Q2 2018 Earnings Call

Company Participants

- Paulo Sergio Kakinoff, President & Chief Executive Officer
- Richard F. Lark Jr., Executive Vice President, Chief Financial Officer and Investor Relations Officer

FINAL

Other Participants

- Duane Pfennigwerth, Analyst
- Gavin McKeown, Analyst
- Michael Linenberg, Analyst
- Petr Grishchenko, Analyst
- Savanthi N. Syth, Analyst
- Stephen Trent, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to the GOL Airlines Second Quarter 2018 Results Conference Call. This call is being recorded and all participants will be in listen-only mode during the company's presentation. After GOL's remarks, there will be a question-and-answer session. At that further time, instructions will be given. This event is being broadcast live via webcast and maybe access through GOL website at www.voegol.com.br/ir and the MZiQ platform at www.mziq.com. Those following the presentation via webcast may post their questions on the platform and their questions will either be answered by the management during the call or by GOL Investor Relations team after the conference is finished.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of GOL's management and on the information currently available to the company. They involve risks and uncertainties because they relate to the future events and therefore depend on the circumstances that may or may not occur. Investors and analysts should understand that events related to the macroeconomic conditions, industry, and other factors could also cause results to differ materially from those expressed in such forward-looking statements.

At this time, I will hand over to you, Paulo Kakinoff. Please begin.

Bloomberg Transcript

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Good morning, ladies and gentlemen, and welcome to GOL Airlines' second quarter conference call. I am Paulo Kakinoff, Chief Executive Officer; and I'm joined by Richard

Lark, our Chief Financial Officer.

Richard F. Lark Jr. {BIO 427746 <GO>}

Good morning. Good to be with you today.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

This morning, we released our second quarter figures. Also, we made available on GOL's Investor Relations website three videos with our results presentation, financial review and a brief Q&A.

Once again, we significantly improved our key indicators. GOL's RPK increased by 2.5% from the BRL 1.1 billion in second quarter 2017 towards BRL 8.3 billion this quarter, mainly due to a 4.1% increase in the number of transported passengers. Strong demand allowed GOL to continue driving pricing to revenue management. Average yield per passenger increased by 7.6% quarter-over-quarter, reaching BRL 0.257.

Supply growth ASK increased to 2.2% compared to second quarter 2017, driven by a 0.6% increase in take-offs and a 2.4% increase in seats. As a result, the average quarter load factor grew 0.2 percentage point compared to the same period in 2017, reaching 78.1%. GOL's on-time performance was 93.6% in the quarter according to Infraero.

We continue to have a strong revenue growth. The combination of higher demand and optimized pricing, resulted in net revenue for the quarter of BRL 2.4 billion, an increase of 9% compared to the second quarter of 2017. Net RASK was BRL 0.221 in this quarter, an increase of 6.7% over the same period 2017. Net PRASK increased at 8% quarter-over-quarter, reaching BRL 0.201. Average fare increased by 6% from BRL 268 to BRL 284. GOL's 2018 guidance is for net revenues of approximately BRL 11.5 billion.

The GOL network serves higher-yielding routes and has a leading share in the corporate client segment. It has the largest share of business traffic in the country. They recently received 737 MAX 8 already in operating our fleet, provides us reduced operating expenses, and in the future we will extend the range of our network to allow us to serve South America, the Caribbean and new destinations in the United States.

With that, I'm going to hand you over to Rich, who is going to take us through some other highlights.

Richard F. Lark Jr. {BIO 427746 <GO>}

Thanks, Kaki. First, I'd like to comment about our controlled cost environment. Total CASK in the second quarter was BRL 0.217, 5.9% higher than the same period in 2017, due to the 31% increase in jet fuel prices. On an actual basis, CASK fell by 1.4%. GOL remains the cost leader in South America for the 17th consecutive year.

Second, our margins continue to expand, while the average price of jet fuel on an adjusted per kilometer increased 13% in this quarter over the (00:05:02) quarter of 2018. Again, this is a quarter-to-quarter comparison. The combination of strong pricing (00:05:07) higher demand and BRL 40 million of results on our oil hedging program permitted GOL's EBITDA margin to expand to 1.8% in the second quarter of 2018. This margin is the highest second quarter indicator since 2010 and a 0.8 percentage point improvement quarter-over-quarter.

Operating income EBIT was BRL 43 million in the quarter, an increase of 93% or BRL 20.6 million compared to the same period of 2017. EBITDA margin was 9% in this quarter, a growth of 2.3 percentage points quarter-over-quarter. EBITDAR margin was 20.3%, an increase of 2.6 percentage points in the quarter-over-quarter comparison. GOL's 2018 guidance for EBIT margin of approximately 11%.

And to finalize this brief review before moving (00:06:02) today, we wanted to share the highlights of our balance sheet strengthening. While the real depreciated 16% against the dollar in the quarter, causing a net exchange and monetary variation loss of BRL 1 billion, our net debt excluding perps to last 12 months EBITDA ratio was 2.9 times as of June 2018, including versus the year-ago metric of 4.2 times.

Total liquidity was BRL 3 billion, an increase of BRL 1.3 billion or 71% versus the second quarter of 2017. The combination of operating cash flow generation of BRL 588 million in the quarter and improved cash liquidity improved our financial flexibility. For 2018, we confirm the scenario of continuous improvement from 2017. We've maintained our commitment to financial discipline, managing the effects of Brazilian currency through our efficient capacity management and dynamic yield management.

In Brazil, in GOL's market, in our Brazilian domestic market, since the industry fare deregulation in 2001, it has been the case that when an airline industry capacity was disciplined, meaning ASK growth below RPK growth, Brazilian industry yields have shown a 71% correlation with the U.S. dollar. When the industry produced excess supply, meaning ASK growth above RPK growth, the recapture fell to 11%. We are very cautious on the capacity discipline of the market nowadays.

