Media Contact
Guillermo Hernández
Tel: +52 (844) 411-1095
pr@gis.com.mx
www.gis.com.mx

Investor Relations Contact
David Sandoval
Tel: +52 (55) 5640-0620
ir@gis.com.mx
http://ri.gis.investorcloud.net/

GIS 2Q20 EARNINGS CONFERENCE CALL
July 30, 2020 @ 9am CT

Operator: Good afternoon. My name is Nicky, and I would be your conference operator. At this time, I would like to welcome everyone to the GIS Earnings Conference Call. All lines have been placed on mute to prevent any background noise. There will be a Question & Answer session after the speakers' opening remarks, and instructions would be given at that time.

I would now turn the program over to Kenia Vargas with i-advize. Please, go ahead.

Kenia Vargas: Thank you, Nicky. Good day, everyone, and welcome to Grupo Industrial Saltillo's Second Quarter 2020 Earnings Conference Call. Joining us today is Mr. Manuel Rivera, Chief Executive Officer; Mr. Jorge Rada, Chief Operating Officer; Mr. Jorge Mercado, Chief Financial Officer; and Mr. David Sandoval, Investor Relations Manager. Please be advised that this call is for investors and analysts only.

During this call, we will be discussing Grupo Industrial Saltillo's performance as per the earnings release issued on Tuesday. If you did not receive the report, it is available at www.gis.com.mx in the Investor Relations section. We encourage you to follow along with the presentation slides that are now available on the live webcast.

Let me remind you that forward-looking statements may be made during this conference call. These are based on information that is currently available and is subject to change due to a variety of factors. For more details and a complete disclaimer, please refer to the earnings release. Also, all figures discussed are in US dollars, unless otherwise stated. It is now my pleasure to introduce the GIS team, starting with Mr. Manuel Rivera, to begin with our conference call. Please go ahead.

Manuel Rivera: Thank you very much, Kenia, and thank you all for joining us today.

I sincerely hope that you and your families are in good health in the midst of this unprecedented pandemic. It is my pleasure to share with you in these difficult times my vision of current events as well as the future of our business. I believe it is important for me to join Jorge Rada and Jorge Mercado on this call so that we can all be available for your questions.

Our priority at GIS has been to protect all of our employees by implementing protocols to prevent infections. These measures have been designed based on best practices in the automotive industry, and they have been reinforced with communication and training for our personnel. We have been successful in our operations in China and Europe where we have had no cases reported.

In Mexico, we have been able to participate even in a greater measure. Through the GIS Foundation, we reinforced our commitment to the communities where we operate. We have donated PCR testing equipment, ventilators and personal protective equipment. We have also financed consulting services for state governments in order to help them develop strategies to contain the pandemic. As a result of this support and many other actions, the state of Coahuila has achieved testing levels and hospital bed capacity similar to those in South Korea. We will continue to monitor the pandemic and take all necessary actions to keep our employees safe.

Countries where we operate are implementing different strategies to contain the spread of the virus. The effectiveness of these actions is reflected in the flattening of the contagion curve in most locations. China has effectively controlled the pandemic. In the main European countries where Draxton sells and operates, daily new cases are below their earlier peaks. And in the U.S., although the curve has been increasing recently, the monthly rates--the mortality rates are lower.

Talking now about markets, we expect that they will recover most of the losses towards the end of the year. As we expected, second quarter was very challenging in the regions where we operate. After the slump in growth experienced in China at the beginning of 2020, its economy has rebounded, and China is now leading the global economic recovery. The U.S. has shown a faster recent recovery than expected, and although Europe was slightly more impacted by the pandemic, we expect a slower pace. However they have issued guidelines to ensure its economic recovery. We are, therefore, cautiously optimistic that the recovery process may be strong in all regions where we operate, as it has already been in China.

Before I turn the presentation to Jorge Rada and Jorge Mercado, let me emphasize the relative strength and position at GIS.

First, as I previously mentioned, our results were severely impacted by the corona pandemic. Second, we have accelerated our rightsizing programs that began last year, adapting our cost structure, working capital, and CapEx to the current situation without compromising our future growth.

In the second quarter, as part of our steps to handle any economic difficulties, we registered extraordinary expenses of USD 3.5 million, mainly related to organizational restructuring and rightsizing, which we needed to implement in order to align our cost structure to the new market levels, as the economy and industry recover.

