

Grupo Rotoplas

Third Quarter 2016 Conference Call

3Q16 Rotoplas Conference Call

Operator:

Good morning and welcome to the Grupo Rotoplas third quarter 2016 results conference call.

Please note 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.

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

As usual, the earnings release and slides to supplement today's discussion can be found on the IR section of Rotoplas' web site.

Today our call will be hosted 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.

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, Mitsy. Good morning everyone and thank you for joining our call today. I hope you have had the opportunity to review the earnings release we issued yesterday after market closed.

As usual, I will begin by giving you some highlights of the first nine months of the year and then Mario will review the financial performance for the quarter and year to date.

During the first nine months of 2016, we were able to close successfully an M&A transaction per quarter, while at the same time taking the adequate actions, across the whole organization, to offset the challenging environment we have faced throughout the year.

Just to remind you, during the first quarter we acquired Talsar in Argentina, a water treatment solution company. So far, we are very satisfied with the integration process made until now. The investment thesis of cross selling Rotoplas Individual Solutions by leveraging the leadership in the water heaters segment of Talsar, is playing very well for both brands.

Then in the second quarter, we increased our footprint from 12 to 13 countries, by arriving to Chile. We completed the acquisition of a minority stake in the Chilean Advanced Innovation Center (AIC) and an option to increase it in two years to 51%. As mentioned in our last call, we have good plans to include its disruptive technology that purifies the water 100% from microorganisms, into Rotoplas products.

And finally, this last quarter we conclude the acquisition of 80% of Sytesa in Mexico. Sytesa while solely focused in the commercial segment, accelerates our penetration into the water treatment and recycling in Mexico. Together we now operate more than 480 wastewater and water recycling plants, making us the biggest operator in the Americas by plant count. We are confident, that this business will become a strong foothold in the Company's future.

These three business represented in total, an investment of more than 2 billion pesos. As for our M&A plans, I would like to comment that we are continuing to seek opportunities to accelerate our strategic ambitions and generate value within the markets and industry where we operate. We continue to benefit from good cash flows and the strength of our balance sheet, thus we remain very well placed to fund targeted acquisitions and organic investment opportunities in the future.

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I would also like to comment that up to date, we have won close to a third of the total water purifying fountains units tendered by the Mexican government. Although, these revenues haven't been reflected on our top line due to some administrative delays, we feel confident to invoice and collect the first installments during the last quarter of this year. The opportunity to continue adding contracts continues, as to date, only 28% of the water fountains have been offered of the multiyear nationwide program, which is to be completed by 2018.

Turning now to operational results, nine months Net Sales decreased by 9.2% year on year due to weak integrated solutions sales.

As for Mexico, individual solutions continue growing due to efforts in marketing, innovation and a strong retail market; however, integrated solutions were strongly affected by budget cuts at the federal level and by changes in the presidential staff. Despite this scenario, we believe government social programs for water infrastructure, should remain funded, thus we should see a rebound in integrated solutions sales in the upcoming quarters, proof is that, in the past weeks we have seen progress on these plans, as the government has released public bids for our type of solutions.

In Brazil, the market has not recovered yet but we sense that we've reached the bottom of the cycle, one positive piece of news for the company, is that recently one of the original contracts from 2014 to sell and install rain water harvesting systems, was reinitiated. We expect to serve such contract during the fourth quarter and the first quarter next year.

Sales from Other countries increased 46.1% year on year due to an increase on organic sales, the US market penetration and the integration of Talsar into our results.

As you can see, we are working very hard to take the appropriate measures needed to ensure value conservation despite a difficult operating environment in the short term, while remaining highly focused on our long term strategy. We have significant growth potential within our product portfolio.

Finally, regarding our 1 billion pesos EBITDA guidance for 2016, due to the current situation where we have been affected by variables beyond our control, we now believe that for 2016 EBITDA we will be approximately 10% below of our original estimate.

With that, let me now turn the call over to Mario who will discuss our financial details in more details. Thank you very much.

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Mario Romero:

Thank you Carlos and good morning everyone. I'll now take you through the financials for the quarter and year to date in more detail. We will then turn the call over to the question and answer period.

Looking at third quarter results, net sales decreased 13.2% year on year due to reduced sales of integrated solutions as Carlos previously explained. Sales from the non-government channels continue to grow at a strong pace, reflecting the good position of our brand and distribution strategy across all countries, reaching an increase of 19.6% year on year.

Since the month of September we incorporated Sytesa's results to our consolidated results. This acquisition will add to our current model of water as a service in the non-government channels as this business is solely focused on commercial clients such as Big Box stores, Office Buildings, Hotels and Shopping Centers.

Gross margin decreased 360 basis points mainly due to a higher FX that affected 133 basis points the cost of raw materials and a change in sales mix composed of more sales of individual solutions than integrated solutions, which have lower margins.