In the second quarter, all the other domestic airlines combined grew capacity at rates higher than expected. On average, they grew their domestic ASKs by 8.3%, compared to their domestic RPK growth up 5.6%, causing the load factors to fall by 2 percentage points to 78%.

Now, EBITDA and EBIT margins for GOL in 2018 are expected to be around 16% and 11%, respectively. We expect earnings per share before exchange variation gains and losses to be between BRL 0.10 and BRL 0.30. Leverage measure to net debt over EBITDA for sic 2008 (sic) [2018] (08:27) should be close to 2.8 times, reflecting the deleveraging of our balance sheet.

For 2019, we expect our domestic capacity growth to be between 1% to 3% and non-fuel CASK to be around BRL 0.14. We also projected an EBITDA margin of around 17% and expect to end next year with leverage of approximately 2.5 times. Now, I'd like to return to Kakinoff.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thanks, Rich. In summary and to finalize, we're working hard to achieve our results this quarter. The traditional low season in Brazil with travel was particularly challenging due to accelerated appreciation of the dollar against the real and industry-wide supply disruption that affected demand for air travel. Our commitment to continuous improvement in our result has proven that our strategy of offering a differentiated, high-quality product while relentlessly focusing on cost efficiency is very good.

We remain focused in offering the best experience in air transportation, including the services to our (09:35), new modern aircraft that connects our (09:39-09:43) through very disciplined capacity and prudent management of balance sheet and liquidity, maintaining our cost leadership and continuing as the preferred airline for our customers while driving sustainable margins and returns for our shareholders.

Now, I would like to initiate the Q&A session.

Q&A

Operator

We will now begin the question-and-answer session. And our first question comes from Mike Linenberg from Deutsche Bank. Please go ahead.

Q - Michael Linenberg {BIO 1504009 <GO>}

Yeah. Hi. Do you hear me? Hello?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hi, Michael.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Hi, Michael. Yeah. We can hear you okay. You're a little bit in a (10:50), but we can hear you okay.

Q - Michael Linenberg {BIO 1504009 <GO>}

Okay. Sorry. It's not a great connection. Two things. When we think about the higher fuel prices and the fact that they have been exacerbated by the currency moving the wrong way, at this point, how much of that do you think you're recapturing through better revenue production? And you know what, maybe if you could give us a sense of what you think the potential lag is before you're able to fully recapture, if you're able to recapture or call it a 100% of the adverse move in fuel and currency?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. Sure. No. Yeah, your question on revenue management, I think, can be best answered by describing how GOL does yield management. I mean, we work to maximize RASM versus actual demand and versus actual competitive behavior.

As I mentioned, in our Brazilian market, which is highly business related and our traffic today – now, we're the largest carrier of business travelers. In the Brazilian market, since the 2001 fare deregulation, it's statistically significant that when Brazilian capacity grows at rates below demand growth, yields in Brazil – yields in Brazilian domestic market are around 70% correlated with the U.S. dollar. When capacity grows at rates higher than that – higher than demands, that what we sometimes call the recapture of currency effects, that correlation of Brazilian domestic yields is 11%.

Now, we're the largest domestic player (12:32) in Brazil for over three years now. We're leading the industry in capacity below demand growth. That's how our behavior has been in this life cycle. That's how it is this year and that's how it is next year and the foreseeable future of our plan. This has allowed GOL to expand yield. When compared to increases in GOL's cost caused by increasing jet fuel prices or aircraft rent because those are the two line items that you referring to in our income statement, these are the main expenses affected by the U.S. dollar and international oil prices, jet fuel expenses and aircraft rent.

We planned on, we're getting and we continue to plan on a 70% recapture, which in our terminology is how much of the impacts on our income statement on the cost variation, either up or down, we are retaining on the revenue side. Now, the issue ends up being (13:34) velocity of that. In the second quarter, we have very rapid ramp-up in a combination of factors, not just on the oil prices but also on (13:45) based on what's happening in EM (13:46) in general and the U.S. market and the U.S. fed and so on. And so, generally, in our experience, the lag that you referred to for us to be able to work, those effects through the forward booking curve is roughly 90 days, okay? It's roughly 90 days. Of course, for the second quarter, we had some other extraordinary effects. For example, the trucking strike, which for a several-week period really took the wind out of the sails of our yield management process. But that's basically what we planned on, that's how our management (14:16) and that's what we continue to plan on.

And that's (14:20) our second quarter results. I mean when you look at (14:24) these truly non-recurring effects, you could argue if oil price variation at that magnitude is recurring or not, if a currency variation of that magnitude is recurring or not. But clearly the trucking strike is not a recurring event. When you back that out from our results in the second quarter and net effects of both currency and oil prices in terms of what we're doing on yield, we recaptured pretty close to 70% on RASMs, on yields, how you want to look at it.

Q - Michael Linenberg {BIO 1504009 <GO>}

Okay. And then just the second one, you had good performance, demand looked good in the second quarter as well as the yield performance. As we look into the third quarter, are the trends consistent with what you saw notwithstanding the impact of trucker strike or the trends consistent with what you were seeing in the June quarter and is there any sort of difference between, if I look at domestic versus international – the international piece, I'm just highlighting that because of the move in the currency and I think that's having a negative impact on demand.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hi, Michael. We are quite optimistic on that because if you see through the timeline, the truck drivers strike was like bump, but did not change the trend. The market is recovering. The demand seems quiet and I think that's from the next quarter, we will see quite the same pattern that we were explaining before.

