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First Quarter 2021 Earnings Webcast

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C O R P O R A T E P A R T I C I P A N T S

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Valentin Mendoza, *Banorte*

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P R E S E N T A T I O N

Operator

Good morning, everyone, and welcome to Nemak's First Quarter 2021 Earnings Webcast.

Armando Tamez, Nemak's CEO; Alberto Sada, CFO; and Adrian Althoff, Investor Relations Officer, are here this morning to discuss the Company's business performance and answer any questions that you may have.

As a reminder, today's event is being recorded and will be available on the Company's Investor Relations website.

I would now like to turn this call over to Mr. Adrian Althoff. Thank you, you may begin.

Adrian Althoff

Thank you, Operator.

Good morning and welcome, everyone. We very much appreciate your participation.

Armando Tamez, our CEO, will lead off today's call by providing an overview of business and financial highlights from the quarter. Alberto Sada, our CFO, will then discuss our 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 Tamez.

Armando Tamez

Thank you, Adrian.

Hello, everyone, and welcome to Nemak's First Quarter 2021 Earnings Webcast.

I would like to begin by reiterating my gratitude and appreciation for our entire team's ongoing effort to safeguard the wellbeing of our people and our communities, all while delivering further progress towards implementation of our business' strategy. I am proud of the resilience and agility we have demonstrated in these extraordinary times which have been critical on a variety of fronts, including achieving continuous improvement in our health, safety and environment practices, implementing measures to reduce cost and reinforce our financial position and tapping into new opportunities linked to the vehicle electrification trend.

I am pleased to share that we made substantial new growth in the quarter in all these priority areas, reaching a key milestone in the implementation of a sustainability roadmap while also delivering a solid business performance and driving growth in new product lines.

Regarding our results, new launches spanning our main business segments contributed to higher volume in the period. Taken together with an improved product mix, exchange rate effects and higher aluminum prices, we saw a 15% year-over-year increase in revenue. At the same time, we maintained a leaner cost structure compared to the same period last year, due mainly to efficiencies secured in the second half of 2020.

In turn, implementation of lower cost and improved product mix supported by new launches in e-mobility and structural applications brought EBITDA 19% higher on a year-over-year basis. EBITDA per equivalent unit also drove improvements, finishing at $15.80, the second highest level we have ever reported for this metric in a first quarter.

Meanwhile, we continue to advance with our deleveraging plans, repaying the remaining credit lines we have drawn amidst last year's pandemic-related production stoppages. As a result, net debt remains at similar levels compared to the close of 2020. Given our business outlook along with our continued efforts to optimize cash flow, cost and expenses, we believe that we remain well-positioned to improve our main credit metrics further, (inaudible), including bringing our net debt to EBITDA ratio down to close to two times at the second half of this year.

Moving on to our sales and marketing activities, we made strides in the quarter towards strengthening our foundation profile (phon) across all product lines. This included securing business to supply components to a leading global manufacturer of electric vehicles, representing a new milestone in our efforts to harness our technology capabilities, our talent and our manufacturing footprint to capture opportunities in e-mobility applications.

This business primarily features the production of complex vehicle housings for SUV applications, along with the use of our proprietary sand package casting technology to produce highly integrated e-motor housings for commercial vehicle applications. We plan to initiate serious production of these components in North America in the second half of the year.

Additional order intake highlights from the quarter include winning business to leverage our in-house capabilities in testing, joining and assembly processes to produce battery housings for (inaudible) hybrid electric sedan applications with a German OEM, and winning incremental business to produce cylinder heads and engine blocks in all our regions. For the period, we won new contracts across our product lines worth a total of around $240 million annually, two-thirds of which represented incremental business. With this, our total order book for e-mobility and the structural application business grew to approximately $900 million in terms of annual revenue.

Additionally, I would like to touch on our continued progress in the quarter in ramping up production in these segments. These included successfully completing the launch of new business in Europe to supply the structural parts for Mercedes-Benz.

Our solution combines high-pressure die casting to joining and assembly technologies, including riveting, adhesives (phon) and spot welding to create highly engineered products for the customer, further demonstrating a trend we are seeing toward more complex, higher value-added requirements in the structural applications for next-generation vehicles. Today, we are now producing and launching e-mobility and structural applications at a total of 12 manufacturing facilities spanning Europe, North America and Asia.

I would now like to move on to recent developments related to our spin-off from Alfa. As we have mentioned in previous locations, our main goal is to merge our two listed entities, Nemak and Controladora Nemak, into a single share-class structure. The expected benefits of such a transaction include improved valuation transparency for Nemak shares under a single listed entity, along with the potential for improved stock liquidity.

Our Board of Directors has completed an assessment of the spin-off process, concluded that they recommend proceeding with efforts to merge the entities. Regarding next steps, we now plan to focus on securing required regulatory approvals in Mexico and eventually to proceed to hold shareholders' meeting to request their approval of the transaction, considering the progress in these regulatory approvals.

