Q2 2018 Earnings Call

Company Participants

- Andre Pires, Chief Financial and Investor Relations Officer

Other Participants

- Bruno Montanari, Analyst
- Frank McGann, Analyst
- Luiz Carvalho, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Ultrapar's Second Quarter 2018 Results Conference Call. There is also a simultaneous webcast that may be accessed through Ultrapar's website at ri.ultra.com.br. and the MZiQ platform. Please feel free to flip through the slides during the conference call.

Today with us we have Mr. Andre Pires, Chief Financial and Investor Relations Officer, together with other executives of Ultrapar. We would like to inform you that this event is being recorded. (Operator Instructions) We remind you that questions which will be answered during the Q&A session may be posted in advance in the webcast. A replay of this call will be available for one week.

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 Ultrapar's management and on information currently available to the Company. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of Ultrapar and could cause results to differ materially from those expressed in such forward-looking statements.

Now I'll turn the conference over to Mr. Pires. Mr. Pires, you may begin the conference.

Andre Pires {BIO 17698724 <GO>}

Thank you. Good morning, everyone. It's a pleasure to be here with you to discuss Ultrapar's second quarter results and to give you some perspectives on the next quarters.

Here with me are the officers from our businesses as well as our Investor Relations team to help answering your questions.

I'd like to start with an overview of the events since our last call on slide number three. Earlier this week, on Tuesday night, we published a notice to the market regarding the operation called Controlled Margin. This is an investigation involving employees of fuel distribution companies, including Ipiranga, in the City of Curitiba, State of Parana. We are evaluating the facts in order to take the necessary and applicable measures.

Also on Tuesday, we were informed of a criminal complaint filed by the public prosecutor of Brasilia against resellers and employees from the distribution companies, among which there are two former employees of Ipiranga for alleged criminal acts against the economic order. These matters had been conducted by our legal team and any updates about these cases will be duly communicated to the market.

Talking about our results, the quarter began with good prospects for our business. In April, we observed an increase in fuel sales volume, particularly ethanol and diesel, with imports gradually decreasing. However, an increase of 18% in oil prices, combined with a 17% devaluation of the real against the dollar were the triggers of the truck drivers' strike in May, which brought the country to a halt, impacting several sectors of the economy and causing huge losses to Brazil.

The country's logistics infrastructure is heavily dependent on road transportation. Hence, the strike affected almost all our businesses. At Ipiranga, during the stoppage due to the blockage in our distribution bases, we had difficulties to deliver our products. They were also impacts in our other businesses, affecting the delivery of LPG at Ultragaz, specialty chemicals at Oxiteno and pharmaceutical products at Extrafarma.

On top of this, there was a significant reduction of BRL0.46 per liter in the price of diesel, which had an impact on margins during the period, given the accounting loss on inventories. During the presentation, I will point out the strike-related losses, which totaled about 200 million in the second quarter alone.

(Technical Difficulty) you can see the graph showing the (Technical Difficulty) for GDP deteriorating after the strike, jeopardizing the recovering the economy expected for the second half of 2018. The data on fuel volumes for the country as a whole shows the impact caused by the strike on the fuel distribution market, a core target of the strike. The graph in the top right-hand corner illustrates the intensity of the impact caused by the fuel terminals locales, which prevented (Technical Difficulty) distribution. The magnitude of declining volumes for me was enough to offset the cumulative growth up until April.

Notwithstanding, we reported net revenues of BRL22.6 billion (Technical Difficulty) higher than the second quarter of 2017 and adjusted EBITDA of BRL718 million, a 6% decline compared with the second quarter of 2017.The estimated impact of the strike on the second quarter results was BRL189 million. If we exclude this effect, adjusted EBITDA would have been BRL907 million, 18% higher compared with the same period of last year, driven mainly by results from Oxiteno, Ultracargo and Ultragaz. Net income came to

BRL241 million, 2% increase over the second quarter of 2017, equivalent to BRL0.44 per shares.

