International Conference Call
TUPY S/A (TUPY3)
3Q21 Earnings Results
November 12th, 2021

Operator: Good morning, thank you for waiting. Be welcome to the earnings release conference call for the third quarter of 2021 of Tupy.

All participants are connected as the listen-only mode and later on a Q&A session will be open when further instructions will be given. Should it be necessary to have the help of an operator during this conference, please press star zero. This conference call is being recorded.

The company would like to remind you that this event is also being webcast simultaneously through the Internet and could be accessed at the address www.tupy.com.br/RI where the corresponding presentation is available. The selection of the slides will be controlled by the participants.

Tupy would like to clarify that any statements made during this call about the operating and financing projects or prospects regarding the business of the company are based on the expectations of management regarding the future of the company. such expectations are highly dependent on market conditions, both domestic and international, the generally economic performance of the country and the industry and therefore are subject.

Here with us we have Fernando Cestari de Rizzo, CEO, and Thiago Struminski, CFO.

Fernando de Rizzo: Good morning, thank you. We thank you all for attending our conference.

We had record figures in revenues, return to margins to historical levels, and increase in return on invested capital, and we will detail these actions that will be during the presentation.

Although the demand in the end is very robust, our clients continued to be affected by the lack of semiconductors and other input, which led to the temporary stoppages or reduction in their operations. On the other hand, this mismatch between supply and demand affects inventory levels, which in many cases are already at critical levels, therefore, it's important to highlight that sales that are not being made now are actually being postponed. If we consider only the volume necessary to recover such inventory, we see a strong demand for Tupy in coming years.

Given the prospect of growth that hasn't yet materialized fully, we prepared the company to absorb such demand by hiring staff, reconnecting equipment, and within our flexibilization strategy moving products from Brazil to Mexico. With that, we had a lower dilution of fixed cost and some inefficiencies in the production process. We have implemented several actions to decrease such impacts always aiming at the best use of assets and return on capital.

With regard to the pandemic, in addition to the issues related to price and availability of freight and materials, we continue to be affected by absenteeism. We keep on doing our share to fight COVID-19 including the screening and testing center of Tupy was converted into a vaccination center that serves our employees and the entire community and has performed more than 120,000 procedures, including screening, testing, and vaccination.

On slide 4, we'll talk about the operating performance and the strength of our business model. As I said, before, our sales have been affected by disruptions in global chains that affected also prices and availability of freight and several materials. Despite such effects, we observed a significant growth in the Ebitda, and compared to 2019, before the pandemic, we had an increase of 23% while volumes dropped 15%, this resulted from a rigid cost control and several efficiency gains in production and procurement process, in addition to using our defense rings.

Lately, we also developed a flexible manufacturing process that allows us to adjust production to the changes in volumes, concentrating production in the most efficient lines. This is an important pillar of our strategy that will be even more significant in the future in the combination with Teksid. We continue to look at high prices of materials and we are transferring monthly these variations with effect in this third quarter already. Our engineering is developing new processes that have contributed to mitigate such effects.

On slide 5, I reinforce that we continue to observe a recovery path based on efficient capital allocation that has contributed to increase the return on invested capital. Leverage remains at healthy levels and our debt is basically formed of bonds to mature in 2031. With this solid financial position, we will pay interest on equity in the amount of 20.5 million still in November.

Now I turn the floor over to Thiago to talk about the main indicators of the quarter.

Thiago Struminski: Thank you, Fernando, good morning, everyone. Despite the assembly difficulties faced by many of our clients due to the lack of semiconductors and other input, volumes continue to recover gradually as in the last 12 months with an increase of 21% when compared to third quarter 20. The mix of volume of transport, infrastructure, and agriculture was 26%, partially or fully machined was 23% were produced in CGI against 27% in the third quarter 20. The share decrease in regard to previous quarters is due to interruptions in production with applications with greater share in CGI resulting from temporary shutdowns of our clients.

Slide 7, revenues have increased by 47% when compared to third quarter 20, the revenues for kilo grew 21% and per geography 59 came from NAFTA, 24 Central and South America, especially Brazil, 12% Europe and the 5 remain percent Asia, Africa, and Oceania. In terms of application, 89% commercial off-road vehicles, 6% passenger cars, 5% hydraulic segments.

Slide 8 we see domestic market, the good performance of applications in commercial vehicles, machines and off-road in addition to indirect exports.

