International Conference Call
TUPY S/A (TUPY3)
3Q23 Earnings Results
November 14th, 2023

Operator: Good morning and welcome for standing by. Welcome, everyone, to the earnings call to discuss results relative to Q3 2022 for Tupy.

All participants are connected in listen-only mode. In this session, when further instructions will be provided. Should you need assistance from an operator during the call, please request or please press rather star zero. This conference is being also recorded.

The company would like to remind you that this event is also being broadcast simultaneously over the internet via webcast and can be followed at the following URL: www.tupy.com.br/RI where the respective slide deck can also be found. Slide selection can be controlled by the participants.

Tupy would like to state that forward-looking statements made during this call concerning the company's business outlooks, operating and financial targets concerning the company's business are provisions or predictions based on the company's expectations concerning the future of the company.

These forward-looking statements are highly dependent on market conditions, both internally and abroad, also depends on the country's general economic development, also the industry, and therefore are subject to changes.

Joining us today are Mr. Fernando Cestari de Rizzo, CEO, Mr. Rodrigo Cesar Périco, CFO, and Hugo Juliano Zierth, RI Manager.

Mr. Fernando, you may proceed.

Fernando de Rizzo: Thank you and good morning, everyone. Thank you for participating in our call today.

This quarter, we made progress on important fronts, capturing the benefits of the acquisitions made over the last two years. These actions reflect the new Tupy we are now building and point the way for the coming years. We are adding value to our additional core product and diversifying into segments with high growth potential and in which we will play an important role, such as the use of biofuels, vehicle transformation, and the spare parts and components segment related to diesel engines, leveraging our authorized service network in more than a thousand points of sale in Brazil and South America.

Over the course of the year, we have readjusted prices, renegotiated contracts with suppliers, and carried out many actions arising from the combination of the foundry plants with a reduction in expenses and fixed costs. All of these fronts have affected the company structurally and had a positive impact on this quarter's figures, contributing to record results and increased margins when compared to the first half of the year.

Despite the challenging environment with the slowdown in economic activity seen by the reduction in the price of materials and an even more unfavorable foreign exchange rate, this quarter with the appreciation of the real and the Mexican peso when compared to Q2 2023. As in the previous quarter, we also had many unfavorable elements with the Brazilian market severely affected by higher vehicle prices, credit restrictions, and high interest rates. This scenario impacted truck sales and production in Brazil.

Abroad, some markets moved sideways, reflecting the fall in economic activity in Europe and in China, and of the high interest rate in the United States. The company's physical sales volume fell by 7% considering both domestic and foreign markets. This drop in volumes accounts for a reduction in revenue of more than R$170 million when compared to Q3 2022. This indicator does not include business related to MWM, which also had its engine machining and assembly operations, serving the South America market, affected. Those revenues were also impacted by a 7% appreciation of the real against the dollar, currency accounts for 68% of our revenues.

While we saw a drop in commodity prices with a contractual impact, we're able to carry out work on our product mix, pass on inflation from previous periods, and also readjust prices with a favorable impact on our unit revenue in US dollars.

With regard to costs, in addition to significant inflation in services and labor, we faced a 16% appreciation of the Mexican peso when compared to last year, a currency that accounts for around 20% of the company's total cost. In addition, we made decisions to prioritize cash generation and reduce tariffs.

All these factors combined affected margins and EBITDA for the quarter with a negative impact of more than R$ 150 million when compared to Q3 2022. Increased efficiency, the capture of synergies and renegotiations with customers and suppliers allowed us in similar volume, and exchange rate conditions to last year achieve an EBITDA of over 500 million and margins of over 15% had this been the case.

Since the acquisitions and implementations of SAP, we have continued to perform gradual integration work. We have evolved a lot, but we still operate with a structure that is larger than the current needs of the market's reserves. We have mapped out various opportunities to reduce costs and process improvements that will be implemented in the coming months.

The deflation of materials and other economic indicators show potential slowdown in some markets. So, we will make the necessary adjustments to maintain our performance. As for the figures of the quarter, net revenue reached R$3 billion, an increase of 10% vis-à-vis the same period of last year. The adjusted EBITDA for the period was R$367 million, the highest quarterly result in the company's history, with a margin of 12.3%, a significant increase compared to the margin posted in the first half, which was 11.2%. Net profit reached R$150 million with a net margin of 5%.

On the next slide, you see the results of the actions taken to increase working capital efficiency. We adjusted production lines and purchasing volumes, which helped to reduce inventories of materials and products. These initiatives impacted the margins given the lower dilution of fixed costs but contributed to a 10% reduction in inventories this year with an impact on operating cash generation in the period which reached R$ 359 million in Q3.