In this quarter, the Board approved the distribution of BRL304 million in dividends for the first half of 2018, equivalent to BRL0.56 per share, which corresponds to a payout ratio of 97% or 61%, if we consider the net income excluding the fine related to the Liquigas acquisition.

Let's now move on to slide number four with the performance of our fuel distribution business, Ipiranga. Sales volume in the second quarter of 2018 reached 5,859,000 cubic meters, a 1% reduction compared with the second quarter of 2017 with a 7% drop in Otto cycle and (Technical Difficulty) in diesel. Both fuels were (Technical Difficulty) by the strike due to the blockade of our distribution terminals. This resulted in an estimated impact of 4% in our sales volume. The strike effect was partially mitigated by the expansion of our service station network and by higher sales to the large consumers. It is worth mentioning that there was a positive trend at the beginning of the quarter according to the graph in the top right-hand corner of this slide, confirming our previous perspective for growth in volumes.

We ended the quarter with 8,044 service stations, a net addition of 301 stations in relation to the second quarter of 2017. During this period, practically 2 million transactions were (Technical Difficulty), an increase of (Technical Difficulty) compared with the first quarter of 2018. While the average number of active participants rose 126% compared with the same quarter. The am/pm convenience store chain launched an exclusive line (inaudible) with its own brand and (inaudible) signature. am/pm stores are now installed at 31% of our service station network, while the number of bakeries and beer caves increased by 19% and 22% respectively year-over-year.

Finally (inaudible) our loyalty program registered a record penetration with the accumulation of 22% in points of all transactions at the pumps in the quarter, with the number of participants reaching 28 million people. The financial results were significantly affected by the strike. The BRL0.46 per liter cost reduction in diesel prices produced a one-time loss of BRL122 on inventory in the quarter.

Lower sales and greater one-off costs linked to the normalization of operations and estimated impact of BRL40 million totaling (Technical Difficulty) negative effect of BRL163 million on EBITDA. On the other hand, Ipiranga's SG&A for second quarter of 2018, excluding expenses related to the consolidation of our ICONIC's results remain stable compared with the same period of last year, showing the results of increased focus on expenses control.

As a consequence, Ipiranga posted an adjusted EBITDA of BRL402 million in the second quarter of 2018, a year-on-year reduction of 29%. If we exclude the impacts from the strike, recurring adjusted EBITDA would have been practically flat year-on-year.

Looking now at the current quarter, the operation environment continues to be challenging as a result of recent changes caused by the strike and the slower recovery of the economic environment. These factors reduce the visibility regarding the future performance. Therefore, in the short term, we do not expect a significant evolution in our results despite our recent improvement in market share.

Despite the short-term challenges, we continue to believe in the good fundamentals of the fuel distribution sector in Brazil. In this sense, we are adjusting our cost and expenses and focusing on productivity. In addition, we have been working on the optimization of working capital in order to improve the return on capital employed in our business. We also continue to focus on improving the relationship of our resellers, prioritizing their shares and the start-up of operations at service stations already contracted. We are more selective in our investments, seeking the best profitability in the face of the current market conditions.

Moving on now to Oxiteno in the slide number five. Oxiteno's total sales volume in the second quarter of 2018 was 193,000 tons, a growth of 6% compared with the same period of last year, largely due to greater sales volume of commodities, which increased by 31%. Specialty sales volume were up by 1%, again in relation to the same period last year, due to higher in the US, despite lower sales in the domestic market due to the strike.

During the strike, Oxiteno temporarily ceased operations at four production facilities in the south and the southeast regions in Brazil given the impossibility of delivering products. The result (Technical Difficulty) estimated loss of 6,000 tons in volume. (Technical Difficulty) EBITDA in the second quarter of 2018 was BRL121 million, 90% higher than the second quarter of 2017, if you exclude nonrecurring effects in the second quarter of 2017 and the impact of the strike. This positive performance reflects their higher sales volumes as well as the 12% devaluation in the real against the US dollar and higher unitary margins in dollars. The combination of these events more than compensated the impacts caused by the strike, estimated in BRL13 million. The EBITDA margin during the quarter was a $134 per ton.

