Y 2018 Earnings Call

Company Participants

- Eduardo Haiama, 'Chief Financial Officer and Investor Relations Officer'

Other Participants

- Andre Sampaio
- Marcelo Sa

Presentation

Operator

Good morning, ladies and gentlemen and welcome to the audio conference call of Equatorial Energia. Thank you for standing by. At this time all participants are in a listen-only mode, later we will conduct a question and answer session and instructions to participate will be given at that time, (Operator Instructions). As a reminder, this conference is being recorded.

I would now like to turn the conference over to Mr.Eduardo Haiama, CFO Please go ahead, sir.

Eduardo Haiama {BIO 7279971 <GO>}

Good morning, everyone. First of all, I'd like to thank you all for joining us in our fourth quarter conference call. As for our agenda for today, I'll start the conference call describing the highlights of this quarter.

Then I'll comment on operating and financial results, give an update on the development of the transmission lines projects, and finally, we will open the Q&A session As for the highlights for the quarter on Slide 3, 2018 has been a very good year in terms of M&A and fundraising. We have been able to secure long-term funding for all of our lines except for the transmission line except for SPVs foreign stakes. In distribution, we were able to sign long-term contracts to finance the CapEx for 2018, through 2020 with BNDES up to BRL 2.6 billion. In March, we have concluded the closing of the acquisition of CEAL, and which will be called Equatorial Energia Alagoas from now on, and injected the almost BRL 550 million in equity to the company.

As for our volumes, the adjustment of the billing from loss combat initiatives except these and are a more interactive threat regarding losses and collection in CEMAR and CELPA that affect the quarter, volumes dropped by a 5.9% on a consolidated basis. In this quarter Equatorial's consolidated EBITDA reached BRL 655 million and this figure was impacted by the first quarter consolidation of CEPISA, which posted negative results and the adoption of IFRS 15 for the transmission assets, that boosted EBITDA by almost BRL 200 million in transmission line -- in transmission segment. I'll further disclose this impact. Moving on Slide 5.

CEMAR energy market. Energy sales decreased by 3.9% at CEMAR across all segments. This drop is mainly due to the change in approach regarding loss combat and collection, and the still weak economy in the region that led to reduction in industry demand affected by the shutdown of relevant plant and also by the weather, with a much higher rainfall and lower temperatures in the period. As for CELPA on slide 6.

CELPA's billed volumes fell by 4.5% in the quarter, mainly explained by the figure I mentioned regarding, the change in loss combat and collection more interactive actions and also by the unfavorable weather conditions that decreased demand. On slide 7, look at CEPISA's energy market. CEPISA's billed volumes fell by 12%, heavily impacted by the adjustment made in the billing process derived from loss combat in the company that amounted to almost 120 gigawatt hour in the quarter. Another fact that impacted volumes was the weather in the fourth quarter, where -- when the rainfall was 108% higher than the fourth quarter of '17 and the average temperature was 2% lower -- 2.1 degrees lower.

Moving on to Slide 8, CEMAR's total losses in the quarter 17.2%. And these losses were already impacted by the change in approach that I mentioned regarding the loss-combat program with a focus on collection. Again in this quarter both quality indicators that impacted CEMAR continue to be reasonably below regulatory targets. Moving on Slide 9, CELPA's losses in the quarter 28.3, also an increase of 0.8 percentage points in the quarter.

CELPA was also impacted by the same stride that I mentioned before CEMAR It's important to remember that according to ANEEL, CELPA is the most complex concession area in the in Brazil. While CEMAR is considered to be the fourth most complex area in the same criteria. Quality indicators continue to be below regulatory targets both for DEC and FEC And in these recent quarters the productivity of the maintenance and standby teams in the field are responsible for this improvement. Moving on to Slide 10, this is the first quarter that we report CEPISA's figures as we had to conclude the acquisition in October of last year.

