Elementia 3Q19 Conference Call Transcript
October 29, 2019 @ 11am ET

Operator: Good morning, my name is Chris. I will be your conference Operator. At this time, I would like to welcome everyone to Elementia's Third Quarter 2019 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. There will be a question and answer session after the speakers' opening remarks, and instructions will be given at that time. Thank you.

And I will now turn the call over to Mr. Alfonso Molina, Elementia's Head of Investor Relations and Treasury. Please go ahead.

Alfonso Molina: Good day everyone and welcome to Elementia's Third Quarter 2019 Earnings Conference Call. Joining us to today is Chief Executive Officer, Fernando Ruiz Jacques, and Chief Financial Officer, Juan Francisco Sánchez Kramer.

Please be advised that this call is for investors and analysts only. During this call, they will be discussing Elementia's performance, as per the press release released yesterday. If you did not receive this report, it's available on the company's website in the Investor Relations section.

All figures discussed today are in Mexican pesos unless otherwise stated. And all growth comparisons are related to the corresponding period of last year.

Let me remind you that forward-looking statements may be made during the conference call. This is based on information that is currently available and as subject to change due to a variety of factors. For more detail and complete disclaimer, please refer to the earnings release.

With that, I'll turn the call to Fernando.

Fernando Ruiz Jacques: Thank you. Great, thank you, Alfonso and good morning everyone. Thank you for joining us to discuss our results and recent developments.

So, our third quarter shows important highlights, including an 8% improvement in EBITDA compared to the previous quarter, higher revenues in our cement business in the US and a significant increase in net sales for our building systems business unit, also in the US. This, in a context of a challenging operating environment due to slower economic dynamics in Mexico, Central America and South America. And, likewise, weather events affected some of our US operations.

Market conditions have created challenges for our metals business unit due to high raw materials costs and availability of special grades. However, we carried out important initiatives to mitigate these effects, which I will review.

After my remarks, Juan Francisco will go through our financials and provide an update on the spin-off process.

So, let's start with our cement business unit in the US, where we registered 4% higher revenues in the third quarter versus last year, stemming from improved volume and pricing. Please bear in mind that some of this volume comes from our redundancy strategy and therefore has a lower margin than the one we produce. It's important to note that EBITDA for this business rose nearly 50% when compared to the previous quarter. Our markets in North America showed stability this quarter, following a period of increased competition that we believe has been stabilized. However, the mandatory evacuations due to two hurricane threats and several tropical storms during the period impacted our sales in the South. We are expecting our markets to stabilize in the fourth quarter and follow normal seasonality.

In terms of our initiatives to improve return over invested capital in this division, on September 27 we announced the sale of our cement assets in Pennsylvania to Lehigh Hanson. Since we acquired this plant in 2016 through the Giant acquisition, we worked to improve its sales and cost structure. However, we came to the decision that this would be the best opportunity to help reduce our leverage levels, by using these proceeds to repay debt and enable us to focus on our operations in Maine and South Carolina. This will help us achieve a better ROIC level for our core assets. We are estimating that once this transaction is fully concluded, we will increase the returns for the Cement business in the US in about 2 to 3 percentage points.

In the US, we will continue working towards increasing the profitability of our business through the optimization of our operations in the medium term. For 2020, we are expecting the markets in which we participate to remain stable despite the global economic slowdown observed and the uncertainty surrounding next year's presidential election.

Turning now to our cement business in Mexico, we observed a market contraction, mainly from slower dynamics in the economy and a sharp decline in productive investments due to the rising local uncertainty. The resulting weakness in demand and lower average prices caused our revenues for this segment to drop by 13% and EBITDA by 15% in the third quarter versus last year. Thanks to our sales strategy and strong commercial network, we were able to mitigate much of the effects from lower demand. We are expecting the trends we saw this quarter to continue for the final quarter of the year and potentially all the way through the first half of 2020.

Our cement business in Costa Rica remained stable despite a market contraction observed throughout the year. We were able to maintain our market share and our EBITDA margin at 26% for the second consecutive quarter. This business is contributing positively to our operating results and represents an important opportunity to continue with the geographic diversification.

