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NEMAKA.MX - Q1 2017 Nemak SAB De CV Earnings Call

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CORPORATE PARTICIPANTS

Adrian Althoff *Nemak, S.A.B. de C.V. - IR*

Armando Tamez *Nemak, S.A.B. de C.V. - CEO*

Alberto Sada *Nemak, S.A.B. de C.V. - CFO*

CONFERENCE CALL PARTICIPANTS

Mauricio Serna *UBS - Analyst*

Alex Falcao *HSBC - Analyst*

Juan Tavarez *Citigroup - Analyst*

Marcio Prado *Goldman Sachs - Analyst*

Valentino Mendoza *- Private Investor*

Augusto Ensiki *HSBC - Analyst*

PRESENTATION

Operator

Good morning, everyone and welcome to Nemak's first-quarter 2017 earnings conference call. Armando Tamez, Nemak's Chief Executive Officer; Alberto Sada, Chief Financial Officer; and Adrian Althoff, Investor Relations associate, 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 will be available on the Company's Investor Relations website. I will now turn the call over to Adrian Althoff.

Adrian Althoff *- Nemak, S.A.B. de C.V. - IR*

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 our business and financial highlights. Alberto Sada, our CFO, will then discuss key 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 Tamez.

Armando Tamez *- Nemak, S.A.B. de C.V. - CEO*

Thank you, Adrian. Hello, everyone and welcome to Nemak's first-quarter 2017 results conference call. We saw mixed results this quarter with growth in sales volume helping to drive our top line on the one hand, but on the other hand the negative impact of the metals price lag affecting profitability. Continued weakness in the passenger car segment also pressured margins, particularly in North America.

Consolidated volumes and revenues increased 2% and 4% respectively while EBITDA finished down 9%. As you may recall, on the aluminum pricethrough arrangement with our customers, sales prices are regularly reset to [trap] changes in publicly referenced aluminum prices. The lag effect created by temporary gaps in sales versus purchase prices, which we call metals price lag, accounted for most of the year-over-year decrease in EBITDA. As the metal price lag was negative this quarter contrary to what happened in first quarter 2016 when it was positive making for a difficult comparable.

In (inaudible) response to the impact we have seen in our results, we have begun implementing a series of companywide initiatives targeting additional cost savings and productivity improvements with the aim of sustaining the level of performance we expect.

Notwithstanding the external headwinds already described, our European and rest-of-world operations delivered another good quarter, mainly on the back of new production program rampups combined with volume increases in existing businesses.

We continue to see solid prospects for our business in the short to medium term in Europe as growth in powertrain dovetails with the rampup of the first [concept] to produce structural and electric vehicle components.

I would also like to highlight our performance in Asia where we are successfully leveraging our technological resources and know-how to support our customer's effort to introduce lighter next-generation vehicles. We have been progressively delivering better results in recent quarters and we believe that we are well-positioned to continue strengthening our customer relationships and reinforcing our competitive position in the Asia region into the future.

Turning to strategic projects, I am pleased to share that we have reached several new milestones in the growth of our structural and electric vehicle component business. These included the successful launch of three new high-volume global programs to produce structural components, two for BMW and one for Audi, whereas our team in Poland is leading the BMW programs when the process of handing off production of the Audi program from Poland to Mexico in order to better serve Audi's new assembly plant in Puebla.

Additionally, we plan to start launching dealer probes in Europe this year serving these new business lines. This will consist of supplying structural components to Alfa Romeo and Audi, as well as an EV component to Daimler.

The Audi program destined for Mexico will be produced at a Ford new high-pressure die casting plant in Monterrey, which we officially [integrated] at the ceremony this past March. In addition to structural components, the plant's high-pressure die casting technology will primarily support the production of engine blocks and transmission cases with most of the volume to be machined on-site. The production capacity is 2.2 million equivalent units.

