ELEMENTIA 2Q16
Conference Call Transcript

July 27, 2016
11:00AM CT

Operator: Good morning. My name is Josh, and I will be your conference operator today. At this time, I would like to welcome everyone to the Elementia second quarter 2016 earnings conference call. All lines have been placed on mute to prevent any background noise. The Q & A session of the call which will be conducted via telephone will initiate when the speakers finalize the presentation. Thank you. I'll now turn the call over to Melanie Carpenter with I-Advize. Ma'am, please go ahead.

Melanie Carpenter: Thank you, Operator. Good day, everyone, and welcome to Elementia's second quarter 2016 earnings conference call. This call is for investors and analysts only. Joining us today from Mexico City are Mr. Fernando Ruiz Jacques, Chief Executive Officer and Mr. Juan Francisco Sánchez Kramer, Interim Chief Financial Officer and Investor Relations Officer. They will be discussing the company's performance as per the earnings release issued on Monday after the close. If you need a copy of the release, please contact I-Advize in New York at 212-406-3695, and we will make sure to get you a copy immediately. Also, you can find the report and other information on Elementia's website at www.elementia.com in the Investor Relations section. I want to briefly mention that managements comments may include forward looking statements, and they are based on information that is current available. Please refer to the disclaimer in the earnings release for details and a full disclaimer. Also, all figures discussed are in Mexican pesos unless otherwise stated. It is now my pleasure to turn the call over to Mr. Fernando Ruiz Jacques, Chief Executive Officer of Elementia to begin with the main highlights and a strategic overview, so Fernando please go ahead.

Fernando Ruiz: Thank you, Melanie, and thanks everyone for your interest in Elementia. I am very pleased to be here to review another strong quarter for our company.

In the second quarter of 2016, in line with our guidance and expectations, Elementia reported double digit EBITDA and operating income growth coming in 15 percent and 22 percent above last year. This performance was driven by the continued growth in both the Cement and the Metal Products Division while headwinds in our BuildingSystems Division persisted.

Given the nature and geography our businesses, there were a few external challenges that we had to overcome. Namely, declining commodity prices and a significant exchange rate volatility in our key market of Mexico. In addition, government budget cuts and interest rate increases in Mexico versus flat interest rates in the U.S., and strong global market volatility resulting from Brexit and the deceleration in China's economy, presented some obstacles for Elementia.

However, I'm very encouraged by the progress we've made in transforming our organization through the successful implementation of our Power of Oneness corporate strategy. The benefits generated by having our divisions working together will help us to continue overcoming what many expect will be a series of continued global volatility.

To that end, we held a remarkable event during the second quarter. For the first time in our history, Elementia held a global convention bringing together customers and employees from all nine countries in which we operate and other countries in which we are present. The theme of the convention focused on strengthening cross selling operations between the Cement, Metal Products, and BuildingSystems Divisions, and we held various activities such as park demonstrations and networking events. Its success was overwhelming, and we received tremendous feedback and recommendations on areas to develop. We are already beginning to see the positive effects, and we will continue to incorporate these types of initiatives.

Turning now to our results by division:
In the Cement Division, our high quality product and Fortaleza's strong brand positioning kept our prices on the top quartile in all the markets we operate in. As a result, cement reported a strong 34 percent increase in revenues.

We believe that cement market conditions in Mexico will continue to drive strong demand despite the government cuts. Moreover, we expect the market to be sufficiently solid as one of the key drivers for this division. Remittances from the U.S. continue to make their way into improvements and renovations in the self-construction sector. This will enable us to continue with the current pricing trend.

However, it is important to highlight that the expected growth for the remainder of 2016, in terms of volume, will be more moderate given that in second quarter 2015, we reached the target capacity utilization rate.

Now, this brings me to talk about our expansion plans for the division. The Tula plant project in Hidalgo remains on track in terms of budget and schedule as there have been no major delays or incidents that would hamper the successful progress of this capacity expansion. As we expressed at the beginning of the year, after completion of this project in mid 2017, we will increase production capacity by 75 percent to reach 3.5 million metric tons per year.

Turning now to the Metal Product Division, despite the decline in the reference price of copper of more than 20 percent, Elementia was able to mitigate this through its effective value added product mix to reflect only a 1 percent decline in its average price.

