Q1 2014 Earnings Call

Company Participants

- Edmar Prado Lopes Neto, Chief Financial & Investor Relations Officer
- Paulo Sergio Kakinoff, President & Chief Executive Officer

Other Participants

- Bob McAdoo, Analyst
- Duane Pfennigwerth, Analyst
- Marcela Nagib, Analyst
- Richa Talwar, Analyst
- Savanthi N. Syth, Analyst
- Stephen Trent, Analyst
- Tom Kim, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and thank you for waiting. Welcome to GOL Airlines' First Quarter 2014 Results Conference Call. With us here today, we have Mr. Paulo Kakinoff, CEO; Mr. Edmar Lopes, Chief Financial and IR Officer; and Mr. Eduardo Masson, Financial and Investor Relations Director. This event is being recorded and all participants will be in listen-only mode during the company's presentation. After GOL remarks, there will be a question-and-answer session. At that time, further instructions will be given.

This event is also being broadcast live via webcast and may be accessed through GOL's website at www.voegol.com.br/ir where the presentation is also available. Participants may view the slide in any order they wish. The replay will be available shortly after the event is concluded. Those calling the presentation via the webcast may post their questions on our website. They will be answered by the IR team after the conference is finished.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of GOL management and on information currently available to the company. They involve risks and uncertainties because they relate to future events and therefore depend on circumstances that may or may not occur. Investors and analysts should understand the conditions related to macroeconomic condition. Industry and other factors could also cause results to differ materially from those expressed in such forward-looking statements.

Now I will turn the conference over to Mr. Paulo Kakinoff. Mr. Paulo, you may begin your presentation.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you. Hello, everyone, and thank you for being with us in our earnings conference call.

Let's begin our presentation with page number three in which we bring the highlights of the first quarter of 2014. Net revenues increased 20% over the first quarter of 2013 or R$411 million. First, we've reached the record level for our first quarter of R$2.5 billion. The operating results, EBIT was 43% higher than the first quarter last year, reaching R$144 million and an operating margin of 5.8%. The EBITDAR also had a strong evolution and totaled R$493 million, which allowed GOL to reduce its financial leverage from 27.9x to 6.5x, following our strategy of gradual deleveraging.

Still on page three, we show record levels on the last 12 months in net revenues and EBITDAR of R$9.4 billion and R$1.7 billion, respectively. The operating result, EBIT, reached R$309 million in the same period, representing an increase of R$1.1 billion against the last 12 months. Our focus on increasing revenue generation and cost control can be noticed in the last 12 months RASK and CASK indicators, which grew by 18% and 3%, respectively.

During the quarter, CASK increased by 17% due to the scenario of record fuel prices, which reached R$2.62 per liter, the highest for a quarter and also the 18% depreciation of the real against the average dollar. Even with this scenario, RASK has increased by 18% on the quarter, up by 1.2 percentage points compared to the CASK. The spread between RASK and CASK has been improving margins quarter-by-quarter.

On the liquidity side, our cash of R$2.8 billion remained in the high levels, representing 30% of the net revenues for the last 12 months. We understand that this is an important strength to go over times of an adverse macroeconomic scenario.

On slide number four, we present in a more detailed way the significant increases in revenues, EBIT and EBITDAR, as well as operational costs, which, as said, has been under pressure by the devaluation of the real and a scenario of record fuel prices. It's important to note that the increase in revenue was 20%, exceeding the increase in costs which is a record 18% in the quarter.

On slide number five, we evaluate EBIT and EBITDAR over the last 12 months quarter-by-quarter. On the EBIT side, we achieved an improvement of R$1.1 billion against the first quarter last year. And shortly, I'm talking on the average of the last 12 months. This led to a cumulative operating margin of 3.3%, an improvement of 13.4 percentage points. On the EBITDAR side, the increase reached R$1.3 billion, totaling an EBITDAR of R$1.7 billion on the last 12 months.

Turning to slide number six, I share with you our operational improvements. Using metrics that involve costs and revenues, we can see the results of GOL's commitment to become more efficient. The indicator of the net revenues per employee improved by 58% since 2011. The same trend is observed in the RPK indicator by the number of employees which improved by 34%. On the efficiency side, we bring two indicators: revenue per flight and fuel consumption in liters per RPK. In both indicators, we can also notice significant improvements.

On slide number eight, we analyze our performance against international peers. From the perspective of the EBIT margin evolution. Among the peers analyzed, GOL shows the greatest evolution in the last 12 months EBIT margin, an increase of 13.4 percentage points as said previously.

