International Conference Call
TUPY S/A (TUPY3)
2Q22 Earnings Results
August 5th, 2022

Operator: Good morning. Thank you for waiting. Welcome to the conference call for financial results for Q2 22 for Tupy.

All the participants will be in the listen-mode only and later on we will have a Q&A session, when further instructions will be given. If you need any help from an operator during the conference call, please dial *0. This conference call is being recorded.

The company would like to remind you that this event is also being transmitted simultaneously via internet, via webcast. You can access at the address: www.tupy.com.br/ri, where you will find the slide presentation. The selection of the slides will be controlled by the participants.

Tupy clarifies that any declarations made during this conference call concerning forward-looking projections, operational goals, financial goals concerning the company's business are forecast based on the expectations of the company's management in relation to the future of the company. They depend on the conditions of the domestic and international markets, general economic performance of the country, and the sector, therefore, subject to change.

We have today Mr. Fernando Cestari de Rizzo, CEO, and Thiago Struminski, CFO.

Mr. Fernando, you may proceed.

Fernando Rizzo: Thank you and good morning. I thank you all for your presence in our conference call.

I'd like to begin with a summary of the quarter with strong results. We increased the efficiency of our operations, we captured synergies and not only in Betim and Aveiro, but in the other plants too. And even with an adverse scenario, we increased margins and increased the return on capital invested.

Net revenue reached 2.5 billion, the highest in the quarter, the growth shows the strength of our business model and the capacity to pass on costs to customers. The physical sales volume reached 176,000 tons, adding the production from Betim and Aveiro. Although it's an important number, this performance is below the potential due to lower demand in the market due to lack of components, which did not allow our clients to produce sufficient amounts. The adjusted EBITDA reached 345 million with a margin of 13.7%, an expressive result in relation to Q1 22 and Q2 21. And even with inflation, high freights and unfavorable exchange rate and sudden stops from clients, we had this, and this is due to our initiatives in efficiency and the reduction of costs. Net profit reached 180 million versus 31 million in the previous year, especially due to the operational result that is better and financial too.

On slide number five we show that our discipline in allocating capital in an adequate way and the choice of projects for optimization of flexibilization in production process contributed for the increase in return on capital invested, which reached 14%, it's an important result since it includes new operations that still haven't reached their full potential.

We'd like to remind you that the ROIC of Q2 22 includes totally the asset base of Betim and Aveiro, but only nine months of operational result in NOPAT. The increase in return on capital is an important commitment of the company, we will continue adopting strategy to allocate capital in a selective way, but above all, in Q2 we will focus on the reduction of working capital and conversion to cash, which had an impact due to the increase in the price of materials and also sudden stops at clients, which due to our process we were not able to adjust production simultaneously.

Now to talk about the main indicators in the quarter, I invite Thiago Struminski, our CFO.

Thiago Struminski: Thank you, Fernando. Even with the restrictions in the production chains mentioned by Fernando, the volumes had a growth of 37% due especially to the increase of the volume in the new operations. In the comparison with the previous quarter, the growth was 3%. The mix of the volume, transportation, infrastructure, agriculture was 18% total or partially machined, 19% CGI. The comparison basis is also affected by the addition of the new operations because their contracts do not contemplate these products and services.

On slide eight, the revenues had an increase of 7% in comparison with Q1 22 and 54% versus Q2 21. We also noticed an increase of 13% in revenue per kilogram when compared to the same period in the previous year even with an unfavorable average exchange rate. In relation to the distribution of revenue per geography, 52% USMCA, 27% South America, Central America, especially Brazil, 17% Europe, and remaining 4% Asia, Africa, Oceania. In terms of application, 85% commercial vehicles and off road, 11% passenger vehicles, 4% hydraulic products.

On slide nine, we observe the good performance of the domestic market in comparison with the same period in the previous year and with an increase of 98% in revenue considering all applications, this due to the better performance of applications in commercial vehicles, off road, and especially agrobusiness, apart from indirect exports. The impact of the stops at clients due to lack of semiconductors for light vehicles was compensated by the greater participation of the operation of Betim in this segment.

On slide ten we show the effects of the revenue in the export market, which went up 45% considering all applications, strong growth in applications for medium commercial vehicles, heavy vehicles, and off road due to the good performance of the markets due to global recovery, and investments in sectors like infrastructure and agrobusiness, apart from a ramp-up and a product mix with more added value.