Given the adjustment the billing process for loss combat initiative in the company total losses increased to 28% in the quarter while the regulatory target dropped to 20%, following the end of flexibilization that was approved by ANEEL and one which beats for the company. Quality indicators they are also adjusted after our arrive at CEPISA, posting a slightly negative increase in the quarter for DEC and decrease in FEC Consider a management model investment to be made in the concession, we believe we will beat the regulatory targets for this indicator in the near future. Moving on Slide 12, we show the consolidated EBITDA for Equatorial in fourth quarter, we posted BRL 655 million of adjusted EBITDA and this figure is already considered the consolidated EBITDA from CEMAR, CELPA and CEPISA We consolidate now Intesa that we just bought the remaining 49% stake in the Equatorial service zone. This is the first time, we are consolidating CEPISA and after the first time we adopted IFRS 15 for the transmission assets, we believe that the easiest switch compare Equatorial's results to those of the previous quarter would be to exclude these new assets.

If we were to consider only CEMAR, CELPA's and the whole year results Equatorial would have posted BRL566 million in the quarter or an 8.8% increase compared to fourth quarter '17. Our goals should probably be -- state to be consolidating on Equatorial in the second quarter '19. Moving on Slide 13, we present Equatorial's regulatory EBITDA . From this point of view excluded BRL 196 million impact coming from the first implementation of IFRS 15 in the transmission assets and also another BRL 40 million of financial update for the DisCos.

Thus, we reached 500 -- BRL 445 million in consolidated EBITDA regulatory 1 for the group compared to BRL 489 million in the same quarter of last year. The main negative contributor in this case was the first consolidation of CEPISA's numbers. Moving on to Slide 14, we show the same regulatory review for Equatorial's net income. Excluding IFRS impact in the transmission segment and the impact of CEPISA's opening balance in a consolidated figure, Equatorial's net income would have amounted to a BRL 155 million or 46% drop year-on-year and this drop is basically explained by two things.

First, the incorporation of CEPISA's results in this quarter and also by the higher negative financial expense at the holding level as we continue to invest in transmission. Moving on to Slide 15, we present amortization schedule leverage for the company. Equatorial's leverage considering the full consolidation of its assets reached 2.8x in this quarter following the consolidation of CEPISA, which contributed with a BRL2.3 billion of net debt and it's still a negative EBITDA If you were to un-consolidate CEPISA's figures within Equatorial, we would have reached 1.8x leverage in the quarter, and that was pretty stable compared to the third quarter of last year. We ended the quarter with a cash position of BRL4.7 billion which is more than enough to cover the next 2 years of debt maturity in the group, not to mention all the fundraising that we were able to secure, and that should allow us to invest without compromise of our cash position.

We believe with this cash position and also debt profile we have a very comfortable debt structure to accommodate CEPISA's and sales cash needs for the foreseeable future as well its transmission CapEx. On Slide 16, we present the consolidated debt position. If you were to exclude the impact of CEPISA acquisition for the group, in this sense, we exclude the end of the net debt of BRL1.5 billion the capital increase we made of BRL720 million, and also the BRL95 million we paid as Grant Bonus to the Federal government. With that, net debt would have reached BRL4.3 billion corresponding to our ratio of 1.8x net debt to EBITDA Moving on Slide 17, we show the main CapEx made by Equatorial in the recent quarters and as can be seen, the investment transmission segments has started to pick up and have reached BRL338 million in the fourth quarter following this start of the construction of almost all the lines.

For CELPA and CEMAR, it's worth reminding that we were able to secure BRL2.6 billion in funding from BNDES to fund the CapEx of '18, '19 and '20. Moving on to Slide 19, as you can see we have obtained the construction license for all the projects except for a small part of SPV 7, given that we have already started construction of several -- or of 8 of the lines in our portfolio. Also in transmission, we bought the remaining 49% stake at Intesa and we start consolidate this figure starting the fourth quarter. Moving on Slide 21 -- on Slide 20, sorry, we start to have a bigger CapEx disbursement following the start of the construction of the lines important to show our fundraising efforts that we made last year in early this year.

So for SPVs one, two, three and 5, we have signed long-term funding with BNB, Banco do Nordeste, amounting to almost BRL1.6 billion for the SPV one, two, three, we also issued a BRL190 million in infrastructure debentures with that we close all the efforts for these project. SPV seven and eight, we have secured fund with SUDAM through Banco do Brazil of almost BRL 800 million and also, we are about to sign long-term funds with BNDES for the remaining two SPVs four and six. We believe these efforts -- it is very important for us to secure liquidity and also secure the returns for these transmission both projects in the long run. On Slide 21 and 22, we basically discuss the development status of these projects.