Slide 9 shows the effects on revenues of international markets. In applications for light commercial vehicles, we see a drop in revenues coming from temporary stoppages at customers resulting from the shortage of semiconductors and other inputs. In application for passenger cars, medium and heavy commercial vehicles, and off-road vehicles, we see an increase in revenues due to the good performance of the market caused by global recovery and resumption of investments in industries such as infrastructure and agriculture.

Next slide we see sales performance in the hydraulic segment, which accounted for 5% of revenues. The growth of revenue of 41% and 104% in the domestic and international markets respectively reflects the gradual improvement of industrial activity in addition to price restructuring.

Slide 11, costs of goods sold and operating expenses increased by 54% year on year leading to a gross margin of 18.8% and 75% increase in costs of raw material and 50% in maintenance and third party materials line resulting from inflation of materials observed in the period and increase of volume produced, a growth of 43% in labor account, especially staff increase, overtime, and negotiation of base date, increase of 15% in maintenance and services from third parties regarding the impact of inflation. Operating expenses increased 23% due to growth in sales and greater usage of freights and commission on sales.

Slide 12, adjusted Ebitda reached 289 million increasing 12% in comparison with the same quarter last year and a margin of 15.8%. Adjusted Ebitda and CVM Ebitda showed the highest volumes of the company. In the lower part of the slide, we see a net income of 125 million with a net margin of 7%.

Next slide, financial results of the period. The drop in financial expenses results from the appreciation of real against the dollar in the period with an effect on interest paid on loans in US dollars as well as reduction of the cost of debt and issue of senior notes to mature in 2031. Increase in financial revenues is resulting from increase of interest rates from financial investments in Brazilian reals, and the result with exchange variance was a revenue of 26 million.

On slide 14 we see the variation of the main working capital accounts as comparing to the second quarter 21, increase of 8 days in the line of accounts receivable impacted by the exchange depreciation since 82% is denominated in foreign currency, an increase in inventories at value of 153 million in addition to the exchange variance, certain stoppage of customers resulting from lack of semiconductors also had a negative impact on finished goods, and the reduction on accounts payable of 9 days, especially due to specific actions taken with supplies in this period.

On slide 15 we made investments of 62 million, an increase of 94% when compared to the third quarter, 23.4% of revenues of the third quote quarter of 21. Considering the last 12 months, the Capex accounted for 2.9% of revenues, investments are related to new programs and machining projects in addition to initiatives related to safety and environment. The prioritization of projects with higher potential of return has been key in our strategy to increase returning on capital invested.

Slide 16 shows the operating cash flow of Tupy, cash burn of 29 million coming from the impact of working capital accounts, increase in volumes, exchange variance and temporary stoppages at clients with an increase in the level of inventory.

Slide 17 we see a net indebtness of 990 million, is 1.15 times the Ebitda adjusted in the last 12 months. Total liabilities in foreign currency accounts for 99%, the largest one related to the bond with a single payment in February 2031, an interest of 4.5% a year, cash 41% is denominated in local currency. We closed the first half of 2021 with a very comfortable cash position of 1.1 billion.

Fernando will talk about recent initiatives. Thank you.

Fernando de Rizzo: Thank you, Thiago. On slide 19, let's talk about the opportunities in the infrastructure segments in the US market. Nonresidential construction indicators are the highest levels of the last 10 years reflecting the public and private investments made. Last week, the Infrastructure Bill passed in the US Senate which will result in additional investments of US$550 billion in the next 5 years.

Despite the lack of details that allow to quantify the effect in our chain, such initiatives will result in a significant increase in demand for construction equipment, trucks, and generators, which will certainly impact our volumes.

Although the company has always invested in innovation, in the end of 22 as a result of several benchmarks, we approved with the Strategic Committee the creation of 2 new areas in our structure: Tupy Up and Tupy Tech. These fronts are important because they go beyond the current business and concentrate on adjacent markets that could benefit from technical competences of Tupy.

Ob slide 20 we talk about Tupy Up that aims to convert, accelerate and escalate business opportunities and promote improvement in existing businesses by innovation and digital transformation. We launched ShiftT within Tupy Up, an accelerator of startups that in the first batch had more than 100 people enrolled. Yesterday we launched the Open Innovation Portal, that's another initiative to get close to the ecosystem, there we will launch challenges inviting researchers, intrapreneurs, university startups and technology companies to solve problems with us. We already have challenges related to quality, use of natural resources, issue of greenhouse effects gases, and machining, and everything has contributed to our digital transformation that goes beyond adopting technologies, but it includes training of people. In this quarter we launched MBA in foundry 4.0, a specialization developed by Senai especially for the associates of Tupy focused on innovation.

