Grupo Rotoplas

2Q20 Conference Call

Operator:

Good morning and welcome to Grupo Rotoplas Second Quarter 2020 results conference call. Please note that today's call is being recorded and all participants are currently in listen-only mode to prevent background noise. The host will open the floor for questions later.

Today's discussion contains forward-looking statements. These statements are based on the environment as we currently see it and as such there may be certain risk and uncertainty associated with such statements. Please refer to our press release for more information on the specific risk factors that could cause actual results to differ materially. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, further events or otherwise.

Please allow me to remind you that the company issued its earnings press release yesterday after market close. It can be found in the investor's section of its website. Also, the presentation for the call and the webcast link are in the investor's section.

Today's call will be hosted by Mr. Carlos Rojas Aboumrad, Chief Executive Officer and Mr. Mario Romero, Chief Financial Officer.

I will now turn the call over to Mr. Carlos Rojas.

Carlos Rojas Aboumrad:

Good morning. Thank you for being with us today. I hope you and your loved ones are safe as we continue to chart our way out of the current crisis and into our future recovery.

It is clear that the COVID-19 pandemic has become major catalyst for change in our societies. The pandemic has brought about profound health and economic challenges across the globe and the response to them is still evolving. However, these challenges have reassured us of our purpose, and we are thankful for the opportunity to continue serving and helping others.

Throughout this crisis, we have focused on the well-being our team-members and our communities, as well as on providing support to our suppliers, distributors and the technicians that sell and install our products. Not only do we continue to provide much-needed water solutions to our clients, but we are doing so while protecting the health and safety of our people by strictly adhering to all local regulations and the World Health Organization guidelines. And, as we head into the "New Normal", we are working towards defining the protocols and workplace practices that will best enable us to ensure that our people stay healthy and safe in the later stages of the pandemic and into the future.

We have also donated water-purification solutions to hospitals that can purify over 3 million liters or water yearly, storage solutions that can store over 1 million liters in vulnerable communities, and we have installed over 1,000 hand-washing stations in key locations across the countries we operate in. In fact, we have made available the prototypes and operating manuals of these hand-washing stations so that any interested party, anywhere in the world, can replicate the effort and help fight the spread of the virus and overall public hygiene. In the same vein, we used our plumber-loyalty program, which now has over 7,800 members, to reach out to them and learn how we could best support them to get through the effects of the lockdown. As a result, we have provided them with new training opportunities, new communication channels and material and logistical support when needed.

Our company's commitment to providing more and better water to our customers and our communities is now more relevant than ever, as is our responsibility to promote sustainable development and protect the environment, effectively increasing our stakeholders' resilience when facing a crisis such as the current one. Our societies are learning, changing, and adapting, and Rotoplas is embracing this transformation, as it is perfectly aligned with our company's mission.

It is important to remember that, as I mentioned in our last call, Rotoplas is not the same company it used to be. Through our efforts at strengthening and streamlining key aspects of our business, we continue on the path of creating value for our shareholders, and we remain on track even through these uncertain times. We have a resilient and diversified portfolio of goods and services as well as effective strategies across our markets. We are constantly vigilant of our operations and always exploring new opportunities. And as our quarterly results show, our efforts are paying off.

I would like to highlight, for example, that our e-commerce platform in the United States reached successive record sales in April, May and June, as we managed to address the changes in habits of our customers as well as the growing demand for agro-industrial water solutions in that market. We are also transforming our business in Brazil, where we divested our underperforming assets and are now focused on developing the service platform through Water Treatment Plants, which represent an extraordinary opportunity which will allow us to take full advantage of our presence in one of Latin America's largest economies.

At the same time, we have managed to weather the effects of lockdowns and operating disruptions in some of our Central and South American markets. Furthermore, considering our performance as lockdown restrictions were eased in some of those markets in June, we now see a very encouraging run rate in countries such as Perú, Argentina, Honduras, and Nicaragua; evidencing that the strength of our brand and the quality of our solutions are at the top of our costumers' minds in the new consumer landscape.

And even as growth and sales in Mexico remain strong and sales of our storage solutions prove their resilience, we are also seeing a rising demand for our b*ebbia* platform that underscores its potential to become a leading purified water solution for the country. In fact, the success of both Bebbia and our e-commerce platform highlight the need to constantly innovate and address new consumer needs and habits.