Continuing with the efforts to strengthen our global footprint, we are seeing sustained progress in the integration of our operation in Turkey. Since becoming part of our Company last November, our team there has continued delivering on the previous business commitments while deepening their engagement with the rest of our European organization.

Moreover, they have gotten off to a quick start in terms of new business wins having already been selected as the production site for a total of three new programs serving European OEMs.

At the consolidated level, we won new contracts this quarter worth approximately $125 million in annual revenues. This included a new program to produce structural components for Daimler at the new high-pressure die casting facility we are close to completing in [Slovakia]. With this new program, we have been awarded contracts to produce structural components for all premium German OEMs.

We also made strides to build upon our customer relationships with our operation in Slovakia, winning an award from FCA for its outstanding contributions to a successful launch of the engine platform serving Alfa Romeo's first ever SUV line, as well as its all-new sedan.

On the financial front, during the quarter, we successfully placed a seven-year $500 million eurobond at the rate of 3.25%. The proceeds from this placement were used to prepay short-term maturity (inaudible), increasing the average life from four to six years. Additionally, it enabled us to better match the currency mix of our debt and cash flows in euros and further diversified our sources of funding. The bond issue was rated one notch below investment grade with a positive outlook from the three major rating agencies.

With that I will hand off the call to Alberto Sada, Nemak's CFO.

Alberto Sada - *Nemak, S.A.B. de C.V. - CFO*

Thank you, Armando and good morning, everyone. Let me start by sharing relevant regional industry data that sheds light on our results. In the US, we saw flattish vehicle sales during the quarter with a seasonally adjusted annual rate or SAAR finishing up 0.2% year-over-year. Sales mix continues favoring large SUVs and pickup trucks at the expense of passenger cars, a trend we have been seeing in recent quarters.

Meanwhile, North America vehicle production grew 1.6% mainly driven by production at locations from other regions. In turn, Nemak customers increased production in North America by 2.7%. However, in line with sales, we continued seeing the impact of lower production of small and midsized vehicle platforms across the board, particularly with FCA and Ford, which is relevant to us given our exposure to engines in these platforms.

Turning to Europe, vehicle sales SAAR recorded a 1.2% year-over-year gain as growth in Western Europe more than compensated for the decline in Eastern Europe. Industry and Nemak customer production in the region both grows at a faster rate of 6.7% and 7.8% respectively, mainly on the back of increased exports to other regions.

Moving on to our results, we saw total volumes up 2% as good performance in Europe and Asia more than offset a decrease in North America. Revenues posted a 4.4% gain due to the higher volumes and aluminum prices.

In contrast, aluminum had a negative impact on our operating income due to the metal price lag affect, which Armando just described. This quarter, the impact of this lag amounted to approximately $16 million stemming from an approximately 8% increase in the commodity versus 4Q 2016. Additionally, we faced a tough comparison, vis-a-vis the first quarter 2016 when we saw a slightly positive metal price lag effect.

Lower sales volumes and an unfavorable mix in North America also contributed to lower profits in first Q 2017. As a consequence of the above, we reported consolidated operating income of $113 million, 15.7% lower than first quarter 2016. This decrease resulted in lower first-quarter 2017 EBITDA, which finished at $190 million or 9.1% less than $209 million we saw in first quarter 2016.

First-quarter 2017 EBITDA margin was 16.9%, 250 basis points lower than the 19.4% we saw last year. First-quarter 2017 EBITDA per equivalent unit reached $14.40 per piece, down from the $16.20 reported last year. Despite the decrease in EBITDA, the free cash flow was $96 million better than the first quarter of last year thanks in part to a more efficient management of working capital. This result speaks well of our capacity to respond to a more challenging business environment.

Net income decreased 31% year-over-year as lower operating income combined with the effect of foreign exchange rate movements resulted in higher income tax provisions decreasing the net result.

Next, I would like to touch on our CapEx program. In the first quarter 2017, we invested $143 million, in line with our CapEx guidance of $430 million for the full year.