Q - Michael Linenberg {BIO 1504009 <GO>}

Okay. Okay. Thanks, Kaki. Thanks Rich.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

Operator

And our next question comes from Duane Pfennigwerth from Evercore ISI. Please go ahead.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Hey thanks. Good morning. Just a couple of questions on updated guidance and thanks for that update. On an ancillary revenue of BRL 1 billion, does that – is that the same line item as cargo and the other which is BRL 373 million year-to-date in the first half? And if so, it implies a fair amount of acceleration in the back half. Could you just speak to what would be driving that?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Hi, Duane. Basically, yeah, and the ancillary is now in the new presentation of the accounting, IFRS 15, that's basically cargo and loyalty primarily and buy-on-board. And basically, those are what we expect.

I mean our cargo business continues to grow in the low-single digits, which is that non-priority side of the aircrafts and our loyalty program continues to grow in the high – I'm sorry, the cargo business is growing the low-double digits and the loyalty program growing in the high-teens in there and a little bit of additional revenue from the buy-on-board is what's in those numbers.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Okay. Thanks. Is that line up in your income statement in the cargo and other line, maybe some of that loyalty revenue you're referring to is up in Passenger or is it one-for-one with cargo and other?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Well, it's – again, what happens there is on the total RASK – those are not in PRASK, if I understand your question. Those are not in the PRASK calculation. Those were the revenues today which are not included in the passenger revenue per kilometer. They are included in the total revenue per kilometer.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Okay.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Part of it was is if you look at the restatement of the accounting this year, two things really happen. There's two movements. One of the movements was the fact that all the other ancillary revenues that were previously accounted for as ancillaries, with the exclusion of the loyalty program and the cargo, and the buy-on board are now in passenger revenue per kilometer and this is on a global basis. All airlines in the world are following this.

The second movement is that the loyalty program revenues are now recorded on a net basis. This basically means that the cost of goods sold, which was previously reported outside of net revenues is now inside of net revenues and that cost of goods sold for the loyalty program to acquire seat airlines.

Now, of course, in our consolidation, the intercompany transaction between Smiles and GOL are limited. So it's really there is – and the net revenues today is the cost of goods sold. The revenues, minus the cost of goods sold of non-GOL or, if you will, our partner airlines in the loyalty program.

For example, American Airlines or Emirates or the acquisition of tickets on airlines outside of GOL is what's in that net revenue numbers. So some of the adjustments you see there, be it up or down are because (19:53), including the cost of goods sold into that (19:55) number. But there are two separate components. One is the issue of (19:59) which I described, and the second would be adjustments in the Smiles net revenues; and then, third the consolidation of that and the exclusion of the intercompany transactions. But we can also provide some more information of that online in terms of helping folks with precise modeling of the CASKs and RASKs.

We provided in our release this quarter an opening on a quarterly basis of the ancillary revenues under IFRS 15 for all the quarters of last year to facilitate the apples-to-apples comparison with the quarterly comparisons this year. That data is in the quarterly release if you want to reference that.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

That's helpful. And then just for my follow-up, Rich, on the 2018 to 2019 guidance walk, you have the net financial expense going from BRL 800 million to BRL 500 million. Can you speak to why you expect lower net interest expense next year. Is that just a currency assumption underlying that or are you effectively suggesting you'll see some deleveraging? Thanks for taking the questions.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. Thanks. No, it's both of those. From a policy perspective, from a capital structure perspective, we've been working now for a while to try to get to roughly a 5% level of net financial expense to revenues, which basically reflects the appropriate capital structure for our business. But inside of that, what's happening is there's still a little bit of deleveraging in those numbers to the tune of about BRL 1 billion over the next 12 months, which we are in the final phases on in our liability management work. Also, there's a runway issue there because a lot of our – the liability management activities we did in this lifecycle were in the last half of last year and the very beginning of this year in terms of our bond issuance and repurchases of the buybacks and so on. And so, the year-over-year comparison, 2018 is still earning (22:20) a little bit of that at the beginning of the year.

So in addition to the deleveraging that I just described which is still coming out of the system, there is also a reduction in the overall borrowing cost, which we're already running at this lower borrowing cost of, call it, 8% to 9% in reais and 6% to 7% U.S. dollars. But that will be fully reflected in next year's number. So in those numbers there for 2019 is roughly BRL 1 billion less of overall leverage and a better comparison of this are more reflective borrowing costs that we're at now, which is in this 7% to 8% overall range.

Of course, we've seen that also on the underlying interest rates, percentage interest rates have come down dramatically in this period. We've also, as our credit improved substantially, we also renegotiate a lot of those costs and will continue to do so.

And so that's really what (23:27). But what's driving that overall really kind of two drivers as we've articulated. I mean we're working to bring the company back to a low BB credit ratio, and, of course, including currency effects on our business, but currency is indigenous to how we manage our business.

And then also, as I mentioned, another way to think about it which we guide on is from a – in terms of those numbers is that think about net interest expense at roughly 5% of total revenues is a number, which kind of reflects the appropriate capital structure for us.

And in terms of currency, when I say currency is part of that equation. It's not a driver. I mean currency is in the accounting conversions. Currency is in a portion of our cost structure, but it's also in our revenues. And it's also in the interest revenues also. It's not just on the interest expense side. It's also in our interest revenues and in other things that are possibly affected by the currency. So, all of those were all in there. That's part of how we're managing that. And we do have to take views on currency in terms of how we're managing our business and our capital structure and those are in there. And we'll continue to break those out, those effects and so people can understand that.

