Elementia 2Q18 Conference Call Transcript

Operator: Good morning. My name is Aaron, and I will be your conference operator. At this time, I would like to welcome everyone to the Elementia earnings conference call. All lines have been places on mute to prevent any background noise. There will be a question and answer session after the speaker's opening remarks, and instructions will be given at that time. Thank you. I will now turn the call over to Alfredo Recke, Elementia's investor relations officer. Please go ahead, sir.

Alfredo Recke: Good day everyone, and welcome to Elementia's second quarter 2018 earnings conference call. Joining me today is Chief Executive Officer, Fernando Ruiz Jacques and Chief Financial Officer, Juan Francisco Sanchez Kramer. Please be advised that this call is for investors and analysists only. During this call, we will be discussing Elementia's performance after the earnings release issued yesterday.

If you did not receive the report, it is available on our website, elementia.com, in the investor relations section. Let me remind you that the forward-looking statements may be made during this conference call. These are based on information that is currently available and may change due to a variety of factors. For more detail and a complete disclaimer, please refer to the earnings release.

All figures discussed are in Mexican pesos unless stated otherwise. It is now my pleasure to introduce Fernando Ruiz Jacques to begin with the main highlights of the quarter.

Fernando Ruiz Jacques: Thank you, Alfredo, and welcome everyone. We really appreciate you being here to review Elementia's performance at the midway point of the year.

Before I begin discussing the quarter, I just want to emphasis that we remain committed to the long-term strategy we stated since our IPO. This strategy can be summarized in two stages.

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First, bringing all three divisions under the same umbrella and offering all products under the same name of Elementia by leveraging our distribution network, strong brands, and our strong influence in all stages of the construction process.

And second, to eventually evolve even further to offer comprehensive solutions for the construction industry.

So far in 2018, we have faced two major headwinds impacting results as one-offs. First, we have had the volume and sales decline in our South Carolina facility due to technical failures at the cement mill, representing a negative impact of close to 230 million pesos. And second, helping the macroeconomic slowdown in Latin America that we tackled through a capacity rationalization and right sizing of the Building Systems Division with an implicit cost of close to 100 million pesos.

On top of that, we made two transcendental decisions in the Building Systems Division that will allow us to recover the growth trend of the business by 2019 and beyond. First, we opened the Indiana facility with op-ex of around 80 million pesos to date, expecting a break-even point by year end.

And the second decision, and in order to improve our products by making them more resistant and manageable during the installation process through R&D, we implemented a new process in production technology in Latin America, which included the migration from chrysotile to synthetic fibers. The total impact associated to this change at June 30th was around 140 million pesos. I am pleased to report that the last pack of chrysotile fiber was purchased last August, so we are approaching a full year of having the new production process in place.

Excluding these one-off effects, consolidated EBITDA registered a 35 increase versus the same quarter of last year.

Now, on to the results and expectations for the rest of the year.

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Numbers came in below the same period last year, as the strong performance in Cement Mexico, Metal Products, and Building Systems US were insufficient to offset the challenges in the Cement US and Building Systems Latam. It is important to mention that second quarter ’18 EBITDA results show a quarter over quarter improvement of 15%.

Let me go into detail on our performance by division.

First, with Cement USA. The results for this division were impacted by the failure of the cement mill of the South Carolina facility at the commissioning space of the yearly maintenance outage performed by a third-party specialist. Consequently, volume produced and sold for the region declined 62% in April when compared to our projections.

However, thanks to our immediate actions to correct the issue, we have been recovering since then, and we expect to fully recover by August. As an example, total volume sold grew 35% in June versus May. In the second quarter, total sales volume declined 11% versus last year. We implemented a customer first strategy to supply our clientele throughout this time by buying volume from third-parties, from both domestic and abroad, with close to zero margin. This effort helped us to recover sales rapidly.

Once again, I am proud of the way our US team acted by putting customers as our priority and getting the facility back on track in an extraordinarily short amount of time.

Because of the aforementioned facts, EBITDA came in at 49 million pesos versus 232 million in the same period of the previous year. On a like for like basis, EBITDA grew 20% for the second quarter.

In a nutshell, considering the figures of last year as a baseline and the effects mentioned before showing a negative impact of more than 230 million pesos, we now expect full year 2018 figures to be below 2017.

We are confident of the recovery of the business in 2019, heavily supported on the South Carolina operations, which have strong fundamentals like growth

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levels in population, employment, immigration, housing costs, and attractive area for retirement and a favorable climate.