Moving on to next slide, number nine, in a comparison with the same peers, now we look from the revenues per ASK perspective. In this indicator, GOL was the only company that showed a double-digit increase, reaching 17.7%. This was an important driver to achieve the operating margin evolution that we talked about in the previous slide.

On slide number 10, the operational data shows that GOL has increased its load factor by 9 percentage points. The 15% growth in RPK led us to a gain of 1.8 percentage points in the domestic market share. Also in the quarter, we increased supply by 1.6% in the domestic market and 1.4% internationally.

Slide number 11, we can see GOL's strategy to pursue and increase PRASK, combining factors such as the new level for occupancy rate, the continuous increase in yield, which increased by 18% compared to the first quarter 2012, and rationalization of supply currently 12% lower than when the company started to cut capacity in May 2012. Such dynamics is the key point to provide a sustainable growth.

On the next slide, we will talk about growth strategies. On slide number 13, we can see the expansion of our strategic partnerships, aiming to increase connectivity and become more attractive. During the quarter, we announced the new agreement with the three major international airlines that fly to Brazil, Air France-KLM, TAP and Aerolíneas Argentinas. The agreement with Air France-KLM follows the successful model of cooperation between GOL and Delta Air Lines. CADE has already fully approved Air France-KLM and Aerolíneas Argentinas agreement. Just for the record, CADE is the Brazilian antitrust authority.

The next slide, number 14, we highlight our new flights, in line with the objective of gradually increased revenues in foreign currency. First, the flight between Campinas and Miami, São Paulo and Santiago, and from Fortaleza to Buenos Aires deserves a special highlight. This last route will benefit all domestic flights departing from Ceará with that VAT reduction on jet fuel by 13 percentage points. That's valid for all GOL domestic flights flying from and to this state.

The slide number 15 brings the key measures we have been taking for the FIFA World Cup. The load factors we have seen until now for this period reinforce the prices we have practiced from the first moment with 98% of the tickets available for less than R$900. That means the continuation of the current price strategy of GOL, we did not change anything related to the World Cup. And the maintenance of the price was only possible due to the addition of flights we could get approved from the Brazilian civil aviation authorities. However, since there will be less business customers travelling during this period, the outlook regarding the demand remains uncertain.

On slide number 16, we would like to emphasize that we are on time with the schedule to implement the GOL+ configuration, having 70% of the fleet with the new configuration. And through the end of this month, 100% of the domestic flights will be serviced for such type of aircraft configuration.

Turning to slide number 17, Smiles' results demonstrate the success of GOL and Smiles' complementary strategies. Our revenue growth has a strong involvement of Smiles, which as we note, is an important distribution channel for growth, among other benefits. During the quarter, Smiles recorded a profit of R$78 million, with a margin of 41.6%. As a way to maximize value for all shareholders and reaffirm its commitment to corporate governance, Smiles will distribute R$1 billion special dividend.

Now I will hand over to Edmar, which will present the results for the period.

Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Thank you, Kakinoff. Good morning, everyone. Thanks for joining us in this morning.

I would invite everyone to move to slide number 19, and I will make a highlight over a few drivers that are leading us to the results we're showing today. First one is load factors. Load factors are beyond 76% for the first quarter. This is the highest ever for a first quarter at GOL. And it shows indeed that the efforts that we're making over rationalization and revenue management and product development are paying off.

The second item that I would like to highlight is the yield. The yield has been growing, as Kakinoff mentioned, 18% over the last two years and 4% over last year. So at the end of the day, PRASK is moving up by 18% on a year-over-year comparison. And this has been the running rate at GOL for the last nine months at least given a year at this point.

In the next slide, I will go over what has impact our CASK, our cost on the fuel side as well on ex-fuel side. But I would like to highlight at this page, the EBIT. Operating results gained 42% bigger than last year. We show today not only a bigger margin but also a bigger company. That is we are increasing revenues and, at the same time, we are capturing more margin, therefore showing better results.

If you look at the EBITDAR margin, this is the second quarter that we are running very close to 20% EBITDAR margin. Again, it shows a different level of the company execution. There is also a slide over the financial result, which account for R$194 million expense below the line.

I will ask you to please move to page 20. And the main comment that I would like to make here is related to the macro environment. Fuel was up by 8%. The real was down by 18%. And over the past two years, on the domestic front, we have taken out 12% of the capacity. Even in this tough scenario, we have been able to improve margins. The margin expansion at this point of time came primarily from revenue, from the top line. On the CASK side, as this slide shows, we have a comparison which is tough on us quarter-over-quarter. That is total CASK going up by 17%, roughly. But if you look at the last 12 months number, you see that CASK is up by 3%, ex-fuel by 5%.

