WEG S.A.
3rd Quarter 2018 Earnings Results Conference Call
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Transcript of the simultaneous translation from Portuguese into English

CORPORATE PARTICIPANTS

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Mr. Paulo Polezi – Finance and Investor Relations Officer

Mr. Wilson Watzko – Controller Officer

Mr. André Salgueiro – Investor Relations Manager

PRESENTATION

Operator: Good morning. Welcome to the conference call of WEG to announce the results of 3Q 18.

Today we are transmitting this conference call along with the slide pack at the address ir.weg.net and after completion and audio will be available in our investor relations website. Should you need any assistance during this conference call please request the help of an operator by pressing star zero.

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With us today in Jaraguá do Sul are André Luís Rodrigues, Chief Financial Administrative Officer; Paulo Polezi, Finance and Investor Relations Officer; Wilson Watzko, Controller and André Salgueiro, Investor Relations Manager at WEG.

Please Mr. André Rodrigues you may proceed.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Good morning everyone. It is a pleasure to be with you once again for the conference call of 3Q 18.

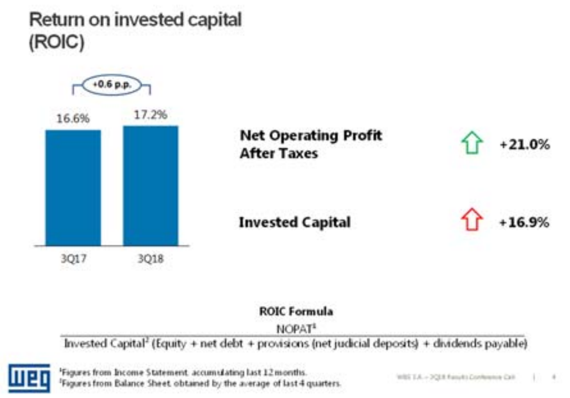
Starting with the highlights of the quarter the first point I would like to highlight once again the strong growth in revenue of 33% in the consolidated results; the growth in the domestic market was 36% driven especially by greater share in our solar generation business by the recent acquisition of steam turbines TGM and by the gradual improvement of the revenue from the transformers business.

Internationally our growth of 30% is still concentrated on the sales of short cycle equipment. As seen in the previous quarter we are already seeing some opportunities for projects that require long cycle equipment.

Additionally this performance was also favored by recent acquisitions and FX variation. Excluding the impact of acquisitions and considering the performance only in local currency the growth was 6%.

The second point was a 26% growth in EBITDA as compared QoQ. EBITDA margin closed the quarter at 15.1%, practically stable as compared to 2Q 18; but was below the margin of 3Q 17 because of a recent acquisition, the new businesses and the impact of FX variation in the cost of raw materials. Paulo is going to show you more detail about this.

And in closing once again I would like to highlight the generation of operating cash that reached 910 million YTD and the growth of ROIC, our main indicator.



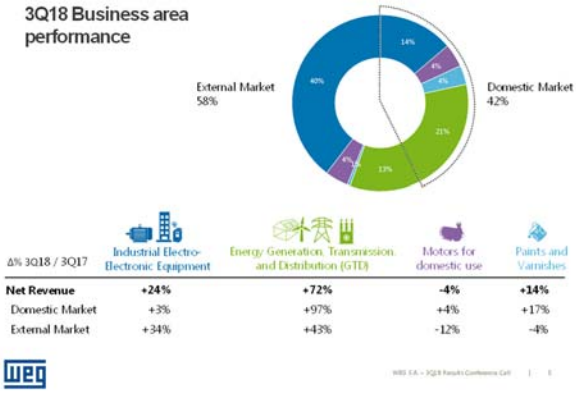
Now moving to slide four we provide more details on our ROIC, which presented a growth of 0.6 p.p. as compared to 3Q 17 reaching 17.2%. The growth in the operating profit after taxes is explained by the growth in revenue and improvement in operating performance.

