

Q1 2018 Earnings Call

Company Participants

- André Dorf, Chief Executive Officer
- Gustavo Estrella, Chief Financial & Investor Relations Officer
- Luís Henrique Ferreira Pinto, Chief Regulated Operations Officer

Other Participants

- Bruno Varella, Partner and Equity Research Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Thank you for standing by. Welcome to the CPFL Energia's First Quarter 2018 Earnings Conference Call. Today with us we have Mr. André Dorf, CEO of CPFL Energia; Mr. Gustavo Estrella, CFO and IRO; and other officers of the company.

The presentation will be available for download in the company's website at www.cpfl.com.br/ir. We inform that all participants will be in listen-only mode during the company's presentation. After the presentation, there will be a question-and-answer session, when further instructions will be given. 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 no guarantees of performance. They involve risks, uncertainties, and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of CPFL Energia and could results to differ materially from those expressed in such forward-looking statements.

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

André Dorf

Good morning, everyone. Welcome to another conference call. Today, we'll be addressing the earnings of the first quarter of this year, 2018. As usual, we have a brief

presentation to deliver, showing a couple of numbers and highlights of the quarter, and then we'll be here for the Q&A.

So, let us begin on slide number 3, highlights. In the first quarter of the year, there was an increase in load measured in our concession area of 3.7%. Here, we highlight the industrial segment - the industrial class. Later on, we're going to show a breakdown by segment or class.

We also posted growth of 15% in our net operating revenue and 14% in EBITDA. It's another great highlight when it comes to our operating performance. The net debt of the company closed the quarter at BRL 15.6 billion, a leverage of 3.31 times net debt over EBITDA of the last 12 months. We also had significant funding, BRL 2.8 billion this quarter, at very competitive costs.

During the first quarter, we had a bit amount of investments totaling BRL 426 million in several businesses of the company, and here, we highlight energy distribution. We also had a conclusion of CPFL Paulista tariff review in April after we closed the quarter, with an average effect of 16.9% to be noticed by consumers. We also had the conclusion of RGE Sul's tariff review, an average effect of 22.47% to be noticed by consumers.

Other relevant issues, I think you're following up the development of the electric segment in Brazil. GSF is still in the agenda for several consecutive quarters being discussed by all companies, agencies, and regulatory agencies, and more specifically focusing now on Eletrobrás the possible sale of distribution and also due to privatization.

We also have a bill and a reform of the regulatory framework in the industrial modernization of the regulatory framework which is also very important for the future of the electrical system in Brazil. And finally, Distribution segment consolidation with a possible change in control of some companies.

On slide 4, we address our EBITDA in the first quarter. On the left at the top, we show our breakdown of our EBITDA of almost BRL 1.4 billion in the first quarter. Distribution segment accounting for 58% of EBITDA generated this quarter, Conventional Generation and Renewable 41%, and 1% with Commercialization, Services and Others.

The bar chart show an evolution of our EBITDA by segment. At the top on the right, we can see significant growth in Distribution EBITDA, pretty much affected, positively affected by revenue and cost effects, show a growth of almost 27% year-over-year. Conventional Generation posted growth of 10%, pretty much related to the recognition of reimbursement from previous GSF periods. Also a drop in EBITDA for Renewable Generation, CPFL Renováveis, of 3.7% related to the slow speed of wind this quarter.

For the second year in a row, winds are below the expected curve when compared to the historical average. So, we are convinced this is an outlier, which happened this year and last year. For Commercialization, Services and Others, we had a more significant drop, 44%, not in absolute terms, but percentage wise, more related to lower margins in commercialization.

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On the next slide, slide number 5, we show the highlights of the Distribution segment. Like I said, we had an increase in load in our concession areas amounting to 3.7%, also an increase in sales at 2.9%. Here, we have a match between sale and verified load which explains the difference. And like I said, another highlight is growth in the Industrial segment of 5.8%, 5.6% at Paulista and 7.8% in Piratininga. So these are heavily industrialized areas, which is a proxy of growth and activity in our concession areas. So, that's a very positive highlight of the first three months of the year. As to losses, there was a slight progress. In the first quarter of last year, we had 9.23%. We improved until the last quarter of last year to 9.01% and now 8.87% in the first quarter of the year.