We believe that loyalty with our team members, distributors and the people who recommend and install our products is a two-way street: we look after them and they look after us. And we extend that vision to our customers and communities, as we believe that solidarity is and will be key in the times ahead. We are grateful for the opportunity to leverage our innovation and client-driven ethos to help address what has proven to be one of the most urgent challenges of our time. And as our societies chart the way forward, we are confident we will continue to play a key role both in containing and mitigating the effects of the pandemic and in building the road to recovery.

Thank you for your time and attention. I will now turn over the call to Mario so that he can go over the quarterly results in more detail. I look forward to your questions.

Mario Romero Orozco:

Thank you, Charlie. Good morning everybody. Thank you again for joining us. I hope you have been safe these past few months.

As Charlie pointed out, and as we mentioned in our last call, Rotoplas entered this phase of the pandemic strengthened and with a clear purpose and objectives. Even as there still is a certain level of uncertainty about the future evolution of the crisis and its full impact, we are confident that our quarterly results evidence our resilience in the face of systemic shocks and, more importantly, our ability to continue to serve our customers at a time when the availability and quality of water is crucial.

In fact, as mentioned, even in those markets where we experienced disruptions due to local pandemic restrictions, we are already seeing very positive signs as those restrictions are lifted, whereas in other markets such as the United States Central America and Mexico, we experienced significant growth throughout the period as consumer habits are changing. Residential water consumption has increased as families are spending more time at home and also industries and business are preparing for the new normal, in which it is estimated that more water is going to be needed to fulfill health protocols.

Providing more and better water is therefore not only our reason for being, but it is also a sound business vision. In fact, in spite of the widespread economic shock associated with the pandemic, net sales grew 1% year-over-year during the quarter and 2% during the first semester. Likewise, sales of our water-as-a-service platform grew 22% during the last quarter, driven by double digit growth in treatment plants, Bebbia and drinking water fountains.

Moreover, we remain focused on our employees' and clients' health, safety and well-being while creating value for our shareholders. To that end, we have maintained a watchful eye on our cash through our cashflow control tower and have continued to strengthen our balance sheet, which closed the quarter with a 0.6x leverage.

Most importantly, we have reached a return on invested capital of 8.8%, an increase of 90 basis points year-over-year. As we make progress in our transformation process, Flow, implementing new initiatives and streamlining our operations, we continue to advance towards our goal of having a weighted-average cost of capital below our ROIC.

The ROIC shows a decrease compared to the immediate previous quarters due to the impact on the generation of operating income from the closure of operations because of the pandemic, the recognition of expenses for the implementation of Flow and the readjustment of work spaces to comply with health guidelines.

Without the impact of the disruption or closing of operations in Peru, Argentina, El Salvador and Honduras, the ROIC would stand up at 9.6%

Now, please allow me to discuss some of our quarterly results in further detail.

Sales in Mexico grew 3% during the second quarter and 7% during the first semester, due to a solid and resilient demand for our storage solutions and to the prioritization of access to water for hygiene and workplace safety. In fact, as Charlie already highlighted, Bebbia, our drinking water service experienced record sales throughout the quarter, proving its value and potential in a changed landscape.

As of June we doubled bebbia's installed units reaching more than 31 thousand purifiers and more than doubling the 14 thousand installed units as of June of last year.

We also continue to innovate within Flow's framework, introducing new storage products and strengthening our marketing efforts, including of course our plumber loyalty program but also our sales teams' productivity.

It is worth noting that while we registered significant growth in the sale of water-fountains, government sales as a percentage of total revenue remain well under our 10% target, amounting to 2.8% during the second quarter. We are also seeing very little correlation between our sales and the construction industry's trends, which are both signs of the success of the diversification that anchors our resilience.

Furthermore, as we have already mentioned, our e-commerce platform in the United States has had three consecutive record-breaking months, evidencing that it is the perfect channel to reach and serve our customers in the "New Normal" in that country. Sales in Central America also increased by double digits, in spite of the lockdown measures and the disruptions to our operations, thanks to the optimization of our sales force productivity and the incorporation of new products to our portfolio in the region.

This growth compensated the losses sustained in Peru, Argentina, El Salvador andHonduras, , which amounted to $275 million pesos as we faced restrictions that severely impacted our operations in those countries, as I will explain next.

