ELEMENTIA 2Q20 Conference Call Transcript
July 29, 2020 @ 9:00am CT

Operator: Good morning. My name is Leo and I will be your conference operator at this time. I would like to welcome everyone to Elementia's second quarter 2020 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 speaker's opening remarks and instructions will be given at that time. Thank you.

I will now turn the call over to Mariana Agüeros, Elementia's Head of Treasury and Investor Relations. Please go ahead.

Mariana Agüeros: Good morning, everyone. Welcome to Elementia second quarter 2020 earnings conference call. Joining us today is Chief Executive Officer, Jamie Rocha, and Chief Financial Officer, Juan Francisco Sanchez Kramer. Please be advised that this call is for investors and analysts only. During this call, they will be discussing Elementia's performance as to the press release issued yesterday. If you did not receive the report, it is available on the company's website in the Investor Relations section.

All figures discussed today are unaudited and in Mexican pesos unless otherwise stated. All 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 is subject to change due to a variety of factors. For a more detailed and complete disclaimer, please refer to the earnings release.

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

Jaime Rocha: Good morning, everyone. And thank you for joining us today. I'm honored to be here with you in my new role as CEO of Elementia. As many of you know, I have been with the company for the last five years, leading the Cement Division, and my entire career has been dedicated to this industry.

Fernando Ruiz and I have been working these past two weeks to ensure a smooth transition and also with the Board to define my mandate to drive Elementia forward. I recognize and thank Fernando who left us 12 years of dedication, dreams and passion.

For me, leading Elementia under the current environment is a challenge as well as a tremendous opportunity to maximize Elementia's many strengths and fulfil our Board's mandate: result driven, customer centered, clean, and efficient execution. We operate in attractive markets for our industry, and with the right execution, I am confident we will generate better results.

Let's take you through the specific strategic objectives we plan to carry out. First, simplify corporate functions and increasing our client focus, strong and empowered local management teams. Second, no setbacks. We will keep a lean operation by reducing costs and expenses and by making efficient use of the resources we have available. Third, maximize capacity utilization in order to drive operational efficiency. Fourth, capitalize our strong commercial and distribution networks. Fifth, remain financially prudent in our leverage and maximize cash generation.

Our performance during the second quarter demonstrates the strong viability of our business. In our key markets where our operations were deemed essential, mainly the US and Mexico, we had very solid results for the cement business, outpacing the market. Cement US registered 30% revenue growth compared to last year, driven by a 5% increase in sales volumes supported by our commercial strategy. We achieved 54% increase in EBITDA, mainly stemming from lower costs and expenses. In line with seasonality, revenues and EBITDA increased 38% and 475%, respectively, versus the first quarter of 2020.

Cement Mexico achieved good results. Despite economic slowdown, an increase of 1% in volumes and revenues compared with the same quarter of '19, while EBITDA grew 1%, mainly due to cost and expenses rationalization and a successful commercial strategy. When compared to the first quarter 2020, revenues and EBITDA increased 3% and 8%, respectively.

Cement Costa Rica registered a 9% increase in revenues despite a 10% decrease in volume sold, but a 26% EBITDA growth mainly due to better pricing and cost optimization. The second quarter showed a 10% increase in revenues and 21% in EBITDA compared with the first quarter.

Moving to the metal division, due to the slowdown in the economy in industrial sectors, volume fell 26%, leading to a 17% contraction in revenues when compared to the second quarter of 2019. Nevertheless, EBITDA was 2% higher, mainly due to cost optimization and SKU rationalization. During the quarter, we had a one-time and non-cash charge of close to Ps. 100 million for balance sheet adjustments.

As a result of strict focus on cash flows, we managed to bring down inventories compared to the first quarter, mainly driven by the optimizing the conversion cycle and being more selective on SKUs, focusing on higher value. The second quarter showed an 8% decline in revenue, but on the positive side, a 2% increase in EBITDA versus figures of the first quarter due to cost optimization.