At the top on the right, we show the performance of our sales. Now, we highlight customers in the free market growing by nearly 3%. The pie chart at the bottom shows a breakdown of our market, a breakdown by consumption segments. Residential, for instance, 35%; Industrial, 35%; Commercial, 17%; and Rural, Local Administration and Others with 18%.

When we compare our growth in our regions, when we compare to the market at large, we also realize that in this quarter, there was higher growth compared to the other categories. So, if we compare the whole concession area of CPFL with Brazil's growth, there is a higher growth of 2.9% compared to 0.7% in Brazil. The same goes for a comparison between our distribution companies in the Southeast, 0.7% in the market and 3.3% growth at CPFL.

In the south of the country, our growth of the country is 0.2% compared to 2% growth at CPFL, which is also much higher. And the most interesting chart of this slide which is at the bottom on the right, it is a sales breakdown by consumption segment. Our highlight is the industrial segment and other classes of consumption growing by 3.6%, heavily affected - positively affected by rural in the south. Rainfall was lower in the south, therefore, higher need of irrigation in agriculture in the south of Brazil with a positive impact on the rural segment at RGE Sul.

Now on slide number 6, a recurrent topic during crisis is delinquency. There's still some sign of improvement in delinquency index at the company. At the top, we have our ADA evolution as a percentage of gross revenue at 0.41%. By the way, we changed our calculation methodology. In the past, we used as a base (10:59) and now we are using IFRS.

So, if we were to post based on (11:05), it would be 0.43%, which is very close to IFRS at 0.41%. So, we no longer have the peak of 0.90% of our gross revenue in the second quarter of 2016. There is no change in our efforts to fight fraud and delinquency. We still have a high volume of spending in these initiatives.

An example is our collection actions, as we can see at the bottom on the right, this chart shows that in the first quarter alone in 2018, we had 417,000 disconnections due to fraud or lack of payment. On the left, we also show the number of overdue bills as a percentage of revenue. So, this is over 90 days, a slight recovery to 0.97% of gross revenue.

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On slide number 7, on page 7, we show some highlights related to energy generation. The first highlight is a negative highlight related to wind generation like I said before. Wind generation is below our forecast at 32% related to slower wind. We also show the performance of the spot price or PLD showing high volatility. We tend to talk about volatility of the spot price, and this chart shows us the broad variation over BRL 500, almost BRL 100 in a short timeframe.

On the right hand side, we show our installed capacity, a slight progress of 0.8% due to new start-ups at CPFL Renováveis. At the bottom, we can see the NIPS reservoir level. Not so concerned compared to previous years. There was some improvement this quarter compared to previous quarters, however, below historical averages. We closed April, as we can see on the left, at 46% of our average capacity in the reservoirs, so above more critical years and, therefore, without any risk of supply for the current year 2018.

So now, I give the floor to Gustavo Estrella. He is going to talk about the financial results.

Gustavo Estrella {BIO 18109709 <GO>}

So, turning to the results of the first quarter, I think this is a quarter with positive results. And remember, we now are already following up the results with the integration of RGE since the beginning of last year. So now, we have just one comparison base. There is a growth in the net revenue of 15.1%, EBITDA of 14.3% and net income of 80.7% growth.

Considering the group's business, so we have a highlight in the Distribution segment with a total variation positive of BRL 167 million vis-à-vis 2017. The main effect here, as André has mentioned, is the recovery of the energy consumption. We already have growth, again, a relevant growth in our concession areas. And, obviously, this provides an important effect in our results.

And in addition to that, we have the effects of the tariff reviews. The tariff reviews, not the ones for 2018, but the ones for 2017 that will affect the comparison of the first quarter of 2018. Also, we have the concession financial asset with a positive effect of BRL 16 million and special highlight in the OpEx line with the PMSO, lower in BRL 62 million. And first, I should highlight legal and judicial expenses, BRL 39 million, and our allowance for doubtful accounts as we have shown was a drop and a positive result of BRL 21 million.