Now I would like to cover our regional results. Our volume in North America decreased 6%, mainly due to unfavorable sales mix, which was driven by the reduction in FCA and Ford's small and midsize lines as described before. As we have shared in previous calls, FCA scaled down production of its vehicles in this segment for which we supply heads, blocks and bed plates. Eventually, we expect to recover some of this volume once FCA deploys production of new small SUV lines, which will contain the same engine. In turn, Ford also lowered production of passenger cars, reducing demand for parts that we produce out of our operations in Mexico.

Revenues decreased 1.7% as the volume effect previously mentioned more than offset higher aluminum prices. EBITDA in North America decreased 18.9% compared to first quarter 2016, mainly due to the lower volumes combined with the negative metal price lag.

Turning to Europe, volumes increased 12.5%, mainly due to the rampup of new programs and integration of Turkey while our customers increased production by 7.8%. Revenues rose 8.8% driven by aluminum prices and volumes, which was partially offset by the depreciation of the euro and unfavorable mix.

EBITDA in Europe increased 3.2% compared to the same quarter of last year as higher volumes more than offset the negative impact of metal price lag and the depreciation of the euro.

In our rest-of-the-world operations, our volumes increased 33%, mainly due to the higher volumes in Asia. Revenues increased 37% driven by this increase in volumes. EBITDA increased by $5 million mainly due to improved volume and profitability in Asia.

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). Mauricio Serna, UBS.

Mauricio Serna - *UBS - Analyst*

Just a couple of things. I would like to get some color, if you could provide us an update maybe on what you are seeing in terms of the US auto sales. Particularly you mentioned that you've been affected by the downsizing of FCA and Ford production of passenger cars. Do you expect this effect to continue impacting volumes throughout the rest of the year or should we see an improvement maybe in the second half?

Also, just wanted to understand -- and thanks again for the information, the color on the metal lag effect. You were mentioning there was a $60 million impact on your EBITDA given an 8% increase in the commodity price. Is there something, a rule of thumb, that we could use that we could use to forecast based on the aluminum prices?

And finally, just if you are keeping -- sticking to the guidance that you provided at the beginning of the year regarding the sales and the EBITDA for the year. Thanks again.

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

Yes. Related to your question, the first one related to volume, I think as you correctly pointed out, we are seeing FCA and Ford reducing the production of the engines that goes to vehicles, small and midsize vehicles that had an impact on our results this quarter.

We saw that same effect last year, particularly with FCA and what we see going forward is that we will most likely see this effect at least for the next quarter or the next as we clearly see that the industry is concentrating more on larger vehicles and SUVs. So that's clearly something that we are seeing.

As I indicated, we will gradually pick up some of these volumes again once in the particular case of FCA once they start ramping up their new SUV lines, which will be using some of these small engines that we are making for them.

Related to the second part of your question related to metal lag, yes, what we experienced this quarter was a relatively strong increase of the aluminum prices of roughly 8% and that translated to the $16 million of negative metal lag impact.

And it's hard to say that there will be a rule of thumb in terms of percentage of aluminum increase versus metal lag because it also has to do with how quickly the aluminum prices shift going forward. So in this case is what is effect. What we will see in the next quarter most likely is a little bit more of this metal lag as we still see aluminum prices increasing a little bit, but they may stabilize probably on the second half of the year.

Alberto Sada - *Nemak, S.A.B. de C.V. - CFO*

And related to your question related to guidance. At the moment, we are not changing our guidance. As I indicated in my presentation is that we are taking additional steps internally at a global level trying to improve our cost structure, as well as some productivity gains to offset what we have deviated in terms of the metal lag for the first quarter. So we are confident that we will put in place the necessary actions to get some additional profitability.

Mauricio Serna - *UBS - Analyst*

Thanks. That's very helpful.

Operator

Alex Falcao, HSBC.

