Q3 2020 Earnings Call

Company Participants

- Abhi Manoj Shah, Chief Revenue Officer
- David Gary Neeleman, Chairman of the Board
- John Peter Rodgerson, Chief Executive Officer
- Thais Haberli, Investor Relations Manager

Other Participants

- Daniel McKenzie
- Fernanda Recchia
- Khalil de Lima
- Michael Linenberg
- Pablo Monsivais
- Roberta Versiani
- Savanthi Syth

Presentation

Operator

Hello, everyone, and welcome to Azul's Third Quarter 2020 Results Conference Call. My name is Beatriz, and I will be your operator for today. This event is being recorded, and all participants will be in a listen-only mode until we conduct a question-and-answer session following the company's presentation. (Operator Instructions) I would like to turn the presentation over to Thais Haberli, Investor Relations Manager. Please proceed.

Thais Haberli {BIO 22113735 <GO>}

Thank you, Beatriz, and welcome all to Azul's third quarter 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 Investor Relations' website.

Presenting today will be David Neeleman, Azul's Founder and Chairman; and 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, but are subject to uncertainties and risks that are discussed in detail in our CVM and SEC filings. Also, during the course of the 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>}

Thanks, Thais. Hi, everybody and thanks for joining us for our third quarter 2020 earnings call. I want to start by saying a big thank you for all the support we have received from our stakeholders, including aircraft manufacturers, lessors, banks, suppliers and the Brazilian government, all part of the management's plan we developed to confront the crisis and optimize the company for the future, most importantly, as everyone knows, how much I care for our people at Azul, I have to express deep gratitude to our crew members, their passion, sacrifice and hard work have put us in a position to emerge from this crisis stronger than ever. Thanks to their support and all the accomplishments over the past few months. I'm confident in the strength of our company and even more optimistic about the future.

Like everyone else, we are closely monitoring the pandemic not only in Brazil, but also around the world. As you can see on Slide 4, the recent trends in Brazil have been favorable. Over the past 90 days, new case counts have been reduced and treatment capacity has increased. Sao Paulo is now in Phase green of its COVID (inaudible) and we're also helped by the seasonality here in the southern hemisphere as we move into summer. We plan to continue monitoring trends and maintaining our operational flexibility to quickly adjust to unforeseen changes in demand. Safety has always been our number one priority and we continue to innovate and deliver a travel experience our crew members and customers are confident in.

On Slide 5, you can see the range of measures we have implemented to focus on the health and safety when traveling on Azul. Our digital boarding process called Tapete Azul or Blue Carpet is unique in the world, resulting in higher NPS scores and quicker boarding times. I truly believe that our focus in delivering a travel experience that enhances customer confidence is one of the reasons for our strong demand recovery.

Moving on to Slide 6, we give an update on our management plan. As we have described before, we believe that by working closely with our partners and stakeholders, we would successfully navigate this crisis. Once again, I have to say, the team did an incredible job. The successful implementation of this plan has given us BRL8.4 billion in additional working capital and cash savings between March 2020 and December 2021. And that's not including the variable cost savings from the capacity reductions.

Again, I'm so proud of this team and as a result of their work, we are the only airline in the Americas and one of the very few airlines in the world to preserve liquidity without raising cash in the second and third quarters.

With that, I will turn the time over to John to give you more details on how well our recovery is going. John?

John Peter Rodgerson {BIO 17734009 <GO>}

Thanks David. Before I begin, I also want to thank our Azul crew members for their support and dedication. Azul is a special place because of our people. Looking at Slide 7, you can see, we ended September with BRL2.3 billion cash, an increase over the second quarter. This is a direct result of the effectiveness of the management plan that David described. The key component of the management plan was to reduce our fixed cost including aircraft lease payments. With these in place, the cash inflows from new bookings are significantly higher than the variable cost to fly our network. This is one of the reasons why the flying that we are doing makes so much sense.

Moving on to Slide 8, we further strengthen our liquidity earlier this month with the successful issuance of more than BRL1.7 billion of convertible debt. With the completion of this offering, we now have BRL4 billion in cash, sufficient for more than five years at current cash burn levels. This strong cash position will power our recovery and allows us to continue expanding our logistics business. Another strategic aspect of our management plan was to re-profile the debt with our financial partners. Since the end of the third quarter, Alex and his team have successfully concluded these negotiations.

As you can see on Slide 9, we now have only BRL425 million in debt, amortizing between now and the end of 2021. We are confident, we have the lowest debt maturities of any airline in our region, which gives us a significant competitive advantage as we move forward with the recovery. Our financial partners clearly believe in Azul and will continue to support us over the long term.

Now, I'd like to focus on our Network and Demand Recovery. As you can see on Slide 10, our diversified fleet gives us an unmatched level of flexibility. We have aircraft ranging from 9 to 214 seats, which allows us to customize our network according to demand, deploying the right aircraft in the right markets. We also have the greatest percentage of NextGen aircraft in the region.