Cash generation is a central objective of the company, and it continue to be so, and the focus of various actions across the coming quarters.

Now, to talk about the main indicators of the quarter, I turn the conference over to Rodrigo.

Rodrigo Périco: Thank you Fernando, good morning, everyone. Revenues grew by 10% when compared to the same period of last year, reaching 3 billion, including the MWM result. Regarding the distribution of revenues by geography, we have the following: 48% originated in North America, 33% in South and Central America, mainly Brazil, 17% in Europe, and the remaining 2% from Asia, Africa, and Oceania. 87% of revenues come from the structural components and contract manufacturing business, which consists of cast iron products in value-added services, such as machining and assembly of components.

6% of revenues come from the energy and decarbonization segment, which includes generator sets, in-house manufactured engines, marine applications, lighting towers, and products and services relative to decarbonization, and 7% comes from the distribution business, which includes revenues from spare parts from MWM, the so-called aftermarket, and hydraulic products.

In the next slide, revenues from the structural components and contract manufacturing segment were impacted by the fall in production in the Brazilian market, reflecting the replacement of engine emissions technology, Proconve P8/Euro 6, and of the subsequent increase in prices in the first half of 2023, as well as macroeconomic factors, such as high interest rates and restricted access to credit.

Revenues from foreign markets grew slightly, reflecting a more cautious outlook and accommodation in some sectors. The value-added products accounted for 39% of this business unit's total revenue.

On slide number eight, next slide, we present the performance of the energy and decarbonization segment, which arose from the acquisition of MWM and includes generator sets, self-made machines, marine applications, lighting towers, products and services related to decarbonization. Revenues reach R$119 million in Brazil and 54 million abroad, representing 12% and 3% respectively of sales in the markets we mentioned.

On slide number nine, we have the distribution unit, which covers revenue from spare parts from MWM and hydraulics. The distribution segment sales in Brazil, which already account for 16% of domestic markets revenue, grew by 186% due to the incorporation of MWM's results. Sales abroad grew by 31%.

Moving to the next slide, costs of goods sold increased by 14% year on year, impacted, among other factors, by the startup of the MWM operation, the appreciation of the Mexican peso and inflation in labor and services. On the other hand, operating expenses fell by 7% compared to the third quarter of 2022. A period that did not include MWM operations. This drop, even with the addition of a new company, reflects the synergies and efficiency gains that have been implemented throughout the year.

Following on with the presentation on slide 11, adjusted EBITDA reached 367 million in Q3 2023, while the margin in relation to revenue reached 12.3%, an increase of 110 basis points when compared to the first half of the year. This result is a consequence of the synergies already realized and also various initiatives to reduce costs and expenses, which offset some factors that had a significant impact on the quarter, including the appreciation of the Mexican peso, appreciation of Brazilian real against the dollar, inflation of labor and materials and falling sales volumes.

Net profit reached R$ 150 million with a margin of 5% on the net revenue. In the year-on-year comparison, the drop was caused by the increase in financial expenses due to the raising of debentures for the acquisition of MWM in the amount of 1 billion with the exchange rate effect and the tax base of assets and liabilities located in Mexico with no cash effect, and also, by the recognition of tax credit with a positive impact of 22 million in the Q3 2022.

On slide 12, we have the financial results for the period. An increase in financial expenses is mainly due to the issuance of debentures in the amount of 1 billion intended to pay the acquisition of MWM and the rise in the CDI rate, which directly impacted the interest rates on loans in Reais. Financial income for the period amounted to 27 million and the increase compared to last year is mainly due to the income from financial investment in Reais.

The result from exchange rate variations, there was revenue of 13 million made up of variations, balance sheet accounts in foreign currency, and to the result of hedge operations.

On slide 13, we have the variations of the main working capital accounts. Taking the second quarter of 23 as basis for comparison, an increase of 76 million in accounts receivable with an impact on the average collection period equivalent to three days of sales caused mainly by the exchange rate appreciation on accounts receivable in foreign currency, which accounted for 75% of the total. Inventories fell by 44 million, an increase by one day in relation to the cost of goods sold. The variation is due to the inclusion of MWM's operation and is offset by the various actions taken by the company to reduce inventories at its operations in Brazil and in Mexico.

In accounts payable, the increase was 79 million with an impact of three days. The higher volume of production when compared to the previous quarter contributed to an increase in the amount of purchases in the period. This line was also affected by the effect of foreign exchange appreciation on accounts payable in foreign currency, which accounted for 41% of the total.