Going now to Cement Mexico, this operation posted an EBITDA growth of 48% year over year. Operations continue to excel, mainly in terms of volume, which was up 30%.

Average prices remain unchanged as compared to the first quarter despite a more competitive environment stemming from the effects of an election year. Our expectation for the second half of the year is aligned to the statistical electoral cycle of six years in Mexico. In other words, we are expecting weaker demand, but we remain confident that we will reach optimum capacity utilization levels and continue showing growth when compared to the same period 2017, but in a more modest way than the first half, to end the year with a strong double-digit growth.

Regarding the grinding project in Costa Rica, I am pleased to report that we have launched operation of the 2,000 and 50,000 tons per year capacity on schedule. We expect a 2.5 to three year ramp-up leverage on self-consumption and revenues to third parties with an EBITDA margin of approximately 20%. We anticipate this 20 million capex project might become the first of a broader business model in the region.

Moving now to the Building System Division, I would like to point out that we took into consideration the comments and requests from the investor community, and we have broken out results into two main regions, the US and Latin America.

Consolidated EBITDA for the division fell 61% year over year for the Latin America region. For the Latin American region, EBITDA fell 82% mainly due to two main factors: first, the aforementioned technology change that includes a new formulation and different raw materials, including the migration from chrysotile to synthetic fibers. Additives and product process brought additional cost and a steep learning curve. We’re confident that this conversion represents and advantage for the handling and installing process for our customers and our distribution network.

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We expect a yearly impact in cost of more than 250 million pesos, of which more than 140 million occurred year to date.

Second, volumes declined in Latin America due to the weak economic growth, especially in the Andean region. In response to this situation, during the second quarter, we executed a right sizing of 20% of the work force and a capacity rationalization in closing three facilities, one in Colombia, one in Honduras, and one in Mexico.

This initiative cost one-time expenses of close to 100 million pesos, which will turn into savings for the second half of the year and the following years.

On a pro forma basis in six months of 2018, EBITDA in building systems Latam registered a 14% decrease year over year.

In summary, 2018 is a transition year for building systems Latin America, with second quarter ’18 one-time costs and expenses relating to restructuring, capacity rationalization, and changes in raw materials. We expect full year 2018 EBITDA below 2017. Nevertheless, we expect a turnaround to help drive growth in 2019.

One the positive side, US operations fared well with 11% EBITDA growth, despite facing a tougher winter, higher logistical costs, and costs related to the reopening of the Indiana facility. The return of the Indiana plant is going according to plan, but operational expenses associated with this process total close to 80 million pesos year to date. And consequently, it operated at a loss. The losses should moderate throughout the year as sales volume increases according to plan, and we expect to reach break-even EBITDA levels between November and December of this year.

On a pro forma basis, excluding impacts from the reopening of the Indiana plant, EBITDA in Building Systems grew 76% during the first half of the year.

In summary, in 2018, we are investing in the reopening of the Indiana facility. That will enable strong growth in the years to come. Nevertheless, we are expecting high

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single digit EBITDA growth for 2018 that will not fully compensate the decline of the Latin American region.

Turning now to the Metal Products Division, operations stabilized and EBITDA grew 1% year over year during second quarter 2018 thanks to stable volumes, positive currency, and copper price effect and a shift toward higher value products and continued cost efficiencies, which compensated for higher energy costs.

Our strategy for Metal Products will continue to focus on three pillars: passing through commodity prices to the market, raise markups by increasing volumes for higher value products that reflect our ability to innovate within mature markets, and most importantly, expand EBITDA levels per ton, and third, remain the industry lowest cost supplier, which means greater efficiency in converting metal.

For the full year, we expect a very similar EBITDA to the one achieved in 2017. The division will continue serving as a very strong cash flow generator.

In summary, and on a consolidated basis, we expect 2018 figures similar to 2017.

Before concluding my remarks, I would like to reiterate that we are analyzing our business portfolio by plant and by region and considering possible divestment that will help us focus on those businesses with higher profitability and growth potential in order to deliver value creation for our shareholders.

With this, I conclude my remarks and now turn the call over to Juan Francisco Sanchez Kramer for further details on our financials. Juan Francisco, please go ahead.

Juan Francisco Sanchez Kramer: Thank you, Fernando, and welcome everybody.

Fernando has already given us detailed remarks on operating results, so I will go straight to the consolidated financial performance.