Turning to our building systems division, Building Systems US market dynamics were lower mainly due to fewer new housing permits despite the fact that builders kept backlogs to fulfil. As a result, with the site temporarily shut down, three of our four facilities from the end of April to mid-June and used the inventory to supply the market. As a result, we reduced our inventory by close to 18%, but revenues for the quarter show 12% increase driven by an average price increase related to higher value products despite the 9% volume decline. However, EBITDA was negative 18 million pesos mainly to the legal fixed cost absorption and therefore a strong increase in the cost of sales. The facilities of Oregon and North Carolina resumed operations by mid-June, but the Indiana facility remains idle for the time being.

Moving to Building Systems LatAm all operation except for Mexico and Costa Rica were locked down due to governmental restrictions beginning in mid-March. Colombia and El Salvador resumed operations in mid-June, but Ecuador, Bolivia, and Peru remain under lockdown.

As a result, revenues decreased 25% led by 39% decrease in volume, which some parts compensated by higher average prices related to our focus on higher value products. Nevertheless, mainly because of the almost zero fixed cost absorption and the impact of severance costs, EBITDA was negative by Ps. 71 million when compared with the first quarter of '19, revenues decreased 23% and EBITDA 254%.

I will now turn it over to Juan Francisco for an update of the spinoff and cement sale as well as our successful execution of the financial initiatives we put in place.

Juan Francisco Sanchez Kramer: Thank you, Jaime. Before going into the figures, let me try to summarize both the impacts and actions we have taken related to the COVID pandemic. During the quarter, we better managed our cash level and achieved a cash position increase of $85.6 million coming from $56.5 in the first quarter to reach $142 million by the end of the second quarter.

As we mentioned in the first quarter report, we established a cash flow generation strategy that we successfully executed since mid-March. The strategy was based on A, credit; B, working capital; and C, cost and expense optimization.

Let me walk you through the achievements. First, we reduced our cash use by $25 million through negotiations with our creditors in which we get payment extension from both long-term and working capital facilities. In terms of the long-term loans, the extension was being spread out in the remaining life of the facilities in order to keep a comfortable maturity profile.

Second, we optimized close to $45 million in working capital. The main optimization came from inventory reduction, accounting for 152% of the total optimization. And the rest came from accounts receivables and payables where we carefully aligned procurement through demand and production.

Third, we increased our gross debt by roughly $9 million from new facilities and regular amortizations. Less than $2 million were from a domestic facility in Bolivia and the rest mainly as part of the negotiations with our creditors for working capital.

Let me elaborate a little bit more on this since there was some confusion in our first quarter call. In summary, we no longer have a committed credit facility. The one we used to have was cancelled at the beginning of the year. On top of it, we have two uncommitted credit lines, one for $15 million, one five, that we already pulled since the first quarter. And the other uncommitted credit line for $50 million, five zero, that we have not used. Again, these two lines are uncommitted.

Fourth, we have done strong cost and expense reduction that spans from reducing and cancelling services from third parties to headcount reduction. This strategy came with severance costs of more than 110 million pesos, but it will deliver more than 230 million pesos of savings on an annual basis. This cash improvement is key to position the company in a much better shape to tackle the potential headwinds that the pandemic might cause for the rest of the year.

Moving on to the spin of process, there is not really any news from the first quarter report. In summary, it has been postponed waiting for the right market conditions.

Now regarding the divestment of the Pennsylvania cement facility in the US, it is still under the examination process by the anti-trust authorities. We believe that the resolution may be released by the end of the third quarter, and therefore, the transaction may be executed within the fourth quarter. The use of the proceeds remains unchanged, which is to deleverage the company. Out of the $151 million, we are planning to use between $130 to $140 million to reduce debt.

Moving now to results of the second quarter, I will begin with the consolidated figures. In the quarter, revenues were 2% lower than the same quarter of 2019 mainly because the market contraction caused by the pandemic either coming from government resolutions to lockdown or because market dynamics changed. The 30% increase in sales between Cement US and 12% Building Systems US helped mitigate the declines in Metals and Building Systems LatAm.