Going to the next slide, net debt on September 30th was 2.2 billion, which corresponds to 1.8 times the adjusted EBITDA for the last 12 months. We only considered 10 months of MWM EBITDA. Foreign currency bonds represented 59% of the total, and in relation to cash 63% was denominated in local currency. We ended the first half of the year with a very comfortable cash position of around 1.1 billion.

I turn the floor back over to Fernando for his final remarks.

Fernando de Rizzo: Thank you, Rodrigo. Moving on to the next slide, in the domestic market, we have a combination of unfavorable factors that led to a drop in the truck market, especially the first half of the year. We have seen a gradual recovery with automakers reactivating work shifts.

In machinery and equipment, despite solid agribusiness fundamentals, the lower availability of credit has impacted sales in the segment. In the foreign market, in general, we have seen an accommodation of demand and a more conservative stance on the part of buyers due to the more restrictive macroeconomic scenario, especially in Europe and China.

The rising interest rates in the US has also impacted demand for various applications. There has already been a reduction in new orders as a result of the normalization of the chains after the pandemic. In the off-road segment, demand has been driven especially by the non-residential construction segments and infrastructure and oil and gas. Smaller equipment and other applications related to the residential market have been affected by the lower interest rates.

Despite market conditions, I'd like to reinforce that our main source of value is within Tupy, as I will discuss in the next slides. Over the course of the year, we performed several actions to cut costs, expenses, and to capture synergies across our operations, which have already brought in significant gains. We also managed to pass on prices and continue to add value to our products. This improvement has happened amidst an adverse backdrop, in addition to the impact of the extension rate, which has depreciated while we face inflation in services and labor, we are sized to meet a larger potential volume, which has been affected by the lower demand for commercial vehicles in Brazil and other segments abroad.

We have made adjustments and faced production stoppages, which while having an impact on margins, have contributed to reduce stock and making working capital more efficient, which has led to strong cash generations.

There are opportunities across all fronts. We're not yet satisfied, and we count on our leaders to be engaged in the search for improvement and efficiency gains. We have a lot of work underway in engineering, sales, manufacturing, and purchasing, with good expectations for the coming year. We are preparing the company to make further progress in optimizing manufacturing, reallocating products to plants with more suitable structure and technical characteristics.

These actions are even more important in this scenario of uncertainty about the performance of certain markets. In the coming months, we'll be implementing a number of other actions to rationalize costs and efficiency, optimizing operations, and mainly aiming at generating more cash.

On the next slide, I want to share the progress of some initiatives that represent the positioning we're now building and the opportunities that we have in business. In manufacturing contract, the combination of Tupy’s and MWM’s skills and the ability to offer complete solutions have contributed to finding new contracts in Brazil and Mexico, receiving interest from automakers in outsourcing [unintelligible – audio failure], and will play an increasingly more strategic role in the chains where we operate.

In the energy and decarbonization segment, we are seeing growing interest from major agribusiness players in biomethane and natural gas engines, typically using trucks or motor pumps. Several projects are already in the ramp-up phase after a successful testing period.

The same is happening with customers using this solution for public transportation modes. Recently, a Bill was presented in Sao Paulo that will exempt buses and trucks powered by hydrogen, CNG, and biomethane from the IPVA tax. Proposals of this nature should take place across the country with a focus on biofuels and on solutions that enable viable decarbonization, increasing demand for our decarbonization solutions.

Our generation projects are also moving forward. We will be starting operations with Primato in the coming months, and we are in the advanced stages of negotiating partnerships for the use of solid urban waste. We continue to expand our leadership in Brazil in the sale of generator sets produced entirely in Brazil, which are not only competitive, but also provide energy security.

We expect significant growth in the aftermarket business over the next few years. MWM has a distribution network of more than a thousand points of sale and will be a benchmark in the aftermarket for diesel engine parts and components. To this end, we will increase our portfolio and offer services that have not previously existed in Brazil.

Lastly, I'd like to share an important recognition of our innovation initiatives. In the last conference call, we mentioned that Tupy made it onto the list of the most innovative companies in Brazil, according to the Valor Econômico Newspaper ranking, advancing almost 100 places in the past two years, and now have been chosen by the National Confederation of Industry as one of the three highlights among large companies in the product innovation category.

Innovation is an important component of our strategy; it has enabled us to achieve leadership in our market and makes Tupy one of its customers' major sponsors in their decarbonization journey. We continue to advance in the battery recycling projects, hydrogen, biomethane, and new technologies for the use of clean fuels and decarbonization in agribusiness.

