WEG S.A.
2nd Quarter 2019 Earnings Results Conference Call
July 25, 2019 – 11:00 a.m. (Brasilia time)
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 and welcome to the conference call WEG to release the results of 2Q19.

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

Any forecasts in this document or any statements made during this conference call about forward-looking events, business prospects, operational and financial projections and goals and the potential for WEG's future growth are mere beliefs and assumptions of WEG's management and they are based on information currently available. Forward-looking statements involve risks and uncertainties and therefore dependent circumstances that may or may not occur.

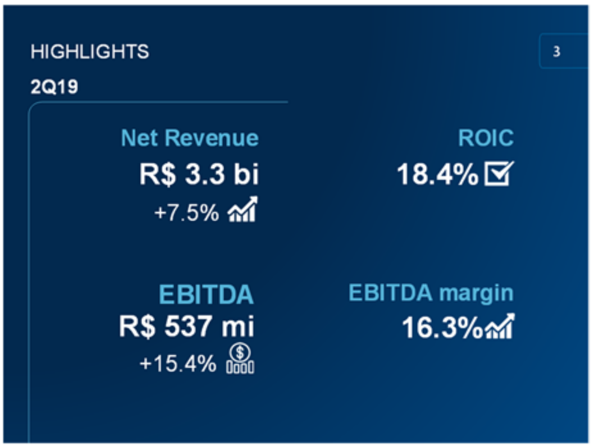
Investors should understand that general economic conditions, industry conditions and other operational factors may affect the future performance of WEG and may lead to results that will be materially different from those expressed in such forward-looking statements. As a reminder this conference call is being conducted in Portuguese and you are listening to the simultaneous translation into English.

Today with us in Jaragua do Sul we have Mr. Andre Luis Rodrigues, Managing Director Financial Superintendent; Paulo Polezi, Finance and Investor Relations officer; Wilson Watzko, Controller and Andre Salgueiro, Investor Relations Manager of WEG.

Please Mr. Andre Rodrigues you may start.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Good morning everyone. Once again it is a pleasure to be with you here for the conference call of our earnings of 2Q19.

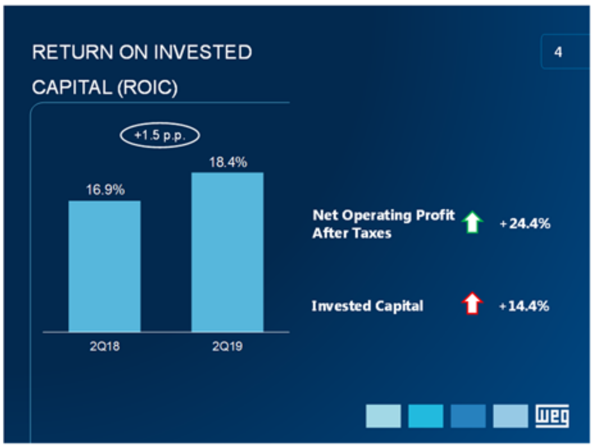


Starting with the highlights, net operating revenue grew 7.5% as compared to 2Q 18, in spite of the expectation of a smaller share of the wind generation business. The details about this performance will be presented by Paulo further on.

The second highlight was the 15.4% growth in EBITDA, which reached 537 million BRL and this is the first quarter ever that we exceeded the mark of 500 million BRL in EBITDA in WEG's history.

EBITDA margin grew 1.1 p.p. reaching 16.3%. This market is a result of a combination that was favorable: margin gains of some operations in Brazil, followed by better profitability of our operations overseas in addition to a more favorable mix of the products that we sold.

Lastly, ROIC reached 18.4% in another quarter of evolution. Factors such as revenue growth; better operational margins; scale gains; and efficiency gains in allocation of capital have support to the growth that we presented over the past quarters.