Alex Falcao - *HSBC - Analyst*

Good morning, guys. My question is regarding again North America. Just wanted to know if there is anything that you guys can do to -- we're seeing negative results throughout. How quickly can you guys respond to that? You said earlier that you are focusing on larger vehicles, so how can you respond?

And also we have seen a surprising pickup on domestic autos in Mexico, the production there. Is that something that we can expect to impact your numbers going forward or it is so small that you are not going to be able to see there? Thank you.

Alberto Sada - *Nemak, S.A.B. de C.V. - CFO*

Yes, related to your first question, I think the effect that we are seeing in North America unfortunately is a combination of the two large effects. The first one is the volume reductions that we saw and the second one is metal lag. Those two elements explain roughly the entire difference versus last year performance.

So I think it's a matter of seeing how the metal develops going forward. If we see stabilization on the metal, we should gradually see that effect obviously reversing. And related to volumes, in this particular case, we also had a negative effect because we experience some additional volume reduction with small vehicles from Ford that we make those in Mexico and unfortunately those products have slightly higher contribution for us in Mexico, so that has a negative effect on our regional results. As we see these volumes stabilizing going forward, we should be seeing better results in North America.

Alex Falcao - *HSBC - Analyst*

Okay. But any particular actions that you can (technical difficulty) to remediate that are North America-specific or it's more of a market sort of thing?

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

So we are, as we speak, talking to some customers in cases in which our volume is significantly lower than originally anticipated to try to get some type of compensation. We are not going to get on the specifics because this is something that we normally manage very closely with our customers. But we are, yes, pursuing some opportunities for some compensation in certain platforms and certain programs, but we have major deviations from existing contracted capacities.

Related to larger engines, we certainly have also where we are participating I think it is important to remind you that, in the bigger engines, not all of them have aluminum blocks. That is one of the reasons that we have been effective and there is unfortunately nothing that we can do in the short term to change that.

As we speak, we are also talking to some customers about exploring the possibility for the new engine designs for larger vehicles to switch from iron into aluminum, but that will take a little bit longer for us.

Alex Falcao - *HSBC - Analyst*

Okay. And about the metal market in Mexico?

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

The metal market is again -- we are not seeing a significant shift. Certainly Mexico is expanding certain capacity. For instance, Kia recently just started operations and we are supporting them with 100% of all their requirements for cylinder heads and we are seeing some higher volumes with these customers, but it is going to take some time for the OEMs to increase their capacity in Mexico. It is expected that the capacity will be in place over the next two years. Maybe two, three years, we will see some positive effect in terms of revenues and profitability from our Company.

Alex Falcao - *HSBC - Analyst*

Okay. Final question. Within the [Europe] problems, how much of that is from Turkey and what do you think is a sustainable level of growth going forward?

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

Yes, fortunately, growth in volumes that we saw in Europe came from Turkey. Turkey has on a yearly basis close to 1 million units of additional [cooling] units. So we are seeing a portion of that increase associated with Turkey, so that should be adding up this volume on a quarter-by-quarter basis.

But also I think it is important to mention that we are gaining marketshare in Europe. As we speak, we have been gaining. Only in Turkey, as I indicated in my presentation, we have been awarded three new programs that we are taking from some competitors that will help us increase volume and revenues and profitability over the next few years.

Also, a lot of new products in the structural components business and electric vehicles are coming from Europe. So we are seeing a nice trend in Europe in which we are gaining marketshare, improving profitability and we see that we are optimistic for that market as well as Asia.

Alex Falcao - *HSBC - Analyst*

Okay. Awesome. Thank you.

Operator

Juan Tavarez, Citi.

Juan Tavarez - *Citigroup - Analyst*

Maybe my first question just to keep the trend on Europe. Could you discuss how much of that growth that we saw this quarter, if it includes structural components and if it doesn't, when should we start to see the first sales of structural components within your reported results?