Now, turning to conventional generation, we had a positive total variation of BRL 29 million. The main effect here is the GSF variation. We have a seasonality issue related to GSF. But here, especially, regarding a change in the accounting criteria of GSF, and the posting criteria of the GSF where we now start posting that by the competence (16:30) system with a positive effect in this quarter because it partially offsets itself over 2018. But in this first quarter, it has a positive effect of BRL 21 million.

And commercialization, basically here we have a margin loss, and when we compare that to 2017, with an effect of BRL 32 million in commercialization. For renewable, we have a total variation of BRL 9 million. Here, we have positive and negative effects. The main negative effect here is the performance of our wind farms especially here because of

lower wind speeds. When we compare that to 2017, here, this effect is BRL 36 million in our results.

Partially offsetting this effect, we have the stake of the short-term auctions, MCSD, Surplus and Deficit Compensation Mechanism, with a positive effect of BRL 12 million in our results. In addition to that, we also had the start-up Pedra Cheirosa complex, with an EBITDA increase of BRL 11 million.

Now, turning to our net income, we had a positive variation of our financial results of BRL 129 million. The main effect here is the drop in the interest rate, bringing us a reduction of BRL 158 million in our financial expenses and we have there lower interest rates, BRL 149 million, and also a drop in our leverage, including assets and liabilities that are regulatory, which also impact our financial results with a positive variation there at BRL 15 million.

Now, turning to slide number 9, we have a snapshot of our indebtedness. You can see that in this quarter, we have a leverage of 3.31 times net debt over EBITDA, a slight increase vis-à-vis the end of last year. And the main variation here is that in spite of the EBITDA improvement from 2017 to 2018, here, we have the variation of our net debt, especially explained by the variations of assets – the regulatory assets and liabilities and these assets are now integrated in the tariff review of the company. And now we start to receive them over 2018, but they do have a negative effect in our total leverage of the group when we compare December 2017 to March of 2018.

(19:25) cost is still in a downward trend. We have a nominal cost of 7.6%, significantly lower when compared to prior quarters. And the debt breakdown, we see that we are largely exposed to CDI. This year, we have made a swap for a fixed rate, taking advantage of the lower interest rate. So we're already very limited in terms of exposure to the CDI, and more now, we are under the pre-fixed rate. So, with that lower interest rates, we have that kind of plan for 2018.

Turning to slide number 10, we have our debt profile and the liquidity of the company. So, we ended the quarter with a cash of a little bit over BRL 3 billion. And when we see in the chart, we see that this is enough to pay all our maturities in 2018. And this is influenced by the funding we had in the beginning of January, a funding of BRL 2.8 billion. Therefore, we are extending our debt and refinancing the company in the long-term.

What we are doing today, as usual in the group, is to work in the refinancing for 2019. That's what we are working on right now. And we expect that in the next few months, we already start working on maturities of 2019 then.

Now, turning to slide number 11, we have a snapshot of the conclusion of the tariff review process of our two distributors, CPFL Paulista and RGE Sul, with positive results. And we have here at Paulista, the net regulatory asset base of BRL 5.2 billion and we're able to maintain the regulatory WACC at 8.09%.

And we see here the performance of the regulatory EBITDA. In the third cycle, it was a BRL 662 million, and for this cycle now, BRL 1.033 billion. There is an increase of 56%.

Obviously, we start to see that – to see the impact starting in April. That's when we had the tariff review process. In a similar analysis, so we have an additional challenge (22:09) the company has been acquired at the end of 2016.

And so, the challenge was in the process of developing that base pre-tariff review that is just one year, 2017. So, here, we post almost BRL 2.4 billion in terms of the net regulatory asset base. And here in the performance, the regulatory EBITDA is even higher starting at BRL 232 million up to BRL 435 million, an increase of 82% vis-à-vis the third cycle. Once again, we start noticing the differences starting May of 2018.