The new plant in the USA is in the process of being commissioned and ready to begin operations. This should help dilute costs and expenses during the second half of 2018. In addition, Oxiteno continues to focus on innovation (Technical Difficulty) new specialty chemicals on the market, notably in the area of coatings and personal care. In addition, Oxiteno was recognized as one of the leaders in innovation (Technical Difficulty) by the newspaper Valor Economico. Oxiteno also stands out for its operational excellence and we see the global award from Shell as the best performing company in the use of catalyzers.

Looking to the quarters ahead, we can observe that the factors that have positively impacted Oxiteno's results remain unchanged, which makes us believe in the continuous expansion of Oxiteno's EBITDA. You'll recall that especially the third quarter is seasonally stronger in volumes.

Now moving on to Ultragaz in slide number six. In the second quarter of 2018, volumes remained stable in relation to the second quarter of 2017. The bottled segment grew 1%, mainly due to the commercial initiatives, particularly in the northeast and mid-west regions of the country. This effect was neutralized by a 4% decrease in the bulk segment, which was the most affected by the strike due to logistical difficulties in the distribution -- in distributing products.

EBITDA at Ultragaz rose 23% in the period, reaching BRL148 million as a result of the management team committed to operational efficiency and low cost besides the continuous focus on differentiation and innovation. Examples of (Technical Difficulty) reduction in freight costs was the migration of clients from (Technical Difficulty) marketing expenses and expenditures (Technical Difficulty).

On the other side, the strike had an estimated impact on Ultragaz of BRL10 million due to the estimated loss of 7,000 tons in the volume in the bulk segment. For the current quarter, we are expecting volumes to be similar to those in the same quarter of 2017. For EBITDA, our perspective is for another quarter of growth due to the results of commercial and cost management currently underway.

Now -- let's now move on to Ultracargo, our liquid bulk storage business, in slide number seven. Ultracargo's average storage area increased by 8% compared with the second quarter of 2017. This was due to the partial resumption of activities at the Santos terminal in June 2017 and the greater handling of ethanol at the Santos and Suape terminals.

In the quarter, Ultracargo's EBITDA was BRL54 million, an increase of 108% year-over-year (Technical Difficulty) greater average storage over the period and higher (Technical Difficulty) at the terminals. In addition, we had some recurring effects, both in the second quarter of 2017 and second quarter of 2018. If we exclude this effect, growth would have been 20% due to higher average storage and prices at the terminals as already mentioned.

For the third quarter, we expect similar levels of average storage and EBITDA in relation to the third quarter of 2017. In this context, I would remind you that the comparisons between third quarters will no longer include any significant effects related to fire at the Santos terminal.

Moving on to slide number eight. Let's talk about our pharmaceuticals business, Extrafarma. Extrafarma recorded a 19% increase in the number of drug stores and ended the second quarter of 2018 with 406 stores, a gross addition of 86 stores over the past 12 months. At the end of the quarter, 54% of the stores had been operating for less than three years compared with 47% in the second quarter of 2017. This reflects the increasingly rapid expansion of our network. Gross revenues increased 16% over [ph] second quarter of 2017 with 17% growth in retail sales resulting from the larger average number of stores, the annual readjustment in pharmaceutical prices and the more intensive pace of promotional activity.

In June 2018, Extrafarma installed a new retail system for improving productivity and better inventory management at the distribution centers and stores in addition to provide a better shopping experience for our customers. The implementation and stabilization phases of the new retail system (Technical Difficulty) the truck drivers' strike, which impacted operations (Technical Difficulty) Extrafarma, blocking the receiving and delivery of products and had an estimated impact of BRL7 million on the results.

Therefore, the larger number of maturing stores and the nonrecurring effects related to the implementation of the new retail system and the strike resulted in a negative EBITDA of BRL7 million in the quarter. Excluding the effect of the new stores and nor-recurring events, EBITDA would have been BRL10 million in the second quarter of 2018 when compared with an EBITDA of (Technical Difficulty) in the second quarter of 2017.

