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GISSA 1Q18 Conference Call Transcript

(Friday, April 20, 2018 at 9:00 AM Central Time)

Operator: Good day, my name is Lynn and I will be your conference operator. At this time, I would like to welcome everyone to the Grupo Industrial Saltillo's earnings conference call. All lines have been placed on mute to prevent any background noise. There will be a question and answer sessions after the speaker's opening remarks and instructions will be given at that time. Thank you. I will now turn the call over to Patricia Cruz with i-advize. Please go ahead.

Patricia Cruz: Good day, everyone. Welcome to Grupo Industrial Saltillo's first quarter 2018 earnings conference call. This call is for investors and analysts only. Joining us today from GISSA are Mr. José Manuel Arana, Chief Executive Officer; Mr. Mario Guzman, Chief Financial Officer; and Mr. Saúl Castañeda, Investor Relations Director. They will be presenting the company's performance as per the earnings release issued yesterday after the close and going into discussion of results through a presentation. If you did not receive the report or the presentation, please contact i-advize in New York at (212) 406-3694 and we will email you immediately. Or go to GISSA's website, www.gis.com.mx under the investor relations section.

Let me remind you that forward-looking statements may be made during this conference call and they are based on information that is currently available. Please refer to the earnings release for a more detailed and full disclaimer. Also, all figures discussed are in Mexican pesos unless otherwise stated.

It is now my pleasure to turn the call over to Mr. José Manuel Arana, Chief Executive Officer of GISSA to begin with the main highlights and a strategic overview. José Manuel, please go ahead, sir.

José Manuel Arana: Thank you, Patty, and welcome everyone, this morning to our conference call. 2018 marks an important year for GISSA, as we celebrate our 90th anniversary. It was back in 1928 when Mr. Isidro Lopez decided to take off the start of a project that for many didn't make sense at that time. He began experimenting with foil sheets, transforming them into all sorts of pots and pans, what eventually became Cinsa. He was a visionary man. With Cinsa, he began building what would become a global and leading company, the GISSA we all know today.

There is no doubt that our globalization strategy has been the catalyst for a fast paced and profitable growth. Following this roadmap, we have taken solid steps to build a company that offers competitive advantages for the automotive and construction industry not only Mexico, but on a global basis. Our evolution continued this quarter as we reached a major milestone in this strategy. A few days back, we announced our decision of consolidating our three Auto Parts businesses, CIFUNSA, ACE, and INFUN into one unit named Draxton.

Draxton allows us to be fully in line with the industry's value chain from R&D, co-design, casting, and machining with a wide range of technologies, processes, and materials to efficiently produce complex auto parts including brakes, power trains, and suspension systems. It also gives us great commercial operating and marketing advantages to better serve our clients.

Since 2017, we have seen benefits driven by this globalization strategy where Draxton has delivered significant savings in the cost of:

- Raw materials such as ferroalloys, sands, and filters among others.
- Machining and tooling (new supplies for China).

During 2018, we have been achieving benefits of synergies in engineering, process improvement, product design, and sales across all the Auto Parts business units. We will inform about the progress of synergies in further communications.

Throughout the years, we have assembled a passionate, smart, capable team focused on creating a culture that adds value to our clients, shareholders, and employees. However, we are aware that these changes made in Auto Parts required additional efforts in aligning our team in order to increase productivity and accelerate efficiencies. That is why we developed the GIS competency model. This model is a behavioral guide made to align GIS towards our mission and vision, inspiring the development of each member of our great team.

Now, let me spend a few minutes reviewing or operating performance for this quarter.

These first three months presented several complications that mostly affected volumes sold in the U.S. and Mexico, yet management's ability to overcome challenges helped GIS report similar levels of last year in consolidated revenues at 4.5 billion, but a 9% growth in dollarized terms. Our EBITDA was down by ten percent to 741 million, only 3% down measured in U.S. dollars. This is all comes from the consolidated effect of our three business units. So allow me to go over the main highlights of each of them.

First of all, Draxton, now serving over 50 customers throughout our facilities in six countries, posted double digit growth of 14 percent to US$176 million. These

results are mostly attributable to the positive performance in Europe and Asia, thanks to higher aluminum volumes sold. Nevertheless, it is important not to underestimate our efforts in NAFTA. Despite continued uncertainties in the region, operations in Mexico and in the U.S., managed to boast a slight increase of six percent when measured in dollars, helped by the favorable effect of price and product mix.