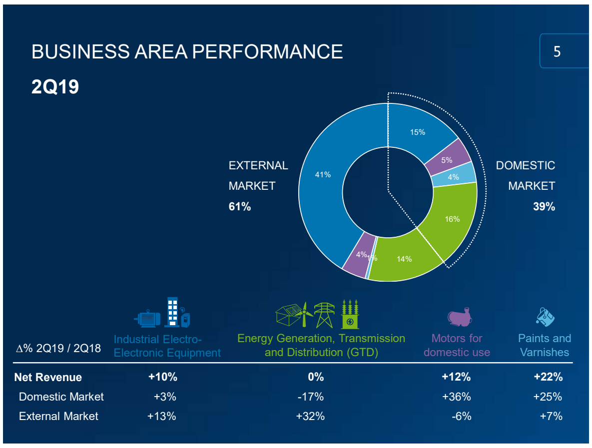
Now moving to slide number four we have more details about ROIC, which presented a growth of 1.5 p.p. compared to 2Q 18 reaching 18.4%.

The growth of operating income after taxes is explained by the growth in revenue and better operational margin more than offset the more capital that we invested to support business growth. The consistency of this indicator in the past few quarters is a reflex of the combination of the business development strategy with an attractive return of capital invested, together with discipline in the use of capital, demonstrated by working capital management and optimization of our investment program.

Now I give the floor to Paulo Polezi.

Mr. Paulo Polezi – Finance and Investor Relations Officer

Good morning everyone. Now moving to slide five you can see the evolution of the business areas of different markets.



I will start in the area of industrial electro electronic equipment in Brazil, where short cycle equipment sales are still growing. The performance of this unit was not better only because in 2Q the sale of long cycle products remained stable as compared to the same period of last year, especially in terms of automation panels.

GTD also presented reduction in revenue in Brazil, especially due to the already expected smaller share of wind generation projects. On the other hand the solar generation still is the positive highlight, especially in terms of distributed generation and the business of transmission and distribution is still positive this quarter with improvement in the business dynamics of all product lines.

In terms of motors for domestic use there has been a significant growth in revenue in Brazil, which is related to the inventory dynamics of some customers that are important and a higher share, higher market share in important segments such as washers.

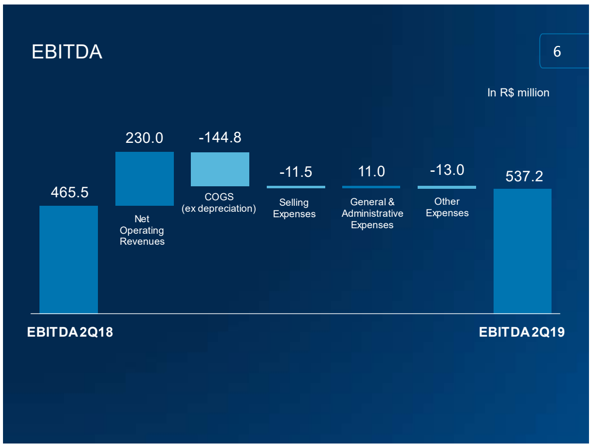
The good performance in the coating business is especially due to the improvement of significant manufacturing industries such as mining, metal structures and home appliances and important projects in the industries of oil and gas and sanitation.

Outside Brazil we can see consistent demand for short cycle equipment and growing demand for long cycle products, with orders and deliveries in terms of high-voltage motors and automation panels. We have projects to increase capacity and to build new factories that also demand long cycle products and continue with good prospects especially in industries related to oil and gas, pulp and paper, infrastructure and mining.

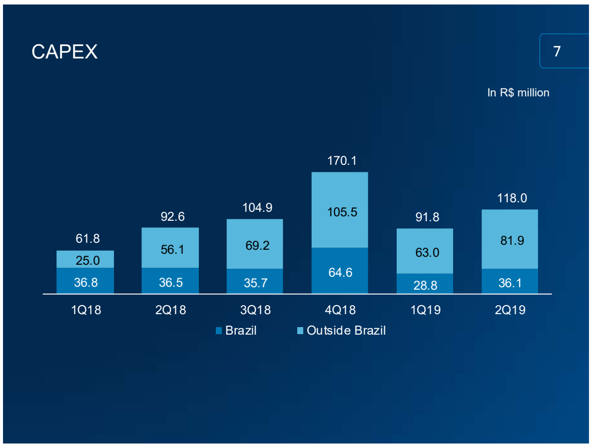
In the area of our generation, transmission and distribution the greatest contribution came from the transformers, which presented a growth in all operations overseas with highlights to the synergies already observed in operations of transformers In the United States and Mexico, and a good book of orders in the factories of generators in India and the US.