EBITDA per ton increased by 16 percent in second quarter 2016, benefited by our effective cost initiatives, overall operational excellence, and the return of copper sales to Casa de Moneda in Mexico for minting of coins.

Furthermore, we remain focused on developing higher value added products through innovation, cost optimization initiatives, and metal yields. In fact, we recently signed a supply contract with Home Depot nationwide.

Last but not least, the Buildings System Division continues strengthening its global market share in seven of the nine countries in which we operate. All with the exception of Mexico, due to the lack of government projects, and Ecuador which was affected by the terrible earthquake in April and immediately impacted demand.

Furthermore, in second quarter 2016, Colombia reported significant growth compared to 2015, despite the road blockage from the mass transit workers union since the beginning of June.

In the U.S., results came in above last year even though we had record flooding in parts such as Texas.

I'm also happy to report that we strengthened our ecommerce activity in China, Indonesia, and Turkey.
I would like to take this opportunity to personally introduce Mr. Juan Luis Alfiero, who we named as our new Director for BuildingSystems. As you know, I personally have been conducting this role on an interim basis, and it took us some time to find just the right candidate. I am positive that Juan Luis is that candidate as he brings vast experience in the construction industry at the global level which is fully what we need to consolidate the division.

Before turn the call to Juan Francisco for some additional color on our earnings, I would like to review our outlook for the remainder of the year.

Overall, on a consolidated basis, we expect our profitable growth trends to continue.

In the Cement and Metal Products Divisions, we anticipate strong growth. Yet, slightly more moderate than to what we had in the first half, driven by similar factors that caused growth during the first six months of the year.

However, in BuildingSystems, we might experience a positive bump from the return of some government programs in the remainder of the year. It is important to highlight that even without these government projects, we estimate figures for this division to be similar to the ones in the second half of 2015.

We are already taking actions in order to offset any obstacles with some of the following initiatives: in the U.S., we began selling to large building contractors. In El Salvador, we introduced water tanks into our product portfolio. In Colombia, we duplicated our water tank capacity. Some of our products have been set as guidelines for the Mexico City Airport project. We will also begin operations in Chilca, Peru this November, and finally, we expect global growth in the lightweight frame construction segment, specifically in the U.S. and Latin America.
We are confident that the decisions that we have made will make us a more profitable company, and the decisions we are taking every day to improve the overall business are the right ones and bring us ever closer to our objective. Thank you very much for your attention, and I will turn the call over to Juan Francisco Sanchez Kramer. Please Juan, go ahead.

Juan Francisco Sánchez Kramer: Thank you, Fernando, and hello everyone. As Fernando stated, these quarter results represent our efforts as a team to successfully carry out the company's corporate strategy, resulting in another period of double-digit growth in our EBITDA and operating income.

Let me begin by giving you an overview of this quarter's profit and loss statement. In the second quarter of 2016, Elementia's consolidated revenues increased 6 percent year over year reaching 4.38 billion, reflecting the self-price increase in the Cement and BuildingSystems Divisions. This line item also increased 6 percent during the first half of 2016.

Consolidated revenues are broken down by region as follows: 75 percent for Mexico and the U.S., 17 percent in South America, 6 percent in Central America, and the remaining 2 percent in the rest of the world.

Let me explain a bit regarding the performance of each division. Beginning with the Cement Division, which reported revenues of 755 million in the second quarter 2016, which represents an increase of 34 percent compared to 563 million in the second quarter 2015. Additionally, EBITDA was 320 million, up 35 percent during the same period.

Both the division's net sales and EBITDA benefitted from higher average sales price, an optimum capacity utilization rates and operating efficiencies.
As you noted from our report, we are not including volume and price variation for this division due to market conditions and its potential impact on our strategy. Most of all, considering the startup of the new capacity for the division. From now on, we will not disclose this information, but understanding the investors markets expectations, we will try to give you as much color on it as we can.

In the Metal Products Division, we remain focused on higher value products and therefore the contribution to margins in U.S. dollar per ton increased versus 2015. As proof of this, our average sales price declined by only 1 percent despite the 20 percent drop in the reference price of copper. We continue with our copper hedging strategy of 2,000 tons per month in order to mitigate negative effects on inventory revaluation, in the event of rapid copper price decline.

