

Q3 2018 Earnings Call

Company Participants

- André Dorf, Chief Executive Officer & Director
- Gustavo Estrella, Chief Financial & Investor Relations Officer

Other Participants

- Bruno Varella, Partner and Equity Research Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Thank you for waiting. We would like to welcome everyone to CPFL Energia 3Q 2018 Earnings Results Conference Call. Today, we have with us the executive Mr. André Dorf, CEO of CPFL Energia; Gustavo Estrella, CFO and IRO; as well as other officers of the company. The presentation will be available for download in the website www.cpfl.com.br/ir.

We inform that all participants will be in the listen-only mode during the conference call during the company's presentation. After the presentation, there will be a Q&A session when further instructions will be provided. It is important to mention that this conference call is being recorded.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of CPFL Energia management and on information currently available to the company. Forward-looking statements are not a guarantee of performance. They involve risks, uncertainties and assumptions because they relate to future events and, therefore, depends on circumstances that may or may not occur in the future.

Inventors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of CPFL Energia and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I will turn the conference over to Mr. André Dorf. Mr. Dorf, you may proceed.

André Dorf

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Thank you. Good morning, everyone. Welcome to another CPFL Energia earnings conference call to discuss third quarter 2018 results. I have with me the main officers of the group. As usual, we will go over a brief presentation and then we'll be all be available to answer your questions.

Please go to slide 3 where we find the third Q 2018 highlights. Increase in load in the concession area up 1.2%, highlighting the growth of the residential and industrial classes more in the free market than in the capital market as we're going to see shortly.

We also had a growth of 4.4% in net operating revenue of the company. And as a result of that and of cost management, we had EBITDA growing 21.4%, the cash generation of the company in the quarter. Our net debt ended the quarter at BRL 15.5 billion and, therefore, a leverage of the last 12 months of 2.92 times net debt over EBITDA. This is the lowest leverage level for the company in a long while. We also continued our investment program. We invested a little or more than BRL 0.5 billion in the quarter, BRL 525 million particularly in the Distribution segment.

Another highlight is the winning project of CPFL Renováveis or Renewables. Winning projects in the 28th LEN A-6 Auction, Cherobim SHPP and the Gameleira Wind Farm Complex. In addition, we have probably following some relevant sector issues. I would highlight here the tariff flags coverage for the Distribution segment to deal with the expenses related to AFDA. In here, we are dealing with insufficient flags and insufficient coverage, generating a higher need for liquidity and working capital by all distribution companies in Brazil.

In addition, we have the GSF team. This is a recurring topic in our discussions, and now this topic is being analyzed by the House of Representatives. It has gone through the Senate House and let's wait to see if there will be novelties by year-end in a great expectation. Not too limited to the electric sector, but of all Brazilians, it's the composition of the first level theme of the new administration that will take office.

Here, we highlight the theme of the Ministry of Mines and Energy. But it is important to highlight that our high expectations apply to all levels of government, state-owned banks, development banks and all the agencies of the new government. The first news are quite promising and we see a good link being considered to occupy these high positions in the government.

Moving on to slide 4, please. Here, we have our EBITDA, our cash generation by segment. Starting with the upper-left hand corner chart, we have our EBITDA BRL 1,548 million in the quarter. 46% of the EBITDA came from the distribution segment, followed by Renewables. This is the most favorable time of the year in terms of wind and renewable sources.

So here, it accounts for a higher share than we normally saw in prior quarters because of the seasonality. In Conventional Generation, 22%, followed by commercialization services and others, 4% of the company's EBITDA.

So, start with the upper-right hand corner, here, we have the Distribution segment, posting a significant EBITDA growth quarter-over-quarter. This stems mainly from a market increase. Market increase drove most of this positive variations that we see in our Distribution EBITDA.

In Conventional Generation, here we also have a positive variation 4.7%. Here we have some recovery of PIS and COFINS, credits and CFUR and recovery of retroactive credit - tax credits which helps this positive number. Renewable Generation grew the same percentage, 4.7% here, very much driven by greater wind power generation in 2018. We had more wind power generated in 2018 than in the third quarter of 2017.

In Commercialization, Services and Others, here we also post an EBITDA growth, particularly stemming from a reversal of ADA in our commercialization company, and because of the new services and contracts of CPFL Serviços. This is also a positive result in this new segment of the company.

Please go to slide 5. Here, we give you more detail about the Distribution segment. We have the highlights for the quarter. Like I said, we had an increase in load of 1.2%. We had an increase in sales of 2% in the concession area. As we can see on the upper right-hand corner, 2%. 2% increase in sales in the concession area, more representative in three clients - three market clients. 5.4% in practically flat for captive market clients.