EBITDA levels for Draxton remain unchanged compared to 1Q17. This quarter was largely eased by savings in energy consumption and reduction in fixed expenses. As rooted in our three main foundations, at GIS, we see continuous improvement for 1Q18; I can name three relevant examples of our commitment to these mindsets. First of all and maybe the most significant one is the Auto Parts new installed capacity exceeding 550,000 tons of iron casting, 10,000 tons of aluminum casting, and 15 million machined parts that allow us to supply global platforms.

The second one was achieved in Poland. This year, we implemented a new standard that allows systematic workflow in terms of employee health, safety, and working conditions. The success has been such that on February 28, we were awarded ISO 18001: 2004 certification.

Third, we proudly opened a new machining plant in San Luis Potosi under the name of GIS Ederlan with an installed capacity of up to 3.5 million units.

These operations follow our strategy of process integration and increased added value.

In 2018, our efforts will be aimed at productivity and extraction of synergies of the aforementioned. I am very confident that we will begin to see the benefits from this integration of time.

Now, moving into Construction aligned with our premium segments positioning strategy in the ceramic tile industry, Vitromex opened an additional boutique under the luxury brand Arko-Lafaenza. This format strengthens our presence in the large form that reported profitable growth trends in the Mexican market. The U.S. market faced difficulties as we continue to make adjustments in our product portfolio that reduced supply levels in a distribution network thereby affecting our capability to adequately serve the market. As such, Vitromex boasted a revenue decline of 15 percent.

In the last quarters, EBITDA levels for this segment have suffered from several external events that highly impacted costs. Nevertheless, GIS is committed to turning around this operation.

At the end of last year, we launched an aggressive plan to improve operations and reduce fixed cost. It pleases me to say that little by little, we start to

experience the 180-degree change that we have been working towards. In 1Q18 EBITDA reached 80 million, a significant improvement from a negative 39 million reported in 4Q17. This can bring forth that all the actions that we are implementing are turning this business around.

We are currently in the process of strengthening our relationship with our largest customers through CAPEX aimed at

- Process, productivity, improvement, replacement, and maintenance of equipment that will make us much, much more productive and will reduce our cost of production.
- Product renewal, the launch of new product lines,
- leaner and more horizontal structure, allowing customer proximity,
- commercial teams reinforcement mainly in the United States
- sell and deliver strategy under very strict planning processes,
- focus and best value to find the adequate portfolio mix.

Last, but not least, in the Housewares sectors, Cinsa' s steady growth pace so far has, without a doubt, come from the opportunities to improve efficiencies. Although revenues increased slightly by one percent, we posted a strong EBITDA growth of 41 percent and EBITDA margin up three percentage points. This growth derived from a favorable price effect in the majority of our captured release, a new line recently added, better product mix operating efficiencies, and cost savings.

Before I conclude, I would like to thank Mario Guzman for his great efforts who have taken us in many ways to a different level of organization. Thank you, Mario.

And to give a warm welcome to Jorge Mercado, our new CFO. Jorge brings more than 25 years of experience in the banking and stock market sectors where he has transformed corporate cultures to achieve productivity, efficiency, and profitability.

I would like to give the floor to Mario so that we can discuss the financial performance in the company. Go ahead, Mario.

Mario Guzman: Thank you, Jose Manuel. Good morning, everybody. Before I dive into the results for the quarter, I just want to thank you, José Manuel, for your kind words and good wishes, as well as GIS for the opportunity to work with this outstanding team. It has been an honor to be part of this company and I am certain that we will continue to see great things happening in all businesses. To Jorge, the warmest welcome and best wishes. I can't think of anyone better than him to lead the company going forward in the financial strategy. Welcome again, Jorge.

Let me turn now to our results. The comparison versus first quarter 2017 is challenging. Since that quarter a year ago was the best in terms of EBITDA. At least in the recent history of the company, on the revenue side, we have some positives and some negatives that ended up canceling each other. In terms of volume, Draxton, the Auto Part business, maintained its overall volume in iron parts and increased its business in aluminum. The exchange rate versus the U.S. dollar reported lower values due to the appreciation of the peso. While on the other hand, our business in Europe when translated into Mexican pesos presented higher sales. Finally, offsetting the lower volume in Construction and Housewares, we had a generally improved pricing and product mix in Draxton and Housewares.

Going now to EBITDA, we reported 741 million pesos this quarter versus 627 a year ago. The mix of currency effects represented a negative of around 30 million pesos. A volume reduction in Construction essentially accounts for the difference. While the reduction in EBITDA in pesos is 10% quarter versus quarter, quarter on quarter, when translating to use dollars, the shortfall is only 3%. The rounded figures have $39 million EBITDA today versus $41 million EBITDA a year ago.