And I guess the other – just the final point I would make is that those numbers do not include gains or losses of the (25:03) exchange rate applied to our debt position on our balance sheet. Those are not in those numbers. We're breaking those out separately for you guys, so you can understand how that works in the short-term. It's just pure accounting effects that are coming in there, but they do go in net earnings as our functional currency is Brazilian reais, but we're breaking that out as well, so you can understand how we think about that accounting effect on our business and we're also (25:39) what our earnings are with or without the exchange rate effects which will also happen only if we get into currency depreciation. We can also have massive gains on the dollar liability position on our balance sheet, which should also be excluded when you look at what the true economic underlying earnings are.

So, I just got to give you that information there because obviously the second quarter was extraordinary in terms of the speed of the exchange rate effects and that needs to be, I think, contemplated as folks look at how to approach earnings estimates which is, as we've articulated, we're encouraging that discussion in terms of what the underlying earnings are for these business. But needs to take into account and exclude the exchange rate gains and losses on the dollar position, on the liabilities, on the balance sheet.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Okay. Thanks.

Operator

And our next question comes from Stephen Trent from Citi. Please go ahead.

Q - Stephen Trent {BIO 5581382 <GO>}

Yeah. Good morning, guys. Well, sorry, good afternoon in your case and thanks for taking my questions. Just two for me. One is I seem to recall news that I believe it was Norwegian Air Shuttle is looking to do some regional expansions and I know they're already operating in Argentina. Just curious as to what extent, if at any – if at all, you guys are coming up against them or any of the new discount carriers in the Southern Cone?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

So, hi, Stephen. It's Kakinoff here.

Q - Stephen Trent {BIO 5581382 <GO>}

Hey, Kakinoff.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

(27:20) any major movement. There are some new carriers in Argentina but the flight requested by Norwegian is a long haul flight from UK to Brazil. It's not at least, not so far, a local comparative. It's really hard when you compare our CASK level, which is at the level of even below southwest for example. So, I believe that a newcomer could come and deliver a sustainable CASK at a lower level than we are living today.

So, I think that there are other markets much more exposed to this kind of threat were you see like (28:11) for instance when you have less – basically your only one player and the fares are pretty high there. So, I think this is much more exposed market that's kind of stretched than when you compare to our current position with low CASK level that we have been able to produce.

We are not underestimating the possibility of having new players in the market, but I believe that they would finally find some meaningful room for their operations in Brazil. We would rather take other markets such as Argentina and Chile, like they are doing at the moment. This is how I see the markets.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. Even in Argentina, they had announced they did (29:02) about going into Argentina, but they seemed to have packed up and gone home. They're not – they've even scuttled their plans for launching domestic service and so they seemed to have come and gone.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. I appreciate that, guys. And just one more from me. I think you may have already mentioned, and forgive me I was a little late coming on to this call. You may have mentioned it either on the call or at some time recently about the truckers' strike in Brazil. If you could refresh my memory, kind of what's your best guess as to what the operational impact of that was in 2Q?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. There's two ways to kind of speak to that. One is the fact that in the specific area of those three weeks of the strike, we ended up with about BRL 8 million additional expenses and about BRL 29 million of additional – I'm sorry, reduction in revenues in the month of May.

But then in the month of June, the lack of confidence, which was caused by this (30:11) on consumers impacted forward bookings, reduced our June revenues by around BRL 23 million (30:20). And so, that's whole another effect. If you want to look at it in kind of a combination of the actual impacts of the strike, but then its impact on the forward booking curve, which kind of extended into June, something in the order of BRL 50 million reduction in revenues.

And so, that you could kind of exclude that out of – or you could add that back to revenues, if you kind of want to see what things would have look like without those impacts. But the larger impact ended up being the impact on forward bookings, because it was supposed to apply to June, which is a month which starts to pick up into the July period. But I would (31:04) is that by July, we are to recover to kind of a normal booking rates. It happened during the month of June.

Another way I could say that is that we had been pretty successful in the month prior to the trucking strike, kind of April to the beginning of May, on the fare side in making those adjustments to compensate for the variations in jet fuel prices and currency.

The wind was very much in the sails on the demand side right up until the trucking strike knocked the wind out of the sails, the boat stopped in the water for about three weeks. And it took about another couple of weeks to kind of ramp it back up again. But by the time we get back into June – I'm sorry, July, from a sales perspective, we were back to the kind of 35% to 40% year-over-year run rate in revenue generation that we had been experiencing prior to the trucking strike.

And that's just kind of where we are right now, here at the beginning of August, but we obviously took a hit there. On a positive side, the fact that it happened in May was less impactful because April, May are kind of our low months from a revenue perspective. So, the fact that it happened in a low seasonal month overall generated much less impact than it, I would say, would have had in a higher seasonal month.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. Got it. Well, I appreciate the color and I'll pass the question. Thanks, guys.

Operator

And the next question comes from Petr Grishchenko from Barclays. Please go ahead.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Good afternoon, gentlemen. This is Petr Grishchenko with Barclays, and thanks a lot for taking my questions. Perhaps if you can just elaborate (33:04) a little more on our fares. Given the speed of BRL move in the middle of the quarter, how much do you think will the fares, higher fares in the second quarter 2018 and with the result of GOL's advanced bookings that took place early in the quarter? And I guess what have you been seeing in June, July, was that uniform across the quarter or you saw, I guess, some changes?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

The quarter was quite controversial regarding the revenue pattern because, as I mentioned, right after the truck drivers, the demand barely appeared, showed up; and while the country itself started a process of re-accommodation regarding production of economic activities and so forth.

So it's really hard to be precise in telling you how much the sales pattern were affected by the truck drivers' strike in over the last two or three weeks. But what we can tell you for sure is that the airline demand was less affected than other segments in the market, considering that 10 days after the strike, we came (34:37) to the regular pattern. What has affected the results most is the capability increasing the youths (34:42), considering the new cost level.