Moving now to our metal product business, we remain focused on our efforts to stabilize the business, recover profitability levels, and generate positive cash flow. This quarter, we continued to observe a market contraction and higher raw material costs due to lack of availability of special grades. However, we are closing the gap in EBITDA through proactive initiatives. EBITDA declined 24% for the quarter on a year-on-year basis but increased close to 50% when compared to the second quarter 2019. We are also working on operating strategies that are aligned with cashflow generation.

In this context, we have a taken a number of mitigation measures that have significantly contributed to the stabilization of our results for the metal business this quarter. Some of these measures were: we continued to rationalize our SKUs with a focus on long-term feasibility, margin increase and cash-flow generation. We continued reducing inventories. We reduced our headcount in more than 10%. The contribution of our commercialized products has grown steadily since 2017 and will contribute this year EBITDA in more than $1 million. We redefined our distribution strategy during the quarter, and many, many, many other actions. We recognize that the market contraction is affecting our sales, particularly of high-margin products, and therefore our profitability. We will continue our efforts to mitigate as much of the factors we can control.

Last, but not least, in our Building System division, in the US we remain focused on achieving stability and growth. We registered a 12% increase in net sales, driven by the ramp-up of production and sales efforts at the Indiana plant. Non-recurring events, as well as the cost of the re-opening Terre Haute plant, have impacted our EBITDA line, which was down 20% in the third quarter versus last year. However, we're closing the gap and without the non-recurring effects, EBITDA would have been better than the third quarter 2018. Furthermore, we are working to increase profitability of the Indiana facility in the coming quarters.

In Building Systems LatAm, we have focused on recovering profitability as evidenced by our 110% increase in EBITDA for the third quarter versus last year. Aligned to the expectations we have shared with you, we are proud to inform you that this the fourth quarter in a row with this trend. This demonstrates the success of our changeover in technology and product portfolio simplification.

So, in summary, we will continue to work towards optimizing our product portfolios, training our sales efforts and reducing costs to improve our profitability. Under the challenging market conditions, we will rely on the strength of our brands and our team to overcome this period and be prepared to capitalize on an economic turnaround.

With this, I conclude my remarks, and now turn the call over to Juan Francisco

Sánchez Kramer for further details on the spin-off progress and our financials. So, please Juan Francisco, go ahead.

Juan Francisco Sánchez Kramer: Thank you Fernando. Let me start with the divestment of the Pennsylvania cement facility and an update on the spin-off process.

As we announced on the 27th of September, we have reached an agreement with Lehigh Hanson, a subsidiary of HeidelbergCement, to sell them the Pennsylvania asset for a gross value of US$151 million. We are waiting on the approval from anti-trust authorities, and if everything goes as expected, we believe we could execute the transaction by year-end.

As we have mentioned on previous occasions, we have conducted an asset and business analysis, and made a definition on our core and non-core ones. As a result of this analysis, the Pennsylvania facility was among the non-core. Also, as we have mentioned in previous quarterly reports, one of the main objectives for this year was to de-leverage the company. So, in line with this, the plan is to use the proceeds for the transaction mainly to pay down debt.

It is also important to mention that as a result of divestment, we will show an accounting and I repeat, accounting, negative impact, which will reduce EBITDA for the business and therefore the consolidated figures for the year, and will have also an impact on the leverage ratio.

The rationale of the divestment of these non-core assets is not only aligned to the deleveraging objective, but also to our commitment to create value to all our stakeholders. In other words, it reduces the multiple paid for Giant's acquisition from the original value and it makes it more a creative and increasing the current ROIC ratio.

Moving now to the spin-off process, let me remind you of three relevant issues first.

First, for every share an investor has in Elementia, he or she will receive a share of the new co, and therefore the controlling shareholders will be the same for both companies at the moment that we spin off.

Second, at the moment of the spin-off, both companies' shares will be valued the same, and from that moment on, the value of each company's shares will depend on the market's valuation.

And three, the current company will keep the cement business, and the new co, or spin co, will hold the building systems and metal businesses.

So, where are we in the process? Given that we are expecting to receive the proceeds from the sale of the Pennsylvania plant in the coming months, we believe it's worth waiting a little bit more to execute the spin-off, because we plan to deleverage and then the capital structure and the value that it might generate for all our stakeholders will be much clearer.