On slide 21, let's talk about Tupy Tech, that concentrates on R&D projects that are disruptive to gain market efficiency and be scalable. We have invested in different technology routes, especially related to decarbonization either in the lithium battery recycling or vehicles that are hydrogen driven. Yesterday we announced the filing of patent application for a new concept of engine block in cast iron to be used in hybrid vehicles. This project is the result of a partnership with Ricardo PLC headquartered in England and global reference in engine design, engineering, and consulting specialized in transportation and energy.

We're speaking of an alternative to be used in hybrid vehicles weighing approximately 5% less than aluminum components and with higher mechanical strength.

In the next slide, number 22, I'll comment on the process of integration of Teksid plants whose closing occurred on October 1st. In this first day we made an online transmission for all the busy units and offices, we visited the plants and talked to several groups of staff members, we found a collaborative environment with a team that is highly skilled and willing to participate in this moment of growth of the company. We have validated synergy opportunities that confirm our preliminary assessments and with several opportunities in the areas of procurement and manufacturing, and we're also implementing new management processes in every area.

As it is usual with this type of transaction, we will have some specific effects in this fourth quarter related to billing of inventory that was there already and closing and consumption of working capital.

We thank you all for your attention, now let's open for the Q&A session.

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 queue, please press star 2. This conference call is exclusive for investors and investment professionals.

Our first question comes from Lucas Lage, from XP Investimentos.

Lucas Lage: Good morning, Fernando, good morning, Thiago, congratulations on the earnings. I have 2 questions. First, thinking about volume, could you give us some news about the volume on the third quarter because pickups is the segment that has strong demand and maybe was more highly impacted by the semiconductor crisis. So, I would like to understand the development of that along the third quarter to get a bit of the impact and to know what to expect in the fourth quarter and to understand what the current manufacturing situation of your main clients is.

And then my second question is about Teksid, what can we think about in terms of higher leverage since October, you know, as a working capital that's related to the merger. Thank you.

Fernando de Rizzo: Hello, Lucas, good morning. Good morning, everyone, good afternoon. Well, about the volumes and perceived volumes, we brought some information and in the last 12 months when compared to 2019 our performance was 15% lower, this is a significant data because when you compare to external or international indicators of the market, economic activity, housing starts in the United States, specific demand, agricultural activity in Brazil, we notice that we did sell very little in this period because there is a demand in the end, but naturally, we had a mismatch between supply and demand, problems in semiconductors and other items in the industry and therefore we lost those sales in the period.

However, they were postponed because capital gains, capital means are still being used and are operating at higher costs and capital goods will have to be replaced in the future. The problem was that customers had a shortage of equipment. Specifically speaking, when we look at where the semiconductor crisis has affected us the most, it was in the pickup trucks and light commercial vehicles in the United States, that's where the highest loss in volume happened both for diesel and gasoline applications, all of them suffered these effects, and it's important to highlight that these are sophisticated projects, many in CGI, many are machined and all of that affects comparison a bit, but even so, when compared, the company did better, performed better despite losing this important sales. And also, we were ready to meet such demand, we made decisions to reduce costs throughout this period in order to adjust ourselves to that situation.

So, you asked about the manufacturing status, we're fine, we shut down or disconnected some equipment in this first half of the year and working in a more orderly way, we generated inventory in some products so that we could shut down some pieces of equipment to manage the situation with the semiconductors. So, these are things in progress, we're working with a leaner company, with fewer equipment connected.

Then when we look to 2022 onward, there is a very suppressed demand in every industry we operate. If you look at the light commercial vehicles' inventories, one of the lowest inventory levels in history, the backlog of trucks is very high, backlog of agricultural machines and the income in agricultural producers in Europe, Brazil and the United States has increased a lot, and so you start a cycle of changing equipment, but there is no equipment available.