Consolidated EBITDA showed a 26% decline. The growth shown in Cement Business Unit was not enough to compensate the decline in Building Systems, mainly due to the impact from COVID coming from the demand contraction and much lower fixed cost absorptions mainly in Metals and Building Systems; and close to $210 million from one timers related to head count reduction and balance sheet cleansing in Metals.

Financing costs was 38% lower than the same quarter of the last year, mainly because of rate reductions on one of the currency swaps of the bond and foreign exchange rate gains.

Moving on to cash flow, before CAPEX, it was more than 1.1 billion pesos, 22% higher than the first half of 2019 despite a 25% lower income mainly because of the strong working capital optimization, lesser interest paid, and higher cash taxes coming from the first quarter related to an end of the fiscal deconsolidation program in Mexico that was previously reflected in deferred taxes. As a result, free cash flow was a generation of close to 1.5 billion pesos.

In terms of our balance sheet, we have impact from the currency fluctuation to several accounts like other receivables and other current assets, property, plant and equipment, net, long-term debt, and other assets and liabilities. The short-term debt was reduced by 48%, mainly because of the negotiations reached with our creditors for the payment exemption and therefore the long-term debt increased. Assets and liabilities held for sale, regarding the divestment of the assets of the Pennsylvania cement facility are shown in other current assets and other current liabilities.

Let me finalize with an update on the class action lawsuit in Building Systems US. The main highlights are: 1 - contrary to the allegations in the litigation, fly ash is not used as an additive in Allura's siding, nor is it used in the siding belonging to many of the products filed in the lawsuit. 2 - while fly ash is used in some fiber cement products and performs well, Allura has not used fly ash as an additive in its formula since 2015. 3 - it is our belief that the product mentioned in the lawsuits is either product not containing fly ash or product that was produced prior to March 2015, and distributed mainly from the North Carolina facility. 4 - we expect to be able to reach a formal settlement agreement during this year. And 5 - the settlement in principle is for $12.5 million and the timing may be completed by 2021.

Before concluding my remarks, I'd like to reiterate that the main targets for the second quarter were cash flow generation, and in consequence, an improvement in the cash position to secure the liquidity of the company. I am to inform that the mission was accomplished in the midst of the pandemic. With this, I conclude my remarks.

Jaime Rocha: Thank you, Juan Francisco. Before we take your questions, let me walk you through our expectations for the rest of the year for each of the businesses.

Starting with cement in Mexico, we expect the construction industry, especially industrial, to recover in the second half by about 10% compared with the first half. Notwithstanding the industry will remain negative this year compared to 2019. We are confident we will generate positive sequential results from our solid customer base, focus on self-construction segments, government infrastructure projects, and financial discipline. In the last quarter of this year, with Merida will initiate operations.

In Cement US, we expect to continue our strong result pinned to the recovery of the construction sector in all key markets. We will remain focused on attracting customers and further reduce costs and expenses to keep our positive results on track.

Cement Costa Rica will likely end the year flat versus last year as we expect the slowdown in the economy. Our strategy will be to continue rationalizing costs and expenses while maintaining the high-profile of our brand.

Turning to Metals, we expect a gradual recovery of volume for the remainder of the year and into 2021, with the seasonal bump of the fourth quarter. Our SKU rationalization, focus on higher value products and cost and expense optimization will deliver positive results for the second half of 2020 versus 2019.

Lastly, in Building Systems, first with the US, the reopening of three of our four plants by the end of the second quarter of 2020 will help us take advantage of the recovery in demand with the reopening of the markets in which we operate. We expect Building System LatAm to recover in the second half given many of our markets remain under lockdown during the second quarter.