A new date for the execution of the spin-off will depend on several factors, like the date of execution of the divestments, the date of the execution of the deleveraging, the agreements with our creditors, and the information and timing that is required from regulating authorities in Mexico.

Let me now turn to our review and our consolidated figures. During the third quarter of the year, our strong performance in building systems, particularly in LatAm, was enough to offset the declines experienced in the other businesses where several factors like a soft Mexican economy and non-recurring impacts in Building Systems US.

Consolidated revenues decreased by 4% while EBITDA remained fairly the same as the third quarter of 2018. In terms of EBITDA margin, this indicator remained at the stable 15% compared to the third quarter last year, and presented an expansion of 1 percentage point from the 14% of the second quarter this year, and also reflected an increase of 7 percentage points in building systems LatAm.

We adopted IFRS 16 beginning January 2019, which increased our assets and liabilities by close to 737 million, and in the income statement, the impact is growing roughly158 million, which is reflected in depreciation.

Operating profits decreased 20% by third quarter last year, but net profit was the same as last year. Financing costs increased by 27% versus the same period of last year, mainly because during the third quarter of last year, we benefited from currency fluctuation. Without this effect, it would have been 27% lower than the third quarter 2018.

Moving on to cashflow, it was 473 million before CapEx, or 17% of the EBITDA generation. Mainly because of our working capital consumption during our examination of inventories and receivables mainly in the US operations for both cement and building systems while we begin preparations for the winter and yearly outages.

In terms of our balance sheet, 44% of our gross debt is in US dollars was 75% is at a fixed rate, which offers better stability with regard to potential fluctuations. Additionally, close to 94% of our debt is long-term. I want to point out here that Elementia's total net debt did increase slightly given the reduction in cash and cash-equivalents. Our leverage ratio considering the last twelve months EBITDA is 3.77 times, which is above our leverage ratio, which is 3.75 times, while the interest-coverage ratio remains at 2.71 times.

With this, I conclude my remarks and ask the Operator to please proceed with the Q&A session. Thank you.

Operator: At this time, if you would like to ask a question, please press * and 1 on your touch-tone phone. You may withdraw yourself from the question queue at any time by pressing the # key. Once again, to ask a question, please press *1 now.

And our first question comes from Alejandra Obregon from Morgan Stanley. Please go ahead.

Alejandra Obregon: Hi, good morning everyone, and thank you for the call and for taking my questions. I have a couple of follow-ups in the US.

First, in the cement business, I was wondering if you could elaborate a little bit more. You mentioned that volume and pricing increase, but that was on a lower margin on sales. So, if you could help us understand that, that'd be very helpful.

And then in the fiber cement business, if you could elaborate a little bit more on what are those non-recurring items that are weighing on profitability during the quarter, that would be very helpful. Thank you.

Juan Francisco Sánchez Kramer: Thank you Alejandra. Starting with the Cement US, as you know, or as we had mentioned before, we are continuing with our redundancy strategy, that is mainly having the capabilities to import cement in order to prevent not being able to supply our customers. So, for that volume, as you might imagine, we have a lesser margin than what we have from the cement that we produce. This volume is particularly going into the southeast region that we cover with our South Carolina facilities.

Now, pricewise, in the north region, it has been stabilized. If you remember we had the entrance of a competitor that is McInnis, and they took market share by reducing prices. The good news is it has been stabilized. There has been no more decline in prices, and we have been able to maintain our volumes and market share.

Going to the Business Systems US, the non-recurring effects, they are mainly through provisions that we are doing for claims and legal charges.

Alejandra Obregon: Understood. Thank you. And maybe one follow-up in Mexico, just trying to figure out if you could provide us an update on the Merida grinder. Is that still starting operations early in 2020?

Juan Francisco Sánchez Kramer: Yes, sure, thank you. The Yucatan project is on-going. We have faced a delay in the execution, so now we are expecting to begin commercial operations between the second and the third quarter next year.

Alejandra Obregon: Right. And could you remind us what's the capacity you're starting with. That's only one line, right? And you have the capability to expand it into a second line in the future, is that right?

Juan Francisco Sánchez Kramer: I mean it's a grind . . ..