In addition, the infrastructure plan that's coming, it doesn't have such an immediate impact because it's still in a bidding process, but because of that we expect a strong demand next year and future years. Also, as these problems are solved, I believe that the situation is a bit clear now, new capacities and semiconductors are arriving in the market delivering products in the third quarter, fourth quarter, investments that were made in 2020, very high investments that take some time to mature, they take some 16 to 18 months for these plants to start production. So, this is a movement that will result in a better supply for our customers. The industry has been mobilized around this and we now see a clear scenario for next year and future years, as well as the pandemic that's getting better, absenteeism is being reduced.

So, we're very confident about our vision. We suffered this year because we operated with an available capacity that was higher than our sales, but even so, we had a good result, which shows the strength of the company and of our business model.

Thiago Struminski: The second part of your question – this is Tiago speaking – in the acquisition of Teksid, we expected 1.4-1.6 times of combined leverage, but in the beginning, Stellantis, which is the owner of the company and that manages most of the contracts in there, did not transfer some of the prices of materials in the last 12 months, so this adjustment was made when we concluded the acquisition, but when you look at the last 3 months, the results are worse because of the leverage.

So, we started next to 1.8, 1.9, but it deleverage quickly because we remove this Ebitda that didn't have the economic base of materials adjusted and included it in the regular Ebitda of the company. So, we end the first quarter with the leverage of 1.15 times in the long run and the main covenant of the company, which is the bond 2031, in the first 2 months of the issue our leverage is very comfortable. We're comfortable to conclude this transaction.

Lucas Lage: OK, perfect. Thank you very much, Fernando and Thiago. Have a good afternoon.

Thiago Struminski: Thank you.

Operator: The next question comes from Vitor Mizusaki, from Bradesco BBI.

Vitor Mizusaki: Good afternoon, congratulations on the result. I have 2 questions. The first regarding price adjustments, as you said now, Thiago, Teksid, but on the side of Tupy all the adjustments in prices of raw materials already came in the result of the third quarter or is there something that we could see of price adjustments in the fourth quarter?

And the second question is about new products. You mentioned that you filed for the patent of engine block for hybrid vehicles. What do you see in terms of opportunities? Could that mean gaining market share in light vehicles? And in the production of this new engine block, will that require material investments from Tupy? Thank you.

Fernando de Rizzo: Vitor, thank you for your questions. First, about the price adjustments, no, we did not transfer all that adjustment, we did a partial transfer of costs. Of course, the company renewed products and there are other initiatives that were made that brought these improvements. I like to highlight the strength of our business model and the capacity of the company to recover that, and we also changed the agreement cycle, and we reduced this room for transfers. This is very important for us because we had very significant changes on a monthly basis, so this is very important looking forward, we need to neutralize such affect working on efficiency and the quality of our products.

We see this in a positive note and now with the combination with Teksid, this becomes even more important to have efficiency gains against the accounts, against the plants, and to have a new efficiency grid, and to find the best cost and to ensure these adjustments and a better service to our customers.

About the hybrid product, this is a technology we always believed in because of specific properties of vermicular iron in some cases. This is a project that uses the original architecture of a European small hybrid engine and combining iron and plastics that work at high temperature were able to obtain a design of a lighter project. In the future, we'll have different fuels in different regions, and of course, the hybrid model is more efficient because electrical application comes in in some part when the vehicle is accelerating and it reaches a certain speed, then the combustion engine comes in when it's most efficient at stable rotation levels.

So, this is the model we were able to bring because for ethanol this is very important technology, as well as tool for applications in Europe, in the United States we see a hybridization model of the fleet and that's an attempt for Tupy to return. We decided to focus some time ago in capital goods and we were successful in that strategy to meet those customers' needs. With Teksid, Tupy now supplies products to all manufacturers of the east of machinery and vehicles and trucks, but it also opens doors in capital goods because there are opportunities in electrical industry, in trucks you can work with the cycle of a combustion engine in other regions, in the road it's better, in the city you can use the electric engine.

So, this is a new technology that makes a lot of sense, it's a challenge of geometry, of the product structure, and the way we're able to create an alloy that meets the needs of these applications.

In terms of investment, it uses this same asset base of the company, it's the same thing we do today, so there is no major change in the asset base.

Vitor Mizusaki: OK, just to follow-up regarding the first question. You mentioned that it was a change in contract and now, if needed, you can do it faster. On average, adjustments would take about 3 months on average, for the new agreements could you give us a more color on that?