Thank you all for joining us today and let's move on to the Q&A session. Back to the operator. Thank you.

Question and Answer Session

Operator: Thank you. We'll now start the Q&A session. To ask a question, please press *1. And to remove your question from the queue, please press *2. This audio conference is dedicated exclusively for investors and investment professionals.

Our first question comes from André Ferreira, from Bradesco BBI. You may proceed, sir.

André Ferreira: Good morning, everyone. I have two questions. The first one, even though Brazil hasn't improved in automaking, there is a positive expectation in the American market. What do you expect to see for 2024? And also, if we could talk about the new engine assembly capability of MWM and also needs to expand capacity you may experience in the coming years. Thank you.

Fernando de Rizzo: Hi, André. Good morning. Thank you for your question. Your sound was kind of choppy, but I think we got most of your questions. I'll start by talking about our market expectation. We believe that Brazil will see some level of recovery, we saw a drop in the year so of 37%, but we can already see our clients resuming work shifts, becoming more confident. We expect to see growth next year to the tune of 15 to 20%.

Abroad, the scenario is a bit different. We see demand slowing down, higher interest rates, some sectors that are driven by residential construction, for example, then you affect mid-sized trucks, and you also affect construction machines of smaller sizes. So that industry is sort of slowing down in terms of demand. The heavy vehicle sector should see a slight slowdown in demand as well of about 3 to 5% in the US, and in Europe 3% and the US a drop of 10% rather in the production manufacture of heavy trucks. Cummings believes that we should see a slow reduction as well in terms of demand for that year, 2024 that is.

As to your question about assembly, our capacity to assemble engines, we have signed good contracts this year, we have already announced them, we have a large project which is ongoing in Mexico to assemble engine in Mexico, a whole operation dedicated to two specific Class 8 truck makers, they'll transfer the production of blocks and heads to our plants in Mexico starting 2025, and for those products, we'll offer machining and smaller assembly procedures.

In Brazil, we have also seen demand and interest on the part of customers that today bring blocks and heads from abroad to be assembled in Brazil. Oftentimes, products that we export from Brazil, they are processed in the US and Europe, they come back to Brazil already assembled. So, they're paying tariffs, that makes no sense, so we are working with them to try and create conditions, economic conditions of efficiency using part of our existing capacity to assemble those components here.

We'll be announcing something to that effect next year. That's a common thing to Brazil, that's important to say. Even though trucks are assembled in Brazil, we estimate that about 60 to 70% of the heads of those engines assembled in Brazil, those trucks they are imported, sometimes they are made by Tupy, but which was exported. In the case of engine block, we estimate something around 50%, products which are imported to Brazil and will join engine assembly line in Brazil.

So, we're working on those fronts for heavy trucks automakers and mid-size trucks also, and we have also been discussing with construction machinery makers and also agricultural machines makers, we estimate that about 80 to 90% of construction and agricultural machines assembled in Brazil, they also bring imported engines. Oftentimes, they are products made by Tupy. And here, once again, we have a huge opportunity because those markets are poised to grow significantly in Brazil, construction and agriculture.

Of course, there is a huge need for infrastructure development in Brazil and agricultural production growing as well, so it's only natural that those products need to be adapted to Brazil. And they're also being adapted for different fuels, we have several options in fuels in Brazil, biomethane, ethanol, a series of alternatives that will be used in agriculture and in construction and also in public transportation and other smaller trucks as well used in cities where you have availability of biogas and biomethane.

We will see then customization and less imports, and that's where we will grow our volumes across those fronts, okay?

André Ferreira: Okay thank you.

Operator: Next question from Luiz Capistrano, from Itaú BBA. You may proceed, sir.

Luiz Capistrano: Good morning. Congratulations on your numbers. I have two questions. We could talk about margins, we've been talking about synergy and some headwinds in third quarter, foreign exchange was one of them. I'd like to understand in this quarter what kind of synergies we've seen and what can we expect going forward.

Once those effects are passed, if we should expect larger margins, not necessarily in Q4, there is seasonality issues in Q4, but perhaps in 2024 can we expect higher margins driven by those synergies? And to what extent if you are comfortable in exposing those numbers.

And also, a second question about demand coming from abroad, I'd like to understand a bit more the drop in production. If I'm not mistaken, 10% in heavy vehicles in the US and you attribute that to interest rates. Am I right? If I'm not correct, please correct me there. Thank you.

