

3Q 2015 Conference Call Transcript

3Q15 Rotoplas Conference Call

Operator:

Good morning and welcome to the Grupo Rotoplas third quarter 2015 results conference call.

Please be advised that today's call is being recorded and all participants are in a listen-only mode to prevent background noise. Later we will conduct a question and answer session. I would now like to turn the call over to your host for today, Ms. Nayelli Corro, Grupo Rotoplas' Head of Investor Relations. Ms. Corro Please go ahead.

Nayelli Corro:

Thanks Lisa, good morning everyone and thanks for joining us today. Yesterday we issued our earnings press release after market close. The release can be found on the IR section of Rotoplas' web site, as well as a corresponding presentation.

I'm joined today by Mr. Carlos Rojas, Rotoplas' Chief Executive Officer, and Mr. Mario Romero, Chief Financial Officer. We'll begin our call with prepared comments and then turn to Q&A.

Before we start, let me remind everyone that today's discussion contains forward-looking statements based on the environment as we currently see it and as such does include risk and uncertainty. 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.

I'd now like to turn the call to Mr. Carlos Rojas. Mr. Rojas, please go ahead.

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Carlos Rojas Mota Velasco:

Thank you, Nayelli and good morning everyone. Let me briefly provide an overview of our third quarter.

Brazil, one of our key markets, again presented a challenge this quarter, as Brazil's economy is showing a sharper than expected deceleration that continued to delay government spending on Rotoplas contracts. Despite these headwinds I'm pleased with Rotoplas' performance this quarter. We continue to see considerable demand for our solutions in all other countries, and we were again able to drive operational margin expansion despite lower Brazil revenues.

While third quarter Net Sales decreased by 6.2% year on year due to weak Brazil sales, EBITDA margins continued to strengthen. Sales excluding Brazil again continued to perform very well; revenues from Mexico and other countries excluding Brazil increased 67% year on year. Rotoplas also achieved 17.8% EBITDA margin for the third quarter of 2015. Mario will go into more detail related to our numbers so let me discuss some key highlights.

We continue to closely monitor the situation in Brazil in order to quickly respond should the situation eventually improve and demand increase, which regrettably is not the case today. Last quarter I let you know that we had closed selected plants and moved machinery to other plants in the region which can be quickly relocated if volume again picks up and at this point there were no further closures in the third quarter.

As we commented, sales in all countries other than Brazil are very robust, again driven by healthy spending levels within all business segments and the increased contribution of higher-margin Integrated water Solutions in Mexico that I had described. This again underscores the fact that demand for our products is strong.

Sales to the Mexico market increased by just under 70% this quarter compared to the same quarter in 2014, as the Integrated Solutions segment in Mexico rebounded following last June's mid-term elections as we had predicted. We're pleased to note that our decision to increase inventory in anticipation of this increased demand in Mexico was the right strategy. Further, despite recent budget cuts at the federal level, we believe the Government's social programs, including spending directed towards sponsoring health and wellness, should remain generously funded.

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Turning to the US, I wanted to let you know we've experienced some delays in the process of opening the new Rotoplas plant in Dallas, Texas but we expect the plant to be up and running by the end of this year, with similar timing as our plant in Atlanta, Georgia.

Regarding potential M&A both in the US and elsewhere, we are actively reviewing potential targets. To share with you a few more details on our criteria: we are considering candidates throughout all of the countries in which we operate that are a good strategic fit for our Company and our business model. Any future acquisition will be focused on water-related industries, ideally in the water treatment segment, and would need to be margin accretive with a hurdle rate of roughly 20%.

We have spoken at length during this call about the different measures we've successfully taken towards creating value while minimizing the impacts of a challenging environment. As Rotoplas' results have shown, there is strong demand for our products. We're focused on four core growth opportunities: First, tapping the U.S. market, particularly California and Southwest US. Second, continuing to identify opportunities for integrated water treatment and sanitation solutions. Third, increased demand for drinking water in Mexico and by the government-backed water fountain project in Mexico's school system. And finally, eventually we believe there will again be important opportunities in Brazil in the coming years.

Going into the fourth quarter, we still expect a challenging scenario in Brazil with moderate expansion in the rest of the countries in which we operate.

With that, I'll turn the call over to Mario to provide additional color on our financials.

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Mario Romero Orozco:

Thank you Carlos and good morning everyone.

I am now going to take you through the financials for the third quarter in more detail and then turn the call over to the question and answer period.

Our sales and profit showed improvement from the first two quarters of the year, as we had anticipated.