I would like to stress that revenues as well as the sales price for the division are not correlated to our business performance, but to international reference price of copper.

Therefore, in the second quarter 2016 net sales declined by 5 percent, reaching 1.88 billion, mainly due to the lower reference price and low volumes sold. However, this was offset by greater sales volume of higher value product and cost optimizations resulting from initiatives to improve metal yields.

These reasons, in addition the strengthening of the U.S. dollar contributed to a 16 percent increase in EBITDA, reaching 308 million in the second quarter 2016.

The Building Systems Division reported revenues of 1.8 billion in the second quarter of 2016, up 8 percent year over year, thanks to improved performances in all of the countries in which we operate except for Mexico and Ecuador. However, we anticipate a potential turnaround for these two countries in the second half of 2016. In Mexico, we might benefit from the government contract expected to begin in the remainder of the year, and in Ecuador, we might profit from a onetime government subsidy of $10,000 per household for home repairs following the devastating earthquake there in April. We expect this subsidy program to begin in the upcoming months.

The average price per business division increased 11 percent year over year which helped to offset the sales volume decline that took place during the quarter. In terms of EBITDA, this division registered 269 million, 9 percent lower than in 2015, mainly caused by the decline in Mexico from the delayed government projects. As well, as we mentioned in the previous quarter, timing of recurring government projects varies from year to year, and so we expect it to occur during the second half of 2016.

Moving now to consolidated cost of goods sold, for the second of 2016 increased 1 percent 3.35 billion while revenues increased 6 percent. The cost optimization was mainly due to operational efficiencies initiatives across all three divisions, raw materials price fluctuation, and higher volumes sold.

The 18 percent increase in SG&A resulted from an increase in marketing expenses, non-recurring costs to improve operating efficiencies, and expenses generated during the implementation of the go to market, and zero-based budgeting projects. Also, as stated in our IPO prospectus, the bargain purchase gain from the acquisition of fiber cement assets in the U.S. that reduced our 2015 figures.

Moving on, consolidated EBITDA rose 13 percent reaching 1.68 billion in the six months of 2016. In terms of EBITDA by divisions and excluding the holding, cement represented 35 percent, metal products 35 percent also, and building systems 30 percent. EBITDA margins for the second quarter 2016 was 19 percent versus 18 percent last year.

Finally, Elementia reported net loss of 26 million for the six months of 2016, mainly due to the impact of exchange fluctuations from the company's dollar denominated debt. Nonetheless, improvements to the company's financial cost resulting from the CEBUR payment in the fourth quarter 2015, more favorable terms obtained for the revolving credit line, and hedging of 20 percent of the international bond.

Turning now to the balance sheet, cash and cash equivalents are as of June 30, 2016 reached 2.9 billion, a decline of 6 percent compared to year end 2015, mainly due to the investments in the capacity expansion project in the Cement Division, which by the way, is performing according to play in both budget and schedule.

I would like to state that the company continues to have a strong position in U.S. dollar. As such, during the second quarter 2016, close to 60 percent of its cash was in dollar basis.

Elementia' s debt position reached 9.17 billion compared to 8.39 billion as December 31, 2015 due to the negative impact of the Mexico peso devaluation and dollar denominated debt.

In accordance with the company's financial strategy of keeping a solid and flexible balance sheet, net debt to EBTIDA ratio was 1.96x times, and interest coverage 5.56x times, all within the covenants set by the financial institutions. Moreover, as of June 30, 2016, 99 percent of gross debt is long term.

We continue to strive for full equilibrium in U.S. dollar terms by keeping the resources generated by our dollar based operations in the cash position. We will also continue implementing our hedging strategy, and will further take advantage of our capacity expansion in the U.S. to bolster these flows.

What is more, we are truly focused on organic and inorganic growth strategy, therefore to have the financial position and funds necessary to take advantage of any opportunities with these two things: first on June 30, 2016, we signed an ECA facility agreement with Santander for nearly up to 110 million with semiannual payments. It is important to mention that this credit line will not substantially raise Elementia's leverage levels. And second, more than 90 percent of our cash position is being held in North America while keeping the minimum cash levels necessary in other countries in which we operate.