In spite of the increase in production, passenger cars and light vehicles continued to be affected by restrictions in the production chains. This was mitigated by the participation of new operations.

On the next slide we see the performance in hydraulics, 4% of our revenue, the growth of revenue 22 and 6%, in the domestic and export market show a gradual recovery of prices.

Slide 12, the cost of product sold increased 43% in the annual comparison impacted by the inflation in input, especially scrap, metal, and coke, apart from the beginning of operations in Betim and Aveiro. In spite of these factors, we reached a gross margin of 20%, a gain of 600 basis points in relation to Q2 21, increase of 46% in the cost of raw materials, 48% in maintenance and third-party materials due to the new operations and the increase in price, 44% higher prices in labor, especially due to the current number of employees in overtime and increase in wages. Operational expenses excluding freight had an increase of 38% in Q2 21, this result is due to the increase in volume and also wage increases. Freight went up 88% apart from the volumes, we had a very high price in freight in all the models.

Slide 13, adjusted EBITDA reached 345 million with a margin of 14%, higher than Q2 21 and Q1 22 in spite of the environment with inflation and unfavorable exchange rate. At the bottom of the slide, we see an expressive amount in net profits, 180 million, with a net margin of 7%. The growth of EBITDA and margin shows the strong operational results in the series of initiatives in management in the last quarters including synergies that have had a positive effect on all plants.

Net profit was impacted by the better financial results, especially due to the positive effect of exchange variation versus previous quarter apart from the reduction in intangible asset depreciation and due to the contracts in Mexico in 2012.

On slide 14, financial result of the period. Increase of financial expenses, especially due to higher gross debt due to the acquisition of the operations of Betim and Aveiro, financial revenues reached 14 million, the comparison was affected by credits to be received from Eletrobras in the previous year. The result of exchange rate variation was a revenue 36 million, especially due to the effect of the foreign currency.

On slide 15, we have the variations of the main working capital accounts, in this case using Q1 22 as a basis for comparison, an increase of 17 days in accounts receivable due to the increase in volumes and the passing on of costs and more exchange rate depreciation with an effect on accounts receivable in foreign currency, which represented 78% of the total, an increase in the inventory, 15 days increase in inventory due to the cost of products sold and the exchange rate devaluation on inventory and foreign currency and this due to stops we had an increase of 17 days in accounts payable, especially due to the increase in production, inflation, and exchange rate devaluation.

Working capital was also affected by the new ERP in the Mexican operations. Since July, we intensified a series of actions to improve the cash conversion cycle in the second semester and we are receiving some amounts due to the contracts we have with clients.

Slide 16 shows the operational cash flow, a consumption of 10 million in the period due to the variation in working capital, the cash flow in this first semester was affected by the beginning of new operations in Betim and Aveiro including the need to form inventories not included during the transaction in the first months of the year. Working capital, which has an effect on cash, was also affected by the growth of sales volume and the passing on of cost to clients, which will be monetized in accordance with contractual dates.

The inventories were impacted by stops, production stops at clients, and will be reduced in the second semester. We hope the flow will be normal in the third quarter.

Next slide, 17, we made investments of 73 million in Q2 22, an increase of 55% in the comparison with Q2 21, but still representing 2.9% of the revenue in the period. These investments are related to new programs, gains in operational efficiency, information systems, initiatives for safety and environment and in projects that are important in the plants of Betim to be executed and will bring synergies. The priority for projects with better potential of return has been a fundamental part of our strategy to increase the return on capital invested.

On the next slide, 18, we show the debt, 1.6 billion, corresponding to 1.4 times adjusted EBITDA in the last 12 months, the obligations in foreign currency represented 81% of the total related to the bond for single amortization in February 2031 with interest rates of 4.5 annual, paid every six months in relation to cash, 47% were in local currency.

In this way, we closed the second quarter of 2022 with a comfortable cash position, 838 million, but with challenges in monetization which begin to happen from now on in Q3.

Now I passed the floor to Fernando, who will make his final comments.

Fernando Rizzo: Thank you, Thiago. On slide 20, I will talk about our vision concerning the main markets.

