3Q22 Conference Call Script
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Operator: Good day everyone, and welcome to G.I.S. third quarter 2022 earnings conference call. Joining us today is G.I.S. President, Mr. Jorge Rada, G.I.S. Chief Financial Officer, Mr. Saúl Castañeda, and G.I.S. Investor Relations Manager, Mr. Arturo Morales. Please be advised that this call is for investors and analysts only.

During this call, they will be discussing G.I.S. performance as per the earnings release issued on Thursday. 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 on-screen presentation.

All lines have been placed on mute to prevent any background noise. There will be a question-and-answer session after the speakers' opening remarks and instructions will be given at that time.

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. Mr. Jorge Rada will lead off the call...

Jorge Rada: Hi, good morning and thank you all for joining us today. It is a pleasure to talk to you once again.

At the face of a challenging environment that has begun to show signs of gradual normalization on certain fronts, we were able to maintain a trend of EBITDA growth and make further progress in margin recovery, thanks in large part to the contracts secured by Draxton in previous years and the benefit of indexation of raw materials and energy prices.

Supply chain disruptions, primarily in semiconductors, and escalating energy prices in Europe continue to constrain vehicle production and sales on a global scale, to such an extent that inventories still remain at historic lows and pent-up demand remains high. On the other hand, we have started to see an easing in terms of raw material procurement and pricing.

Over the coming quarters, we expect the pent-up vehicle demand and gradual normalization of the supply chain to be major drivers for the automotive industry recovery, which in turn will benefit Draxton's volumes. In this sense, we are preparing for this scenario by making

well-planned investments to expand our casting and machining capacity at all the regions where we operate.

Our outlook for future growth, particularly in EBITDA, is further strengthened by the start-up of the ongoing investments that we have announced in recent months and the new contracts won by Draxton, which are worth approximately $153 million dollars in annual revenue so far in 2022.

Regarding the sale of Vitromex, the process is still under review by the antitrust authorities. This transaction will allow us to gear efforts on strengthening the GIS auto parts business unit.

This quarter's results show we are well on track to achieve our long-term goals and that our overall strategy, including the commercial and financial fronts, has been adequate to face the headwinds of the global environment.

I will now hand the presentation over to Saul Castañeda, our CFO.

Saúl Castañeda: Thank you, Jorge, and good morning, everyone.

GIS's financial performance was greatly supported by the growth recorded in casting and machining volumes following the programs captured in previous years by Draxton and the effect of raw material and energy price indexation, which more than offset global supply chain constraints and higher power prices.

Revenues for the third quarter increased 23% year-over-year, to $305 million, driven primarily by higher volumes at Draxton and the indexation strategies deployed in every region.

EBITDA reached $38 million at the quarter, a 69% increase year-over-year, driven by the same factors that boosted consolidated revenue. This led to an EBITDA margin of 13%, compared to a 9% posted in the third quarter of the previous year.

It is important to note that this result marks the third quarter of consecutive sequential EBITDA growth and a continuation of the margin expansion that started at the first quarter

2022, thus attesting the success of our strategic approach to address the backdrop's challenges.

Earlier this month, GIS made the payment of the second installment of the Dividend approved by the Annual General Meeting. With this payment, a dividend equal to $1.41 pesos per share was distributed in total during 2022, reaching a 4.8% of annual dividend yield.

As of the end of September the Consolidated net leverage ratio continued to improve on a sequential basis, standing at 1.8 times, on the back of the stronger EBITDA generation year-to-date and a solid cash balance that remains at suitable levels.

The Company's leverage metrics would greatly improve as soon as the potential divestment of Vitromex is consummated, from which we expect to receive around $260 million dollars of net proceeds.

Regarding the investments announced in previous quarters, the different projects are running as planned, with the first phase of Draxton's capacity expansion starting with validation processes in the next quarter, this phase will increase casting and machining capacity in North America with a volume ramp-up.

Those investments are geared towards to meet up the surging vehicle production, as Jorge just mentioned, and to wind up the new business won so far this year, which are mostly programs compatible with hybrid and electric vehicles platforms.

As was mentioned in our earnings release, the completion of these investments will result in an additional casting capacity of 60 thousand tons; incorporate a new high value-added process to our portfolio; triple our machining capacity in North America; and significantly increase our machining capacity in Europe.

I will now hand the presentation back over to Jorge.

Jorge Rada: Thank you Saúl.

Well, moving on to the automotive industry developments.

