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Daniel Rojas, HDI Capital

PRESENTATION

Operator

Good morning and welcome to the GCC second Quarter 2019 Earnings Call. Before we begin, I would like to remind you that this call is being recorded and all participants will be in listen-only mode. There will be an opportunity for you to ask questions at the end of today's presentation.

At this time, I would like to turn the call over to Ricardo Martinez, Head of Investor Relations. Please go ahead.

Ricardo Martinez

Thank you, operator. Good morning everyone and thank you for joining our earnings call. With me on today's call are Mr. Enrique Escalante, our Chief Executive Officer and Luis Carlos Arias, our CFO.

Before we proceed, let me remind you that the information discussed today may include forward-looking statements regarding the company's financial and operating performance. All projections are subject to risks and uncertainties, and actual results may differ materially. Please refer to the detailed note in the company's earnings report regarding forward-looking statements.

I would now like to turn the call over to Mr. Enrique Escalante, Chief Executive Officer. Please go ahead Enrique.

Enrique Escalante

Thank you, Ricardo, and good morning everyone.

I would like to begin our call today by discussing the main drivers of our performance this quarter in those markets in which we participate. Luis Carlos will follow to review financial results and will then turn the call back to me for comments regarding this year's guidance.

Our second quarter results continued to be impacted by challenging weather conditions in most of our markets in the U.S. As is widely known, we began the year with an extraordinary winter season, with severe snowstorms and longer than normal below-freezing temperatures. During the second quarter twenty nineteen our business was adversely impacted by heavy precipitation and record floods. As a result, the start of the construction season has been delayed. In terms of distribution, the extended winter season resulted in delays which impeded our ability to deliver our products to end customers and forced us to redefine our cement plant sources and supply routes.

We are also facing a slowdown in the execution of contracted projects due to the related labor shortage in these regions. To a lesser extent, we experienced some delays in the testing and approval process of oil well cement produced at our Chihuahua plant during the quarter which is now resolved and we are currently shipping to the Permian basin.

Despite these challenges, I would like to stress the fact that our business fundamentals remain solid, with a strong customer backlog in the U.S. We are already seeing signs of recovery so far in July- particularly in cement, with initial sales volumes above our internal forecasts as the U.S. weather starts to improve. It is crucial that these favorable weather conditions continue, enabling the shipment of our considerable backlog.

Let me now turn to the key performance drivers in the U.S., starting in the South and moving North. I will then review GCC's Mexico operations.

In El Paso, Texas, infrastructure works continue to be the principal driver of growth, but at a slower pace in the second quarter due to delays at a few of our main projects. This includes works related to the Santa Teresa, New Mexico, paving projects. Also, the Biggs Airfield runway reconstruction, which was announced last quarter, was slightly delayed due to external factors but is now successfully underway.

Turning to the Permian Basin oilfields in West Texas, while cement consumption demand remains strong, we are experiencing a more competitive environment that forced us to adjust our pricing strategy accordingly to

maintain a healthy balance between volumes and profitability in this area. This resulted in lower sales volumes for the quarter, but we expect to recover these volumes throughout the remainder of the year, in many cases with higher contribution margins.

Despite some delays in the testing and approval process of oil well cement produced at GCC's Chihuahua plant on which I had commented, we have already begun shipping oil well cement to our new terminal in Fort Stockton, Texas which is now operational. This will increase our exported volumes, and we are confident it will also drive additional customers to the region while improving product availability to our current clients.

In terms of pricing, as we had previously announced, the additional eight U.S. dollar per metric ton price increase is in place since April first in all of our markets, excluding oil well cement. While we have experienced some pushback, we have achieved an average of five U.S. dollar per ton increase.

Performance at GCC's Colorado operations has been strong; in line with our expectations, supported by solid demand from public infrastructure projects which have enabled us to gain share within this market. These dynamics are expected to continue, as we are seeing new projects being bid.

Turning to the northern Midwest and Plains states, our performance in these regions was mainly impacted by the heavy rains and floods experienced into the second quarter. In particular, a Nebraska paving works project was affected during the quarter.

In the Dakotas and Iowa, demand was again driven by windfarm construction activity. Despite being more acutely impacted by weather-related delays during the second quarter, we expect this segment to remain strong, particularly in twenty twenty, due to the solid windfarm backlog we are seeing for this market supported by the federal incentives for these projects are still in place at one hundred percent through twenty twenty, after that, the incentives will be reduced twenty percent until phased out. We believe this is a segment which will continue to strengthen for our Company.

In North Dakota, we are seeing more activity from oil well cement produced at our Rapid City plant, as volumes shipped to the Bakken oil fields have been increasing.

In addition, prolonged flooding of the Mississippi river in the western area resulted in supply shortages during the quarter from other producers. As a result, we are starting to benefit from additional demand in this area.