Operating margin decreased 820 basis points year on year, due to onetime costs including the closure of the Tucuman plant in Argentina, expenses incurred for the inclusion programs of the recent add-ons and for the ramp-up of operations in the USA. In this way, EBITDA margin decreased 680 basis points year on year.

Now looking at our performance for the first nine months of 2016, net sales have decreased 9.2% year on year, due to the economic challenges that Brazil keeps facing and Mexico had recently, both affecting the water social infrastructure programs which have translated into very low sales for our integrated solutions.

In the other hand, gross profit margin have increased 180 basis points, due to better prices and lower costs of raw materials.

Operating margin decreased 60 basis points as a percentage of sales, due to fix costs and one-time expenses, which are not being absorbed because of lower sales volume of integrated water solutions. EBITDA margin remained pretty much in line with the previous year.

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In the face of continuing challenges, during the year, our treasury and cash management have been outstanding, our teams across the 13 countries where we operate have done an exceptional job taking care of all this nonoperational items, resulting in a 19% increase in net profit year on year and a 10.9% increase on earnings per share over the last twelve months.

Year to date we keep a healthy balance sheet and a strong cash flow to continue with our disciplined capital deployment to drive total shareholder return. After the acquisitions, we have made during the year our net debt remains 282 million pesos positive.

With that, I would now like to 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. Operator, please go ahead.

Operator:

Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one to ask a question

We'll take our first question from Adan Rodriguez with GBM.

Adan Rodriguez:

Hello, Carlos, and Mario. Thank you for taking my call. Can you give us a little bit more color regarding the growth you see for Sytesa?

Mario Romero Orozco:

Thanks, Adan, for your question. Well, Sytesa, as we mentioned, is the leading water treatment and recycling company in Mexico. With the platform they have, plus our platform, we became the single highest operator and plant count in the Americas. The potential of this business is very important. First, regulation in terms of water recycling and treatment is increasing. Just to mention quick data, revisions by governmental officials have increased 73% on the commercial segments, making them more compulsory under revisions. Second, the market is very big. Just to give you data, being the biggest, we only have 1.5% market share, so there's an enormous opportunity to penetrate this market segment. Third, the price of water in the nonresidential side is increasing 3.5% faster than inflation, so that creates a unique market opportunity that,

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adding Sytesa's operating capabilities, plus Rotoplas Commercial platform could be a good uphold for Rotoplas' near future.

Carlos Rojas Mota Velasco:

I think to what Mario said, we like to measure data with this. We are increasing our capacity to offer water solutions, integrated with the recurrent invoicing. This is a service, more than selling a product or a solution one time. It's a service that we are providing every month with long-term agreements that will establish our area this kind of solutions in our Company. Add it to water fountains that I also—it's an evolution that requires maintenance, so also it's a service that is including a monthly invoicing for maintenance. So, we are developing more and more solutions under this basis.

Adan Rodriguez:

Okay. Thank you. Another question if I may; can you tell us what you expect for the second phase of the School Drinking Fountain program?

Carlos Rojas Mota Velasco:

Well, until today, as we mentioned, we have been able to achieve 29% of the bids that had been during this period of this year. Remember, that we are talking about scholar year. That's from summer of last year until summer of this year. So, the government will be starting to bid soon another, approximately 10,000 more water fountains, and, well, we have been prepared with new products, new solutions, which we know they like it. We are in the process of stalling all our program for maintenance and we expect that with this maintenance we can provide the difference against other participants and have a benefit to at least continue with the same proportion, or increase it like we are expecting in the market share of these solutions.

Adan Rodriguez:

Thank you for your comments.

Operator:

Our next question comes from Pablo Ricalde with Bank of America Merrill Lynch.

Pablo Ricalde:

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Hi. Good morning. Thank you for taking the question. I have two questions. The first one is related to the EBITDA reported in the Integrated Solutions segment. I don't know if you could provide any color on the chief EBITDA, excluding the effect from Sytesa. The second question is related to the EBITDA margin seen in the other region, in the other countries regions, sorry. I'm guessing part of the negative result is due to the closing of a plant in Argentina, but I just want to clarify if there's something else.

Mario Romero Orozco:

Thanks, Pablo, for your questions. One, regarding the other countries results, as you mentioned, the closing of the Tucuman plant affected the performance at the EBITDA level for that region. Secondly, while we are opening market and clients in the US market, obviously, that creates an increase in operating expense by hiring sales force, having marketing expenses going while you open those markets. So, those two are the ones that are impacting the results in other countries.

Regarding the Integrated Solutions, there's two effects. Sytesa, as you mentioned, is a big contributor of EBITDA, and, secondly, as we barely mentioned, in Brazil, there are some contracts starting to happen. As Carlos mentioned, some of these was already reflected there, so those two are why the margin there is above normalized levels.