Our clients that reported results have shown maintenance or growth in sales in the Q2. The order portfolio is robust, especially in commercial vehicles, both light, medium, and heavy, but also in agriculture and construction a robust portfolio of orders. in the US, the demand for home construction is high, but may be affected by inflation and interest rates. Non-residential construction should be stimulated by the investment package that should occur until 2023. Specifically in Brazil, at the end of the year there will be a change in the emissions of engines according to PROCONVE 8, CONAMA, equivalent to Euro 6. Different from the transition of Euro 5, we don't see expressive volumes of pre-purchase. In Europe due to high rates of usage of the trucks and consequent defeat becoming older, we see a strong demand from our clients. Now in off road in the short-term we should see a reduction in activity, but there are discussions on plans to stimulate investments in infrastructure in Europe.

Our clients were affected by interruptions in their supply chains, but the expectation is that this should decrease in Q3.

Here on slide 21, we show the company's agenda for Q2 22 and beginning of 2023 second semester and beginning of 2023. Talking about manufacturing, our operations are more efficient with better operational indicators. We observe a quantum leap in the plants in Joinville and Mexico and we trust in the operational progress in Betim and Aveiro with important projects for manufacturer and metallurgical engineering, which should appear in the results of the next quarters. Cash management is a priority.

All this progress is observed in all our units due to the location, and we see that we have this extra revenue, and we are competitive in the industry and this due to the Tupy system of production. Also, we made in Q2 an important move to optimize the structure of our fixed costs, which will include the efficiency in the next quarters. This is our effort to maintain the competitiveness of Tupy and to face the increase in interest rates or economic deceleration. We have a robust pipeline with new projects, our engineering is very dedicated to developing new components for engines, and also, structural items for capital goods with many opportunities that have been demanded by our clients.

In relation to MWM, we announced the acquisition in April, we are now planning the integration phase. The operation is under analysis by competition authorities in Brazil (CADE).

On slide 22, I'd like to give you an idea of the company we are building. Only as an exercise and not representing a guidance, if we analyze the results of Q1 and if we add the public indicators of MWM, we're talking about a company with the billing close to 12.5 billion and more than 1.5 billion in EBITDA. Based on this solid base, we are building a new Tupy; a company that is relevant in the low-carbon economy and prepared to take advantage of the opportunities with a unique positioning in the market and technical credibility capable of taking care of all the needs of services of our clients, and also, with plants located in competitive regions, and a team with great execution capacity and much more diversified, exposed to new sectors with great expectations of growth.

But to conclude, I always like to remind you that all of this is done by people, I have two thank this result to all the employees of Tupy who have worked hard to overcome the goals in a continuous way. This culture we have built is made by a fantastic group of professionals and with the experience of Tupy, the talent that we received with Betim and Aveiro and of even new talents that will join the company soon. This combination has resulted in growth with profitability, important projects of sustainability, and new avenues of opportunities that motivate us to deliver much more.

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

Question and Answer Session

Operator: Ladies and gentlemen, we'd like to begin the Q&A session. To ask a question, please dial *1. To remove your question from the list, please dial *2.

This conference call is exclusively for investors and investment professionals.

Our first question comes from Pedro Fontana, Bradesco BBI.

Pedro Fontana: Congratulations for the results. What is your expectation about the transaction the acquisition of MWM? When do you believe it will end? Thank you.

Thiago Struminski: Thank you for the question. Well, the authorities' competition analysis are analyzing the acquisition of MWM, we're talking about an evaluation only in Brazil, we believe there will be a decision close to the Q4. MWM has some opportunities in terms of growth, we're evaluating, all of this will depend on investment. Next year, yes, we can add Capex to develop the areas of energy and decarbonization.

Pedro Fontana: Thank you.

Operator: Our next question comes from Fernanda Oliveira, BTG Pactual.

Fernanda Oliveira: Thank you, congratulations for the results. I have two points, the first concerning margin. The margin was strong in this semester, could you give more details how much comes from synergies with Teksid, how much is gaining efficiency, how much is price increase? Give us more details about the margins of Teksid.

And the second question in relation to volume, could you mention the volume you lost and when do you believe volumes will normalize? Thank you.