Slide 11 shows the evolution of our network. By December, we will have added back a remarkable 88 cities. In fact, we'll be serving 113 destinations by the end of this year. I want to thank our operating teams for their flexibility in responding to these massive changes to our network. This is a clear demonstration of our resilience and ability to adapt.

On slide 12, we tried to provide a global perspective on our traffic recovery. It was never our objective to be one of the fastest to recover. This is a direct result of our unique fleet, competitive network advantages, and the design of our management plan, combined with the recovering demand in Brazil.

On Slide 13, you can see that we remain true to our network strategy by being the only carrier in 76% of the markets we serve. This is a clear indication that our competitive advantages are stronger than ever. By the end of this year, we expect to recover approximately 70% of our total capacity and over 80% of our domestic capacity.

Moving to Slide 14, I wanted to show you two important indicators we are watching. On the left is a weekly booked revenue and domestics ASKs as a percent of last year. The key feature of this chart is how both measures are improving together. Usually, demand that pulls capacity but sometimes it's also capacity that drives demand. On the right, we show how corporate travel has evolved. Pre-crisis, we're about 60% corporate. We estimate that currently corporate revenue represents about 25%, a significant sequential improvement over the last six months and much better than many parts of the world.

On Slide 15, we further show how resilient our revenue base is. Publicly reported corporate ticket prices for Azul show us down only 4% in September compared to last year, while our flown average fare overall is down, this is mainly due to mix from lower corporate participation and our much reduced international network. Average fares within each segment are showing strong signs of improvement, and we're confident the mix will continue to improve over the coming months.

Moving on to Slide 16, you could see that our unique route structure and fleet flexibility allowed us to quickly recover key parts of our network, capacity and hubs such as Campinas and Recife are already back to pre-crisis level performing better than other industry hubs and providing the platform for the next recovery phase.

On Slide 17, I wanted to give you an update on our codeshare with LatAm. We now have 151 combined non-stop routes selling, and even with reduced schedules at both airlines, the LatAm codeshare is larger than Azul's entire codeshare volume pre-crisis. This partnership is a unique opportunity that will allow us to emerge stronger and better positioned from this crisis.

I'm excited about the opportunities we have in logistics as you can see on Slide 18. Azul Cargo is setting revenue records every month with the highest growth coming from e-commerce. Our diversified fleet and broad network of destinations allows us to reach all of Brazil quickly and efficiently. To meet this increased demand, we have converted four E1s to dedicated cargo aircraft. Going forward, logistics will be a key area of focus and investment for Azul.

On Slide 19, we wanted to update you on TudoAzul. Customer engagement in that program has continued to be very high through the pandemic. Our recurring revenue program, the TudoAzul Club in particular, has performed very well. In addition, we just re-launched our credit card portfolio with a new premium card. It's the best airline cobranded card in the market and the initial results show this will be a unique opportunity to drive further customer loyalty.

Finally, I would like to end by showing you, why we are so optimistic about the future. Many of you have questioned, if the industry will ever recover to pre-COVID levels or if the market will be smaller post-crisis. We want to remind you that as you can see on Slide 20, Brazil is still an emerging market, with significantly fewer travelers than Colombia, Mexico or Chile. There is no reason that a continent-sized country like Brazil with diverse demand centers and limited alternative forms of transportation cannot catch up to the other countries in the region. I want to emphasize that, Brazil grew significantly in the last 10 years, it was growing before COVID and still has tremendous room to keep growing. COVID will not change that.

Finally, moving on to Slide 21, I truly believe and I'm confident that we are emerging much stronger. In the past few months, we've examined every inch of our company, optimizing for maximum efficiency. Our competitive advantage has only widened with our strong cash position and successful implementation of our management plan. Azul Cargo has huge opportunities ahead, and our strategic partnership with LatAm is only getting started. Our crew members are ready to fly, and we look forward to continuing to show our customers, our partners and our investors what it means to be the best airline in the world.

With that David, Alex, Abhi and I will answer any of your questions.

Questions And Answers

Operator

(Question And Answer)

Thank you. Ladies and gentlemen, we will now begin the question-answer session. (Operator Instructions) Our first question comes from Savanthi Syth, Raymond James.

Q - Savanthi Syth {BIO 17476219 <GO>}

Hey. Good morning everyone. And maybe for Abhi. Could you talk about -- this is kind of helpful in the presentation and showing kind of the percentage of mix in business versus leisure, but curious if you could talk about what you're seeing in terms of demand and revenue in 3Q and how that's progressing as it relates to kind of leisure separately in business and -- related to 2019?

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

Yeah. Hey, Savi. Abhi here. Sure. Yeah. So look, I mean, we've been very encouraged by the demand trends recently. I think our competitors as well talked about the holiday in September. The September 7 holiday really was the first sort of event that started to bring back bookings in a very strong way. And that's continued through September and October and now even in November. Last week was another record booking week relative to the start of the crisis. And we continue to chew-in to the percentages compared to last year. So the graph that John showed, how bookings are recovering compared to -- well with capacity compared to last year, that's something that we're watching very closely. They're moving very nicely together and it continues its upward trend.