Net Sales in Argentina totaled $322 million pesos, but we estimate that the disruptions to our operations, which were limited or stopped for 33 days in the semester, reduced our sales by $125 million pesos. However, as Charlie pointed out, we are seeing a really positive run rate in June as restrictions have been eased, with sales growing double digit in local currency and exports increasing 81%.

Sales in Peru decreased significantly due to the lockdown measures implemented in the country, which closed down our operations for 81 days, negatively affecting sales by an estimated $139 million pesos. However, following the reopening in June, we are already seeing a solid recovery trend, increasing sales double-digit across all business lines.

The intermittent closures of our distribution centers in Honduras and El Salvador had an estimated negative impact on sales of $11 million pesos. Our operations in Guatemala, Costa Rica and Nicaragua continued throughout the quarter without interruption.

Finally, the divestment of our product unit in Brazil on May 1st netted us $134 million pesos and will significantly contribute to our ROIC, while enabling us to strengthen the presence of our water-as-a-service platform in that key market through our treatment and recycling plants.

In terms of our portfolio mix, sales of products during the quarter accounted for 92% of total sales. Sales of services, as I already mentioned accounted for 8% and grew by double digits, attesting to the growing strength of our water-as-a-service platform as we enter the new social and economic landscape brought about by the pandemic.

Regarding our P & L results, it is worth pointing out that our quarterly operating profit totaled $178 million pesos and $456 million pesos in the first semester. These results are 32.3% and 17% lower than those of 2019 due to the operating restrictions I discussed before, which reduced cost and expense absorption. We estimate that the impact of this restrictions in Argentina, Central America and Peru amounted to $67 million pesos during the second quarter and $79 million pesos during the first semester.

We also had to undertake additional expenses to recondition our plants and offices in order to fully implement the relevant workplace safety protocols, which amounted to $7 million pesos. Additionally, we made one-time expenses totaling $21 million pesos related to the implementation of Flow and we invested in advertising campaigns to promote Bebbia.

Our quarterly adjusted EBITDA totaled $294 million pesos, a 12.8% reduction year over year due to the operating restrictions that I have already discussed, which affected the result by an estimated $83 million pesos.

Finally, we registered a quarterly net loss of $59 million pesos before accounting for discontinued operations. This is the result of the decrease in our operating profits due to the lockdown disruptions as well as FX losses on our dollar-denominated positions and accounts receivable in local currency, totaling $99 million pesos. We also faced higher interest expenses and a negative effect of $16 million pesos from our monetary position in Argentina. However, net income still increased 87% in the first semester. Furthermore, the gains in derivatives and FX positions in the first quarter compensated for the FX losses in the second quarter

In regard to the strength of our balance sheet, as I have already mentioned, our net debt to EBITDA ratio is 0.6x—well below our 2x ratio policy.

During the quarter we took a $65 million pesos or 10 million soles loan from the government in Perú which is meant to help alleviate the pressure caused by the total lockdown. The loan has a 12-month grace period, 1.46% annual interest rate and a three-year tenor. Apart from that loan our debt position also considers the sustainable bond AGUA 17-2x, which as we discussed in our last call, netted 4 billion pesos, has a maturity date of June 16th, 2027 and was issued at an 8.67% rate.

It is important to note as well that we have decreased the cash-conversion cycle by 16 driven by an improvement in accounts receivable and a decrease in inventories,. This is a direct result of the negotiation of better terms with clients, an initiative that originated within the Flow program and is closely monitored by the weekly cash control tower.

CAPEX remains at 7% of total sales which we believe to be a very sustainable level. 34% of CAPEX is allocated to water treatment plants in Mexico and now also in Brazil, as we redefine our value proposition in that country.

Charlie has already gone through the most important actions we have undertaking in the ESG space. I would only like to add that as some of you may know, Rotoplas has been included in the S&P/BMV Total Mexico ESG Index, which substituted the S&P/BMV IPC Sustentable. The index includes the 29 issuers and REITS with the best ESG performance and attests to our commitment to ensure that we adhere to the highest standards in bringing more and better water to our customers and communities.