In terms of the progress of our debt hedging strategy, on April 29th, we carried out the second hedging trench for 10 percent of the company's international bonds, reaching 20 percent.

In terms of our CAPEX for the period, we spent 1.8 billion in the first half of the year, but because of the strong cash flow generation, we only utilized close to 300 million of our cash balance for the period. Elementia continues to focus on strengthening its financial discipline, so we are exploring acquisitions in the countries in which we operate. In this regard, we hope to have a positive move in the coming quarters.

As we look ahead, we will continue searching for ways to enhance our leadership in the region from markets we serve. Our strong positive financial position gives us the capability to continue seeking opportunities for regional expansion and product diversification to drive long term sustainable growth across our three divisions. With that, I conclude my comments and ask the operators to please open the floor for your questions.

Operator: Thank you. At this time, we will open the floor for your questions. If you would like to ask a questions, please press the star key, followed by the one key on your touchtone phones now. Questions will be taken in the order in which they are received. If at any time you would like to remove yourself from the questioning queue, just press star two. Again, to ask a question, please press star, one now. We have our first question coming from Juan Tavarez from Citi Group.

Juan Tavarez: Hi. Thank you. Good morning. My first question is regarding the Metals Division. We mentioned that you sold a bit more of the higher value added products. Could you give us a sense of how much of your volumes in that segment were in that category of high value added, and how that compares to last quarter. Also in Mexico, regarding the government programs, since you mentioned that there is some volatility there in those sales, but you're expecting a recovery in the second half, could you give us a sense of how much of your sales last year came from these government programs, and how much you're expecting to represent for this quarter as well? Thank you.

Juan Francisco Sánchez Kramer: Hi Juan. Thank you for the questions. Let me start with the Metal Divisions. Let me put it like this, we have been having an average of 20 percent of our volume sold to be in the completed base, and the rest has been moving on for higher value specialties. In this second quarter, in particular, we have lesser commodities volume and higher value added for two main reasons. For one, we started in June back again, supplying the Casa de Moneda in Mexico, and second, we have more copper alloy pipe for the – the word in Spanish is *condensadores* – condensation for the U.S. market. So, those two main issues drive our volume of higher value products back up. For your question on the government programs that took place in the first half of 2015, Fernando would like to comment.

Fernando Ruiz: Regarding the BuildingSystems Division, in Mexico, if you see it as a whole, these government projects represent 5 percent of the total volume. If you see it in only in Mexico, it is close to 30 percent of the sales.

Juan Tavarez: And you're expecting that same type of contribution for this year? So far in the first half, it seems like it's below trend, right? I'm not sure if you would expect that to catch up in the second half?

Fernando Ruiz: It is a big program that we have been awarded for the last couple of years. We have been awarded three times already, this program. We are expecting to have this program again in the next couple of months. I mean, there has been a lot of movement, but nothing has been concluded. We expect, as I told you, that we will be awarded with this project again, but our worst case scenario as I stated when I was going through my initial reading is that we expect to have at least the same volumes as that of last year without the government project. If we are to be awarded with this project, we will definitely have a very interesting growth there.

Juan Francisco Sánchez Kramer: It is important to highlight that we are improving revenues on volumes sold to the network, in order to mitigate these programs that Fernando mentioned that are quite important but does not have the same seasonality in the year.

Juan Tavarez: Great. Thank you. That's very helpful.

Fernando Ruiz: Thank you.

Operator: Thank you. Our next question comes from Cecilia Jimenez from Santander.

Cecilia Jimenez: Yes, hi. Good morning everyone. Congrats on the results. I actually have two questions. First, regarding the Cement Division and the expansion of the Tula plant. Should we expect margin contraction already for 1Q 2017 due to the ramp up process, or should we see it already in second half of the year. That's my first question. And then, the second question is, regarding the findings of the Boston Consulting Group study, what are the main findings of that study, and I believe SKU reduction was one of them. When should we see those improvements taking place and materializing on your results. Finally, a follow up on that. What improvement we should see in BuildingSystems Division from an EBITDA margin perspective. Thanks.

