Q3 2016 Earnings Call

Company Participants

- Paulo Sergio Kakinoff, President, Chief Executive Officer & Director
- Richard Freeman Lark, Chief Financial & IR Officer

Other Participants

- Duane Pfennigwerth, Analyst
- Joshua Milberg, Analyst
- Michael J. Linenberg, Analyst
- Pablo Zaldivar, Analyst
- Ravi Jain, Analyst
- Savanthi N. Syth, Analyst
- Stephen Trent, Analyst
- Victor Mizusaki, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to the GOL Airlines Third Quarter 2016 Results Conference Call. Today's presentation will be made by Paulo Kakinoff, President and CEO; and Richard Lark, Executive Vice President and CFO.

This call is being recorded and all participants will be in a listen-only mode during the company's presentation. After GOL's remarks, there will be a question-and-answer session. At that time, further instructions will be given.

This event is also being broadcast live via webcast and may be accessed through GOL's website at www.voegol.com.br/ir where the presentation is also available. Participants may view the slides in any order they wish. The replay will be available shortly after the event is concluded. Those following the presentation via the webcast may post their questions on our website, and their questions will be answered by the Investor Relations team after the conference is finished.

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

At this time, I will now turn the presentation over to Mr. Paulo Kakinoff for opening remarks. Please go ahead, sir.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you, and good morning, everyone, and thank you also for joining our third quarter 2016 earnings call. The cover photo of this presentation was taken in the new GOL lounge. I want to invite everyone to visit the space, which is located in Terminal 2 of Guarulhos Airport in São Paulo.

Richard will take us through the quarterly results, and I want to review a couple of highlights, so please turn to page 2 of today's presentation.

Today, we report a good performance in the third quarter, due to the lower industry capacity, the stronger Brazilian currency and fuel savings. The key milestones in the third quarter include traffic growth of 10% over second quarter 2016 to 8 million passengers; a load factor increase of 1.2 percentage points to 8%; an average fare increase of 15.8% year-over-year and 6.1% versus second quarter 2016; and finally, a unit cost reduction of 6.4% versus third quarter 2015. Excluding fuel, they fell by 3.1%.

We have solid revenues of BRL 2.4 billion on 6.7% reduction in capacity, and we drove industry-leading but modest unit revenue growth of 3.3%. And that was in line with our expectations. Ancillary revenues are approaching 13% of revenues.

GOL experienced operating margin expansion in the 3Q, posting a margin of 9.7% accompanied by an operating result or EBIT of BRL 232 million, due to the rationalization of capacity which reduces the number of seats available for sale by 20%, leading to a 1.5% increase in units and a strict control over cost, which fell by 12.6% overall.

Our third Q consolidated profit reached to BRL 66 million. We generated a net cash flow before financing activities of BRL 390 million in the quarter. And we closed the quarter with just over BRL 1.8 billion in total liquidity as represented by our cash resources and receivables.

We conclude our service to the Summer Games held in Rio de Janeiro in August and September with absolute success. All in all, we carried more than 7,200 athletes, 5,600 passengers with reduced mobility or special needs and 49 delegations. The launch of the newest accessibility ramp, the improvements in our processes and procedures, also combined with the excellence of our service as well as the high level of securing our operations, represent the medals we won in the games and which we wear with great pride.

During Q4, we will return the remaining 13 aircraft in our fleet reduction plan, which will take our fleets to 122 aircraft by the end of the year. Our seat capacity reduction should be on the order of 17% in Q4, allowing us to achieve our full year target of a 17% reduction.

In terms of outlook, I think this is a time to be cautious. The success of our efforts in driving forward bookings, higher load factors is supporting improved views. Taking into account the upcoming holidays, we are seeing better fare trends in November and December and January, and notably we've closed-in bookings giving the overall industry revenue trends we have been monitoring.

It's a little too early to tell if we will maintain the improvement in yield, mainly from February 2017 on. A couple of encouraging signs are the increase in yield resulting from our decreasing capacity, as we have reduced our domestic capacity by 4.3% in the quarter. This bodes well for our unit revenue outlook.

The domestic industry is growing 6 kilometers ahead of GDP growth. We have seen system (6:54) competitive capacity adds in markets that we serve, and it's increased competition that's diluting revenue on routes that we also serve. As forward prices have softened in recent weeks, we expect that Q4 will be slightly up over last year.

