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NEMAKA.MX - Q1 2016 Nemak SAB De CV Earnings Call

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PRESENTATION

Operator

Good morning, everyone, and welcome to Nemak's first-quarter 2016 earnings call. Armando Tamex, Nemak's CEO, Alberto Sada, CFO, and Maximilian Zimmermann, Investor Relations, are here this morning to discuss the Company's performance and answer any questions that you may have. As a reminder, today's conference is being recorded and it will be available on the Company's Investor Relations website.

I will now turn the call over to Maximilian Zimmermann. Please go ahead, sir.

Maximilian Zimmermann - Nemak SAB De CV - IR

Thank you, Operator. Good morning and welcome, everyone. We very much appreciate your participation. Armando Tamex, our CEO, will lead us in today's call by providing an overview of our business and financial highlights. Alberto Sada, our CFO, will then discuss the industry trends and our first-quarter financial results in more detail. Afterwards, we will open up for a Q&A session.

Before we get started, let me remind you that information discussed on today's call may include forward-looking statements regarding the Company's future financial performance and prospects, which are subject to risks and uncertainties. Actual results may differ materially and the Company cautions not to place undue reliance on these forward-looking statements. Nemak undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

I will now turn the call over to Armando Tamex.

Armando Tamex - Nemak SAB De CV - CEO

Thank you, Max. Hello, everyone, and welcome to Nemak's first-quarter 2016 results conference call. We have gotten off to a good start in 2016 with the new contracts across our business lines and remaining on track to meet our targets for the year.

EBITDA increased 6% in the quarter to \$209 million, driven mainly by improved profitability in North America, and top- and bottomline growth in Europe. Moreover, as part of our efforts to reinforce our foundation for growth this quarter we invested \$131 million in our strategic projects,



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including the construction of a new high-pressure diecasting plant in Mexico, the expansion of our in-house machining capacity across our regions, and the development of a new structural component business.

Revenues were \$1.1 billion, an 8% decrease year over year. This result was mainly due to lower aluminum prices and the depreciation of the euro.

Please keep in mind that we have passed [through] clauses in all our contracts, which offset the effects of aluminum price movements when it comes to our bottomline.

Next, I would like to highlight our performance in Europe. In particular, we have been benefiting from the launch and ramp up of new programs in the region. We won most of these programs within the last couple of years, and now they are starting to show up in our results.

We have been capturing increased demand in our powertrain business from most of our customers, and our customers have been gaining market share. As a result, we saw growth in volumes and a more favorable sales mix. Despite the position of the euro compared to the US dollar, revenues and EBITDA in Europe grew 2% and 5%, respectively.

Turning to our sales results, this quarter we were awarded new contracts with global customers worth a total of approximately \$250 million in annual sales, half of which represented incremental revenues. These included new contracts to produce cylinder hats, engine blocks, transmission parts, and structural components.

I am also pleased to share that the operations in Mexico and Europe received the General Motors Supplier Quality Excellence Award, and the Volvo Cars Quality Excellence Award, respectively. These awards underscore NemaK's track record of excellence in quality performance, as well as our commitment to meeting and exceeding our customers' expectations.

I will now like to touch on the implementation of our business strategy. We are making significant investments this year to support our entry into the market for our structural components. As we have mentioned previously, we see considerable growth potential in the structural components over the medium and long term. Industry experts expect that the size of the structural components market will surpass that of the market [for hats] in blocks combined by 2030.

We are pleased to announce that as part of these efforts, construction has begun on a new plant in Europe dedicated to the production of structural components. This plant is being built next to our existing facility in Slovakia, and it will be the third facility in our system with the capability to produce structural components. We plan to invest \$55 million and expect to start operations in 2017.

Meanwhile, at the high-pressure diecasting plant in Mexico, which is in the final construction phases, we have begun test production [grounds] for our structural component programs that [RF cable] to keep costs starting in the fourth quarter of this year. In addition, we have continued improving our technological base in our product development center in Poland, which will be a key site supporting our structural component program launches across our global system in the coming year.

Moving on, I would like to mention that we expect ongoing investments to expand our in-house machining capacity across our regions, which is the centerpiece of our vertical integration strategy to further support profitability. The main benefits of increasing the share of casting with machine in-house include logistics and quality improvements. We are focusing on channeling these investments into new programs, with the aim of almost doubling our in-house machining capacity over the next four years.

