Earnings Conference Call

8/10/2017

OPERATOR:

Ladies and gentlemen, thank you for waiting and welcome to Eucatex's conference call to discuss its results in the second quarter of 2017. We inform that participants will be in listen-only mode during the Company's presentation. Afterwards, we will begin the Question & Answer session, at which point further instructions will be given. If any participant requires assistance during the conference call, please dial *0 to reach the operator.

Before proceeding, we would like to clarify that any forward-looking statements made during the conference call related to the Company's business prospects and its operating and financial projections and targets are based on the beliefs and assumptions of Eucatex's Management and on information currently available. Forward-looking statements are not a guarantee of future performance. They involve risks, uncertainties and assumptions, as they relate to future events and are therefore dependent on circumstances that may or may not occur.

Investors should understand that general economic conditions, industry conditions and other operating factors could affect the future results of the Company and, consequently, actual results may differ materially from those expressed in such forward-looking statements.

I will now pass the call over to Mr. José Antônio Goulart de Carvalho. Mr. José Antônio, you may proceed.

JOSÉ ANTÔNIO GOULART DE CARVALHO:

Good morning everyone. Thank you for joining us in this morning's conference call, during which we'll present Eucatex's results for the second quarter of 2017 and also for the first half of the year. Generally speaking, this was another tough quarter for the Company's markets of operation. This was another quarter in which markets registered lower year-on-year volumes. Considering the ABRAMAT construction material index, volumes fell 7% from last year, that is after consecutive contractions in 2014, 2015 and 2016, I mean, a cumulative decline.

If we compare to 2013, the accumulated decline in volumes is 35%, according to the ABRAMAT index. According to IBÁ, it wasn't very different for the domestic market, I mean, the 7%, considering ABRAMAT and IBÁ, in terms of panels, it was around 6%. The overall market, if we consider the domestic and export markets, was not as bad, because panel exports continued to grow.

The market, this quarter, contracted slightly, as we'll show later on, but in the six-month period, the combined domestic and export markets for panels even grew slightly, by 2%, supported exclusively by exports. I mean, the quarter showed slightly mixed signals, sometimes we had positive indications and believed in an improvement, and others we had negative signals again, so the horizon is far from clear.

There are good news too, we've all been monitoring the issue of inflation, which seems completely under control, at under 3%. This has created room to lower interest rates, which are now in the single-digit, which is very important, as most Companies have their liabilities pegged to this indicator, and this reduces the pressure on servicing debt.

It therefore gives Companies some room and creates an opportunity for new investments. But like we said, mixed signals, on the other hand we still have very high unemployment rates, despite the data released today, of a reversal, or the initial signs of job creation. But the fact is that the rate is still high, which shies away consumers, causing them not to consume and therefore delaying any recovery.

Let's wait for the result of the suspension of the investigation of Brazil's President, let's see if the Government will get a little stronger to push a more positive agenda and try to vote and pass the reforms that are so important, and if the Government will then be able to reach November with a slightly better political and economic scenario, so we can have a calmer environment for the new presidential election, instead of trying to find a messiah, which is always very risky.

So, let's begin our presentation. It is very similar to previous quarters, so it's basically an update, and we'll go over it quickly.

Starting with slide 2, the highlights in the period. Our net revenue in the quarter increased to R$ 290.3 million, up 3.5% from the prior quarter. In the six-month period, net revenue grew 3.2% to reach R$ 573.4 million, slightly above or in line with inflation in the period.

Recurring EBITDA in Brazilian real increased by 2.4% to R$52.5 million in the quarter, and more substantially, by 6.8% in the six-month period, to reach R$ 97.7 million. However, EBITDA margin remained relatively stable. In the quarter, EBITDA margin fell slightly by 0.2 percentage point, to 18.1%.

In the six-month period, however, the margin expanded by 0.5 percentage point from last year to reach 17%. Net income, as opposed to these indicators we just presented, decreased significantly, mainly due to the financial expense, largely influenced by exchange variation. In the first six months of 2016, the Brazilian currency had depreciated significantly.