Starting with North America, vehicle production was up 25% year-over-year, despite the supply chain constraints, particularly in semiconductors. Vehicle sales posted a slight annual increase, standing at same levels of last quarter, as inventories still remain at minimal levels, even with the increased pace of production. Within the next few months, semiconductor supply pressures are expected to ease, so that vehicle production and sales in North America will continue their trend of gradual recovery.

In Europe, vehicle production climbed 22% year-over-year, even as the Russo-Ukrainian war continues to exacerbate the energy and supply chain situation in the region, which in turn has caused energy and raw material prices to rise to record highs. Following the same dynamics, vehicle sales declined 4% but remained at the same levels recorded in the past quarter.

As for China, vehicle production and sales increased 25% and 23% year-over-year, respectively. On a sequential basis, vehicle production and sales climbed 41% and 31%. And this trend is expected to continue with the support of fiscal stimulus for the purchase of new units.

Now, Draxton’s performance.

Draxton's casting and machining volumes grew 17% and 41% versus the third quarter last year, respectively, mostly driven by the incorporation of new programs, which allowed us to more than offset the effects of semiconductor shortages and other supply chain disruptions. Year-to-date performance was also positive, with annual growths of 8% in casting volumes and 19% in machined parts.

In North America, we were able to keep up with the positive trends of this market, particularly with an important increase in machining volume. Meanwhile, in Europe and Asia, sales volumes received a significant boost from the new commercial vehicle programs.

As mentioned, Draxton's volumes are expected to rise as the industry gradually recovers and new production programs and capacity expansions come into operation the next quarter. And, as Saul has already mentioned, our investment plan is aligned with these expectations.

Draxton's revenue closed the quarter at $225 million dollars, an increase of 33% year-over-year, thanks to the combined effect of higher volumes and raw materials and energy prices indexations. Year-to-date, revenue increased 26% versus the same period last year.

EBITDA increased 80% year-over-year and 17% versus the previous quarter, totaling $34 million dollars, as a result of the efforts towards the indexation strategy and the higher volumes already discussed. EBITDA per ton also showing positive trends throughout the year.

Summing up, the third quarter of 2022 performance marks a step forward on our path to improve our profitability amid a complex scenario for the automotive industry.

So far this year, Draxton has won new business worth approximately $153 million dollars in annual revenue, nearly 90% of this programs are compatible with hybrid and all-electric platforms.

Now, moving on to Vitromex…

Revenue for the quarter was up 12% year-over-year, supported by the improved product mix resulting from the ongoing launch of large-size items and a favorable yet softer consumption environment, which more than offset the volume effects linked to the scheduled plant shutdowns, to carry out capacity reconfigurations and expansions.

EBITDA fell 7%, to $116 million pesos, due to the volume effects already mentioned, an increase in natural gas prices and costs related to plants' updates and capacity expansions.

Our strategic approach for this business will continue focusing on costs' reductions, introduce higher value-added items to improve product mix, and tap into the capacity expansion already completed.

Regarding Cinsa.

Revenue decreased 18%, to $428 million pesos, following softer consumption dynamics in the domestic market.

EBITDA totaled $16 million pesos, as the price adjustments to match market conditions, the introduction of new products and improved customer service were not enough to offset the effects of the downturn in the consumption environment and higher raw material costs.

Going forward, we will pursue the consolidation of our e-commerce channel, boost sales to other countries, with a larger focus on the United States, and develop initiatives to achieve greater operational efficiencies and improve productivity.

With this, I conclude my remarks for today. Thank you all for your attention.

And now we can start with the Q&A session.

Thank you very much.

Operator: Thank you. At this time, we will open the floor for your questions. Ladies and gentlemen, if you have a question, please use the "raise hand" function on your zoom tool, please make sure that your microphone is turned on.

Our first question comes from Laisha Zaack, please go ahead.

Laisha Zaack: Hi, can you hear me?

Saúl Castañeda: Yes.

Jorge Rada: Yes.

Laisha Zaack: Oh, thank you, Jorge, Saúl. Thanks for taking my question.

I would just like to ask two different ones. The first one would be in the line that if you see any short term benefit from the drop in prices of raw materials, you know, scrap has been falling quarter over quarter. So I would want to know if there's a benefit that you see from that. And the second one is that if it's possible that you could share with us the schedule of Draxton's investments and when will production ramp-up for each one of them?

Jorge Rada: Sure, thank you, Laisha for the question.

I think it's a very interesting question because during several quarters, we were discussing the metal lag impact in a negative way because prices were going up and we were suffering from the lag, you know, that we adjust prices one quarter after the prices have moved.