Moving to the next page, page 21, those are the main items that have impact to our cost, and I will go over them briefly. Most of them are explained in our release. The first one is fuel. Fuel (15:10) with the price increase R$104 million more in our expenses. On salaries and wages, again we have social security provisions that were not due in the first quarter of 2013 because there was a write-down related to the change in the methodology of payment, so it's R$20 million. Collective pay rise, decided back in December by 6%, and profit sharing and variable compensation to crew, which accounts for R$22 million on a comparison with the first quarter. We didn't have this expense one year before.

On sales and marketing, and we are highlighting here two main items. The first one is commissions related to sales. We are increasing the level of sales, therefore, we are not only increasing the level of commissions, but we are also going for different channels at different costs at this point of time.

And also, this is an issue that had affected our results in the first quarter. This is loss of sales primarily fraud related to credit cards. We have reached the peak in the first quarter. The recent number show an improvement on a month-over-month or rather on a week-over-week basis. So we should see this number decreasing along the year. I'm very positive on that, even keeping the sales at the current level.

The next item that I would like to highlight is landing fees. Our connection fees were not due in all airports all over the year in 2013. Therefore, this line will be increased by that this year that is there will be connection fees being collected all year round at all airports at this point.

And as for services, we are highlighting something that is very usual we have in Brazil. That is readjustment of contracts related to CPI (17:28). And then also the enhancement of IT services primarily to passengers that we have been deploying. That is it will – it comes back in terms of efficiency, as Kakinoff mentioned, a little bit earlier today.

Now moving to the next page, this is a slide which is well known to all of us. This is our cash position, 30% of last 12 months revenues and also our amortization profile. As you know, there will be a capital reduction in Smiles.

Smiles will issue debt up to R$700 million, and it can be very positive again on that. We are working on our profile at the same time. So depending on the kind of decision that Smiles makes over the profile of its debt, we will change our profile. So on a consolidated basis, there won't be any pressure in the next 24 months. That's where we are working on now.

At the same time, I would like to remind you that there will be a capital increase related to the Air France transaction. It will bring $52 million to the company, as well as another $23 million related to commercial expenses and synergies. Kakinoff is reminding me here, it's all of them in U.S. dollars which will take us roughly an extra R$200 million in the next weeks.

Related to the credit profile, our bonds have seen a rally recently. In the last few weeks, they have been trading at a premium which reflects the better position in terms of credit that the company had shown in the last quarter.

I will invite you to move on to page 23. This is a hedge slide, and I will start with fuel. In the last quarter, we have contracted, let's say, a meaningful amount of fixed price with Petrobras. This is the right side of the chart. For delivery in the next few months, you'll see that in the left side of the chart, top of the chart. And those bars, the orange bars, we have roughly 1 million barrels, means 25%, 30% of the consumption for that period. We have been touching (20:22) the market on a daily basis, so the position that we have nowadays is different with this one. And I think that we have been very successful in capturing the recent downturn in the FX that helps us with the final price for fuel in Brazil.

On the bottom part, we see the dollar hedge. We have decreased our position. We think that the current scenario of R$2.20, mid-R$2.20 is not the level for the second half of the year. And that's why as well we're not changing the guidance in this point of time. We are keeping that. We have again a conservative approach. And we would like to see some more time of, I would say, stability to address that in our guidance.

On the next page, we are, let's say, building up or down our results so we come to the bottom line. And I would like to highlight again our conservative approach to the Venezuelan situation. We have recognized the loss of R$76 million in the financial expenses this quarter. And this is by far, the most conservative approach of the companies growing (21:46) money in Venezuela so far. We have MTM, the money that we have there, from VEF 6.3 to VEF 10.7 which everyone understands, is the current FX for repatriating – for bringing back home the money that we have in Venezuela, okay?

By saying that, I will give the floor back to Kakinoff for his final words. Kakinoff?

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you, Ed. The first quarter results were absolutely within the plan. And any eventual variation, as CASK ex-fuel, for instance, was already in our projection. Thus, we reaffirm our guidance for the year of 2014, with a high level of confidence to achieve operating margin.

Now we would like to hand the presentation over to the audience to be able to start the Q&A session.

Q&A

Operator

Thank you. Our first question comes today from Michael Linenberg of Deutsche Bank.

Q - Richa Talwar {BIO 17123496 <GO>}

Hey, Kakinoff. Hi, Edmar. It's actually Richa filling in for Mike. Good morning.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Good morning.

Q - Richa Talwar {BIO 17123496 <GO>}

So my first question is on the cash you expect to receive from Smiles. Edmar, I know you commented on this, but with regard to the capital reduction plan, the R$1 billion, and you said you're expecting to get R$700 million. Can you remind us on the timing on when you expect to receive that cash?

