International Conference Call
TUPY S/A (TUPY3)
2Q21 Earnings Results
August 6th, 2021

Operator: Good morning thank you for waiting. Welcome to the earnings conference call for the second quarter of 2021 of Tupy. All participants are connected in listen-only mode and later on a Q&A session will be open when further instructions will be given. In the event you need help from the operator during this call, please, press star zero. This conference is being recorded.

The company would like to remind you that this event is also being transmitted simultaneously via webcast and can be accessed at the address www.tupy.com.br/RI, where the corresponding presentation is available. The selection of slides will be controlled by participants. Tupy clarifies that any statements made during this call about the outlook of business, operating and financial projections or goals relating to the company's business are forecast based on expectations of management about the future of the company. Such expectations depend highly on domestic and international market conditions, also on the general economic performance of the country and international markets and therefore are subject to change.

Here with us we have Fernando Cestari de Rizzo, CEO, Thiago Struminski, CFO. Mr. Fernando, you may continue.

Fernando Rizzo: Thank you, Priscilla. Good morning everyone, we thank you all for attending our conference.

We'll start with a short summary of the second quarter, which started with a previous moment preparing the company to absorb the strong increase in demand that we pointed out since the last quarter of last year. We hired about 2,000 employees in Brazil and Mexico this year, we also turned on equipment and within our flexibilization strategy we moved products from Brazil to Mexico. Although the demand at the end continues to grow, some of our customers were severely affected by the shortage of important inputs, such as semiconductors, reducing or stopping their operations. Such sales are not lost, but to a great extent they have been postponed.

In terms of volume, such stoppages meant around 12,000 tons that were not converted into revenue. This reduces a dilution of fixed costs and bring inefficiencies to our process. Results were also highly impacted by freight and cost continually growing costs of raw materials and low availability of scrap variety and lower quality of it. This context makes variations in the process with consequential variations in the quality of the metallurgy. In addition, we continue to be affected by absenteeism caused by the pandemic. We continue to do our share in fighting

COVID-19 including the screening and testing center of Tupy was converted into a vaccination center for the entire committee. Considering the lack of semiconductors and other input, we observed the great mismatch in the demand and the end of production of our customers which causes our volumes still not to reflect the recovery of global economy as well as the inventory of products of customers are at very low levels, this factor in solid fundamentals will ensure strong demand for next years.

On slide number four, we can observe a significant increase in scrap costs. This cost will be transferred, but at a first mum moment they present a mismatch in prices of acquisition of such raw material. These factors combined impacted EBITDA in approximately R$35 million in the period.

On slide five, we show that despite such effects we continue our recovery path with allocation of capital that is consistent, and we increase significantly the return on invested capital, we also reduced our leverage, and the debt is basically due to the bond to mature in 2031. With this solid financial position, we're pleased to announce a payment of interest on equity in the amount of R$19.6 million in this month, also as approved by our Board of Directors future distributions amounting to 39.3 million will be resolved on a timely manner.

And now I invite Thiago, our CFO, to present the indicators of the quarter.

Thiago Struminski: Thank you, Fernando. Good morning everyone.

Given the strong impact of pandemics in the second quarter of 2020, we'll use as basis of comparison the results of the first quarter of 2021. Despite the assembly difficulties faced by many of our customers due to the lack of components, volumes followed their gradual recovery strategy or trend observed in the last 12 months presenting a 1% increase in the comparison with the 1Q21, especially in the domestic market. The mix of volume, transportation, infrastructure, and culture is 27 for partially or fully machined against 25% in 1Q21 and 24% were produced in CGI against 25% in 1Q21.

Slide seven, revenues increased by 7% in comparison with the 1Q21, revenues by kilo grew by 5%. Regarding distribution of revenues by geography: 58% came from NAFTA, 23% South and Central Americas, especially Brazil, 14% Europe, and 5% remaining Asia, Africa, and Oceania. From the application point of view, 89% commercial and off-road vehicles, 6% passenger cars, 5% hydraulic segment.

On slide number eight, we see in the domestic market, a good performance of commercial vehicle applications, machines and off-road, in addition to indirect exports.