For the current quarter, we are projecting similar growth rate in revenues together with an impact on EBITDA due to the network expansion and the increased number of maturing stores as well as the one-off effects of the stabilization of the new system.

Going now to slide number nine. In this last slide, I would like to comment on some actions and initiatives we are taking in order to ensure the recovery and strengthening of the company as well as mentioning our priorities for the second half of 2018 and 2019.

At Ipiranga, despite the short-term challenges, we continue to believe in the good fundamentals of the sector. In this sense, our focus is on the commercial and operational management, in line with the current market conditions. We are adjusting our cost and expenses, focusing on productivity. In addition, we have been working on the optimization of working capital with the objective of improving the return on capital employed in our business.

We also continue to focus on improving our relationship with our resellers, prioritizing the support and customer service, maintaining our strategy of differentiation and innovation of services and (Technical Difficulty) at the service stations. Ipiranga has a (Technical Difficulty) platform of convenience businesses for facilitating consumers' daily routine and mobility.

At Oxiteno, as already mentioned, we will initiate the production at the new plant in the US, contributing to the improvement of profitability. As you know, since last year, we have been working on the commercial front through pre-marketing to accelerate the planned ramp-up phase. (Technical Difficulty) the first half of 2018 and then (Technical Difficulty) already represents around 30% of the plant capacity. Again, the recent devaluation of the real (Technical Difficulty) the returns from this business.

At Ultragaz and Ultracargo, our intention is to maintain the focus on operation efficiency, while at Extrafarma, we are strengthening the business's foundations for growth with the implementation of the new retail system.

On CapEx, we have been more selective in decisions we make on investments (Technical Difficulty) the discipline in the allocation of capital (Technical Difficulty) by the returns. Parallel to this, we have been working on initiatives to reduce working capital and increase control over costs and expenses in an effort to strengthen our cash generation. We have resilient businesses and positions of leadership in the markets in which we operate. We are confident that we are taking the necessary steps to return to growth pace of our results, always looking to improve the generation of value for our shareholders.

With this, I conclude what we have prepared for you today. I'd like to thank you all for the attention and would welcome any questions you may have. Again, I'll begin the Q&A session.

Questions And Answers

Operator

Mr. Pires, before we begin the Q&A session, we are having a slight difficulty with your speaker line. So what we'll do right now is wait for a moment (Technical Difficulty) our Q&A. And I will reconnect the speaker line down to you. So please stand by as we reconnect the speaker line hopefully to get rid of the cutting. One moment, please. Thank you for your patience. The floor is now open for questions. (Operator Instructions) The first question comes from Bruno Montanari with Morgan Stanley. Please go ahead.

Q - Bruno Montanari {BIO 15389931 <GO>}

Good afternoon, good morning. Thanks for taking my question. Andre, I just want to double-check something. You mentioned you -- if I understood correctly, that you do not expect a major improvement in margins at Ipiranga despite gaining market share. Just wanted to understand this. This is a result of Ipiranga perhaps (Technical Difficulty) the margins for the existing customers or if this a change in mix more towards (Technical Difficulty) clients and the TRRs? And also if could give us an idea of what is the margin distinction between retail and large clients on a percentage basis or on a nominal basis, that -- this would be helpful. Thank you very much.