Third quarter net sales decreased 6.2% this quarter year on year excluding the considerable impact of the real devaluation, sales would otherwise be flat. Individual solutions accounted for 70% of sales; a 12.9% decrease while integrated solutions contributed 30% of sales; a 14.6% increase year on year. As Carlos commented, Brazil's economic and political crisis continues to deepen, resulting in weak sales as expected.

When looking at sales by country, we showed strong growth in all countries ex Brazil. Mexico's sales increased by 69.9% due to the resumed sales of integrated solutions once the electoral ban was lifted. In other countries, we benefit from the combination of our uniquely diversified portfolio along with strong execution, resulting in a 56.8% increase in sales to countries other than Mexico and Brazil and resulting strong 67% year on year increase in revenues from Mexico and other countries excluding Brazil.

We ended the quarter with a gross profit margin of 43.4%; a 440 basis point increase from the third quarter of last year. This improvement was a result of more sales of integrated solutions which have higher-margins, greater fixed cost absorption from Argentina, Central America and Mexico and better raw material costs.

Along these lines, we continue to benefit from lower oil prices which kept resin prices and Rotoplas' raw materials costs low, which also positively impacted our gross margins in the third quarter. This more than compensated for any negative foreign exchange impacts we experienced during the quarter due to our exposure to currencies in the countries in which the Company operates. We expect these tailwinds to continue to outweigh foreign exchange related effects in the near term.

We benefited from ongoing efforts and resources that we have directed towards streamlining our operations and improving efficiency wherever possible. This includes

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the zero-base budgeting practice that we implemented starting this year as well as measures we took during the first half of the year to mitigate the effects of the economic contraction in Brazil. This has clearly resonated in our 150 basis point reduction in SG&A this quarter.

As a result, EBITDA improved to 278 million pesos from 219 million in the third quarter of last year; a 27% increase. We also saw our EBITDA margin increase to 17.8% from 13.1%.

Net income increased by 57.6% due to a better sales mix that included a higher volume sold of integrated solutions, which have higher margins, and due to control of operating expenses throughout the organization.

Now taking a look at our performance for first nine months of 2015, net sales totaled 4.3 billion pesos, from 4.9 billion in the same period of last year. The decrease is a result of the current situation in Brazil previously mentioned.

However, gross margin increased by 180 basis points as we benefit from higher fixed cost absorption and better raw material costs which helped us offset exchange rate effects.

Despite our expense management initiatives to mitigate the decrease in sales volume and non-recurrent expenses in Brazil, our operating margin expanded by only 150 basis points.

We were able to maintain our profitability in both integrated and individual solutions due to improved raw material costs and strict expense management discipline.

In closing, we continue to manage our working capital effectively to ensure value creation despite a difficult macro environment, as a result our cash position increased 11.8% quarter over quarter.

Operator, I will now turn the call over to the question and answer session which will begin with questions from the teleconference followed by questions received via our website.

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Operator:

Thank you, sir. Ladies and gentlemen on the telephone, if you wish to ask a question, please press star, one on your telephone keypad. If you are using a speaker phone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Again, that is star, one, to ask a question at this time. We'll pause for just a moment.

Okay. That is star, one ladies and gentlemen, and we will take our first question from Joe Ritchie from Goldman Sachs.

Evelyn Chow:

Good morning, guys. This is Evelyn Chow for Joe. I just wanted to start out with a question on Integrated Solutions. Clearly very strong EBITDA margins this quarter. I just wanted a bit of color on how you think about the sustainability of this margin rate and maybe sort of the long-term potential of the Integrated business.

Mario Romero Orozco:

Evelyn, can you come back again with the question because we've got some background noise?

Evelyn Chow:

Absolutely. I wanted to start with a question on Integrated Solutions. Clearly had very strong EBITDA margins this quarter. I guess I was just wondering, long-term how do you think about the opportunity for Integrated margins and what is the sustainability of the current EBITDA margin rate?

Carlos Rojas Mota Velasco:

Evelyn, this is Carlos. We believe, as we mentioned even from the Road Show, that the needs in water solutions are enormous in all the countries we participate, so we have to believe that there are many opportunities in Integrated Solutions, and because of the difficulties of these solutions to delivery, the reason that's why they have better margins. We believe there are solutions for harvesting rainwater, solutions for

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sanitation, solutions for purifying water, the drinking water fountains. So we are working in these projects, and we believe there are huge opportunities in the future.