The most advanced in line is SPVs eight, the one we won in April '17 auction, we have already reached at the 50% of the construction. The synchronous condenser that's part of the line that is realized with an BRL18 million in annual revenues is in the final passing and should start running soon. On slide 22, we show pictures of how the construction is going for each SPE, where we can see already that some of the field towers are being assembled or there are many others that are being assembled and also how it advanced the civil work in substations. With that, we believe we can conclude this presentation and start the Q&A session.

Thank you. (Question And Answer)

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator Instructions). Our first question comes from Farnando (inaudible), UBS Please, Mr.Fernando, you may proceed.

Please Mr.(inaudible), your line is already opened.

Marcelo Sa {BIO 16454581 <GO>}

Sorry, this is Marcelo Sa speaking, another question on the PIS/COFINS tax. I want to understand a little bit better, what made you guys feel confident that you can book a gain on this, considering that taxes are considered to be partially expensed. And as a result, you'd have to report to the consumers, so I want you to tell us a little bit more your legal piece on this and if you guys had a chance to discuss that with the regulator and what the regulator's view.

? Thank you.

Eduardo Haiama {BIO 7279971 <GO>}

Thank you. Well, first of all, it's important to just understand what we have accrued and what we have won. But this is a case we have been disputing for many years in the case of CEMAR 2006, and we recently won.

This is a final decision, so there is no discussion about that. When you have the situation, when you have a final decision from the justice well it's already enough that you have right you might say exactly when you're going to be able to use, there are some let's say , the hypocrisy that you need to go through , not at first, why don't you start using, but it already belongs to us. And who won in this case CEMAR and CEPISA last year end of last year. We have all the two company discussing these issues that is CELPA and CEAL that is still like there are discussions going on.

And for those companies, we haven't accrued anything, right because until you really win a final decision from an accounting perspective, or want to ask auditors and even the lawyers. It's something like you cannot approve, right, as opposed to, for example, in the liability that you start to write accruing liability contingent, whether or not you believe it's probable instead of possible or remote. As for what we accrued as our asset and what we accrued as our liability it's more like a discussion exactly, how far behind we need to reimburse right for the cause that we won right in this case we have used 10 years and basically, because there is a legal injection in Brazil, that is disputing exactly how many years customers in general can complain and/or against customers, regarding mistake during might have in the deals or the fields in which we have clarity on this lawsuit, we prefer to use the most conservative one that is use in the civil procedures for this kind of case. And that's why we adopted the 10 years.

As for the other two companies that we haven't yet won we're only going to accrue anything by the time the justice system gives a final decision, it's hard to say if and where we're going to have this final decision. Because, you can always continue to have these kind of dispute despite the fact that is the Supreme Court has already ruled that it is unconstitutional discharge, and charge with PIS/COFINS,ICMS, but until we have a final decision we are not going to do anything. I don't know if it helps.

Marcelo Sa {BIO 16454581 <GO>}

Yes, it did.

Let me confirm two things. So did you guys have a chance to talk about the regulators even now that you've only -- your understanding based on the argument that you just provided or have you had a chance to even now?

Eduardo Haiama {BIO 7279971 <GO>}

No, we haven't discussed our case. But like I said -- the lawsuit is off -- this as somebody said, we won, it's a final decision. So with that, you have , right, you have an asset.

As opposed to regarding liability specifically, if you go with the law, its10 years, there was - and comes up what we call civil procedures. I don't know how to speak --the real way to speak that in English. If you look at the consumers, right, would be if you look at the regulatory the regulation by now it would have been 3 years, given that there is not a lawsuit disputing, how long you're able to charge consumers the vice versa for mistakes in the past try to overcharge or not, we prefer to adopt the most conservative one as 10 years.

Marcelo Sa {BIO 16454581 <GO>}

Okay, got it.

And another question will be on CELPA and CEAL, I don't know that you guys had the same lawsuits, I mean, ongoing process with the company, but I was wondering when CEAL and CELPA filed this lawsuit so we can start counting what would be the potential gain since you have favorable timing. Was it started in May, as in, do you have the view?