It is leisure that is leading the recovery as it is in many parts of the world, which is not surprising. When you look at, for example, our direct channels such as our app or our website, leisure is at 100% or very close to 100%. And in terms of revenue, right? And in terms of volume, it's probably pushing over a 100%. And I fully expect that to continue as we head into our peak summer season. And I think leisure will be over 100% in revenue over the next couple of weeks and months.

Corporate is behind, but it's also catching up. And the pie chart showed how much ground it's made up. One advantage that we have is our corporate is less dependent on the Sao Paulo, Rio type corporate. It's more fragmented, small-medium businesses, smaller cities, agro business. So I think that it's recovering about 5 points a month, if you will. We're somewhere around 35% to 40% of corporate recovery at this time. And which I think is -- I think Ed Bastian said it was 15% in the U.S. So I think we're definitely ahead of the curve. And we're heading into summer now. And if we can pick-up at this number post carnival I think we're in a very -- in a good position to get to around 75%, 80% by June, July of next year.

So, leisure is leading, corporate is improving. And in fact corporate, you have variations between different industries. You have finance, which is still behind, but you have oil and gas, which is over 50% at this point. So, you have variations, which I think is natural, but the good news is that it is catching up. And the best news of all is that, we feel confident in the bookings and that gives us confidence to continue the capacity recovery on the domestic side and that's -- you can see that in our capacity guidance and you can see that in how well cash is doing. So, the trends are good and we're going to keep going.

Q - Savanthi Syth {BIO 17476219 <GO>}

That's great color. Thank you, Abhi. And just a quick question on fleet deliveries. Just wondering what your expectations are for 4Q and then again in 2021-2022 based on what you've been able to work with? It doesn't sound like you did any more adjustments to the order book.

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

Yeah, Savi. We had an agreement with both Airbus and Embraer to take aircraft that were already built. And so that was kind of what we did and so we will be taking a couple of additional units in the fourth quarter. But we will set them in the same payment structure that we have with our other leases, they're all 100% financed. So there's no financing risk there. But our outlet will be the E1s converted to cargo, right? And so if the demand recovery comes back very quickly, we can fly those as passenger aircraft to the extent that demand lags for whatever reason in 2021. Then we can convert more of those aircrafts into cargo. We've already done four and we have a project to go as too many as 10 next year. So that'll be our relief. We've had a couple of natural redeliveries, we're sending three aircraft to Breeze, and we had, just in the last quarter, two natural redeliveries as well.

And so, it's fluid the fleet as you can imagine, but remember, we've pushed out significantly all of E2s and all of our Airbus fleet. And so I think we've got a lot of flexibility as we move forward. And there's scenarios where we're short aircraft by the second half of 2021, and that's a good thing, right? So that'll give us opportunities to talk to the OEMs and get better deals.

Q - Savanthi Syth {BIO 17476219 <GO>}

Makes sense. Thanks.

Operator

Our next question comes from Michael Linenberg, Deutsche Bank.

Q - Michael Linenberg {BIO 1504009 <GO>}

Yeah. Hey, good morning, everyone. Hey Abhi, just back to the -- you said the 100% of revenue, more than a 100% Leisure, are you implying that there are cancellations by corporate? What's behind that?

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

No, no, sorry. I meant compared to last year. So, if you look at bookings on a weekly basis, leisure revenue has already reached the levels of last year.

Q - Michael Linenberg {BIO 1504009 <GO>}

I see.

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

And corporate is around 35% to 40%. So in the share is the numbers you see there about 25 and 75, but I was referring to the recovery of the revenue of the booked revenue compared to last year. The same time last year.

Q - Michael Linenberg {BIO 1504009 <GO>}

Okay, great. And then just going back to -- on Slide 14, which touches on the corporate Leisure split, there's also the chart there where you compare capacity growth and booked revenue by -- can I know, John, sort of quickly said, sometimes it's capacity pulling sort of revenues or revenue and demand sort of pushing up capacity. Over the last couple weeks, it does look like you're booked revenue is outpacing capacity growth. But how much of that is organic versus stimulated, because when I look at your yields they are running down 20% to 30% year-over-year? Is that more stimulation or is there an organic element to that? So, I'm trying to figure out what's driving what?

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

Yeah. So in regards to the yields the yield that you're seeing are the flown yields right for the third quarter. Those flown numbers are impacted by what happened back in April, May and June and you also have the impact of the capacity that's coming back online very quickly, right? I mean, this is the ramp-up that we're doing in capacity is something like 20%, 30%, 40% month-over-month in some months. So it's going to take time for the flown revenue to catch up to the booked revenue, especially when you have changes of this velocity and of this magnitude. So what's really important for us in terms of future planning is what are the recent trends in terms of bookings. So you're right bookings are pretty strong right now. And as I said last week was actually a record week in terms of booked revenue since the crisis and also in terms of the relative to last year. That informs our decisions on what kind of capacity we'll have out December, January and February. So that gives us confidence. It's organic in the sense that it has been driven by the seasonality, right? So we are entering the best seasons of the year here in Brazil. And so you are going to have that increase in volume.