So we were pretty much ahead of that cost curve prior to the strike and then once the revenues were affected for 10 days, the whole market lost the opportunity of immediately compensate the additional cost level. I think that the trend might be neutralized during the July month considering that is a high-season month in Brazil and the demands are pretty strong. So volatility is there, but I don't see any change, in our view, of having the growing demand, which give us a more pricing power in order to compensate the cost of the airspace.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Okay, we're seeing – we can't see full out into the fourth quarter, but at this point, we expect high demand, with load factors averaging the high 70s, lower 80s from now through the rest of the year. It's important to mention that the key is really capacity. Our current domestic capacity plan is calibrated for the current rate of demand growth here in Brazil and we have the ability to flex that up or down.

And so we're well prepared for alternative demand scenarios because what matters is really going forward and our ability to generate economics out of that. The key for that is capacity because the Brazilian economy is showing there's moderate early (36:19) low interest rates, low inflation. We have a very good domestic demand environment for the second half of this year. And in election year, we just started election season here in Brazil.

They generally have had positive impacts on air travel. I think demand increases during election season, which has just started. And, of course, all this we're saying is on the domestic side, which is a key driver for our business. Again, the markets for flights on the international side – Brazil to South America, other countries, Caribbean and Florida, which are our addressable international markets, we're a little bit more cautious there. We're just starting to expand there. But we are a little bit more cautious on the international portion of our business.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Right. So, I guess a question based on the capacity and the fleet management. You decided to convert around 30 MAX 8s order, I think, to MAX 10s, right, as you disclosed and those are slightly bigger aircraft maybe 20, 30 seats more seats depending on the configuration. But correct me if I'm wrong, I thought one of the reasons for MAX 8 was to have flexibility to fly to Florida as well as to be able to use the aircraft domestically.

But just given the range for MAX 10 maybe around 6,100 kilometers which barely covers the distance between Brazil and Orlando, like does this indicate you're more confident in domestic market and less emphasis will be put on international expansion or I guess any color on what led to this decision will be very helpful.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Sure. The MAX 10 has a quite specific mission. We have some controlled airports in Brazil. We have high demand carrying people from our hubs, between our hubs, and from the most congested hubs to the northeast part of the country.

The MAX 10 will deliver the lowest CASK among all the narrow-body models available in the world (38:40) perfectly fit into our network, given each commonality with the 737 MAX and NG. I mean we – the MAX 10 shares basically the same engine, the same cockpit. So, we will just add bigger planes, bigger boards connecting our hubs, reducing our CASK, and producing a considerable amount of additional revenue.

The MAX 8 has this hybrid function. We can equally reduce the cost per seat due to its significant lower fuel consumption, around 15%, at the same time that we can reach longer ranges. So the MAX 8 will continuously expand our network once it could give us the opportunity to address more destinations in South America, the Caribbean and also in the United States.

There are at least 10 additional destinations that we could add over the next 40 (39:52) international ones, those would be operated with the MAX 8. But the MAX 10 has a different mission. It's more (00:40:02) with our CASK in the domestic market than reaching new destination.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Got it. That's very helpful. Last question from me just on the fuel hedges, can you please remind us how much of your fuel consumption this quarter was hedged and how much of fuel consumption is hedged for the rest of the year?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. We're about 70% hedged for the rest of this year of our consumption at prices in the high-70s. We were probably around 30% to 40% hedged or so effectively in the Q2 period, which, on the fuel side, specifically generated for us about BRL 40 million of operating gains. It's important to say that I've seen some reports out that they're calling that non-recurring. I mean, our policy decisions are recurring and so everything we're doing on a policy side, those are recurrent.

The execution of that depends on what's happening in the actual businesses. I go on revenue management, competition as well as the actual commodity prices. But we continue to do that actively and that's a compliment to what we're doing on the revenue management side and the revenue management side gains or losses being a function of what we're doing on the capacity management side.

And so it's important to remember that the way that kind of works for us in terms of how GOL manages our business is it really starts with the disciplined and flexible capacity management that (41:40) management within our business obviously which is specific. Our network is specific. Our customer base is specific.

And then we complement that with the hedging policy which is always present. And then we're executing that. How that has translated into execution recently had been a relatively higher level of hedging in the last couple of quarters. I mean, we've been averaging between, up until, say, Q2, we were averaging around 25% to 40% of our forward consumption hedged out on the curve.

At the beginning of – during the second quarter, we have increased those given our specific views on oil as well as our business, and that means that has resulted in that. Where we sit right now, we're about 70% hedged through December of this year.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Great. Thank you very much for the answers, and best of luck to you.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

Operator

And our next question comes from Savi Syth from Raymond James. Please go ahead.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Hey. Good afternoon, everybody. Just on the comment that you mentioned on the recording and on the call again that you're a little bit more cautious on the international and I noticed that you haven't changed your international capacity guidance or and then I think it's more MAX expected coming this year than before. Considering what's the flexibility there if you (43:25) a lot stronger to maybe kind of move some of those MAXs more to the domestic market versus international or how you're thinking about that?

Hello? Hello?

Operator

I believe the speaker line is having technical difficulties right now. Please hold on until I reconnect the speakers.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Okay.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

So...

Operator

All right. I've reconnected the speaker line with the audience.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Hello?

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Hey, guys. I don't know how much of that my question you....

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Could you please repeat because I think that we have some problems with the connection, if you can further repeat your question?

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Yes. So, you see your commentary has been a little bit more cautious on the international addressable market in near-term. And then I noticed that, one, the capacity guidance for international hasn't changed and it looks like you're getting one more MAX than previously planned. But what I was wondering is kind of domestic continues to be strong and you feel confident in it and you're worried about international. What's the flexibility this year to kind of change the international plans there and maybe focus a little bit more on domestic?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Can you hear me now, Savi?

