Q4 2016 Earnings Call

Company Participants

- André Pires de Oliveira Dias, Chief Financial and Investor Relations Officer

Other Participants

- Frank McGann, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Ultrapar's 2016 and Fourth Quarter 2016 Results Conference Call. There is also a simultaneous webcast that may be accessed through Ultrapar's website at www.ultra.com.br/ri and Engage-X platform. Please feel free to flip through the slides during the conference call.

Today with us, we have Mr. André Pires, Chief Financial and Investor Relations Officer, together with other executives of Ultrapar. We would like to inform you that this event is being recorded, and all participants will be in listen-only mode during the company's presentation.

After Ultrapar's remarks are completed, there will be a question-and-answer session. At that time, further instructions will be given. We remind you that questions, which will be answered during the Q&A session, may be posted in advance in the webcast. A replay of this call will be available for one week.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Ultrapar management and on information currently available to the company. They involve risks, uncertainties, and assumptions, because they relate to future events, and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Ultrapar and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Pires. Mr. Pires, you may now begin the conference.

André Pires de Oliveira Dias

Well, thank you very much. Good morning, everyone. It's a great pleasure to be here to discuss Ultrapar's fourth quarter and full year 2016 performance. Some of my colleagues from our businesses and from the IR team are also here to help me answering your questions.

Starting with slide number 3, we're going to discuss the performance of 2016. I'd like to start emphasizing that Ultrapar reached another year of earnings growth in 2016 despite the challenging economic environment we faced in Brazil. The resilience of our businesses, the execution capacity of our teams, the investments and our focus on differentiation and innovation all contributed to the continuation of our growth and value creation.

In 2016, we reported a consolidated EBITDA for BRL 4.2 billion, an increase of 7% year-on-year. Net earnings reached BRL 1.6 billion, up 4% from 2015. Consistent earnings growth and consequent cash generation once again allowed us to increase dividends. The Board approved dividend payment of BRL 472 million for the second half of the year equivalent to BRL 0.87 per share. As a result, the accumulated dividend declared in 2016 reached BRL 907 million in line with the growth of our earnings in 2016.

The annualized dividend used is 2.5%, considering the average share price in 2016, and the payout ratio is 58%, same levels of recent years and an indication of our confidence on our results and performance going forward.

In 2016, we analyzed and executed various initiatives and projects that allow us to pave new avenues of growth for our businesses. Working diligently and with a solid business model, we announced three important transactions. We signed a sale and purchase agreement for the acquisition of Alesat in the fuel distribution business, and Liquigás in LPG distribution, both pending approval from the Brazilian Anti-Trust Authority. We also announced the creation of a new lubricant business with Chevron, just being approved recently by the same authority. We are convinced of the benefits these operations will bring to Ultra and to Brazil.

We also announced a robust organic CapEx plan worth BRL 2 billion in 2017. This is a clear demonstration of the continued opportunities for growth in both scale and productivity, as well as for the modernization of existing operations. Our growth was followed by a return on equity of 19%, and by the maintenance of our financial soundness, a characteristic the company cultivated over many years. Net debt to EBITDA ratio remained at historical levels of 1.36 times.

Let's move on now to slide number 4 and talk about Ipiranga. During our last call in November, I mentioned that one of the growth drivers at Ipiranga would be the acceleration of the expansion of our service station network, which should bring benefits as the divestments mature.

Our network grew by 5% in 2016, thanks to our investments in converting unbranded gas stations and opened new ones. In 2016, we had a gross addition of 453 new service stations throughout Brazil. That's more than one service station per day, and we finished the year with a total of 7,563 service stations.

Ipiranga's strategy based on differentiation, innovation and convenience goes hand in hand with the accelerated expansion of the network. A good proportion of the new service stations also included differentiation initiatives, which strengthened ties with our resellers and clients. In 2016, this strategy was put into practice through an investment into 256 new am/pm convenient stores, which are now part of nearly 30% of our network, 128 Jet Oil units, 163 bakeries, and 138 beer caves among other initiatives.

Early this month, we held our annual resellers marketing convention, which brought together more than 6,000 people, the largest participation in history. They had the opportunity to get to know our marketing plan for 2017, as well as new differentiation and innovation initiatives.