In Montana, we continue to leverage GCC's new Trident plant to serve our Canadian customers while we address the increased sales we are seeing in both Montana and Idaho. Given the strong demand coming from these markets, and as part of our original strategy, we continue looking for the best sales mix in order to optimize our profitability in this region.

Let me now provide a brief update on GCC's Rapid City Plant. I'm pleased to let you know that the plant's stabilization process has improved significantly during the quarter, reaching production levels which will enable us to successfully meet our twenty nineteen full year demand. On our last call, we noted that we were experiencing two main issues related to certain auxiliary equipment. First, problems related to the coal mill alleviator have since been solved. Second, with regards to the conveyor belt, temporary modifications have been made to the feed system and we are working closely with our suppliers to identify the best permanent solution, which is likely to happen by year end or in the first quarter of next year.

However, it's important to note that all major equipment at the facility is running well, and as of today we have spare capacity and inventory. The efficiency of our variable cost structure is improving now that this operation is more stable, and we aim to achieve target costs at stable production rates.

Another challenge- and cost pressure- which was resolved during the quarter was the quality of coal produced and the need to buy from third parties, which impacted the majority of our cement plants. This issue has also been resolved by adjusting the mine plan accordingly, assuring higher quality coal moving forward.

Turning to our Mexico operations, we delivered strong second quarter results on the back of both price and volume growth. Market dynamics remain similar to our prior quarter, outperforming the country as a whole, with industrial maquiladora plants, warehouse construction and robust mining projects driving sales volumes. In the northern cities, the middle-income housing segment also continued to show strong demand.

Finally, regarding our Sustainability efforts, as an active member of the Global Cement and Concrete Association, we have established our main goal of reducing net CO2 emissions by nine percent by twenty twenty and by thirty-one percent by twenty thirty. In addition, we are currently working on additional long-term targets, which will be developed by year-end.

I would also like to share with you some of the key highlights from the annual sustainability report we released in April, available in our webpage:

- The use of biomass fuel at GCC's Juarez plant reduced CO2 emissions by thirty-eight percent in twenty eighteen
- Rapid City has permanently shut down two wet kilns
- Two GCC cement plants earned an EPA Energy Star certification, one which achieved the highest possible score
- GCC's Mexico's Great Place to Work ranking increased to thirtieth place, from our seventy fifth place in twenty seventeen
- Twenty nineteen was also GCC's fourteenth consecutive year being recognized as a Socially Responsible Company by the Mexican Center for Philanthropy

The above is another example of our commitment to building a stronger and a more sustainable company, in line with our overall focus on ensuring we employ global best practices throughout our organization.

Let me now turn the call over to Luis Carlos to review the quarter's financial results and I'll return for some closing comments.

Luis Carlos Arias

Thank you, Enrique, and good morning to everyone. Let me begin by reminding you that results for the Trident plant in Montana were consolidated effective July first, twenty eighteen. Our results also reflect the reclassification of the Oklahoma and Arkansas ready-mix assets sold in June last year as discontinued operations. Prior period results have been restated in accordance with IFRS-five, including sales, costs, expenses and volumes.

Consolidated net sales for the second quarter increased by three point five percent and decreased one point one percent on a comparable basis, excluding the sales from the Trident cement plant acquired last year. This was mainly driven by the decline in comparable sales in the US which was partially offset by the strong performance of our Mexican operations and better prices in both countries.

Pricing dynamics in general continued to be favorable during the second quarter of twenty nineteen.

Mexico performed above our expectations, with sales growing eight point four percent year on year boosted by growth in volumes and better price environment, which was also supported by segment sales mix.

Cost of sales as a percentage of revenues increased two point eight percentage points compared to the prior year quarter mainly reflecting an increase in variable costs in concrete and variable selling expenses at our coal mine, as well as at our Rapid City Plant related to the last part of the operational ramp up process. In addition, higher operation expenses associated with the coal mine operations and the recent acquisitions which we did not have last year as well as higher depreciation expenses. Finally, we saw an increase of lower margin oil well cement sales from our Tijeras plant to the West Texas markets also impacted this cost line

In Mexico we continue to see pressures in energy costs; the electricity rate has increased by around thirty-five percent year to date as compared to first half of twenty eighteen, but, as we had previously mentioned, we are working on alternatives in the form of renewable energy and we have already selected a new long-term electricity generator which we expect will drive significant future cost savings in the beginning of twenty twenty-one. We will be sure to provide relevant updates as they unfold.

Regarding fuel, aside from the effects of previously purchased and poor-quality coal produced, as Enrique had discussed, we are in the process of increasing the usage of alternative fuels whenever possible at all GCC cement plants in order to achieve between twenty to forty-five percent substitution rates in the mid-term.