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Yes. Yes. Thanks.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Okay. So, this is – I was about to mention that we are considering our international demand, the forward booking curve is pretty solid. We have just implemented some minor adjustments because of the MAX 8 delivery schedule. We've got a two weeks delay in comparison to the original product and that made necessary minor adjustment in our schedules.

So you probably know that we have been much less affected than our competitors when we talk on international demand because we are not operating wide-body. The beauty of having the sort of fleet is that we are able to quickly adjust their capacity, never destination to reallocate wherever we have better demand.

At the moment, in comparison to our original schedules, we do not see any major change, which would make us reallocate capacity for the international market towards the domestic. It is pretty much balanced, but – and I believe that we will reach our target. The minor adjustments are much more related to the aircraft delivery standard to the market.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Also, in our particular case, in the GOL case, one of the things that we're doing in the international expansion is together with our partners, Delta, (46:32), in the case of Orlando/Miami markets, we're (46:36) on connecting traffic. And then that, from a risk management perspective, puts us in a lower risk scenario in terms of demand generation.

But, yes, to the extent we do get better performance on that as we kind of grow into next year specifically Orlando, Miami, other destinations that we're adding in the arc of the Caribbean over to the Andes with the MAX aircraft coming in which has this 1,100 kilometer longer-stage length, these initial MAX that are coming in, the majority of them are being deployed on these international routes from South Florida arc all the way over to the Andes in the northwest part of South America, which includes Quito, Ecuador. As you know, we just recently - we're going to be starting flights to Quito, Ecuador at the end of this year.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Savi, it's also important to highlight is that in Orlando and Miami, we will be having, with Delta, which would generate us also a considerable traffic. Therefore, I think that we are somehow hedged regarding the demand because of the strength of our partner network in the United States. Okay?

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Yeah, that makes sense. I appreciate the detail. And maybe, Rich, a little bit on the aircraft asset sales. I know it's kind of lumpy and then hard to project but does the current environment kind of accelerate your thinking of - accelerate your desire to do more aircraft sales? Or how should I think about like what the motivations might be on the timing of some of these aircraft sales, as it's been the (48:23)?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. That's a good question. I think it's a fair question because it's a relatively new execution in our business. We tried to elucidate on that a little bit in our Q1 call because, really, it was - the first quarter of this year, we really started on the regular dispositions of the NG portfolio. Part of that is we were waiting to have certainty on the MAX deliveries because effectively what we're doing is we're replacing the NG 800s with the MAX.

And just kind of maybe stepping back a bit, our first order with Boeing was for 80 800 NGs. We did 40 finance lease, 40 sale leasebacks. And those aircrafts, over the next couple of years, will be entirely transitioned out and replaced with the MAX and so the disposition of those aircraft is now regular.

We can't predict exactly how we would, let's say, negotiate those deals. But, as a rough assumption, you could assume one to two aircraft per quarter for the next 16 quarters until we have a full monetization of those aircraft. But obviously those - like for example, what we've provided - the guidance we provided in the short-term, meaning 2018, those are based on deals - those numbers are based on deals we've actually already done and those already negotiated.

But there's the market component. We want to get the best deal possible for our shareholders. The NG has the interesting component that it's one of the most liquid aircraft assets in the world. For example, last year, of the over - the NG has over 7,000 aircraft in operation. Last year, there were over 1,400 sales or sale and leaseback transactions, and that aircraft especially mid-market, our midlife aircraft which are basically our NGs are seven, eight, nine years old.

The first NG we received on the first Boeing order was 2006. There's a lot of demand for those aircraft from buyers, the leasing community and so on, to reallocate those into other markets. As you know, China is a huge consumer of aircraft, probably consuming over the next cycle here; about 25% of all aircraft that are being produced are going into that market.

These aircrafts aren't going into our neighborhood or our neighbors. They're really going into other markets around the world, so the NG is kind of benefiting from these trends. Obviously, the source of our operating profits on those aircraft in our aircraft business are - one of the main sources of that is our scale. It's one of the largest operators of 737s in the world. Yeah, we're top eight now. We used to be top five but there's a couple of Chinese in there. We're top eight operator of 737, which means that we have very solid deal terms in economics on those aircraft.

Then, I guess, the final point I would make on that, the reason why and now seeing some of the reports debate recurring, non-recurring, I don't fully understand that. But meaning, first of all, policy perspective, we have a very specific policy with how we do that part of our business and it is a recurring part of our business.

I think the issue is why you're starting to see some of these operating results now is that the very first aircraft - GOL is a relatively young company in terms of being an asset owner and operator. The first NG we took was in 2006. But now, we're basically a more mature company in terms of that program. And so as we ramp up the MAX in our fleet, that will - as we replace the NGs with the MAX, that economic component of our business will be a regular component of our economics going forward. Now, there may be some variations on that in an individual part of the cycle based on the demand or pricing of the sales of those aircraft.

But, for this year, there is - and I'd say this year or next year, for sure it's about one to two aircraft per quarter of our NG portfolio being disposed, at the same time we're ramping up on the NGs and I would say the broader assumption I could - if you wanted to simplify your projections would be over the next 16 quarters assume kind of a linear disposition of our remaining 27 aircraft over those 16 quarters. But by the end of four years, we will have fully disposed of the NG portfolio and we'll be on year five of our ramp-up on the MAX portfolio.