Fernando de Rizzo: There was no change in the contract, but in the transfer form because the market is an adverse situation with very significant oscillations, and since the previous agreement did not transfer the costs and neutralized impacts, we must remember at all times that what stimulates the prices of commodities is the same phenomenon that stimulates the demand of our customers. Since they benefit from that as well, we came to this agreement. This is an agreement made during this period of high changes, high variations in prices for those materials.

But I always like to say that the strength of the company to be able to balance these relationships so we can maintain and preserve the quality of our business and our investment. This is what we're after.

Vitor Mizusaki: OK, thank you.

Operator: The next question from Marcelo Motta, from JP Morgan.

Marcelo Motta: Please, comment a bit on the margin of price adjustments. If I understood it correctly, there's still some price adjustment to take place during the fourth quarter and the cost of raw materials is stable. Should that mean some gain in the margin? I would like to understand what that impact would be.

And now the second question, you mentioned the impact of Teksid on leverage, but I would like to understand its impact on margin, how could that be? And how do you plan to report those figures so that Teksid does not pollute the core business results so far? Thank you.

Thiago Struminski: Thank you for your question, Marcelo, this is Thiago speaking. From the point of view of margins, we have to look at the right time frame. First and second quarter did not show the adequate margin of the company, we suffered a lot from this mismatch of price transfers, there were other effects as well, many shutdowns due to lack of semiconductors and other input that were not helpful for our manufacturing organization, but the third quarter is heavier on this. Yes, there are some negotiations too and this mismatch that will go into the fourth quarter, but we must look at the fourth quarter carefully because it's a bit atypical because when including Teksid in the business, it comes with one month less of invoices because we did not buy the inventory of some subsidiaries that need to be sold, so that has an impact of 4 to 5 weeks on the results.

There can be some more encompassing shutdown of car manufacturers to try to organize the plans for 2022, we don't know when that will happen. The fourth quarter therefore can be a bit unstable, we're not so sure about how much, and the tendency is to reduce a lot this mismatch that had a strong impact in the third quarter although it's not completely over.

When we look at the results and the margin of Teksid, the combination of Teksid margin and Tupy margin will have an effect, our goal is to report the margin on a consolidated basis because there are several exchanges between our assets and Teksid assets that tend to favor the whole, so it's OK to have a negative impact here if the whole is favored.

So, our guidance continues to be in order to bring this margin back to the level of 14% in a consolidated manner. Of course, in the beginning it drops because we combine a historical margin of 14% of Tupy, whereas in Teksid it was 3.7% in the last 4 years, so that brings down the consolidated margin. But we will recover our expected synergies as time passes in the future.

Marcelo Motta: OK, thank you.

Operator: ladies and gentlemen, I would like to remind you that to ask a question, please press star 1.

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

Fernando de Rizzo: Well, I thank you all for attending, your trust in the company.

The last conference call we highlighted our commercial efforts, in this quarter we were able to respond to customers' demand and mainly perform our sales strategy partially transferring costs including from previous quarters despite everything we faced, the pandemic, semiconductors, sudden suspension of purchases from clients, year-to-date Ebitda is 859 million, that is 23% higher than 2019, which was the best year so far, therefore, our operating results and the increase on invested capital are the main highlights of this quarter.

But we still have many opportunities to that effect, both in current operations, as well as in the ones recently acquired. We can recompose the inventories of customers, inventories which are the lowest levels in history, the suppressed demand due to lack of components, and it's worth remembering that capital goods market needs to buy new products, and so, this is a demand that will be present in the future.

Infrastructure programs also strengthen our demand in 2022 and in further years because it will take 3 to 4 years to happen, and the combination of the new plants in Betim and Aveiro opens opportunities for greater operational efficiencies, both in the best use of capacities, as well as in the benefit of purchase of raw materials, and above all, it strengthens our business model and commercial strategy execution.

We see a favorable demand in the market and a decrease of the factors that have affected our performance during 2021. At the same time, we have prepared the company for growth, we also dedicate ourselves to the next chapter of the company, and therefore we increase investments in research, development, and innovation, but mainly our presence in the ecosystem working in a collaborative way that enriches the solutions we can develop.

In the partnerships announced throughout this year, our knowledge about materials is being used for researchers in several IT rounds in the market, such as recycling of lithium batteries, hydrogen powered engines of high performance, as well as in the design of hybrid vehicles. There are many other business paths that were able to take and the journey of decarbonization also that's been led by our customers.

We hope to be able to share more results of those initiatives in coming months because a lot is being done in the company. Thank you all very much and have a good day.

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