Operating expenses as a percentage of sales increased one point two percentage points in the quarter, mainly due to higher corporate expenses due to the activation of the Long Term Incentive Plan, a share-based bonus awarded to our top management tied to ROIC achievement, and the cost reclassification as a result of the creation of the Corporate Technical and Operations Office which began operations in the first quarter of this year. While these expenses were previously recorded under cost of sales, most have since been reclassified to the operating expenses line.

EBITDA increased two point two percent in the second quarter, with the margin contracting zero point four percentage points to twenty-nine point five percent

As we mentioned on our previous call, EBITDA this year and hereafter will benefit from the implementation of IFRS sixteen due to the fact that the majority of the former rental expenses from operating leases is now reflected in amortization increasing this year's EBITDA around eighteen million dollars, neither impacting net income nor free cash flow.

Net financial expenses fell nineteen point three percent in the quarter due to a decline in interest expense and lower debt balance as a result of the successfully refinancing of all of our debt, as well as the absence of fees compared to the second quarter of twenty eighteen.

Income tax, by contrast, increased four point three million dollars year on year mainly due to the higher share of Mexico's pre-tax income in the consolidated result, which carries a higher income tax rate.

Consolidated net income increased three hundred ten percent to twenty-five point one million dollars in this quarter.

Moving to our cash generation, due to the seasonal nature of our business, free cash flow remained negative in the second quarter of twenty nineteen, at fifteen point two million compared to two million dollars last year, mainly reflecting lower EBITDA generation after operating leases, an increase in working capital needs, due to higher inventory balance as a result of lower sales and in preparation for the peak construction season, and higher cash tax expenses. Lower interest expenses, lower maintenance capex and a reduction in other expenses and provisions partially offset this increase.

We have maintained a strong balance sheet and efficient capital structure that will enable us to deliver strong shareholder value through the combination of strategic and prudent investments in our business to continue growing and increased dividend distributions- all while maintaining a healthy leverage ratio. As of June twenty nineteen our net debt to EBITDA leverage ratio stood at one point eight times, significantly below industry average level.

During our Annual Shareholder meeting in April, an annual dividend payment of zero point eight Mexican pesos per share, was declared, and the Board of Directors approved yesterday for it to be paid on August fifteen of this year. This represents a fifteen percent increase compared to last year's dividend payment.

With that, I will now return the call over to Enrique to discuss the new guidance and for his closing remarks.

Enrique Escalante

Thank you, Luis Carlos, While the underlying trends of GCC's business remain solid, based on the performance of the first half of twenty nineteen, we are revising our guidance for the full year.

We now expect total cement volumes in the U.S. to increase three to five percent year over year with a one to three percentage point increase on a like to like basis, compared to our previous range of four to six percent and two to three percent increase, respectively. Labor shortage continues and the length of the construction season is hard to predict. Therefore, we do not expect to be able to recover the full volume decrease in the balance of the year.

We are expecting volumes at our ready-mix business to remain flat for twenty nineteen, as compared to our prior guidance range of an increase between six to eight percent. This is due to the substantial windfarm volumes we had previously expected during twenty nineteen to be pushed back to the twenty twenty period and additionally this segment was more acutely impacted by weather conditions previously discussed.

In terms of pricing in this market, our guidance remains unchanged.

Turning to Mexico, although this business has performed above our expectations, we remain cautiously optimistic given the political and macroeconomic uncertainty, but expect performance in Chihuahua to continue to surpass Mexico's overall performance. Therefore, we maintain our Mexico outlook for this year.

Regarding profitability, we now expect EBITDA to grow between fifteen to seventeen, year over year, and between seven and nine percent on an adjusted basis, excluding the IFRS sixteen accounting impact. Our estimates for capital requirements remain unchanged, but on the back of lower EBITDA generation, we expect free cash flow conversion to be above forty percent and net debt to EBITDA ratio to be around one point one times.

I would like to take this opportunity to reaffirm our unwavering commitment to our shareholders. We are committed to generating long-term value. While our Company has faced a challenging operating environment, which has impacted certain aspects of this and last quarter's results, we remain focused on those areas and variables within our control, particularly related to our fixed costs, as we streamline our cost and increase our sales volumes in an efficient manner.

With that, this concludes our prepared remarks and we are now ready to take your questions.

Operator, please go ahead.

Operator

Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, it is star, one if you would like to ask a question.

We will take our first question from Dan McGoey with Citi.

Daniel McGoey:

Good morning, gentlemen. Thanks for the call. Just wondering if you could talk a little bit more on the engine energy front. You mentioned both the lower quality of coal mined as well as purchases from external sources. Could you quantify exactly how much additional cost that represented, maybe in terms of margin points in the first half of the year and what do you expect, given the solutions that you mentioned? Then, Enrique, as well, you mentioned about volume opportunities from shortages of supply the Mississippi River region. Can you talk a little bit about how significant that might add to volumes, as well as—I guess that's a longer distance to ship; would that be a lower margin or higher-margin than your other U.S. business? Thanks.