The second quarter was stronger than the first quarter in each and every line element, mainly due to the seasonality in our US operation. When compared to the

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second quarter last year, we show incremental revenues with a declining EBITDA.

Consolidated revenue in second quarter ’18 grew 12% for the quarter, reaching 2.29 billion pesos, a 6% increase in consolidated Cement Division, mainly driven by the Mexican operations, a 4% increase in consolidated Building Systems, showing growth in both the US and Latam, and 22% increase in Metal Products, coming mainly from higher reference price of copper and incremental volume.

On the other hand, the consolidated EBITDA margin contraction of 369 basis points due to a 381-basis point contraction at EBIT level drove an 11% decline in EBITDA to 1.06 billion during the quarter.

However, we experienced several extraordinary effects, some of them on a one-time basis.

The summary of these extraordinary effects at the EBITDA level is:

- The one-off impact from our US Cement mill in South Carolina totaling, to date, close to 230 million.
- The reopening of our Indiana facility to the US Building System operation with a year to date impact of close to 80 million.
- The impact from the technology change and its learning curve in Latam Building System totaling roughly 140 million as of June,
- and the one-off impact from the capacity rationalization and right sizing of the Latam Building Systems operations in order to align our business to the market conditions totaling close to 100 million in the quarter.

Overall, the total extraordinary effect is 550 million in the first half of 2018.

Below the operating line, Mexican financial expenses increased by 1.7 times in a year over year basis for the quarter, mainly due to an increase in the TIIE and LIBOR rates, the financial expenses associated with derivatives and the mark to market impact due to the depreciation of the Mexican pesos versus the US dollar.

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These impacts were partially mitigated by the rebalance of the data structure we concluded by year end in 2017 through which we achieved fixed rates for more than 70% of the gross debts, 57% pesos, 43% dollars debt balance, bringing us a comfortable equilibrium between assets, liabilities, and cash flow, and a very comfortable maturity profile.

Taxes for the first half of the year decrease 39% versus 2017, driven by a 72% decline in profits before tax, leading to an appearing effective tax rate of 126%. Excluding loses at US Cement and the holding level, mainly due to that it concentrates most of the debt and is in financial cost, the effective tax rate for the first half of 2018 is 31.9%. In consequence, net income was negative in 134 million.

Our cash flow, before capex, reached 1.68 billion in the first six months of ’18 thanks to the improvement in working capital, through our decrease in inventories, and increasing suppliers. In terms of capex, we have invested close to 990 million so far, mostly towards maintenance for all our 34 facilities, including bringing the US cement assets to the industry level according to the three-year plan, as well as investments made in the cement expansion in Costa Rica.

Now, looking at the Balance Sheet, we continue strengthening our balance sheet. As such, in June we replaced our committed revolving credit facilities, which now have another availability of $400 million. Additionally, we also extended the payoff availability and maturity by three years.

The company’s net debt increased to 14.95 billion from 14.35 billion at the end of 2017, mainly because cash and cash equivalent came down to close to 650 million. The net leverage ratio therefore reached 3.49 times and interest coverage 3.0 times.

We remain committed to the deleveraging throughout this year. Aligned to our focus on creating value for our shareholders and our capital allocation strategy, we are running a deep analysis on each and every business unit and facility in order to find which business fits better our strategy and are in a better position to capture the

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potential growth. As so, there might be some divestment of non-core assets in the near future.

Before concluding my remarks,*(I'd like to raise today that we are analyzing our business.)* I will quickly go through the share report chief program. The shareholders meeting approved 2 billion as a cap for this program, and Elementia mine purchased over 1% of its total shares outstanding through this mechanism, aiming to supporting our shares trading volume. As of the end of the first half of the year, we held in position 8.8 million shares, or 0.81% of total shares outstanding.

With this, I conclude my remarks, and now I ask the operator to please open the floor for Q&A. Thank you.

Operator: Certainly. At this time, ladies and gentlemen, if you would like to ask a question, please press the star then one on your touchtone phone. You may withdraw your question at any time by pressing the pound key. Once again, it is star then one to ask a question, and we'll pause for a moment to allow questions to que.

Once again, ladies and gentlemen, that's star then one.

And we can take our first question from Fernando Ulacia with Credit Suisse. Your line is open.

Fernando Ulacia: Hi. Thanks for taking my question. My question is on the Latin American Building Systems. When do you expect these weak numbers explained by the change in raw materials, technology, and learning curve will end? Thank you.

