Q3 2017 Earnings Call

Company Participants

- Abhi Manoj Shah, Chief Revenue Officer
- Alexandre Wagner Malfitani, Chief Financial Officer and Investosr Relations Officer
- Andreas Bottcher, Market Manager
- David Gary Neeleman, Chairman
- John Peter Rodgerson, Chief Executive Officer
- Unidentified Participant

Other Participants

- Daniel J. McKenzie, Analyst
- Pedro Bruno, Analyst
- Savanthi Nipunika Syth, Analyst
- Savi Syth, Analyst
- Stephen Trent, Analyst
- Victor Mizusaki, Analyst

Presentation

Operator

Hello, everyone, and welcome to Azul's Third Quarter of 2017 Results Conference Call. My name is Hoberta [ph], and I will be your operator for today. This event is being recorded. (Operator Instructions) I would like to turn the presentation over to Ms. Andrea Bottcher, Investor Relations Manager. Please proceed, ma'am.

Andreas Bottcher

Thank you, Hoberta, and welcome, all, to Azul's third quarter 2017 earnings call. The results that we announced this morning, the audio of this call and the slides that we'll reference are available on our IR website. Presenting today, we'll have David Neeleman, Azul's Founder and Chairman; John Rodgerson, CEO; Alex Malfitani, our CFO, and Abhi Shah, our Chief Revenue Officer, are also here for the Q&A session. Before I turn the call over to David, I'd like to caution you regarding our forward-looking statements. Any matters discussed today that are not historical facts, particularly comments regarding the company's future plans, objectives and expected performance, constitute forward-looking statements. These statements are based on a range of assumptions that the company believes are reasonable, that are subject to uncertainties and risks that are discussed in detail in our CVM and SEC filings. Also during the course of this call, we will discuss non-IFRS performance measures, which should not be considered in isolation. With that, I'll turn the call over to David. David?

David Gary Neeleman {BIO 687871 <GO>}

Great. Thanks, Andrea. Thanks, everybody, for joining us today for our third quarter earnings call. I'd like to start first by thanking our crew members, who work hard every day and take care of our customers and they're really giving the best travel experience in the industry.

Thanks for their dedication, we delivered an outstanding quarter, which is one of the most profitable of all the airlines in Latin America. Our -- we're executing our margin expansion plan by growing the capacity double digits. I'm pleased to report that we had a record operating margin of 12.5% in the third quarter. We grew capacity 13% year-over-year, while also expanding topline 15%, which resulted in 83% load factor, highest ever. Now that's amazing considering that we're upgauging aircraft a lot and so to have these higher load factors, it's really amazing and it's a testament the story we told, which really opening up our route and increasing the load factor on a lot of routes that were constrained by smaller aircraft. So we continue to grow ASKs through, as I mentioned, of gauging this fleet. We are going to add 7 new A320neos between November and January. They're just in time for our Brazilian high season. We're moving full-steam ahead on training crew members and getting ready to receive these aircraft. Now, as we've explained before, this transformation that we're going through, where we're replacing E-Jets for neos, is unique in the airline business. Others maybe replacing their COs or classics for neos or Maxs, but we're going up 56 seats for very similar trip cost. This is putting a little pressure on our non-fuel CASK because we've got so many pilots in training as we move the speed over, but we see this as a big investment in our future. As I mentioned on the last call, we are moving aggressively to speed up this transformation process. We're looking at selling some E-Jets before -- at a faster rate and taking on more neos, and we hope to have some good news on that front by next earnings call as we speed up the process. We're also making significant progress on delevering our business since the conclusion of the IPO. We ended the quarter with an adjusted net debt-to-EBITDA ratio of 3.9, the lowest in South America. The debt -- we also were able to reduce our debt by BRL737 million in the quarter to BRL2.9 billion. While the cash remained stable at BRL3.1 billion, representing 41% of our last 12 months' revenue. We are also very active in the capital markets during the past couple of months. In September, we successfully concluded a secondary offering that's 400 million shares, removing an overhang and increasing liquidity, and it was quite a challenge to get some of our existing shareholders to sell because they're all on this earnings call and they're loving the story going forward and so they're wondering why they'd be selling if the stock has so much upside.

Last month, we successfully issued also -- last month, we also successfully issued BRL400 million of unsecured senior notes at a 6% yield. John is going to talk more about this and how it's going to significantly improve our debt profile going forward. We continue to run Brazil's most efficient airline operation. Year-to-date, our on-time percentage rate is 86.4% and completion factor reached 99%, one of the highest in the industry. These results are testament to the hard-working crew members that are working across the system to raise the bar of our -- to raise the bar for our customers and this is an amazing accomplishment considering that we serve 104 cities, 97 in Brazil, 40 that nobody else serves. So to be able to have these kinds of completion rates and on-time percentage is truly outstanding. I'm so proud of our crew members. We've added three new cities during the third quarter and 10 new destinations over the last 10 months. We'll start flying for Belem and Belo Horizonte to Fort Lauderdale by December, and have recently announced plans to strengthen our Northeast hub in Recife in 2018 with four new destinations. So looking ahead, this is really a margin expansion story, so we're going to continue to do that through three strategic growth drivers -- through three areas in the company.