Enrique Escalante:

Hi, Dan. Good morning. Thank you for the questions. Let me start with your second question on volumes on the Mississippi while we look for more specific answers on your first question. The additional potential volumes that we can get related to deploying (phon) of the Mississippi are basically in the same market areas as we're already shipping, namely the Twin Cities market, Eastern Iowa, and those regions. These don't represent any additional distances or cost of shipping costs for us, it's just incremental volumes. What we're evaluating at this moment in terms of volume is precisely how much we will have available because we committed already volumes to our customer base there. We are telling them we're going to supply to you all the volume that we've committed at the current negotiated prices, and any increase over those committed volumes to them or to additional customers is going to come certainly at a higher price depending on the supply/demand balance, as we expect the other producers to continue to have enough product available in the region.

We are at the moment assessing that potential volume, Dan. I can tell you that today we may be looking at around 50,000 to 100,000 tons of volume, but we cannot commit at this moment to that volume yet because it's being negotiated with the customer base.

In terms of the energy issues we had specifically related to the coal seams (phon) at the mine, we were going in the mine to what we call a parting (phon). This is rock and sand in between the seams which lowers obviously the quality of the coal once it's extracted. We were placing these mining conditions during the first quarter of the year. Then during the second quarter what we did is to change the mine plan to go to other different areas in the mine where the seam was of better quality. This improved immediately the quality and now all the plants are receiving high-quality coal, and the efficiencies in the (inaudible) have returned to normal levels.

Also, given that problem, we didn't have enough coal the first part of the year, so we had to purchase I think around 40,000 tons total in the year from the third parties, which is basically coal that we ship to the plants, obviously no profit compared to our own mine-produced coal. Everything has been resolved. We don't have to buy any more coal during the second part of the year, and if the mining continues as it is today, we'll have a second half of the year with totally normal cost and quality conditions on the coal side.

Luis Carlos Arias:

I can add, Dan, that of the 2.8 percentage points that I commented on my remarks, almost 1 percentage point is due to both of those two things, the increase coal cost between the quality of the coal and higher freight because we have to buy coal from a third-party. The 2.8 percentage points, almost one percentage point in both the problem that we have with the coal and Mexico's increased cost in power.

Daniel McGoey:

Got it. Thank you very much

Enrique Escalante:

Thanks, Dan.

Operator:

We will take our next question from Eric Neguelouart Bank of America.

Eric Neguelouart:

Hi. Thank you for the call. I'd like to ask about guidance, a couple of questions. First, in the U.S., in the first half of the year volumes are down 1%. Can you explain the rationale for the 3% to 5% guidance? You won't have inorganic growth in the second half of the year and organic volumes are down 8%. Regarding guidance, the lower guidance is only a result of lower volumes in the U.S. or should we continue seeing cost pressures like we've seen in the first half? Thank you.

Enrique Escalante:

Eric, good morning and thank you for your question. Again, I will address the second part of the question first. All the volume decrease in terms of the guidance decrease in terms of—it's totally related to the U.S. and weather shipping conditions. Again, if we continue to have a good weather for the second part of the year, we will ship the backlog and that will not change what we have forecast for the second part of the year. However, since we already lost some volume on the first two quarters, it's going to be a hard to recover those volumes. The main reason for that is, number one, having enough good weather days to ship the volume. The second part is that it's hard to recover given the labor shortages. Basically, what we have been noticing in the markets is that once we lose a day or two or three or whatever because of weather, in the past those volumes were easy to recover by people working overtime or during weekends to recover and catch up on those projects. That is not happening anymore as we see in the industry, at least in the regions where we are, because there's not enough labor to cover for those volumes.

Again, in summary, the loss volume is weather related. It's related to the first half of the year and we expect to be okay in the second part of the year.

Talking about the pushback that I mentioned on pricing, we don't expect to see any more of that in the second part of the year. We feel prices have stabilized for us after the discussions that we've had with customers and the actions we've taken, and as I mentioned in the report, in many cases we're looking at a higher margin after the shuffling of some volumes with some customers during the first part of the year. So, pricing should be stable for the rest of the year.

Eric Neguelouart:

Understood. Thank you.

Operator:

We will take our next question from Ramon Obeso with Scotiabank.

Ramon Obeso:

Hi. Good morning, Enrique, Luis Carlos. Thank you for the call. Two questions, if I may; the first one is a follow-up question on the cost increases we saw in the quarter, especially at the coal mine. Based on previous

questions, should we consider this as a short-lived event; is that correct? My second question relates to the contraction in EBITDA margins in Mexico. Could you give us additional color on this? I mean, is it all about energy and fuel cost increases? Is there anything else that we should be aware of? What levels of EBITDA margins should we expect in the coming quarters in Mexico? Thank you.

Enrique Escalante:

Ramon, good morning and thank you for the questions. Can you repeat just briefly the first question on the coal?