Second, maybe you can talk about your new contracts that you won this quarter. How much of that $125 million was your core powertrain division versus the new structural component contract? And maybe if you can give us an update on where are we today on the total backlog for structural components? Thanks.

Alberto Sada - *Nemak, S.A.B. de C.V. - CFO*

Related to your first question about structural component growth, we are seeing the rampup of -- and I think Armando mentioned that on his part -- we are seeing the rampup of production of structural components in Europe this quarter. It was more on the last part of the quarter, so that will continue adding volume on the remaining of the year.

We launched very successfully production for two customers in Europe, which will add additional volumes as we move along the years. In this particular quarter, we did a launch. It was more on the last part of the quarter.

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

Related to the backlog, I think we have already got two contracts for the structural component business, as well as for EVs worth approximately $280 million worth of business. We are very happy with the development and we have a lot of quotes on the pipeline and we are confident that we will achieve what we said before, which is going to be about $1 billion in revenues by about 2021, 2022.

Juan Tavarez - *Citigroup - Analyst*

Okay. So I guess the new contracts you settled this quarter, probably half of that was structural component (multiple speakers)?

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

A little bit less, Juan. We won a very important contract with Daimler. Unfortunately, we are not in a position to share the size because of confidentiality issues with the customer, but this is for a very important vehicle line for the S-Class and we are working with that customer very closely in other potential parts for also structural components. So we are very confident that we will continue expanding our business not only with that customer, but also with other customers in Europe, as well as in North America.

Juan Tavarez - *Citigroup - Analyst*

Okay, great. Thank you very much.

Operator

(inaudible), Goldman Sachs.

Marcio Prado - *Goldman Sachs - Analyst*

This is actually Marcio Prado. I have some follow-up questions. First one is like I think in the fourth Q 2016 call, the Company gave a view on total volumes for 2017, revenues and EBITDA a bit of around $802 million. So given the first-quarter results, I think volumes were pretty much in line when we adjust seasonally with a view for the Company for 2017, but EBITDA seems a bit lower.

So the first question is whether you think that the price metal lag effect will correct over the year and that $802 million in EBITDA, if it's still a good number to think of for 2017.

The second question is on the structural component rampup in Europe and overall for Nemak. If we want to think of margins, if we, as the structural component business ramp up, if we should think of something back on margins as we model the Company in 2018.

Still on the structural components, given that around circa $1 billion total contract for the Company expect for the next four years for structural components, what percentage should come from Europe and what percentage should come from the US? Thank you very much.

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

Related to guidance, as I indicated, yes, we started unfortunately with a lower number on the quarter than on the EBITDA on the other areas such as volume and also revenues were aligned to our (inaudible) and guidance. As I indicated, we are not changing the guidance yet. We are making internally a lot of effort to try to come with some cost-savings opportunities. We are pushing every single business unit as well as our [purchasing] people how we can get savings so that we can recover from this.

Related to metal lag, it is very difficult for us to predict how the markets will evolve. This is something beyond our control. Certainly we wish that the metals or the aluminum prices stabilize so that we can recover a portion of that, but that is very difficult for us to really predict.

Related to structural components, certainly a significant portion of our business has been captured already mainly in Europe -- in North America and that explains one of the reasons that we delayed this goal of $1 billion in revenues because we are seeing that in North America it's taking a more cautious step related to introducing structural components business.

We still don't know how this is going to come, is going to be affected most likely if the new administration in the US changes capital relations. Still I think it is early to tell what is going to be the outcome of those potential regulations and certainly we are expecting that a significant portion will come from Europe as well as from China.

As we speak, we are also quoting a lot of new business opportunities, not only for the structural components, but for electric vehicles perhaps in these two main regions. We have also already been awarded with some parts that we will make in North America, but still OEMs in North America have not made their mind in terms of how soon and how they will introduce some new parts made out of aluminum in their vehicles.