The exchange rate [to the U.S. dollar] closed 2015 at R$3.90, and at the end of the first half of last year it closed at R$3.20, or something like that. This year, the indicator was the opposite, I mean, the Brazilian real appreciated around 2%, leading to an opposite effect on the financial expense and consequent impact on net income.

On slide 3, the revenue breakdown, as we've already commented on the previous slide. On the left-hand side, the breakdown by product, no news here, and on the right-hand side the breakdown by segment. What we could say differently about the chart on the right, if you remember, in the beginning of the year we had important maintenance shutdowns of our production lines.

This maintenance activity is not recurrent on an annual basis, sometimes it may take longer between maintenances, but we shut down the lines in 1Q17, which caused a decrease in exports, and consequently in their share of net revenue. Now, exports resumed their previous share, of around 15%.

Still in the subject of exports, on slide 4, the chart on the left-hand side shows the evolution. Despite the growth in volume - exports grew around 5-5.8% quarter over quarter – we had two impacts: the weaker mix, we ended up exporting a larger volume of commodity-like products, not necessarily with lower margins, but with lower unit prices. And we also had, like we said before, the appreciation in the Brazilian real.

These two effects caused a contraction of export revenue in Brazilian real, despite the higher volumes, so revenue fell 2.9%. On the right-hand side of the slide, you can see this had a relatively small impact on the export-to-total revenue ratio. Rounding up the numbers, both quarters were around 15%. Actually, in the second quarter of 2016 the figure was slightly higher, at 15.4%, so rounded to 15%, and now it was 14.6%, also rounded to 15%.

On slide 5, you have information from our wood segment, which is formed by the products listed in the pizza chart on the top right-hand side of the slide. There was no significant change in the share of any of these products.

It’s interesting to see, at the bottom of the slide, the relative performance of Eucatex, the numbers in blue, compared to the Market’s numbers in red. In the quarter, domestic market plus exports grew around 12% in volume, while the market fell 2.1%, the panels market as a whole, as I mentioned in the highlights, in the beginning of the presentation.

In the six-month period, the numbers improved for the Market, from -2.1% to +2.4%. This has a lot to do, like we said, with exports, and also the performance of MDF, which performed better in the domestic market compared to MDP. MDP is losing a lot of territory, it’s a typical industrial product, and MDF is more common in retail, which has been performing better, generally speaking, than the production-line industry, which I think is a little related to the matter of creativity: retailers serve cabinetmakers, which make unique pieces of furniture, with added-value, and the industry has been insisting on reducing costs and making simpler pieces, and has therefore been losing room to retailers.

Our performance in the six-month period was also positive, outgrowing the Market. We grew 6.8%, if we add exports and domestic sales. If you look at the chart on the upper left-hand side of the slide, you can see the growth in volume was not accompanied by an equivalent growth in revenue. This is what I mentioned last slide about the weaker mix and the appreciation of the Brazilian real influencing exports. And in the domestic market, which composes this revenue too – as it includes both exports and domestic sales – this is also true to some extent, we've seen a weaker mix in the domestic market, despite the higher sales volume, so revenues did not grow at the same pace.

On slide 6, which we always include in the presentation, on the upper portion of the slide you have installed capacity utilization. Starting from the left, fiberboard, which had registered a very poor utilization rate last quarter, due to the maintenance shutdowns I mentioned.

This quarter, we used 76% of our capacity, which is more or less how this line operates. There are two fiberboard lines, which are a little older and really operate at around these rates, 76-78%, not much above that. And last quarter they had recorded a utilization rate of 55%, so a positive increase in capacity utilization.

The other lines, especially the two major production lines of panels, MDF and MDP, and Flooring Laminated, recorded healthy utilization rates, in line with the previous quarters and the last one, in the column chart on the right, is the two flooring laminated lines. These lines are very simple and we always bring information on them. They can have interrupting shifts, i.e. at night, etc. and there's no problem resuming production in these lines. They have very large capacity, which is good, we’ve been operating at around 40-50% of their capacity for some time, so we can grow a lot in the flooring segment without having to make new investments.