Ramon Obeso:

Yes. If the coal expenses that we saw this quarter are short-lived event?

Enrique Escalante:

Yes. Okay, yes. I thought that's—no, thank you, Ramon. I think that's what I heard. I just wanted to reconfirm. Yes, definitely, I mean, it's behind that completely. Again, I mean, the incremental costs, because of purchasing coal and the incremental cost because of lower coal quality, both of those two factors impacting the costs are behind us and we don't expect to have that going forward.

I will let now Luis Carlos answer your second question on the Mexico margin.

Luis Carlos Arias:

Yes. Hi, Ramon. Yes, basically, the problem that we have with the fuel and power in Mexico are the main explanations. Also, we include corporate expenses in our Mexican operations, so this quarter and the first quarter, as I said, with the activation of the long-term incentive plan and the reclassification of some expenses that we used to have in custom sales of the new office that we created, that is impacting the margin of the Mexican operations. But that's because how we treat the corporate expenses in our numbers.

Enrique Escalante:

Just to elaborate a little bit on what Luis Carlos is saying, I think that in summary we can say that the only permanent cost increases we are seeing going forward are the power costs in Mexico because, of course, as I said, the fuel cost is going to go down, so the power cost compared to last year, it's so far permanent for the rest of the year, and, of course, the long-term incentive plan that we didn't have last year is also a permanent increase going forward. Having said that, I think that the margins for the Mexico division will remain at the focus levels for the rest of the year.

Ramon Obeso:

Will remain at what level, sorry?

Luis Carlos Arias:

No. What Enrique means is that we don't foresee any reductions going forward aside from that impact that we had during the first half.

Ramon Obeso:

Okay. Thank you. Thank you very much.

Luis Carlos Arias:

You're welcome. Thanks.

Operator:

We will take our next question from Mauricio Serna with UBS.

Mauricio Serna:

Hi. Good morning and thanks for taking my questions. Just a couple of things I wanted to go over. On the U.S., for the numbers that you provided on the press release, it seems that you still managed to expand EBITDA margins. I just was wondering if that was all due to IFRS 16. I mean, excluding that, is there a decline? Then I was also wondering about, you also included in the press release some of the pressure or some of the additional expenses in the U.S. came from the acquired operations. Are these related to integration expenses or what kind of expenses are we talking about since the operations were acquired almost a year ago? Then finally just on the revised guidance, looking at the numbers without the IFRS adjustments, if you are looking for 15% to 17% EBITDA growth this year, it means that it's an implicit growth, I think, roughly about 30% for the second half the year. I just was wondering, seeing that nothing's going to change on the Mexico margins and, I mean, you are implicitly guiding for declining volumes in the second half, if it all comes down to the U.S., how much growth or how are we seeing that growth being reconciled to reach the lower end of the guidance? Thank you.

Luis Carlos Arias:

Hey, Mauricio. On the first question, if you remember, we had the divestment of the Ready Mix assets last year, so there's a big increase in margin of the U.S. operations with the asset swap that we did. The cement operations are significantly much more profitable than the Ready Mix assets that we sold, so that's a big impact in our reduced (phon) operations, not just for the first half but also going forward.

Can you repeat your second question please?

Mauricio Serna:

Yes. Just was wondering what kind of expenses were incurred on the acquired operations, I mean, related to integration or, I mean, just because it's been almost a year since the acquisition.

Luis Carlos Arias:

Yes. Well, it's basically on the fixed cost side is the incorporation of that operation in our P&L since we treat the Ready Mix asset that we sold, those are way below on the discontinued operations so, above, in the cost part of the P&L we are incorporating the fixed cost part of the new operations, meaning our fixed expenses and depreciation and all. That's the main thing.

Mauricio Serna:

Got it. Related to the guidance for full year and the implicit growth in the second half?

Luis Carlos Arias:

Can you repeat that question please?

Mauricio Serna:

Yes. Sure. Just looking at the numbers from the guide, you have a 15% to 17% growth excluding the IFRS, which doing the numbers, it implies a 30% growth in the second half of the year. But, then again, you're kind of implying lower volumes in Mexico and stable margins from what you've seen in the first half, which is a decline versus last year. It all seems that it comes down to U.S. to reach the full EBITDA growth, so just trying to understand to reconcile these numbers, just to understand where are the improvements from U.S. coming from exactly?

Luis Carlos Arias:

Yes. Well, as we explained, there is a strong backlog in the second half of the year and it's the big construction season. A lot of the increased margin and increased EBITDA during this second half of the year is explained by operating leverage because we are going to ship quite a big part of the annual volume during this second half of the year. If you take into account the operating leverage, and as Enrique explained in his remarks, we're very focused on controlling fixed costs so that explains how we get to the guidance of EBITDA numbers.

Mauricio Serna:

I guess are we good to assume EBITDA margins north of 30% for the second half in the U.S.; would that be a fair assumption?