Fernando Ruiz Jacques: It's a grinding, yeah. It's a grinding line. It's not a complete cement line. So, for the moment, we are working only in one cement, one grinding plant. And yes, in the future, we could build another one. But for the moment, it's only one.

Alejandra Obregon: And what's the capacity?

Fernando Ruiz Jacques: It's 250,000 tons per year.

Alejandra Obregon: Thank you. Very helpful. Thank you for taking my questions.

Fernando Ruiz Jacques: Thank you, Alejandra.

Operator: And our next question comes from Jamie Nicholson from Credit Suisse. Please go ahead.

Jamie Nicholson: Hi, thanks so much for the call. I have a couple questions about the divestiture. You mentioned gross proceeds of 151 million. I'm wondering if you have an estimate of net proceeds.

And also, how much EBITDA was generated by that business.

And then, finally, you mentioned there was some negative accounting impact, and you expect the leverage ratio for the year to go up. Can you explain that a little bit more? Thank you.

Juan Francisco Sánchez Kramer: Hi Jamie. Thank you for the question. Sure. So, as we mentioned we will, or we reached an agreement for 151 million gross. That means that there's some liabilities there that will reduce the amount for us.

On top of that, regarding your question how much EBITDA does this facility generate, what I can tell you is that it is the lesser contributor to our US systems cement and, therefore, this transaction makes the full acquisition of Giant more accretive.

Can you remind me your third point please?

Jamie Nicholson: Oh, okay. You mentioned on your comments that there were some negative accounting impacts related to the divestiture, and therefore you expect your leverage ratio for the year to increase. I think that's what I heard. So, I'm wondering if you could explain that?

And also, I didn't quite hear if you said what you expect from net proceeds?

Juan Francisco Sánchez Kramer: Okay. Yes, so let me begin by the third and go back.

What I meant to say with the negative impact on the EBITDA, is that there is a different value between book value and what we're getting, and that will create an accounting negative impact on EBITDA. And, because of that, the full year's EBITDA will be reduced, and therefore, if we consider this impact on the 12-month EBITDA, it will increase the net debt-to-EBITDA ratio.

Jamie Nicholson: Yeah, I'm sorry. So, the accounting impact, is that non-cash charge? And do you have a quantification of that?

Juan Francisco Sánchez Kramer: Correct.

Fernando Ruiz Jacques: It is a non-cash.

Juan Francisco Sánchez Kramer: It's a non-cash and the final figures for that are being concluded, so we do not have yet a final figure for that.

Jamie Nicholson: Okay.

Juan Francisco Sánchez Kramer: Your second point, on what will be the net income for us, what we are targeting to deleverage, it is between 130 and 140 million.

Jamie Nicholson: Net proceeds?

Juan Francisco Sánchez Kramer: Yes.

Jamie Nicholson: Okay, thank you. And then just-.

Juan Francisco Sánchez Kramer: It's what will be used to pay down debt.

Jamie Nicholson: Great, thank you. And then, just one final question if I may. You mentioned working capital consumption in the third quarter impacted cash flow. I'm wondering what you're expecting for the fourth quarter, if you expect to generate proceeds from working capital in 4Q, and what your outlook for cashflow is in the fourth quarter aside from the proceeds from the divestiture. Thanks.

Juan Francisco Sánchez Kramer: Thank you, yes. Good point. Yes, we are expecting to have cashflow generation from working capital by year-end. As I mentioned, we are beginning to prepare for the winter. In the US operations, we always increase inventories to prepare for the yearly outages, mainly in the cement business. And in the building systems, we also prepare with inventory for the winter.

Nevertheless, as I mentioned, there is a cumulative effect from inventories and receivables, so the plan is to reduce mainly these timed receivables and also inventories, but in other regions where we do not need them to be so high.

Jamie Nicholson: Okay. Thanks very much.

Juan Francisco Sánchez Kramer: Thank you.

Operator: And once again, to ask a question, please press * and 1 on your touch-tone phone.

Our next question comes from Elizabeth Gunning from PGIM. Please go ahead.

