Nemak, S.A.B. de C.V.

First Quarter 2022 Earnings Webcast

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Marcelo Motta, *JPMorgan*

Brad Lindenbaum, *Stone Forest Capital, LLC*

Alejandro Azar, *GBM*

Peter Bowley, *Bank of America Merrill Lynch*

PRESENTATION

Operator

Good morning, everyone, and welcome to Nemak's First Quarter 2022 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 turn the call over to Adrian Althoff.

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 you 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 over the call to Armando Tamez.

Armando Tamez

Thank you, Adrian. Hello, everyone, and welcome to Nemak's First Quarter 2022 Earnings Webcast.

Our business performance in the quarter reflected in part the main assumptions embedded in our full-year guidance. In particular, the slightly higher volumes along with incremental cost pressures; additionally, the war in Ukraine unfortunately magnified certain impacts on our results.

Notwithstanding the global semiconductor shortage, which continued to constrain customer light-vehicle production, our consolidated volume showed sequential improvements in the quarter, aided in part by new product launches in our E-Mobility and Structural Applications segment. In turn, higher aluminum prices, which were passed onto customers, drove a year-over-year increase in consolidated revenue.

As I just mentioned, the war in Ukraine presented additional challenges, putting further upward pressure on energy prices and inflation. It also caused temporary reductions in vehicle production in Europe, which consequently exacerbated volume headwinds in the region. Altogether, these impacts drove a reduction in consolidated EBITDA on a year-over-year basis.

At the same time, we took important steps to support business continuity and resilience amidst the extraordinary volatility in our industry environment. We continued to exercise a prudent approach to costs and expense management, all while laying the groundwork for an expected acceleration in the production ramp-up of our E-Mobility and Structural Applications segment.

Additionally, we maintained communication with customers around recent inflation-related trends, including in energy, raw materials, labor and transportation, among other categories, with a focus on mitigating knock-on effects on our business. In this period, we continued to work closely with our customers to adjust our prices with the aim of providing fuller protections against volatility in such items.

Moving onto strategy implantation, we have reached key milestones in the quarter on the electrification front, continue to advance with the production ramp-up of our E-Mobility and Structural Applications segment, while simultaneously securing contracts to produce battery housings for fully electric vehicles worth a total of $350 million annually. As you may recall from previous communications, we plan to allocate total Capex of approximately $200 million to support the production of these parts at three new manufacturing facilities for these deals across Europe and North America.

These contracts altogether represent the single largest business award in our Company's history across product lines, providing us with an unprecedented opportunity to further scale our capabilities in highly specialized joining and assembly processes that will fulfill electrification and lightweighting needs of our customers.

Meanwhile, we continue to pursue a robust pipeline of potential new opportunities in our E-Mobility and Structural Applications segment. This pipeline currently comprises business to be sourced within the next 12 months for a total of more than $1.4 billion annually. Given our progress to-date, in discussions with customers together with our proven track record of launching and mass-producing highly engineered applications for electric vehicles, including battery housings, e-motor housings and structural parts, among others, we believe that we are well-positioned to surpass our goal of securing contracts in these segments worth $2 billion annually by 2025, well ahead of the original goal we had established for ourselves.

As we made further inroads towards strengthening our EV-related growth prospects, we also continued to adjust our capital allocation priorities accordingly. Our E-Mobility and Structural Applications segment already accounts for the majority of our strategic investment needs. Moreover, as a result of our recent success in growing our order book to produce these parts, we believe that we are now entering a more intensive phase of Capex deployment to support our transformation strategy, driven by outlays required to develop and launch this newly-awarded business.

In light of these incremental requirements which are not fully embedded in our current year guidance, in the short-term, we plan to direct resources allocations almost exclusively towards meeting investments and operating needs, prioritizing long-term value creation while remaining attuned to industry conditions, as well as the needs of our business.

Rounding out recent highlights, we are pleased to share that we won contracts across our product lines in the quarter worth approximately $380 million annually, 100% of which represented incremental business. On top of the contracts, we also strive to produce battery housings. Key highlights included contracts to produce IC powertrain components for approximately $40 million annually using existing capacity in Europe and North America.

Additionally, we recently announced that we were named a GM Supplier of the Year winner for 2021, marking the 20th time in our history that we have received this award. We believe that this recognition is a testament to our focus on consistently exceeding our customer expectations, as well as our continued commitment to work hand-in-hand with them to develop lightweighting solutions to help drive sustainable mobility forward.

Before I conclude, I would like to touch on recent projects towards reducing emissions and improving energy efficiency in our operations. Under our climate strategy, we are committed to implementing a variety of investments in support of the transition to carbon-free energy sources, with a focus on machinery, equipment and processes, among other needs. To this end, one of our main levers is to increase the percentage of renewables in our energy mix. Based on our investment plans towards the remainder of the decade, we believe that we are well-positioned to bring our share of renewables in our energy mix to 70% by 2030.