Fernando de Rizzo: Thank you, Luiz. Let's start with the second question. I'll talk about the US truck market. It has been growing for the past two years that US truck market, and we observed that the average age of the American fleet has never been so young. They're about five years old, their fleet. If you compare the Brazilian fleet, we're talking about 17-19 years of age for the fleet. So, it's a very efficient fleet in the US. So, replacing that is not cheap. We have advanced technologically for trucks as of recent times with significant gains in terms of fuel consumption. The new engine generations reduce up to 8% fuel consumption; 8, which is significant.

And those are projects we have been working on and I mentioned we're going to be manufacturing that in Mexico, those are new engines with new technologies, much more efficient than the existing engines, but we understand that the market tends to slow down to accommodate for a series of reasons. If you see a drop in residential construction, for example, you have less construction materials transport, so there is a series of cascading effects.

We do not expect to see growth in demand next year. We will see perhaps a drop both in mid-size and heavy trucks to the tune of 10%, as you said, if you look at certain agents that work with the market, S&P, ACT Research, that's what they're saying. In Brazil, we see a positive momentum, a growth of 22%, that's what we expect to see and that's part of our plans for the products that we sell in the sector.

With the heavy construction segment, we still see some tailwind, oil and gas the same, the residential construction side is a problem because the mortgage costs have spiked in the last… 8% a year right now, and that of course affects construction of new houses. All of that combined will have an effect on the economy. That's how we see that market on a higher level.

What I tried to mention during our previous speech is that Tupy today is a combination of three large companies, the traditional Tupy, Teksid and MWM, and we have a lot to capture from that combination. So, there are efficiency gains to be captured. Somebody asked how much we think we have exceeded; I'd say today about 40-45% of synergies have been captured, almost half. You ask: “how do we see that going forward”, we saw an impact coming from foreign exchange rates and a reduction in volume compared to last year to the tune of about 150 million.

So, if I had the same market conditions I had last year, our numbers would be around 150 million better, our margins would be over 15% incorporating WM of course, which has a lower margin as we know, in traditional Tupy and Teksid, which had an even lower margin.

So, all this work has been done to consolidate purchases, procurement, contracts for negotiations and other readjustments, and now, only now, we're seeing operating gains, gains coming to fruition. I'm starting to be able to connect the plants. I'm moving products and connecting the plants, and then I'll capture even more benefits. We are eliminating replications. I can work with fewer assets.

So, it's along those lines that we are now starting a new internal phase to capture further internal synergies. We have installed SAP in Mexico two years ago, or last year rather, and now we start to consolidate other activities at the head office. So, we are increasingly doing that, so it's a sum of large companies and there is a construction work to be done inside, in-house.

Our expectation in terms of margins, your question, we do not provide that guidance, as you know, but we see a low demand next year, we do have great opportunities in-house to be captured, opportunities in the purchasing department to be captured, and overall impact of those sudden foreign exchange variations that we saw at the peso and the US dollar really affect our short-term results, and that takes about 18 months to readjust.

We also see inflation on the one hand, which has affected labor and services, we saw deflation for mineral commodities this year, which is linked to the economic activity, of course, so we are trying to find out how to maintain the company organized and at the same time capture benefits in-house.

So, that's the overall scenario that we see going forward for next year, okay?

Luiz Capistrano: Okay, Fernando, thank you for your answer, quite clear.

Operator: Thank you. Our next question comes from our webcast platform sent by Gabriel Tinen, from Santander:

“Good morning. I'd like to know about the evolution of the synergy, especially in the Aveiro and Betim in terms of a more efficient allocation of products and what still needs to be done. If you could give some color on the Teksid, I'd appreciate it. Thank you.”

Fernando de Rizzo: Hey, Gabriel, thank you for your question. Well, basically, as I mentioned before, we have made considerable progress across the whole procurement structure, commercial area, contract renegotiation, and other commercial term readjustments, and we are now starting to capture gains that we see inside our plants, inside our operations, and that will depend on products being shift. We made important investments in Betim, we transferred idle equipment to Betim, it's a critical area for our product manufacturing that works with sand, which is completely in Betim, it's starting operations now in this quarter, which we call the core shop, we are reducing obsolete assets, and we are now improving the company. That's why we work with sand and resin, or core. We estimate 40 to 45% of synergies having already been achieved, and there's a whole avenue of opportunities for us to explore.

As I mentioned, if the foreign exchange rate had remained in line with inflation, we would be running at a much better margins than what we presented just now to you. So, we were impacted by those conditions, and we had some cost adjustments with suppliers and customers that allowed us to present the current results. In absolute terms, they're pretty much in line with what we had last year. So, the company is quite focused and prepared, but as I said, we continue to work, our agenda is do our homework in-house for 2024.