Even Brazil, that hasn't stopped completely investing in their solutions, we continue having the relationship with our customers every other week, and they are interested in the solutions. They know they need it. Today, as you know, they are living in difficult times, both politically and economically, so they are just waiting for the right time. They even have in the budgets our solutions, but they just don't have the ability to make it happen.

So, we are very enthusiastic about these potential opportunities in our business. Did I answer everything for you?

Evelyn Chow:

Yes. Thank you. That was very helpful. I guess maybe a follow-up question, just thinking about the growth margins you reported across the business this quarter. Of that 440 bits, can you help me size how much benefit you achieved from raw materials versus fixed cost absorption versus better mix?

Mario Romero Orozco:

Sure. Hi, Evelyn. This is Mario. From the 440 basis point expansion, 70% goes to better price mix, 20% to better raw material costs, and 10% fixed cost absorption.

Evelyn Chow:

Thanks, Mario. Then I guess maybe just last question for me, you know, I think you've mentioned a couple of times about the strong backlog you have in Integrated Solutions in Mexico. Can you help me understand better, what is the dynamic of when that backlog actually ships and how much sort of the typical sales backlog ratio is in that business?

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Mario Romero Orozco:

Hi, Evelyn. As mentioned in previous calls, there is no backlog in terms of contracts. There is on a month-and-month operation that we sell our different government customers.

Evelyn Chow:

Okay. Understood. Thank you.

Operator:

We'll now take a question from Ulises Argote from Santander.

Ulises Argote:

Hi, guys. Thanks for the call. I was just wondering if you could comment on the performance for the specific countries that you group under the Others Geography, and especially on how things are coming along the US in terms of sales. Thanks.

Carlos Rojas Mota Velasco:

Hello, Ulises. This is Carlos. First, with the US operation, we started our operation in California and things aren't going as we thought they are developing. We are already starting to analyze the markets in other states in the US because we are expected to have our operation—new plants operating at the end of this year. In the rest of the countries, they have been, all of them, very strong for Individual Solutions for many different reasons. The droughts, they have been very difficult in most of the countries and the needs of purification water, filtration, so we feel there's still a very strong market. This year, we did our market research, as we do every year, and all of the countries—we gained market share in all of the countries. We have a large market share, so the polls we win, they're not enormous but always there is a winning position that we feel very happy with it. So, this is the way we see it, Ulises.

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Ulises Argote:

Thank you very much. Just maybe as a follow-up, could you comment on what are your expectations for the cost of materials in the coming year?

Mario Romero Orozco:

Well, as explained in the conference call, we expect to have still a positive scenario going into the fourth quarter. Next year we think the Company's going to benefit from still low oil prices, plus new reactors are coming into place which will increase offer of the raw materials, gaining more cost advantages into 2016.

Ulises Argote:

Okay. Thank you very much.

Operator:

We'll now take our next question from Fernando Perez from Grupo Bursatil Mexicano.

Fernando Perez:

Hi. Good morning, Carlos and Mario. I have one question regarding Integrated Solutions. I was wondering if you have, like, any guidance regarding the fourth quarter. My second question is if you have any accounts receivable still from Brazil. Thank you.

Carlos Rojas Mota Velasco:

Thank you, Fernando. This is Carlos. To explain our overview of the results of the business, let me tell you that for the full-year we expect sales in EBITDA to be slightly below over last year's as we continue with positive performance in Mexico and the rest of the countries. I have very tight discipline in our operating expenses in order to mitigate partially the loss of 30% of our total revenues coming from Brazil and the big impact on EBITDA. Saying that, for our fourth quarter, we expect to deliver similar sales in EBITDA as the fourth quarter of last year.

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The Integrated Solutions in Brazil, there's no possibility now. You know that the crisis they are living, especially politically, I could say that all the government operations are, I could say, frozen, at least in all of our areas, but I could say that in almost all of the areas in the Brazilian government. So, there's no—any significant moves in this political crisis. Things should be stopped until then.

Fernando Perez:

Okay. Thank you. Do you still have any accounts receivable from Brazil regarding the Integrated Solutions like the previous signed contracts or anything?

Mario Romero Orozco:

Can you come back again with your question, Fernando, because we got some background noise?

Fernando Perez:

Yes. I was wondering if you still have, like, certain accounts receivable from Brazil from any previous signed contract or, like, a previous question like you have any backlog there.

Mario Romero Orozco:

Well, two things regarding that. We still have the signed contracts and they are still open to execute whenever they have money available at the different government entities, and going into next year, we understand that they still are budgeting some of our Integrated Water Solutions, so I think the situation there is to be patient and to wait for the market to come back. Again, we are not losing market share. The thing is more on a macro level, so we are expecting to correct that. We don't know when, but for sure it's going to be correcting itself in the coming future.

