicated, for Volkswagen that represents about 0.5% total volume.

At this point in time, I think it's a little bit too early to tell what impact, if any, this situation with Volkswagen will have on the future diesel application. I think it's too early so far that we have not seen any related effect besides the Volkswagen. And which I already mentioned that we have a very low participating with them.

### Patrick Archambault - Goldman Sachs - Analyst

OK. Yes. Sorry. There's a bit of background feedback here.

My question was more about not Volkswagen, but if Europe itself sees some kind of decline in diesel penetration across the entire market? It would seem to be that, if anything, that would be positive for you. If diesels are only 12% of your global mix, they're underrepresented, so a move to gas would actually be beneficial for you. Is that a correct supposition?

Armando Tamez: To some extent, yes. I think we are prepared and we have flexibility in our plants in Europe which are ones that are mainly producing these type of applications. We have flexibility to produce gasoline cylinder heads for gasoline blocks if needed. But so far, as I indicated, we have not seen any change in mix in Europe so far.

### Patrick Archambault - Goldman Sachs - Analyst

Got it. OK. That's helpful color. I guess moving on just to the mix impact which was a big year-on-year tailwind for you, one question I had was - when you say mix is it a more sophisticated engines, as you say, with higher tolerances that have a higher content? Or is it a mixed tailwind from a move to larger displacement engines which you've certainly probably seen in North America just with the significant share gains of light trucks?

### Armando Tamez - Nemak SAB De CV - CEO

That's a good question, Pat. I think it's both. It's both. First of all, certainly, the new products as I indicated in my presentation. We have seen more sophisticated cylinder heads and more sophisticated engine blocks that have significantly more content than in the past.

Just one example, cylinder heads today it is common to have integrated exhaust manifold, which in the past that was the [third] part. Now, we are the leading producer of this type of aluminum cylinder heads worldwide; as well as the new plugs that are coming with more complexity than in



the past. And, certainly, we are getting better pricing on those products due to the complexity and more value-added. And as well the cheap oil prices that everybody's enjoying, especially in North America, are helping the consumer to have more disposable income which translates for the consumer in requesting as well bigger engines. And we need to remember that for V6s and V8s in North America, those have two cylinder heads. And, certainly, we have on those bigger engines or larger engines better pricing than in the smaller ones.

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**Patrick Archambault** - *Goldman Sachs - Analyst*

OK. Great. I'll leave it there and let somebody else get in the queue. Thank you.

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**Operator**

Juan Tavares, CitiGroup.

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**Juan Tavares** - *CitiGroup - Analyst*

Thank you. Good morning, everyone. Just my first question tied to the sales mix question previously - how much of your total volumes are being machined internally? And then my second question is regarding your new contracts. If you can help break it down into how much of those new contracts were structural components versus your existing core business of engine blocks and cylinder heads?

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**Armando Tamez** - *Nematik SAB De CV - CEO*

Today, Juan, we have approximately 40% of the products that we produce machined in-house. And as we have indicated previously, our goal is to reach approximately 70% by the end of the decade, fully integrated into machining. This may change, and we will be evaluating. We are seeing that this is very positive, not only for our customer but also for us in terms of improving the quality, improving also logistic costs, as well as getting better financial results for our Company.

Second, related to your question about the new contracts, I can give you the breakdown. On approximately 40% of these, \$1 billion is represented by cylinder heads, 10% for aluminum blocks and the rest is on a structural component and other parts such as (inaudible) machine [casings] - about 20%. Fifty percent is in North America, one-third or 33% in Europe and 17% in the rest of the world.

So we have already announced contracts for (inaudible) parts that there were approximately about \$125 million. And, as we speak, we are almost ready to, in the following month, announce another very, very important contract. At this point in time, we are not allowed to disclose that because we are in final negotiations. But we're very confident that this contract will be announced in the following month.