And in the case of the MAX portfolio, we'll be doing around 60% of the MAX order will be done in a finance lease format and 40% will be done in an operating lease format. And so we'll be increasing the relative ownership of those aircrafts going forward. And this is something that's important for both shareholders, but also our bondholders because we build up a significant equity TAP in that process which acts as a cushion and it's not on our balance sheet. This is kind of an off-balance sheet asset that we have. Today, we have an excess of $300 million of TAP available in the current fleet and just based on the accounting, that's an off-balance sheet dollarized asset.

And the other thing you're also seeing why those results have been perhaps a little bit higher than expected is because they're dollarized. And so, as the Brazilian real is appreciated, that has increased the operating results on our dispositions of those aircraft. Hopefully, that - but if you need some additional information, we can speak offline to help with modeling and so on.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

No, that was comprehensive. I appreciate it. Thank you, both.

Operator

And our next question comes from Gavin McKeown from Amundi. Please go ahead.

Q - Gavin McKeown {BIO 16048042 <GO>}

Hi, folks. Rich, can I just ask you to go back on hedging, if you don't mind? So, (55:08) you've spoken about the fact that it's kind of a dynamic applied for hedging policy.

But just in terms of actual balance sheet, can you remind me exactly, if you can, is any hedging in place at all for your dollar debt? I know that over 50% of your OpEx base is roughly dollar-based or dollar-linked. Can you remind me what percentage of your revenue is reais versus dollar today?

And now, just to understand, I don't quite follow what you said, which I want to make sure I follow-up. Did you mention in your earlier comments that you think the fuel hedging gains are repeatable, make sure that I understood that properly? Thanks.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. Sure. No. Thanks, Gavin. A couple of points. On a balance sheet perspective, meaning our balance sheet, roughly, call it, $2 billion of debt we have on our balance sheet today, on balance sheet, we don't hedge that from a policy perspective because over the course of the cycle, it's not necessary to hedge that in terms of how we do the matching of our assets and liabilities. The dollars that we have on our balance sheet are - the majority of those are secured against aircraft assets and the unsecured portion is basically matched to this equity TAP that I just mentioned.

And so, the way we manage that over the cycle is a matching of assets and liabilities on a currency basis. Now, you don't see that in our accounting because as our functional currency is Brazilian reals. When we buy an aircraft from Boeing, it gets reported on our accounting on a cost basis and depreciated in reals. And so you don't have the benefit of the U.S. dollar accounting for that asset nor do we have the benefit of the market value of those assets. But those - when we actually have to pay off those debts, those are matched with the market value of those assets, not the accounting depreciated value.

And so that's why we don't hedge the balance sheet because it's not necessary and this is a policy. But on your other question, which there are really two components. From an operating perspective, what we do in our business is we do have active programs that will protect us against short-term variations in the impacts of both currency and oil prices on our short-term cash flows. And we generally will do a higher level of hedging in 6 to 12 months and a little bit lower level of hedging 24 months out, and we generally won't go much more than 24 months out. The reason why we go out to kind of a year or two is really just to take advantage of things like backwardation and relative value to build hedge positions, taking advantage of the volatility of the market. But the philosophy there, in terms of why we do that, is basically to complement what we expect we're going to be able to get on the yield management side of the equation.

And what I was trying to describe was that - and it depends on the capacity dynamic that we'll see competitively. But at an individual - at any given moment in time, we will be dealing with a certain capacity and competitive set, which we project out - it depends obviously on what competitors are doing and so on and we will then estimate the supply-demand effects on the "pricing power", if you will; our ability to pass on to revenues, the variations in exchange rates and oil prices that will affect our operating expenses.

Now, our operating expenses are roughly 50% - 45% to 50% affected by the currency. Within that 50% number is oil, the jet fuel. Oil - jet fuel cost 30% of our total cost structure - 30% to 35%. That is in that 50% bucket, and so that component of our cost structure is impacted by these variations in exchange rate and in oil prices, and so that's the dollar-linked or dollarized component of our cost structure.

On the revenue side, it's a function of yield management. But generally, in our experience, when we have a healthy supply/demand balance, we generally plan on roughly a 70% ability on the yield side to work through the impacts on the cost side to yields through fares, which can generally happen over a 90- to 120-day period.

That only works if we have a good supply/demand balance, and the numbers I was mentioning on the call are actually statistically significant numbers, if you kind of look at the modern Brazilian airline sector since we've been working in it since 2001, when you have ASKs growing lower than RPKs. The Brazilian industry yield is 71% correlated with the U.S. dollar.

When you have Brazilian ASKs growing at a higher rate than Brazilian RPKs, that number goes down to 11%. So it's highly sensitive to that component of supply and demand. We have to work with that. That guides us on what we think we can get on, what we call, recapture or our ability to pass on cost increases.

In the current environment that we're dealing with this year, our experience has been that we're working in this kind of 70% level. And our Q1 numbers as Kaki was mentioning, we've built up a little bit of a cushion. I mean, in Q1 we had - we were successful in pretty much getting 100% recapture of the effects on currency and the oil prices.

In Q2, when you discount out the effects of the trucking strike, which took the wind out of the sails on - wind out of the sails, S-A-I-L-S, impacted sales, S-A-L-E-S, for about three to four weeks and it took - so we lost a little bit of the momentum there. But when you back that out, we got around a 70% recapture in the Q2 based on the supply-demand dynamic. Obviously, we have to do the proactive deal management. It's a lot of work to do that. We think we have an advantage today on that as the largest domestic in leading on that, but it is a function – it really comes out of what everybody is doing competitively on the supply side, which all of us airline guys know very well.

But – and so just going back to your question, I mean so what that has done, that has guided us on what we think we're going to be getting on the yield management side and then we complement that with our hedging activities, which are then based on views on both oil prices and the currency, and that is – the result of that is spend.