We have growth of the Residential segment to highlight going to RGE and RGE Sul, a more significant growth in the southern region of the country because there's a temperature difference quarter-over-quarter. Higher temperature in 2018 generated more significant increase in the south region. We see stability in the Commercial segment.

Here, we don't really see a more substantial recovery of the Commercial segment. However, in the Industrial segment, we see more exciting growth of 2.4%, highlight going to CPFL Piratininga, RGE and RGE Sul. Here, it is worth highlighting some segments that drove this kind of growth. I would highlight chemical, automotive, rubber, plastics and food industry. These were the segments that really drove this recovery.

In terms of losses, we continue to work on this to invest in recovering losses. Here, we see an indicator of 8.87% which was lower than in the second quarter of 2018 and which was lower than the third quarter of 2017.

In the pie chart on the bottom left-hand corner, we see the market breakdown in the concession area. Industrial continues to account for the largest portion, almost 40%, followed by Residential, Commercial and other segments.

In the middle chart, we illustrate the comparison or the behavior of CPFL Energia comparing with the regions. Overall, CPFL grew 2% its sales versus 1.3% growth of the Brazilian market. In the Southeast, we grew 1.7% versus 2.2%; and in the Southern region, we grew 2.6% versus the whole region growing 1.5%.

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I'm not going to get into details about the charts on the right, but they show sales performance by consumption segment. Here, I would highlight in the quarter the Residential segment and the Industrial segment: Residential, because of the difference in temperature; and the Industrial segment, because of the slow recovery that we are observing particularly in the segment that I mentioned.

Moving to slide 6, please, here, we talk a little about generation. The big theme of the quarter regarding generation, not only applying to CPFL, but obviously interconnected systems at reservoir levels, with the third quarter with a yellow light in terms of reservoir levels of the regions and of the NIPS system, but we ended November a little more optimistic. We moved from the low part of the curve. We don't have any more of the worst curve in the history and the recent rainfall has shown a marked recovery in the Southeast and in the NIPS system overall.

This results in our spot price on the bottom left-hand corner, we can see the volatility of spot prices along the months and along 2018. We can observe on the chart that we started 2018 more or less at half the chart at BRL 180 to BRL 100, because of that yellow light, regarding hydrology, we hit a top mark of BRL 505 and now it was at BRL 142 in the first week of November.

On the right, we see the effects of hydrology on GSF, an indicator that we monitor. And that generates financial impact to generation companies. In September, in the quarter we had the worst GSF level, and now the trend is that it will ramp up, given that we are going to start a favorable hydrological period.

On the next page, we have a little more details in our results. And I turn the floor to Gustavo Estrella, the CFO of the group.

Gustavo Estrella {BIO 18109709 <GO>}

Well, I am on slide number 7 with our results. This quarter we had robust results. You can see the performance of our EBITDA of 21.4% in the quarter, up 22.5% in the nine months. When we compare the net income, 60% up vis-à-vis 2017 for the quarter and for the nine months 106% higher. This net income of this nine first months of the year of BRL 1,496 million is already higher than the whole year of 2017, which was BRL 1.2 billion.

As we can see in the main effects, the main effects really come from the Distribution segment with a total variation in our EBITDA of BRL 230 million positive, and the main effect here is coming from what we call market and tariff. We have seen that concession market had a growth of 1.2% and the main effect here is undoubtedly coming from tariffs. And here especially we have an effect of tariff reviews of our distribution companies of BRL 178 million and this is coming from the tariff review of companies that did have the tariff review over 2018.

We also had a positive effect in here, this is basically inflation effect and the adjustment of the financial asset, adjusted by the IPCA. And we have a variation of almost BRL 90 million. Some lower variations of - for private pension fund of BRL 6 million. And here, we have a

positive effect - I'm sorry, this is a negative effect of PMSO in the quarter of BRL 70 million negative.

Here, we do have some seasonal effects. Basically, we were affected by legal and judicial expenses. And for our ADA in this quarter, once again, these are seasonal effects. It's important to look at the legal and judicial expenses that are not recurrent. And in terms of result and the same applies to ADA. But when we look at the nine months, both legal and judicial expenses, as well as the ADA for 2018, they are at lower levels than what we had in 2017.

So, this is the trend, which is a positive trend when we compare what we have so far to - in 2018 to 2017. In Conventional Generation, there was a total variation of BRL 50 million. As André has mentioned, we are recovering retroactive credits. The main one has to do with PIS and COFINS credits at EPASA, and that was BRL 11 million and this is our main effect coming from Conventional Generation.