A - Andre Pires {BIO 17698724 <GO>}

Hi, Bruno. Basically -- thanks for the question. Basically what we -- I mean, we are observing at this point is that the impact of the strike are still somewhat in the market, right. So it is very difficult to have the right visibility to try to have a very correct expectation in terms of the evolution from now on. It's not a question of our positioning in the market. It's a question that the market is under pressure, especially after the strike. As I mentioned in my call, we came into the second quarter with very, let's stay, very positive impressions of the beginning of the quarter in terms of volume and in terms of margins. And obviously the strike created a big -- created a big impact on the quarter. So we came out of the quarter with, let's say, with a different scenario in terms of competition and different scenario in terms of margin as well. So that's why we don't see much evolution in the short term at this point, right. Obviously, we're going to work towards a normalization of that as the impacts of the strike start to dissipate. We have to take into consideration obviously that the price of diesel is too (inaudible) the refinery gains. So this is something that has an impact in the market. As for the mix, no major change in the mix. Basically, you saw very good volumes for Ipiranga, especially in the B2B side. This is due to, let's say, the efforts we have been making. So we take some of the customers we've somewhat lost in the last couple of years, especially during a period where you had a very tough competitive environment for diesel because of imports. So as you know, most part of the imports came more for diesel that gasoline and therefore on the B2B side, which is more diesel, the competition was tougher. And last but not least, the difference between a B2B customer or, for example, the margins or the B2B margins versus the margins in the retail [ph] is around 40%. But this is the same historical level that we have been observing over the years.

Q - Bruno Montanari {BIO 15389931 <GO>}

Right. And just a quick follow-up. And when you mention the still intense competition, I understand that imports are no longer coming or are not coming at the same level of magnitude they were before. So is the competition between the well-established players or is the competition still with the white flags [ph]?

A - Andre Pires {BIO 17698724 <GO>}

No, imports are not coming, or not -- at least are not coming on our own relevant way to the market. The competition -- this is a very competitive market. So it's within everybody and especially when you have -- in the case of diesel, our price that is somewhat frozen, the competition remains -- I mean, the market becomes more pressured. Let's view it like that.

Operator

The next question comes from Frank McGann with Bank of America Merrill Lynch. Please go ahead.

Q - Frank McGann {BIO 1499014 <GO>}

Yeah, if I could follow up on that question as I think Ipiranga is probably the area where the most focus should be probably. In terms of the competitiveness of the market, I mean, it's been competitive like you said for a long time. It seems to becoming more competitive. And I'd just -- I don't know if that's because of the franchisees are demanding more from you than before and perhaps some other players as well. Is it because there's just more fluidity in the market, it's -- you know, perhaps some more -- in some way a more open market because imports can be a competitive threat. If maybe perhaps you could discuss that a bit. And then secondly, when you say not -- the results are going to stay continue to be impacted, are we talking about results staying more or less to the reported numbers for the second quarter, in line with that level or maybe a little bit better or are we talking about the adjusted number, taking out the strike effects and thinking that the results will stay at that higher level?

A - Andre Pires {BIO 17698724 <GO>}

Well, thank you, Frank. Thanks for the question. The market -- the market, I mean the competition of the market is very much related to the fact that, one, you have a frozen price at the refinery gate, which makes it difficult to expand margins on that particular situation. And two, a market where -- what we had seen over the years is a more challenging economic scenario with less opportunity to grow volumes and also, in a sense, disposable income. So it becomes more competitive because the volumes are not there. I mean that's, let's say, a very quick summary about what we've been seeing. In terms of the evolution of margins and volumes, I mean, it's difficult to say (inaudible) to be so precise in terms of how we are comparing to. But basically when I say -- evolution is improving from now on is what I'm trying to say. This is more challenging, but again the visibility is very low. And although the strike has ended more than a month ago, I think the impacts of the strike are somewhat still there. So it's going to take some time to dissipate. Even on the economic activity, as you probably have been observing -- the economics activity has already come back to normal after the strike and there was a big -- this was a big dent in the expected recovery of the economy in Brazil. But something that is important on that front to mention when we talk about the way the market is structured right now is what we are doing in terms of focusing in the improvement of our capital allocation and improving our return on invested capital. I mean, I talked about on the speech in being very selective on our CapEx approach. But not only that -- optimizing our working capital is another area of focus that we are doing. And last but not least, we are accelerating the inauguration of gas stations that had already been contracted by Ipiranga, especially over the last quarter or the last quarter of 2017, which, let's say, were already contracted, already signed, but due to one or other reasons were not operational. So we are speeding up this process and very optimistic about that. And then -- and bear in mind that those are investments that have already been expensed -- that have already been done, right. I mean, so basically this should contribute towards the end of the year for better volumes for us and also should in a way keep our focus on maintaining our leadership position in terms of market share.