On a final note, I would like to emphasize that we expect industry conditions in key markets to remain conducive to bottomline growth. In particular, we are confident that we are well-positioned to continue capitalizing on the automotive lightweighting trend, which is further intensifying as [environments] around the world raise the bar for fuel economy and emissions standards to capture attractive business opportunities in the coming years.

I will now hand off the call to Alberto Sada, NemaK's CFO.



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Alberto Sada - *NemaK SAB De CV - CFO*

Thank you, Armando, and good morning, everyone. Let me start by sharing relevant industry data that sheds light to our results.

During the quarter, the seasonally adjusted annual rate for vehicle sales in the US was up 3% from the first quarter of last year, due to overall favorable economic conditions. Furthermore, low gasoline prices continue benefiting the sale of light trucks in the region. Industry and NemaK's customers' vehicle production were up 5% and 3%, respectively.

In Europe, the seasonally adjusted annual rate in the quarter was up 4% compared to the same quarter of last year, driven by Western Europe's recovery, which more than compensated for lower sales in Russia. Industry and NemaK's customer production both increased 2%, driven by Western Europe's recovery.

Now, let me move on to discuss our results. Volume in the quarter was 12.9 million equivalent units, a 2% decrease from the same quarter last year, mainly due to higher volumes in Europe being offset by lower volumes in South America and North America. I will now turn to our financials.

Revenues were \$1.1 billion, 8% below the same quarter of last year, primarily driven by lower aluminum prices and, to a lesser extent, the depreciation of the euro compared to the US dollar. Aluminum prices decreased 17% in this period, translating into a negative revenue affect of approximately \$70 million. It is important to highlight that, as Armando mentioned, we have a pass-through of aluminum prices in all our contracts with our customers, and therefore, there is no major impact on our bottomline.

As you may be aware, approximately one third of our revenues are generated in euros. The translation effect of the euro in our results this quarter was [\$14 million].

Gross profit increased 2% to \$202 million. The increase was mainly driven by an improved sales mix, currency effects, and operational efficiencies which more than offset the euro translation effect. Now, let me move on to our bottomline.

Income from operations was \$134 million, a 4% increase from the same quarter of 2015, mainly due to the increase in gross profit, which I just mentioned. EBITDA for the period was \$209 million, a 6% increase compared to the first quarter of last year.

This increase was due to higher income from operations described before, EBITDA for improvement unit increased 8% from the same period, to [\$16].2 per unit. Net income increased 35% compared to the first quarter of last year to \$97 million in the period. It was mainly driven by a foreign exchange gain combined with higher operating costs.

In terms of our balance sheet, as of the end of March, we had a net debt position of \$1.3 billion, \$60 million higher than December of last year. Cash and cash equivalents were \$101 million. Now, allow me to give you some details on our regional results.

Our volume in North America decreased 2%, mainly due to the phase-out of an export program, whose replacement will be produced by operations in Europe, combined with a production down scale of [FTA's] midsize sedan line. Revenues decreased 11%, mainly due to lower aluminum prices combined with the volume effect previously mentioned. As indicated before, aluminum prices are a pass-through under the contracts we have with our customers.

In contrast, EBITDA in North America increased 8% compared to 1Q 2015, mainly driven by a positive mix shift combined with positive currency effects.

Moving on, we are very pleased with the financial results achieved in Europe. Volumes increased 8%, surpassing our customers' production volume. Despite the devaluation of the euro, revenues and EBITDA increased 2% and 5%, respectively, compared to the same quarter of last year. Excluding the transaction effect of the euro, revenues and EBITDA increased 6% and 9%, respectively. In our Rest of the World operations, our volumes decreased by 25% mainly due to the lower volumes in South America. Revenues decreased 23%, mainly due to the lower volumes combined with the depreciation of local currency.

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Keep in mind that our sales in this region represent 7% of our revenues in the quarter. On the other hand, EBITDA remains stable due to improved profitability in Asia, which offset lower volumes in South America.

And with that, I would like to open the call for your questions. Operator, please instruct the participants on how to place their questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Juan Tavarez, Citi.

Juan Tavarez - Citigroup - Analyst

My first question is on your margin expansion that you delivered this quarter. Could you help us understand how much of that expansion would you attribute to a favorable Mexican peso or other currencies, and how much of it came from sales mix gains? Is it half-and-half, or how do you kind of categorize that.