Third, GIS has maintained a strong financial position with a net debt-to-EBITDA of 2.9x and a healthy cash level of USD 78 million.

Fourth, our plants have resumed operations, and even during these tough times, our business units have brought in new business opportunities. Draxton received new machining orders from China, and we are proud to say that following our interest in entering into the electric vehicle business, we closed our first deal for brake components for Tesla. Vitromex also won an important Home Depot bid tender in Mexico, and Cinsa's exports increased thanks to the new Graniteware line.

Finally, if there are no major COVID-19 outbreaks in the U.S. or Europe, we expect that by the fourth quarter, we will be in a range of 80 percent to 90 percent of our pre-COVID-19 revenue levels; and, thanks to our rightsizing initiatives, very close to our initially-planned EBITDA margin. I will now pass the presentation to Jorge Rada.

Jorge Rada: Thank you Manuel, and good morning to everyone. Let me turn now to Draxton. Regarding the automotive industry, I will share some trends in the markets where we sell and operate.

In North America, Draxton's main market, compared to April data, during May and June, we saw a recovery in light vehicle sales due to the reopening of activities, especially at car dealerships. Sales outpaced production, causing inventories to tighten. In order to recover inventory levels at dealerships, OEMs are expected to drop planned summer shutdowns and keep manufacturing cars. This is even more evident for trucks and SUVs where Draxton has an important share of its North American business. Similarly, in Europe, light vehicle sales are starting to show slight improvements. The reopening of the economy, better control of the pandemic, government stimulus measures, production restarts and OEM's promotions, all reinforce the positive outlook for the rest of the year.

In China, OEMs returned to pre-COVID production levels starting in late April. During the quarter, light vehicle sales and production remained strong due to government infrastructure investment, automotive loan incentives and subsidies for the acquisition of new vehicles.

We are positive about recovery levels at the end of the year in both, North America and Europe, as OEMs and governments are taking steps to accelerate the auto industry, given its importance to economies. Some types of incentives are: easy credit terms - such as no interest and long payment terms - price discounts, unemployment insurance, tax incentives and scrappage schemes.

Now I'm going to talk about Draxton's quarterly performance. During the second quarter, foundry volume decreased 65 percent year-over-year mainly due to the global crisis of COVID-19. The volume of our North American operations suffered a 70 percent drop, while in Draxton Europe and Asia, the volume decreased by 60 percent due to the stoppage in vehicle production in Europe since March.

Lower sales affected our EBITDA with a result of negative USD 6 million, which includes rightsizing, provisions and extraordinary charges for USD 2.3 million. For the next two quarters, we expect a gradual recovery in the automotive markets, and we estimate that our volumes could return to 85 percent to 90 percent of pre-COVID levels. With our organizational adjustments and efficiency programs, we estimate that we will return to a similar pre-COVID EBITDA-to-Sales margin towards the end of the year.

I would also like to share with you that despite this very challenging environment, Draxton has obtained new significant orders. One of the most important new projects is the brake components order from Tesla, which Manuel already mentioned. With these new orders, Draxton has obtained contracts for 105,000 tons in the last 12 months. Additionally, we are currently developing more than 200 new projects that will represent a volume of 140,000 tons per year.

In Mexico, demand for brake components continues to grow due to the installation of new facilities from our brake customers. So, even though it may take time for the automotive industry to recover its pre-COVID levels, we estimate demand will exceed our installed capacity by 2022.

Furthermore, Draxton has implemented organizational changes to boost its Research and Development activities. This will enable us to offer innovative solutions to our current and potential customers regarding new high-performance materials. Let me now turn the presentation to Jorge Mercado, who will talk about our other business units and consolidated figures.

Jorge Mercado: Thank you, Jorge, and good morning, everybody. Now let's move on to Vitromex. Vitromex has been working according to its restructure and profitability plan. We have been implementing some measures across the business, like restructuring the portfolio to adapt to its market's needs. We have also rationalized the capacity in our plants. And so far, this year, a leaner cost structure has led to a 7 percent cost decrease versus last year. As a result of these actions, we have improved our working capital by almost 40 percent, making both inventory and service levels much more efficient.