Now, as John said, you have to have the seats though to accept that revenue, right? So it is one thing that I'm learning so much in this process is that they really go together and sometimes demand is going to say look I need more capacity. But sometimes the capacity is going to drive the demand whether it's connectivity, whether it's improved corporate schedules, increasing frequencies from 2x a day to 4x a day, to 6x a day that drives revenue or whether it's adding back cities, like we've added back the 88 cities. So they're very very closely linked, it's organic. The capacity is being informed by the demand that we are seeing and the confidence that we have and we're putting up the capacity and we'll see -- we're seeing what happens and as that chart shows, we've been pretty -- we've been consistently rewarded so far since April and that gives us confidence to go forward.

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

And Mike, if I could just add, Brazil -- Sao Paulo just went to the green phase about 30 days ago, right? So it's within the fourth quarter not in the third quarter. Schools are still not back in session yet. It's one of the few countries in the world where they haven't sent kids back to school yet. And so to see the demand that we're seeing right now with just getting start on the recovery gives us a lot of hope as we move through the end of the fourth quarter.

Q - Michael Linenberg {BIO 1504009 <GO>}

It just taking everything that you and Abhi just said, is it reasonable to assume that your PRASK, your year over decline in PRASK for the fourth quarter will be less than the year-over-year decline that we saw in the third quarter? Is that -- is that what the trends are telling us?

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

Yeah. So, Mike, I'm focusing on RASK overall, which includes cargo, ancillary all those kinds of things.

Q - Michael Linenberg {BIO 1504009 <GO>}

Fine. That works.

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

So yeah, so it -- it's going to be similar if not a little bit better and one of the reasons is that the capacity keeps increasing, right?

Q - Michael Linenberg {BIO 1504009 <GO>}

So yeah, that's fine. That makes sense.

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

Exactly. So, we're balancing RASK recovery and we're balancing ASK recovery. And the level of bookings is what tells us, which way to go. And right now, I'm feeling very confident that the capacity recovery is the right way to go. You can see that in our cash numbers.

Q - Michael Linenberg {BIO 1504009 <GO>}

Yes.

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

And so, as -- until the capacity curves start to stabilize as we approach a 100% then the rest will start to catch up.

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

I think the way we establish the management plan, Mike, is really unique to what we're doing. And so when we paid our aircraft rent flying incrementally, we don't have to pay anything additional, that's not the same that's been -- that's happened with other carriers in the region, right? And so every incremental flight has required incremental ownership cost for that flying and so it's actually cash flow positive for Azul to build it network back online. And you're seeing that, I mean, that's why we're one of the only carriers in the world that didn't burn cash in the second and third quarter when there really wasn't a lot of demand. Now, let's move forward into the fourth quarter, into the first quarter as we continue the demand recovery.

Q - Michael Linenberg {BIO 1504009 <GO>}

Great. And then just one quick last one on TAP. I just -- to the comment that you made about TAP, you sold the stake. Is that besides having aircraft on lease to them. Is that the end of your investment in them? Is there anything left?

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

There's no equity investment any more Mike. The commercial relationship on the sublease side with the aircraft and commercial side with the co-chair and the joint venture, those are all very positive for both Azul and TAP, both the leases and the joint venture. So those will continue moving forward and we have the bond right, which is now secured. It's always been secured by TAP's loyalty program, but now the government has - is putting in a big capital infusion into the company, securing the future of TAP.

Q - Michael Linenberg {BIO 1504009 <GO>}

Okay. That's right. So you still have the bond? Okay. Great. Thanks everyone.

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

Yeah. I think what's great about the bond is, that we've got the deal done -- the convertible deals done, it's still totally unsecured. And so that could be --

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

Yeah. The bond is still unencumbered. So it's another asset, another unique asset that we have. That we can potentially monetize.

Q - Michael Linenberg {BIO 1504009 <GO>}

That's a great point. Thank you. Thanks everyone.

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

Thanks Mike.

Operator

Our next question comes from Dan McKenzie, Seaport Global.

Q - Daniel McKenzie {BIO 15071178 <GO>}

Oh, hey. Good morning guys. Thanks. One housecleaning question here. Just given the savings on the renegotiated leases, what are you looking for, for interest expense in the fourth quarter? And then, just related to this. I'm wondering if you can provide some insight on, say a balance sheet roadmap for year-end and what you'd like it to look like year-end of 2021?

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

Hey, Dan. So we gave guidance on the rent payments that we'll have for the year. And what that represents in terms of the total rent payment if we were not deferring, right? And from that, you can calculate what the interest expense is going to be. Because the expense continues accruing, right? The cash is not leaving. But the expense continues accruing. So you can calculate that with the numbers that we provided.

We also provided a few -- a couple of quarters ago, we provided guidance on what we estimated. The lease liabilities would be by year-end. And we're on track to deliver that, except for the fact that exchange has moved, right? So we were in the kind of mid-BRL12 billion in terms of lease liabilities. And we'll be a little bit above that, but still below BRL13 billion just because of the exchange move. And then you can have net debt which we also have on the balance sheet that shouldn't change we know between now and end of year.