On slide nine, we see the effects of revenue from international markets. In passenger cars, light commercial vehicles we see a drop in revenues coming from temporary customers stoppages, which were impacted by shortage of semiconductors. In the medium and heavy commercial vehicles and off-road vehicles, we observe an increase in revenues given the good market performance given the global recovery and resumption of investments.

On slide ten, we see the sales performance in the hydraulic segment, which accounted for 5% of revenues. The growth of revenue from 22% and 26% in the domestic international markets respectively reflect the gradual improvement in the industrial activities, market recovery, pent up demand, and price restructuring.

Slide 11 shows the costs of goods sold and operating expenses had an increase of 8% when compared to quarter-on-quarter leading to a gross margin of 14.3%, 9% increase in costs with raw materials, 7% in maintenance and third party materials resulting mainly from materials inflation, a growth of 12% in labor account mainly due to staff increase and overtime payment, an increase of 8% in payments with expenditure of energies resulting from the high increase in volume produced and generation tariffs, in addition to mix of finer materials with greater use of electric furnaces. Operating expenses increased by 4% due to the growth of sales and therefore greater use of freight and commissions on sales as well as personnel expenses.

Slide 12 shows that adjusted EBITDA reached 186 million, a reduction of 7% when compared to the previous quarter and a margin of 11.3%. in the lower part of the slide, we see a net income in this 2Q of 31 million.

Next slide we, talk of financial results. The drop in financial expenses comes from the appreciation of real against the dollar with an effect of interest paid on dollar-denominated loans as well as reduction of the cost of debt, it was also affected by the premium on the prepayment of *pro rata* and senior notes to mature in 2024. The increase in financial revenues results from the increase in cash position in reais due to the appreciation of real compared to the previous quarter they had an impact on the exchange variation at the balance sheet accounts denominated in foreign currency, which resulted in non-cash expense of 62 million. On the other hand, hedge operations based on the zero-cost collar instrument resulted in income of 11.4 million in the period coming from derivatives market to market, of which 300,000 which cash effect.

Slide 14 we have the variation of the main working capital accounts also compared to the 1Q21: reduction of 15 days in the Accounts Receivable impacted by appreciation of exchange rate since 80% is denominated in foreign currency, an increase in inventory of 98 million with a decrease of three days when regarding cost of goods sold. Sudden stoppages of customers also had a negative impact on stock of finished goods, there's a reduction of six days on Accounts Payable also due to appreciation of exchange rate, and at the end of June 49% of payments were made in strong currency.

On the next slide 15, we made investments of 47 million, an increase of 48% when compared to the first quarter 21, accounting for 2.9% of revenues of the second quarter 21. Considering the last 12 months, Capex accounted for 5% of revenues in the period, investments are related to new programs and machining projects and addition to initiatives related to safety and environment.

Slide 16 shows the operating cash flow of Tupy. Cash generation amounted to 44 million coming from the improved working capital indicators and tax refund in Brazil of 15 million.

Next slide, number 17, we show the net debt of R$772 million corresponding to 0.9 times the adjusted EBITDA in the last 12 months. Total liabilities in foreign currency accounts for 93%, which is the largest portion related to bond with the single amortization of February 2031 and interest of 4.5% per year paid on every semester. With regards to cash, 42% was denominated in local currency. We closed the first quarter, or rather the first half of 2021, with a comfortable cash position of R$1.3 billion.

Now I had the floor over to Fernando to talk about markets.

Fernando Rizzo: Thank you, Thiago. On slide 19, we see those opportunities resulting from increase in demand, as I called in the beginning of the call, were captured by the company that's more efficient and prepared for growth and also by the combination of assets of Teksid, which will be integrated in October, both plants of Brazil and Portugal. The acquisition is aligned with the long-term strategy of Tupy, we're talking about the opportunities that require technological solutions and which the knowledge of complex and metallurgies and materials is a differentiation, therefore, we have increased investments in Research and Development and Innovation creating two areas: Tupy Tech concentrated on disruptive R&D projects to broaden the frontiers of our current business while profiting from opportunities in renewable economy in the markets we operate; and Tupy Up, which aims to convert, accelerate and escalate opportunities in new businesses and improve existing ones through innovation and digital transformation.