This growth more than offset the growth of the capital invested that was required to support business growth, both through recent acquisitions and also by our investments in working capital, fixed assets and intangibles that we made over the past 12 months. The consistency of this indicator along the year is an evidence of our strategy of the development of new businesses, which although they have structurally lower margins have an interesting return on invested capital.

Now I would like to turn the conference over to Mr. Polezi.

Mr. Paulo Polezi – Finance and Investor Relations Officer

Good morning everyone. Now on slide number five you can see the evolution of the business areas in the different markets.



In the area of industrial electro electronic equipment in Brazil the sales of short cycle equipment keep their up trend; on the other hand the long cycle equipment sales, especially automation panels, have demonstrated a slight decrease comparing QoQ thereby justifying the growth in this quarter, the smaller growth in this quarter.

Solar generation business was the highlight. Now there are four recent solar projects added to our portfolio.

Another highlight in GTD was the improvement in performance in the transmission and distribution business, which already indicated some improvement with more orders in our portfolio. Additionally, since March we have been consolidating our TGM operation, the company of steam turbines in this business area. In engines for domestic use there has been a slight growth in revenue as a consequence of the consumption dynamics in Brazil, which did not show significant recovery as compared to last year.

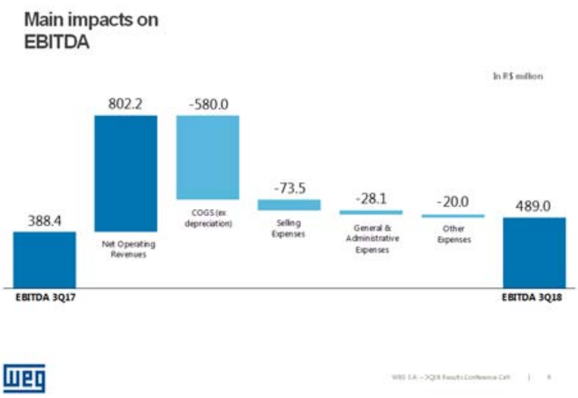
Our performance in the coating business reflected the performance of industrial and consumables market, which presented a recovery in the past few quarters.

Internationally the highlight is still the area of electro electronic equipment, where the growth is driven by short cycle products. Additionally as we mentioned in previous quarters we have observed projects for capacity increase and construction of new factories, which also demand long cycle products especially in industries related to oil and gas, pulp and paper and mining.

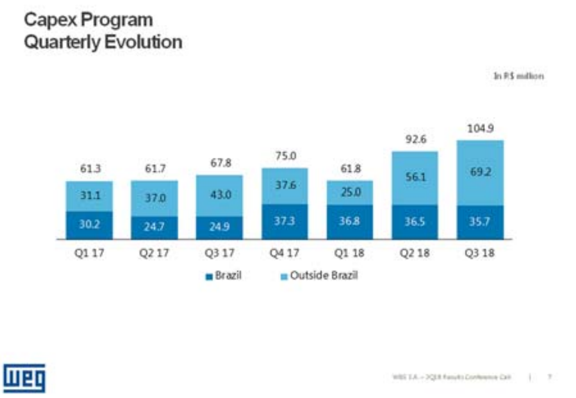
In the area of GTD the main contribution was the transformers business which presented a growth in all our operations overseas, with a highlight for the consolidation of the new transformers company in the United States.

In domestic use engines revenue has presented a slight drop especially because of fewer orders being made in the local market in China, added to the weak performance of the operation in Argentina, which is suffering the consequences that their local economy is dealing with.

In coatings our revenue in the international market also reflected difficulties in the economic scenario in Argentina, our main market outside Brazil.