Juan Francisco Sanchez Kramer: Hi, Fernando, and thank you for the question. As we mentioned, there is two main impacts in Latam for Building Systems. One is the construction of the market for which we did a capacity rationalization, which we idled or shut down three facilities in the region with a total cost of close to 100 million for the quarter. This will bring savings in the second half of the year and from there on.

The second issue in Latam, as you well pointed out, we changed the technology, and it comes with a different formulization and a learning curve. So for this issue,

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what we will be mitigating is the impact of the learning curve. Nevertheless, the additional costs for the change in formulation will remain. So in summary, this 2018, we see it as a transition year for the weigh in, and we believe that we are setting the basis to recover the growth trend from 2019 and on.

Fernando Ulacia: Okay. Perfect. Thank you very much. Really clear.

Operator: Once again, ladies and gentlemen, it is star then one to ask a question today.

We can take our next question from Marcelo Herz with Invex.

Marcelo Herz: Yeah. Good morning, guys. I have a couple of questions: one, following up on the previous question on the Building Systems Latam. What we be a normalized EBITDA margin that you can expect once all these effects go away? And the second question is I believe you had a net leverage target for this year of around 2.5. How confident are you that you'll be able to reach that target?

Fernando Ruiz Jacques: Thank you, Marcelo. I will address your first question. What we're forecasting on a normalized basis is that the margin for Latin America for Building Systems Latin America should be around 10 to 15%. And the second question, Juan Francisco.

Juan Francisco Sanchez Kramer: Thank you, Fernando. Marcelo, to your question, yes, we mentioned at the beginning of the year that we were targeting 2.5 times. Given the constraints on EBITDA generation, we are not that optimistic. We believe that we will remain above three times for the rest of the year, but certainly on the way down.

Marcelo Herz: Okay. Thank you.

Operator: Once again, ladies and gentlemen, it's star then one to ask a question.

We'll take our next question from Alejandro Lavin with Citi Group. Your line is open.

Alejandro Lavin: Hi, good morning, everyone. Thanks for taking our questions. I have a couple of questions on US Cement and the Building System divisions. First of all, is it fair to say that we are at the bottom of this restructuring and transition process? And the second would be on EBITDA margins, kind of a follow up question on the previous one. What is the pace of recovery that you expect margins for these two divisions for the second half of this year and next year? Thanks.

Juan Francisco Sanchez Kramer: Thank you, Alejandro. To your first question on US Cement and Building Systems Latam, yes, we believe that we have reached bottom line in the second quarter, mainly due to the impact on the damaged mill for the cement operations in South Carolina. That hurt us deeply, but as Fernando mentioned, we are in the process of recover. And by August we expect to be back on track.

In Latam, as well, we've done all that was required to realign the operations to the market conditions, making the second quarter to be the bottom line. This realignment will bring savings for the future. So we believe, again, that it is rock bottom.

To your second question regarding margins, we remain confident that the US cement business will be in a normalized position between 20 and 25% once we conclude all the three-year plan that we've stated.

For the Building Systems, again, for the near future, we expect margin recovery, near future I mean the following year. We are expecting a margin recovery of between 10 and 15%, and we see normalized margins for these operations on close to 15%.

Alejandro Lavin: That is very clear. Thanks a lot.

Operator: Once again, it's star then one to ask a question.

We'll next go to Cecilia Jimenez with Santander. Your line is open.

Cecilia Jimenez: Thank you. Hi, gentlemen, good morning, and thanks for taking my question. I'm sorry if you have already mentioned this, but I was late on the beginning of the call. I would like to have your views on Mexico Building

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System Division, particularly, and your relationship with the potential foreign expenditure from the government in infrastructure next year.

Particularly, the government has mentioned seven projects of infrastructure to be started in 2019, and I would like to know from your side whether you see an opportunity on the Building systems side or in the cement side on this segment. Thanks for dividing the Building System Division between the US and the rest of the countries. It's very useful. That would be my first question. Thanks.

Juan Francisco Sanchez Kramer: Thank you, Cecilia, and thank you for your comments. We really appreciate your feedback on the reports, and we try to comply as much as possible.

Going to your questions, the Building Systems in Mexico view, that is pretty much aligned to your second question regarding the government projects. We do see opportunities in Mexico, not only because of this project, but because the moving trends of the market. Each day, the construction is more focused on cities. Population is continuously moving to cities, and so the urban population is growing much faster than the rural population. So, we've also realigned our business to focus on flat panels for the Building Systems. That represents a very big opportunity for light construction systems. That is what we believe will become the preferred construction system for cities that are growing in a vertical way.