Now, what you're asking me, about the recurring nature on the – in any given quarter, I mean, for the last couple of quarters, we have had the last, say, three to four quarters, we've had gains on our oil hedging program; obviously, a function of how much we're hedging. But that has been – but the gains have been a result because of the increases in oil prices over this last period.

And so the way that works with us is that we'll have gains on the hedges if we had an appreciation in oil prices. If we didn't have an appreciation in oil prices, we're not going to show those gains on the hedging. But how we look at that is basically we're calculating – if we're not having gains on a hedging in a particular quarter or if oil prices go down, we're having gains on the operating side in terms of reduced expenses.

Net-net, how we manage those is based on EBIT operating margin targets, and so a combination of all those factors that I was trying to describe is in our actual EBIT margin, and then, of course, our EBIT margin guidance. And that's in there. And that's how we're managing the business. That's how variable compensation is designed. And so that's basically what I would say in terms of how that rolls in.

So if we're having a gain on a hedging position in a particular quarter, that's complementing what we're getting on the revenue management side. If we're not having a gain, it's either because the commodity prices were flat or they declined, and then we're having a gain in a different way, which would be a reduction of operating expenses.

But I'd like to say it's like – think about our business, roughly 50% dollar-linked or dollar-denominated with the oil prices in there. And then if we've got a good supply-demand balance – in Brazil domestic, the yields are roughly 70% correlated with the U.S. dollar, with around a 90-day lag. Obviously, I'm super simplifying it to try to give a simple answer as possible. Sorry, you had another question?

Q - Gavin McKeown {BIO 16048042 <GO>}

Thank you. Very comprehensive answers that you had. I just want to make sure you – part of your base case (01:04:55) might be to have this kind of continual gain from hedging, but that's a good explanation. Thanks.

Just to be clear, though, part of the question in terms of the FX breakdown of revenue, so 70% is reais?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

No. What I was trying to say there is - and this is - you have to be - obviously, we always have to be careful with the...

Q - Gavin McKeown {BIO 16048042 <GO>}

(01:05:15)...

A - Richard F. Lark Jr. {BIO 427746 <GO>}

...statistics. I mean, for example, these numbers are giving you - the key statistics on those correlations are giving you is above 7 (01:05:24). So it's highly statistically significant. But...

Q - Gavin McKeown {BIO 16048042 <GO>}

Sure.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

...the way I would try to describe it is think about that - what I said there's that 70% is the correlation, a correlation of 70% if we have a good supply-demand balance. It's not that they're linked to the dollar...

(01:05:42)

Q - Gavin McKeown {BIO 16048042 <GO>}

Just what component of your revenue is earned in reais on a kind of trailing...

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah, I know. I was getting to that. I know you were getting at that. Also, I'll give a caveat there. The answer to that is today it's about 15% of our revenues are billed in US dollars, okay?

Q - Gavin McKeown {BIO 16048042 <GO>}

Okay.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

That doesn't mean that that they are dollarized revenues. I mean, they're billed in U.S. dollars. And so, I just always be careful with that because even if I had 50% of my revenues billed in U.S. dollars, it doesn't mean that they are correlated with the US dollar.

It's a function of what markets I'm working in and the composition of the customer - be he a business traveler or a leisure travel. The reason we have this such high correlation in our business in Brazil is because around 70% of our customers are business consumers in Brazil, which are traveling for business purposes and they tend to be price-sensitive but they're price inelastic. They're not going to stop traveling if fares go up, while the leisure component or the VFR component is highly, highly price-sensitive.

And so, for example, you take our business going in Argentina, for example, which is the large chunk of our international revenues, those revenues are built in dollars. And for us, it is a business traveler so they're relatively price inelastic. But for me to look you in the face and say, I have 15% of my revenues in dollars and they're on place between Brazil and Argentina, that wouldn't be intellectually honest. And so you have to fuel that back a bit.

Our international revenues will tend to be South America and more business, and so they will be pretty resilient from a currency perspective. Our flights to Florida which we're launching are going to be initially more leisurely - a more leisure, VFR-based. And so, even though they're going to be built in dollars, when we have a currency appreciation of the U.S. dollar in Brazil, meaning that it's more expensive for Brazilians to buy tickets to go to Disney World, we'll generally see demand fall.

And even though those revenues are built in dollars, they're not necessarily providing us something that's highly correlated to the U.S. dollar, simply because the billing currency is dollar. And so, I just give you that information there. Obviously, each airline will have a different portfolio but I just don't want to generalize.

Q - Gavin McKeown {BIO 16048042 <GO>}

Excellent, really helpful. And sorry, just to clarify one other quick point you mentioned in your introductory prepared remarks that the target like at the end of the year was 2.5 times but 3 (01:08:29) times on the slides. Did I mishear the 2.5 times?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

You're asking leverage targets?

Q - Gavin McKeown {BIO 16048042 <GO>}

Yes. So basically, it's 3 times on the slide. I thought you mentioned 2.5 times in your prepared remarks.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

What I - the 2.5 times was referring to 2019.

Q - Gavin McKeown {BIO 16048042 <GO>}

Okay. Great. Okay.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

This year, our official target is 2.8 times for the full year and we were at 2.9 times based on the quarter. So that's - we're also providing some initial thoughts about 2019 and that's the 2.5 times.

Q - Gavin McKeown {BIO 16048042 <GO>}

Right. Thank you so much.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Thank you.

Operator

And this concludes our question-and-answer session. I would like to invite Mr. Kakinoff to proceed with his closing remarks. Please go ahead, sir.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Ladies and gentlemen, I hope you found our presentation and the Q&A session helpful. Our Investor Relations team is available to speak with you, if needed. Thank you very much.

Operator

This concludes the GOL Airlines' conference call for today. Thank you very much for your participation and have a nice day.