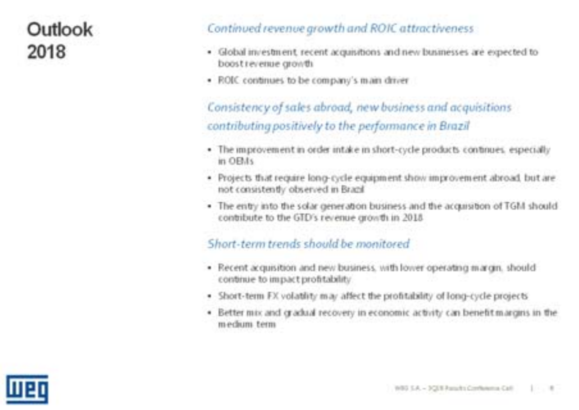


On slide number six you can see the evolution of EBITDA in 3Q 18, where the highlight was the growth in revenue. EBITDA grew 25.9% as compared to 3Q 17 with a margin of the 15.1%. As André mentioned the performance was practically stable as compared to 2Q 18, but was below the margin that we had in 3Q 17 especially as a consequence of the impacts of the acquisition of WEG Transformers in the USA and the fast growth of new businesses, such as solar generation, which have lower operating margins and also the impact in the short term FX volatility on the cost of materials of our long cycle projects.



Finally on slide number seven we show the investments of recent quarters. In 3Q 18 investments amounted to 105 million BRL, 44% allocated for Brazil and 66% for our manufacturing units overseas. We should highlight that the recovery of the market behavior gradually requires more and more disbursement for the expansion and modernization of our production capacity.

Now I finalize my part and I turn the conference back over to Andre Rodrigues.



Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Thank you Paulo. Before we move to the Q&A session I would like to highlight a few points. First of all as we recently mentioned in our call our ROIC is one of our main drivers for 2018 along with the revenue growth. In the foreign market the recovery of sales is consistent and the industrial production has been growing in the main global markets. Additionally important industries continued their trajectory of recovery with the emergence of opportunities in the projects involving long cycle equipment.

In Brazil on the other hand the solar generation business, the acquisition of TGM and the recovery of the economy will continue to contribute for our growth in revenues in 2018.

Lastly, we continue to pay attention at the short term oscillations, where the recent acquisition of new businesses and short term FX volatility may impact our profitability; but then on the other hand the improvement in our mix of sales and a gradual recovery of economic activity in Brazil may have a positive impact in our midterm businesses.

Now we are moving to our Q&A session.

Q&A Session

Operator

Ladies and gentlemen we are now going to start our Q&A session. If you want to ask a question please press star one and if you want to take your question off the list please press star two.

Our first question comes from Lucas Marchiori from Safra Bank.

Mr. Lucas Marchiori – Safra

Good morning thank you for the call. I have two questions to ask, the first on the portfolio of solar products. Could you give us an update of the value, the current value of this portfolio and when we are going to start seeing the delivery of solar products domestically? I would like to have more detail about the size of this portfolio.

The second point as Polezi mentioned domestic or home appliances and I would like to understand more about China. Argentina is very clear; the fewer orders that you are getting from China is this related to Pres. Trump commercial war? What is it?

Mr. André Salgueiro – Investor Relations Manager

Hello Lucas good morning this is Andre Salgueiro and I will answer about the solar business and then we will answer about the home appliances market. The solar business as we said from the beginning of the year we expected the revenues to be between 500 and 600 million BRL. I think we are more close to the high, closer to 600 million.

In terms of solar farms there was a new project, a new solar farm that was added, this is a new project added to our portfolio and we are looking to an amount of 240, 250 million BRL in the portfolio for solar farms. About 80 million more or less possibly this year and the rest for next year and I think that the additional information is that here we are already talking about solar farms, and additionally we have distributed solar generation, which is more recurring and this is keeping the same key tone with a significant growth as compared to last year.

Mr. Lucas Marchiori – Safra

How big is the distributed portfolio? Can you share that with us?

Mr. André Salgueiro – Investor Relations Manager

Well it is really a short term portfolio. They come in all the time. So it does not make you really sense looking at it because it is a very short term portfolio. What we estimate for this year is that revenues from distributed solar would be around 100 million BRL for this year, it is closer to 150 and it is growing.