We are also very proud to share with you the ESG KPI Dashboard, which is available on our website and details our most relevant Environmental, Social and Governance (ESG) results since 2016. The dashboard and our new Sustainability Management System Platform will strengthen our efforts to measure and improve our ESG performance as well as our commitment to transparency and accountability.

In conclusion, as we discussed in our last call, we expected that the pandemic would have an impact across all of our major markets. However, we also expected that our strong balance sheet and the flexibility it affords us would allow us to continue serving our clients and to strengthen our water-as-a-service platform, all the while ensuring the well-being of our people. As Charlie pointed before, we are now beginning to realize the scope of the social and economic changes brought about by this crisis and even as we are still dealing with its dire effects, we are already thinking about the way forward as well. Our business model has proven resilient and we have managed to reach out and support our stakeholders during these challenging times while continuing to advance towards our value-creation goals.

We will continue ahead in this path, relying on our capacity for innovation and our adaptability and we will continue to keep you informed of any relevant events as we have been doing to date. We are confident that as our societies adjust to the new realities in front of us, our company will play a key and increased role in helping our costumers address their water needs.

Thank you for your time. We will now answer any questions you may have.

Mariana Fernández:

We have the first question from David Seaman. "Can you please share earnings per customer behavior in Bebbia given your service result of 40 percent of consumers being open to filters, is that a worrying statistic?"

Carlos Rojas Aboumrad:

It's actually positive that people in Mexico, where we are currently offering bebbia, are willing to move from bottled water to purified water. The reason we came up with Bebbia was that there were lots of pain points in the customer journey for purchasing and installing a service of a water filter at home. So, we decided to do that same model where we are responsible from end to end service. And we're actually seeing tremendous growth in interest for bebbia. It is still very new. There is still a lot of work to do in terms of brand awareness and service awareness, what we're seeing is a great opportunity to increase investment in marketing efforts to continue to grow new subscribers per month. And that has just to give you an idea, June growth of new subscribers per month grew around 200 percent compared to June of last year, which is going very well.

Mariana Fernández:

We have another question from Regina Carrillo. "Hi, is there any guidance you can give us for the second half?"

Mario Romero Orozco:

Hi, Regina. How are you? Good morning, thanks for joining today.

At this point we are not giving any guidance given such a volatile environment that we are experiencing. As explained during the call and the press release, the good news is that the company is having a strong demand for most of their products and services.

The things that we cannot control like the lock-down, as the ones we saw in Argentina and Peru and parts of Central America, which as explained it really affects our profitability levels. Because as a company, we have decided to keep the whole team employees and staff in place. So, having said that, and as mentioned during the call in June, we saw a very impressive month.

Just to give you an idea of magnitude sales we're 50 percent higher than in April when all the countries were open. And if the second half is to remain the same as June, where all the countries are open, then we'll have a better second half than the first half. But again, there are too many variables out there moving day by day. We are doing our best efforts to try to work them out.

Our strong cash position, the good demand that our products and services are showing in such an environment proves that we have a very resilient portfolio. So if things play well, you might see a better second half than the first half.

Mariana Fernández:

The next question is from Rodrigo Salazar. "Hi, thank you for the call. I have actually three questions. I'll start with the first one. Could you elaborate more on the 20 million expense on flow? What impact did you see in Mexico products due to the pandemic? And that's why we saw more pressured market. And also, if you could explain a bit more on the US dynamics, how are you seeing it behaving in the coming quarters and if you are planning on reporting separately on the future."

Carlos Rojas Aboumrad:

Hi Rodrigo I'll answer first part of your questions. And then Mario will complement about the 20 million peso expense in Flow and on how we're registering this.

In terms of Mexico most of our solutions are much more related to water needs and those performed very strongly There's a few products such as piping, which were affected partly by the construction industry in Mexico, the construction industry in Mexico had a important reduction during the first semester, and so that did pressure margins partially in Mexico.

Also, part of services some points, such as offices where we did see a reduction in demand as a consequence of people staying at home and not going to the office to work.

In terms of the U.S., we do see that there's great opportunity to continue to transform the traditional purchasing habits from people going to a physical store to purchasing more online. So, we do see great possibilities to continue to transform the business model from purchases at physical stores to the more remotely where we are, the leaders in terms of e-commerce for these kind of products in the US. Today, it is not large enough for us to report separately, but we do hope that it will be the case in the future. Mario, would you like to answer the 20 million pesos expense in flow?