In engines for domestic use the revenue is still presenting the impacts already observed in the past few quarters with a smaller placement of orders in the local market in China and of the performance of the operation in Argentina, which suffers because of problems in the local economy.

Now in coating there was a drop in revenue in the foreign market also reflecting difficulties in the economic scenario in Argentina, one of the main markets for this business unit outside Brazil.



Slide six shows the evolution of EBITDA in 2Q 19. EBITDA grew 15.4% as compared to 2Q 18 and EBITDA margin closed the quarter at 16.3% with an evolution of 1.1 p.p. as compared to 2Q 18, as a consequence of margin gains of some operations in Brazil followed by better profitability of our overseas operations, in addition to a more favorable mix as a result of better revenue from wind generation, with the characteristics of lower operational margins.



Finally on slide seven you can see the growth of the past few quarters. In 2Q 19 investments reached 118 million BRL. 31% were allocated in Brazil and 69% allocated in our overseas manufacturing units with growth as compared to 2Q 18, especially because of the advanced in investments in the first foundry of WEG outside Brazil, which is in the final phase of construction in Mexico.

I now end and give the floor back to Andre.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Thank you very much Paulo. So wrapping up the presentation and before moving to the Q&A session I would like to emphasize our recent accomplishments and prospects for the rest of the year. As we have recently published there are some important developments overseas such as the refinery in Oman and Arkema in Europe, demonstrating the company's growing recognition of solutions in the project in partnership with major global companies through exclusive contracts or inclusion of us as an approved global provider, which makes is unique and provides special opportunities to WEG.

With the aim of advancing towards software and IOT solutions we announced our new department of digital businesses, which will be responsible for developing products and digital services and will support all business units in the developing the application of new technologies.

In May we also announced our technological cooperation agreement with Embraer to develop new technologies and solutions to enable electric propulsion in aircraft. Although this is a long-term partnership without any prospects of short-term results, it demonstrates our technological capacity and the recognition of important customers of our products.

Lastly, we keep our expectation to grow in 2019; however at a lower level because of the acknowledged reduction of our wind projects. As to EBITDA margin we expect to present in the year and evolution as compared to 2018 considering the better performance of mature businesses in Brazil and a better profitability of the overseas operations. The growth in revenue and Ebitda margin together with the efficiency in capital allocation will continue to support ROIC that favorable levels. Now we may start our Q&A session. Operator please you may proceed.

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 BTG Pactual.

Mr. Lucas Marchiori – BTG Pactual

Good morning everyone thank you for the conference call. I have two things to say. Andre you mentioned briefly that in the presentation, your exclusivity contract with Oman. I think there are some limitations in terms of what you cannot disclose. Could you give us a little bit more information on volume, when this will be shown in the results, in which line, the manufacturing GTD? Just a little bit more detail about this specific contract, this is the first question.

The second could you··· You talked about recovering your margin of operations, especially WEG Transformers. What level of margin, operation? Is there any room for improvement or is the run rate already appropriate for you? These are my questions thank you.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Hi Lucas thank you for your question. I will talk about the supply to Oman, which is a joint venture project between Oman Oil and Kuwait Petroleum and the total investment is about 8 billion in investment. Of course this is not the WEG contract; WEG signed the contract with the engineering company Tecnicas Reunidas from Spain. It was an agreement and WEG becomes the exclusive supplier of engines and low and high-voltage inverters. As to the amount we signed a first tranche and there might be another two tranches for the development.