Mr. Paulo Polezi – Finance and Investor Relations Officer

Good morning Lucas this is Paulo Polezi answering your question. Talking about home appliances in the international market, as I mentioned in the call in fact there are two factors which are not really helping us this quarter: number one is China and a little bit more detail about what is going on in China. We are dealing with stronger competition especially in the Chinese local market and we need to accommodate our market share in China.

To offset that we are trying to develop differentiated products with higher value-added trying to differentiate our brand in the local market. At the same time we also need to remember that there is a devaluation and this decrease is the competitiveness of our products.

And lastly in China there is a quite strong trend of globalization of the platforms and also higher efficiency of products, and we also have the intention of advancing in that direction to mitigate this fiercer competition that we have there. It is not now only; it is since the beginning of the year.

Also internationally we should remember our businesses in Argentina. If you are not really familiar we have a manufacturing plant there for home appliances, especially kitchen appliances engines. So the combination of these two factors are making our performance more difficult in this area.

Mr. Lucas Marchiori – Safra

In China it is not related to the limitation of the importing of home appliances by the US from China?

Mr. Paulo Polezi – Finance and Investor Relations Officer

We are not seeing that. No we are not.

Operator

Our next question comes from Marcelo Inoue from Citi.

Mr. Marcelo Inoue – Citi

Good morning thank you for allowing me the question on Capex. My question is about Capex. Your Capex, your quarter Capex was around 60, 70 and now it is closer to 100 million, a significant increase, almost 50% increase in your Capex. This level of Capex reflects your recent acquisitions; but I would like to understand how much of this increase was related to the Capex for the new assets and could you talk about what you expect for

Capex from now on in terms of region and segment? Thank you.

Mr. André Salgueiro – Investor Relations Manager

Marcelo thank you for your question this is Andre Salgueiro. Capex has in fact increased slightly this quarter with two main impacts: number one is that we have come to the final phase of our casting process and Mexico and so we are now expecting more expenses for that project and there is a strong component of FX variation. So most of the Capex is done overseas and when we look at it in BRL there is an impact of FX variation that affects especially this quarter.

Now looking into the next year we are still in the budgeting phase and so we do not have a final number; but it is natural to assume because of the completion of Mexico casting we are going to have a level slightly above the level that we had this year.

Mr. Marcelo Inoue – Citi

Thank you Andre.

Operator

Our next question comes from Alexandre Falcao from HSBC.

Mr. Alexandre Falcão – HSBC

Good morning everyone. I imagine you must be working very hard in designing your budget for next year. Could you give us a little bit more color about your main lines and if you have a growth that is above what the market is expecting for Brazil? What are you expecting for the growth in Brazil and could you tell us more about Mexico as your casting plant is ready and Mexico? So what should we expect in terms of volume and improvement and mix and margins in Mexico? Thank you.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

This is Andre Rodrigues talking. So we are defining our budget and so not everything is precise for next year, especially with everything we are going through in Brazil recently. We are slightly more cautious before we disclose our numbers for next year.

But just to give you a slightly more color there are a few things we can mention. Number 1, WEG's mature businesses if the economy keeps on developing and everything evolves positively and naturally WEG's mature businesses will be likely to present a better performance than the one we had this year. Another positive aspect that we were finalizing is that our T&D portfolio will be better than it was last year as we could see in this quarter, as we mentioned this year. If our T&D portfolio may have a better performance one thing that always gets our attention is that we need to be careful in a comparison basis for GTD especially in terms of wind. Our portfolio in 2017 and 2018 is similar; but we are expecting a reduction of that portfolio and another point that we need to pay attention to is that new businesses, solar this year, TGM acquisition, WTU that did not have a comparison basis in the previous year will have the comparison basis next year.

So we need to observe all of this and we are in this process of defining what we can expect for 2019 and then we may have more precise information once we finish that. As to our casting business and the completion of our investments in Mexico, with this investment in Mexico we are going to get the last phase of our verticalization strategy in Mexico. So it is much more an investment to increase competitiveness or become more vertical, and what we expect from that is a better structure for product cost and an optimization that may come from working capital when we talk about inventory, because today engines are produced in Brazil, sent to Mexico and they get to the production. Once we have the casting business and Mexico we may have that, too.