Thiago Struminski: Well, I'd like to begin with margin, Fernando can talk about volume. This process of margin recovery involves not only performance in Betim and Aveiro, but also contribution from the other plants. We made a great effort since last year to recover the performance in Mexico, they have a good rhythm of performance, there are synergies that involve all these subsidiaries, so when we have a benefit here, it also benefits other plants. So, we continue with our plan, synergies as we had foreseen in the past, in this quarter 13.7, it's not very different from our historical performance even with the dilution due to the new operations in Aveiro and Betim, in the past they had 3 to 5% EBITDA margin.

Yes, we're on a good track, we continue with this performance, and we hope to improve in the next quarters, but it's a gradual improvement, no quantum leaps, a gradual, a continuous growth.

Fernando Rizzo: Good morning, Fernanda. Continuing, this comes from the building of a new company, this is what we have done in the last four/five years, new professionals, new talent, we hired new manufacturing systems, new engineering systems, all this design of this architecture of the company will give these results, and we're seeing progress in all the fronts, a new purchasing organization that I mentioned three years ago, all of this is working better.

Concerning volumes, it's difficult for us to evaluate. What we do is a comparison between market indicators and historical sales. When we compare with previous quarters, you can see that quarters when we did not lose market share our physical sales were lower, we made this comparison in Q1, 15,000 tons. So, we estimate numbers around this, it's difficult because you have sudden stops at clients, and also, orders that are not placed because clients are waiting to plan better.

We believe this is almost over, so we see new volumes of semiconductors coming to the market and all have said that in the second semester the impact of semiconductors will be smaller, will be lower. This is important data, clearly, we observe that the inventories at clients are low in terms of finished products, we see that freight is very busy and the fleet is getting old, so after some time, the fleet is no longer ideal and becomes inefficient and needs more maintenance. This gives us the safety to believe that there will be a robust demand in the next quarters because of this situation, older fleets, even with an economic deceleration.

Fernanda Oliveira: A follow-up in terms of margin, you mentioned that you see a more normal scenario in terms of raw materials, so what is your strategy to pass on to clients higher costs? Can you gain in margin passing on all the extra costs, new costs to clients?

Fernando Rizzo: This is a transparent process, all of this is foreseen in the contracts and here we had quarters when inflation was higher than the costs we passed on, and if it drops, we see a scenario that will be more normal. It's difficult to make forecasts concerning commodities, but these costs will be passed on to the clients.

What you should understand is that when we pass extra costs, we adjust by the variation of a ton of scrap, copper, and so forth, and this you observe that as the price of materials go up, there is a compression of the margins. There are many facts, sale of inventory, so it's difficult to foresee, but yes, we pass on the costs, but this also includes the new prices, which may drop from now on.

Fernando Rizzo: thank you, congratulations.

Operator: Our next question comes from Mr. Capistrano, Itaú BBA.

Luiz Capistrano: Fernando, Thiago, good morning, thank you, congratulations for the results. My first question you answered. Just a follow-up, it's clear that you had excellent margins in the quarter, and I believe it should improve when barriers disappear. What I want to know is a little more about the short-term, Q3. Since you closed Q2 with a higher inventory, do you see changes in the cost of raw materials? In Q3, can we see a drop in margin because of the cost of raw materials that you bought in the past and the price of raw materials today is lower and then margins go up again? So, can you talk about margins in Q3?

The second question concerning working capital, it's clear the focus in Q2. Can we expect a normalization in the short-term in Q3 or will it happen in a gradual way going back to normal next year or at the end of this year? Can you give us more details about working capital? Thank you, congratulations.

Thiago Struminski: Concerning the first point, we may feel this effect, but also there is a delay in passing on cost of materials, which is favorable for us. When we look at working capital, we have two challenges: first within accounts receivable, we had a considerable amount in sales, our revenue went up a lot, Betim and Aveiro had the need for inventory, we explained this in the past and their accounts receivable is longer, so within these units we have some temporary difficulties, this is being solved; we had another seasonal situation in this quarter, the rollout of SAP in Mexico, but as of July, we will have an operational cashflow that is positive, August too, and at the same time, this process, sudden stops at clients generated higher inventory than we need, we're dealing with this additional volume, Portugal will stop in August due to vacation in Europe, and judgments in other plants.

So, working capital will adjust itself, but it's gradual, the adjustment is gradual, we won't have leaps, but a gradual improvement because of these movements and happenings in Q2.