And then second, just elaborate on what you'd expect to do with the proceeds, yeah, you already have a very strong liquidity position, so just curious if you consider any debt repayment opportunities or other shareholder-friendly action?

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Hi. Thanks for the question. So it's a little bit different than people may think, okay? The R$1 billion capital reduction means that from (24:16) on a consolidated basis, there will be R$450 million going out of our total cash, okay? So we have nowadays R$2.8 billion, for instance, and we do a capital reduction of R$1 billion, in the very next day, there will be R$450 million left. And why is that? Because R$550 million, that's the majority part, there will be only a change in geography. The money will move from Smiles to GOL (24:53) which is the holding company. That's the change that we have, okay?

So since Smiles had the approval from its board to issue debt, we have to understand what is the profile of the debt. And at the very same moment, we have to work here on a consolidated basis to stretch the profile that we have. At this point of time, we have been discussing with the Brazilian banks, Bradesco and Banco do Brasil, to be very specific about our fourth debentures, which are due next year. We are still negotiating. But if needed, we will stretch it. If there is any news over that, I will come back to market and announce, okay? I hope I have clarified that for you.

Q - Richa Talwar {BIO 17123496 <GO>}

Okay. And then second, Kakinoff, you kind of reiterated your conservatism regarding the World Cup. I was just curious how much of a margin impact you might be expecting from that? I mean, you're guiding for 3% to 6% for the year, so I'd be curious to know what that margin guidance could look like if we didn't see any slowdown from the World Cup event?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hi. Technically, I cannot give you, at this very moment, a projection related to the margins in June. What I can tell you is that the current demand is quite comparable to the June demand last year when we were by the beginning of May. So I mean, we are foreseeing basically the same demand but surely we do not know how the business travelers' demand will behave over the World Cup.

Surely, we have, considering our projections, a reduction in such demand once the business travelers won't travel as often as they would in a typical June, July month. I cannot tell you at this moment, as I mentioned before, how much we are going to deteriorate the margin in our projections because also that is part of our pricing strategy.

So the only information I can give you by now is that the World Cup impact has been already built into our projection, and that means our annual guidance, which we are confirming today with a higher level of confidence.

Q - Richa Talwar {BIO 17123496 <GO>}

Okay. Got it. And if I could just squeeze in one more. On the Air France-KLM deal, now that you have antitrust approval, could you just refresh us on your thoughts regarding the $25 million of synergies you expect. I think you said that's over the course of two years. Should we expect it to be more front-end loaded, or if there's any low-hanging fruit from the transaction or how should we think about the progression of that?

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

The agreement that we have – this is Edmar here. The agreement that we have with Air France-KLM says that we will get $52 million for the capital increase. We'll get $23 million related again to commercial and synergies that the project will gain. And there will be a remaining $15 million which will be due in the next two years, $7.5 million each year. Okay? This is the cash flow that we have from the agreement, and this is a condition (28:37) not related to any meeting targets of any kind, okay?

Q - Richa Talwar {BIO 17123496 <GO>}

Okay. Thank you.

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Thank you.

Operator

Our next question comes from Savi Syth with Raymond James.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Hey. Good morning. Just on the margin side, I was curious. I know you're reflecting a weaker currency than currently persists, and I understand your conservatism around that. But I was wondering, is there anything beyond the kind of weaker currency that's keeping that margin in the 3% to 6% range?

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Savi, this is Edmar here. Good morning. Thanks for the question, okay. Please remember what we did last year. Same kind of volatility. The real moving from R$2.15 to R$2 and then R$2.40 very, very volatile. The average for the FX up to March 31 was R$2.37. In the last few weeks, yes, R$2.25 or below R$2.30.

In our opinion, it's too early to say that this is the level that will be for the year. We do expect some more volatility in the second half of the year. Remember that we have elections. Remember that we have the tapering in the U.S. being decided and bringing a lot of volatility to the market, especially currency. So we are conservative now as for changing any item of our guidance. But as Kakinoff mentioned, we have a higher level of confidence in the guidance we gave because of what we have done so far.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hi, Savi. It's Kakinoff. I'd like to complement by saying that we would like to keep the same philosophy behind the guidance building process which we have utilized the last year to be more than realistic but actually conservative as Edmar has properly said. And then by the end of the year, we were able to deliver the top end of our guidance.