Having said that, aligned to the government project, it has been said that there will be support for housing, social housing, and aligned to this, again, we believe that it will be done in multi-apartment buildings. So we have positioned ourselves to begin capturing this opportunity. This is really the opportunity that we see in the future. Other projects are more aligned to the cement business. Nevertheless, we remain focused on self-construction, so infrastructure projects, even though it will help the market overall, are not our main priority.

Fernando Ruiz Jacques: Just expanding on Juan Francisco's answers, Cecilia, and to point it out, from the cement projects Mr. Lopez Obrador announced, for instance in the Mexican airport, we are currently selling concrete pipes. So we are

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imbedded in that project. Likewise, in the reconstruction of the earthquake that we had in last September, we also have--there's immense opportunity there to use our Building Systems systems that we have, so we also see opportunity there. Going back to Juan Francisco, in the housing, we see that we can do a lot.

Cecilia Jimenez: Okay. Very clear. Thanks. I have a second question on the US part of the business, particularly on Capex. Do you think after the event in South Carolina plant, and taking into consideration what you're seeing in your operations at this point, is there enough favoring in the Capex you have forecasted for maybe the second half of this year and 2019? What I have in mind is roughly $30 million for 2019, and I would like to see that's the number you feel comfortable with or we should see in increase, maybe, in that share. That would be my second question. Thanks.

Juan Francisco Sanchez Kramer: Thank you, Cecilia. I will go back a little bit to what we've mentioned. It is the three-year plan for the US Cement operations. Basically, we stated that according to the plan to bring back the assets to industry standards, by doing so, being able to recover the lost market share and recover the gap that we have in terms of pricing. That plan was between $80 and 90 million in these three years. The first phase was completed in 2017. For that, we allocated a little bit more than 30 million, and the plan for 2018 is close to 25. So straight to your question, this 25 will not move. Within this 80 to 90 million, we have been able to allocate the impact of the finished mill. That was not too much in terms of Capex. It was roughly a million and a half. So the figures for 2018 and 2019 will not really move because of this.

Cecilia Jimenez: Okay. Thanks. And if I may, my third question would be on asset scale or M and A. We have Cemex just announced this morning a potential further asset sale for 1.5 to $2 billion over the next two years. So my question is, in your case, are you foreseeing any asset management within your portfolio, either selling a part of a division or specific assets or acquiring anything in the region, particularly on the Cement side or Building System Division? That will be my final question. Thanks.

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Juan Francisco Sanchez Kramer: Thank you, Cecilia. As we've mentioned, we are analyzing every business, every facility and trying to really define whether it fits to our strategy and/or it fits the potential growth that we are expecting for the full business. Because of strategic reasons, so far, we cannot disclose anything else regarding the specific businesses or geographies. So, once we reach a point where we can disclose it, we will.

Fernando Ruiz Jacques: We're focusing, Cecilia, on deleveraging. We have a 3.4 something net debt EBITDA ratio, so we're focusing on the leveraging today.

Juan Francisco Sanchez Kramer: And to the second part of your question, that was acquisitions, we are usually, again, analyzing opportunities, but for the time being, and until we reach our target of the leveraging, we will not do an acquisition.

Cecilia Jimenez: Okay. Got it. Thank you very much.

Operator: Once again, ladies and gentlemen, if you would like to ask a question, please press the star then one on your touchtone phone. We'll pause briefly for any additional questions to que.

Again, that's star then one. At this time, there are no additional questions.

I'd like to turn the program back over to CEO Fernando Ruiz for any closing remarks.

Fernando Ruiz Jacques: Great. Thank you, operator, and to all of you for your continued interest in Elementia. Before we depart, I want to make sure I leave you with a summary of the key messages that we want to convey to you.

First, we had a misfortunate event in the South Carolina cement facility that caused loss of sales and profits, but we are very close to getting it back on track.

Second, the reopening of the Indiana facility came with an implicit investment in op-ex that we are confident that it will bust the growth from 2019 and beyond.

Third, we resized our Latin American Building System structure and assets to a leaner organization, adapting ourselves to the depressed market conditions which will render savings in the second half and on and on.

And fourth, we changed the product and process technology in our Latin American Building Systems to offer a product that gives advantages to our customers and distribution network. By doing so, we stopped the procurement of chrysotile.

Our teams remain available for any further questions you might have. Have a nice rest of the day. Thank you very much.

Juan Francisco Sanchez Kramer: Thank you.

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