I would like to conclude by highlighting recent advances in the implementation of a sustainability study. As you may already know, this past March, we announced targets to reduce our greenhouse gas emissions by 2030, marking a new chapter in our effort to help reduce the automotive industry's overall environment impact and contribute to a more sustainable mobility. Following the completion of the regular valuation process on the science-based targets initiative, we have committed to achieve a 28% absolute reduction in direct and certain indirect emissions in this timeframe.

With that, I would like to hand the call over to Alberto.

Alberto Sada

Thank you, Armando, and good morning, everyone. I will share additional context on industry trends, as well as drivers of our business and financial performance during the first quarter.

Light vehicle sales increased in all regions as pent-up demand and better market conditions supported continued industry recovery. North America and Europe, our main markets, showed improvement in the first quarter due primarily to better economic conditions, government stimulus programs and disposable income-driven demand. Annualized U.S. vehicle sales SAAR were 16.7 million units, 11% higher than in 2020; whereas in Europe, sales were 16.3 million units, 3% higher than the previous year.

In contrast, the global semiconductor shortage weighted on customer light vehicle production, which decreased 8% in North America and 5% in Europe. In the case of North America, adverse winter weather conditions also represented a headwind in the period. At the same time, I would like to emphasize that historically low inventory levels, combined with the current favorable light vehicle sales trend, make us confident that there will be a sustained recovery in light vehicle production in the region in the second half of the year.

Moving on to the rest of the world, light vehicle sales and production increased 90% and 71% in China compared to the same period last year, when the country saw widespread COVID-related production shutdowns. Meanwhile in Brazil, sales and production decreased 8% and 4% respectively, mainly due to the pandemic-related effects on the country's economy.

Nemak's total volume increased 2% on a year-over-year basis during the quarter, primarily attributed to a combination of new product launches, including our e-mobility and structural applications segment, and more favorable industry and economic conditions in Europe and Asia, which more than compensated industry headwinds in North America.

On the revenue side, improved product mix, higher aluminum prices and depreciation of the euro against the U.S. dollar, among other factors, contributed to a 15% increase in the reported period. During the quarter, we continued our efforts to make our cost structure as flexible as possible to drive operational efficiency, maintaining a rigorous control of our full range of manufacturing and administrative expenses, which enabled us to sustain a significant portion of the cost reductions we implemented in 2020.

EBITDA in this quarter amounted to $169 million, which represented an increase of 19% year-over-year, mainly on operational efficiencies and a more favorable product mix. In turn, we delivered a unitary EBITDA of $15.80, the second highest such figure we have ever reported in any first quarter. Nemak's operating income was $89 million, 37% higher than the previous year, due mainly to the same factors that benefited EBITDA.

Net income was $40 million, which compares to the $14 million net loss reported in the first quarter of last year. This result was due mainly to the same factors supporting operating income, along with a lower noncash currency effect.

We also remain focused on our cash preservation efforts, finishing the period with Capex of $63 million, which was $34 million less than the same period in the previous year. I want to emphasize that we remain on track with our planned investment schedule for the full year, as a significant portion of this investment derives from new product launches ramping up over the remaining quarters. Additionally, I would like to reiterate our focus on e-mobility and structural applications. For the full year, we expect to allocate more than half of our Capex to the new product launches and other strategic initiatives to this business segment.

As of March 31, net debt was $1.25 billion, which was similar to our level at the close of 2020. During the quarter, we repaid in full the remaining credit lines we have drawn amidst last year's pandemic-related production stoppages, which amounted to $85 million, reflecting our positive outlook on industry production trends for 2021. At quarter end, our net debt to EBITDA and interest coverage ratios were 2.7 times and 5.9 times respectively. It's worth noting that if we were to analyze our results from the last three quarters, these ratios would already been at pre-pandemic levels.

Looking ahead, I also want to emphasize that we're committed to maintaining a prudent approach to financial management as we continue to drive forward the implementation of our business strategy. As you may already know, Fitch cited our efforts on both these fronts in a recent publication announcing their decision to ratify our BBB- credit rating and upgrade our outlook from negative to stable. In particular, they highlighted the strong recovery in our business, our competitive position in our main product lines, and our increasing product diversification into structural and EV components as key considerations underlying this decision.

Moving on to regional results in the quarter, North America volume decreased 8%, due primarily to effects of lower customer vehicle production associated with shortages of semiconductors, as well as extreme winter weather in the south of the U.S., along with the wind-down of our manufacturing operations in Canada, which were completed in the second half of 2020. However, revenue was slightly higher as aluminum prices more than offset the decrease in volume.

Turning to EBITDA, we saw a 10% decrease in the quarter, due mainly to the lower volume just explained. Improved operational efficiency nearly offset the temporary effects of the natural gas situation in the region. This situation lasted for about one week and had a negative impact of approximately $9 million. It's worth noting that unitary EBITDA was only 2% lower, reflecting benefits of the efficiencies I just mentioned. Absent the natural gas situation, EBITDA would have been in line with last year's figures, while unitary EBITDA would have been higher.