In turn, these investments represent a centerpiece of a roadmap to achieve a 28% reduction in greenhouse gas emissions by 2030, after our goal was approved by the Science Based Targets initiative last year.

With that, I will now send off the call to Alberto.

Alberto Sada

Thank you, Armando. Hello everyone, and good morning.

I would like to begin by providing a recap of our results, as well as relevant industry trends in the quarter. During the quarter, volume finished higher on a sequential basis, supported by easing OEM supply chain constraints in certain markets, although lower on a year-over-year basis.

Revenue was higher versus last year, as aluminum prices more than offset effects of softer volume. At the same time, higher energy prices and inflation, together with the extraordinary impacts of the war in Ukraine, weighted on costs. Looking at the quarter as a whole, we believe that our results keep us well-positioned to meet our full-year guidance, particularly given recent volume trends, along with our ongoing measures to control costs and expenses.

Let me now go into the details. During the first quarter, light-vehicle sales decreased year-over-year in most of our regions, as supply side conditions continued weighting on vehicle production and therefore, vehicle availability. Demand drivers included effects of the global semiconductor shortage and the war in Ukraine, which caused temporary disruptions in the supply of certain automotive components being sourced from Ukraine, particularly for European OEMs.

Notwithstanding these challenges, it should be noted that vehicle production showed signs of improvement on a sequential basis, most notably in North America. Based on our consultations with industry experts, we believe that a slight easing of semiconductor supply constraints may have contributed to this trend in the region. Considering the factors that I just described, and in spite of the work, we continue to see our industry outlook in line with our guidance assumptions.

I would also like to emphasize that we see the pent-up demand for vehicles in our main regions as supportive of light-vehicle production, and therefore, demand of our products going forward. For example, vehicle inventory levels remain at historically low levels in the U.S., averaging fewer than 20 days in the first quarter. In Europe, waiting times for new vehicles remains stretched, in some cases lasting more than nine months.

Given our view that overall robust demand for vehicles will continue, we believe that light-vehicle production in North America and Western Europe could potentially achieve further recovery in coming periods, provided that supply side conditions show further improvement.

During the first quarter, Nemak's total volume was 10 million equivalent units, finishing 21% higher on a sequential basis, but 7% lower year-over-year, mainly on effects of reduced customer production, as I just described.

Looking at the top line, higher aluminum prices more than offset the effects of lower volume, as revenue amounted to $1.1 billion, which was a 9% increase year-over-year.

EBITDA in the first quarter was $150 million, which compares to the $169 million reported the same period of last year. This reduction was mainly due to inflationary effects, including energy, labor costs, raw materials and transportation, among others, and to a lesser extent, to volume effects associated with the semiconductor shortage. As a result, our unitary margin was $11.6.

We simultaneously continued to advance on commercial negotiations aimed at mitigating the impacts of higher energy prices and inflation of our business. While these discussions remain ongoing, given the extraordinary nature of these impacts and the long-term focus of our customer relationships, we're working to achieve suitable agreements to compensate these effects. As you may be aware, energy prices have seen a pronounced increase since last year. Moreover, this trend has been exacerbated by the war in Ukraine. Energy represents around 5% of our total cost structure. However, due to the magnitude of recent energy price increases, particularly in Europe, this line item represented a significant headwind in the first quarter.

Additionally, we saw inflation-related impacts across categories ranging from labor to transportation. For the quarter, we estimate a total inflation-related impact of approximately $40 million.

In response to increased volatility in the industry and general economic conditions, we expanded a variety of initiatives aimed at maintaining strict control of costs and expenses, while continuing to prioritize the allocation of available resources towards new product launches, supporting our customers' electrification plans.

Operating income in the quarter was $36 million, reflecting the same factors that affected EBITDA. This figure compares to the $89 million reported in the same period of last year.

Net income was $6 million, compared to the $40 million reported in the first quarter of 2021. This result was mainly affected by the same factors impacting operating income.

On the Capex side, we continued implementing our investment schedule for the year, recording investments of $89 million in the quarter, which was 41% higher year-over-year, mainly due to the increased expenditures in our E-Mobility and Structural Applications segment. For the full year, we still expect to allocate more than half of what we consider strategic Capex to this segment.

Given our need to ramp-up on the investment in support of recently awarded business for EVs, in the short-term we plan to focus capital allocation almost exclusively on strategic Capex. We will continue to evaluate the use of potential additional leverage to support shareholder value creation, including dividends and share buybacks on an ongoing basis, but only after accounting for the needs of our business, as well as our leverage targets.