Q - Frank McGann {BIO 1499014 <GO>}

Okay. And in terms of like the third quarter and I know it's early to target an EBITDA number, but are you thinking it's going to be closer to the reported number of BRL402 million you had in the second quarter of this year or could we see a recovery back, closer to the first quarter levels and then stabilize there?

A - Andre Pires {BIO 17698724 <GO>}

Frank, I'll leave you to that. I mean, it's -- I mean, I cannot give you a more precise estimate at this point.

Operator

(Operator Instructions) The next question comes from Luiz Carvalho with UBS. Please go ahead.

Q - Luiz Carvalho {BIO 18040760 <GO>}

Andre, thanks for taking the question. Again, in the -- after the Portuguese call -- just two quick follow-ups. The first one a follow-up on previous question regarding imports. Just checking, did you have any impact or any gain from imports during the second quarter? And the second question is more about the leverage. You mentioned in the Portuguese call that, I mean, you know, the current leverage of close to 2.6, 2.5, net debt to EBITDA is not that comfortable. And of course that we do see some, I will say, nonrecurring impacts on that front. But how do you see the -- with the sort of lower CapEx and potentially also lower cash generation, the leverage coming down over the next couple of quarters? Do you have any, how can I say, any target for, I don't know, mid-next year, late this year, in terms of leverage? Thank you.

A - Andre Pires {BIO 17698724 <GO>}

For the first question related to import gains, this was negligible. I mean, the number was small in the second quarter, so completely negligible. Now in terms of -- can you repeat the second question again? It was about leverage, but I think --

Q - Luiz Carvalho {BIO 18040760 <GO>}

Yes, sure. In terms of leverage, I mean, you mentioned during the Portuguese call that the current net debt-to-EBITDA leverage is not comfortable or not where the company wants to be, right. And I mean, you mentioned as well you're now cutting CapEx as you announced earlier this year -- however, the cash generation also could be lower, right? So the EBITDA could be lower. So how do you see the de-leveraging process bringing the leverage back to, I don't know, 1.5, 2 times over the next quarters? Do you think that -- do you have any internal target that you can share with us?

A - Andre Pires {BIO 17698724 <GO>}

Yes. Thanks, Luiz. You know, basically a lot of the measures that we have been taking in order to bring back this number. We don't have a target, but basically our objective is to be between 1.5 and 2 times net debt-to-EBITDA. And then basically, I think that the main and most efficient tool is being more selective on our CapEx process. As I mentioned in the call, the call in Portuguese, not only being selective but also using other methods of bringing businesses to, Ipiranga especially, for example, looking at more, let's say, earn-out type of bonuses for resellers rather than the signup bonuses which has been the norm for Ipiranga; using third-party balance sheets in the way of financing, for example, our resellers, and therefore working both on the CapEx and in working capital as well, as a mean to improve our operating cash flow generation and therefore consequently, reduce our leverage. Obviously, there is an expectation in the next 12 months of a better EBITDA than in the last 12 months because in the end, we had some important impacts, especially if you take into consideration the fine paid for the non-acquisition [ph] of Liquigas. But all-in-all, I mean, our focus is on the selectivity of investments and using other two methods of investments and optimizing working capital in order to improve our generation of operating cash flow.

Q - Luiz Carvalho {BIO 18040760 <GO>}

Perfect, very clear. Thank you very much.

Operator

This concludes the question-and-answer session. At this time, I'd like to turn the floor back to Mr. Pires for any closing remarks.

A - Andre Pires {BIO 17698724 <GO>}

Thanks, everybody. Thanks for your attention and for participating in our call. As always, our IR team is available to answer all the questions you might have. And I hope to see everybody again on our next call for the third quarter results. Thank you very much, and have a good afternoon. Bye-bye.

Operator

Thank you. This concludes today's Ultrapar second quarter 2018 results conference call. You may disconnect your lines at this time.