As I mentioned, replacing smaller aircraft with larger, more fuel-efficient next-generation aircraft A320neos, growing our loyalty program TudoAzul, which is already up to 8 million members and expanding our ancillary revenue. So exciting quarter for us. So with that, let me turn the time over to John, and he can give you some more details.

John Peter Rodgerson {BIO 17734009 <GO>}

Thanks, David, and welcome, everyone. I want to start off by thanking our crew members as well, we truly have the best crew members in the world and that's how we were able to deliver such great results. As you can see on Slide 4, we had a very strong third quarter this year, with an operating margin of 12.5% and an EBITDA margin of 31.7%, one of the highest margins in the industry. Capacity increased 13% and RASK went up 1.5%, hitting a record load factor of 83%.

As David said, we're making significant investments in our fleet transformation, and even with these ramp-up costs and the increase in fuel prices, we had a 1.7% reduction in CASK, while provisioning for profit sharing for the fourth quarter. We also reduced our total debt by BRL950 million year-over-year, resulting in a 42% reduction in our financial expenses. Moving on to Slide 5 and then taking a look at our revenue. In the third quarter, our average fare increased 8% to BRL308 and a load factor increased almost 200 basis points, reaching an all-time record high. This confirms what we've been telling you that we had a significant need for these A320s in our fleet.

Based on our differentiated business model and the fact that we're the only carrier on 71% of the routes, we were able to grow double digits in the third quarter 2017, and at the same time increase unit revenue. This increase is even more meaningful considering the almost 10% increase in stage length.

Moving on to Slide 6. I'm very excited about the next couple of years. Over the next few years, we expect to go through a fleet transformation as we invest in new-generation aircraft, replacing our older generation aircraft with A320neos and Embraer E2s. In addition to being extremely fuel-efficient, these aircraft have more seats than the older generation aircraft that they will be replacing, contributing to a significant increase in margins going forward.

Our A320s have the lowest CASK in Brazil, and are currently flying an average of 14 hours a day. The neos have a 29% CASK advantage over the 195s that we're currently operating and are expected to represent 14% of our total ASKs this year, and will represent 41% of our ASKs in 2020.

We also have an order for more than 30 Embrear E2s, which have a 24% lower CASK compared to the existing 195s that we're operating, supporting our fleet transformation strategy, as we move forward.

As we look on Slide 7, you'll see that TudoAzul maintained its strong growth during the third quarter, reaching 8.2 million members. We added 1.7 million members over the last 12 months. We also were able to increase our gross billings ex Azul by 47% during the last 12 months, with the majority of this increase coming from the sales to banking partners, further increasing our share of the Brazilian loyalty market. Unlike other airlines in Brazil, TudoAzul is 100% owned by the company. This means that we have no tax inefficiency and benefit 100% from the cash flow generated by this high-growth, high-margin business.

As David mentioned, and moving on to Slide 8, we successfully concluded a secondary offering in the month of September. As a result, we're able to increase our float from 29% to 46% and successfully addressed any concerns about liquidity as we more than doubled the liquidity of our stock. That was not the only transaction that we recently had. If you move on to Slide 9, you can see a summarized term sheet of the bond that we issued in October.

The deal ended up being 10 times oversubscribed and had the highest oversubscription ever for a first-time issuer. The debtholders truly understood the margin expansion and deleveraging story. This seven-year US dollar denominated bond with no financial covenants or collateral, and we expect to swap this in the reais so we don't lose our competitive advantage of having the majority of our debt in local currency. As you move on to Slide 10, you can see the need for this debt.

These resources of this transaction will be used to pay down more expensive secured loans contributed to signficant extension of Azul's debt maturity, from 2.2 years to 4.4 years on a pro forma basis. As we look at the balance sheet, I have to credit our new CFO. I'm proud to report that we ended the quarter with a solid liquidity position of BRL2.3 billion.

Including receivables, our total liquidity position reached BRL3.1 billion at the end of the quarter, representing 42% of last 12 months revenue. We paid down BRL677 million of debt while maintaining the same level of cash. As a result, we ended the quarter with a total debt position of BRL2.9 billion and leverage ratio of 3.9. We have more cash and receivables than we have debt on the balance sheet today. We're excited to have the highest cash position in South America, and the lowest leverage ratio in the region.

Moving on to Slide 12. In addition to having higher margins and a stronger balance sheet, we also have valuable assets not found in other carriers, as you can see on Slide 12. We own 100% of our loyalty program, which we do not intend to spinoff in the future. We also have dollar-denominated deposits and maintenance reserves equivalent to BRL1.2 billion, which we do not consider as part of our cash balance.

And we also have our strategic investment in TAP with a carrying value of BRL808 million. Moving on to Slide 13 and just summarizing, David mentioned at the beginning of this presentation that we're successfully executing on our margin expansion strategy. We continue to execute on upgauging to the A320neos and E2s, fully expanding our loyalty program TudoAzul, which just reached 8.2 million members and executing on our cargo and ancillary business, including baggage fees to help us expand margins going forward. In addition to this margin expansion, we are also significantly delevering the business.