Europe volume finished 9% higher, driven by new product launches for electric vehicle applications. Revenue grew 23% on higher volume, as well as aluminum prices. In turn, EBITDA recorded an increase of 63%, primarily due to a higher volume and richer product mix, supported by the continued ramp-up of our e-mobility and structural application business, a leaner cost structure and a more favorable Europe exchange rate.

Rest of the world volume increased 37%, mainly supported by increased sales in China and India, where we benefited from the combination of new product launches and stronger market conditions. As a result, we recorded a 59% increase in revenue, which, combined with operational efficiencies and a better product mix, drove a more than doubling of EBITDA compared to the same period of last year.

With that, I conclude my comments. I will now open the call for Q&A.

Operator, please instruct the participants on how to place their questions.

Operator

Our first question comes from the line of Luis Yance with Compass. You may proceed with your question.

Luis Yance

Oh, hi, Armando, Alberto, Adrian. Thanks for taking my questions and hope you guys are doing well. A couple questions on my side, and I apologize if you already mentioned that in your remarks, I connected a little bit late.

My first question is, if you could talk a little bit more about the semiconductor shortage. You mentioned there was some impact in North America; I was pleased to see that not as bad as I would've thought, and even Europe was less impacted. Just wondering if you can comment why you guys weren't as impacted. And clearly the situation is still with us in terms of a shortage, so just wondering if you expect to see some sort of slowdown or a bigger impact as we move forward, or not necessarily, and why not. That'll be my first question there.

Then the second one is in terms of profitability. Your EBITDA per unit, quite impressive on the quarter, despite the impact that you mentioned on natural gas. Your guidance sort of implies that that profitability, on a per-unit basis, comes down to $14.20, I guess. Just wondering, given what we've seen the past three quarters, including this one, the $15.80, but even the second half of next year, does $14.20 sound too conservative? And if not, what would be the—why should we expect to see that profitability eroding towards that $14.20, what would be the drivers? That'll be my first two questions. Thanks.

Armando Tamez

Thank you, Luis, this is Armando. I will answer the first part of your question related to semiconductors, and then I will let Alberto to more and more detail to the profitability question.

Everybody knows there is a shortage of semiconductors in the industry. The main reason for that is because the producers of semiconductors decided to allocate more chips, or semiconductors, to other industries, like telephones and videogames, consoles and so on. Of course, as you could imagine, we were affected. According to analysts, the industry lost approximately 1.3 million vehicles during the first quarter, and that was a combination in different regions, so North America certainly had an effect, as well as in Europe, and also a portion in Asia.

What we expect based on customer communications, as well as industry experts, is that these will continue during the second quarter and potentially a portion of the third. However, our customers are optimists related to recovering a significant portion of the volume for a net effect of, potentially, 1% to 2% vehicles lost at the global basis. We are taking all precautions related to these, and of course, when we are seeing that our customers are announcing shutdown of plants, we're aligning our discipline in terms of cost structure.

On the positive side, I can tell you that inventories of some of the products that our customers are offering are at historically low levels, so that's very positive. Certainly, some of the customers, especially in North America, have announced already that they are planning to skip the normal summer shutdown. We are hoping that the industry will recover during the second half of the year, and certainly, we will keep you posted.

Alberto Sada

Hi, Luis, this is Alberto.

Related to the second part of your questions, on profitability, certainly this quarter came very strong, as we have highlighted, on the back of product mix, as well as continued operating efficiencies. But you also need to take in mind the way that the seasonality works on a yearly basis.

Traditionally, the first half of the year is higher in volume, and therefore we should see a little bit higher profitability in the first half than the second half. We should be seeing the profitability on a per-unit basis average out a little bit as we move along the year.

Having said that, I think we are, again, optimistic in general about the industry and the year, and certainly, we're working very intensely to contain the cost structure in the way that we have adjusted it in 2020. With the combination of positive situations, certainly we will see better results, but for now, we have the same figure for the full year as we have guided.

Luis Yance

Great, thanks a lot, Armando and Alberto.

A follow-up if I may, I guess on the product mix that you mentioned. In terms of the electrification efforts that you are—and you're showing pretty good progress, especially in the backlog side, could you remind us, this quarter, what percentage of your volumes or your sales were in this kind of segment? Clearly, we haven't seen data on that portion; just wonder if, at some point, you plan to show the market the specific data for that portion so we get a sense also not only in terms of prices per unit, but also in terms of profitability per unit. I understand that at this point you don't have a lot of scale, so that might impact you. But just trying to understand if this product mix was mainly because a ramp-up in this electrical vehicle portion of the business, or it was something else.

Armando Tamez

Yes, thanks, Luis.