Marcio Prado - *Goldman Sachs - Analyst*

Thank you. If you allow me just a quick follow-up. Given that these rampups are slightly slower in North America than initially expected, just wanted to understand a bit more detail your CapEx implementation. Like you implemented [14150 million] CapEx this year, which is more. When we think seasonally -- when we think like quarterly adjusted than the $430 million that you guided in the previous call.

So just wanted to understand with volumes and the rampup coming a bit lower than expected, any reason why CapEx is running a bit higher than the quarterly adjustment would imply?

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

No, this is just a calendarization issue. We still had following the $430 million with contracts that have been already been awarded. This is not -- we are leaving a very small amount of CapEx for some additional potential programs that we may get, but I will tell you that probably more than 90% is for programs or for contracts that have been already signed and awarded to us.

Eventually, if in the future some of the OEMs in any region decide to delay or implement the structural component business at a slower pace, we see it also on the positive side that that will help us reduce existing assets and most likely we will have to reduce our CapEx into the future, but this still I think too early to tell. It will depend a lot especially in the North American region about the regulations that will be informed officially in March of 2018.

Marcio Prado - *Goldman Sachs - Analyst*

If this is the case in the long run as you mention, the middle term in 2018, could it lead the Company to adjust dividend policy?

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

This is something that we will need to discuss with the main shareholders of the Company and it will be presented at (technical difficulty) time depending on (technical difficulty) and cash flow generation and I think it is a little bit too early to tell what will be our dividend policy.

Marcio Prado - *Goldman Sachs - Analyst*

Thank you. Thank you for the answers. Thank you.

Operator

[Valentino Mendoza], Private Investor.

Valentino Mendoza - - *Private Investor*

I was wondering if you could give us some color on the erosion of the profitability in the European operations. Does this have to do with the integration of Turkey or what do you mean by just unfavorable sales mix? Thank you.

Alberto Sada - *Nemak, S.A.B. de C.V. - CFO*

Thanks, Valentino. Good question. No, what we saw in Europe was also two things. First, we saw the metal lag as well in line with what we saw in North America. We also saw metal lag in Europe and we also had an FX situation. Remember that the euro has been depreciating against the dollar. So when we extrapolate that to US results and we compare that to last year, that also generated less results.

And related to volumes, volumes did increase, but we did not see that entirely in our bottom line and it's essentially the effect of what I just described. Turkey has a little volume and the profitability of Turkey at this point is slightly less as we integrate the operation, but it is not really a huge effect that we saw on the results. It's mainly driven by metal and FX.

Valentino Mendoza - - *Private Investor*

Thank you very much, Alberto.

Operator

Augusto Ensiki, HSBC.

Augusto Ensiki - *HSBC - Analyst*

Just a question on EBITDA in Asia, a small part, but seemed that the EBITDA per units increased significantly over the past year or so. Is there further upside to this? Does this -- will it ever reach the levels of North America or Europe or where do you think that this goes -- stabilizes? Thank you.

Armando Tamez - *Nemak, S.A.B. de C.V. - CEO*

Thank you. This is a good question. Certainly we are targeting to improve our profitability in every single region. In Asia, as we have indicated in previous calls, we are seeing that customers are introducing new powertrains that are significantly more complex than in the past and certainly we are able to capture with the main OEMs from Europe and North America new business opportunities and we are able to get better pricing and again, it is explainable due to the higher complexity on powertrains and we are benefiting by that.

Also, we are gaining some economies of scale that in the past we didn't have and certainly we are looking forward to get better margins in Asia. We just recently reviewed with our team and we are seeing solid prospects for the future in that region.

Augusto Ensiki - *HSBC - Analyst*

Thank you very much.

Operator

Thank you. There are no further questions in queue at this time. I would like to turn the conference back over to management for closing remarks.

Adrian Althoff - *Nemak, S.A.B. de C.V. - 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 good 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.