And we're currently executing on both of these fronts. As you move on to Slide 14, you'll see we're reaffirming our 2017 EBIT guidance of 9% to 11%, and we're very, very excited about the future that holds for us at Azul. And with that, we'll turn it over for questions.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Savi Syth with Raymond James.

Q - Savanthi Nipunika Syth {BIO 17476219 <GO>}

Just looking at the 2018 [ph] capacity growth outlook, I was wondering if you could talk about, as we go into 2018, how we might compare to 2017 either in growth levels or in terms of up-gauging versus new market mix.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

This is Abhi here. So yes, in terms of 2018, obviously, we're not releasing our ASK guidance right now, but what I can tell you is that we're completely focused on the up-gauging strategy and so most -- more than 100% of the ASK increase you'll see domestically is going to come from up-gauging. We still have a lot of markets within our network that are really screening for this larger aircraft. And one thing that's really good for us and it's our strategic advantage is that we're still strong in so many different parts of the country.

So we're Number 1 in Recife, we're Number 1 in Porto Alegre, we're Number 1 in the Midwest in Cuiaba. So with all of these different hubs and focus cities, where we can put the A320. So our Number 1 focus is up-gauging, that's where you're going to see the vast majority of the ASK growth. It's going to keep pushing up our stage length and the E-Jets are then going to focus on business routes, either increasing frequency or connecting some dots. In terms of magnitude, you can expect that the domestic ASK growth next year will be in the same magnitude as it is this year and that's about the range that we're looking at.

Internationally, it's a smaller base, but domestic, which is 80% of our business, will be in the same magnitude of ASK growth as this year, driven largely by the up-gauging strategy.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Keeping departures in that 1% to 2% growth and it's just truly coming from the up-gauging.

Q - Savanthi Nipunika Syth {BIO 17476219 <GO>}

That's helpful. And then if I look at fuel efficiency, then you've seen some really great fuel efficiency gains this year with that strategy, should we see that continuing into next year as well then?

A - John Peter Rodgerson {BIO 17734009 <GO>}

Absolutely. I mean, that's why we bought the 320neo and it's an unbelievable fuel machine and so we're very excited about it. And pre any additional deals to kind of sell of more E-Jets we're bringing on neos any quicker, I think the number is 21 or 22 by the end of next year compared to we're ending -- we're getting a couple of aeroplanes now towards the end of the year, but it's a significant increase if you look at what we're ending this year with, with what we're ending next year with.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Savi, this year 14% of our total ASKs will be A320neo. Next year, 27% of our ASKs will be A320neo. So that's really going to make a nice jump in our overall -- for the network.

A - David Gary Neeleman {BIO 687871 <GO>}

That's pre any additional announcements that we will make, we can make going forward, so we are --

Q - Savanthi Nipunika Syth {BIO 17476219 <GO>}

So on that, you're still looking to do more on the E190s if you can, is that right?

A - David Gary Neeleman {BIO 687871 <GO>}

Yes. I mean, that's why I said in my remarks we're moving aggressively. There is demand for the e-jets in the world and we're talking to several entities about selling quicker and then bringing on some neos even quicker than what we have scheduled today. So that's -- our fleet department is hard at work at that. We're getting close to some of those deals. So we'll let you know as soon as we get them completed. Our commitment is to try to stay metal neutral but we want to have the more efficient aircrafts in our fleet.

Operator

The next question comes from Dan McKenzie with Buckingham Research.

Q - Daniel J. McKenzie {BIO 15071178 <GO>}

I guess, John, first question here, what was the contribution from TudoAzul on third quarter operating income, and is this 30% of operating income growing at a steady clip as we look ahead over the next one to three years? It's something that you guys are putting a spotlight on and it seems like a good part of the story. I'm just wondering if you can just help us put some numbers or help us think about it.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yes. Dan, we don't disclose TudoAzul separately for competitive reasons, but what I will tell you is, we have about 25% of the total revenue pie in Brazil, and we are only at about 15% of the pie for our banking revenue and so one thing that we saw is we got -- billings were up significantly and our average price is actually up as well year-over-year and so as we talked about our margin expansion plan, getting to those 15% operating margins, we believe, we're going to get one margin point just coming from TudoAzul. And so we expect to see that coming over the next couple of years.

Q - Daniel J. McKenzie {BIO 15071178 <GO>}

And just one (inaudible) I think this is important too is that if our load factor is going up, the number of empty seats that we have in absolute terms is actually greater, because it's 83% of an airplane that has 172 seats instead of one that has 118 seats. So we have more seats available and the reason this business has so higher margin is that we can select where we want those customers to fly. We force them into certain routes, in certain times of the year, in certain days of the week, where we have the empty seats. So that's what makes that business such a high-margin business.

Understood. And then if I could follow up with -- from Savi's question here, the A320, 41% of the ASKs, as we look out a couple of years here, what are the non-fuel cost implications as we look longer term? Should we think about non-fuel costs being flat to declining as we look ahead over the next two to three years just given the up-gauging and is there any perspective you can share about how to think about that?