We do not disclose the amount of the contract; but I think that the most important point here is that this contract will make it possible to show WEG as a global player. This is a project that provides great visibility outside Brazil and so the brand WEG has a good reputation outside Brazil internationally, and this places us at a different level of quality as a supplier with our supply agreement and it opens other opportunities for WEG and other supplies of the type. And I may also say we have made, there are some contracts from the past in terms of trying to develop WEG commercially outside Brazil, and after this contract we have opened some doors much more easily than we did in the past.

So part of the contract will be developed this year and part of it next year, about 50 - 50 each year and the reflex is you are going to see and industrial electro electronic products.

Mr. Lucas Marchiori – BTG Pactual

Are going to see the results of that in the next quarter?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

We are more⋯ More towards the end of the year you will be able to see the impact of this.

Mr. Lucas Marchiori – BTG Pactual

About WEG USA?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

I am sorry. About WEG USA well, the margin improvement is in WEG USA; but we also are developing margins in other units that we acquired in the past and yes, WEG USA has been having positive margins since 1H TY and we expected this to take place right in 2H LY; but we were surprised by an unexpected inflation in the US market and so this became a reality. It is still in the process, margins are still getting better and we have the opportunity to continue to develop the margins in that unit and in other units outside Brazil. So we still have room for growth.

Mr. Lucas Marchiori – BTG Pactual

Thank you very much Andre.

Operator

Our next question comes from Rogerio Araujo from UBS. You may start Rogerio.

Mr. Rogério Araújo – UBS

Good morning gentlemen and thank you for the opportunity. I have two questions, one is a follow-up of the thing of WEG being recognized as a provider of projects solutions, recognized as a global supplier. I would like to hear what has happened. You said that WEG has been approved to take part in this project. Did you ever try to do that before and why did not you win in the past?

And I think that another issue here is whether you see any situation of companies that produce their own low-voltage electrical motors might choose to by WEG instead of manufacturing themselves? So looking slightly more into the future do you think this is a possible, a feasible scenario when WEG will start to become a low-voltage electric motors for less efficient players in this segment? This is my first question.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Thank you for your question. WEG has only won this contract. Now and why did not we have it in the past? Well this is a process. We need to develop our brand to have access to bigger and bigger markets and this is what WEG did. We have had the chance of publishing and so in oil and gas WEG is renowned outside Brazil and there more and more companies got to know WEG and have access, having access to our products, quality, capacity to innovate our products and now this has placed us on a different level. I think that once again in a scenario such as this, this places WEG at a different level as compared to the past. There are more towards that were opened to us.

We mentioned Oman, but there is Arkema. Arkema is a chemical industry, French, with global presence and we also closed in energy efficiency contract with them for the replacement of motors. This is an exclusive contract with Arkema for the whole of Europe and we can work with them in the rest of the world too. So this is another opportunity for WEG to develop in the international market.

And the second...

Mr. Rogério Araújo – UBS

The second question regarded the supply of electrical motors. Do you think that in the future some companies will start buying WEG instead of manufacturing their own motors?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

No, I do not think that is likely Rogerio. Globally speaking in terms of global players they are all very well established and we have a share with more than 2000 manufacturers of motors in China, so we see more market consolidation in terms of the supply of electrical motors for these companies to resell. I do not see it is likely because these companies would need to do margin on top of margin in resale and it is not going to be competitive. So I do not see that trend and I see the possibility of consolidation.

And talking a little bit more about Oman contract just another example, all OEMs it is not just WEG that is selling directly to the refinery. A pump vendor, so the pump has an engine and they will only be able to sell to the refinery if they have a WEG motors. So I do not see any companies buying the motors to resell; but develop a strategy growing through the OEMs that WEG has been doing for a long time.

Mr. Rogério Araújo – UBS

And is this market very big of projects that you did not participate before? More in terms of low and medium-voltage electrical motors? Do we know how big the market is? Are there any major projects?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Well Rogerio we can calculate an estimate of the value of the global market later on, but this happens with exclusivity contracts we have with many countries in the world. We may develop this in the United States and we can confirm afterwards we have more than 25 customers for global supply. So they are customers that buy from WEG in Brazil, China, the US, Europe and they are exclusive contracts with global customers. If we get the evolution of the past three years this number has been going on. So there is also the possibility of developing in other geographies, too.