In summary, the results of this quarter, which was at least complex make us confident in the prospect for Elementia through the recovery phase. The initiatives we carried out have left us lean, more efficient and more financially sound to capitalize the opportunities we have identified.

Melanie Carpenter: That concludes management's remarks. Operator, we're ready for the questions.

Operator: Thank you. At this time, we will open the floor for your questions. First, we will take the questions from the conference call and then the webcast questions. If you would like to ask a question, please press the star key followed by the one key on your touchtone phone now. If at any time you would like to remove yourself from the question queue, just press the pound key. For webcast participants, simply click the question box on the webcast player. A popup window will appear and then simply type your question in the box and click send. One moment while we queue for questions. And once again, that is star one.

We'll take a question from Alejandra Obregon of Morgan Stanley. Your line is open.

Alejandra Obregon: Hi, good morning, Elementia team. Thank you for the call. And Fernando, thank you for the collaboration all this time. And Jaime, congratulations on your new role.

Two questions on my end, first on US pricing, if you could just please provide some color on that 24% price growth reported during the quarter. What regions could be driving this, more specifically? And second in Mexico, it seems that profitability reported during the quarter implies some higher costs if we think of it on a per ton basis - just compared to what we've seen in the past so if you could give us some color. Could this be associated to lower fixed cost dilution, transportation costs? Any color here would be very much appreciated. Thank you.

Jaime Rocha: Okay I'll take these. Thank you for the question. First of all, US pricing, talking about cement, we had some increases at the end of the first quarter, probably marginal in terms of absolute numbers. We're talking about $2-3 dollars for the market for short ton sales.

And for the second question, our main savings on cost for Mexico were because of fuels because we use petcoke as a main fuel and the price dropped about 20%. And despite of the increases in energy, for example, like in electricity, we have reduced our variable costs. In terms of fixed costs, we are constantly rationalizing the fixed cost. We had this restructure also in some areas of the company. So in general terms, it's what we did and that's why we reduced costs in general.

Alejandra Obregon: Thank you and maybe just a follow up, in Mexico could you please provide some color on how the bulk versus bag mix is looking? Has that changed in the last quarter?

Jaime Rocha: Okay. I would say that it has been an increase in the bag market compared to the bulk market because of the slowdown in the industrial sector. That's clear. And in our case, it has not been maybe the case because we have been working strongly in infrastructure projects. It has kept our percentage of bulk compared to bag in about a 40/60 ratio. But in general terms, the market for sure had a change in the mix, and now maybe we're talking about instead of 60/40, maybe we're talking about 65/35 or maybe even 70/30.

Alejandra Obregon: Understood. Thank you very much.

Jaime Rocha: You're welcome.

Operator: And once again, that is star one to ask a question. And there are no questions over the phone so I'd like to hand the call to Melanie Carpenter for any web questions.

Melanie Carpenter: Okay. Great. From the webcast we have a question saying on cement, how are you able to grow 1% volumes in Mexico? Could you give us more color on that? And in the US, after all the operational restructure, do you have an EBITDA margin in mind? Should we think industry like around 20%? And on construction systems, why does the class action provision increase? How much until now have you provisioned?

Jaime Rocha: Okay. Thanks for the question. First of all, about Mexican cement volumes, there is mainly four reasons. I would say first, the business continuity. We have been declared essential. That's maybe the first one. So we have been open for the full quarter. Then the second one is the high profile of our distributors. The third one would be our market coverage is focused on the central region of Mexico, and I would say this was the least effected. And last is that we are the main ready-mix supplier at the New Mexico City Airport works. So all this together helped us to keep our volumes from last year.

Then the second question about the margins in the US, I'm rather confident that in the medium-term, we can achieve this 20% EBITDA margin at least in the quarters where we have positive weather conditions, like it's the second and third quarter. Maybe it's going to be difficult to get to the 20s in the first and fourth quarter because of weather conditions. The seasonality in the US is quite strong. But what is clear is that we can achieve this 20% as we got it in June, for example.