Again, as we indicated, for this year, our run rate for the structural components of electrification, we're planning to sell approximately $250 million worth of revenue, which is about 10% of our entire revenues. As I indicated, we are already seeing, in spite of the fact that—you're right, that we don't have the scale that we would expect to have. But in spite of that, we are seeing better profitability on the new components, at approximately 10% to 15% higher margin on a per-unit basis. That explains some of the results that now we are seeing.

Luis Yance

Great, excellent. Thanks, Armando and Alberto, for the answers.

Armando Tamez

Thank you.

Operator

Our next question comes from the line of Guillermo Diego with Santander. You may proceed with your question.

Guillermo Diego Delgadillo

Yes, sure, thanks for the call.

In fact, a couple of questions; maybe starting with the Capex, how sustainable—I mean, you may have a little bit of spare capacity, but how sustainable is it to keep the Capex below the depreciation, at least for the next maybe four to eight quarters, or two years, or do you see to make the catch-up to depreciation in the short term?

Maybe the second question is on the working capital. We have seen an improvement in the industry trends, and as you mentioned, recorded in the overall volumes, but it doesn't seem to be going up to the working capital. When do you expect, or how should we expect this normalization to go back to, maybe to the accounts receivable inventory base and the accounts payable base? Because today, it seems we are a little bit far away from that.

The third question, just on the dividend; you already mentioned the levels of cash and maybe debt, and therefore that you have made substantial effort to keep the financial conditions in place.

I believe if the recovery keeps up, should we see a dividend now in the short term? Maybe those three questions, please.

Alberto Sada

Sure, Guillermo, thank you for your questions.

Related to the first two points that you mentioned, on the Capex side: certainly, as we explained, this first quarter came a little bit lower than you would expected, where you just leverage the total Capex here in the four quarters, but that's the result of scheduling. We should be expecting to see a little bit higher Capex here in the next quarters, as the timing of some of these new products—the new product launches kick in.

We should be seeing a little bit more investment, and it should be aligned with what we have guided for the year. That's a little bit higher than the depreciation for the year that we have, and the reason for that, in spite of having over-capacity is the fact that we're investing in new product segments which have requirements of different processes where we need to add capacity.

Guillermo Diego Delgadillo

Okay.

Alberto Sada

Yes. Related to your second question on working capital, that's something that we have been putting a lot of effort in the last years to make sure that we have a working capital that we can contain at fairly good levels. You should have seen that working capital came in fairly well in the first quarter and we expect to maintain it in that level for the remainder of the year.

Certainly, put a lot of emphasis on our operations to maintain inventory levels low; we tried to match receivables and payables. As we see more activity, receivables will increase, but at the same time we'll see more payables increasing. Only know we tried to contain it in a way that it will not use cash from operations. We should be seeing similar levels going forward.

Guillermo Diego Delgadillo

Similar levels as the first quarter, right, as the (inaudible) base, inventory, the same trend?

Alberto Sada

Yes, correct. Because normally at the end of the year, we see a positive working capital development, and then you invest a little bit during the year, and then you report some of that at the end of the year. That's the normal seasonality of our space on production schedules.

Armando Tamez

Guillermo, if I may, related to your question…

Guillermo Diego Delgadillo

Yes, the dividend, yes.

Armando Tamez

…about dividends, let me just remind you that Nemak, over the last six years, excluding of course 2020, in which we face a big financial crisis due to the pandemic, we have been giving dividends to our shareholders at a very reasonable level, our main priority. And that's one of the reasons that, last year, we decided to present to our shareholders the cancellation of the dividends, even though they were already approved and it was accepted by our shareholders' understanding that we were basically taking care of the financial situation of our Company.

Now we are seeing more stability, and certainly, as I indicated in my presentation, we're expecting to reach levels close to two times during the second half of the year. Once we are at those levels, we will certainly present to, first, our Board of Directors and then to our shareholders, a potential dividend. But yes, we're committed to maintain dividend for our shareholders, as long as we have reasonable profitability as well as a solid leverage ratio.

Guillermo Diego Delgadillo

Okay. Maybe just a long-term (inaudible) question. If we consider the recent positive recovery and even if we put some positive numbers, it seems like the return of our investment capital is fairly—no, above the cost of capital, so you're fairly generating value, in the long term at least. Is there some vertical lift (phon) or something structural that you're going to change to try to improve the ROIC in the next quarters?

Alberto Sada

Well, we think that's a very important indicator that we follow, for sure. Every project that we engage with comes with profitability that it's at or above (inaudible) rate. Expect gradually, as we add more products, to have an improvement on the return on invested capital for the Company.

But we want also to use as much equipment as we have for the new products, to the extent as possible, so that we can maximize their use so that we don't have more assets that we haven't paid which we have (audio interference) to a greater extent in the past. Yes, it's an indicator that we follow, and we expect to improve it, based on our ability to add more products at higher profitability than average, as well as, as we see the improvement in the volumes recovers from COVID-19 situation.

Guillermo Diego Delgadillo

Great, thank you for the time.

Armando Tamez

Thank you.