As of March 31, net debt was $1.28 billion, 2% lower than the close of December of 2021. At the end of the quarter, our net debt to EBITDA and interest coverage ratios were 2.5x and 5.0x respectively. Excluding refinancing costs associated with our bond issued last year, our interest coverage ratio was 6.7x.

During the quarter, the extraordinary inflation-related impacts limited our ability to make inroads on leverage reduction. However, provided that we have reached statutory terms in customer negotiations and inflations, and that the industry conditions in our main regions have stabilized or improved, we expect to bring our net debt to EBITDA ratio closer to pre-pandemic levels in coming periods.

Moving onto regional results in the quarter, North America volume was 5.3 million equivalent units. This is 6% lower year-over-year, due mainly to the effects of reduced customer production linked to ongoing semiconductor shortages, as explained previously. However, year-over-year revenue was $602 million, 16% higher in the same period versus last year, lifted by higher aluminum prices.

EBITDA was $68 million, which compares to $82 million in the same period of previous year, as inflation-related impacts weighted on business performance.

Europe volume was 3.5 million equivalent units, 8% lower year-over-year, mainly due to lower OEM production, which was exacerbated by knock-on effects of the war in Ukraine. Revenue finished at $390 million, slightly lower than the $397 million reported in the same period of last year, as higher aluminum prices partially offset the effects of lower volumes, and the depreciation of the euro against the U.S. dollar.

EBITDA was $41 million, which compares to $75 million in the same period of last year, mainly affected by higher energy prices and, to a lesser extent, to volume effects.

Rest of the world volume was 1.2 million equivalent units, down 8% year-on-year, mainly due to lower customer production in Brazil. In terms of revenue, higher aluminum prices more than compensated for the impact of lower volumes, resulting in a quarterly figure of $139 million, a year-over-year increase of 15%.

EBITDA in the region was $7 million compared to $12 million in the same period of last year, driven by the same inflation-related impacts as in other regions.

That concludes my section. I will now turn the call back over to Adrian to open up for Q&A.

Armando Tamez

Thank you, Alberto.

We are now ready to move on to the Q&A portion of the event. Operator, please instruct the participants on how to place their questions.

Operator

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

Marcelo Motta

Hi everyone, thank you.

Two quick questions; the first regarding especially energy prices, right? You guys mentioned that you are working with your clients to pass through this increase. I just wanted to understand, how long do you think it could take for the clients to accept the renegotiation, so for how long margins could be impacted by this?

Also, I wanted to look at the supply chain issues. Aluminum's super important for you guys, so just wondering if, in addition to higher prices, are you guys facing any type of bottleneck to receive aluminum or anything on that front? Thank you.

Armando Tamez

Yes, thank you, Marcelo, for your question.

Related to inflation, not only energy, but also other elements such as transportation, labor and other materials, we are in close negotiations with our customers. We have made some progress, and we are asking for the retroactive, for January 1, 2022. As you can imagine, in this industry, some customers are, again, raising questions, and of course trying to navigate under these rough waters, but we will be very firm with all our customers, requesting what we consider is an above and beyond what we quoted when we negotiated our contracts.

As I indicated, that we're making good progress, and we believe that most of our customers will (inaudible) during the second quarter, and probably one or two, maybe it will take a little bit longer. But we will be very, very firm, again, presenting what is our true cost for them, and also, again, they have been able to increase prices. Certainly, we believe that now is our time to recover what we are, again, being impacted.

Related, Marcelo, to the supply chain issues, fortunately, I think we are not experiencing any issues in terms of getting, for instance, our raw materials and aluminum. We are well-protected. We have different suppliers around the world, and we are not getting, as of today, any potential issues with the materials or any other resources that we need to continue operating.

Marcelo Motta

Perfect, thank you very much.

Armando Tamez

Thank you, Marcelo.

Operator

Our next question comes from the line of Brad Lindenbaum with Stone Forest. You may proceed with your question.

Brad Lindenbaum

Hi, so you covered some of my question just now. Another question I have is about the demand for autos, or the demand from your customers. Are you seeing better visibility in the second quarter or for the rest of the year in terms of their orders? It looks like the OEMs are having continued supply chain issues themselves.

Armando Tamez

Yes, well, that's a good question. What we are seeing is the following. Certainly, in Europe, due to the Ukraine/Russia conflict, that we are seeing less demand, certainly. Some of our customers have been impacted by this conflict, because they were getting some components from Ukraine, and that is getting certain effect.

On the contrary, we are seeing higher, let's say production rates in North America. We believe, and in conversations with customers, that they are moving some of the semiconductors that they were expecting to use in Europe, to North America, and I think that is, to some extent, getting better demand in that region. As you are indicating, certainly, our customers are, to some extent, facing some issues with supply. They are moving some of the production that they were getting from Ukraine to other countries to solve these issues. Hopefully, they will be able to solve the issues.