Mario Romero Orozco:

Sure Charlie, thanks to all of you, for joining us on the call today. Just to complement, the U.S. was close to be the second largest market after Mexico during second quarter. And probably is going to be the next year's case that we'll need to report the US because of the magnitude and IFRS compliance.

As for the flow expense, as you well know, or most of you know, the company is running a transformation program named Flow, we have studied 14 different companies that have run similar programs in the past. All of them public companies. And seventy five percent of those companies have presented these one timers every quarter to give transparency and make it a comparable base to investors and analysts, we will be presenting in the coming quarters the same information of the flow program. And these one timers are mostly one off's that the company deciding to do or consultancy fees which are paid now because of the program.

I will probably go with Alain Jaimes question. Thanks for joining us. We actually paid a dividend in May of 80 cents per share. So, for the remainder of the year, there's no plans for additional dividends. So that answers your question.

Mariana Fernández:

The next question comes from Liliana de León. "Could you please give us more color behind EBITDA in services? With that growth in sales, it seems that it was not enough to improve profitability. Is there something particular this quarter or maybe some Bebbia related expenses that affected the growth?"

Carlos Rojas Aboumrad:

I will allow for Mario to respond in a little bit more technical terms, but I would mention that bebbia and Sytesa require quite a bit of investment to generate growth. Bebbia, the way it grew since we take the entire customer acquisition cost and the cost of the product and installation costs it takes a little bit of time to get a return on that investment. The quicker we grow, the higher the negative impact on the EBITDA.

So, it's a little bit counterintuitive, but it's actually a reflection of this negative impact and it's a reflection of the positive trend on bebbia's growth.

In terms of unit economics, we're not disclosing the details, what I can tell you that it offers a positive return and way over our WACC. So, we're very happy to be growing this business unit as aggressively as possible.

Mario Romero Orozco:

Just complimenting Charlie's answer.

As Charlie mentioned, we believe it is a time to think and go big after bebbia. So we're making a lot of commercial and marketing efforts to push that business. Second, as we mentioned, we divest the products division in Brazil, but we kept a team in Brazil which is building the Sytesa business. That business in Brazil is burning cash today because they're building the water treatment plants as we speak and this is dragging Sytesa Mexico's EBITDA. So that is that is why profitability in services is not there yet. But as our CEO mentioned, we're very confident on the IRR returns on the economic basis. And these are the bold moves of the company's future. And is investment and expenses are being allocated to that

Mariana Fernández:

Santiago de León is asking: "Could you give us more color in your service segment? What do you expect going forward? And do you expect that the margin will be after the pandemic regarding development water treatment plants? Could you give us an update on that? How many plans do you expect to have at the end of the year?"

Carlos Rojas Aboumrad:

Well, again, I'll answer in general terms and Mario will come with the details. But in terms of wastewater treatment plants for Mexico, we have seen a slowdown on investments in industrial projects or large construction projects which impact the demand for new plants.

It's not that it has been reduced indefinitely, but some projects are taking longer to materialize. So, we're on time from prospect to execution is taking a little bit longer. In terms of projected margins, where we can take into account the investments we do to grow these services in a longer period of time, that they will continue to get stronger as we get higher levels of revenues. Mario would like to comment in more detail in terms of numbers.

Mario Romero Orozco:

Sure. You know, before COVID and with the transformation program we have spoken about, we were aiming to reach EBITDA margins in the neighborhood of 20 percent for the year.

As you know, this pandemic changed everything and our different business segments have been affected and countries as well. So, the target is still there once we are over this health crisis, we believe that the normal growth and margins should be should be there as well as ROIC.

Carlos Rojas Aboumrad:

Just to say something additional to waste water treatment plants, we are seeing a very strong demand in Brazil. There seems to be more interest in investment in Brazil today, which is very exciting for us to be participating in.

Regarding the projections or to the guidelines for the second half of the year. There's tremendous uncertainty. If it's not for that uncertainty, we could say that we would be getting very close to that ROIC being equal to WACC, which we mentioned at the beginning of the year as target. But there's lots of variables that are in play today. So in normalized terms, we would be very confident that we would be getting there. We're very happy to have a very strong, detailed plan with very detailed initiatives, each initiative having owners. Every initiative, having milestones with milestone owners, all of these milestones and initiatives with very clear due dates, and we're making very good progress with this transformation of flow, which is the main driver to get us to have a ROIC above WACC. It's just a matter of when it will be reflected, if it is the case that one of the unforeseen variables impacts this in a short term.