Due to the effects of the pandemic in the second quarter of 2020, Vitromex revenues contracted 25 percent compared to the same period of last year, with April being the month with the largest decrease as all plants were shut down. The full impact of the pandemic was felt in the months of April and May. In June, we experienced a significant recovery compared to April and May. Revenues were almost 60 percent higher, while our EBITDA was positive.

Reported EBITDA for the quarter was negative MXN 45 million, which is 64 percent better on a reported basis than last year. Now excluding extraordinary effects of the slow-moving inventory liquidation and restructuring charges for the quarter, EBITDA would have been MXN 9 million positive.

Now going out to the month of June alone and excluding previously mentioned effects, EBITDA margin for that month of June of 2020 would have been 12 percent on a run rate basis versus reported 9 percent.

Now let me just walk you through some of the consolidated figures. GIS has faced the current situation by accelerating the rightsizing program that we initiated in the second quarter of 2019. All businesses have undergone structural changes and working capital investments have been adapted to handle the current crisis. Even though the second quarter results were impacted by the pandemic, figures in June reflected the benefits of rightsizing and the gradual recovery of volumes, which led us to believe that by the end of the year, we will be able to recover pre-COVID EBITDA margins.

As Manuel and Jorge mentioned, GIS has continued to have a very disciplined and responsible approach regarding its debt policy. We made use of our credit lines in order to close the second quarter with a healthy cash level of USD 78 million, net debt-to-EBITDA of 2.9x and committed credit lines of USD 50 million. We have assured financial flexibility through both the refinancing carried out last year, which exempted us from significant payments for this year and next, and the renegotiation of our leverage ratio covenant for the next quarters. We have an excellent, and close relationship with our key lenders, and they are helping us remain flexible.

We will continue implementing our profitable growth strategy, and we are sure that the measures we have taken in all our businesses will improve our competitive position for the next quarters, even in this challenging environment.

This concludes my remarks for today. Thank you for your attention. Operator, please begin the Q&A session.

Operator: And our first question comes from the line of **Jose Vazquez with GBM**.

Jose Vasquez: Hi, good morning Manuel, Jorge Mercado and Jorge Rada. Thank you for your time and taking my questions. It is related to

Vitromex. You said that in June, it showed a very positive performance given the current situation. And that taking out all the restructuring charges and some inventory charges, it would have been the first in several quarters to post a positive EBITDA. So, looking ahead, seeing this trend, do you believe that we could see positive EBITDA in the remainder of the year? Thank you.

Manuel Rivera: Jorge?

Jorge Mercado: Thank you, Manuel, and thank you, Jose. Well, as you recall, Jose, we have been reporting the improving performance of Vitromex since last year. Vitromex results have always been affected in the last quarter of last year and this--the quarters of this year by the actions that we took last year in the restructuring. First was the charges regarding the close of the Saltillo plant, and then the strategy to decrease the levels of inventory that we have carried for a long time. And those are basically the numbers that we take out to understand the run rates of Vitromex. And consistently, if we take out the months of the pandemic in the last quarter and the first two months of this year, we were seeing run rates for Vitromex, which were on the positive side. And we do think that if we continue that trend and we have volume growth, we will be able to see improvements in the margins of Vitromex.

Certainly, at the end of the day, what needs to happen is that the volume comes back. From our side, we are focusing on the things that we can control, like the rightsizing process and taking the costs out and remain flexible. So, if volume does come back at reasonable levels, yes, we will see improvements in the margins and have positive EBITDA. But it has to be both a combination of things that we're doing--which are in the right direction--and how the market evolves as we come along in the future.

Jose Vasquez: OK, thank you.

Operator: Our next question comes from **Alejandro Azar with GBM**.

Alejandro Azar: Hello everyone and good morning to all. Hope your families are also well. Thanks for taking my questions. And I'll just follow up first on Vitromex, and then I'll move on to the Draxton. Jorge, you mentioned a margin in June, and Manuel also mentioned new contracts, I believe, in Vitromex. Could you give us more color on this? Because in the question before this one, you mentioned about volume coming back. So, is this volume significant to move the needle and to have margins positive from the third quarter and forward?