And then, my second question is just around your volume activity, which you were highlighting right now. I think what we saw this quarter was the industry growth outpaced the customer -- your customer growth in North America. Yet your volumes went down. I think you just finished explaining that part of it is due to the phase-out of an export program. But just maybe to get some color on your side of why does it look like your customers are losing market share in the US were North America, and second, how much of your US production was part of this export program, like how much of your volumes are usually exported, and what should we expect going forward, thanks.

Alberto Sada - Nemak SAB De CV - CFO

This is Alberto. Related to your first question about the reasons on the margin expansion, I think it is distributed between the three factors evenly. It is about a third -- 30% of the effects have to do with mix. The other third is efficiency. And last, another third is around the exchange rate. So pretty much it is distributed among those three effects.

And then on the volume side, as indicated, in North America we had -- we experienced this phase-out of the project that we were producing for the export market. We were exporting this product to China, and that product is phased out in North America and being relocated to Europe, so on a consolidated basis, the net effect is zero. But in North America, obviously that implies less volume for us.

And to your last question about our customers' market share, we have not seen any erosion on their share at this point. If there are any minor differences between production of the total industry versus their production, then it probably has to do with seasonality on their end, ramping up, ramping down, maybe some inventory effects. But we are not seeing any permanent deterioration of market share or anything like that.

Juan Tavarez - Citigroup - Analyst

Okay, great. And just to understand the program you used to export to China from the US, so that transition has already happened? Should we see that continuing next quarter, or --? (multiple speakers)

Alberto Sada - Nemak SAB De CV - CFO

Yes, that started this year and that is the effect that we will see in most of the year.



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Juan Tavarez - Citigroup - Analyst

Okay, thank you very much.

Operator

Ivan Enriquez, HSBC.

Ivan Enriquez - HSBC - Analyst

My first question is regarding the structural component and the contracts that you said you won. You said you won contracts in powertrain and transmission and structural component. Can you give us a sense of the new contracts for structural components that you just added to your program? Yes, (multiple speakers) and secondly, we saw that the EBITDA per unit in the different regions is close to 18% in the US, and is slightly lower in the other regions. And you said that you are investing across regions in internal machining, and (inaudible) process. Can we expect the European and Rest of the World EBITDA per unit to increase to the levels of North America? Thank you.

Armando Tamex - Nemak SAB De CV - CEO

The first question related to the new contracts that we will receive during this quarter, this is a very important new contract that we have for a German OEM, and that we will be producing in Europe. Unfortunately, we cannot give you a lot of details due to confidentiality agreement that we have with this customer, but what we can say is that this contract is worth approximately \$60 million per year in revenues.

This is also very important and it will be supported by a new plan that will -- building as we speak near Slovakia, as we already indicated in our report.

Alberto Sada - Nemak SAB De CV - CFO

And, Ivan, related to your question on margins, on our regions, I think we will be seeing a very high margin expansion going forward into the Rest of the World operations as we see volumes in Asia growing a new business that we are launching there, essentially reaching our bottomline. Our North America business will be gradually as well improving with the adding of machining and improved mix as well. So, it should be relatively stable but growing.

However, I would see a little bit more growth would be in Asia, which right now it would be influenced by South America performance, and also the launching of projects in China, but which we will be seeing gradually improved.

Ivan Enriquez - HSBC - Analyst

Great. Thank you, guys.

Operator

Gilberto Garcia, Barclays.



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Gilberto Garcia - Barclays Capital - Analyst

I have a question on price. You mentioned obviously that the pass-through for the effect of aluminum prices. But it appears the average price for your products actually fell down to a lower extent from the declining aluminum price. So, I was wondering if this was due to a better mix product that you have talked about as the reason behind the margin's improvement, or if it is more a matter of the metal lag that we see some quarters.

Alberto Sada - Nematik SAB De CV - CFO

The effect of mix, as indicated, does improve our margin. And that is associated to [a third]. But that is when you see it on a per-unit basis. If you see margins on a percentage basis of sales, definitely the effect of aluminum has a positive effect on the EBITDA as a percentage of sales because we see less of revenue, but that does not translate into the EBITDA.

So, percentage-wise, just due to the aluminum effect, it is close to a 1% difference between the first quarter of last year and this year.

Gilberto Garcia - Barclays Capital - Analyst

Right. No, I understand, but what I mean is that the average price for your products fell about 7%, which is a moderate decline for prices for aluminum. Obviously, it is not a perfect relationship, so I was wondering if the better mix products also translated into higher prices that somewhat offset the decline in aluminum.