Mario Romero Orozco:

Yes, and to that we have three scenarios inside the company. The good news is that independent of any of the three scenarios that we are running as of today, none of them to take us out from our medium and long term strategy, the company is very well funded. Debt maturity, it's until 2027. The growth path is clear. Probably 2020 will be kind of a bridge year, but our long term strategy is intact and we feel confident on that.

Mariana Fernández:

There's a question from David. "A few cash flow questions. Is there a mix effect that explains the source of working capital gains? What prospects are there for gains in inventory? You mentioned investments in Sytesa, yet capex is lower year on year. Are you deferring maintenance spend? Thank you."

Mario Romero Orozco:

Yes, thanks, David. Well, I'll start with Sytesa. Part of the transformation, we are being more thoughtful on maintenance capex, we are managing data on a weekly basis and we are asking people to present business cases and this is part of the transformation that we are running.

What has happened is that we were we're getting better at making maintenance capex decision and that it's and you can see the CapEx trend sequentially how that is moving and that is good and that explained by Flow. On your working capital gains question. There's a mix effect that explains that. Well, once to is that we are working closely with our clients and accounts receivables are getting lower. Inventory is a little bit tricky because of all this volatility that we were experiencing in 14 different countries. We do have a very interesting initiative going on as part of the transformation to do better inventory management. So, some gains will be obtained from these. But I think those will be really unbankable once the situation gets more normal, because, as I mentioned in one of the previous questions from Regina just look in April and June an increase in sales of 50 percent. Imagine the adaptability that the supply chain needs to handle with such swings. So, once we get into a more normalized level, I think those gains in inventory will be reached.

Mariana Fernández:

There's another question from. José Cebeira. "Congrats on their results and I have one quick question. We have seen a reduction in the mobility. These makes you believe that a third quarter report could have a recovery comparing to what we have seen during the end of the second quarter?"

Carlos Rojas Aboumrad:

Hi Pepe. Thanks for the question.

Not necessarily. The biggest restriction was when we couldn't operate at all. This was the case for a few countries in Central America, for Perú and for Argentina for some periods of time.

It will benefit the business if construction picks up a little bit. But again, most products haven't shown to be as strongly correlated to construction, just a few of them. In terms of water solutions people are actually finding that if they need a water solution, they won't wait. They want it now and Rotoplas has figured out ways by being very agile, very flexible to service those needs.

And what we do see is that people will continue to be very conscious about their availability of water and the quality of that water, and they will continue to transform their habits and their demand for our products. So that will continue to be a trend. Rotoplas has been very agile in adapting to whatever the new normal is. And we've already seen a very strong June. I think we can continue to see months similar to June with the increase or the or the development of the business as a consequence of the evolution that we're having through Flow.

Mario Romero Orozco:

I think I think you've got it right, if they're not massive lockdowns like the one suffer in Q2, we might see a good Q3. Because demand their water needs are there. but again, we don't know yet.

Carlos Rojas Aboumrad:

There is just this one last one from Liliana regarding CAPEX for Bebbia. "Can you please explain a little bit better the technicality on how you register a product installation?"

Mario Romero Orozco:

There is no CapEx in Bebbia. Well. There is, but it's only for the institutional products, the ones that go into large places such as offices and hospitals and hotels, but for the residential everything flows into expense.

Carlos Rojas Aboumrad:

And in terms of geographical expansion targets, I guess what we'd like to share is that there will be some resource allocation to service demand in wastewater treatment plants in Brazil, but won't be necessarily the most relevant moving forward, strategically, we are focusing on capital allocation more towards North America. That will be the main focus of capital allocation moving forward.

Thank you, Liliana.

And thanks, everyone, for connecting now on this occasion via Zoom I think it went very well in terms of logistical terms. Mariana, please. I think we're ready to now move to the final segment.

Mariana Fernández:

Perfect. Well, thank you, everybody, for joining us and see you next quarter.

Mario Romero Orozco:

Thank you very much for your time and interest, have a very good day.