And here, at the bottom of the slide, also for informational purposes, the breakdown of costs from panels, those that take resin, basically MDP and MDF, and those that don’t take resin, which is fiberboard.

On slide 7, the paint segment. This was a very difficult quarter for the Company, both the quarter and the six-month period, and for the Market too. On the right-hand side, the column chart represents Market data, you can see the Market contracted around 1% in the six-month period, but if you look at the table, right underneath it, you can see Eucatex fell more sharply. I believe this was the first six-month period after many years that we lost market share in the paints segment, since our volume fell more sharply than the Market as a whole.

On the other hand, the good news - if I may say so - is that, when you look at the table on the left you can see an increase, not that revenue was positive, but it lagged the decline in volumes, so there was some price gain that softened this revenue drop caused by lower volumes. But since the end of May and early June, we’ve taken several measures regarding the structure of our field team. We've made recent changes to the national sales management, with the reinforcement of the Marketing team, we brought a new marketing manager and we believe these measures, coupled with others, should help us resume our pace in the paint segment.

Now, slide 8. Here, we have financial data, a summary of financial data. We’ve already commented on net revenue, this growth of 3.5% compared to last year. If we look further down, gross margin, we see a small contraction in percentage points compared to the previous year. That is in spite of the Brazilian real appreciation, since sales improved. That is due to two lines above, changes in biological assets.

We have biological assets, so it's a relatively complex calculation, with a future interest rate curve, the actual rate, forest growth, etc., but what it comes down to is that biological assets, in the quarter and in the six-month period, the variation was not as significant as in last year's quarters, with a consequent impact on gross margin. But that has no cash impact. It's interesting to see the line between these two items, biological assets and gross income, which is COGS, and to see that it is absolutely flat as a percentage compared to the previous periods.

Further down in the table, administrative expenses as a ratio of sales, also flat, no news here. Selling expenses, if you look on the right, in the six-month comparison, it decreased as a ratio of net revenue and nominal values, although in the quarter it increased slightly. This is mainly due to marketing expenses or marketing investments we made in the period.

The result of this revenue, margin and expenses, looking at Recurring EBITDA, in Brazilian real, you can see growth in the quarterly and in the six-month comparisons, like we said in the beginning. The EBITDA margin contracted slightly, so a little lower in the quarter and a little higher in the six-month period, i.e. relatively stable. Net income, like we discussed earlier, decreased somewhat significantly, but if you look here at the details, you can see it's mainly on account of the financial expense.

Debt position, now on slide 9, did not change significantly either. Net debt is very close to the end of the year, even slightly lower. In U.S. dollars, it is even lower, due to currency appreciation in the period. The net debt to EBITDA ratio improved slightly, from 1.8 to 1.7, so quite under control.

Our challenge, and let me say we'd like to have had the opportunity to announce it now, was to lengthen the debt maturity profile. We've been working on it since the end of last year and we have a lot of deals close to conclude, I can say that today discussions are much more around costs than around obtaining these facilities, or getting their actual approval. I believe that there's a great chance that, over the coming weeks, but certainly within 3Q17, we'll see a significant change in the debt profile.

On slide 10, investments are planned at R$81 million for the year, not very differently from last year, with a strong focus on sustaining forest and industrial activities. At the bottom of the slide, the column chart. So far in the six-month period we've spent slightly less than last year, but we're very in line with it, with almost R$41 million spent in the first half and R$81 million planned for the full year. We've very aligned with the schedule for the year.

This is the last slide, we always present it, it's very informative and there aren't usually any major news here. In terms of forests and recycling, we have the same 46,000 hectares of forests in the state of São Paulo. There's information on the table about our average radius.