Eduardo Haiama {BIO 7279971 <GO>}

Well CEPISA and CEAL, they file the same time right? But it was the same case. There was like -- ours of course, each company issue to file lawsuits independently, but it was in the same time, right? So CEPISA and CEAL, is running the same time

Marcelo Sa {BIO 16454581 <GO>}

But we would have -- for example, if you have liked a 10-year period, you would have a benefit of one year, for example, for CEAL, like you had in CEPISA?

Eduardo Haiama {BIO 7279971 <GO>}

Yes. There will be more or less similar, right? And CEAL and CEPISA, they have kind of over the same market size, right.

In CEPISA, we filed if I'm not wrong it wasn't that much long ago I think it was, I'm not sure maybe it was 2016-17 each check and then you can retract 5 years, right.

Marcelo Sa {BIO 16454581 <GO>}

Yes. Thank you. The attention is that you have to return to the consumer also 10 years probably you wouldn't recognize a need for CEPISA in this week?

Eduardo Haiama {BIO 7279971 <GO>}

Yes, you're right.

Marcelo Sa {BIO 16454581 <GO>}

That another question would be earning release , you guys disclosed the adjustment EBITDA for CELPA, I don't know if I understood correctly , but there is an adjustment of

BRL 170 million may be, related to the business use but I understand it didn't have the impact for CELPA, so business is the same with adjustment.

Eduardo Haiama {BIO 7279971 <GO>}

That's another thing. It's more like what we saw is like that what's -- how the regulator calculates the benchmark of cost. They get the cost from particular companies.

Right to round the benchmark, and that's what the they put in the tariffs. And what we saw is like when they do that, they use the PMSO right, the operating cost net of PIS/COFINS tax. So within the tariffs, what consumers pay in the end these are like the tariff that they benefit from the credit coming from the PIS/COFINS that some of this cost generates, right? And what we are doing is like we work kind of a double counting against us right. Because when we calculate the actual PIS/COFINS that we pass to consumers and is a pass through, right? We were the deducting again that credit that we have right in our OpEx and PMSO and gave it to consumer, so we are giving not only the tariff that drive, right -- this cost of PIS/COFINS, but also we are like giving again, right, as a credit.

So we are charging a lower PIS/COFINS tax in the end, but I don't know if it's clear, so the--

Marcelo Sa {BIO 16454581 <GO>}

It's a good thing that--

Eduardo Haiama {BIO 7279971 <GO>}

Yes.

Marcelo Sa {BIO 16454581 <GO>}

Got it. Okay, thank you.

Eduardo Haiama {BIO 7279971 <GO>}

Thank you.

Operator

Our next question comes from Andre Sampaio from Santander.

Andre Sampaio {BIO 19422379 <GO>}

Hi. I would like to ask you a question about the new losses and collection methodology that you guys are using and you guys could discuss what really changed operationally, it would be nice. Thanks.

Eduardo Haiama {BIO 7279971 <GO>}

Thank you Andre. The main change is like when you saw this historical numbers of CEMAR and CELPA, right, CEMAR, we started to combat loss 2008, '09. And your high success not only reducing loss but also improving collection in this period. When you saw what happened at CELPA, when we started combat loss by 2013, it was the same in the beginning in 2016, let's say, when we had this financial the Brazilian depression impacting volume and everything else in Brazil.

But what we saw recently, if we continue to act like a combating losses without paying attention to what would be the impact on collection, and that was the problem in the past, right, we were able to not only reduce a lot of losses, but also sometimes even increase in collection, right? If we continue to treat these two actions separately, we would basically kind of eliminating losses but you have a problem in collection. So in the end, from a cash flow perspective towards negative. So what are we have been saying, this for quite a while to the markets like, we need to change its behavior to markets. In general, restore to normality in those regions, meaning you going to having growth again and healthy consumers.

Right? In terms of financial perspective But until then, we need to be more careful if what we are doing in terms of the loss combat program, because in the end we would be hurting ourselves. So, we have been studying this a lot, right? throughout 2018 and start to implement this, feel like our end of third quarter and fourth quarter in a way that whenever we combat the loss, we do it always with a high collection we want to reduce losses or we're going to continue to do that. But if we don't do won't do it at all costs and that was the case right? before then given that we were so successful in reducing loss in collection, that we didn't have to pay attention what would be the impact because the impact was almost 0. But with the crisis that we have, we need to be more intelligent much like overstretching right? consumers and even our cash position here.