So, the results of this quarter are actually showing around $2 million dollars of positive impact of metal lag in this case because raw material prices are going down, not so fast as they were going up in the past, but we could see in this quarter a benefit about $2 million dollars.

We don't see the price of scrap going down in the next quarters, we think that there is going to be a price stabilization. So, if this happens, then we will not see big positives or negatives in the next quarter, but this quarter, you can see in that result $2 million dollars of benefits, approximately.

Regarding the investments of Draxton. What I can tell you is that, at the moment in operational terms, let's say launching, I will ask Saul to give you the scheduling of the investments, but regarding launching, what I can tell you is that the first line that we are adding in San Luis Potosi will start making validation parts, some tests, by the end of this year.

So, in December, end of December, or early January, we will start sending parts to our customers so they can validate the product. And that will take approximately three months more, so they can make the tests and homologate the product. And after they complete this validation process, we will be ready to start the production. So, in the second quarter, we will see the line number six in San Luis Potosi already running.

The second line, which is second line we announced as investment is going to be in production in the second part of the year.

So, next year, you will see an additional capacity during the year of two additional lines, which is about 60 thousand tons of capacity in addition to what we have today. In Irapuato, we've already announced an investment which triples the capacity for machining and adds a new process which is called plating, which is kind of coating for the parts that protect the parts from corrosion, these two processes will start production next year.

By the end of this year, we will start making some tests in the machining, we will start already making production parts in the first quarter of next year. And the plating will be starting on the second-third quarter of next year.

So next year is a year full of activity of increasing capacity. So, we are very, very happy and enthusiastic about this additional capacity which not all the companies can be saying the same, that they are growing in Mexico. We believe in Mexico; we believe in the growth of the automotive industry. And we are very happy about that. Now I will pass the microphone to Saul so he can share with you the scheduling of the investments.

Saúl Castañeda: Sure, thank you Jorge, and thank you Laisha for your question.

As just Jorge mentioned, it's a very important one. As you know, these CAPEX will be around 140 million for Draxton, just for Draxton North America and Europe, most of this investment in North America.

It is important to mention that during this year, particularly during the second semester of 2022 we are already having the CAPEX cash flows for around 45 to 50 million probably, and we will also get cash flow probably during the three quarters of 2023.

As just Jorge mentioned, the first 30 thousand additional capacity that we call the sixth line will start operations at the last quarter of this year. And basically, one year later at the end of 2023 we will have the other 30 thousand additional for this expansion.

And it is important to mention as you probably recall that we did not take any loans or credit lines for this and we are facing this with our own funds that for every casting expansion we have a credit line, so we are going to use this credit line during the fourth quarter, starting to use this line.

Laisha Zaack: Okay, thank you very much. That was very enlightening. And thanks for taking my question again.

Saúl Castañeda: Thank you, Laisha.

Jorge Rada: Thank you, Laisha.

Operator: Our next question comes from Carlos Alcaraz. Please go ahead sir.

Carlos Alcaraz: Hello, good morning. Thank you very much for the call and congratulations for the results. I have two questions. The first one is about Draxton volume. What volume of casting and machining do you estimate to finish the year? And the second

one is about the resources from the sale of Vitromex. Will they be used centrally to pay of debt? Or will you keep a part of these resources in your balance sheet?

Jorge Rada: Okay, let's start with the Vitromex resources.

Saúl Castañeda: Thank you, Carlos. As we just mentioned before, primarily we are going to use these funds to deleverage the Company, that will be our primary purpose, we would like to analyze in which proportion we would like to use these funds, each of our credits, but definitely that will be our first approach.

Then, we would like to support our organic growth as you know and as I just mentioned, so far we are dealing or facing these CAPEX investments with own resources. So, we would like to have also these net resources or proceeds available for organic growth, but also we would like to have a solid balance as well with the remaining resources of this divestment and also with the balance to pursue any inorganic possible transaction, we are not specifically pursuing anything at this moment but we would like to have the opportunity and the balance to analyze these kinds of opportunities in the near future.

Jorge Rada: Well, regarding the volume, I want to make sure that I understood the question. You would like to know, what is the, let's say, run rate of Draxton at this moment, right? Globally, in terms of volume.

Carlos Alcaraz: Yeah.