Following the trend of the last few quarters, Ipiranga posted a 9% decrease in the overall volume in 2016 compared to 2015. Fuel sales volume for light vehicles in the Otto cycle declined by 9% in line with the drop in diesel volumes, both a reflection of the economic situation, deterioration of the employment rates, a reduction in disposable income, and low growth on the light vehicles fleet by 2%.

More specifically, in the fourth quarter of 2016, diesel sales fell 19% year-on-year, reflecting a reduction of market share in wholesale segment. Sales for light vehicle segment in the fourth quarter of 2016 fell by 8%, affected mainly by the same factors mentioned previously.

In this context, in 2016, we reported consolidated EBITDA of BRL 3 billion, an 11% growth over 2015. In the fourth quarter of 2016, Ipiranga's EBITDA reached BRL 863 million, almost stable compared on a year-on-year basis.

I'd like to remind you that in the fourth quarter of 2015, we had an extraordinary inventory gains, while in the fourth quarter of 2016, Petrobras announced three cost adjustments in our derivatives, two reductions and one increase in December. After upward and downward moves, the cost of diesel fell, while the gasoline costs remained at the same levels.

For the current quarter, the operating environment and EBITDA variation should stay largely in line with the preceding quarter. It is important to highlight that the accelerated expansion of our service station network should impact throughout 2017.

Now moving on to Oxiteno, slide number 5. For the full year of 2016, sales volume increased by 2% over 2015. Breaking down these results, volume of specialty chemicals was 1% down as a consequence of the weak economic activity in Brazil. Commodity sales, however, rose by 17% on the same comparative basis, which helps to achieve greater efficiency in the capacity utilization and dilution of costs at the plants especially in the first half of 2016.

In spite of a weaker real average exchange rate, movements in opposing directions in 2015 and 2016 were unfavorable to Oxiteno. In this comparison, comparison FX rate in the beginning of 2015 was BRL 2.66 per dollar and ended at BRL 3.90, while 2016 began at BRL 3.90 and closed at BRL 3.26 per dollars.

The same movement in exchange rates occurred in raw materials, mainly the palm kernel oil, where cost movements were favorable in 2015 but unfavorable in 2016. The price of palm kernel oil practically doubled from 2015 to 2016, with a significant effect on the home and personal care segment.

Considering all these effects, EBITDA reached BRL 459 million in 2016, 38% less than in 2015. In the fourth quarter of 2016, sales volume increased by 4% compared with the fourth quarter of 2015. Specialty chemicals volume was up by 6% with a 4% increase in the domestic markets. The fourth quarter of 2016 was the second consecutive quarter of growth in the segment, indicative of the gradual recovery trend for the Brazilian economy. The agrochemical, automotive fluids and coating segments were the highlights.

On the other hand, commodities reported a negative variation of 8% in sales volume due to a scheduled maintenance stoppage at the Camaçari petrochemical complex in November of 2016. Despite the higher volume sold in the fourth quarter of 2016, the effect of the BRL 0.55 stronger over the U.S. dollar coupled with a significant increase in the cost of certain raw materials resulted in an EBITDA of BRL 45 million, down 75% compared to the fourth quarter of 2015.

In the first quarter of 2017, we expect continued growth for specialty chemical sales in the domestic market for the third consecutive quarter, in line with the slight recovery of the Brazilian economy. However, the dynamics of price of raw materials and foreign exchange levels continue to pressure our margins.

Moving on now to Ultragaz in slide number 6. Ultragaz continued to outperform the market despite a weak economy. In the first quarter of 2016, consolidated sales volume increased by 7% on a year-on-year basis. Similar to previous quarters, this growth reflects investments made to add new resellers in the bottled segment, which showed a 6% growth in volume, and to capture new clients in the bulk segment with an 8% rise in the period.

For 2016, Ultragaz reported an year-on-year volume growth of 4%. Together with discipline in cost management, in the past two years, Ultragaz has evolved to a more differentiated approach through initiatives that enhance service quality and consumer confidence. Ultragaz EBITDA increased by 12% in the fourth quarter of 2016 to BRL 122 million.