And in this process during the second quarter we present some of the initiatives resulting from such movement: the partnership with University of São Paulo to develop research in recycling of lithium ion batteries, a project that meets emerging needs of our customers and that includes 15 researchers with an investment of R$4 million; also, we announced the high-performance hydrogen engine project in partnership with AVL and Westport from Canada, AVL from Austria. This is an initiative that we are fostering to develop materials, geometries and machining techniques that enable our clients to explore the full and efficient use of hydrogen potential. Likewise, we’re working on projects with other alternative fuels supporting the strategy of decarbonization of our customers. We also launched our startup accelerator ShiftT, and in its first call we had enrollment of 108 intrapreneurs from the whole country.

On slide 20, I'll show some indicators about our main markets, the markets we operate in. The resumption of the economic activity allied with the full package to encourage consumption causes projections of US GDP for 2021 to be increasing. Currently, the expected is a growth of 7%. This phenomenon has an impact with a wide need for transportation equipment in all modes, residential construction, mining infrastructure, and Agri business. In addition, there are programs aimed exclusively at infrastructure, which can leverage even more our demand.

Pandemics changed the consumption habits of people; consumers have prioritized buying durable goods with an impact on our chains. The growth in consumption and interruption of supply chains have maintained levels of inventory at a very low historical level, which will sustain activities of manufacturing in coming years.

On slide 22, we see the reflex of the increase in economic demand by medium commercial vehicles in the United States, which led to an increase of the backlog.

Slide 23 shows indicators of heavy trucks of class 8, we also see the backlog in this area. Slide 24 a record of this demand looking at the Agri business segment, which has very solid growth in sales and projections of growth of two digits in the main markets caused by favorable prices and commodities and high production volume.

Now I thank you all for your attention and we will open for the Q&A session. Thank you.

Question-and-Answer Session

Operator: Ladies and gentlemen, we will now start the Q&A session. In order to ask a question, please press star 1. To remove your question from the list, press star 2. This conference is only for investors and investment professionals.

Our first question comes from Catherine Kiselar, from Banco do Brasil.

Catherine Kiselar: Good morning, Thiago, Fernando, and everyone. Thank you for the call. My only question is about the working capital accounts, if you could give us an overview of this effect on customers I would thank.

Thiago Struminski: I'm sorry, your connection is very poor. Could you repeat your question?

Catherine Kiselar: Of course! Is it better now? OK, I'll repeat it. My question is about the effects on the working capital account of Tupy. Could you give us an expectation about the second half of the year both operations of Tupy from the point of view of customers as well?

Thiago Struminski: Oh, OK, thank you. Well, in terms of working capital account, we have to look line by line. Accounts Receivable has had a reduction, a significant reduction in many days, which resulted partially from capital or currency appreciation which has a strong impact on foreign currency denominated accounts, so 80% of receivables, and we try to improve our flow. The inventory has increased in monetary terms because we ended up producing a lot more, but it has decreased in number of days. The negative impacts came from sudden stoppages in customers, which have an impact on our inventory of finished goods, and we also have to look of inventory in foreign currency, which is around 60% of our total. In Accounts Payable, we had an increase, of course, because of inputs, and on the other hand, there was the appreciation of real against the dollar, which accounts for 50% of these accounts.

So, as we advance in the cash cycle as a whole, the cash cycle has improved considerably, especially when compared to the first quarter, we went from 73 days to 61 days, but now we start looking at these accounts in a more strategic way because, as Fernando said during the call, we have a very high expectation of growth in volume, especially in the inventory side, we have to be prepared to absorb that demand.

Catherine Kiselar: Excellent, thank you. My second question is about investment. We saw the levels of investment made in the second quarter, what could we expect for the next half of the year and what would be the target of such investments?

Thiago Struminski: Well, when we look at the investments line, we have to be cautious not to look on a quarterly basis because that doesn't represent the strategy of the entire operation. Of course, when we compared to the first quarter, there is an acceleration because you can't even compare to the first quarter, but of course, the major investment of the company today is to absorb Teksid and it starts to mature in the beginning of the first quarter and there is a regeneration of sand and machining with good gains of economic efficiency, they tend to be the priority.