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yes, absolutely. Our CASK ex-fuel should be going down over the next couple of years as we deploy more and more of these aircraft. One great thing that I want to highlight is inflation in Brazil this year is about 2%, 2.5%, so we used to have the excuse of high inflation, but that no longer exists. The only kind of excuse we have now is investment in the future, because we're investing in pilots, in training to get ready for more of these aircraft coming, but you should see our CASK going down over the next couple of years, absolutely. That's why we bought these aircraft, and we need to execute on that.

A - David Gary Neeleman {BIO 687871 <GO>}

You look at those the reduction of CASK on the E2 was 27% or 29% -- 24% and 29% so you replace some of the aeroplanes going negative 24%, negative 29% going forward as they become a bigger and bigger part of the fleet, that non-fuel CASK number definitely should be dropping.

Q - Daniel J. McKenzie {BIO 15071178 <GO>}

Very good. If I could squeeze one more in here. I guess, Abhi, with respect to the wide-body expansion, I'm just wondering if you can share how you get comfortable with the idea that there's the domestic critical mass there to support the international growth and in your mind, I guess, in the outlook or in your plans, does the growth work even if the macro backdrop doesn't cooperate here?

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Hey Dan, so I think this goes back to the point I was making a little bit with Savi, is that one thing that's really unique about our network and we've developed over the years is we have hubs and focus cities that serve different parts of the country. So we're strong in various different geographies here in Brazil. So for example, we announced Recife to Fort Lauderdale, Recife to Orlando we already had. Well that's servicing a completely different demand base than our flight from Campinas' or our flight from Belem is going to. So because we have three big hubs, Campinas, Belo and Recife and other focus cities, we really have the opportunities to connect these hubs to where our partners are strong. So our Belo Horizonte-Orlando is designed to serve the local Belo market and the interior of (inaudible). Recife is all about the Northeast. Belem is all about the North and Campinas is all about Sau Paulo and the South. So they're really servicing different parts of the country and we're special because we have the network to support that international service. We build the domestic networks first and then we add on the international flights to make sure we have the connectivity and the feed.

And on the other side, we are partnering with really strong partners, whether it's JetBlue, whether it's United or whether it's DAP over in Lisbon. So if you just make the permutations and combinations of our hubs to where our partners are strong, I see a lot of opportunity for wide-body aircraft and I feel pretty good that we're going to have more options in aircraft and we can really choose the best of the markets.

A - David Gary Neeleman {BIO 687871 <GO>}

And let me say one more thing about the new aircraft that we bought, the A330-900. Now this is an airplane that has the new-generation engines on it. The trip costs for that airplane on an operating cost basis are less than the BRL200 [p] and has more seats. On average, depending on what configuration you look at, it's about 40 or 50 more seats on that aircraft. Sure the lease payment on those airplanes are higher than the current aircraft that we have, but the CMR costs are lower. So as we deploy those five newer airplanes in our high-utilization routes like Lisbon and Orlando and other places we fly, then the old airplanes that have a much lower cost gives us a lot of flexibility. So if things went really bad like they did before, we can always put those planes on the ground.

Our lease payments are less than we have on a 320. And then we can fly them during the peak season. So it gives us ton of flexibility in our fleet even though we'll have 12 wide-body aircraft, five are the kind of more expensive, more efficient airplanes, seven are the cheaper, less efficient, and so we can go up and flex up and flex down based on -- and so that flexibility is just really critical and then all the factors that Abhi mentioned with the -- we're very careful how we do international. When we did the Lisbon fly, for example, having this -- the partners at both end, it was almost immediately profitable, we started flying it. So that's critical but then flexibility on fleet is also important.

Operator

The next question comes from Stephen Trent with Citi.

Q - Stephen Trent {BIO 5581382 <GO>}

Just -- some have already been answered, but just one or two additional ones from me. HNA Group, I know that really, doesn't have much to do to you guys. There's a bit of noise in the first -- not long ago about that company looking at financial and capital leasing options. Am I correct in saying that HNA Group in terms of Azul's daily operations, doesn't really have much to do (inaudible) and clearly just very successfully tapped the capital markets without HNA's help. So am I correct in saying that any potential volatility at HNA doesn't necessarily have implications for Azul?

A - John Peter Rodgerson {BIO 17734009 <GO>}

That's absolutely right. They are an investor. They invested -- HNA invested money during the crisis when we needed it. And we're very grateful to them. They are a good partner. They -- we don't -- they sit on our board. We have a couple of members that we had a board meeting yesterday, they were there. They're very happy with their investment. It's actually -- the value has increased significantly since they made the investment. Traditionally, they're long-term holders of companies and they said they have no intention of selling any shares, and so we're happy to have them kind of sitting on the table with us. We don't need them on a day-to-day basis, but we're very grateful to them and see them as valuable members of our team going forward although we don't need them for anything. So just wanted to make that very clear. It's not -- it's a good relationship, but they're very -- they're not involved in the day-to-day here and -- but they're very happy with their investment.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay, very helpful. Appreciate that. And just one other thing from me, your balance sheet's gotten a lot stronger. Your balance sheet (inaudible) revenues gone north in a nice way. Any sort of medium-term thoughts with respect to whether you guys might consider starting dividend program?