Mr. Rogério Araújo – UBS

Thank you very much. The second question is very quick: what is the effect of the IFRS on your EBITDA margin and also did you calculate how much that affects ROIC, if it does?

Mr. Paulo Polezi – Finance and Investor Relations Officer

Rogerio this is Paulo Polezi. IFRS 16 for this quarter according to our calculations EBITDA margin would be impacted between 0.4 and 0.5 p.p. So additionally to the impact of depreciation and this is explained in note 13 of our financial statements and we need to think about our mercantile lease and they are outside Brazil at lower rates and that is why the impact is not so significant.

As to an impact in ROIC there is an impact of that results from that and just as I said it is not so representative in EBITDA, neither in ROIC.

Sr. Rogério Araújo – UBS

Thank you very much.

Operator

Our next question comes from Joao Noronha from Santander.

Mr. João Noronha – Santander

Good morning everyone thank you for the opportunity. In terms of solar power could you give us more information about the current size of the business and in distributed energy what is the revenue and how you have been growing? Thank you very much.

Mr. André Salgueiro – Investor Relations Manager

Good morning Joao this is Andre Salgueiro. In terms of solar power in 1Q TY we mentioned that we were not going to give too much detail in terms of the portfolio and backlog as we had been doing last year, because this is a new segment and more representative, but it is as we have been mentioning to you since late last year.

This is very positive, very focused on distributed solar generation, in our portfolio has been growing consistently since last year and we are keeping that trend. So the placement of orders and billing is evolving, which means that we expect this business to grow over the next few quarters. The point of attention is because of solar farms that last year we delivered four farms and this year we have three, two of them already been delivered, one and if you compare the wind··· The solar farms if you compare 2019 the 2018 the building or the revenue performance is smaller this year, which will obviously be offset by distributed generation. But the overall prospect is very positive because of our GD.

Mr. João Noronha – Santander

If we look YoY what you lose in terms of farms would be offset by the growth in distributed?

Mr. André Salgueiro – Investor Relations Manager

Yes, GD so we are going to recover the farm, well, it depends on how GD evolves in 2H TY, but we are expecting the consolidated solar power will be slightly better than 2018 if we take the whole year.

Operator

Our next question comes from Marcelo Motta from J.P. Morgan.

Mr. Marcelo Motta – JP Morgan

Good morning. I have two questions, the first one could you comment on the company's market share in the international markets. Have... You won market share in Asia but I would like to understand better about the US and Europe markets.

So thinking GTD that are many drivers, so less wind, the solar generation but more distributed energy. How that compares distributed energy would be better or worse? So I would like to understand more the direction of your margins.

Mr. Paulo Polezi – Finance and Investor Relations Officer

Hi Marcelo good morning, Paulo Polezi here. Your first question about market share well, actually we have a continuous process of market evolution and market share gain. So in some of our businesses we can have more exact information in terms of industrial electro electronic equipment, and other equipment GTD is difficult to get the information, it is more commercial.

So it is a continuing process. We do not have details. The update that every two years and I cannot give you an example: four years ago in the United States we were three and market presence and two years later WEG became second in the US with presence close to 15% of the market. So it is an evolution that is gradual and it takes place all over the world. So we are very careful and we try to update every two years to give you more precise numbers. So it would be too hasty to give you numbers about the market, but the perception that we have of the businesses is an advanced in all segments over two digits growth, and our two digit growth is an example of that.

Mr. André Salgueiro – Investor Relations Manager

Just as to GTD margin we need to separate businesses from GTD. In terms of wind and solar farms that we work more as integrators. A significant part of this business belongs to third parties and we complement with some pieces of equipment that are manufactured by WEG and resell the full solution. So we hope margins for these businesses to be structurally lower than in other businesses, so this is the first part.