Jorge Rada: Okay, we are running around 400 thousand tons of volume per year, this is our run rate at the moment, okay, and 420, something like that, this is up and down a little bit. So, with the additional two lines that we are installing in San Luis Potosi, we will go in the next couple of years to 60 thousand tons more, okay? So this is in Mexico, we are growing because of the nearshoring, and this is where we are adding additional casting capacity.

In Europe, we don't have to add capacity, what we are doing is adding more machining capacity. And in China, we are also growing, our order book is very solid and probably in the future we will have some bottleneck opening capacity, not additional melt, sorry, casting capacity, but morely something to be able to produce a little bit more, because our order book

is really solid. So, answering your question, run rates are around 420 thousand metric tons per year, and this is growing.

Carlos Alcaraz: Okay, I understood. Thank you for the information.

Jorge Rada: If you have any additional question regarding this, very happy to answer.

Operator: Our next question comes from Alejandro Wabi. Please go ahead sir.

Alejandro Wabi: Hi, good morning Saúl, Jorge, Arturo. I just have three questions. I'll separate them.

The first one is a follow up on your last question about your run rate capacity. If my numbers are correct, let's say your practical capacity or real capacity should be around 550-570, I think that's including the new expansions. So, would that number be correct? You are operating 70% capacity utilization with the 420 figure?

Jorge Rada: Yeah, more or less, actually is going to be more than 600 thousand after the investment in San Luis Potosi, and definitely we have several plans that are running at 90% capacity utilization, some other plans are running around 60 to 70 percent, especially in Europe. But we expect that the utilization will increase as we start launching new programs that we have won in the past years, okay? So, we see the Draxton volume going, as I mentioned, from 420 to probably 500 thousand Pretty soon.

Alejandro Wabi: Okay, that's good to know Jorge.

And my other question is, I just want to pick on your brain guys regarding the industry cycle. What can you tell us about the environment in the short term, as we enter a possible recession in the coming quarters? It is interesting to see how automotive inventories are depleted even below past recessions, at levels below past recessions, and production is still growing despite lower sales. So, what are your thoughts on how the industry enters this part of the cycle?

Jorge Rada: Well, it's a very interesting question, because there are many versions, many people have different opinions. But what we have seen with different analysts is that the industry is running, I would say recession light volumes for already three years,

you haven't seen these volumes for three years in the past history, and the modern history, I would say.

So even if there is an official recession in the economy in the US, there is a lot of pent-up demand, there is no inventory in the dealers. So, the OEMs will take advantage of potential recession, and try to fill up the pipeline, okay? So, when the recession phases out, they will have the service level inventory ready for the customers to buy their brands, because remember, if you don't have the car in the US in your dealer, the people will go and buy the car that is available maybe next door or across the street in another dealer.

So this is why we are optimistic that even if there is a recession, the recession should be relatively short. And these will be taken advantage of by the OEMs, to try to hill up the inventory levels.

In addition to that, we have been awarded a lot of business, new business, for that reason, we are making these additional investments in Mexico. And with these new programs, which are in general relocation of programs from other regions to Mexico, we are very optimistic that we will be able to fulfill or to fill up the capacity of these additional two lines really soon.

Alejandro Wabi: Thank you, thank you for that color, Jorge. And the last one would be on the longer term. And I'm thinking that the proceeds from the Vitromex are already in your belly if I can say that. How do you see Draxton moving forward? I mean, do you guys see Draxton moving to a larger role in the brake system segment? Would you like to increase your footprint in some regions? Maybe having a plant in the US to strengthen your footprint in North America? How do you see the company going forward?

Jorge Rada: Well, good question. In the future, what we see is a continuation of the growth in Mexico for the North American market based on the nearshoring trend that we all know. And we see that a lot of our customers are growing in Mexico and drive from here from Mexico, they are going to deliver products for the whole North American market. Okay, we want to take advantage of that in terms of additional tons of castings, but also we see Draxton investing in growing more on value added it means machining, and potentially other processes like plating, coating, and even reassembly of additional components in some of our castings.

When you add more value, you are also increasing the loyalty from the customers, you can deliver products farther away to different regions and be able to attack markets that in the past you were not able to attack based on the relatively low value added that you are given to the product. If you are more value added, then you can travel more and your products can travel more.

That is taking over some of the operations that our customers at the moment are considering to be core business for them. But to jump from a casting company to a brake company it's a big jump. And so, what we are doing is to follow in the trend of outsourcing the OEMs that are trying to dedicate more resources for the electrification. The tier ones are taking over some activities that in the past were exclusively made by the OEMs. And to do that they are outsourcing more to the tier twos and in some cases we are tier two remember we make brake components. We sell it to a tier one. And these tier ones are outsourcing more and more value added.