Juan Francisco Sánchez Kramer: Thank you, Cecilia. This is Juan Francisco. Let me begin with the Cement expansion. It is, as we mentioned, going according to plan in both project and schedule, so we are quite confident of the startup in mid 2017. To your question on when should we expect margin decline, we are expecting margins to be a little bit lower, probably by the end of the year, and the lowest point of the margin that we expect is probably in the third quarter 2017, given that it will be starting up, roughly, from scratch and ramping up. As long as we reach the full capacity of the utilization rate, margins will be impacted by this. Having said that, we are expecting a potential ramp up of about 2.5 years. If we start in mid 2017, by the end of 2019, we should be back on full margin recovery.

Cecilia Jimenez: Thank you.

Fernando Ruiz: Your question about BTG, as you know we already finished the analysis we conducted with this consulting company. We are already in the implementation phase. I could give you some key findings. I would not like to explain a lot of it, because it involves a lot of our strategy. But what I can tell you is that we found, for instance, 80 percent of our sales done in Mexico are done only in five states, so we have a great opportunity area there. 95 percent of our sales with 30 SKU's, and we used to have more than 3,000 SKU's, so basically, with this study, we're having a lot of focus, and we know now where to target. We have a clear strategy, and as I told you, we are already in the implementation phase. In the U.S., the only thing I can tell you is that we also found a lot of opportunities. We are very happy about the findings we found. Today, basically, we are focusing to big builders. Big builders, there was a tremendous opportunity there. These guys manage a great part of the volume that is being sold in the U.S. We are already started with this strategy, and hopefully, we will harvest the things that we are planting today in the near future.

Cecilia Jimenez: Great. Perfect. That's great. We thank you. Maybe just a third question, if I may. Recently, there was the announcement of home improvement store from Chile coming to Mexico. My question is do you see that as a threat, or is it actually a possibility to have another distribution channel with your products in Mexico. I'm talking about specifically about home center –

Fernando Ruiz: Sodimac.

Cecilia Jimenez: Sodimac, yes.

Fernando Ruiz: Good question. We see it as another distribution channel, so we do not see it as any risk for us. We know about the quality of the company. It's a great company, so we do not see any risk for our operation.

Cecilia Jimenez: Okay, great. Thank you.

Fernando Ruiz: We have already talked to them, so we see a nice opportunity increase our sales using that channel.

Cecilia Jimenez: Great, thanks.

Juan Francisco Sánchez Kramer: Thank you, Cecilia.

Operator: Thank you. Our next question comes from Omar Rodriguez from Credit Suisse.

Omar Rodriguez: Hello, everyone. Congratulations on the results. First of all, I would like to ask if you could provide us some color on the contribution of the ready mix in the Cement Division for 2Q 2015 and 2Q 2016 in terms of sales I mean. On the cost side, I would like to see if you could tell us how much of the cost of production of the division are variable versus the amount that is fixed. I have a quite a few questions for Metals and BuildingSystems, but I don't know if you prefer to answer those questions first.

Fernando Ruiz: Thank you for your question. To your question of the contribution of ready mix, what I can tell you is by second quarter 2015, we only had one ready mix plant in operation. By this second quarter 2016, we are operating four facilities. As you know these facilities are small, but for the first time the incremental volume was relevant, because on this month three more. In total, our financial, we are focusing on self-construction, so we will keep the ready mix operations in a small level. We are not planning to increase it too much. Probably one or two more of these facilities, and probably, that will be all. This, of course, is moving the figures for the full division, but in this variation. To your question on how much is variable, and how much is fixed, let me try to explain it in a different way. In general terms, the cost of cement about 50 percent of the total cost is energy. That is mainly electricity and fuel. About 25 percent is raw materials, and the remaining 25 percent is maintenance, labor, etcetera. So, you can say that about 25 percent is fixed, and 75 percent is variable. Of course, there are some pieces of electricity and other items that also are fixed. This is just gross numbers.

Omar Rodriguez: That's great. Thank you. On the Metals Division, a question about the EBITDA per ton, profitability increase. Could you give us some color of how much was it because of less or higher efficiencies in the production, and how much of the improvement came from a better sales mix?