Pablo Ricalde:

Okay. Perfect. In fact, I have a follow-up question on the EBITDA guidance. The new \$900 million EBITDA implies \$386 million for the fourth quarter. So I don't know if you could provide any additional details on how do you expect to achieve that level.

Mario Romero Orozco:

Well, thanks for your follow-up question, Pablo. First, as Carlos mentioned during his conversation, we haven't been able to invoice any of the water fountains that we have already installed and working across Mexico due to because you have to install it, make it work, then you have to have the authorities verify that it's working properly, and that takes sometimes a big time until you start recognizing that revenue. So that is mostly going to happen on the fourth quarter.

Secondly, we are now seeing some rainwater harvesting and baño digno or the other competing bathroom by the Mexican government happening in the fourth quarter. If you remember, last year we had those in the third quarter. Because of this situation, they have moved into the fourth

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quarter, so we are in the bidding process of doing that, so you will see a pickup there on Mexico Integrated Solutions.

Finally, as we also mentioned, Brazil we're starting to see on a very mild way, a recovery on this water infrastructure progress by the government.

So, those three are going to converge into a fourth quarter plus the good performance we're having in the Integrated Solutions segment.

Pablo Ricalde:

Perfect. Thanks, really helpful.

Operator:

We'll take our next question from Guillermo Diego with Santander.

Guillermo Diego:

Mario, Carlos, thanks. Could you give us the specific detail of how much through the invoice of water fountains represent the million pesos, how much of the \$386 million—that is going to give you, please?

Mario Romero Orozco:

Can you—well, I think I understand half of the question, Diego. Can you repeat the question, please?

Guillermo Diego:

Yes. Sure. For the fourth quarter, you were expecting Ps.386 million. That's quarter-on-quarter growth of around 160% year-on-year growth of around 82% and you're talking about greater fruition of it is going to come from the invoice of water fountains from the Mexican government, so could you specifically detail how many millions are you expecting from that invoice of water fountains?

Mario Romero Orozco:

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Well, that detail we don't provide. That amount it's not only water fountains but water harvesting and baño digno programs by the Mexican government are also coming from the fourth quarter plus the re-initiation of the rainwater harvesting programs in Brazil. Those are the three components that will be coming to the fourth quarter. The water fountains, it's a good part of it, but not the total of it.

Guillermo Diego:

Okay.

Operator:

As a reminder, if you would like to ask a question, it is star, one on your telephone keypad. We'll take our next question from Derek Taylor with Goldman Sachs.

Derek Taylor:

Hey, Carlos. Hey, Mario. Thank you for taking my call. Real quick, just wanted to clarify with the new EBITDA guidance. If I remember correctly, the initial EBITDA guidance of \$1 billion was organic, meaning not including the acquisitions that you've made. Is that still the case?

Carlos Rojas Mota Velasco:

Hi, Derek. Thank you very much for your question. No. What we are now revising our guidance to this minus 10% includes organic and inorganic activity in the Company. The reason was that we were, as explained during the conference, very greatly affected by the delays in water infrastructure programs by the governments, mainly in Brazil and Mexico.

Derek Taylor:

Okay. Perfect. Thank you. If I could just ask one more quick question, in terms of EBITDA margins going forward, I know that there was the one-off with the Argentina plant, but how can we think of margins going forward into 4Q, as well as into 2017?

Mario Romero Orozco:

I think the way we should think about the margins going forward is, as you might probably see from the information that we have released, the Integrated Solution, especially the ones that we

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are gaining traction on them, like the water treatment and recycling, plus the water fountains are growing in that segment. So that is going to benefit the overall margin of the Company. Plus, on the other hand, once those started to recover, obviously we will be better at absorbing the fixed costs that this has carried over throughout the year.

Derek Taylor:

So I guess just a follow-up, do you think that the continued ramp up in the US is going to continue having any affect going into next year, and if so, how much of an affect?

Mario Romero Orozco:

Well, the ramp up operations of the US, I think while we keep opening market, obviously this additional commercial efforts will affect some of the other performance in other countries, but once the new operations stabilize, the margins we've been looking there are pretty much better than the Individual Solutions in other countries. So, once that US started to perform well, I think, Individual Solutions will be benefit from that.

Derek Taylor:

Thank you, Mario. That helps.

Mario Romero Orozco:

Thank you, Derek, for your questions.

Operator:

As a reminder, if you would like to ask a question today, it is star, one. We'll pause for just a moment.

It appears there are no further questions.

Mario Romero Orozco:

Well, thank you everyone for participating in our third quarter results of Grupo Rotoplas. Have a nice day.

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Operator:

That concludes today's conference. Thank you for your participation. You may now disconnect.