Q - Daniel McKenzie {BIO 15071178 <GO>}

Okay. Very good. And then I guess just, second question here. Just, I guess, Abhi, picking up on your commentary, around being in a good position for corporate travel to recover at 75% to 80% in June or July of next year. That would be a pretty impressive recovery, of course. And I'm just wondering if you can elaborate a little bit on what your clients are saying about video conferencing versus the need to see the clients in person? And then just separately, just given the diversity of the network, I presume at this point, it's the big cities leading the recovery. But I'm wondering, what you can share about the recovery, just by geography and say what you're seeing in some of the smaller cities as well. I'm just wondering if you can elaborate a little bit more on that.

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

Yeah. Sure, Dan. Yeah. So in terms of our customers, it's interesting, it's by industry, as I said oil and gas is over 50% but finance is at 20%. And even within finance, for example, we have one bank that's flying a lot, and we have another one that's not flying at all. And so it seems to be a lot more sort of individual policies. Many companies here in Brazil are adhering to the global policies, multinationals especially. Even though the circumstance in Brazil, the seasonality is different.

So, I -- the really positive thing and that's what David talked about initially is that we're not seeing any opposition to the act of air travel, right? I think the industry has done a really good job in talking about safety on-board, in implementing tons of stuff about safety on-board. And that's really increase customer confidence in a way that -- that's not really a discussion from our corporate customers. I don't get feedback saying, oh, I flew you guys and I didn't think it was safe. Not at all. I think it's more about just kind of when is their policies going to bring people back to the office? And again, we have one bank that's flying a lot and another one that's not. So I think it's more individual kind of, what they feel comfortable with.

In terms of geographies. It's actually not the big cities that's driving the recovery. And we showed on the graph that Congonhas in Downtown Sao Paulo is still lagging behind. As sort of big large corporate sort of brings up the tale of the recovery. Where recovery is very strong, is the North. Northeast is very strong. Our hub in Campinas is doing very well. Recife is doing very well. The fact that we're added back so many destinations is bringing back tons of connectivity to our network. We're still more connected than last year. That's partly because of less corporate demand, but also because that's the demand that's coming back first.

And so, our unique position and the breadth in our network, together with the fact that we can have ATRs, and Embraers and A320s and even A330s flying domestically really allows us to come back online. Capacity in 4Q will be double of 3Q right? And we're confident in that, because of the bookings that we have seen. And flown revenue will catch up over time once we get to a steady-state scenario. So geographically it's more connections. It's not big cities actually. The breadth of our network is really helping us right now. And the fact that we just fly to so many places that nobody else does, really it allows us to capture that demand into our hub.

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

And, Dan, it's not the same. The video conference is not the same as visiting your client, taking him to dinner. We fly throughout all of Brazil. And we often say, look, the first deal you lose because your competitor visited your client, your butt's going to be back on an aircraft, right? And I think that that's what we're all about. We wanted to kind of frame for you Brazil is still in a huge growth phase. And so maybe get set-back a couple of years because of COVID in terms of growth. But Colombia and Mexico being 65% bigger than Brazil makes no sense, I mean look at the size of the economy, look at everything that's happening in Brazil makes absolutely no sense.

And so, Brazil will be back to growth and we're going to take advantage of that. And so, yes, maybe there is some people that choose not to fly and choose to do video conference. But many of those same people that chose not to fly, back and forth Rio, Sao Paulo, they're actually flying to the Northeast and are renting beach houses. And so that's a lot of what the demand that we're seeing right now. It's not -- they're not afraid of traveling. They've just chosen because they can work remotely. So they're working remotely all throughout the country.

Q - Daniel McKenzie {BIO 15071178 <GO>}

Very good. Thanks so much you guys.

Operator

Our next question comes from Pablo Monsivais, Barclays.

Q - Pablo Monsivais {BIO 17389900 <GO>}

Hi, good morning. Thanks for taking my question. I have a few questions here. The first one is a quick one. Do you have any update from your previous quarter on expected lease payments for the next two years? And my second question is on the unit revenue side. On the unit revenue you said that you want the capacity to be back and then you will focus on unit revenues, but how should we see the recovery for 2021 and probably 2022 in terms of unit revenues? And then in terms of average fares, how for example leisure fares in the third quarter of this year compared to last year? And what should we think about average fares in the first quarter of 2021 compared to the first quarter of this year? Thank you.

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

Sure. Hey Pablo. So on the leases, it's actually the profile that we have been describing over the last couple of quarters where we were for few months at a Zero Percent payment then we went few months at 20%, right now we're at 40, over next year we will be six months at 60% and six months at 80% and then in 2022 it will be the full year at a 100% and all years in 2023 we start repaying back that debt, but that debt will be paid in very small installments over a number of years. So we'll never go above a 125 rent. And again, it's not that our rent expense going to go up. We'll just be repaying this interest-free loan that we were able to negotiate with our lessors, right? So no big change in the profile and again very valuable negotiation because it's what's allowing us to be ahead of the curve in terms of cash generation and ahead of the curve in terms of network recovery.