Operator

Our next question comes from the line of Alfonso Salazar with Scotiabank. You may proceed with your question.

Alfonso Salazar

Yes, thank you and good morning, everyone.

I have some questions regarding the long-term overview of the auto industry and how Nemak is adapting to the transformation from the ICE to the EV world. It's very encouraging to see that you're already monetizing the opportunities with EVs. But do you perceive an acceleration in this trend toward EVs, especially after the announcement made by General Motors? What are the implications for your core business? By that I mean, (audio interference). How do you see sales of these products five or 10 years, again?

The second question that I have is, we have seen a number of the startups trying to produce autos, electric vehicles in the future, especially in China but in other countries as well. Do you anticipate a more fragmented auto industry in the future? And if that is the case, what does Nemak—how is Nemak is preparing for a more fragmented industry in the future? Those are the two questions that I have. Thank you.

Armando Tamez

Thank you, Alfonso.

Certainly, we have developed a strategic plan in which we are looking very, very carefully to the penetration of electrification, Alfonso. We foresee that, yes, eventually we want to switch for more electrification. We are seeing, as we speak, higher penetration in Europe and also in China. In the U.S., it's a little bit behind; however, with the new administration, certainly there will be incentives to foster the electrification trend.

We have already indicated, certainly participating in both the internal combustion engine—remember that part of the strategy is also to produce hybrid vehicles that have a combination of both the internal combustion and electric, plus the pure electrics. We are participating in the three of them, and I think we are moving at a very nice pace in the three segments. I think we have captured a significant portion of the available business, working with many, many different customers.

We believe that, certainly, there will be certain transition. You mention what has been in the press related to the announcement made by the CEO of GM. Ms. Barra announced that they would be phasing out old internal combustion engine by 2035. That is an announcement made recently, and that the original date that they had was 2038. They made these modifications. Because recently, if you go to *Automotive News*, one of the leading—the head of Cadillac, indicating that, well, that was a desire. However, they will evaluate during that time if the market is still preferring going to electric or internal combustion engine.

That explains a little bit that no one else follow GM in that objective of phasing completely out of internal combustion engine. I think they need to watch how customers react, as well as infrastructure, prices of electric vehicles compared to internal combustion and so on.

Related to the startups, we are seeing many, many companies. We are expecting that, eventually, there will be consolidation in the industry. In this industry, you need scale to become profitable. Just to remind you—and I have been (inaudible) this industry for long, but at the beginning, also, there was more than 1,000 OEMs or manufacturers of vehicles, and they've consolidated in a handful of players. There was a lot of consolidation during the last maybe 20, 30 years. But if you go back in history in this industry, there were more than 1,000 different brand names. If you don't have the scale, certainly it's going to be very difficult, first, to have the resources for investment, R&D and differentiate yourself.

Yes, a lot of people are trying to enter in this interesting market. As you have seen already, valuations for EV vehicles are very high, so very attractive so far. But eventually, I think, once it matures, it will become more challenging, and I think valuations will be, in our opinion, going more to the fundamentals of the business, and then consolidation will come.

Alfonso Salazar

That's very useful. Thank you very much.

Armando Tamez

Thank you.

Operator

Our next question comes from the line of Marcelo Motta with JPMorgan. You may proceed with your question.

Marcelo Motta

Hi, everyone, thank you very much for taking my questions.

Just a couple questions. I mean, the first one is if Nemak could tell us what is the, let's say, the implied element of price on the guidance? I mean, if we look at the level of revenues in the first quarter, it's already almost 30% of full-year guidance. There is some seasonality as well, but we did believe that the fact that aluminum prices continued to increase might indicate that the number of revenue (audio interference) could be some (audio interference).

Also, looking at EBITDA per equivalent unit, in Europe, I mean, there was a big increase. The company commented about a better mix and the depreciation of euro compared to dollar, but just wondering if there is something else there that was responsible for this very strong improvement of almost 50% on EBITDA for equivalent unit in Europe.

Alberto Sada

Yes, thanks for your question, Marcelo.

Yes, certainly we are observing the situation with the aluminum prices. Aluminum prices have been gradually increasing in the last few months. The current figures that we're seeing are a little bit higher than what we had assumed in our guidance, so that explains why results are, on the revenue side, slightly higher.

Related to the EBITDA per unit that we're seeing in Europe, certainly Europe came very strong, and that was on the back of several factors. The first was associated with the better product mix that we have. The second one is efficiencies that we have been working around all our different operations. The third one has to do with foreign exchange rate: as you know, the euro has also been appreciating against the dollar, and the translation effect of our results in Europe when we report that in dollars reflects in higher figures.

To put it in figures, about 40% of the effect has to do with volume and mix; another 40% has to do with efficiencies on our operations and costs; and the remaining 20% has to do with that translation effect of the euro to dollar.