So, we now end our presentation, and we 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. The first question is from Bruno Varella, Solana Capital.

Q - Bruno Varella

Hello, Estrella, Dorf. I have three questions to ask. Firstly, I would like to have a better understanding of the dynamic of losses at RGE Sul. There was a drop of 60 basis points for non-technical losses, but also 75 bps increasing technical ones. I'd like to understand if things are related and what about these increasing technical losses, very strong from one quarter to the next?

The second question, well, there was a strong impact of BRL 770 million in the supplier account and cash flow – consolidated cash flow. That's another point I would like to understand. What is behind the strong impact? And lastly, could you tell us more about consumption at discos in the second quarter for the closing of April? Thank you.

A - Operator

Thank you for your questions, Bruno. Good morning. Luís Henrique is in charge of regulated operations and he's going to answer the third question about discos consumption after we closed the quarter, April and May.

A - Luís Henrique Ferreira Pinto

Hello, Bruno? How are you? In terms of consumption, April was slightly above our expectations, mostly due to temperatures. In our distribution companies, consumption was slightly higher than what we had in our previous budget. So, we still have this trend, like Gustavo said, of an upturn. It is very mild now, but it is an upturn in consumption, particularly in the industry as we said before.

As to residential, this is also related to temperature. It does have an influence. We had high temperatures from April onwards vis-à-vis the historical average for this month. As for losses, could you repeat the question? I think you wanted to know about the technical aspects, right?

Q - Bruno Varella

Actually you had an increase in technical items, but a strong drop in non-technical items. Is there a relationship between both due to this inverse move and what is the reason? If it were isolated events, what would lead to this increase in technical losses?

A - Luís Henrique Ferreira Pinto

Ever since we acquired the company, we've been calculating again and reassessing every piece of information, not only losses, but also other technical information. And there's variation, by the way, in the measurement process, the border (26:42) we are working again all the calculations about technical losses. So the technical losses, if we consider load seasonality, because it does have an impact on losses, we are doing all the calculations again. And the global one is not so heavily affected, but we are trying to have a better balance between what is actually technical and non-technical.

So within Enel's rules, because we also have some changes there today, for instance, high voltage by distribution, no longer for load flow, so there are many new procedures being adopted, so we can come to a more adequate and correct number in this breakdown between technical and non-technical.

Before I give the floor to Gustavo to answer the second question, just a general comment on consumption, Bruno. There was a more vigorous growth in the fourth quarter of last year, general consumption in discos, our concession area. We still had very strong growth in the first quarter, but it is not so vigorous in April and May. So it's still growing, but more moderately compared to previous periods. Apparently, it is something we see in many segments of the economy which had a very vibrant growth in the first quarter, but are failing to keep up the same trend over April and May.

A - Gustavo Estrella {BIO 18109709 <GO>}

Okay. So, Bruno, let us talk about variation of suppliers. This is basically cash management. That's something we'd do particularly at the end of every year, postponing payments of some suppliers. Cash restriction, for instance, at a company, that's when we work on this kind of operation. And we did it last year. So, I postpone the maturity after an agreement with a supplier. I postpone the payment, and usually it happens over the first quarter of the following year. So basically, this is what happened. This is not a regular move of the suppliers account, but this is a postponement of maturity for some suppliers, and then we concentrate payment in the first quarter. And I close the previous year with a high balance for suppliers, and this balance is adjusted over the first months of the following year. So this explains this move.

Q - Bruno Varella

Great. Thank you very much, gentlemen.

Operator

So we now end our Q&A session. I will turn the floor back to Mr. André Dorf for his final remarks.

A - André Dorf

Thank you very much. I would like to say that we are still working on optimizations and efficiency gains, focusing on short-term results. And at the same time, we are evaluating and investing in opportunities, business models, digitization that will create value in the long term. Once again, thank you all for your participation in this call and for trusting us over this period of time.

Operator

The conference call of CPFL Energia has ended. Thank you for your participation and have a nice day.

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