Mr. Alexandre Falcão – HSBC

So could you talk about the installed capacity? If you have the demand, a demand shock or you are ready for that how much idle capacity you have today to absorb growth and how much investment would be required?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Another thing that we always mention is that we are modular and this is one our competitive advantages. We can accommodate demand without much investment in Capex.

When we talk about short cycle businesses we have been disclosing that we are close to the ideal capacity, we are almost full capacity everything that is short cycle; and in our long cycle businesses we still have some way to go because of everything that happened with the crisis in Brazil. The good news is that 2017 was better than 2016 and 2018 is no better than 2017 was and our expectation, excluding once again the wind, we are likely to improve that next year.

So short cycle when I say that we are almost full capacity for the long cycle we are around 70%, 90% depending on what we are talking about. So in terms of a better recovery than we are expecting no problems for short cycle and either for long cycle, because we can add capacity very fast without much Capex investment. So long the recent years I think we have clearly demonstrated that in the way that we operate.

Mr. Alexandre Falcão – HSBC

Thank you very much.

Operator

Our next question comes from Thiago Casseb from Credit Suisse.

Mr. Thiago Casseb – Credit Suisse

Good morning everyone thank you for the question. Talking about oil and gas in Brazil with the recent scenario you see good prospect in the domestic market in Brazil because of oil and gas investments?

Mr. André Salgueiro – Investor Relations Manager

Hi Thiago this is Andre Salgueiro answering. We had auctions late last year, they were very successful. So we have an outlook of investment in oil and gas in Brazil thinking in a five-year time and with think that this is going to be significant; but they are more meat and long-term opportunities. We are not seeing for charities for 2019 for example. So it is something for late 2019, 2020.

I think that the only thing that is worth mentioning is the change in the market. In the past there was very strong concentration in local players and now we have international players and we still pay attention at competitiveness and how we are going to take part in those processes.

But I think we have proven along the years that we have products, technology and competitiveness in terms of cost to be involved in oil and gas projects anywhere in the world. So if it is in Brazil this helps us, too.

Mr. Thiago Casseb – Credit Suisse

Thank you very much Andre.

Operator

Our next question is from Rogerio Araujo from UBS.

Mr. Rogério Araújo – UBS

Hi thank you, thank you for the opportunity. I have two questions, the first one regards GTD in Brazil. We have seen very strong growth, much greater than we were expecting and we tried to do the math of what explains solar. The solar part is less than half. We had 88% organic growth in GTD and in solar it is half of that and the other half is difficult to explain.

You mentioned when the power hello⋯ In 3Q 17. If you could give us more detail about GTD investments and what explains such a significant growth this would be very helpful, then that was my first question thank you.

Mr. Paulo Polezi – Finance and Investor Relations Officer

Rogerio this is Polezi answering. Giving a more details about the numbers in terms of GTD we had to record revenue in this quarter, it was about 670 million BRL and then I am talking about 97% QoQ according to our calculations and I think that the difference between my number and yours is TGM.

So number one solar plants and also distributed generation as part of the growth 40% is explained by the solar businesses; and number two in terms of relevance we have the expansion of our sales in T&D about 25% and then what explains this is an increase in sales, especially in projects for renewable energy; and then the improvement, we have better orders in our book for power; and then number three we have wind about 10% for wind and as a reminder in 3Q LY there was an interruption in a project that we were delivering; the last 10% TGM that explains part of this growth. And I think with these elements we can explain to you the reasons for this significant growth in this quarter.

Mr. Rogério Araújo – UBS

Thank you very much Paulo this is very clear. My second question regards WEG Transformers. Could you tell us about the turnaround? Have you broken even? What is the turnaround in future quarters? How much is it contributing for a reduction in margin and is this pressure going to be relieved over the next few quarters?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

This is Andre Rodrigues answering your question. This pressure is going to go down in future quarters. Yes all action plans that we have been developing to improve margins and the growth of the unit they are in line with what we were developing and this year what we did not expect was to have an internal inflation that was as high as we had in the US as you have been seeing the higher steel prices and other raw materials. This internal inflation that was higher led to a result that was below our expectation; but what we are doing in concrete terms we are renegotiating prices and together with all actions that we are already implementing and is that in the future we will be able to reverse slightly faster our performance and then we were expecting that it happened strongly this year.