Marcelo Motta

Perfect. If I may ask just another follow-up question on the margins. You comment that the profitability, when we look at the EV structural component, is already 10% to 15% higher, even though the company doesn't have the optimum scale for this segment. On a steady-state and with the right scale, I mean, how much higher does Nemak believe that these margins could be? I don't know, 20%, 30%, 40%? Just a broad range, just for us to understand how profitable this segment could be.

Alberto Sada

Yes. We should be seeing, once stability reaches, to seeing more like 15% improvement overall in the profitability of this new segment. As you can see, it's a very promising opportunity for us, both because it represents significant higher volume, as well as in total profitability given the market dynamics that we're seeing in this segment.

Marcelo Motta

Perfect, thank you very much for the answers.

Operator

Our next question comes from the line of Valentin Mendoza with Banorte. You may proceed with your question.

Valentin Mendoza

Hi, Armando, Alberto, Adrian. Congratulations on the strong results and thank you very much for taking my question.

The first one is sort of a follow-up on Luis' question regarding your structural components and EV business. I mean, in light of your current backlog of nearly $900 million in revenues, it seems that you will certainly reach the $1 billion goal you set for 2021. In that sense, I was wondering, what would be the next target in this regard? Also, related to this, Armando just mentioned that over $150 million of 2021 revenues will come from this business; so the question will be, what could be the expected contribution of such segment in 2022? That will be my first question.

Armando Tamez

Yes, thank you, Valentin.

Certainly, as we indicated in the past, our goal was to reach $1 billion worth of new business by 2022. We are confident, based on the prospects that we have in front of us, that we will reach that milestone even before our original date. We are, today, all in, more than $1 billion worth of fairly interesting business, more on the EV side than on the structural side. I would say approximately about 60/40, in that area. We would like first to consolidate the business and then, absolutely, we will set a new target, but we are seeing that Nemak is penetrating. As I indicated today, we are producing in 12 out of our 38 manufacturing facilities components for electric vehicles, as well as structural components. We have more than 10 customers already buying from us, and we have many additional prospects with them and with other customers.

We see a great future for our Company. I think we have demonstrated, so far, that we're a reliable source. We have very nice market penetration on the hybrids, electric components, as well as powertrain, and also on the fuel electrics, winning new contracts with different OEMs. We believe that that will be something that is expected to continue growing.

I think it's important to remind everybody that we are looking for profitable growth. We are not just looking at growth for the sake of growth. We are looking at how we can create value for our shareholders and our Company. Certainly, we're expecting to increase our profitability.

Related to the margins that we're getting, I think we already indicated that we are seeing between 10% to 15% better margins, and that's what we can comment from this side, Valentin.

Valentin Mendoza

Actually, my question was—the second part—or the follow-up in this, was the expected contribution to sales of this segment in 2021. You mentioned that it should be around 10% in 2021, so this would be your expectation for this contribution in the next year.

Alberto Sada

Yes, Valentin. I mean, that number should be gradually increasing to match the numbers that we have, the $900 million of pipeline that we have in this segment. It's going to be—the figure for 2022 will be subject to how that ramp-up materializes. We're seeing a very strong push by all of the OEMs of the segment, so we expect this year to increase on an important matter (phon) in 2022. We'll certainly disclose the figure once we're coming close to the year.

Valentin Mendoza

Okay. Thank you very much, Alberto.

Just one follow-up question if I may; it has to do with working capital. I just wanted to know, how are you thinking on receivables, and especially on inventories that have grown, importantly, during this quarter, and I assume it has to do also with the semiconductor shortage. What would be your expectation on this side? Should we expect a reversal towards the second half of the year?

Alberto Sada

Yes, Valentin. Working capital, as we explained, we have very good control on the cash needs for working capital. Certainly, we see the figures on inventory, the figures have been growing in the last few quarters, but there's two reasons for that. One of them is the increase in aluminum prices, which reflects in higher cost of the inventory, and the other one is, we're catching up on some inventory as we are supplying products that depleted inventory in the last year.

We're getting a little bit of catch-up, plus the effect of aluminum prices. But at the end, we do see the total amount of working capital has been quite stable, because we have been able to work around the different elements to retain a fairly good working capital figure. We should see that pretty much stable for the remainder of the year.

Then at the end of the year, as we said also before, we should be seeing a positive working capital development as volumes reduce, based on seasonality.

Valentin Mendoza

Okay, that was crystal clear. Thank you very much.

Alberto Sada

Thanks, Valentin.

Operator

Our next question comes from the line of Andres Cardona with Citigroup. You may proceed with your question.

Andres Cardona

Hi, good morning, everyone. I have two questions.

The first is, if you can provide us with an update about the process to merge Nemak and Controladora Nemak. Not sure if you talked about this before, but I was able to connect a little bit late.

The second one is if—your early dynamics for April, if you have seen any relevant changes from first quarter results, right, if there is an increase on the shortage of semiconductors, a change in terms of volumes.

Maybe a last one is, when you look forward, let's say five years, how much, in terms of percentage, do you think the EV could represent from your revenues, if there is something that you can share with us? Thank you.