The second is the distributed generation with a slightly more constant margin, slightly better margin which is more focused on retail without any major variations. And there is all the rest that goes into GTD in terms of generation, both wind and solar plus T&D. We have the long cycle products dynamics, so when the market demands products with price better, improve margins; the market, when demand goes down we in source projects with margins that are not so good.

So we have this dynamics. What we are seeing now is a combination of a recovery of long cycle products especially for T&D and a proportional reduction of wind billing with a smaller margin. So if you add the two factors you see that GTD is improving its margin and it is likely to continue with his friend over the next quarters.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Just complementing what Paulo said about WEG's expansion in the foreign market, so we have demonstrated consistently that we have been capturing market not at one given geography, but in many different geographies. WEG has been growing consistently in the United States and when we analyze not just in one segment, but when we analyze the growth rate in the foreign market, so industrial electro electronic equipment, GTD, this is very consistent in the United States, in Europe and China. In the case of China this is leading us to increase capacity of WEG's newest plant for the manufacturing of electrical motors, which went live early 2016. So yes, WEG has been seeking and finding opportunities to grow in these markets and to increase its market share.

Mr. Marcelo Motta – JP Morgan

Thank you very much.

Operator

Our next question comes from Gabriel Rezende from Bradesco BBI.

Mr. Gabriel Rezende – Bradesco BBI

Good morning thank you for the opportunity to ask questions. I have two questions related to the foreign market, the first one relates to Mexico, when is it going to start operating and how can it contribute to gain competitiveness in North America?

The second one regards market share. How can the new contracts with Arkema and Oman, how can it drive market share in the foreign market?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Hi Gabriel. Mexico foundry will start operating shortly and producing first in the test phase and then officially. So it is just a matter of weeks it is going to start operating and we follow, and this year we might not see any major changes because it is preoperational, but more consistently next year, when we see higher production volumes.

So it is a significant investment. We are almost sure that the most modern foundry in the whole of Mexico is our plant, it is really a state-of-the-art technology and right from the beginning we need to have capacity because it is difficult to reduce the bottleneck afterwards. So next year and over the next few years we will see the improvement.

These contracts once again it is difficult to tell now what this will mean in terms of new markets to WEG, for the international market WEG with this type of agreement changes its level of qualification as the supplier of equipment that require high technology and reliability and quality.

We are mentioning these two examples which are recent examples; but as I have just said we have 28 more than that global contracts with major players, major international players, but there are many examples and recently we supplied a high-voltage motor with 45 tons to the North of China and part of it was developed Brazilian engineering, part of it in India and the final assembly in China to assure that are optimization of competitiveness of this product.

WEG is more and more positioning itself as a relevant brand for these products and all the markets where we operate around the globe. And one thing leads to the other, as I said in the case of Oman we are already getting many calls. Many people and companies are coming to WEG. In the past we had tried to make contact with them but they did not know is so well, we did not have much of a track record and now as we have a better track record they are coming back to us.

Of course this is all the result of the strategy focusing on industries. Over the past few years WEG has created teams that are dedicated to covering certain industries all over the world, oil and gas for example, and all of this is a result of the long-term strategy that we are being very faithful to the execution.

Mr. Gabriel Rezende – Bradesco BBI

Thank you very much.

Operator

Our next question comes from Gabriela Cortes from Banco do Brasil.

Ms. Gabriela Cortes – Banco do Brasil

Good morning everyone thank you for allowing me to ask a question, congratulations on your performance. We have been talking a lot about market prospects and everything. Could you tell us what is your expect in terms of cost of raw materials and other inputs in 2H 19?

And also can you confirm this year's Capex that you presented for 1Q? And as to that there has been a considerable drop in gross debt. So was it due to any settlement or is it out of FX variation? Could you tell us more about that?

Mr. Paulo Polezi – Finance and Investor Relations Officer

Gabriela good morning this is Paulo Polezi answering your question. You asked three questions in one. You talked about the cost prospect. In our case the first thing you need to remember in terms of our cost structure are metal commodities: number one copper, then steel and aluminum in this order and we have been observing an improvement in costs in strong currency and this has helped us effectively and contributed to the margin, and we are working with a scenario of maintenance of this condition in terms of costs remaining stable.