Luis Carlos Arias:

I will defer that back to Ricardo if you'd like, during our calls with him, to give more color on that, and, of course, to everybody on the call.

Mauricio Serna:

Thank you.

Luis Carlos Arias:

Thank you, Mauricio.

Operator:

We will take our next question from Adrian Huerta with JP Morgan.

Adrian Huerta:

Thank you. Good morning, everyone. Two questions, one is just what is the level of annual sales that you expect to have in Canada; and the second question is if you're still seeing opportunities to do a catch-up on cement prices in the acquired assets of Montana. Thank you.

Enrique Escalante:

Hi, Adrian; this is Enrique. Thanks for the questions. So far we haven't changed significantly the plan of splitting the volume between—of the Montana plant between the U.S. market and the Canadian market. We continue basically with our original plans of shipping around 108,000 tons to Canada. We are, as we mentioned during the call, seeing a potential optimization by taking on some more additional volume in Montana and Idaho, given that those states have currently better margins than the Canadian market. However, since we have a long-term

view and treat our customers with long-term commitments, I mean, we won't do any drastic changes in the short-term. But the optimization will come more from optimizing the whole logistic systems and seeing if with the new capacity in Rapid City we can divert more volume towards Idaho and Montana.

In terms of—I'm sorry, the second question, Adrian, was?

Adrian Huerta:

Was on price, Enrique, potential catch-up on prices in Montana.

Enrique Escalante:

Yes. The pricing is going well in Montana, no main issues, no push back in that market or in Canada. In Canada, we're going as we had agreed originally in terms of pricing with the customer base there.

Adrian Huerta:

Understood. Thank you, Enrique.

Enrique Escalante:

Thank you, Adrian.

Operator:

We'll take our next question from Chelsea Colón with Aegon. Please go ahead.

Chelsea Colón:

Hi. Thank you. I just have a couple of questions. Regarding the electricity situation in Mexico, can you give a little bit more color around that and this long-term supplier that you've selected; is it renewable energy or regular conventional energy? I think you mentioned that you're expecting benefits beginning in 2021, but before I thought you said the benefits would begin as early as next year, so any more information you can give on that would be helpful. Then also, could you provide us some more granularity on the utilization rates right now at the Montana plant, the Rapid City expansion, and the Mexican kiln that you reactivated recently?

Enrique Escalante:

Hi, Chelsea. Good morning. This is Enrique. On your first question on powering Mexico, definitely a big impact compared to last year as we have mentioned in several forums that the central power company in Mexico increased rates in the second half of last year, so we're seeing around a 35% increase year-over-year in power cost for the Mexican plant. That's the effect that we have been mentioning on the cost side. Long-term supply, we are in the process of negotiating a contract. At this moment we're in the final phase of that contract negotiation. The power is going to be bought from a new generator totally for renewable energy. The benefits are going to be, as you mentioned, coming in on 2021. The whole next year is still going to be basically with CFE here in Mexico because the renewable energy plan that we're talking about in question here is still under construction in its final stage; it's going to be operational next year.

In terms of the utilization rate of the plants in the U.S., Montana is going to be running at full capacity, same as the new kiln in Mexico—I mean, ironically, it's an old kiln but the new production of that kiln. It's a small kiln, about 130,000 tons and it's running now and we expect to keep it running at capacity for the rest of the year.

In terms of Rapid City, we're trying to get some numbers here to give you that's a more specific answer. The plant is going to be running basically at 70% of its capacity for the rest of the year.

Chelsea Colón:

Can you remind me exactly when that facility started up?

Enrique Escalante:

December of last year.

Luis Carlos Arias:

The expansion, yes.

Enrique Escalante:

Yes, the new capacity.

Luis Carlos Arias:

The expanded capacity, yes.

Chelsea Colón:

So, 70% utilization is the average for the year or just for the second half of the year?

Luis Carlos Arias:

This is the average for the year. As Enrique explained in his remarks, it's more than enough to serve those markets since we expanded our plans from around 700,000 tons to a little bit more than a million tons. Without the utilization, it's more than enough to serve our customers there.

Chelsea Colón:

Okay. Thank you.

Luis Carlos Arias:

Thank you, Chelsea.

Operator:

We'll take our next question from Cecilia Jiménez with Santander.

Cecilia Jiménez:

Hi, guys. Good morning and thanks for the call and taking my questions. Most of them have been answered already, but I have two follow-ups. Number one, in terms of EBITDA margins, I believe I have two questions. Do you think do you foresee in the near term it could be possible to reach pre-crisis levels of EBITDA, meaning roughly 33%, 34% EBITDA margin? That's number one. Number two, also in the U.S. specifically—I'm sorry if you mentioned this before, I got cut-off, but do you foresee additional price increases during second half of the year to combine with the increasing operating leverage you will have there? I believe that would drive margin up. Those are two questions.