Armando Tamex - Nematik SAB De CV - CEO

Yes, to some extent, as we have indicated in previous calls, we are improving our product mix by adding more value to our products. That includes adding more machining content as well as introduction of new products that are more sophisticated, and certainly due to the complexity of these new products that we are launching, we are able to get better pricing than in previous years.

Gilberto Garcia - Barclays Capital - Analyst

Okay, thank you very much.

Operator

(Operator Instructions) Valentin Mendoza, Banorte.

Valentin Mendoza - Banorte - Analyst

Congratulations on another quarter of good results. My question is also related to NAFTA's profitability. Mainly I would like to know if you think that this margin expansion is sustainable in the future, at least for this year, meaning that it is about 66% of the expansion is related to a better sales mix and efficiencies. Could we expect margin around 21% right?

Alberto Sada - Nematik SAB De CV - CFO

Well, I think there is obviously a seasonality in the remaining of the year. I think it is very hard to assume that the first-quarter margin remain for the entire year. So, you will see lower margins as we have seen in previous years on the third and fourth quarter. So eventually, those should even out and average to slightly higher than what we had last year in line with our overall guidance for the year.

So, we see this very consistent with our expectation for the year.

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Valentin Mendoza - *Banorte - Analyst*

Thank you.

Operator

Ana Sepulveda, Invex.

Ana Sepulveda - *Invex - Analyst*

My question is regarding your EBITDA. In your last quarters, we had something that you guys called a metal lag that actually impacted negatively the margin. I was wondering if that could be also one of the key factors for emerging expansion this quarter.

Alberto Sada - *Nemak SAB De CV - CFO*

Actually, not; we saw that last year because that is when we see the highest drop in aluminum. This quarter there is a very, very small effect of metal lag. We are seeing stable aluminum prices, so yes, obviously depending how aluminum moves, but as of now they are pretty much stable.

Ana Sepulveda - *Invex - Analyst*

Okay, thank you very much.

Operator

[Nicholas Languieil, Lorembial].

Nicholas Languieil - *Lorembial - Analyst*

I have a couple of questions. The first one is related to the automotive industry. You showed the US vehicle sales this quarter grew 29%. In Europe, we had an increase of 4.2%. So it's understandable why the Nemak volumes had a decrease of 2%. So if you can give us more color about like the relationship between vehicle sales in markets and the volume sales of Nemak. And, is there any lag, the explanation of the lag of the trends?

And my second question is about the -- your contract expiration per file. If you can give us like the percent of your contracts in terms of your volumes that expire in the following quarters? Thank you very much.

Armando Tamex - *Nemak SAB De CV - CEO*

Thanks for your question. To answer the first part of it, related to the volume, I think we explained that just a few minutes ago, which has to do for us in North America due to this phase-out of the platform that we are moving out from North America and locating that in Europe. And to second point is the scale-down of the US midsize vehicle applications that have an effect this quarter for us.

Alberto Sada - *Nemak SAB De CV - CFO*

On the second part of your second question related to the contract life or the expiration of the contracts, what I can tell you is the following.



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In this industry, I would say that almost 100% of all the contracts that we have at Nemak are for the life of the products, and normally, in the power chain business, contracts last on average for about seven years. And we have been in our history -- a very, very high replacement contract once we are getting a new part. So, we have a very high percentage of rate of retaining new contracts. As we announced last year, we were able to win approximately \$1.2 billion in new contracts.

This quarter we announced \$250 million, which a little bit more than half is new business, and the other one is replacement. So, basically, what I can tell you is that once we finish a contract, normally we are making a replacement part for the replacement cylinder half or engine block transmission case that will continue, let's say, our customers selling. I don't know if that answers your question.

Nicholas Languiell - *Lorembial - Analyst*

Perfect, thank you very much.

Operator

At this point, ladies and gentlemen, I would like to turn the conference back over to Mr. Zimmermann for any closing comment.

Maximilian Zimmermann - *Nemak SAB De CV - IR*

Thank you, Operator. I would just like to thank everyone for participating in today's call. Please feel free to contact us if you have any follow-up questions or comments. Have a great day.

Operator

Thank you, ladies and gentlemen. This does conclude today's teleconference. You may disconnect your lines at this time and thank you for your participation.

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