Finally, a remark on the rails of our JVs Evercart GISederan and Everlast. We do not consolidate them as per IFRS, but the performance results fully included in the contribution of these JVs shows a significant generation of EBITDA. A performance comparison shows an EBITDA for the quarter of 355 million pesos for this year and 919 for the first quarter of 2017. The contribution to this quarter EBITDA from the JVs amounts to 114 million pesos. Net income for the quarter is 473 million pesos versus 796 million pesos a year ago. There are 2 nonoperating effects that will normalize themselves with the passage of time during this year. During the first quarter of 2018 and 2017, we had a positive foreign exchange gain on the financing costs because of the devaluation of the peso. The impact in 2017 was larger than the tax impact this year. The difference of this effect represents around 130 million pesos that help to explain a significant part of the difference. Also, this year, as we have reported in the past, we are reflecting monthly the increase in depreciation and amortization related to the intangible assets and the step up in the fixed asset base of the Infun acquisition. The tax impact on the bottom line for this quarter is 40 million pesos. These two factors represent almost 50 percent of the difference in the quarters on the net income levels.

On the debt side, we are reporting 6.3 billion pesos of net debt at the end of this quarter versus 6.6 a year ago. The net leverage remains at the levels of 2.2, 2.3 times EBITDA.

Going farther into the performance by each segment...

I would like to begin with Auto Parts, which is now Draxton I will refer here to figures in U.S. dollars. As José Manuel mentioned, we took an important step towards consolidating the units strategy and from now on, we will refer to CIFUNSA, ACE, and INFUN as Draxton within our financial reports.

Draxton exceeded our expectations for the quarter. Our star products and operations this quarter were the FCA's crankshafts in Irapuato, Mexico, the business of power trains and chassis in Teruel, Spain, and brakes in Brno, with this recently started molding line in Czech Republic. Thus, revenues in dollars were up 14% to $176 million; also, helped by a better price and product mix, and the positive EUR-USD parity effect.

EBITDA reported the same $34 million of first quarter 2017. EBITDA could not replicate the growth of sales due to some delays on the implementation of the raw materials pass through to selling price, continued pressure on material cost and energy, and the appreciation of the local quarantines in Mexico, Poland, and Czech Republic, that impacted to the cost of structure of those operations.

Turning now the Construction segment in first quarter 2018 Vitromex' s revenues increased 15% to 881 million pesos, resulting from lower volume sold specifically in the U.S. market, as adjustments made in our product portfolio prevented us from offering our distribution network the normal supply levels.

On the up side, our costs cutting initiatives implemented since fourth quarter of last year are starting to bear fruit, EBITDA totaling 18 million pesos benefit from 15 million in savings in fixed costs, which included marketing, personal, and maintenance costs among others.

Although this is of the Calorex which we are not consolidating now, this business posts double digit drop of 36 percent in EBITDA. As you know, the divesting process Calorex is still subject to approval by COFECE regulator in Mexico. Back in March, we and Rheem received some observations by COFECE, and we are addressing those observations in order to complete the transaction. We will inform the market of any new developments.

Finally, let me comment on the Housewares segment. Cinsa includes revenue by one percent to 371 million pesos. Despite facing a slowdown in economic activity, this segment EBITDA and EBITDA margins for first quarter of '18 both significantly improved. The absolute EBITDA increased by 32 million pesos. That's an improvement of 41%. The margin improved three percentage points to 9% due to better product mix, operating efficiencies, better pricing, a lower cost in peso terms of imported inputs. The ongoing efforts on cost control helped to offset higher raw materials prices.

Now, in terms of Capex for 2018, we have assigned a total of 2.1 billion pesos broken down as follows:

- 1.25 billion pesos will go to Draxton including technological updates, maintenance, and capacity increase both in casting and machining across all geographies of this business.
- We are allocating 750 million pesos to Vitromex to pay for some equipment refurbishment, debottlenecking of capacity and compliance within environmental regulations.
- Finally, the remaining 100 million pesos will be invested in Cinsa to improve process and competitiveness.

The planned investments are in line with GIS, the strategy plan, focused on improving competitiveness and profitability in the Auto Parts, now Draxton business and the Construction segments.

Talking a little bit about depth about the net debt I already mentioned for first quarter 2018, total 6.3 billion pesos. While net debt to EBITDA ratio was 2.3 times.