Finally, in Mexico, any specific dates to have the implementation of substitution of energy in terms of utilization of alternative fuels? Those are my three questions. Thanks.

Enrique Escalante:

Good morning, Cecilia. This is Enrique. How are you? Thanks for the questions. I'll start with your second question in terms of price increases, the potential for additional price increases in the U.S. in the second half of the year. No. Today we don't see enough appetite for an additional price increase in the U.S. in general. As I mentioned, there may be some opportunistic price increases given the supply/demand issues in the Mississippi River. Those will be, obviously marginal compared to the whole market where we operate.

Cecilia Jiménez:

Okay.

Enrique Escalante:

Having said that, we said in the last call that we were working with the oil well service companies in the Permian Basin, talking about potential price increase in October. That's still under discussion. That may be a price increase that we could see in the last part of the year, but it's still early to say. This was basically a result of us not being able to bring in the Chihuahua new capacity on time because of the testing protocols that was also discussed earlier, so things have been delayed a little bit there.

Cecilia Jiménez:

Okay.

Enrique Escalante:

In terms of Mexico, I didn't understand your question. I think it was on substitution of alternative fuels for the plants in Mexico?

Cecilia Jiménez:

No, for Mexico and the U.S. as well, but I believe Mexico is a little bit far behind on that.

Enrique Escalante:

I'm sorry. Okay. We have here our goal for the Chihuahua plant. It's to reach 30% substitution. I can tell you there that we have fully implemented what we call the project here in Chihuahua, and last month we commissioned the new burner in the main kiln to be able to burn more alternative fuels, and everything is going well. We still have to tweak the system a little bit with one fan that's a little bit underrated capacity, but that's something simple to resolve. We should be reaching around 30% substitution midterm in the Chihuahua plant.

Juarez we've gone up to 45% and we're doing some changes in raw materials at the moment required by the large (phon) company in the U.S. that we sell the specialty product from Juarez. That has resulted in a temporary reduction and uncertainty (phon) fuels, but we don't see a problem to go back to 45% levels which was already reached.

Same thing for Samalayuca. Samalayuca should be able to reach a 45% substitution.

Pueblo is the only plant in the U.S. that is running on alternative fuels, mainly at TBS (phon). There are some plants still burning some other biomass fuels there and the permits are in place, so we expect to be able to reach around 20% to 25% substitution by the end of the year and with the potential to continue to increase that substitution going on next year.

In terms of your first question, I will defer that to Luis Carlos to see if we can reach—I mean, you said, if I understood well, prerecession EBITDA levels; are you meaning prerecession pre...

Luis Carlos Arias:

Yes.

Cecilia Jiménez:

(Inaudible) around above 33% basically.

Luis Carlos Arias:

Yes, but was your question specifically if we continue to have that objective going forward?

Cecilia Jiménez:

Yes, and if there's a timeframe for that.

Luis Carlos Arias:

Yes. Basically, we are very focused on reaching that EBITDA margin. We think it's a very feasible. If you see the last couple of years, we have done great steps in achieving that. In terms of timeframe, it's difficult to say it, but I can tell you that every member of this Company knows about that objective, so we're very focused on achieving that target.

Cecilia Jiménez:

Okay.

Enrique Escalante:

Obviously, the projects that we've been discussing reduces specifically obviously targets like the power substitution in Mexico and the increase of alternative fuels at all the plants.

Cecilia Jiménez:

Muy bien. Thank you.

Enrique Escalante:

Thank you, Cecilia.

Operator:

We will take our next question from Pedro Sabregat with Compass Group.

Pedro Sabregat:

Hi. Good morning, Enrique, Luis Carlos, and Ricardo. Thanks for taking my question. Just wanted to ask a little bit more on the IFRS 16 impact that I see that based on the data provided on the 1-Q, the impact was close to 600 basis points while in 2Q the impact was closer to 250 basis points on the margin. Can you give a little bit of color on the impact of these measures, the IFRS 16, going forward? Is there a chance you could give us the full 2018 EBITDA margin with IFRS? On the other hand, is it fair to assume that most of the impact comes from the U.S. operations? Thank you.

Luis Carlos Arias:

Yes. Hi, Pedro. I can tell you that on an annual basis, the effect of the IFRS is around \$20 million and it's a split evenly during all quarters; and, yes, most of it is in the U.S. where we have the big part of the leases. It's around \$5 million each quarter, so you can run your numbers with those \$5 million per quarter and \$20 million on an annual basis.

Enrique Escalante:

More specifically, Pedro, the leases in the U.S. are basically the rail car fleet to move the cement, which is around 2,000 rail cars that are permanently on lease, the rest is just small light vehicle fleets.

Luis Carlos Arias:

A quick correction; it's around \$18 million, the annual impact of the lease because \$2 million are included in the financial expenses. So, it's \$18 million on the EBITDA level and \$2 million on the financing expense.