Armando Tamez

Yes, thank you, Andres.

Related to the process of merging the two entities. Since the beginning, Alfa created that vehicle of Controladora Nemak to spin off of the Company. From day one, it was our intention, as Management team, as well as the Board of Directors and of course the shareholders, to merge the two entities, to create more transparency for all investors and shareholders. We are in that process. Of course, we need to file with the CNBV, Comisión (phon) Nacional Bancaria, for the paperwork. I think our Legal team has already been working very hard to prepare all documents.

We're in that process, Andres, and then it will be up to the authorities to give us the green light. Once the green light is given, certainly, we will call a shareholders' meeting to propose this merger. Certainly, we are looking forward for that to come, as soon as the CNBV give us the green light, which we expect will be in the next maybe between two to three months, hopefully. But you need to remember that unfortunately, this is out of our control and in the hands of the authorities.

Related to volumes, as we have indicated, certainly, we face some shortages of semiconductors, along with our customers. We suffered during the first quarter, that we have seen some effects during the second quarter. Our customers are expecting to recover those volumes during the third and fourth quarters of this year. Hopefully they can be successful getting enough semiconductors to build the vehicles and trucks that the customers are expecting.

The positive news is that the market is extremely strong. Just to give you some numbers in North America, in the South, our annualized sales for the month of March reached about 17.7, which was significantly higher than expected by industry analysts, as well as for us. The market is there. Just, I think, our customers need to fix these issues related to the semiconductors.

What we're seeing, and again, depending on the region, is the mix between pure electric and internal combustion engines or hybrids. We're seeing, on average, and depending on the analyst that you follow, by the end of the decade, that it will be approximately, globally, about 20% electric vehicles and 80% continue with internal combustion engine or hybrids. That's our figures for about 2030. I don't have it for the next five years in front of me, but certainly we have it available and we can provide that at a later time.

Andres Cardona

Thank you very much.

Armando Tamez

Thank you.

Operator

Our next question comes from the line of Alejandro Azar with GBM. You may proceed with your question.

Alejandro Azar

Hi Armando, Alberto. Good morning and congratulations on the results. Most of my questions have been already answered, but I follow with a strategic one.

First, given that emissions will no longer play a role with battery electric vehicles, OEMs might shift focus from lightweighting to cost reduction, and thus maybe shift some components from aluminum back to cheaper materials from iron or steel. What are your thoughts on this? That will be my first one.

The second one is if you can provide us, if there's a chance, with the aluminum price on your embedded guidance.

Armando Tamez

Yes. Thank you, Alejandro.

Related to the lightweighting, I think it's important to mention the following. Certainly, one of the challenges that our customers are facing is regulations. That is, for instance, CO_2 emissions. The lighter the vehicle, the less emissions the vehicle produces. And for electric vehicles, of course the lighter the vehicles, you can increase the range. Yes, absolutely. Customers are looking at a variety of materials just to make sure that they can comply, first, with regulations; second, that they can produce vehicles that are cost-effective, but, as well, have the range that customers are expecting. Of course, you can go for high-strength steel or other materials, reduce the cost, but you increase the weight.

They are internally debating. There is no perfect solution for a single material. I think it's important also, Alejandro, to mention that Nemak is mainly producing aluminum components, but we are also, today, as we speak, producing with multi (phon) materials. We are producing battery trays that have not only aluminum, but also high-strength steel and other materials. Nemak's looking at how we can serve our customers better regardless of what are the materials of choice by our customers.

We are producing as well plastics. We don't produce, but we assemble those components in part of the battery trays that we are producing today.

The second portion, Alberto?

Alberto Sada

Yes, and related to your question on aluminum prices for guidance, the embedded aluminum price from an LME point of view is close to $2,000 per tonne. That's the basis that we use to calculate the revenues for our guidance.

Alejandro Azar

Thank you.

Alberto Sada

Alejandro, a little higher than that…

Alejandro Azar

Yes.

Alberto Sada

…yes, but those are the figures.

Alejandro Azar

Thank you, Alberto.

One more if I may on the structure on electric vehicle component business. Could you remind us the breakdown by region of those $900 million in the order book? And also, what's the percentage of EV applications and structural? The other one would be, if you are ready to increase your guidance of $1 billion for 2022, as it seems really obvious that you are going to surpass it.

Armando Tamez

Yes, thanks, Alejandro.

In terms of the mix that we have between EVs and the structural, I'm happy to tell you that's approximately 60% of our business is related to EVs and 40% to structure. Today, I think we have a nice mix. Certainly, Europe is with a little bit larger portion of the revenues that we're getting, and everybody knows that regulations in Europe are significantly more strict and tougher than in any other region.

That is why our penetration in Europe is a little bit higher. I will say approximately about 60% to 70% today is coming from Europe, and the rest being North America, a little bit of portion also from China.

Alejandro Azar

About your $1 billion guidance, Armando?