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**Juan Tavares** - *CitiGroup - Analyst*

OK. Great. And just on your comment of your products that are machined in-house, when you mentioned that the target could change, will you bring it forward a few years? Or how could we think about that changing and how would it impact CAPEX?

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**Armando Tamez** - *Nematik SAB De CV - CEO*

At this point in time, again, I think it's a little bit too early. It's proven that it's a good business, not only for our customers but also for ourselves. Our customers are extremely pleased that Nematik is investing in providing them with more value-added. And, again, eliminating logistics costs which is also a big savings for them. Plus improving the quality loop that we have more rapid feedback and we're able to, again, provide better service.



So I think, all, in all, we may increase the 70% target or even the target that we set for 2020. Potentially, we could improve that timing by one or two years.

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**Juan Tavares** - *CitiGroup - Analyst*

OK. Thank you. Very helpful.

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**Operator**

(Operator instructions). [Umberto Garcia], Barclays.

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**Umberto Garcia** - *Barclays - Analyst*

Hi. Good morning. Thank you for the call. You mentioned that there was an effect on the aluminum price lag in the quarter. Should there be a reversal of this benefit in the fourth quarter? Thank you.

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**Alberto Sada** - *Nemak SAB De CV - CFO*

Yes. Hi, [Umberto]. This is Alberto. Well, it all depends on how the aluminum prices move. I think we have been seeing aluminum prices going down in the last year, year-and-a-half. So depending on where those prices - how those prices develop in the fourth quarter is how we see a reversal or not.

Right now, we're not anticipating any major shift, so we are not anticipating a reversal in the fourth quarter unless there is a sudden increase in aluminum prices.

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**Umberto Garcia** - *Barclays - Analyst*

OK. Thank you.

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**Operator**

Valentin Mendoza, Banorte.

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**Valentin Mendoza** - *Banorte - Analyst*

Good morning, everyone. Congratulations on the results. I have a couple of questions. The first one is could you please break down the individual contributions to the margin increase in the quarter, even with sales mix, depreciation of the Mexican peso, incremental income, machining and the positive metal price lag that you mentioned in the press? And the second one is would you please give us some color on the lower effective tax rate of the quarter? And also would you please share what are your expectations for this in the future?

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**Alberto Sada** - *Nemak SAB De CV - CFO*

Sure. And I think we mentioned a portion of this. Approximately 50% of the effect is due to the mix and efficiencies that we have been obtaining. And I think Armando mentioned about this positive mix effect mainly in North America; but we're also having efficiency all across the board.





And the other half is related to the combination we discussed, both FX, energy and metal price lag. Other [price values] this is small - close to about 20% of the difference from one quarter to the next.

Does that cover your first question?

Related to the second question, I think - and this is something that you'll be seeing related to the lower effective tax rate on most companies that have the functional currency U.S. dollars and have U.S. denominated debt. So the effect of the U.S. denominated debt on a company that is reporting in pesos but has functional currency in U.S. dollar generates a loss, an exchange rate loss that translates into a lower effective tax rate.

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**Valentin Mendoza** - *Banorte - Analyst*

Thank you very much. It was very useful.

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**Operator**

Karl Martinez, Interacciones.

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**Karl Martinez** - *Interacciones - Analyst*

Yes. Hi. Good morning, Max. Good morning, Alberto. I was wondering if you could tell us what do you think if there could be any impact with the new [TPP] agreement in the U.S. is approved? If you could give us a big of color on that?

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**Maximilian Zimmermann** - *Nemak SAB De CV - IR*

Thank you, Karl, for the question. Again, on the TPP, so far this has not been implemented. Our understanding is that this new agreement will be effective starting in 2018. Our understanding - and again, I think it's still too early to tell what will be the impact, if any, related to this new agreement on the trans-Pacific countries.

And we have, again, been informed by [ENA] - [ENA] is the society of automotive suppliers in Mexico. And what they are telling us is that they have negotiated a [content] of about between 35% to 50% on auto parts. And still we don't have information at this stage about what will be the potential content on the parts that we manufacture.