In accordance with the resolutions adopted by the Board of Directors at yesterday's meeting, the company will propose to its shareholders a dividend payment of Ps. 1.12 per outstanding share of which 60 cents will be paid on May 7, 2018 and the remaining 52 cents on November 5, 2018. The proposal is subject to approval at GIS next Annual Ordinary Shareholders' meeting, which will be held on April 26.

Once again, thank you all for your attention. I will now ask the operator to open the floor for the Q&A session. Thank you.

Operator: Thank you. At this time, if you would like to ask a question, please press the star and one on your touch tone telephone. You may withdraw yourself from the question queue at any time by pressing the pound key.

Once again, it is star and one on your touch tone phone to ask a question. We will pause a moment to allow the questions to queue.

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We will take our first question from Alejandro Chavelas with Actinver. Please go ahead. Your line is open.

Alejandro Chavelas: Hi, congratulations on the results. Just to have a quick view, if you could tell us when you expect Vitromex to normalize and two percent margin for the quarter was definitely very low. So when would you expect normal margins or what would be your expectations for the rest of the year for Vitromex. Also, if you could comment on…you mentioned certain changes in your portfolio. If you could provide some more visibility on what this implies, the changes in the portfolio in Vitromex. Thank you.

José Manuel Arana: Yeah, this is José Arana. On the first question related to our expectation on bringing the business back to where we would like to be, if you compare 1Q17 for many reasons was a very good quarter to volumes, and in addition to that, lower cost basis for one of the main inputs is gas. Gas and electricity has increased, as well as all of the components that are the basic components to create the different shapes and the painting of the tile that is quoted in U.S. dollars primarily. What we expect throughout this improvement is by the end of the year, we should be coming back to our profitable standard, which is not our goal. Our goal is to be close to the best competitors. You can see in the earnings reports the ratings or the performance. So we are aiming to be very close to our competitors in 2019, but the pace and all of the actions to be implemented primarily all this CAPEX is more than 150 projects that are carefully identified, and we have reinforced our people to be able to execute each one of these projects.

On the product line, the main product line is in the U.S. Basically, each one of the customers primarily the big boxes expect to have a renewal every three to four years. We extended that period because we did not develop the product line. So we, our goal is that every year, we should be replacing 25 percent of the sales by new products. By early next year, we will be in that rate of exchanging or replacing 25 percent in the U.S. with new products.

Alejandro Chavelas: Perfect, thanks a lot.

Operator: Thank you. Our next question comes from Alejandro Azar with GBM. Please go ahead. Your line is open.

Alejandro Azar: Good morning, everyone. Thank you for taking my questions. If you could expand a little bit more on why Europe and Asia within Draxton reports profitability pressures.

Mario Guzman: Well, essentially what we are, as you know, we are able, depending on the geography to pass through the selling price the cost of some of the raw materials and in some cases, the cost of the electricity. There is a time lag between the impact on our PNL and the time we can pass through that impact to the market. That is the main reason behind that especially in the braking system. There is another factor that has been going on for the recent past. It's the relative reevaluation of the Poland zloty and the Czech koruna. They have been evaluating and bringing some pressure into the cost structure in our operations in Czech Republic and Poland. I would say those are the two factors that have hit the PNL in this first quarter. We see them as transitional since the surcharge will eventually catch up and also the currency factor is something that would not necessarily be there for the long term.

José Manuel Arana: Yeah, in addition to what Mario said, in NAFTA it's very common to have quarterly adjustments with customers in the Auto Parts sector. In Europe, the

adjustments are yearly, not quarterly. It takes a year for us to turn that cost, incremental cost to the customer within the formulas that we have.

Alejandro Azar: So, we should expect because I didn't understand because the year already finished. You mentioned you have time lag on the surcharges. So the next pass through would come at the end of 2018?

Mario Guzman: Well, in some of our business, we have been successful in negotiating that loss to move it on a quarterly basis. So it's an ongoing process.

José Manuel Arana: Yeah, if it's an incremental of 1Q18, we were not able to turn that around until 1Q19.

Alejandro Azar: Okay, perfect, thank you.

Operator: Thank you. Once again, if you would like to ask a question, please press the star and one on your touch tone telephone. We will pause a moment to allow additional questions to queue.

Star and one for any additional questions.

It appears we have no further questions. I would like to turn the program back to our speakers for any additional or closing remarks.

José Manuel Arana: Well, thank you very much once again for the continued interest in GIS. Please don't hesitate to contact us if you have any further questions for any follow-up. You guys have a great day. Thank you for your time.

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