Armando Tamez

Yes, thank you, Alejandro.

I think we will eventually, once we reach our objective or target that we set of $1 billion, we will be ready to prepare the second objective. Hopefully we could do it before the end of this year, but we will study this based on the backlog that we have, as well as opportunities that we are seeing. But as we speak, I'm very confident that we will be able to reach this target, hopefully before the end of this year.

Alejandro Azar

Thank you. Thank you very much to you both, and congrats on the results.

Armando Tamez

Thank you, Alejandro.

Alberto Sada

Thanks, Alejandro.

Operator

Our next question comes from the line of Luis Yance with Compass. You may proceed with your question.

Luis Yance

Thanks, yes, and just a quick follow-up on the discussion about electrical and structural. It was good that you gave us some kind of breakdown by region. Just wondering if there's one, two or three products that are the lion's share of that backlog, kind of similar to what we see in the traditional business blocks and heads? Or is it a combination of multiple products?

I guess a related question to that, in your traditional business, you used to be, in most cases or in a large number of cases, the only provider of that particular component. Just wondering if you're heading towards that direction with the EV and the structural. What sort of market share in the product that you provide do you think you have at the moment?

Then the last question would be, how do you unlock value at (inaudible) which looks quite promising? If you were to do a billion in sales or even more, you're talking at some point $150 million, $200 million in EBITDA. Clearly, electrical-only type of companies trade at a much higher multiple. Is it in your vision to potentially sell a stake once it's fully mature, or even list the Company to unlock that value? Any sort of long-term thoughts you can share with us? Thanks.

Armando Tamez

Thank you, Luis. Very interesting questions.

Related to the EV and the structural parts, certainly, as I indicated, we see huge potential. I need to give a lot of credit to our business development area, that we have a very strong team there that has made an excellent job of analyzing the entire vehicle. We have selected a few components out of the vehicle that we believe are parts that are very challenging from the technical point of view. Certainly, we don't want to produce parts that our customers consider commodities. We like to make highly-engineered, challenging, difficult parts to make, similar to heads and blocks.

We have selected a few parts on the structural side of the business in which we can offer our technology, our technical capabilities and add value to our customers as well as to our Company. We have a few components that, again, we are selecting, and I give a lot of credit to our business development area for that analysis and study, along with our technical people.

Related to the EVs, we are basically targeting three main—or four, I would say, different type of components. I will start, for instance, on the growing hybrids we are making for our customers, battery trays, using high-pressure die casting. As I indicated in my presentation, we are adding more value and adding more, let's say, integration to those components requested by our customers and of course by our technical team.

We're also making e-motor housing, some of them using high-pressure die casting, some of them using our patented process, the core package, using high complexity parts that use a lot of integration. Certainly, we can differentiate ourselves in that area.

Also, we are making battery trays that are part of the structure as well as all the battery cells. Those are very interesting parts we are making, as we speak, several different products for different customers. Last but not least, also, new box housing for electric vehicles. Those are the components that we have selected, and we see high potential. Part of our philosophy is to concentrate in products that are very challenging, difficult to make, and which we can differentiate our technical capabilities.

Certainly, it was not by accident that we became the supplier of choice for heads and blocks. We want to do the same for the EVs and structural components that we make. We are proving today to the market—remember, just a few years ago, we were 100% concentrated in internal combustion parts; now, I think our customers are recognizing Nemak as a leading supplier of these types of components, and they are inviting us to quote interesting parts. Certainly, we will continue working very hard.

I think it's important also to mention that approximately 80% of our R&D budget is directed to these type of components. We are investing heavily in this area to develop the capability and provide our customers with better solutions that support their needs. This is an area that we will continue pushing very hard. Today, I'm happy to tell you that we have approximately 20%-plus on the hybrid components, and I think we are the largest today in the world. Certainly, our main competitors in that segment are our customers, but they are realizing that we can have better value and significantly more competitive costs.

Luis Yance

Thanks. On the long-term vision, how do we unlock value; do you list it, or what are your thoughts, down the road?

Armando Tamez

I think, Luis, we are seeing, as we speak already, unlocking value. We are not, let's say, today, selling at a loss or anything. On the contrary. We are getting, today, in spite of the fact that we don't have the scale yet, but we are building the capabilities very, very fast, learning as quickly as possible. Some of that, I think, with the support of our customers. I need to give them credit for that. But we are already unlocking value on the new products and getting, based on the work we've done, on the investments that we are making to support these new product lines.

Luis Yance

Great. Thanks a lot guys, congratulations again and good luck on the outlook. Thanks.

Armando Tamez

Thank you, Luis.

Operator

There are no further questions at this time. I'd like to turn the conference back over to Mr. Althoff for additional or concluding remarks. Sir?

Adrian Althoff

Thank you, Operator.

I would just like to thank everyone for participating in today's event. Please feel free to contact us if you have any follow-up questions or comments. And have a good day.

Operator

Thank you for joining us today. This concludes today's conference.