Again, I think it's too early. Once we have a little bit more clarity in terms of the content of this [TPP], we will let you know.

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**Karl Martinez** - *Interacciones - Analyst*

Perfect. Thank you very much.

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**Operator**

Lillian Stark, Morgan Stanley.

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**Lillian Starke** - *Morgan Stanley - Analyst*

Hi. And congratulations on another (inaudible) quarter profitability. My questions have been answered. Thank you.



**Operator**

Patrick Archambault, Goldman Sachs.

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**Patrick Archambault** - *Goldman Sachs - Analyst*

Yes. Thanks for letting me get back in here. One of the ones I forgot to ask is I believe your guidance is unchanged, right, at 710 to 745. And if you do that, it does imply a flattish EBITDA performance for the fourth quarter. Obviously, your year-on-year trajectory was considerably better than that in the third quarter. So is there just a bit of conservatism that's built into that? Or are there some of these year-on-year tailwinds that have been very supportive in the third quarter, are they expected to mitigate in some way as we get into the fourth?

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**Armando Tamez** - *Nemak SAB De CV - CEO*

Thanks again for your question. We are confirming our guidance as we have indicated to everybody before. But in terms of revenues, about \$4.7 billion. And in terms of EBITDA at the same - \$745 million. And in terms of CAPEX, \$435 million. At this stage, remains unchanged.

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**Patrick Archambault** - *Goldman Sachs - Analyst*

OK. Doesn't it imply a slow-down in terms of the EBITDA trajectory then as you go from third quarter to fourth quarter? And if that is the case, what would be the reasons for that slow-down?

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**Alberto Sada** - *Nemak SAB De CV - CFO*

Yes, Pat. This is Alberto. Please remember that there is seasonality on the, let's say, performance of the auto industry. So the fourth quarter traditionally is a lower quarter.

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**Patrick Archambault** - *Goldman Sachs - Analyst*

Alberto, not to interrupt you there, but I'm talking about year-on-year, though.

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**Alberto Sada** - *Nemak SAB De CV - CFO*

OK. I guess, as Armando indicated, the guidance is the same that we have provided.

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**Patrick Archambault** - *Goldman Sachs - Analyst*

OK. Maybe I'll work with you guys offline and get a better handle on that. Thanks a lot.

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**Operator**

Juan Tavares, CitiGroup.

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**Juan Tavares** - *CitiGroup - Analyst*

Hi. Thanks. Good morning again, everyone. Just quickly on FX, if you can give us a little bit of clarity on how we should be thinking about your sensitivity to this Mexican peso. How much of this is passed through to the customer? And if you have any operational hedges around the currency, both in Europe or in Mexico? Thanks.

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**Armando Tamez** - *Nemak SAB De CV - CEO*

Yes, sure. On the FX side, all of our contracts that we have in North America and I think those that we operate in Mexico are U.S. dollar denominated. So there are no arrangements with the customers to pass any of those benefits. Those are part of our cost structure. And that's part of our [detailed] normal operating business.

Thirty percent of our revenue and results come from Europe. Those are euro denominated and we do not engage into any hedging agreements on those [respects]. And for that reason you are seeing the changes in our revenue lines and EBITDA lines coming from our European operations given the movement of the euro versus the dollar.

So far, the movement in peso has been positive for us. A portion of our costs is peso denominated and 100% of our revenue (inaudible) North America is dollar denominated.

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**Juan Tavares** - *CitiGroup - Analyst*

OK. Great. Thank you.

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**Operator**

We have no further questions at this time. I'll turn the conference back over to Mr. Zimmermann for any closing comments.

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**Maximilian Zimmermann** - *Nemak SAB De CV - IR*

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

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**Operator**

Thank you, ladies and gentlemen. This does conclude today's teleconference. You may disconnect your lines at this time. And thank you for your participation.

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