And the last question about the class action, I will turn it to Juan Francisco.

Juan Francisco Sanchez Kramer: Thank you. So, regarding the class action, as we mentioned, we are very close to get a final settlement, and the total amount for the settlement is $12.5 million, out of which we roughly have in position already $4.3 million. Regarding the covenant situation, also as we mentioned, the net debt to EBITDA ratio by the quarter end is 4.83 times and the waivers have been requested as usual.

Melanie Carpenter: Okay. And then there's a follow up for Juan Francisco to review the amount of the credit line. Is it possible that that amount could be decreased? And then do the covenants with the banks have cross-default clauses? Are those covenants of maintenance or incurrence?

Juan Francisco Sanchez Kramer: Okay. So first of all, the credit lines are uncommitted so they can change at any time. And they are not obliged to give it to us. So even though the amount is the same in concept, in the reality, it might be less than that or none at all. That is very important. Nevertheless, it is still under review and it is still there. Regarding the covenant clauses, they are cross-default, and we have already the waivers for that.

Melanie Carpenter: Okay. We have one more in the webcast. They're asking what is the outlook for leverage for the rest of the year? And can you remind us of the covenant limits after your negotiations with creditors? Do you think these results will prevent a rating downgrade?

Juan Francisco Sanchez Kramer: Okay. So the negotiations with the banks were in terms of getting a defuse of the payment of the principal for six months of this year. And these amounts were spread out in the lifetime, the remaining lifetime, of the facility. So there is not a big impact on the future amortizations. That is for the long-term facilities.

Within the negotiations and for the negotiations, of course, we shared with the banks what we see for the year and some more quarters, and so we are all aware that we are above covenants and because of that, we have already requested the waivers. Nevertheless, it will be done in a quarterly basis as usual. And the outlook is as we have come down from more than five times to 4.8; we believe that the trend will be positive for the year end and we will continue lowering the rates, of course not to the level that are our target, that is 2.5 or 2 not this year, certainly.

Melanie Carpenter: Okay. I believe that takes care of the questions from the webcast. Leo, if you want to requeue for any more questions, please.

Operator: Certainly. Once again, to ask a question, please press star one on your touchtone phone.

We'll take that question from Reuben Weislogel of JP Morgan Asset Management. Your line is open.

Reuben Weislogel: Hi, guys. Thanks for the call and for taking my question as well. Quick question on the proceeds from the asset sale, both the timing and the conviction around how that might come into the company.

Jaime Rocha: Juan Francisco, will you take this?

Juan Francisco Sanchez Kramer: Yes, sure. So as we mentioned, the proceeds or the total amount of the asset sale is $151 million, out of which we plan to use most of it to deleverage the company. That has been the target for these proceeds since the beginning. So roughly between $130 and $140 will be used to pay down debt. The timing, as we mentioned, we believe that the release from the authorities will be achieved by the end of the third quarter and so the transaction might be executed in the fourth quarter.

Reuben Weislogel: That's helpful. And do you guys have a high level and conviction that that timing is realistic given what's going on, or do you see some likelihood that that could easily be extended into 2021?

Juan Francisco Sanchez Kramer: No, we are confident on this timing. We have had discussions with the FTC and we are confident on this timing.

Reuben Weislogel: Great. Thank you.

Operator: And there are no further questions on the phone lines. I'd be happy to return the call to Melanie Carpenter for any webcast questions.

Melanie Carpenter: There are no more questions on the webcast so I am going to turn it back to management for their closing remarks.

Jaime Rocha: Thank you, operator, and thank you all once again for your interest in Elementia. I would like to thank again our shareholders and creditors for supporting us throughout these challenging times. Please feel free to contact me or Juan Francisco if you have any questions. We hope that you and your family stay safe and have a nice rest of the day.

Melanie Carpenter: That concludes their remarks. Leo?

Operator: Thank you. That does conclude today's Elementia 2Q 2020 earnings conference call. Everyone, have a good day.

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