So, now we are going to maintain a better level, 3% of revenue below depreciation, but we tend to increase the level of such investments to accelerate the growth we'll capture in the future, but we're just coming out of the pandemic, so we are being careful in the use of capital, but the trend is to accelerate the level of investments, especially strategic investments.

Catherine Kiselar: OK, excellent, thank you. Now talking about Teksid, is the closing expected for next quarter or did you have any more information? Could you give any follow-up on that?

Thiago Struminski: Well, the process now, given that we have the approval by antitrust authorities, it involves the separation, the physical separation and company separation of some assets because Teksid has some aluminum assets and the acquisition comprises assets in Brazil and Portugal, the other plants that in the beginning were in the perimeters have to be separated now. So, this is the process, it tends to be finished in the beginning of the fourth quarter, that's when we can actually finish the deal, complete the deal.

Catherine Kiselar: OK, thank you and have all a good day.

Thiago Struminski: Thank you.

Operator: Our next question comes from Marcelo Motta, from JP Morgan.

Marcelo Motta: Good morning everyone. I have two questions. first, could you comment a bit on the volume of semiconductors and stoppages in customers, of course that ends up changing the time of demand because of the lack of programming in production that you end up having. Do you have any forecast for the third quarter? This morning other companies announced stoppages in production, so I would like to understand this issue of semiconductors and how could you improve the efficiency in a scenario that seems so unpredictable, so difficult to predict.

Fernando Rizzo: Thank you for your question, Marcelo. I would like to go back in time a bit because we have prepared the company, hired people, reconnected equipment, made investments for that, added more energy capacity, and then we faced this situation. When we compare economic indicator in countries we deal with, for example, the United States, Brazil, and Europe and you will look at our physical volumes, you'll see that the volumes in Brazil in the last three years are similar and the volume of the external market has really been affected negatively because we had the orders placed and then we started observing sudden stoppages, and at the same time, we saw all the effects of raw material prices and even availability of materials.

So, these are very important effects because they end up contaminating the plant and generate inefficiencies in the process. Now what we see is that we have been severely affected in the second quarter still, 2,000 tons, but we don't have control over this amount because there are clients that decided to stop their operations fully and that occurred with a certain frequency and were we were told like three or four weeks ahead, which is very little for our process, so we could say they were sudden. And there are other customers that reduced their production rate and not only in semiconductors and that affects our sales.

So, this effect may have been even greater than that. We had signs of improvement and the signs we received is that the system would be in an upward trend, especially because the industry we serve is very well-prepared, they have troubleshooting teams to solve suppliers' problems and help them, and many actions were taken. I believe they advanced a lot, but now there's a new cloud over the system, which is the advancement of delta variant, especially in some countries of Asia that are important suppliers of such components, Malaysia, Vietnam, and China mainly.

So, we're not confident of what comes ahead, we will face some turbulence still. In the short-term, we don't foresee very serious effects, but throughout the quarter there may be other outages. We don't buy this type of components, we don't relate to these suppliers, so we cannot tell you in detail. It does not affect directly our operations, but it affects the assembly programs of our customers, so there are companies in Brazil stopping their operation, such as Volkswagen and some other companies, so we see a turbulent scenario, we are getting organized for that and we are unpleased with the margin of course because it's much lower than our standards, than what we prepared the company for, we lost because we prepared the company to produce more and we didn't sell that much, and we also face this difficulty with the mismatch of materials.

I will talk about the measures and plans we are taking. Our point of view is that we will still have some volatility in this quarter, and we had the announcement by GM of their plans in the US plants it does not affect us so much because GM (General Motors) is a relatively small customer for us, Ford has faced problems like pick-up other manufacturers, Chrysler as well, so we are trying to manage the situation the best way possible and preparing the company for that condition, but this demand it does not disappear, it's important to bear that in mind, it's only postponed, what matters to us is the use in the end.

So, if the truck you'll see that the indicators of inventory of pick-up trucks, construction, and agricultural machinery, if it's not available, they remain using an older equipment in an inefficient way because the maintenance cost is too high, so the industry manages the situation that way, but as the product becomes available, you only have the current fleet becoming old and this demand will be fulfilled as the industry resumes its activities, and it will resume because investments are being made and the industry is getting organized for that.

Marcelo Motta: Perfect, thank you very much, Fernando.