We see taking over those activities and making Draxton grow but not necessarily to go and make complete breaks, because that's not our core business. And that will be, let's say, a conflict with our customers, but we are cooperating with them to try to help them with these kind of outsourcing trends.

Alejandro Wabi: Thank you. Thank you, Jorge. Great color and congrats on the results.

Jorge Rada: Thank you, Alejandro.

Operator: Once again, to ask a question, please use your right-hand function on your Zoom Tool. Please make sure that the microphone is turned on.

We have a follow-up question from Alejandro Wabi.

Alejandro Wabi: I just jump on a new one for Saul, in terms of liability management Saul, with the rates at current levels, wouldn't it be possible for you guys to actually buy the bonds at discount? Or given your strong, you know, balance sheet, I don't know, I haven't seen where are the bonds trading, but if you could share with us a little bit

on the analysis that you know, perhaps it will be better to have that, you know, that cash and invested at a current rate? I don't know. What can you tell us about that?

Saúl Castañeda: Thank you, Alejandro, very good question.

Let me ask that in two different ways. The first, I would like to emphasize at this moment the healthy leverage ratio that we have, because we are below two times net debt to EBITDA. So, we have basically a good balance and a great maturity profile. But even though as I just mentioned, the first purpose of the potential divestment will be the deleverage.

Regarding your question, we are definitely taking a deeper look on this as you just mentioned, at this moment, the bonds are trading basically at par levels. So, we could be able to prepay those at basically a hundred or par level. So, we will like to be ready to have the ability to move forward in different ways to take an advantage there. I would like to add also that at this moment a mark to market the several financial instruments, derivative financial instruments are an important asset for us, I will say around 20 million.

Those are reflecting basically the value of those instruments regarding swaps, rate swaps, and currency swaps. So, we would like to take the time to analyze the sector, the appropriate moment to prepay or to unwind those in any case. But definitely that benefit that we have at this moment as a mark to market will compensate or more than offset if we will move to a new credit line. I don't know if I made my point here, but even if we move forward with a different credit line in the future, at a higher rate, we can be compensating that or more than offsetting that with the unwinding of this mark to market of this financial instrument, derivative financial instruments, but all of those must be analyzed in a comprehensive way, regarding just the things that I just mentioned, the appropriate time and the options during before or after we have these net proceeds for divestiture, but you made an excellent point. We are pretty aware of that. And it's something that we would like to keep in the table for a deeper analysis.

Alejandro Wabi: Very clear Saul, and one more, if I may, and I'm sorry. What can you tell us about dividend policy? In the past five years or seven years Grupo Industrial Saltillo has been given shareholders a little bit more. Is there any way that we can estimate dividend

policy going forward? I don't know, a percentage of your cash generation, a percentage of EBITDA, a percentage of the net income. What can you tell us about that?

Saúl Castañeda: Sure, thank you, Alejandro. Good question also.

As you just mentioned, GIS has been very, specifically paying dividends in almost every year, since probably 2016 or even before that date, I will say at this moment, our policy is more linked to a specific amount that it is defined as pesos per share. And each year it's adjusted mainly by inflation.

But it is an important point, because basically, a couple of weeks ago, we just made an analysis, and we realized, as we already know, we confirm in that study that GIS has a great dividend yield. It's around four to five percent as an average on the last four or five years. And we made different kinds of analysis regarding, as you just mentioned, like a percent of cash, or a percentage of EBIT or EBITDA, or even net profit. But so far, I will say we will keep this policy regarding a fixed amount that is going to be adjusted annually by inflation.

But this can be revised in the future, definitely. But I will say at this moment, we believe it can be in the same way that we are just having in the past. But I would like to emphasize we are on the top, probably top five of the Mexican stock exchange companies regarding dividend yield. And as you mentioned, or probably you saw in our earnings release, we just made the second payment of the dividend for 1.41 pesos, it's around a 5% of dividend yield. And I will say for the next year an option to estimate that will be to take that amount or figure and to get an inflation adjustment.

Alejandro Wabi: Thank you. Thank you, Saul, very clear.

Saúl Castañeda: Thank you, Alejandro.

Operator: With no further question, I would like to return the call to the management for the close on the call.

Saúl Castañeda: Thank you and thank you everyone again for your interest in GIS. Please don’t hesitate to contact us if you have further questions. Have a nice day.

Jorge Rada: Thank You.