Of course we need to look at FX aspect of that. So compared to last year in 2Q we saw FX slightly more stable and so we need to please the two items in our calculation: commodity prices and FX variation. So 2H TY is likely to be more favorable for our businesses with regards to these commodities that are part of our cost.

The second part of your question regards Capex. So we have an annual Capex program. This year we have already provided a lot of information about it. The budget that has been approved is 530 million BRL, most of it, 70% overseas; 30% in Brazil. This Capex has been originally planned to complete our plant in Mexico.

And in order of relevance we have the expansion of the motor plant, manufacturing plant in China. As you said we are also investing in a facility to build frequency inverters in China and lastly the new wind generator, the final power, we do not know yet the details. So there are lots of investments spread in Brazil and all over the world to improve our processes. This is the overall picture. In Mexico too there was FX variation that played a role, number two China, and number three investments in Brazil that explain this quarter's Capex.

Your third question reduction of the debt. So debt Brazil has been working and this is not new, it has been a year, so a reduction that is in cash and debt especially because of FX rate reduced many debts at higher cost, usually above CDI. The result is that we reduced debt, reduced cash and at the same time there was a reduction in financial expenses. We still have something to do but most of this work has already been done to reduce our indebtedness.

Ms. Gabriela Cortes – Banco do Brasil

So you think we can consider at this level more stable in terms of what you are reporting for June 2019?

Mr. Paulo Polezi – Finance and Investor Relations Officer

Save it is probably yes. There might be variation up or down. If we find any interesting, competitive opportunities in the market we are always looking at that. We have an amortization that is consistent; the company is generating cash at the same time and this is the most important thing and we are looking… Or if in we are looking at the market and if any interesting opportunities come up with might be involved in them.

Operator

Our next question comes from Mr. Augusto Ensiki from HSBC.

Mr. Augusto Ensiki – HSBC

Good morning thank you for the question. Could you tell us more about your software structure? How is it going to fit into the new businesses that you operate? Are you going to change in accounting methods?

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

Hi Augusto thank you for your question. Talking about the new structure that we call WEG Digital Businesses I think that along its history WEG has been investing in electrical machinery and automation products and systems for companies in the power industry. WEG is not just a supplier of equipment, of motors and inverters, but it works in automation with all the basis in industrial activity. So we have recently published our Motor Scan, but we have been doing a lot there. We have some solutions that comply with the Internet of Things and also internal systems with internal software of our production.

So what used to happen is that this was slightly dispersed in our business units and the solution that we found is that we have reached a certain size and we have a new department grouping all our initiatives under one single initiative to develop digital businesses outside and inside the company. This is recent, the whole strategy is recent and it is being refined now. We do not have a revenue estimate, but naturally we are going to start first in Brazil and then we are going to expand it internationally and I think at first it is going to be slightly more diluted in industrial electro electronic equipment, but once there is something that we find relevant we are going to make a disclosure and we might change the way we publish this.

I think the key message here is that the company is structuring itself to do that. At first we were slightly more low-profile in terms of publishing our capacity to be in that market in terms of internal developments. Of course the words the end of the year we are going to have a WEG Day here in Jaragua, one of the pilots manufacturing plants of this intelligent plant and we are going to include it in the visit to show what we have developed and now we want this to be translated into products to be offered to our customers to complement our extensive product line.

Mr. Augusto Ensiki – HSBC

Thank you very much.

Operator

As a reminder if you want to ask a question please press star one. We are now ending our Q&A session. I would like to give the floor to Mr. Andre Rodrigues for his closing remarks.

Please Mr. Rodrigues you may go on.

Mr. André Luís Rodrigues – Managing Director Financial Superintendent

So thank you all very much once again for attending our conference call and I hope to meet you again in a few months when we publish the results of 3Q. Have a good day and thank you very much.

Operator

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