Our program, at the bottom, the column chart, for 2017, is of 4,800 hectares. We'll plant new forests in around 3,800 hectares and manage 1,000. We are managing proportionally less this year than in previous years, which has a lot to do with where we are harvesting, which clones we are harvesting, which type of farm, of soil. So, this is very technical and since we don't want to lose productivity, we are choosing, this year, to manage a smaller volume compared to previous years. On the right-hand side, the recycling program. There's a big difference in the recycling volume this quarter compared to the previous quarter.

One the positive side, we've been able to use more of the bark. During the process of harvesting the forest, we don't remove the bark on the spot. Some companies do that. The harvest gets more expensive, but you don't have to transport the bark. We don't debark the logs on the spot, we do it at the plant and, until not long ago, we didn't use the bark a lot, we used to take the bark to the plant and then almost donate it for removal.

Now, we're having increased opportunities and developing ways to take advantage of the bark at the plant to produce thermal power, so we're requiring less recycling.

Well, that's what I had to say. Like I said, very similar to previous years, to previous quarters, so much more an update and, if you have any questions, I'm available to answer them. If you have a question, any doubts, we'll be available.

OPERATOR:

We will now start the Question & Answer session. To ask a question, please dial *1. To remove your question from the queue, dial #.

Our first question comes from Mr. Lucas Ferreira, with JP Morgan.

LUCAS FERREIRA:

Good morning everyone. José Antônio, I'm curious to hear from you how you see demand now in 3Q across the different channels, to both retail and industrial clients. Do you see any recovery compared to what we saw in 1H? Just wanted to get an idea of whether you started to see any sign of recovery in the quarter that's just started.

And, regarding prices, we saw the industry conducted a price adjustment this year, apparently players are a little more aligned – correct me if I'm wrong – with some one-off increases, let's say, in some lines, and more general increases in April.

How do you see this price scenario? Stable? Do you think there's any risk of price drop or of price increase, perhaps? How do you see prices going into 2H? Thank you.

JOSÉ ANTÔNIO GOULART DE CARVALHO:

Good morning and thank you for your question. Actually, I had a bad connection in the beginning and didn't get it. So, if you could repeat it later, please. Regarding this final part about prices, we had some minor price realignment in this first half. We've already quantified it, now as of September, it's not valid for August, so valid from September 1, we have some important clients adjusting prices. We expect some minor impact still in September, but we should already see some impact on prices in 3Q.

So, I don't think… if we can't have a recovery, I don't see any risk of prices falling back, at least in terms of Eucatex. And, like you said, generally speaking, our peers have been quite aligned in terms of prices. I don't know if you had asked anything before about the channel…

LUCAS FERREIRA:

About volumes. What have you seen in 3Q so far? Are you seeing any recovery? 3Q is usually stronger anyway, but has that been the case? Are you, let's say, more optimistic in relation to volumes in 3Q?

JOSÉ ANTÔNIO GOULART DE CARVALHO:

Let's say, like you said, there's a seasonal factor, which is positive for 3Q and 4Q. I think the challenge remains in relation to MDP, because MDF has been performing well, I mean, MDF is performing better. I think that's even something people are saying a lot, even during our meetings with the furniture industry: why is MDF performing better? Because you are serving retailers, you're serving cabinetmakers, who are making higher-value furniture, with unique designs, and the furniture industry continues to insist and to go after cost savings and remove value from the furniture, and that has been losing - let's say - the customer preference.

Now, that aspect aside, between these two types of panels, the second half will be, or should be, even because of seasonality, better than the first half. Exports are also helping the Market a lot. Not just us, but as a whole today, panel exports already account for around 16%. If you consider domestic and export volumes, over this total of 16% of panel exports, that's a little more than one month of sales. So, this has been very important and I think it should remain strongly this way.

LUCAS FERREIRA:

José Antônio, you mentioned prices. Just to confirm exactly, how much did you raise prices in 1H? You said for September, if you could comment how much it was and more or less the size of this increase.

JOSÉ ANTÔNIO GOULART DE CARVALHO:

In 1H, it was very discrete, it's hard to say because it creates almost like a mist. There are different clients, with difference relevance, so we negotiate with some flexibility. I'd say around 3-4%, and for 2H I expect a little more, I mean, as a former officer of the company would say, "in the cloud", I think we'll increase prices by around 4-5%, mostly on panels. In terms of paint, we've already had a price recovery in the period.