Right? Here we have more the normality in the growth that we have. That's the main, the main thing and what's the main impact in the loss combat at the end of the day. Is to reduce the amount of that we charged from the past right? depend on the client, depend on the segment and also for some clients there we know, there is usually we try to always, try to comment, and if there is no response at all, I mean it's not like, I keep like that. Try to believe, they're going to be able.

They're not going to be -- some of these guys they are like unconnected or disconnected and not really providing cash flow, it was negative. I don't know if that explains your question.

Andre Sampaio {BIO 19422379 <GO>}

Yes, I think that's it, I would like -- also would like to ask another question on the transmission segment, if you guys explain this how did you implement the new rules from IFRS Actually I would like to understand better the new margin for the construction part of the sector.

Eduardo Haiama {BIO 7279971 <GO>}

Okay, well basically today, what was the original rule in IFRS, you basically estimate your project IRR for the lines that you have right? And based on that, you basically like whenever you invest some money, let's say that you have any investment of BRL 1000, right? And I estimated that the project IRR was let's say 10%, just as a simplify sales.

So, whenever I invested, let's say a 100 the day after , I will start to accrue an interest of 10%, rights? and this interest was exactly the revenues that I accrued in every quarter until I ended the construction, so when I ended the construction, I'm going to start to receive the real cash flow right coming from the concession. So what was and how our concession would behave, we would continue to accrue the 10% interest over the updated financial asset that I have. But then I would subtract as I received the cash flow, the revenues. Right From the concession.

And that's the way until we have a kind of zero value at the end of the concession. That's the way it was. How the accounting firm is deciding the end how the accounting firm, IFRS decided to change the way we accrue this, they said no you cannot like accrue using your I implied IRR, you need to do an NPP right of yours cash flows, not only revenues minus OpEx but also the CapEx. Based on this NPV, that's the margin that you're going to add whenever you invest.

And whenever you have in the future, when you operate a margin for the OEM So to simplify things let's imagine that, I forecast that I wouldn't have zero margin by operating the line for the next 30 years, I accept this business model I don't want to have margins on an OEM The only margin that I was going to have is over the CapEx. So the way I have to do this, today is like I calculate NPV, I'd be driving discount rate that is going to be different from the IRR, reach this NPV,, this would be more than we have, whenever I invest during the construction. So let's get another the same example, there are BRL1,000 that have of gross CapEx here before it was an IRR of 10% and counted 5%. So let's say by kind of its 5%, the NPV is another 1,000, right? So whenever you have 100, I also recognize another BRL100 as a margin for construction.

It's kind of complicated, but I hope you understand.

Andre Sampaio {BIO 19422379 <GO>}

I thanks for the help on this, so I think going forward, we should continue to see margins on this right.

Eduardo Haiama {BIO 7279971 <GO>}

Yes, and the best thing is like, it's going to be all over for all the company's right because each company going to have a different calculation for the discount rate, But that's how it's going to work right? So now, whenever you see our reinvesting in the Greenfield project, we have to recognize the construction margin and whenever we operate -- I give an example of zero margin of OEM, but I may not, you're also going to have some margin in OEM going forward. So that's the way IFRS numbers will be.

Andre Sampaio {BIO 19422379 <GO>}

Okay, perfect. Thanks.

Operator

(Operator Instructions). This concludes today's question and answer session.

I would like to invite Mr.Eduardo Haiama, to proceed with his closing statements. Please go ahead, sir.

Eduardo Haiama {BIO 7279971 <GO>}

To sum up, we'd like to reinforce our commitment in delivering differentiated appreciation to our shareholders, for exceptional financial and operating results. We'd also like to highlight our adherence to the highest level of corporate governance, and transparency and reassure that both me and our Investor Relations team are available should you have any further questions.

Thank you all again for taking part of our fourth quarter conference call and have a good day.

Operator

That does conclude Equatorial's audio conference call for today. Thank you very much for your participation. Have a good day and thank you for using Chorus Call.