Manuel Rivera: Yes, Alejandro. Basically, and it has been discussed in previous calls, Vitromex has to develop a fast program for recovering profitability. First step was to rebuild some organization, that has already been done. Second, putting systems in place. And I would say they are now 70/80 percent. As a result of those initiatives, those have been significantly reduced. When we talk about inventory effects, that's related to products but were produced several months ago, some of them even a year ago at higher costs. So, when we are talking about excluding those inventory effects, if we were selling all the products using current costs, we will be obtaining EBITDA margins close to a two-digit figure--very close.

So, that has been mainly the result of, first, adapting better our product mix/SKUs to the market mix and very significant cost reduction from the manufacturing side. So, we were very encouraged. As you know, April was a very difficult month; May was slightly better but June, even though we still were lower than our originally-planned volumes, one-digit figure, the company for the first-time showed positive EBITDA with the margins better than before.

Now the situation is a little bit different. We feel relatively comfortable for the months of June, July, August, September. There is some pent-up demand. We still need to be cautious going forward in terms of our forecast. But I think what it important is when we are talking about rightsizing, what we are implying is that we would be adjusting all of our cost structure in the volumes. So, yes, we may be wrong in forecasting our volumes plus 10, minus 10 or a relative number, but if we see a trend at a certain level, we will certainly--and the company is committed to adjust its cost structure to be--to those levels. So, the company commitment is to maintain EBITDA margins.

Alejandro Azar: Thank you, Manuel. A follow-on on that is you mentioned inventories, do you have an estimate on when can we see those inventories gone, the higher cost ones?

Manuel Rivera: Yes. It's a matter of very few months. Actually, it has been reduced almost to half. Especially during the quarter, we reduced about 2 million square meters of inventory in Vitromex. And the most important point is that while we reduced, the sales improved because now the company has a much better S&OP system. So, the quality of that inventory in fulfilling the market's needs are much better. But from the accounting point of view, I think, in a couple of months, that will be in half.

Alejandro Azar: Thank you for the answer. And if I can move on to Draxton, the obvious one on the Tesla contract, could you tell us more about it in terms of technology? Are you using high-end technologies or more value-added in these ones than the ones you have in North America? And I understand that Tesla has a different supplier in North America. Would you say this also is related to Tesla increasing its supplier base? Or...

Manuel Rivera: Jorge Rada can you answer this question?

Jorge Rada: Yes. Sure. Hi, Alejandro, thank you for your question. Well, Tesla is--as you know, we are producing brake components for the auto industry through Tier 1 suppliers. So, this is-- what we produce is brackets and calipers for the brakes, that are the main two components of the brakes, and they are going to be assembled in a brake system for Tesla. In our case, we will produce an iron bracket, which is one to be delivered as cast, without any additional machining. And for the aluminum caliper, we will do the caliper, and we will do also the machining for that, okay? And that will be assembled by a Tier 1 supplier, delivered to Tesla in Europe for the new models, Y and 3, okay? So, that's--what we have said several times in other meetings is that electric vehicles, the technology for the brakes is going to be very, very similar, like actually, the same as internal combustion vehicles because they have to stop anyway. And so, what we are very optimistic about is that even though the trend for hybridization and electrification, in general, is there, and eventually, those numbers will grow, our technologies, our components are suitable very well for hybrids and electrics. So, we see a very promising future as this trend goes on.

Alejandro Azar: Thank you Jorge. And would you say you are working on other auto parts besides brakes for electric vehicles? Even you mentioned, I think, products under production or R&D.

Jorge Rada: Yes, sure. There is especially one component that is very, I would say, suitable for e-drives for the electric drives, and this is the differential case. The differential case is an iron component that needs to be iron, ductile iron. And normally, the new businesses are coming additionally with machining, which is additional value-added for our business. And we see that as this trend continues, the cars have one or two, and sometimes even four differential cases. So, it means that even with electric vehicles, there is, I would say, a potential market growth for us as these components have to be in ductile iron. And we are developing the skills to produce those. We are already making them in Europe, and we already won a business for differential cases machines in China for Volkswagen for the plant they have in Dalian.

Alejandro Azar: Excellent. And one more, if I may. You guys also mentioned that you are optimistic on the demand exceeding your capacity by 2022, especially in brakes in North America. Do you have an estimate of how much—what percentage in terms of your products is sourced regionally? Because a lot of the growth, I understand, comes from a relocation from China to North America.