Fernando Rizzo: You're welcome, Marcelo.

Operator: Our next question comes from Victor, from Bradesco BBI.

Victor Mizusaki: I have two questions. The first one, you mentioned the EBITDA in the second quarter was impacted by the stoppages in assemblers and also pressure from costs. You mentioned a margin of around 11%, does it make sense to consider that now in the third quarter Tupy is running in line or even above the

11% in EBITDA margin? How do you look at this margin, when do you plan to go back to the levels of the second quarter last year?

And interest on equity, you announced the payment for the next quarters, but I'm looking at the balance sheet since the cash disbursement of Teksid will be lower than expected and now we have the discussion of the tax reform, does it make sense to expect an increase in payout of Tupy for 2021?

Fernando Rizzo: Good morning, Victor, thank you for the question. I'll start with the question on the margin, how we envisage it.

First, we're talking about three essential effects that affected our margin: first, the variation in custom materials and the mismatch; second, the lower sales due to effects of other components in the industry that there was a shortage of; third, the quality of raw materials that caused inefficiency in the plants. So, the first factor, of course, we continue to see inflation, market indicators are still going up, this morning US indicators seemed to have stabilized a bit, but it's still a… looking back in the last two or three weeks, iron ore and there may be a stabilization, but of course, we don't have any control over that, and because we don't have any control, we understand that the contract format of Tupy have not been efficient to face this and we started negotiations with our clients to transfer such costs in a faster way including to recover that variation, because this is the idea that customers demand exist, this is happening with every other material, everybody trying to transfer that.

We were successful in many of these conversations, customers are sensitive to that, they understand what's going on, and obviously we are discussing and negotiating as we always do, we built our business model around that, and the curves have been so steep in variations occurred in the last quarters that the system got unadjusted. But of course, we are trying to solve that, and these are actions we must take, we have variations in resins, materials that are made from oil, chromium, iron, silicon iron, and scrap, pig iron. So, we hope we don't have to see this mismatch in the third quarter.

As for the contamination of the plant, we took other internal measures of control, such as preparing metal and materials when we see decrease in this impact, but the market and these prices encourage us to receive raw materials that are contaminated, it's very complex in this industry with such a fragmented supplier base, because we are recyclers, we suffer consequences in that process.

And in semiconductors industry, we're trying to understand it better and having a consistent program from customers and try to adjust our costs accordingly. We're not replacing labor, we're trying to manage and reduce cost structure that was created to meet this higher demand that continues to be necessary for customers, but we are managing it more carefully now for the next quarters. So, we do expect to recover most of these costs, and this is the spirit of our industry and our long-term relationship with customers.

Thiago Struminski: Just to complement on the second question, we generated a lot of cash in the last quarters and we finished below an optimum level, 0.93% of leverage this quarter, and most of our debt is due in 2031 at a good cost level, so we always worry about having an efficient capital allocation, we announced payment interest on equity at high levels and now the next step is to use Teksid and synergies, and if there is no other major investment or strategic project, we have space, we have room in the balance sheet to be more aggressive in terms of dividend payout. If there is any big project ahead, we can discuss that, but right now, there is room for that and interest on equity is a sign of that.

Fernando Rizzo: As for Thiago and Catherine's question on integration of Teksid, given the format of this transaction with the previous approval of antitrust authorities, we have room to work this integration better having access to more information before the closing, and we have an integration team that's dedicated to that working to capture these benefits before the closing date.

Victor Mizusaki: OK, thank you.

Operator: Our next question comes from Werner Roger, from Trigono Capital.

Werger Roger: Good morning, congratulations, Fernando, and Thiago, for the good result. Given the circumstances, it's such challenging times we are in, semiconductors, pandemic, scrap prices, so it's been very positive overall.

Looking at ANFAVEA data on vehicle production, heavy duty vehicles are 15,000 per unit, it's a very high amount since 2013, it is the highest amount, that's Brazil's figures. With regards to that, could you give us some idea of the occupation of the plant in Brazil given this strong movement of truck production? We don't know about off-road machines, but what about the occupation level of Joinville plant in Brazil and Betim?