Mr. Rogério Araújo – UBS

Thank you very much.

Operator

Our next question comes from Marcelo Motta from JP Morgan.

Mr. Marcelo Motta – JP Morgan

Good morning everyone. I have two questions to ask. Number one when we look at your margin as we mentioned during the presentation there was some pressure because of the devaluation of the currency, raw materials prices. How much is in fact of FX, of the mix? How much of that do you think you will be able to reverse in 4Q because FX appreciated?

The second regards new products. WEG can go in many lines with many different products, electronic products, engines, electrical vehicles. Is there any line that could surprise us in terms of a very fast growth next year?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Let us talk about margins. One point that we always mentioned and that replace close attention at in terms of the variation in margins QoQ is driven by many different factors. Here specifically something that we are always alert is when there is significant volatility in the FX rate usually you can see a stronger impact in one quarter, and this is what happened, a strong volatility of FX rate in 3Q had the relevant impact in the margin for this quarter and this is because for a long cycle projects they are developed along one year with predefined prices and sometimes a fluctuation impacts the margin in that quarter. So that added to the problems that we found in WTU as announced led to a drop in margin, a margin that according to reports was slightly lower than the market expectations.

In terms of what we see for the future it is difficult to see how much that is going to be translated into growth for WEG. So in terms of storage we have enclosed a supply in the US, I think in Vermont if I am not mistaken, a storage unit that we are going to deliver something new for our company and this is reflected in countries such as Brazil and we believe that this is a business that is likely to grow.

Another thing that we announced recently, everything leading to the 4.0 industry, motor scanning is a product that we are also launching. We expect to advance in those fronts, too.

So let us think of TGM where we already have businesses. TGM was a unit here in Brazil that concentrated most sales in South America and in Europe through a joint venture that we have there; but in some markets where WEG already had a commercial and structural presence such as South Africa and the United States and Mexico they were markets where TGM at did not have in the list of suppliers for those markets. We are developing that too and we are using the strength of WEG's structure and brands to develop those markets.

We have also been talking about electric traction that WEG is following closely and then also Volkswagen in terms of bourbon deliveries that the prototype is already being tested in São Paulo and the schedule we have. I do not know the details but we are going to go into a process of marketing as of next year and we are trying to develop a small bus with electric traction. And there are many lines where we are trying to advance in order to diversify so that we may grow along time.

Mr. Marcelo Motta – JP Morgan

Thank you very much.

Operator

The next question comes from Murilo Freiberger, Bank of America Merrill Lynch.

Mr. Murilo Freiberger – Bank of America Merrill Lynch

Good morning everyone thank you very much for allowing me to ask a question. Actually I would like to hear a comment about two things: number one I would like to hear about long cycle. Do you see any improvement? So you see the quotes in terms of wind and this is going to go into the results of 2019, 2020 and in terms of distributed generation and there are segments that are really surprising in terms of growth that is bigger than expected. So how is this segment within solar business this year and what you are expecting for the next few years in terms of distributed generation?

Mr. André Salgueiro – Investor Relations Manager

Hi Murilo good morning this is Andre Salgueiro. As to long cycle products outside Brazil the first observation that we must make is that WEG's exposure to long cycle outside Brazil is not relevant and it has never been as relevant as it used to be relevant in Brazil in the past. We have some exposure to that but our main focus of sales and most of our sales still come from short cycle outside Brazil.

That said as part of the operations that we have outside Brazil and also in terms of exports we have seen an improvement and as we mentioned in our press release some important industries, because of a recovery of commodity prices, oil and gas especially, mining, pulp and paper, we have seen some projects there and our operations outside Brazil, which deal with long cycle products, especially electric machinery in the US and WEG India, they have a quite robust and strong order portfolio and a significant growth as compared to last year and we expect to grow from this year to next year.