Luiz Capistrano: Thank you, Thiago, very clear. Thank you.

Thiago Struminski: Thank you.

Operator: Our next question comes from André Mazini, Citibank.

André Mazini: Thank you. In Europe and in the US the risks there is a lack of natural gas, especially in Germany, in Europe, affecting the production of cars, you are in Portugal, probably better in energy. Do you believe that you can have a slowdown in Germany due to lack of natural gas? And then the US due to import tariffs from Mexico to the US after the energy reform in Mexico? So, most of your production is in Mexico exported to the US, so if these risks are confirmed, so if production in some continents becomes difficult, how do you see these geopolitical risks?

Fernando Rizzo: André, first of all, our product is not simple to move, it's very complex to move our products between regions, suppliers, and so forth. So, in reality, what we're seeing is that what can happen we may have more volume to Europe, we may export more because there are restrictions in Europe, higher costs, rationing of natural gas, so maybe some products, for some products we may see more demand to export to Europe.

We're well-positioned due to the location of our plants, availability of materials, energy, and qualified labor. These are important elements when we look at the long-term in our industry. So, in this aspect were OK. Concerning US and Mexico, our contracts have provisions for this that protect us and we're part of a production chain that they cannot interrupt, so we don't anticipate any problems for our operation, for our deliveries to clients if we have unfavorable situations there.

Looking at the long-term, we're very well-positioned, when clients look at risk management, it's safer to have a product in Mexico and South America for the US. So, geopolitically in the next few years, we see this and that's why we're positioned to supply to Europe, we supply a lot to Europe already, but we can supply from Mexico too and because the US due to USMCA they import from other regions 70% of their demand for our products. We understand that as the rules advanced in USMCA we will tend to capture higher volumes to really produce more in Mexico. Our clients will need this, and Mexico is very competitive for these new demands.

Historically, the US always imported these components from other regions, Mexico, which word presents 30-35% of demand. So, that's how we see it, but this is not in the short-term. it's long-term including development and so forth.

André Mazini: Thank you.

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

Marcelo Motta: Good morning, thank you for the questions. Two quick questions. How do you see other items in expenses? Raw material, for example. Steel is automatic the passing on of energy, but there are costs of energy in the world. Are you concerned with the price of energy? And how could this affect margin and also sales expenses?

When you look at revenue, there was a leap in this quarter, could freight have a higher impact? Do you believe you will continue at 6-6,5?

Thiago Struminski: Thank you for the question, Motta. When we look at operational expenses, we made good progress, we felt the effect of freight, it went up almost 200% in comparison with last year, we also have wage increases, cost of third party also increased, but the main effect is freight. We have to be careful, most of this effect is passed on to clients.

Marcelo Motta: Thank you.

Operator: Our next question comes from webcast:

"How is the company evaluating the synergies with recent acquisitions? Are sales adding more value to clients? And even with the acquisitions, we see a low debt. Can we expect greater distribution of dividends?"

Fernando Rizzo: Well, Lucas, let me begin answering. First, on the synergies, when we have direct competitors, it's difficult to evaluate all the synergies. As we get to the closing of the transaction, October 2021 and since then, we're learning a lot about opportunities, synergies, some synergies are fast, for example, purchasing, the purchase of the same raw materials and so forth you can have better contracts, but we have operational synergies of manufacturing, engineering that I mentioned, they depend on engineering projects, adapting machines, work methods that have to be reorganized, and we learned a lot with these companies we acquire and we share good practices that we have and this is the great progress we expect in the next quarters.

These are not immediate synergies, we are redesigning the allocation of products among plants, we will concentrate products with similar characteristics in each plant to become more competitive and more efficient. We haven't been able to do all of this, it depends on projects, tooling, and adaptations in machines. But in general, we believe we are obtaining synergies in an anticipated way. In terms of debt, we have an adjusted net debt of 1.4, in fact, very comfortable, especially when we look at the distribution of this debt, but this number doesn't contemplate the integration of the assets of MWM, which will make this number higher than 2 times and the growth opportunities we have to evaluate.

So, in terms of dividends, we will hold them back a little to understand the priorities, also, we are planning to grow the operation of MWM, so for creation of value to the client, the acquisition of MWM is good, Tupy is now preparing itself for greater variety of products and services at a time when our clients are busy with other technologies, allocating capital in many fronts, their business is changing, our clients' business is changing, and we're positioned to really have activities that used to be done at OEMs, and we believe they will outsource more activities, a strong outsourcing from now on, and companies have to be ready for this, especially engineering and technical.