And the second question is about scrap. As Thiago said, we saw a decrease of more than 20% in iron ore and pig iron is very closely related to that, and I believe scrap is also. Do you know how scrap correlates to the prices of pig iron in Brazil? And even if this process faces some quality, is there an indication of higher demand for scrap because the market would use more pig iron?

Fernando Rizzo: Well, as for heavy duty vehicles and our capacity, we operate with flexibility among plants, so we always maintain our plans more efficient, fully operational, we are making this movement, and this is part of the situation we managed in the first half of the year and moving products. The answer is: yes, we are prepared to deal with the higher demand from domestic customers because Brazilian customers are exporting a lot, not only due to domestic payment, but also because they are exporting, and almost all our customers that manufacture truck engines produce for the domestic market and have an additional capacity to export, and they're all operating well right now and have plans to grow in the future.

This is an important point; the agricultural and construction customers all see growth for Brazil in the future and are planning on having additional capacity. We have that capacity because we have space in Mexico and Teksid, Teksid combined with Tupy increases the domestic market share Brazil of Tupy of 40%, by 40%, and Teksid has room to grow and, of course, it faces challenges in gains of efficiency that our team is involved and working to solve, but, yes, there is room for growth and we are prepared to absorb the demand in Brazil because this is part of our agreement with customers.

The outlook for Brazil is good and our plans are in that direction as well, we agree with you.

In terms of scrap, we see some volatility in the market in last weeks, there is a correlation with pig iron and scrap in Brazil, but there are other effects that sometimes affect; Gerdau reconnecting plants, expanding its operations, for example, this is a typical excuse for the scrap market in Brazil. But also, in Brazil there is exports and imports of scrap, as I mentioned previously, in the United States we saw some indicators showing at drop in these last two or three weeks, maybe we are already seeing an effect of a certain slowdown that could help us reduce this price, and this is good because the demand will remain, it won't disappear, this is important to make clear because there is a very high pent up demand.

We have a chart of inventory in the first slides of the presentation, the inventory of scrap in the United States and the backlog in the truck industry is also a result of a very low level of inventory because the assemblers have their production fully sold probably up until the first half of next year. So, within this scenario, it's important to see that this low decrease in prices will help us, they are related, they are complementary and for many people the exchange between scrap and pig iron is good for a balance point, a breakeven point.

Werger Roger: OK.

Operator: Excuse me, should you have any questions, please, press star 1. Thank you.

Please, wait while we collect the questions.

Excuse me, this ends the Q&A session of Tupy. I would now like to turn the floor over to Fernando for his final remarks.

Fernando Rizzo: Hello, Priscilla, thank you.

Well, thank you all for your participation, for your questions and your trust in the company.

First, I would like to say again that we are not pleased with the margins of this quarter and not with the instability of margins we've had in the company, our business model is targeting to reduce such variations, but we are going through a very atypical moment and we have no other choice but to transfer these increases in costs, and we're working with different suppliers and importing inputs, our contracts have always worked well, but they are not being efficient enough right now, this is why you are revising them.

Despite the costs of raw materials, the impact of shortage of semiconductors in the change of our suppliers, we envisage a very strong demand ahead in all the markets we operate. The company is being prepared for that strengthening its operational efficiency, procurement, increasing capacity in production and value generation, we’re also have expanding with new projects, and we continue to progress in the production chain. We're going to take over to Teksid in October, at the moment that seems quite convenient because we believe that these international challenges will have been behind us and we will have overcome them and we will be prepared for the situation, and the demand will remain high. So, this is a very time to have good to have extra capacity because we envisage very strong demand in future years.

We will remain with our strong financial discipline, which is shown by our low debt and reduced leverage ratio, solid cash position, and efficient cash allocation, which allowed us to announce a payment of interest and equity for the next three quarters.

We are investing in many projects, startup accelerator, Tupy Tech, Tupy Up, studying new materials, operating with hydrogen engines, we are involved in the decarbonization agenda, but this is not distracting the management of the company; our focus is to manage margin, this mismatch between prices and costs, and anticipate the synergies of Teksid. So, this is what we're focused on, the whole team is far focused on that, and once again I thank you all for your support and trust to continue to grow in the next quarters.

Thank you all very much and have a good day.

Operator: The conference call of Tupy has now ended. We thank you all for participating and have a good day.