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

And before we pass it over to, Abhi, on the specifics, the way we structured this is the best cash flow answer for Azul, right? And so other players may do other things but it's for -- in our best interest that if we're paying 40% aircraft rent to fly and bringing an additional cash and so you will see us doing that all throughout 2021 if there's a vaccine or not we're still only paying 60% rent for the first six months. We're still only paying 80% rent for the back half and so there is a scenario where Azul builds a significant amount of cash in 2021 as the demand recovery comes back and because of the way that we've negotiated these lease terms.

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

Yeah. Hey Pablo. Yeah, so the -- we're obviously balancing unit revenue and capacity and it's not like we're focusing on one more than the other. Obviously. We'd like both to come back as soon as possible. Even though for example November has doubled the capacity of August, our unit revenue is up and it's steadily been up each and every month as we have executed this recovery but it's going to take time for the flown revenue to catch up because what we are watching is bookings and bookings into a larger and more recovered airline as we move forward. So you will continue to see this difference between bookings and flown at least for the next couple of quarters until we get into the second part of 2021 and then you will see the unit rev -- the flown unit revenues start to catch up to what we had earlier in pre-crisis.

But as John said, this is the right thing for us to do in terms of how we bring the airline back online in a very responsible way. And so it would take a little bit of time for the flown to catch up because the differences are so big. November was double of August, 4Q was double of 3Q. And so it just takes time for the flown revenue to catch up. In terms of leisure fares, average fares overall, if you separate the mix issue, and the biggest mix issue is international versus domestic, right? So we are only 8% of our capacities domestic right now. It was 25% last year. International fares are 3x, 4x domestic fairs in absolute terms, especially when you consider a business class on a long-haul product. And so that's one main reason for overall fares. Then you have the more connections you have corporate versus leisure, but if you drill down to each individual segments and look at just leisure fare for example, they are shown really good recovery over the last few months. Our booked average fares are up over 60% since July. Leisure fares just compared to last year are within 10% of last year just that segment alone.

So those numbers are recovering very nicely and again as we start to level out the capacity of recovery, those will get realized into the flow numbers over the next couple of quarters. And of course you have the operating data that John showed which is that our corporate fares have been very, very resilient compared to the industry. So it's just a matter of time for these numbers to show up in the flown revenue but because we are recovering so fast, it will take a few quarters to do so.

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

And I think there's also a high-end leisure segment that Brazil hasn't seen before. With the borders being closed and people not able to go to Paris and London and Frankfurt and Rome and New York, Brazilians are spending time in the Northeast of Brazil and that is something that there are certain weeks of the year were fares are up significantly year-over-year just because there's so many people looking for these leisure destination.

Q - Pablo Monsivais {BIO 17389900 <GO>}

Interesting. And then kind of a follow-up, I guess that also, Abhi you mentioned last quarter that International market won't be your top priority right now that you're going to focus more on the domestic side, and I guess that when international travel itself, you will have obviously average fares increasing. How are you seeing international traffic evolving more than a quarter? So do you think that you're going to be back at some point adding some international routes or should we expect that market to remain depressed for the next six months?

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

Hey Pablo. So yeah, look international is going to be slow and that's normal given the restrictions on borders and currency of course, but we are fully utilizing our A330s, right? So we have the airplanes flying domestically, which is very, very positive for cargo. It's very positive as well, for example between Campinas and Recife our two largest hubs. The aircraft delivering a ton of connectivity flying to Manaus, to Belem as well. And the airplanes are not flying are doing maintenance. So actually, so our A330 feet is fully utilized, our focus is domestic. The only market that we are ready to open is Orlando to the extent that the U.S. border opens up anytime soon, will be ready to begin Orlando again shortly thereafter, but we have no other ambitions beyond that in the short term for international. It's going to be from Campinas only, the rest of the time the airplanes will fly domestically and they really are contributing in a very, very positive way both the passenger connectivity and for cargo.

Q - Pablo Monsivais {BIO 17389900 <GO>}

Awesome. Thank you very much.

Operator

Our next question comes from Fernanda Recchia, BTG Pactual.

Q - Fernanda Recchia

Hey, thank you for taking my question. Just a quick follow-up here on the fares behavior. I understand that on a year-over-year basis, we have seen a drop due to mix, mainly because of the reduced international network, but when we look at the quarter-over-quarter, we also are seeing a decrease. So I wanted to further explore this why we are seeing a decrease on a quarter-over-quarter basis? And also looking at 4Q in 2021, how you're looking -- I mean, you already mentioned that you are expecting the international rebound and this should bring tariffs up, but if you could elaborate on domestic average as well, how you're seeing? Thank you.