A - Alexandre Wagner Malfitani {BIO 2519089 <GO>}

I mean, Stephen, it's Alex here. We're in growth mode right now, right? So I think it's prudent for us to maintain a healthy cash balance, as we continue to grow with this refleeting that we're doing, and we like being the airline in the region that has the highest margin, the highest leverage and the -- the highest liquidity, the lowest leverage. Even though we're confident that Brazil is recovering. We're entering into I think a positive swing here in the economy. We always need to be prepared. It's a cyclical business here and we want to have this robust position because we believe it's more defensive and that's how we want to keep it.

A - John Peter Rodgerson {BIO 17734009 <GO>}

And we're a couple of years away from that, I mean, I think, we went through a tough time, we accumulated some debt, now we're expanding margins, we're increasing our cash flow, we're paying down debt. A couple of years from now, if we can get midteens or even higher margins, and we have that cash flow, we pay down our debt, certainly would be something we would consider in the future, it is that or buying back some stock. Those are certainly things on our to-do-list, but it's -- we're a couple of years away from that. We've got some housecleaning to do, and we're going to continue to strengthen our position and then we'll definitely consider that in the future.

Operator

The next question comes from (inaudible) with Deutsche Bank.

A - Unidentified Participant

John, you mentioned with E2s coming in, that CASK was 24% better than the E190s that they're going to replace, does that include sole aircraft ownership cost, like if you were to debt finance some, would be that be that 24%?

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yes. So, Mike, where it comes from is that the E2 -- the 195-E2 stretches itself a bit too, right? So it can go up to 136 seats. We're currently at 118. So you're getting 10% more seats than the aircraft, 15% lower fuel burn.

And then for us, specifically, one thing that I -- we built this airline from 0, and so we've got a lot of expensive ownership on E1s and so David often comes into my office and says, what would the airline look like if we had current market E1 lease rates, what would the airline look like? And so obviously, with our much improved balance sheet and margins, the offers that we get for E2s today are significantly better than we were paying for E1s and that's with more seats, lower fuel burn and so we're very, very excited about that aircraft. Now it's a 2019 and beyond story, but -- we're still carrying with us the sins of being a startup carrier in Brazil, from nine years ago. And so I think you need to put that in perspective and we're very, very excited about how profitable this airline will be as we look forward two to three years.

A - David Gary Neeleman {BIO 687871 <GO>}

(inaudible) based on where we've been, and what we're paying for our E1s today, it's crazy what we're paying for them, but it's -- we don't have a problem getting the E2s for a very similar price going forward.

A - Unidentified Participant

And then -- that's great. And just notwithstanding the comments David that you made about the A330neos. But what are you guys seeing in the marketplace right now for pricing on Airbus neo narrow-bodies? I mean, I know that it's a very robust demand environment for air travel, and then we're seeing some of the highest numbers out there, and yet, we're seeing some real intense competition among many of these new lessors that have come onto the siege, and we're hearing things like 0.6, 0.7 lease rate factor. So I don't know if that's either -- trying to bring on more A320neos sooner rather than later, but if you could talk about maybe the cost of what you're seeing for some of these new airplanes, how that market looks like right now?

A - John Peter Rodgerson {BIO 17734009 <GO>}

Hey Mike my job is to calm David down, okay? So we're going to do it. We're going to take more 320s to the extent that we can exit 190s, but we don't want to get ahead of ourselves. We want to make sure that we're trying to do this fleet transformation as fast as we can, but you're absolutely right. There's a lot of competition out there from lessors and there's aircraft that's available not only on the narrow-body side, even on the wide-body side. But we want to execute to an aggressive plan that we have now and again to the extent that we can exit aircraft from our fleet, we will be looking at adding additional aircraft to our fleet, to be consistent with our overall strategy. What I don't want to do is I don't want to be just opportunistic and get somebody's leftovers and it's very, very important, our brand and how we treat our customers and so we want to make sure that we have a fleet that's consistent and has a great customer experience.

A - David Gary Neeleman {BIO 687871 <GO>}

(inaudible) by the fact that -- you're right. It's not just narrow-bodies, wide-body prices have really fallen dramatically. So it's an opportunity for us and that's why -- obviously, moving out of some of these E90s sooner, maybe some book implications but certainly, it's worth it for us. We've looked at it and said, let's speed it up if we may have a book yet but not a cash yet, but it makes kind of sense when you look at the margins compared to these two aircrafts on the routes. When we replace one and sticking to another on, the margin just goes crazy, and so we have all these settings of growth to speed that up.