Operator: Thank you. A question from André Mazini, Citibank. You may proceed.

André Mazini: Good morning. Thank you for your availability. I'd like to ask about the off-road line, both domestically and abroad. For the domestic market we saw a drop of 22% in the quarter for the off-road market, is this because of the Euro 6? Or where is it coming from?

And in the foreign market off-road, drop by 19%. And the question is: was this due to the strike in the United Auto Workers?

United Auto Workers, yes, but that depends on how you classify the vehicles. But anyway, was it the strike on the part of UAW, or where were those impacts coming? And will you expect those impacts to extend, to linger going forward? Thank you.

Fernando de Rizzo: Hello, thank you for your question. Yes, the strike did affect the assembly of some Ford pickup trucks, and they're and important customer to us, it also affected Stellantis and GM, a smaller customer when compared to Ford, we had some impact in Q4 also because of that, but it's relatively smaller, and this of course will start to recover in Q1 next year. I do not see a major lingering effect coming from that.

As to your question about off-road, or the off-road segment, we've seen a slowdown in demand for agricultural machines across the world, not only in Brazil. And the construction, the small construction machinery, they have also seen lower estimates. We're talking about smaller engines, of course, smaller components for machines that work in a house construction, home construction, smaller machines, but for heavy machinery, or larger machinery, we still see a robust market, healthy market going forward.

That's the perception we have now. There are some market indications that point the way drop of 5% globally. We expect to see a growth in Brazil next year in the machinery or the machine segment, we should grow between 5 to 10%. That's how we see.

And about your question about the Ford 150, is part of our light commercial vehicles, yeah, the answer is yes.

André Mazini: Thank you.

Fernando de Rizzo: And just one more thing, André. You also asked about Euro 6. Euro 6 has not affected machines. That's a different rule. So, we see only commercial vehicles being affected there, mid-sized trucks, heavy trucks and vans mainly, and also, urban buses, of course.

André Mazini: Thank you.

Operator: Next question from Marcelo Mota, from JP Morgan.

Marcelo Mota: Good morning. If you could please talk a bit about this Primato contract, which starts in operation next year. If you could tell us about the ramp-up, the contribution it will have to revenue. And also, in terms of decarbonization, how do you see the evolution of that component within the revenue mix? Not account for much in the pipeline yet, so how do you see that going forward? Is it a two/three-year plan? do you see more contributions?

And also, an outlook for cash generation. What do you expect for Q4 and next year? Thank you.

Fernando de Rizzo: Thank you for your question, Marcelo. Yes, the Primato project will generate revenue as of Q2 2024, but it's relatively small compared to the whole universe of Tupy. The important thing about Primato is a project it generates biomethane, it will offer 3 million liters of gas of biomethane per day for the machines operating in that region to produce biofertilizers. But the good news is that we see a very strong demand for those projects, a very strong demand be it for building biomethane plant construction, be it for equipment that use biomethane out in the field, conversion of buses, trucks, other machines, motor pumps, we have launched irrigation motor pumps, like combustion engines can use biomethane, so for example, in our sugar cane operations to distribute vinasse 800 meters or a kilometer, you'll need those systems, it's a high volume of vinasse that need to be treated, and for overall irrigation purposes of farms.

I think I mentioned in the previous answer that I gave, Tupy will grow mainly across manufacturing contracts in the coming years – I’m talking about large projects –, we will see growth rates both in the aftermarket industry segment and in the biogas, biomethane business.

So, we have a set of products today, a set of alternatives, but Brazil produces little biomethane today, we explore only 3% of our total biomethane capacity, and the biomethane being produced today is being used to replace natural gas in a plant that produces beverages in Rio. And there's other smaller operations in São Paulo generated from sugarcane vinasse and also being injected in distribution networks or pipelines for natural gas.

So, that's the business that has a huge growth potential in Brazil. Legislation is being adjusted now, so we'll soon see buses running on that fuel, trucks running on that fuel, which are totally clean, and we'll be at the forefront for those products going forward, both for production of biomethane and also for the equipment that will consume biomethane to run.

Tupy has within MWM the largest research center for engines in Latin America, and that research center is totally dedicated, fully dedicated – and that's an important investment – dedicated to developing solutions for biofuels. We're talking about biogas, biomethane, ethanol, and a variety of alternatives that we have in the pipeline. Palm tree oil, for example, to generate energy to use in remote areas of the country.