EBITDA for the full year grew by 25% over 2015, reaching BRL 447 million. For the current quarter, we expect EBITDA levels similar to the last few quarters. It's important to highlight that the first quarters normally bring lower volume from a seasonality impact.

Moving now to slide number 7, talking about Ultracargo, which is our liquid bulk storage business. Ultracargo's average storage increased by 11% compared to the fourth quarter of 2015 and 3% compared to 2015. This was largely due to increased handling of fuels at the Suape, Aratu, and Santos terminals.

Ultracargo reported EBITDA of BRL 74 million in the fourth quarter of 2016, an increase of BRL 61 million compared to the fourth quarter of 2015, mainly due to the growth in average storage and in average tariffs at all terminals.

In addition, in the fourth quarter of 2016, we recognized revenues from insurance payments of BRL 74 million and expenses of BRL 23 million, all related to the fire in Santos. Excluding the Santos operations, the other Ultracargo terminals recorded 24% increase in EBITDA in the fourth quarter of 2016. For 2016 as a whole, Ultracargo's EBITDA was BRL 171 million, an increase of BRL 145 million compared to 2015.

In addition to the effects on results, it is also important to highlight the effects of our negotiations with insurance companies that impacted only the balance sheet described in our financial statements. We continue to implement the commissioning plan and expect resuming activities by the middle of this year in the part of the terminal incentives that it is still currently suspended. Excluding Santos operations, EBITDA for the current quarter will be in line with recent quarters, and we will incur expenses related to the resumption of activities in Santos.

Moving on now to slide number 8 and talking about Extrafarma. Extrafarma ended the fourth quarter of 2016 with 315 stores, which corresponds to a net increase of 61 stores or 24% when compared to the end of the fourth quarter of 2015. Throughout the year, gross additions to the network reached 71 stores, 27 in the first half and 44 in the second half, mostly in the Northeast region.

At the end of the fourth quarter of 2016, 45% of all the stores were in the maturing phase. This compares with the 37% at the end of the fourth quarter of 2015. Extrafarma's gross revenue increased by 28% compared to the fourth quarter of 2015, mainly due to the increased average number of stores and 21% growth in the same-store sales.

For 2016, gross revenues at Extrafarma rose by 18%, also a reflection of the growth in number of stores and same-store sales. According to Abrafarma data for this sector, market sales growth was 8% for quarter and 11% for the year. Extrafarma's fourth quarter 2016 EBITDA reached BRL 13 million, a 52% growth on a year-on-year basis. This was mainly due to increase revenues and initiatives to raise the retail management standards. These effects were partially offset by the larger number of stores still ramping up in 2016. Extrafarma's EBITDA increased by 29% to BRL 37 million.

For the current quarter, we estimate an EBITDA at the same level of the previous quarter. Nevertheless, it should be impacted by some non-recurring expenses related to the transfer of our distribution center from Belem to a new one in a neighboring town with better logistics conditions and also more modern equipment as well as to some severance expenses.

Now, moving to slide number 9, I'm talking about priorities and outlook for Ultrapar. We recently announced our BRL 2 billion investment plan for 2017. This is a further indication of our confidence in continued growth opportunities for both increasing scale and productivity, as well as for the modernization of existing operations.

Among the main growth initiatives we mentioned at Ipiranga, a more accelerated expansion of the service station network at Oxiteno, further internationalization (17:19) of investments with the ethoxylation plant in the United States. At Ultragaz, the focus on differentiation at Ultracardo, the expansion of the Itaqui port terminal, and at Extrafarma, our continuous focus on accelerated expansion of the company and improvements on the retail pharmacy management.

Additionally, as discussed at the beginning, we are confident in the benefits that the two strategic initiatives currently being examined by the Anti-Trust Authorities will bring to Ultra, as well as to our specific industry sectors and to Brazil. We've also seen signs of a gradual recovery in the economy, and this should benefit our businesses more closely correlated with the GDP.

With that, I conclude the presentation, and are available for any questions you might have. Thank you very much.

Q&A

Operator

Thank you, sir. The floor is now open for your questions. And the first question will come from Frank McGann of Bank of America. Please go ahead.