Pedro Sabregat:

Okay. Thank you very much.

Luis Carlos Arias:

Thank you, Pedro.

Operator:

We will take our next question from Carlos García with Signum Research.

Carlos García:

Hi, everyone. Thank you for the call. I only have one question remaining and it's in order to (inaudible). How much (inaudible) do you expect to increase the production of oil well cement for the rest of the year?

Enrique Escalante:

Carlos, this is Enrique. Thanks for the question. Oil wells production increase for the rest of the year, it's basically around 50,000 tons in the Chihuahua kiln and approximately another 50,000 to 100,000, depending on the (inaudible) on the Tijeras plant. This is incremental production that has been shipped to the Permian Basin in addition to the Odessa (phon) plant being sold out at full capacity.

Carlos García:

Okay. I see. Thanks.

Enrique Escalante:

Thank you, Carlos.

Operator:

As a reminder, it is star, one if you would like to ask a question. We will take our next question from Alejandro Azar with GBM.

Alejandro Azar:

Hi, everyone. Good morning and thank you for taking my questions. I just want to get more color on the dynamics of each market. If you could, mainly in Mexico, if you could explain about which sector is getting all the potential? I just want to know if, for example, the informal sector is declining in Chihuahua also as it is declining in the whole country. I don't know if we can start with that one.

Enrique Escalante:

Alejandro, good morning. Yes. Thank you for the question. Of course, we can start with that one. Informal sector, generally speaking, has been declining in Chihuahua as a state. However, most recently we have seen a small, slight improvement in Ciudad Juarez given the full employment in the city and, of course, because of the economies being tied mostly to the U.S. economy. Juarez has been a little bit of a change, let's say, a little light at the end of the tunnel because the segment has been not growing in the year.

Other sectors that have been doing better, as we spoke before, are the commercial construction, again, in Juarez with industrial buildings or maquiladora type operations; some mines remain renewing their contracts in the Chihuahua Mountains, certainly at a little bit more price pressure than last year, but, still, the volumes are going forward.

Middle-income (inaudible) yes?

Alejandro Azar:

Yes. Can you remind us how much of your volumes, the percentage goes to Government-related projects?

Enrique Escalante:

Yes. We'll give it to you. Let me ask Ricardo to look for the right number, but it's very minimum. We have basically some work going on in Juarez for the second part of this year with some street saving in a couple of overpasses. That will probably total 7% to 8% of our shipments in the state of what's Government infrastructure. It's really, really minimum.

That's mainly the mix in the Mexican market. As we mentioned, we're certainly concerned given what we've been seeing in the rest of the country and it forces us potentially becoming also to Chihuahua in terms of decrease of the overall market.

Alejandro Azar:

On the U.S., would you say the infrastructure sector is outperforming the residential or which one has the delta in the growth?

Enrique Escalante:

Definitely infrastructure. It's running strong in most of the markets where we participate.

Alejandro Azar:

Okay. Thank you, Enrique.

Enrique Escalante:

Thank you, Alejandro.

Operator:

There are no additional phone questions at this time. I would like to turn the conference back. I do apologize. We did get one question from Daniel Rojas with HDI Capital.

Daniel Rojas:

Hello, gentlemen. Thank you for the opportunity for making the question. Just a follow-up on the previous one, you said infrastructure is running strong in the U.S. I just wanted to understand is this at the Federal level or this is State spending? Thank you.

Enrique Escalante:

Daniel, thank you for the question. Mostly infrastructure, although there's some State spending, I will say, because in many Federal projects there're matching funds from the State, specifically in infrastructure and paving and those sorts of projects. But, the funds are mainly coming from the Federal level.

Daniel Rojas:

Do you think this will continue or the mix between those two sources of funds, how should it behave in the next following month?

Enrique Escalante:

We expect it to continue obviously at a slower pace in terms of bidding. Bidding usually happens mostly at the beginning of the year. As we said in the report, as of last month we were still seeing some bidding of projects which is not very usual and it's a reflection of how strong the sector is going, from one hand, and, of course, that it has been delayed from last year and this year because of weather, as we explained, in another hand. But, we expect it to continue to be strong the rest of the year and also coming into next year, as we explained, for example, with the wind field farm project that we have (inaudible) in Iowa.

Daniel Rojas:

Okay. Understood. Thank you.

Operator:

I would now like to turn the conference back to Mr. Enrique Escalante for any additional or closing remarks.

Enrique Escalante:



Q2 2019 Earnings Conference Call

Thank you for joining us today, we appreciate your interest in our company. We look forward to meeting more of you over the coming months and providing relevant updates. In the meantime, our team remains available to answer any questions that you may have. Thank you and enjoy the rest of your day.

Operator:

Thank you. Ladies and gentlemen, this concludes today's call and we thank you for your participation. You may now disconnect.