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

Yeah, Fernanda. So the big difference you are seeing is just the pace at which we are recovering the network and the time it takes for the flown average fares to show up in the data, right? And so as I said, the booked average fares for leisure traffic are is within 10% of last year, which is very, very positive given how fast we are recovering our network. It's going to take a couple of quarters for the flown numbers to show up, because of the booking curve and the time it takes for the booking curve to fill in.

Remember that the demand environment is changing very quickly the bookings that we are seeing now are 10x larger than what we saw back in April and May, right? So it's going to take time for that data and that -- and that revenue to show up in the flown number. So it's more a matter of time and a matter of how we are recovering the capacity and once that stabilizes you will start to see average fares and the unit revenue start to converge to what we had before. And just for international we are not expecting any major growth in international next year. The only new market that we will add once the U.S. borders open up is Orlando but we're going to remain very conservative on international and focus our widebody aircraft flying domestically.

Q - Fernanda Recchia

Okay perfect. Just to make sure, if I got it correct. So the increase in book you're seeing now, will reflect on the 4Q right, or in the first Q, you will still be impacted by the lower demand in May and April?

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

It's going to start to come in every single quarter more and more. So 4Q you will have impact once you will be less impact and 2Q will be less impact, but every single quarter will get better as we are flying this new and improving booking scenario.

Q - Fernanda Recchia

Okay. Thank you.

Operator

Our next question comes from Savanthi Syth, Raymond James. Savanthi, your line is open.

Q - Savanthi Syth {BIO 17476219 <GO>}

Sorry about that. Thanks for the follow-up here. Just wondering on the cargo side, if you could provide a little bit more color? It is -- you're excited about the opportunity, it sounds like its kind of passenger doesn't recover as quickly there's an opportunity to add more E1s in there. Just how large can from a revenue standpoint can that segment gets? And how much progress have you made so far?

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

Yeah. Thanks, Savanthi. So, we've actually made very good progress. If I guess what the revenue numbers now October was double of May, and almost double of June even. So it is growing very, very quickly. Of course having the A330s flying domestically is helping a lot. The four Embraer aircrafts are fully utilized. Utilization pushing eight hours a day. One or two of them have already been signed up, sort of on a dedicated with one of our customers, but the other ones are flying as we need them and other customers are calling us. We just crossed over 1 million packages a month and we expect that to be 1.3 million, 1.4 million, 1.5 million over the next couple of months. And it's in 20% of (inaudible) overall and it was 5% before now of course passenger has come down but there has been sort of a re-reaping of the relevance of the cargo business and I expect that, well it was 5% before to be 10%, 12% going forward once passenger comes back.

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

Yeah, Savanthi, the converting the four E-Jets makes business sensitive. We're lucky as we have the E-Jets available and we can do it in a relatively quick period of time but it's not like passenger demand is bad. So let's do this out. It hasn't something a little business case that makes it work and those are already sold out for the next six months to our e-commerce players. And so we'll continue to evaluate that and as there's an arms race in deliveries in the country and it's very, very clear. Amazon's coming, had delivers very strong. (inaudible) there's a bunch of players that are running after this e-commerce space and it's really our network advantage that's unmatched. One guy cannot compete with us because we serve a 130 domestic destinations and that makes a huge difference.

Q - Savanthi Syth {BIO 17476219 <GO>}

That makes sense. Thank you.

Operator

Our next question comes from Roberta Versiani, Citi.

Q - Roberta Versiani {BIO 21207378 <GO>}

Hi everyone. Good morning. Thanks for the call. Thanks for taking my question. Just a couple of more general ones on my side. Firstly, I'd like to hear, what are your views regarding the competitive landscape in Brazil. For example, there was some news about Airbus operator that wanted to launch a more premium airline in the country. What would be your thoughts on that? And maybe could it be that fragmentation becomes sort of standard fee right now. And also continuing all the changes surrounding the markets in Latin America? Just as you see any opportunities for maybe some regional extension in a post-pandemic work? And thank you.

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

First of all, we have no desire to go to Argentina, Chile, Peru or any of those places. Brazil's a big enough headache for us. As for competition, Azul is leaner and better than ever. We were rated the best airline in the world. We're happy to compete with anybody. The new Airline that's talking about starting up, is talking about flying to the triangle. Got OYO's Brasilia, and Rio, welcome to Brazil. We've built this over a $1 billion of equity capital that's into this business. We're stronger than ever and we're ready for anybody to compete with. And so again, there will always be competition. In that way we always need to be stronger and more efficient. And I think our crew members know that and we welcome competition.

We have great local competitors today and we're a better Airline today because of our competitors. And bringing more competition will help us raise our gain. Once we became and rated the best airline in the world, we need to step it up every day. We're doing that from an efficiency standpoint and from a product standpoint. But as for aspirations in the rest of Latin America, the opportunities in Brazil, you can see that in the chart. Brazilians need to travel a lot more. We're going to double aviation in Brazil over the next decade.

Q - Roberta Versiani {BIO 21207378 <GO>}

Okay. Great. Thank you.

Operator

Excuse me, ladies and gentlemen, we will now begin the question-and-answer from the webcast.