I'm not telling you that we are going to again deliver the top end, but as I mentioned before, we have a higher level of confidence of delivering the EBIT margin which had been shown in our guidance basically because we have utilized very conservative approaches for every indicator. So the exchange rate has behaved very, very volatile on the last three years. And we wouldn't like to mislead the market and not even ourselves by strengthening the guidance at this moment just because we are living at a lower level of exchange rate. So that's the reason why.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Got it. That makes a lot of sense. So if you look at April, May, how has unit revenue and demand done? It sounds like similar to last year, but are you seeing kind of similar strength as you saw in the first quarter on a unit revenue basis?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Let me talk only on the April figures, because we want to say (32:11) we wouldn't like to not obey quite several recommendations we get from the Brazilian SEC related to information on the future performance. April, we have achieved the load factor at the level of 78% for the domestic market and 76% in the combination of international and domestic. That shows that our strategy of recovering first PRASK and then getting the opportunities to increase load factor without damaging our margin strategy has been quite successful. That is the all-time high load factor for an April month.

So the market has been too challenging but as shown in April, GOL has been able to manage those challenges in order to keep its growth pattern in line with our expectations. So we are not delivering the huge figures any longer because, as you can understand, we were the only company doing that in the country. And that was an important disadvantage in comparison to our competitors in which applies to month strategies. So this is the reason why we are delivering just the load factor information, but you can see based on that April month, it was a positive one.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Understood. And then just a last quick one. What was the gain from sales in 1Q 2014? What was the benefit?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Sorry. Please repeat it.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Sorry. What was the kind of gain in 1Q 2014 from the sale leaseback?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Okay. Just a moment, please. It was roughly R$40 million, R$38 million to be very specific. And again, this is a very important issue for us because part of the (34:38) these gains is exceptional or whatever item. I would like to reemphasize that this is all about (34:50) strategy. We have announced a couple of years that we would do a lot of sale leaseback in 2014 and 2015, okay?

So at the same time that we recognized this gain on the other line, we also increased our rent line because we are not taking any financial results, okay? Any financial funding here for the aircraft. I mean, the reason why we recognized that, again, is because we have a price with the manufacturer, which is lower than the market. And this is again related to the size of the order that we have. Just going back to the numbers, R$48 million, okay, almost R$50 million.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Okay, understood. But that price is recaptured then in your rent expense? Is that fair?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Yes. Down the road, there is an increase in the rent line because we are not taking an aircraft, which will be owned by ourselves. You see, it does explain part of the increase on the rent line, because nowadays we have 11 aircraft more than we have one year ago as part of the fleet on the operating lease mode.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

But your rent is based off of the higher aircraft price, correct?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Yes, because we're taking 800s, and we are returning 700s as well.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

All right. Great. I've taken a lot of your time. Thanks, guys.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Yeah. Thank you. The average prices automatically gets higher once it's a bigger airplane, so different value.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Understood. Perfect. Thank you very much.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

Operator

The next question is from Tom Kim of Goldman Sachs.

Q - Tom Kim {BIO 6741640 <GO>}

Hi. Thanks for your time here. I wanted to ask your thoughts on one of your domestic peers expanding on to international routes, and your views on their potential competitiveness given the fact that they'll have range to go nonstop to a lot of the markets in the U.S. that you're actually also targeting as well?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Okay. So thank you very much for the question. If you allow me, I would like just to step back to better explain our international development strategy. As mentioned by the beginning of the next – of last year, GOL has said that it's part of our strategy to increase our international currency revenue. So we had, at that time, 8% of our total revenues nominated in international currencies. And we would like to achieve in a period of three years the level of approximately 17%. So then we have reinforced our international expansion strategy by creating new routes or reactivating others that wasn't feasible in our history.

Based on that strategy we have, until now, increased the international currency revenues from the level of 8% to the current 12%. And United States, is part that strategy. We have started to fly to Miami and to Orlando via Santo Domingo since December 2012. And those flights have been presented themselves very, very successful. And that happens, and probably this is the information missing to some of you guys. That happens not only because there is a strong demand to fly to such market but also considering how important is that offer to our frequent flyer program to Smiles, the last instance (39:05).

So this is a very good example of combining the strategy between the airline and the loyalty program which makes, specifically, this flight to United States, particularly good to our strategy. But it's also important to highlight that United States is just one among 15 international markets GOL is flying every day. And we are expanding our international strategy flying to United States, flying to Chile, as we have just announced and also having an additional flight from Fortaleza in the northeast region of Brazil to Buenos Aires.

Are there some room for further expansion? We are just analyzing these opportunities, and it's likely that GOL will announce new routes already by the end of this year, considering its strategy. So this strategy is less dependent than the competitors' movement, and I would say the other way around. Those flights are delivering very interesting result, which make them even more robust from a strategic perspective. Therefore, we are not considering that the competitors' movement would affect that decision too much.