A - Unidentified Participant

If I could just squeeze in one more with -- for Abhi, on bringing on the A320neos, I know one of the positives in addition to giving the additional seats for TudoAzul. Just curious about what you're seeing on connections. I know one of the sort of side effects or consequences were that you'd be able to do a little bit more connecting, maybe by way of ECP [ph]. Are you seeing an increase in those connecting rates, and if there's anything that you can give us, any numbers or even rough sense of how that has changed to brought the 320neos into your system, that would be great.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

So I mean, one thing we talked about a lot about our story is we're widening the pipes on the trunk route, if you will, and so -- and because we have multiple hubs and we have multiple focus cities, we obviously flow a lot of connecting traffic in-between these cities. So yes, you're exactly right. I mean, we are seeing connecting rate increase, I would say, in the range of 5 percentage points year-over-year. And it's helping, especially the smaller cities. So I'll give you an example. Recife, which has 57 daily departures has the same number of A320 operations as Campinas does, because we have 27 cities and we just need five daily Recife flights on 320s.

All of our flights going into there need to be 320s so they can feed all of those destinations. All of the interior Sao Paulo cities we're flying multiple ATR frequencies. We're up-gauging some of those to E-Jets because we just -- because the pipes are wider. Those smaller cities are really benefiting. These smaller cities usually have lower load factors, historically they have because of the nature of the market, but now we're seeing those load factors come up closer to system average and that's helping push up the overall load factor. So the overall connectivity has increased about 5 percentage points, driven largely by these smaller cities, the before's and after's, as we call them, have really benefited from the widening of the pipes.

Operator

The next question comes from Pedro Bruno with Santander.

Q - Pedro Bruno {BIO 19082978 <GO>}

With the revenue trend you were showing looks impressive, like you mentioned with unit revenue growing year-over-year despite the strong capacity addition, could you give us an idea of how you're seeing both short-term and other going forward? The RASK ex there was jet implementation mainly in the domestic -- obviously, mainly in the domestic market here in Brazil, so we get an idea of the demand ex the implementation of the new jets.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Yes, so obviously, we can't break down our domestic RASK publicly between A320s and non-A320s but for example, this year 14% of our ASKs are A320s. So 86% of our ASKs are very dependent on good revenue performance from the E-Jets and the ATRs. So for us to be able to deliver this unit revenue improvement on 13% ASKs and 10% stage length, it requires the E-Jets and the ATRs to perform well also -- it just cannot be the A320s and it just cannot be international. So overall, we're seeing good demand this quarter, started with leisure demand in July and some really good corporate demand in September and beyond. I think the E-Jets and ATRs -- the ATRs are benefiting a lot from the improved connectivity. The E-Jets are focused on business markets, high-frequency markets, and they're benefiting from a recovery in corporate demand.

I think, we can say that with some certainty after a long time that we're seeing corporate demand pickup. We had good growth in demand in September. We saw it in October as well. And so, I'm -- this combined with the fact that the industry overall is showing good discipline -- good capacity discipline and good fair discipline as well. So as I said on our last earnings call, the table is set for good revenue performance and I think the industry overall is taking advantage of that. And I do expect that to continue fourth quarter and as far as I can see. So I think the E-Jets are doing well also and I think the industry overall is benefiting from good macro conditions and good discipline in the market.

Q - Pedro Bruno {BIO 19082978 <GO>}

Yes, thank you very much. Just one more question also on the implementation of the A320. Is it fair to assume that the margin of positive impact should be lower at some point for these planes as you're probably putting them where you most need them, and you mentioned you still have a lot of routes that are craving for them, right? The next year should already see any of these, let's say, decrease in the marginal positive effect or next year should be similar to what you're seeing in the second semester of this year now or if you could give us an idea of maybe when this effect would play in?

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Yes. Yes, Pedro, so right now, we still have a lot of markets that we need to up-gauge, and as we look at the list of markets that will probably take us until the middle of 2020. I have the first 30 airplanes, already know exactly where they're going to go and it's going to be all up-gauging in our network. Regards to, is it going to be marginally worse after that?

One thing to remember is the network effect. As we're widening the pipes, as we're improving the markets, the smaller cities that go in and out of our hubs, it makes everything stronger. So it's not necessarily true that the 31st, 32nd airplane is going to be weaker than the 25th or the 20th airplane because we significantly strengthened our network in that process. So not only do we see a lot of opportunity of up-gauging, which I think will take us until 2020, but then we can connect dots, we can add new markets, all within a very, very strong network. So I'm very excited about the opportunities for this airplane and there's a lot of runway ahead of us in how we can use this aircraft.

Operator

Our next question comes from Victor Mizusaki with Bradesco BBI.

Q - Victor Mizusaki {BIO 4087162 <GO>}

I have two questions. The first one, the federal government recently decided to reopen Pampulha airport. So I'd like to know if the decision will have an impact on your operations at Northeast. And the second question when we take a look on your investment in TAP, you book a gain of something around 12% [ph] quarter-over-quarter. So I'd like to know you can give some color on how that is performing.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Yes, Victor, first on Pampulha, it's very early in the process. I don't want to comment publicly on our plans or what we're going to do. It's obviously very strategic, but it's early in the process. We're following it very closely, and obviously, we'll take the appropriate action as needed and what makes sense.