In Renewable, we have a higher effect in the wind farms, wind generation, that has a volume of energy produced this year, which was higher than the volume we had in 2017. Therefore, we have an additional revenue coming from Renewable. And also, we had some penalties in 2017, which we did not have in 2018. This also provides us a positive effect in the comparison. And also, as

André has already mentioned, we did have a negative effect of BRL 14 million coming from the impact of GSF. Another important thing in our result comes from the financial results. Basically, because of the variation of interest rates, that allowed us to have an increase of BRL 101 million, thanks to lower interest rates.

Now, slide 8. We analyze the performance of our leverage. We go back to a level that since 2012 we were not able to see. We are now at BRL 2.92 billion in the third quarter 2018. Also, it's very important to highlight that now we have a regulatory asset of almost BRL 2 billion also affecting our leverage. Without that regulatory asset, we would be at a leverage close to 2.5 times net debt over EBITDA.

It's important to stress that this BRL 2 billion will be integrated to the tariff review over 2019. Therefore, that will go back to cash accelerating our reduction of leverage over the next year.

Our gross debt cost basically is stable vis-à-vis the prior quarter, as we have mentioned, mainly all our exposure is of CDI over net debt, and here we shall grow that, but in our net debt, we had zero exposure to CDI. And now, we have 45% of our gross debt already pre-fixed. At pre-fixed interest rate for 2018, we'll go back to having exposure to CDI in 2019. But this year, I would say that we have stability regarding financial expenses up to the end of the year.

Now, turning to slide number 9, we analyze our liquidity in the company. We have ended the quarter with a cash of BRL 3,575 million which is more than enough to cover all our

maturities in the short-term. And here we are following our policy of a previous refinancing of the company in order to avoid any type of exposure to market volatility.

On slide number 10, we have a highlight of our projects. The main one is Boa Vista SHPP, which should start operating in 2020. This will be anticipated. In the next few weeks, we should have the project going into operation 100% with ahead of time when we consider to the schedule that we had in the auction. We have two projects that we were winners in the A-6 Auction should have been SHPP with 28 megawatts installed capacity, and Gameleira Wind Farm Complex was 69 megawatts of installed capacity. Both of them should have their startup in 2024. And we will now start the development of these two projects.

André Dorf

Well, this is André Dorf again. We have a final slide to share with you. This is an interesting initiative coming from the company. We have ended the third quarter. The first addition of the CPFL Inova, this was an initiative that we created here in the company in order to extend the interaction of our initiative of our business areas or management areas. And what is - in terms of what's happening about startup and technologies out of the company, we know that major innovations are happening out of the larger companies, and for us, this is a new learning such as for any other company to be able to bring that in and to create a type of cooperation with a startup.

So we launched this project in a partnership with Endeavor, which is a company totally dedicated to foster startups and scale-ups. We intend to accelerate to other startups in this first edition, we had 496 enrolled in the program, and our solutions are listed in the bottom part of the slide. Everything is very hands on, very practical and it is of great interest for our business and for our company. So at the end of this initial edition, we already have BRL 6 million in contracts with these companies.

And this solution should bring us optimization of processes in the company, also new services to be provided to the market, and also solutions that will optimize costs, avoid losses, will deal with data in a different fashion, anything that could allow us more efficiency in our services, as well as greater productivity in the company.

So I now end the presentation. I will turn the call back to the operator to start the Q&A session.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Bruno Varella, Solana Capital.

Q - Bruno Varella

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Hello, André and Estrella. I have three questions. The first is, I'd like to know, from your standpoint, can we see a higher EBIT of RGE Sul higher than RGE?

And the second question about RGE Sul, I was looking at the EBITDA of this quarter. And in the comparison with the prior year, we have an increment, but I would like to understand why there was a restatement of some account because the RGE Sul EBITDA last year was BRL 77 million negative and now the BRL 72 million positive that we see now. So, was there a restatement of any sort?

And finally, I'd like to understand the legal and judicial expenses that you mentioned, Estrella. I would like to know what is the origin of this. Does this have anything to do with the CPFL Paulista pension fund discussion? Where do these expenses come from and are they to be expected to recur in the next quarter? Thank you.

A - Gustavo Estrella {BIO 18109709 <GO>}

Hello, Bruno. Thank you for the questions. First, regarding RGE Sul, the higher EBITDA than RGE, well, we have the situation in the first quarter of this year, RGE Sul with an EBITDA for the first time it was higher than RGE in the year.