With MWM we have physical capacity available, but above all, technical capacity that supplements our technical capacity and allows us to have more services for our clients on a global basis. Thank you.

Operator: The next question comes from Guilherme Nunes:

"Good afternoon. What is the difference between machined products and non-machined products and modular CGI? How are the gains with synergies with Teksid? Do you believe you will develop more synergies than initially expected?"

Thiago Struminski: Well, we cannot give you the prices, but we can tell you that it's better for us when we have more machining, so another step inside our plants. On average, we have 300-400 basis points when we cast and machine the products, same way CGI is a metallurgical technology that few players have, few competitors have CGI, so this gives us a better position to negotiate with clients. Teksid in both aspects, machining, and CGI, is behind us, there are many opportunities to grow at Teksid and with MWM, they have a very advanced specialty in machining that can help us to make even more progress at our clients, also in other phases.

So, in general, it's a robust supplement in terms of portfolio that helps us a lot, machining, and CGI.

Operator: Next question César Garcia, individual investor:

“Please, talk more about the current scenario concerning the price of scrap iron.”

Thiago Struminski: Well, we began to have a period of stabilization after many months and quarters, we begin to see a drop in the cost of material in all the regions, especially scrap. In spite of lower prices, we see lack of availability of some materials in Brazil and Mexico, in Europe we see increases in electricity and natural gas, but in general, this geopolitical instability in Europe makes us concerned, especially the prices of energy and gas, but this has improved a little.

Operator: The next question comes from Eric Cionek, shareholder:

“I'd like to know if there is a drop in the price of materials of Tupy, would you have better margins, but a drop in EBITDA? So, how much of the increase in EBITDA is due to inflation?”

Thiago Struminski: The way our contracts are structured, every time there's an inflationary impact, we pass on the new costs, so the margin is diluted, we increase absolute EBITDA, and we margin drops. Then, we have the opposite effect, margin goes up, and absolute EBITDA drops a little due to the absolute price of raw materials dropping. We should see this in the next quarters.

Operator: The next question comes from César Garcia, individual investor:

“Do you see opportunities to increase machined products and CGI products? Do you believe you will increase the volumes of machining and CGI?”

Fernando Rizzo: Yes, we have a project called Ultralight Iron, this project can bring us back to applications in passenger vehicles and hybrid vehicles. This was built with thinner walls so we can be lighter than aluminum with a lower carbon footprint and lower cost for the client. This has called the attention of our clients, we're working hard in engineering with clients, in commercial vehicles it's a growing trend due the demand for lower emissions, better materials, more resistant materials, as you improve combustion, you need to use better materials, but this application for passenger cars is interesting and it can create a new opportunity of growth for Tupy. We believe a lot in this new project; it has a great potential.

Operator: We'd like to close the Q&A session for Tupy. I'd like to pass the floor to Mr. Fernando for his final comments.

Fernando Rizzo: Well, thank you for your presence, for participating. I'd like to thank the trust of our shareholders and our council, they participated actively in building this new company, apart from the companies. These solid partnerships that we built with clients, suppliers, universities, startups, they have generated consistent results, and this traditional dedication of Tupy to research positions us on new technological roots, like recycling of batteries, hydrogen engines, hybrid engines, and new business due to the new economy. All these projects continue making progress and they are demands from society looking for feasible alternatives for decarbonization, growth, and sustainable growth.

You know our historical margins of Betim and Aveiro, but we have reached a combined margin around 13% and there are many opportunities still. So, the margin recovery is better than our plan, but we're still working to stabilize these operations because soon with MWM after the evaluation from the authorities we will have new avenues to explore in energy decarbonization, aftermarket parts, machining, and assembly.

So, we continue to see a robust future, especially due to the need to substitute capital goods that are getting old and have operated with higher costs, and also, the lower production of our clients in the last quarters. So, please notice the reports from our main clients because this will give us some idea of the future demand for us, and they seem to be very robust and favorable.

Thank you and we wish you a good day.

Operator: The conference call of Tupy is concluded. Thank you for participating and we wish you a good day.