Elizabeth Gunning: Hi. Thank you all for the call. I had some trouble hearing the second gentleman who spoke, so, when you were discussing the spin-off, I missed actually a fair amount of your commentary. Can you just clarify now the timing? If I understood you correctly, the timing is going to be delayed until after the divestiture of the Pennsylvania asset, and you're waiting for regulatory approval. So, is the timing on the spin-off first quarter, or second quarter of next year? And when are you going to present something to creditors, so we have an idea what your company will look like?

Fernando Ruiz Jacques: So, Elizabeth, we're delaying the spin-off, given that we are expecting to receive the proceeds from the sale of the Pennsylvania asset in the coming months. So, we believe it's better to wait until we execute the divestment, and reduce the debt, to continue with the spin-off process. So, therefore, a new date for the execution of the spin-off will depend on several factors, like the date of the execution of the divestment, the date of the execution of the deleveraging, the agreement from our creditors, the information and the timing that is required from regulating authorities in Mexico. So, at least will be in the first quarter of next year. We do not see it during this year.

Elizabeth Gunning: Okay. My understanding is the equity holders have been presented with a plan already, is that correct? Or are they getting a new plan?

Juan Francisco Sánchez Kramer: Could you elaborate a little bit further?

Elizabeth Gunning: Well, my understanding was the equity holders of your company have been presented with a spin-off plan for approval? Is that correct?

Juan Francisco Sánchez Kramer: Yes, that is correct. We had a shareholders' meeting in June, that was the last one. So, it has been presented and it has been approved.

Elizabeth Gunning: Okay. It's a little frustrating being a bondholder and not knowing what's going on. It's impacting your bond prices quite a bit. It just would be helpful if we got a little more communication from you on this.

Juan Francisco Sánchez Kramer: Thank you for your feedback. We will be pleased to hold a one-to-one conference any time.

Elizabeth Gunning: Okay. I would be very appreciative. Thank you.

Fernando Ruiz Jacques: Sure.

Juan Francisco Sánchez Kramer: Thank you.

Operator: And once again, that is * and 1 on your touch-tone phone to join the question queue. And we will pause a moment to allow questions to queue. [pause]

And it looks like we got a follow-up question from Alejandra Obregon from Morgan Stanley. Please go ahead.

Alejandra Obregon: Thank you for the follow-up. Just a question in Mexico - we've been seeing a difference in bulk and bag performance. So, I was just wondering if you could provide us some color in what you're seeing and what are the trends in performance, based on these two segments. Thank you.

Juan Francisco Sánchez Kramer: Sure. Probably you remember we mentioned that we change the mix of bulk and bag in order to allocate the volume from the expansion that we did in our Tula facility. So, with that change, we went down from roughly 70% in bag to some 60% in bag. Currently, we are trying to increase the bag percentage, and we are at about 63%.

Alejandra Obregon: And in terms of performance for the industry, have you seen the bag business declining over the bulk?

Juan Francisco Sánchez Kramer: No. It has happened through history, the bag market segment is more resilient since it goes mainly to the . . .

Fernando Ruiz Jacques: Do it yourself.

Juan Francisco Sánchez Kramer: Correct.

Fernando Ruiz Jacques: It has more resilient to the Do-it-yourself, to the bad economy, no? Say it like that. So, yeah.

Alejandra Obregon: Understood. Thank you very much for taking my question.

Juan Francisco Sánchez Kramer: You're welcome.

Operator: And I would like to go ahead and turn it back to Mr. Fernando Ruiz Jacques for closing remarks.

Fernando Ruiz Jacques: Perfect. So, thank you, Chris, and thank you all once again for your interest in Elementia. As mentioned by Juan Francisco, we will keep you updated on the progress of our spin-off in the months ahead. So let me just close with these final remarks.

So, our results show that we're back on profitable growth for Building Systems LatAm and CementUSA, and that we have been able to improve our business unit results and develop strategies and alternatives to turn headwinds into opportunities in a constantly changing and challenging environment. We are aware about the challenges we're facing, not only in this environment, in particular for the metal business. So, we will remain steadfast in our commitment to develop innovative solutions that generate higher value to our investors and stockholders, maximize the company's value and increase our focus on better service to our customers.

So, having said that, that concludes our call. So, please feel free to contact me or Juan Francisco if you have any further questions.

So, have a nice rest of the day. Thank you.

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