A - John Peter Rodgerson {BIO 17734009 <GO>}

But I think, that airport is not going to have a significant amount of movements and what we've created in Belo is significant. The size of Belo Horizonte today is the size that Campinas was for us three, four years ago and so -- and we're going to continue to invest in the Belo airport. It's a strategic hub of ours, we are now flying internationally from that hub, and so we don't see it to have any material impact on our hub.

A - David Gary Neeleman {BIO 687871 <GO>}

First, at operations, they have decided two per hour -- two departures an hour, is all that you can have out of there. So no doubt we will have some of those and so it's when you combine that with what John just said, it's going to be a very small impact. As far as TAP goes, Portugal is on fire. I mean, really -- not literally I mean, I didn't say that. But Portugal is a destination, I'd like to think TAP has had something to do with that really because the (inaudible), who is the Chief Revenue Officer over there, went over there and started this movement to put more flights into North America.

They now serve Toronto and Boston and JFK that weren't served before and daily JFK, New York, which added additional service in Miami, more additional service, and then created a stopover program where people can stopover and spend two or three days. You've actually seen a migration of people from Brazil moving to Portugal that are helping our flights. So revenue is just really booming over there big time. Now we saw a lot of work to do on restructuring the costs, making good progress on that. It takes a little longer in New York to do that kind of stuff, but we're working closely with the unions, and so we're very pleased with what's going on at TAP, the revenues like I said are doing great and hope that the cost will catch up. And so expect TAP to be profitable this year and even more profitable in the years to come. So excited about it.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Okay, thank you. And just last question. With regards to the decision to sell some E-Jets, is this given or depend on the economic activity, maybe you can postpone this decision.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Victor, our problem today is being able to crew all of the aircraft and the investment we're making in the fleet transition and so even with a stronger economic recovery next year, we would still prefer to exit a couple of E1s and then you have a limited base of pilots so we'd rather fly those with A320neos or Embraer E2s, as you get into 2019 and 2020. And so -- to the extent that we can exit older generation aircraft from our fleet, that's our strategy. Older generation aircraft out, new generation aircraft in, try to stay as metal neutral as possible until we get a real Brazil recovery.

Operator

The next question comes from (inaudible) with Barclays.

A - Unidentified Participant

As we grow the fleet and I'm just wondering it seems like you are necessarily through a more competitive environment with (inaudible) and I'm wondering if you can just maybe quantify the overlap you have today versus what it's going to be once you expand the network?

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Yes, so currently, Azul is -- has very limited overlap with our competitors. We are alone in 71% of our routes, and we're dominant in another 15%. So I do not expect that this number to change significantly and the reason again goes back to the fact that we have multiple hubs in multiple geographies in Brazil, where we are very strong. So in Campinas, we're obviously very strong, in Belo Horizonte, we're very strong, in Recife, we're very strong, in the Midwest and Cuiaba, we're very strong with limited overlap.

So our goal all along for the A320 has been to strengthen our own network. It's been to improve economics of the domestic long-haul flying, improve connectivity within our network. So we're really putting these airplanes within our network where we are strong in our hubs, in our focus cities, connecting those dots, adding frequencies, and up-gauging. So I do not expect this number to materially change due to our A320 actions. We have plenty of space within our own network where we can really efficiently and profitably deploy this airplane.

A - John Peter Rodgerson {BIO 17734009 <GO>}

I just want to clarify something. Abhi said he's putting it in the network. He's putting it on the routes that we've had in the system for more than eight years. So it's -- to flying to Salvador or flying to Recife, we've been flying to these markets. So it's one aircraft out, and one aircraft in. And so this consistent model that we've deployed over the last eight years, that's what we're doing over the next couple of years. So it's not only going into our network but these A320s are not opening new cities and developing and not going head to head with our competitors. Even though we have the lowest CASK in the country and we have the most efficient airline with 88 crew members per aircraft compared to our competitors, which are -- some almost double that. We don't fear competition but we're putting it where we think we could be the most profitable and that's just dedicating them on existing routes that we have today and just up-gauging.

A - David Gary Neeleman {BIO 687871 <GO>}

And just to add what they said, when we do add a new city, it's a city that had no competition. So it's a city that has no air service today. So we have -- we do have a list of 30 new cities, we added 10 in the last 12 months, and we're going to continue to add new cities. But these are all cities -- these 30 cities on our list do not have any air service today. So we will trickle down those E-Jets that will be replaced, some will sell, some will trickle down to the system and some of the ATRs then will go into brand-new cities. And so -- and we see that those markets mature really quickly because we have such an extensive network to connect them to both domestically and internationally.

A - Unidentified Participant

Got it. And it's fair to assume that the fleet becomes more diverse I guess right as you go into more (inaudible) sources like phasing out I guess ATRs or E-Jets?

A - David Gary Neeleman {BIO 687871 <GO>}

Not really. It's actually becoming more -- we are actually more consolidating because we're -- as we are moving into two pilot groups, there will be E1 and E2 pilot group and then there will be the 320 and 330. So it's not -- we're diversifying and getting more fuel-efficient, cheaper, lower cost airplanes that we talked about before but the complexity is actually becoming less.