Q - Tom Kim {BIO 6741640 <GO>}

Okay. And I appreciate all that detail and color. And clearly, the tremendous ramp in your load factors on international is a good testament to this rapid development of your international exposure.

Can you just help us understand the Santo Domingo opportunity? I think this has been a market where you've been looking to expand. And correct me if I'm wrong, is Santo Domingo – are you looking to convert that into a hub? And can you just update us on your investments sort of in that market as you embark on your international growth opportunities?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

We are basically tapping (41:28) Santo Domingo as a geographical hub. So as I mentioned, we are already operating flights to United States via Santo Domingo already for 15 months. So we are, every month, improving our operational SKUs (41:44) to offer such type of flight. And there is a clear potential, but we didn't decide on improving or increasing our operations through Santo Domingo. It has been very promising, but there are no decisions yet related to make it more robust hub to the company.

Q - Tom Kim {BIO 6741640 <GO>}

It's my last follow-up, if I may. Are there any regulatory constraints or approval processes that you need to go through to make it a hub if you want it to make it a hub?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Actually, no. No regulatory constraints. There are surely discussions in order to make it even more attractive from the economic point of view. So in case we decided to go for building a hub, we would be able also to deal with the local government and also the local providers to achieve a more competitive cost scheme to operate more flights via Dominican Republic. But there aren't regulatory constraints at the moment (43:06).

Q - Tom Kim {BIO 6741640 <GO>}

Thanks a lot for all of your time. I'll jump back in the queue.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

Operator

Next question comes from Duane Pfennigwerth with Evercore.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Hey. Good afternoon.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hi.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

So we've been hearing a lot recently about how Delta is helping to improve results at its minority investment, partners like yourselves, like GOL. And I just wanted to talk with you a little bit about how they're helping to shape your view of capital discipline, because when we look at Delta's strong performance, what really stands out is strong free cash flow and capital discipline.

And if we think about GOL, you certainly have shown capacity discipline but I'm not sure you've yet demonstrated capital discipline. If we think about your aircraft commitments, plus PDPs, so I think it's R$1.4 billion in 2015, R$1.3 billion in 2016. It still feels like a positive free cash flow for GOL is years away. Could you respond to that? Is that a fair assessment?

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Hi, Duane. This is Edmar here and thanks very much for the question. It's a very good opportunity to go over our cash or capital strategy here, okay. First, remember that this year, the target is to have a free cash flow-neutral, okay. And this is primarily related to having better margins, as well as having a discipline on the CapEx side, okay? CapEx side. And next year – we will assume here just for a second that the margin expansion will continue, there will be also discipline on the CapEx side.

And why I'm telling you that? Because what we disclosed in our financial statements is the total commitments that we have on the financial side but we have said that we have a special agreement with Boeing due to the amount of orders that we have with the manufacturer. So we cannot disclose but we have a cap. I will repeat that. We have a cap for PDP, for any aircraft that we deliver, okay?

On the cash side, it's limited. And I will be very positive here. It's a cap that we can live with, with the current margins. That is if we push up, if we grow up our margins from now on, then there will be excess cash here.

So the main point for us remains the balance sheet and the cost of debt, okay? Our balance sheet has a lot of exposure to the U.S. It will remain like this for a while. And this primarily relates to tenors. We don't go along here in Brazil at this point, but we do in the U.S. But as we have been discussing, we are always looking for opportunities in the capital markets. So one of the targets that we have for the midterm is to lower our cost of funding. That is as our ratings go up or as our metrics improve, we will probably change the debt that we have for lower coupon debt.

So this is primarily, the main, let's say, drivers for our strategy. But I can be very positive. If we keep the margin from now, from this level that we are talking for 2014, and we're confident on that, up, there is no other scenario that we have. There is no cash constraint, no any pressure of any kind at this point. But I agree with you that we still need some time to fulfill all of that goals, goals with aim this case (47:24). Again, this year, the first half is to be free cash flow-neutral, and then for next year on, to have a strong results that we'll be able to deliver a positive bottom line even with the FX being against us.

And on the aircraft delivery side, please remember that we have been, let's say, postponing, stretching our deliveries, so there will be less pressure on the CapEx side. Next year, we have less aircraft than we had three years ago. Later on, I will shoot you an e-mail with the right amount of plane. If I'm not mistaken next year, we're taking six planes.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Okay. I appreciate that detail. Just a one follow-up point there, Edmar. I assume when you say free cash flow-neutral, we're discussing after net CapEx, this whole concept of net CapEx, which includes...