Juan Francisco Sánchez Kramer: For the full incremental SG&A, about 20 percent of the increase, 25 percent of the increase, was due to this improvement on metal yields. Another 10 percent or so was other initiatives that were cutting costs. Mainly, reducing inventories and inventory variations, etcetera. Another important topic of this, or the incremental EBITDA's, was, of course, the value added, so we have higher volumes of product with much more higher EBTIDA per ton contribution. Lastly, the effects impact and the business, given that we fully, 100 percent dollarized.

Omar Rodriguez: Okay, great. And just a last one on Building Systems. Could you give us an idea of how the market share has evolved for Allura in the U.S., and I remember there was some pricing catchup that could be done over there, so I don't know if you could offer to us how is that progressing?

Fernando Ruiz: Omar, honestly, for strategic reasons, I would not like to go in that. What I can tell you is that we have increased our volume more in a double digit basis, so we are on the right track. Our volume has increased more than double digits, so we are in the right track.

Omar Rodriguez: Great. Thank you very much, guys.

Fernando Ruiz: Sure.

Operator: Thank you. Again, if anyone would like to ask a question, please press star, one now. Our next question comes from Hernan Kisluk from MetLife.

Hernan Kisluk: Hello. Good morning everyone. Thank you for taking my questions. I have two questions. The first one is regarding the search of the new CFO, if you could provide us an update on that. The second one is regarding the cost in the BuildingSystems Division, because even though prices grew 11 percent year over year, and sales grew 5 percent, there was a decrease in EBITDA margin of 1 percentage point, so I would like to know what is the cost dynamic, or what is driving the compression in margins there? Thank you.

Fernando Ruiz: Thank you, Hernan. Let me address your first question, and Juan Francisco will address on the second one. Regarding the CFO position, what I can tell you is that we are still in the process of looking for the right candidate. We want to make sure that whoever fills out this role will be the best fit for our company and brings vast experience in the construction industry. So, let me add that Juan Francisco has been doing an exceptional job as interim CFO, so I have absolutely not worries in that matter for the moment.

Juan Francisco Sánchez Kramer: Your second question, Hernan, as you mentioned, we have a greater cost on SG&A for the division. The two main reasons are for once in costs, it is regarding to right sizing of some operations, and given that we do not have the government projects, in particular, in Mexico, there are fixed costs that are not being absorbed. The second one is in SG&A, and as I mentioned, the main three reasons are marketing, the cost or expenses related to the implementation of two main projects. The go to market and the zero based budgeting. Also, there is some distortion, to put it in a way, in terms of competition, because in 2015, we have the benefit of the value acquisition, or the acquisition of bargain price from the 5 percent assets in the U.S.

Hernan Kisluk: Okay, thank you very much. A follow up on the BuildingSystems Division, in previous quarters, you had mentioned that you were going up in the learning curve in the automatization process in Central America, so I would like to know if you are done with it? If you are operating normally now, or we should expect more improvements coming from this area?

Juan Francisco Sánchez Kramer: For one, the project that we mentioned last quarter is completed. We completed the automatization of Cost Rica and El Salvador facilities. There is still room for improvement in other operations, and we are doing and analyzing several opportunities to improve our cost position, so you might expect something about this in the near future. We will let you know when that starts.

Fernando Ruiz: Also, just to let you know, we are currently making some investments as well in Mexico and in Colombia mainly, also to improve our operating costs, so hopefully, we will finish that by the end of this year.

Hernan Kisluk: Okay, perfect. Thank you very much.

Fernando Ruiz: Sure.

Operator: Thank you. Again, if anyone would like to ask a question, please press star, one now. Again, that is star, one, if you would like to ask a question. At this time, I'm showing now further questions. I would like to turn the call back to Mr. Fernando Ruiz for any closing remarks.

Fernando Ruiz: Thank you, Operator, and once again, thank you all for your interest in Elementia. As always, we remain available should you have any further questions, so please contact Juan Francisco or myself, and we will be happy to answer them. Have a nice rest of the day.

Juan Francisco Sánchez Kramer: Thank you.

Operator: Thank you ladies and gentleman. This concludes today's teleconference. You may now disconnect.

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