So it depends on the market. This is very much focused on the US market. So I have shale gas, pulp and paper and in India it is more focusing on infrastructure, generation and water movement like sanitation, irrigation. This is what demands in Mexico.

As to GD this is a market as we say that is important and it is becoming more and more important in fact and we announced 50 million BRL revenue for distributed generation and this year our expectation was to double that number and now we have more than 150 million for this year and this in fact demonstrates an improvement and how this market has been performing in Brazil.

So the expectation is quite positive and there is a trend for growth; but it is difficult to tell how much the market is and how it is going to evolve. Our business model has been working well for small projects that we call retail distributed generation, small homes, small commercial facilities. We have integrated, they are trained in WEG and are responsible for certain regions to work in sales installation and technical assistance and this has been working.

And we have the smaller projects which are not like a solar farm, but sometimes we get them and we do them with companies that we higher with our engineering team and I think that in terms of market, and as we have said that a few times before, Brazil is one of the main countries in terms of solar radiation. We have mentioned that the worst place of solar radiation in Brazil is still 30% better than the best place in Germany, and although China has been investing a lot Germany is one of the countries that is most developed in terms of solar generation. So our expectation for the next few years is quite positive.

Mr. Murilo Freiberger – Bank of America Merrill Lynch

Thank you very much for your answer.

Operator

Our next question comes from Victor Mizusaki from Bradesco BBI.

Mr. Victor Mizusaki – Bradesco BBI

I have two questions; the first is a follow-up on Murilo's question about distributed generation. Can you some, WEG's market share in this segment especially? Considering that WEG is the only company that has national distribution for this segment what is your market share? Can you tell us more about that?

And the second question is about transmission. In your last call you said that we were getting to a phase in this sector where many of the auctions and other projects would start contracting process. Could you give us any numbers in terms of backlog or how you see this segment?

Mr. Paulo Polezi – Finance and Investor Relations Officer

Hi Victor this is Polezi answering your question. Talking about the G&D market it is a number that is difficult to give to you. I do not have it available right now. The comment I have to make is that we have many different models in the market, there are many different companies working in this segment. WEG undoubtedly is one of the most relevant companies in this market in terms of relevance and size and so our perception is that we are leading this market - but there are many different models.

There are integrators or investors that do it alone, others outsource everything, others sell part of the equipment. So I do not think this information is so well structured in the market. Maybe in the future we can address it in more depth than disclose more in the future calls; but what we can see from our portfolio and demand and fast growth, as Salgueiro mentioned we are strongly represented in the distributed generation market okay?

A little bit about transmission and distribution giving you an update about this process. What we had been saying is that we keep this message. It is a market where suppliers work in two models, both precontract and also investors that do not work with the contract; but in terms of those who prefer precontracts we mentioned before, we had some precontracts, some won and others did not. Our customers won two lots and we are working to deliver those lots.

There are several outstanding contracts in the market, many of them have not yet finalized choosing their suppliers and we are negotiating with other players. These are ongoing processes. The thing that it has been improving gradually since October 2017 - and I am talking about these negotiations - and we can see that it starts with smaller pieces of equipment, it gradually evolves two words bigger pieces of equipment.

And finally also in this area we are working on other fronts such as the sale of equipment directly to the winners of auctions are other suppliers in other lots. So in the market it is also common for you to supply to other suppliers and have more than one brand in just one venture. So this is an overview of the market for you Victor.

Mr. Victor Mizusaki – Bradesco BBI

Thank you very much.

Operator

We are now closing our Q&A session. I would like to turn the conference back over to Mr. Andre Rodrigues for his closing remarks. Please Mr. Rodrigues you may start.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Once again thank you very much for attending our conference call and we will meet for the release of the earnings of 4Q and this is going to be next year, so have a good afternoon.

Operator

WEG's conference call has now ended. We thank you all for your participation and wish you a good day, thank you.