Q - Frank McGann {BIO 1499014 <GO>}

Okay. Thank you very much. I have two questions, if I could. One is just on Ipiranga. You've done an excellent job keeping margins very strong. I was just wondering what types of – in the current weak environments that you're seeing, I was just wondering what types of pressures you're seeing, either from a cost side or relative to the weak demand that might make it more difficult going forward to sustain those margins, or what trends you're seeing that could affect those.

And then secondly, in terms of Extrafarma, in terms of going forward and continuing to expand the network, you mentioned the 45% of stores are in the mature phase. When do you think you've passed kind of over some points, I don't know what percentage it would be, where the net positive effect of the – being in the mature phase with a little bit better cost sales mix begin to offset should (19:56) be more than the period where you're having more that are immature and that are – have less favorable economics.

A - André Pires de Oliveira Dias

Hi, Frank. Thanks for your questions. Well, starting with Ipiranga, I mean, we continue to focus on the implementation of our business model throughout our network. I think there are some specific points that are worth noted when we look at the recent performance. One is the pace of the expansion of our network. I mean, we finished at 2016, opened 453 new service stations, which represents 333 net additions to our network.

So the implementation – and in most part of the cases, this expansion basically had convenience included. Our convenience penetration is now at 30% versus 23% a year ago for example. In addition, out of these 453 openings, 70% of those were basically branding unbranded service stations, which normally brings a better return on invested capital (21:16-21:17).

So as for the margins, obviously, we have to bear in mind that the fourth quarter normally is a quarter that you have, from a seasonality point of view, a level of EBITDA margin per cubic meter that is higher than the average of the year. When we look at the average EBITDA margin or EBITDA in reals per cubic meter for 2016, which was BRL 131 per cubic meter, we continued to focus on expanding this margin. However, obviously, the pace of expansion of this margin will not be as strong as it was in the last couple of years. That's one point.

The second point is in terms of volume, we are expecting better volumes in 2017 versus 2016, basically coming from the – basically the maturity of this accelerated expansion of our network and also by the fact that we're probably going to have a more, I'll say, equitative competition environments in Brazil after the recent change in pricing policy from Petrobras. So those factors plus potential recovery in the economy especially after the second semester should bring better volumes for Ipiranga in 2017 versus 2016.

For those reasons, we don't – we are not seeing major pressures in terms of cost and in terms of trends. I mean, Ipiranga does not intend to change its strategy in terms of focusing on the financial sustainability of its business. But obviously, we are anticipating better growth in terms of volume in 2017. We're anticipating also some recovery in terms of market share, considering those impacts that I mentioned to you.

Talking about Extrafarma and the expansion of our network, you're right. 45% of our stores are still in its maturing phase. We don't have a specific, let's say, target in terms of when the maturing number of stores will start to decrease. Obviously, we are opening over one-third of our network every year. So, we have an objective to open 100 stores in 2017 out of 350, so it's like a third, right. So, it did have an impact from an expansion point of view.

Our expansion in 2016 was 24%. The market grew by 8% in terms of opening a new store. So we are growing three times quicker, three times more than the market. This will continue to impact the results, but at the same time, we're already seeing the results of increased revenues. We are increasing revenues also, prices as much as the market is increasing revenues.

So the impact of those stores that are maturing are not being enough to offset the growth of EBITDA. We grew EBITDA by 29% in 2016. So, again, I think the combination of organic expansion that is much quicker than the markets and the fact that the revenues are growing at a much quicker pace are offsetting, obviously, the impacts that we have on stores that are maturing, and we are continuing to see Extrafarma as one of our main avenues of growth for Ultrapar, and focusing on the organic growth of Ultrapar.

Q - Frank McGann {BIO 1499014 <GO>}

Thank you very much.

Operator

I'm showing no additional questions. We will conclude the question-and-answer session. I would like to hand the conference back to Mr. Pires for any closing remarks.

A - André Pires de Oliveira Dias

Well, thanks, everyone, and thanks for the participation. And any – as always, any further questions you might have, you could address to our IR team, and I hope to see you again in our next conference call, which will happen in May. Thank you very much. Have a good afternoon, everybody.

Operator

Thank you, sir. Ladies and gentlemen, thank you. This concludes today's Ultrapar 2016 and Fourth Quarter 2016 Results Conference Call. You may disconnect your lines at this time.