On the other hand, Brad, what we are seeing is that there is very high pent-up demand. A lot of consumers in different regions want to buy vehicles, and certainly, I think the demand is there. It's a question of how our customers manage supply chain issues.

Operator

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

Alejandro Azar

Good morning, Armando, Alberto. A couple of questions here; the first one is on supply chain. Do you think that the war, the effects of the supply chain, the ones you mentioned on Ukraine, are those only applicable to Europe, or could you see an impact maybe in the next quarters, affecting production in regions like North America or Asia? That's the first one.

The second one is, upon your remarks, you mentioned entering a more intensive phase in Capex deployment. Does your $400 million, $450 million Capex for this year, going to be revised up?

The last question is, Ford recently announced they are going to separate the operations of internal combustion engine and EVs. Do you think you could move it to that direction? What needs to happen for that? Thank you.

Armando Tamez

Yes, thank you, Alex.

Related to the supply issues, certainly, this conflict that we are experiencing in Europe is affecting mainly the European region. We believe that, for instance, again, most of the production in North America or the suppliers are in the region; we don't see a major effect. At least, we have not been, let's say informed by our customers, and we are seeing strong demand, actually, in North America, with nice volumes. On the contrary, related to this conflict, we are seeing, in Europe, less volume.

I think to be totally transparent with you and the audience, that we are seeing also some issues in China, especially with some lock-outs related to COVID situation. That could create some concerns for the Chinese market. Of course, the government is putting all main supply to reduce the spread of the virus in the region, and we don't see, for instance, any—at least at this moment in time, any effects, as I indicated, in North America, or even South America.

Moving to the Capex, as we have indicated, we're very proud and happy that we got the largest contract ever in our history, and with a premium German OEM. We are not, at this point in time, able to reveal the name of the customer, but it's a very important customer for Nemak and we're very proud. They awarded us with three different contracts at the same time, to produce electric battery housings for their complete fleet. We would be supplying this customer with almost 90% of all their electric vehicles. Nemak would be the sole supplier, so we're very, very proud. Certainly, that will require the Capex.

We're increasing, Alex, our projection for Capex for this year from $450 million to approximately $470 million. The total investment needed to support these new contracts would be in the range of about $200 million, and we would be opening three new facilities, one in North America and two in Europe, to support this premium customer.

As you're indicating, Ford recently made the announcement of splitting their business on the ICE and the EVs. At this point in time, we see, Alex, a lot of synergies to maintain the resources into one single entity, and we don't expect to separate the business. But having said that, we are seeing a lot of new opportunities, attractive opportunities with premium customers that are willing to, let's say, create for us a win-win situation with nice profitability projections. Certainly, you will see more in the next few months. We are very confident that we will reach our target of having $2 billion of worth (phon), significantly faster than what we anticipated just a few months ago.

Alejandro Azar

Armando, if I may, a follow-up on that. Not separating the business, but disclosing the information as a separate business within results, I think that that could give investors and analysts more transparency into the fundamentals of each business unit.

Armando Tamez

Yes, that's a good point and thank you for asking, Alex. Absolutely. I think once we have some scale, absolutely, we will give more transparency to the investor community to separate, for instance, the profitability and sales and revenues, and even Capex for the two businesses. Let's say, the core of what we have as a legacy business, and the new opportunities on the EV and the Structural side.

Alejandro Azar

Thank you, Armando.

Armando Tamez

Yes, thank you, Alex.

Operator

Our next question comes from the line of Peter Bowie (phon) with Bank of America. You may proceed with your question.

Peter Bowley

Hello, gentlemen. Thank you for the call and for the opportunity for questions.

I just wanted to ask, given the strong interest you're seeing from customers in the Electric Vehicle segment, and despite the fact that EVs probably generally require more semiconductors than internal combustion vehicles, how quickly do you think you can move from EV sales accounting for, I believe, around 10% of total sales, currently, or recently, to a higher share in, let's say 2025?

Armando Tamez

Yes, fair question. Certainly, absolutely, you're right that the EVs require significantly more semiconductors to operate, and more accounts have significantly increased compared to older generations. Having said that, we believe, Peter, that, for instance, the industry is already making significant efforts to, again, on these suppliers of semiconductors, to make huge investments. In communications with them and analysts, they are projecting that by the end of this year and no later than the first quarter of 2023, they will have enough capacity in the system to support 100% the demand of the new vehicles, as well as the current vehicles. We don't see that as a threat, near or long-term.

On the other hand, you're right. This year, we're approximately in the range of about close to $500 million in revenues with the new product line, and we are moving very fast. At this point in time, we cannot reveal what is the expected mix by 2025, but certainly, we're expecting that that will significantly increase.

Peter Bowley

Thank you.

Armando Tamez

Thank you.

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.

Armando Tamez

Thank you.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation and enjoy the rest of your day.