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

Okay. So I think we have our first question from the -- from Hannah UBS. She's asking us to talk a little bit about -- no we talked about the lease payments. One question was the change in the flow of lease payments, which we already covered. The other ones, how much is the reduction is from the lease liabilities? It's come from the rate increase. How much from changes in the payment cash?

Yeah. So the reduction and lease liability. I think everybody's used to IFRS 16 up to this by now. When you have a change in the leases -- lease modification, you have to recognize the assets and liability. You have to adjust for the change in the terms of the lease agreement. The lease liability has been reduced because of payments happening later in time, an increase in our cost of capital due to the COVID crisis and discounts in the lease, the rent payments as well. Right? Out of those, I think we talked about this in the past. About 60% probably the interest -- the discount rate, and the rest primarily comes from the payment deferrals.

The fact that you are paying the same amount of dollars later in time. But if you recall this is a loan of over BRL3 billion that we got from our lessors at no interest. Right? So this was a financial transaction. I think it'd be very easy for everybody to see just the huge value and the benefit from this negotiation. It's embedded in the lease terms, but that's effectively what the result is. Right?

And then we also had a rent reduction. So, I think one thing is important to highlight, you all know how excited we are about our nextgen aircraft. Right? We are ahead of the curve in terms of our fleet transformation. We already have about half of our capacity coming from nextgen. And we can't wait to bring these nextgen aircraft into the fleet. We could potentially get reductions, bigger reductions in our rent payments if we extended the leases on our old generation aircraft. That's what our competitors are doing. It's very easy to do. It's an option that we can exercise whenever we want. But we do not think it's in our best interest to do that.

We have the cash to pay a little bit more rent right now and see these aircraft going away in their original lease expiration date. Right? And then be able to bring in A320neos and E2s which will have lower rent payments, lower fuel burn, higher seat counts and better ESG figures as well. Right? So it makes total sense for us to be able to spend a little bit more rent payments now, but get rid of these old generation aircraft and continue to be years ahead of the competition in terms of moving on to nextgen.

And I think another question we have we have here is on the dynamic of sales and transportation liability also from UBS.

We've seen some gains there while current booking curve is likely shorter. Our sales recovery is quicker than demand or could be explained by tickets sold before COVID and not being rescheduled yet.

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

No, the gains that we have showed, are all new bookings. Okay. That's an important point to say, that we're tracking new bookings. We have seen customers use credit shells but it's a very -- it's a small percentage of the cash that's coming in. Our refund balance also is small compared to the overall pie of what's out there. It's 80% credit shells, 20% refunds that we have over a year and it's very spread out. So we don't expect any impact from that. But all the bookings numbers that we've shown are new bookings not rescheduled bookings. And therefore that's why they're translating so positively into the improved cash numbers.

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

Yeah. And even if you look at our air traffic liability on the balance sheet, Abhi mentioned sort of the credit shells and refunds. Those are the smallest portion. They don't amount either even to a third of our ATL. It's really the new bookings that Abhi has been able to sell that represent the vast majority of our ATL. We monitor both the credit shell and the refund queue we've been managing them. They've been coming down in total compared to just an absolute terms and also compared to our ATL and like Abhi said, if they ever become refunds the refunds are less than 10% of our ATL today and they are spread over almost a full year, right? It's not all coming due in one month. It's all kind of spread throughout a high number of years.

Operator

(Operator Instructions) Our next question comes from Khalil de Lima, Reach Capital.

Q - Khalil de Lima

Hello everyone. Thanks for taking my question. I would like to know how you are seeing the customer behavior right now? I know before on the second quarter they were buying with less -- less time to travel and now just see if confidence is raising? And also I know in

June or July you guys launched a new program that allowed customers to buy tickets with longer installments, I think was 10x without interest and I would like to know how you guys are perceiving these new product if this helping at all? Thank you.

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

Yeah, Khalil, yeah, so definitely customer confidence has increased especially as we are getting into summer, we are seeing customers book for the route into December and into January as well. And we also know from our net promoter scores, customer satisfaction is actually very, very close to last year, which is an amazing sign, given sort of all the news out there. So, I think customers are confident. We have -- we're flying tens of thousands of customers every single day. We rarely get reports of customers when to change seats or move flights or anything like that. So customer confidence is improving with the summer season. Customers are booking for the route.

And you're right, we do have 10x installments, it's actually come and gone. It's not new in the sense that Brazil had it. It's been around for a couple of years and went away and now it's come back and I think if it just helps customers pick the first step is to fly again, then I think it makes a lot of sense, because we're confident in our product in our experience and we know that once customers try us that they'll keep fly again. So, we're seeing very positive feedback from our customers.

Operator

Ladies and gentlemen, this concludes today's question-and-answer session. I would like to invite John to proceed with his closing statements. Please go ahead sir.

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

I'd like to thank everybody for your patience. We've done a lot in the last three months, a lot in the last six months. As you can see, we're excited. There's great industry discipline out there, and Azul is ready to move forward, and you're going to see us be stronger every single quarter as we move forward. Thank you. We look forward to meeting with you all individually.

Operator

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