Fernando Perez:

Okay. Thank you.

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Operator:

We'll take our next question from Daniel Rojas from Bank of America.

Daniel Rojas:

Good morning, Carlos, Mario. Thank you for holding the call. My question is regarding the waste water treatment plants. I understand you signed a contract in the state of Tabasco. I'm interested in knowing if this is a one-off or are you going to focus in this area and if we can see similar contracts going forward. Second—I'm sorry if I missed this—you talked openly about acquisitions. I'm interested in knowing if you have geographies of interest or if it's going to be in the Integrated or in the Ideal (phon) solutions. Thank you.

Mario Romero Orozco:

Hello, Daniel. Regarding your question, the sale in Tabasco is not a one-off; it's part of our Business portfolio. We are selling all these systems throughout the different states, and it is one of the focus of the Company, building this water treatment facility. Going forward, we are focusing more on Integrated Water Solutions and selling them not as an equipment but also with maintenance and service.

Regarding M&A, Carlos is going to take on that question.

Carlos Rojas Mota Velasco:

Daniel, regarding M&A, we have been building a pipeline of alternatives in Mexico and abroad. We have been analyzing both Individual and Integrated Solutions. We have developed in the past during our strategy planning a coherence matrix so we can have more objective analysis, what are the best opportunities for the Company. So, today I can tell you that we are not yet in due diligence in any of these alternatives, but they could be, in the near future, a possibility to get into that due diligence process.

Daniel Rojas:

Okay. That's good enough. Thank you.

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Operator:

We have no additional telephone questions at this time. I apologize, sir. We did get one more telephone question and that is from Francisco Rodriguez with GBM.

Francisco Rodriguez:

Good morning, gentlemen. Thanks for the call. I just wanted to know if you could elaborate a little bit more on this contract in the state of Tabasco. For instance, you mentioned that you don't sell any, let's say—I believe that you're selling equipment on a month-by-month basis, however, there should be a contract for the maintenance part of the business. So I was wondering how much does the maintenance represent out of the total sale you're doing to the state of Tabasco, and if it is possible for you to share with us any prospects on this type of sales going forward. Thank you.

Mario Romero Orozco:

Well, thank you for your question, Francisco. That's a very good question. We don't have the number with us right now, but we'll get back to you with the answer. Going forward, as explained previous, we are focusing on developing more aggressively our Integrated Water Solutions, especially in the Water Treatment segment, so you will hear from us going forward getting this business bigger.

Francisco Rodriguez:

Thank you.

Operator:

Once again, ladies and gentlemen, star, one to ask a question, star, one on your telephone keypad.

Nayelli Corro:

Operator, I will now turn the call over to question-and-answer session from the website. We have one question from Andres from Interacciones. The question is: what will you

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say was the main factor for extraordinary performance in Mexico considering this quarter has been the highest quarter for the Company in terms of earnings?

Mario Romero Orozco:

Well, Andres, thanks for your question and interest. On the first point, as we mentioned before in the calls that we had, there were an electoral ban that pushed forward all the Integrated Water Solutions in Mexico. So the reason why Mexico has a very strong performance in 3Q was to catch up on all these months without Integrated Water Solutions.

Nayelli Corro:

The second question is: can you give us more color on the performance of the Water Fountains project in Mexico?

Mario Romero Orozco:

Well, one of the water fountains in Mexico, we are seeing more traction now that rules of operations are more clear for schools. If you look at—we see data quarter-after-quarter is starting to happen. Apart from some cabinet changes in the past month, we think the new Secretary of Education is going to be very active on giving better infrastructure to schools, so we think in the next—in the coming years the Water Fountain project will gain more traction.

Nayelli Corro:

The third question is: are you considering to disclose US performance as you do in Mexico or Brazil in the short-term?

Mario Romero Orozco:

Not in the short-term. We're going to be disclosing the US once it becomes relevant, so that probably could be by 2017.

Nayelli Corro:

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The last question is: are you reiterating your EBITDA guidance for 2015?

Mario Romero Orozco:

I guess Carlos has already answered that before, so I think we're done with your questions. Thank you very much, Andres.

Nayelli Corro:

We thank you for your time and for your interest in Grupo Rotoplas and hope you'll join us again next quarter. Until then, we'll be sure to provide you with important updates. Thank you again and goodbye.

Operator:

Ladies and gentlemen, this does conclude today's conference and we do thank you for your participation. Have a wonderful rest of your day.