A - Unidentified Participant

Got it. And last question if I may. Can you perhaps share your thoughts on the potential opportunity of -- or selling your loyalty business and I don't know if you actually considered it as a possibility.

A - David Gary Neeleman {BIO 687871 <GO>}

No, we have no plans to do that. We believe our focus now is to just grow into our fair share. And like John mentioned, we have about 15% revenue share today from the loyalty pie, but Azul has 25% of the revenue in aviation. So we have a multi-year plan to grow there, and we were very proud that we were able to go through the Brazilian crisis without having to sell this very valuable asset because not only would we give up a significant chunk of the cash flow, right? But we would also get tax inefficiencies. Today, we are very tax efficient and we're benefiting 100% from this cash flow. Obviously, it's great to have it and it's ready to be sold if we want to, but we don't think we will in the near term.

Operator

The next question comes from Stephen Trent with Citi.

Q - Stephen Trent {BIO 5581382 <GO>}

Just very quickly, just one more for me. When I look at the quarter's results with passenger yields down 1 some odd percent year-on-year nominally, with average stage length increasing almost 10% over that same period, is it fair to say or maybe (inaudible) but is it fair to say that some of the newer destinations you guys are servicing happen to be relatively passenger yield, which routes versus the ones you were servicing before, just wanted to kind of get some color.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

No, I really think it's more just a function of the ASK than the stage length. I mean, anytime you can increase ASK 13%, stage length is up 10%, aircraft size is getting bigger on average as well, and you're still able to increase unit revenue. I think that is pretty good. In terms of the new routes, I mean, as John said, a lot of the up-gauging -- most of the up-gauging is going to existing routes. So we're not really opening new point-to-point routes. We're just up-gauging routes that we have been flying for a long time. And we have opened new cities, yes, but these are cities that we serve with an ATR a couple of times a week or once a day so it makes up a pretty small percentage of the overall ASK contribution and the ASK growth as well. Most of the ASK growth is coming from up-gauging, which, again, with the ASK growth 13%, stage length up, aircraft size up, international having a larger contribution to the capacity story as well, which has an absolute lower RASK, you still able to increase overall RASK, I think is pretty good. And so I think it's just a matter of those metrics and not really sort of the new bases, which are still a very small percentage of our overall network. Does that answer the question?

Q - Stephen Trent {BIO 5581382 <GO>}

Yes. Very helpful, Abhi. It's just struck me that if you're back at envelope stage length adjusted yield [ph] that looks pretty strong given the capacity guys have put up there, so I appreciate the color.

Operator

The next question comes from Savi Syth with Raymond James.

Q - Savi Syth {BIO 17476219 <GO>}

A couple of follow-up questions on the cost side. I know that you mentioned the pilot training. I think, you may alluded to maybe as this is kind of a one-year phenomena. Is that fair or are we reaching a new high level? Or is it just kind of catching up with the growth and once you have a pipeline, some of that cost start to come down?

A - John Peter Rodgerson {BIO 17734009 <GO>}

So a couple of things. I think this is a kind of a two-year phenomenon, but it's somewhat lumpy, right? So there are quarters where you will see this, there are quarters where you won't. But if we adjust for it -- you'd be seeing our CASK going down by maybe 4% to 5% if you take out all the investment that we're doing under fleet transition and also the provisioning for profit-sharing that we did in this quarter.

A - David Gary Neeleman {BIO 687871 <GO>}

And just explaining the lumpiness to it, right? This third quarter didn't take any A320s but we have six coming over the next three months, right? And so you do that. And so depending on where the new aircraft come in, that's why you're going to see lumpiness to it. But overall, it's a consistent path to getting to a lower CASK on a go-forward basis.

Q - Savi Syth {BIO 17476219 <GO>}

Makes sense. And then also next on the profit-sharing, was that similar to last year? Was there any timing issues or --

A - John Peter Rodgerson {BIO 17734009 <GO>}

No. In last year because we didn't have as robust result as we have this year. Obviously, that component was almost nonexistent. We did provision in Q3 and we will have some -- assuming everything goes the way it's planned and we're still getting a good Q4, there will be some provision on Q4 as well kind of through similar magnitude as Q3.

A - David Gary Neeleman {BIO 687871 <GO>}

(inaudible) have profit-sharing in --

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yes.

Operator

(Operator Instructions)

A - John Peter Rodgerson {BIO 17734009 <GO>}

Well, great. Well, no question. So thanks, everybody, for the call. We're going to keep working really hard. We're -- like John said, we're excited. The future is really bright here at Azul. Brazil's kicking up a little bit. We're seeing some improvement in the macro situation here. So we're -- but either way we're prepared. So great management team, great crew members. I couldn't be more thrilled to be the founder of such a great company. So -- and we're going to work really hard for our shareholders because we're all in that category as well. So thank you, again, and we'll talk to you next quarter. Bye-bye.

Operator

Ladies and gentlemen, that does conclude Azul's audio conference for today. Thank you very much for your participation and have a good day.