Our expectation, given the characteristics of the two concession areas, which are basically similar, but with a potential of investment in the RGE Sul area higher than in RGE, our expectation is that, perhaps in one or two years, we'll be able to overcome the EBITDA of RGE, but not for this year. This year, RGE EBITDA will be higher than the EBITDA of RGE Sul.

I'd like to remind you that in the beginning of 2019, we should have the merge of the two companies. So, we're going to see the results of one single company. But in terms of the business plan, we will continue to manage this, looking at the companies separately, so that we can know exactly whether the business plan that we addressed it in 2016 is being executed as defined by our board of directors.

Q - Bruno Varella

You mentioned an EBITDA variation of RGE Sul, a negative EBITDA. Well, last year was a year of adjustment in RGE Sul, because of the adjustments we made of the PPA, the process to restate the balance sheet after an acquisition, the PPAs, the power purchase agreement.

So, we have to know exactly what comparison you are making, if it's in the individual balance sheet of RGE Sul or the usual balance sheet for consolidation purposes because they have different basis. I need to know whether we are comparing the same thing here.

A - Gustavo Estrella {BIO 18109709 <GO>}

Well, actually I was using the restated balance sheet and not the one for consolidation purposes.

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Well, then, what we see is that, indeed there is a difference. It is basically because of the restatements that we had to mirror the PPA effects. This is basically regarding contingencies in the balance sheet of RGE Sul. If you want, perhaps, we can speak more in detail in person and I can explain to you the variations. But the reason is exactly this, the accounting of PPA reflected in the RGE Sul individual balance sheet of 2017.

Q - Bruno Varella

Okay. Perfect. And finally, we talked about legal and judicial expenses, this is basically because of civil claims. Again, when you look at this isolatedly, the third quarter is not a good proxy to show a trend of legal provision, because we have perhaps a predetermined seasonality to recognize legal provisions in our balance sheet.

A - Gustavo Estrella {BIO 18109709 <GO>}

So what we normally do is, look at the year-to-date comparison. Year-to-date, despite some seasonality that we had different from 2017, year-to-date, this is kind of soft trend in the two-year comparison, our expectation in our view is that, we have a positive trend with a volume of legal and judicial provisions, again, based on several claims at lower levels than what we had in 2017.

So, considering everything we're doing at the company in terms of follow-up of lawsuits, legal claims, and having preventive measures for both civil and labor claims, with everything we've done, we start seeing - we start bearing the fruit in the balance sheet of the company.

Q - Bruno Varella

Thank you. But one last question regarding leverage. You mentioned adjusted leverage of 2.5 times the EBITDA. And given the concern of the controlling shareholders regarding the 3 times net debt over EBITDA that the company was having, what would be a level that you would consider comfortable for you to work with looking forward, and to go back to paying dividends with a somewhat higher yield, would there be something like 2 times or 2.5 times?

A - André Dorf

Hello, Bruno. Well, here we don't have a leverage target. We changed the philosophy of the company. We used to work with a maximum leverage, having a maximum dividend payout. And, therefore, our debt cost varied between short- and long-term debt, and we had to accumulate a lot of cash to deal with a somewhat more short-term debt. But all of that has changed.

So now, because we're generating more cash and we have fewer capital intensive projects and fewer dividend payouts in the last two years, we have significantly reduced our leverage. The target is that we'll reduce this leverage a little more. We don't have a target index though.

Looking forward, we have to consider looking more dividends to our shareholders. But at the moment, we don't have any final decision regarding how to pay dividends from the future results of the company because we don't have any pressing need on the part of our shareholders.

Q - Bruno Varella

Perfect. Thank you very much.

Operator

We are now closing the question-and-answer session. I would like to invite Mr. André Dorf to proceed with his closing statement. Please go ahead, sir.

A - André Dorf

Very well, we are getting to the end of the first two years since we started this corporate transition. So we have focused a lot of our efforts on cultural issue and trying to harmonize the culture, but always placing the company in the first place, always doing what is best for the company. We have devoted a lot of attention to operating aspects with investments and an organization that will give us more quality and greater control over information and over our operations, and also focusing on lower costs for the company. You've seen some results of these endeavors, and we are reporting this to the market.

In addition to operating issues, we are dealing with a very agitated sector in terms of consolidation, M&A and privatizations. I want to stress that we are keeping our ears and eyes open to all opportunities of growth, other organic growth through auctions or by acquisitions, but always with a lot of discipline which is our mark.

With this, I end this conference call to discuss our results. I thank all shareholders and partners of the group for their trust and confidence, and I would like to thank you for joining us in one more conference call. Thank you very much.

Operator

This does conclude CPFL Energia conference call for today. Thank you very much for your participation and have a good day.

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