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Yes.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

...the financing of the aircraft as opposed to a gross CapEx number, which would be kind of the full value of your aircraft. Because, I think, if you're spending time with Delta, I would encourage you to appreciate that difference.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Yeah, we have done that. And please take also – sorry then, it's Kakinoff, just please take it in consideration that we have established that the reduction of our indebtedness level is part of the priority, not only by increasing EBITDA and then reducing the leverage but also by prepaying some debts. Something that we have done already last year. Once our obligations were at the level of $250 million and we would be able to pay $550 million.

So we have learned a lot from Delta, that's for sure, not only in the revenue management side but also in the capital management. And we are consistently delivering our strategy, which is slightly different than Delta based in the intentions to reduce significantly our indebtedness level. But you can be sure that, at that time, will be further expand and appreciate it.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Thank you.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

Operator

The next question is from Bob McAdoo with Imperial Capital.

Q - Bob McAdoo {BIO 1881798 <GO>}

Hi, folks. Obviously, your operating line numbers were very good, but below the line, there were two or three things, which I guess I didn't understand. I was a little surprised on it. I was curious if you could just spend a little time talking about the negative line for interest rate hedge and also for foreign exchange hedge.

And also, if I look on the income tax on the fourth quarter of 2013, we had a pre-tax loss, and then there was a credit offsetting some of that, so that the net loss was somewhat less much like we have here in the States. But this quarter, we have a negative pre-tax and then additional tax on top of that, so that the bottom line is actually worse. So I was wondering if you could help us understand how to – give us some guidance as to how to think about that going forward as to – whether the tax line is always going to be negative, or how should we be planning on that? And then again – so maybe some better understanding of the two hedge transactions.

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Okay. Hi, Bob. This is Edmar here, okay?

Q - Bob McAdoo {BIO 1881798 <GO>}

Hi, Edmar.

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

And I will go in parts, okay? First one is FX. FX depends a lot on the real. So we don't know. This quarter, we recognized a gain on the balance sheet, because the real appreciated. So the burden of debt in U.S. dollars had decreased in real terms. That's why in the slide number 24, we showed again that R$133 million all considered (51:59). This is just the balance sheet. There is a loss of R$61 million, and this is the hedge positions that we have over FX. So this is the MTM on a daily basis, okay? Meaning that we have a position that, on average, was at a higher level than the R$2.26 per dollar that was the closing rate for March, okay? So it explains the FX.

On the interest hedge, in our financial statement, you will find that we have a major position of more than $1 billion of hedge for the interest of the airlines, which we will receive in the following years, in the next few years. And this is a protection that we made. So we will protect the variable part of the rents that we will pay from the moment we receive the aircraft until we end up the agreement, so it's a few years down the road.

But for accounting reasons, and you know better than I do, we have to recognize the loss right away, so it accounts for another R$56 million. And this is primarily related to the interest rates in the U.S. They went up at the second half of last year. But if you compare the position at the end of March with the position at the end of last year, you will see that they have decreased.

As for tax, first and foremost, from now on, you will see a negative line here on taxes because of Smiles. Smiles is a separate entity. We consolidate Smiles, but Smiles makes profit and, therefore, we pay taxes over there. There is always a small difference related to deferred taxes which are on the opco of the airline and this is related to the Brazilian legislation. Sometimes, it's a single-digit number and sometimes a little bit more. But it depends on the events that takes – the events that happened within the quarter.

Okay, now putting altogether. FX, it's very hard to predict, has been very, very volatile, okay? Taxes, we do expect negative numbers from now on, on a regular recurring basis primarily because due to Smiles. And on interest rate, it depends. I think you have understood. It depends a lot on the U.S. There is one special item this quarter which is Venezuela. Venezuela is also FX-related. We have recognized a loss of R$76 million. And we are taking all the cash that we have in Venezuela to the VEF 10.7, VEF 10.9 FX rate that is the new rate, if you will, that the government has published as of January this year.

We were for sure the most conservative airline, and we have anticipated that. So our cash, which is very important for us, is at market levels. So there is no, let's say, deviation here from what we expect to receive and repatriate. I hope I have helped you in understanding all the big items here below the operating line.

Q - Bob McAdoo {BIO 1881798 <GO>}

Yes, it is very helpful. I appreciate it. Thank you.

Operator

Thank you. Our next question is from Stephen Trent with Citi.

Q - Stephen Trent {BIO 5581382 <GO>}

Good morning, Kakinoff and Edmar, and thanks for taking my questions.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Good morning.