So, it's a very large universe, Marcelo, both for generators, which is traditional to produce electricity, but all machines that might use that. So, in the universe of Tupy we see growth rates which are important for biogas and methane and also in the replacement segment, spare parts in the industry. We see huge opportunities to diversify there. Our revenue is quite linked to automakers and the idea is to diversify those revenue streams in the short run, but you'll see growth in the engine assembly, machining, but the company across all areas we are trying to invest next year to diversify.

Marcelo Mota: Okay. Thank you.

Rodrigo Périco: This is Rodrigo. To your question about cash generation, as for the fourth quarter of 2023, historically it's a weaker quarter, it's a seasonal issue, but the company has an expectation of receive some adjustments in terms of the price level. And as to 2024, we would do not provide a guidance, but as we start looking at next year, I can tell you that everything that the company intends to invest in CapEx and its obligation with shareholders, they're all covered by our operational generation. So, our leverage level will be very much in line with what we've seen at the close of the current quarter.

Marcelo Mota: Okay. Thank you. Thank you.

Operator: Now we have a question from the webcast from Mr. Eric:

"Good morning and congratulations on your results. It is possible to see that the initiatives linked to biomethane products are today the main lever to bring growth to the company. How can you describe the competition in this sector? What are your competitive edges to find ITRs in this segment?"

Fernando de Rizzo: Okay, Eric, thank you for your question. It's an area where we will see high growth rates, but still relatively small when you compare the whole universe of the company operates around. When we look at the competition, that equipment in Brazil is important either from Germany or from Canada. All the systems from treatment to the treatment to the treatment of waste, all the bio digesters, the gas washing systems to reach the biomethane product, it's all imported. Our efforts were to nationalize all of that, make that viable in Brazil.

So, this business has always focused mainly on sugar cane because sugar cane has a higher volume, but there's also potential in production of protein in Brazil. The challenging protein production in Brazil lies in the fact that you have several small holders that treat animals, grow the animals and supply protein to large meat packing plants. So, how can we have units that would gather 10-15 small holders that we can now receive waste from, that we can treat that waste and generate added revenue for us and reduce costs for them, providing gas electricity or equipment.

At the same time, we could also manufacture or produce fertilizers. So, we see a huge growth in Brazil, really big, it's the type of business that needs to be offered as a service. We're talking about biotech, biotechnology to treat waste and to understand how bacteria work or works, we have to monitor all that, and also the machines that run on those gases, those machines also need to be closely monitored. So, the need for service is very high as well.

So, that's why our proposition is around that. Embrapa has already encouraged that, back in the 80s they started encouraging farmers to have their own systems. But these are very complex systems. You have bacteria on the one hand, how to have engines working well, you have to wash the gases. Those are electronic probes that they use to ensure the system is working well, in an efficient and reliable manner.

Today, we have machines operating, we have electricity plants to support milk production, so we have lactating cows, gases, they already had their biodigestion systems that would burn their gases, so it's a waste treatment plant that would convert that into gas and would burn the gas in a flare at the plant level. Today, at the farm level.

So today, we wash the gases and convert that into electricity for those operations because when you produce milk, you demand a lot of electricity, of course. So, that solution would make sense for milk production. But what we have learned is that when you produce pork, or swine meat, or poultry, you have a lot of waste, which is rich, and that waste, that residue was not being explored.

So, I always like to mention that number. The production potential for biomethane in Brazil accounts for 70% of the use of diesel in Brazil, diesel oil, so that fuel is being liberated into the atmosphere and we're simply sending 70% of that out into the air. If we were able to capture that, we will have a very good position in Brazil, and Brazil would be different from other regions because we hit this surplus of fuel that needs to be consumed, and the most economical way to consume that is by replacing coal and also by replacing diesel. And that's where we have been working on those projects to replace diesel engines in fleets that collect garbage, urban fleets in São Paulo, for example, companies that have the concession to collect garbage, they are testing our systems and also several bus companies working with our systems.

We have a very interesting TIR above the company's average today, and the competition, of course, depends on a combination of knowledges, and the barrier is in that level of knowledge that you need of different engineering disciplines that we do have in the company to be able to service that system from end to end.

Thank you for your question, Eric.

Operator: Thank you. A question from Andressa Varotto, UBS.

Andresa Varotto: Good morning. I have two questions distribution this quarter. We saw a very good performance and the question is about the main drivers for that segment and if you have already incorporated MWM's contribution on that front.

And the second question about SG&A. We've seen a drop in SG&A quarter on quarter and the question is: is the current level sustainable or could we expect more reductions going forward? Thank you.