Jorge Rada: Correct. Actually, there are components--I'm going to go a little bit back. When the companies, the automakers come to Mexico and they install facilities to produce cars, at the beginning, normally, they import their main components. I'm talking about Japanese, Koreans, Europeans. And then they start the relocation of components. And we are seeing a big relocation trend for brake components. So, almost all the brake suppliers--producers--are growing or installing facilities in Mexico, or growing their existing facilities in Mexico.

So, there is actually only one manufacturer that doesn't have a plant in Mexico, all of the others are already installed in Mexico, and they are growing. And based on this, we see that from about 40 percent of our portfolio in Mexico now--or three years ago was brakes, and three years from now, it will be close to 60 percent of our portfolio. So, we are already obtaining new businesses, and we are negotiating with all these customers additional business. So, we are very confident to say that in 2022, the demand in the market will exceed our capacity that we have installed right now.

Alejandro Azar: Ok Jorge, thank you. Thank you, Manuel and Jorge Mercado for your answers.

Jorge Rada: Thank you, Alejandro.

Operator: And now I would like to turn the program to Kenia Vargas for the webcast questions.

Kenia Vargas on behalf of Jorge Lagunas with Apalache Analisis: Thank you, Nicky. We have one question via webcast, and it says—"it is regarding dividends--and it says which has been the Board's position in this regard given the current environment? What is the medium-term view on dividends?"

Jorge Rada: Hi, Kenia, and thank you very much for the question. Regarding dividends, the Board of GIS decided this year to suspend dividends, aligned with the strategy to face the pandemic across all the businesses. And regarding next year, it will depend on the economy and how are we able to go back to the financial flexibility that we had previously to the COVID and then puts us back to a trend that is aligned with the original agreements that we have with our lenders. We want to be in a position in which we can continue to grow profitably.

Manuel Rivera: And complementing what Jorge has just mentioned, we feel comfortable in terms of our forecasted EBITDA generation for the following quarters. However, by the way leverage is computed, in which we use the last 12 months, we would have been in a generation in the third quarter--excuse me, the results of the second quarter. There have been instances, in which we negotiated a coverage ratio the traditional way, but just excluding the results of the second quarter. So, that certainly causes a distortion in our valuation, and it would be there until we release the results of the second quarter of this year. But the company expects by then to resume the previous dividend policy.

Kenia Vargas on behalf of Montserrat Araujo with BBVA: Okay. We have another question, and it is from Montserrat Araujo with BBVA. And it says, "Hi, good morning, everyone. Thanks for taking my question and I hope you're all safe. Going back to the volume recovery in Vitromex, how are you seeing the demand dynamics on the construction sector in both Mexico and in the U.S.? Do you think the better pricing levels are sustainable in the coming months?"

Manuel Rivera: Could you repeat the question slowly? The connection is not optimal.

Kenia Vargas: Sure. I'm sorry. It says, "Going back to the volume recovery in Vitromex, how are you seeing the demand dynamics on the construction sector in both Mexico and in the U.S.? Do you think the better pricing levels are sustainable in the coming months?"

Manuel Rivera: Yes. I think it's important--the construction in Mexico certainly is significantly better. Though it is important to point out that about two-thirds of the demand for Vitromex in Mexico is driven by remodeling. And remodeling has not been typically you see…what we've found in the past is somehow countercyclical to construction. New construction certainly has been affected, it's about one-third of the volume. Of course, there were new construction, but that's already growing--ongoing previously. So, that mix continues. So, that will maintain the market. So, --but we are forecasting in Mexico is demand probably around 10 percent lower than the pre-COVID levels. The U.S., as you probably know, has maintained very good levels of new houses, selling of new houses with some remodeling. I don't know if that answered the question.

Jorge Mercado: To complement Manuel and regarding the pricing, as Manuel pointed out, we still see a tougher environment going forward, certainly with some recovery. That might put some pressure on pricing at the end of the year. The Vitromex team has been working a lot, and as we mentioned, in production on improving service levels, and also been very active in understanding what is the right product mix for each segment. And that has helped Vitromex being able to gain pricing through mix management and revenue management. We'll continue to do that, but we do expect an environment which will be demanding and competitive as there will be a lot of capacity out there that we'll try to place in production.

Operator: And it appears that we have no further questions. Jorge Mercado, do you have any closing remarks?

Jorge Mercado: Thank you very much all for attending the call, and we wish you all to be safe.