Q - Stephen Trent {BIO 5581382 <GO>}

Good morning. Just two for me, if I may. If you can refresh my memory, I had thought that at some point in the past that you guys might have approached the Dominican Republic flying through like a new brand strategy or at least a slightly different brand strategy. Is that something that still might be in the works, or when do you potentially do more international flying out of Santo Domingo that you're going to stick with the same brand?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hi, Stephen. Actually, at the time, we didn't mention that, that would be in a different strategy or even a different brand. The market has some of the guys that considered that opportunity. As we mentioned before, we are testing Santo Domingo as a hub. So far, the experience has been quite good, quite positive. But we didn't decide yet on foreign investing and applying new routes from there.

Therefore, not even discussions related to brand strategy or something like that took place in the company. So maybe this is the second step once we decided to further invest in the country and to develop this hub. But at this moment, is this part of our international flights expansion strategy and basically operated by GOL as it is today.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay, very helpful. That may have been something random I read several months ago and didn't come from you guys. Very helpful.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

That's it (58:18).

Q - Stephen Trent {BIO 5581382 <GO>}

Second question, if I may. And it is not exactly a fair question but just wanted to get your view. I saw you guys write down the Venezuela cash which strikes me as logical. And at the same time, some of your competitors are kind of still out there telling the market that they expect to get all their cash back at the original rates. I guess, I would ask you, in your view, what are the main reasons, do you think, would motivate this sort of golf (59:02) in terms of differing expectations on the Vene cash repatriation?

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Steve, this is Edmar here. Thanks for the question.

Q - Stephen Trent {BIO 5581382 <GO>}

Hi.

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

The fact that we have recognized the loss doesn't mean that we are fighting very hard to take the money out from the country at the VEF 6.3 levels, okay? This is, first and foremost, we have meetings with the government. We are working with IATA. We are working with ALTA. And we are aligned with the other airlines as for taking out the money at the historic – at the agreed FX rate that we have, okay? This is one.

But our accountants here are very conservative, and they tell us every day that if we do have a problem in Venezuela and, let's say, that we don't take out the money because at this point of time, some of the money hasn't been out of the country for more than a year, and then they convince us to be conservative and tell the market what is the real side of the story. And again, we were the first and we were the most conservative. I cannot tell you about the accounting and about the judgment of the other airlines. In our case here, we have been very candid about Venezuela. And I would like to reinforce that it doesn't mean that we are looking every day for every opportunity to take the money out at the agreed current FX rates.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hi, Stephen. It's Kakinoff. I could summarize that by saying that I do not know whether it's good or bad. But the difference is that we have somebody here called Edmar, and this guy is very cautious (1:00:52).

Q - Stephen Trent {BIO 5581382 <GO>}

Fair enough. Well, that was very clear and very helpful. Appreciate the time and I'll leave it at that. Thanks, guys.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Yes. Thank you.

Operator

Thank you. Our next question is from Diego Leon (01:01:14) of GBM.

Hi, guys. Thank you for taking my call. I was just wondering when are you expecting your capital increase.

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Diego (01:01:32), this is Edmar here. The CADE has just approved. We need to wait a couple of weeks for the final approval. And then, we will start the process with CVM, the local SEC, which will take roughly another two weeks or so. So I would say that in 45 days or even less than that, there will be – the capital increase will be done.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Yeah. Just to make sure that we have properly communicated that, the CADE has already fully approved that, but there is a procedure to be implemented related to the commendations and final statements. And then we are going to able to start the process to have the money invested in the company. So that those periods, in combination, that results in the 45 days maximum, as said by Edmar.

Q - Operator

Okay. And I understand it represents 1.2% of your preferred shares?

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

1.5%.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

1.5%.

Q - Operator

1.5%. Okay. Thank you.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

You're welcome.

Operator

Our next question is from Marcela Nagib of JPMorgan.

Q - Marcela Nagib {BIO 17631091 <GO>}

Hi. Good afternoon. I just wanted to know how you're thinking about your dollar bonds and if you're thinking about any potential liability management?

A - Edmar Prado Lopes Neto {BIO 15245559 <GO>}

Hi, Marcela. This is Edmar here. First, the bonds have been reacting to the improvement in the credit metrics that the company has been showing over the last few quarters. They have been trading with a premium recently which we understand is related again to the results. And as for capital markets, we are looking at it all the time. So if there is an opportunity, we may touch it. But at this point of time, I have nothing to say about it just to recognize that the market is giving us credit for the improvement we have shown.

Q - Marcela Nagib {BIO 17631091 <GO>}

Thank you.

Operator

This concludes today's question-and-answer session. I would like to invite Mr. Paulo Kakinoff to proceed with his closing remarks. Please go ahead, sir.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

I just would like to thank you again for the attention and to reinforce that we are fully available here for further questions along the day. Okay. Thank you very much. Have a nice day, everyone.

Operator

This concludes GOL Airlines' Conference Call for today. Thank you very much for your participation and have a nice day.