Fernando de Rizzo: Andressa, thank you for your question. First of all, the distribution segment, which is our main aftermarket arm, spare parts, Tupy and MWM we are focused on diesel engines in Brazil, that has been our main target, if you will, we have been investing in system resources to develop more products to make up our portfolio and that's why we see a growth.

With the acquisition of MWM, we have also acquired a distribution network across Brazil, a thousand stores that are able to distribute our products, and about 400 authorized service shops that repair our engines and other brands as well. And this distribution channel is quite strong across a series of items you have included in our portfolio. We do that every month, put some major effort to increase our portfolio month by month. Our target is to try to integrate two to three items every day in our portfolio. That's a significant engineering effort, product development as well, foreign manufacturers helping us out.

So that's an area which is relatively small in the company, 3 to 4% of our revenue, but we also see huge potential for growth. And Tupy and MWM becoming leaders in the diesel engine segment in Brazil, offering other alternatives, blocks and heads, and other components we are incorporating now, and we should continue to see growth in that sector.

As to the SG&A portion of the question, we see both effects: an effect coming from the consolidation of acquisitions; and a recent effect coming from freight. We renegotiated freight recently, which has also affected those sales expenses. But actually, we continue to work in that direction because we understand that there are opportunities to be captured there as well. It's part of this synergy capture design that's part of the company's efforts nowadays. Thank you.

Andresa Varotto: Thank you Fernando.

Operator: Next question from the webcast from Bruno Mileno:

“Congratulations on your results. Looking forward, what would be the outlook for the use of hydrogen in vehicles?”

Fernando de Rizzo: Thank you for your question, Bruno. A very timely question. Recently, our Austrian partner, AVL, they reviewed the performance of our project, our project has reached 50% of thermal efficiency. In other words, we are converting 50% of hydrogen into force, into power, better than current diesel engines, and it is getting closer to the performance of a fuel cell. So, from the point of view of mechanical performance, performance development of the system, it is going pretty well.

In 2025, we will launch products to a German automaker which will start selling trucks that will run on hydrogen, also equipment being used in ports, some specific routes of ships and vessels, and we have a very high expectation for Brazil because we'll have the cheapest green hydrogen production in the world.

This is not an easy material to transport, so we expect this to be used in Brazil. We're talking about relatively simple systems, very similar to the current engine systems, I mean, the framework is similar, of course, it's a different block and head, but to a certain extent, the architecture is very similar to what we have now, but it's not a project that will affect Tupy’s revenues in the short run.

Now, even if I'm saying we're going to be launching programs in one or two years, this should not affect our revenues in the short run. Green hydrogen is relatively expensive when you talk about replacing diesel, but it does have the European seal for zero emission vehicle. And starting in 2030, a portion of those European automakers will be zero emission vehicles, either electric or a hydrogen-running engine vehicles.

Based on what we’ve seen in terms of technology advancement, this is moving forward fast, but it is something we're going to be looking into for the long run and we will see good revenues as of 2030. Of course, we believe we will be providing more complex systems by then. But it's an important development front for Tupy, and we are preparing some material for our Investor Day next year, we're going to be touching upon that next year.

But of course, that's not something for the short run. Thank you.

Operator: This concludes our Q&A session for Tupy. Back to you, Mr. Fernando, for your final remarks.

Fernando de Rizzo: Well, thank you all for joining our call today. We have shared important progresses we've achieved throughout this past quarter, be it capturing new synergies across our operations and also in the building of this new Tupy. Our focus will remain on process improvement, efficiency gains, cost reductions, operating cash generation, always maintaining our traditional strategic and financial discipline. That's how we manage this company. The company has been growing, but we have maintained a strict financial discipline and strategic clarity for our investments.

Those steps had been predicted in our schedule since the initial phases of our acquisitions, but now as the market slows down, it becomes even more relevant. So, we have highlighted that the new Tupy is a work in progress, we are generating more efficiency for our traditional company adding value to the products we have always produced, and also participating in new sectors where we see good growth potential, which will be captured in the coming years.

I'd like also to thank the confidence of our shareholders and the commitment of our team as we search for better results despite the challenges we have faced. We have been discussing different opportunities for new businesses across all the areas where we operate, and we expect to have good news next year.

But despite the challenges, we remain optimistic and confident in what we've been doing, in the opportunities we have ahead, and confident in the whole robust fundamentals that support this business. So, thank you again and have a nice day everyone.

Operator: Thank you. Tupy's earnings call is now over. Thank you all for joining and have a nice day everyone.