LUCAS FERREIRA:

Thank you.

JOSÉ ANTÔNIO GOULART DE CARVALHO:

Good morning and thank you for your question.

OPERATOR:

Once again, as a reminder, to post a question, please dial *1. To remove your question from the queue, dial #.

Our next question comes from Mr. Juan Pires, with Charles River.

RUAN PIRES:

Good morning José Antônio. My question is regarding working capital. We saw in the beginning of the year that you worked with a line of suppliers, a little of accounts payable, the trade payables slightly below previous years and I believe accounts payable or accounts receivable is still slightly over, which generally reduces the Company's free cash flow. Is there a whole new policy in this respect, any change in terms of payment and receivables? What can we expect for the coming quarters? Thank you.

JOSÉ ANTÔNIO GOULART DE CARVALHO:

I don’t have the details, but I can say that there was no change in the policy, there could be some, let's say, not in accounts payable. It could be the mix of suppliers that was less favorable, in terms of shorter payment terms.

In terms of clients, I can say that there’s been a movement for some time, I mean, the Market is not easy, which is always a challenge in terms of credit, especially in terms of trying to get longer terms and we’ve been supporting it as best as we can, but nothing significant. In other words, in terms of policy, to be objective, there was no change.

RUAN PIRES:

Great, so I could say: for the coming quarter, if you don’t have – I think seasonality helps in this respect, this month of result – what do you project, in terms of the debt for the coming quarters? Thank you.

JOSÉ ANTÔNIO GOULART DE CARVALHO:

Like you said, cash generation in 2H should be better. Let’s say, we invested a lot in restructuring, it’s not completely finished yet, but most of the work has been done, in our commercial and administrative structures. We spent on severance payments and that should decrease in 2H.

On the other hand, we expect better sales due to seasonality. It’s very hard to predict, I mean, I don’t believe there will be any major change in terms of indebtedness. There’s always the unknown factor of the dollar exchange rate, because it’s significant in our structure, how it will fluctuate, how it will behave, even though we have in the short term, especially, a substantial volume in U.S. dollar, which is fully based on our export volume. I mean, we keep transacting ACCs, and around this ACCs there’s the export volume.

We are exporting around US$40-45 million, which is more or less the volume of ACCs. But if there’s an appreciation or depreciation in the USD exchange rate, that has an influence even because of this significant volume that I told you, on debt. So, in real terms, I think 2H should be better, but there’s this unknown part, mainly in terms of exchange rate, so it’s hard to make a prediction about indebtedness.

RUAN PIRES:

That’s great. I just wanted to get a sense of your expectation. Thank you.

OPERATOR:

Once again, as a reminder, to post a question, please dial *1. To remove your question from the queue, dial #.

There being no further questions, I'd like to call on Mr. José Antônio for his closing remarks. Mr. José Antônio, you may proceed.

JOSÉ ANTÔNIO GOULART DE CARVALHO:

I'd just like to thank all participants and thank you for your questions. I believe we've been able, the Company has been able to show, despite the adverse scenario, we mentioned at the opening of the presentation the ABRAMAT index, which is a very important index for construction materials, we have paints, flooring, doors and we talked about the 6% decline in the domestic IBÁ index.

I mean, in spite of this adverse environment, the Company has been delivering consistent results with great resilience quarter after quarter. This is the result of the work we've been doing internally, in restructuring the areas, in developing products and production processes.

This has allowed the Company to post increasingly consistent results in this adverse scenario. Like I said, I hope we'll be able to have a more positive political and economic agenda, let's see if the turmoil reduces, considering this investigation of the president that did not go forward, and as we are able to have a more stable environment in 2018, to only then elect a president with increased legitimacy and drive Brazil forward. Thank you very much and have a nice day.

OPERATOR:

That concludes Eucatex's conference call. Thank you for listening and have a nice day.