We do expect cost to fall in the full-year 2016 by 7%. This is an impressive performance particularly given our capacity reduction. As a result, we are anticipating better fourth quarter margins and profits and also better cash flows, but we need to factor this softer trend into our future plans.

So, for now, our fourth quarter 2016 plans are unchanged, but we'll continue to look carefully and evaluate our 2017 plans. We should caution that this guidance is heavily dependent of the final outcome of Q4 fares and use where we will continue to be active. We are planning for rising costs in 2017, and that's due to higher jet fuel prices and labor rates.

Our goal is to arrest the trend of declining unit revenues in 2017 and achieve positive unit revenue comparisons for the year as compared to 2016. We will rely on effective revenue management and good design techniques to achieve this as we are learning heavily on our fleet modernization to help mitigate unit cost pressures.

We expect to better profit, cash flow and returns in 2017 despite the competitive environment. Our priorities for the balance sheet this year and next year are unchanged. We'll continue to focus on the basics, running a reliable operation, offering our customers exceptional service and delivering results for our employees and our shareholders.

I would like to thank all the organizations and our Team of Eagles who played a vital role in helping us get through this period of rapid economic change. We are convinced we will arise from this arduous and complex process even stronger, more efficient and fully prepared for a new cycle in Brazil's economy.

Slide number 3, GOL has the best fares and the lowest cost of any airline in Brazil. We are number one when it comes to traffic. We have 24.5 million customers up to September this year. We are number one when it comes to coverage at main airports in Brazil with 52 bases.

Indeed, we are number one when it comes to customer service. Not only do we offer our customers the lowest fares, the best on-time performance, the fewest numbers of lost bags or cancellations, but we also offer our customers miles in the Smiles product. As a result, our forward bookings and load factors are rising. We have ordered 120 aircraft, which will enable us to grow to 43 million customers by 2019, up from the 39 million customers in 2015. We have been doing this for a long time over 15 years.

GOL offers the number one customer experience in Brazil, and during the quarter, we continued to lead. Aiming to ensure a better flight experience for our customers, in August 2016, we launched the GOL Premium Lounge at the Guarulhos International Airport in São Paulo. The new VIP lounge has modern and distinctive spaces especially designed to provide clients with increased ease and convenience. We will be inaugurating two more lounges at the Galeão Airport in Rio de Janeiro in the first quarter next year. In fact, GOL will be the only airline to offer VIP lounges in the domestic market.

On October 4, we undertook the first commercial flight in South America with Internet on board on the Congonhas-Brasilia-Congonhas route. The company's entire fleet will be equipped with this service by October 2018. We also rolled out our new website at the end of October. The customer feedback on the recent additions to our customer experience has been very positive. Customers are enjoying the lounge and on-board Wi-Fi and are finding it easier to find our lower fares. The key elements to our customer experience remains our commitment to delivering the lowest fares and delivering the number one in on-time performance.

We expanded our codeshare agreement with Copa Airlines and Aeromexico and initiated a new partnership with Emirates. As a result, passengers served by these companies will only have to check-in themselves and their baggage once and will be able to take advantage of an extensive route network. Customers will also benefit from being able to accumulate miles and redeem tickets through loyalty programs.

We increased our activities with Smiles in order to provide more benefits and amenities to customers, exemplified by the expansion of miles accumulation to promotional fares. In addition, customers entitled to a category upgrade during the year and who accumulate more qualifying miles than necessary will be entitled to carry the surplus forward to the following year, helping them maintain their category or possibly entitle them to a new upgrade.

So, with that quick review, I ask Richard to take us through the results presentation, and then we will take you through the question-and-answer for the quarter. Richard?

Richard Freeman Lark {BIO 3484643 <GO>}

Kaki, thank you. On slide 5, you can see we have the lowest cost of any airline in Brazil, with an average cost ex-fuel of BRL 0.13. The key point to take away is that the gap between us and the other airlines, which we compete against is widening. So our competitive advantage is increasing.

Slide 6, our coverage continue to be quite wide, 63 bases with 52 airports served in Brazil, and nine countries with 800 flights every single day.

Slide 7, we enjoy strong market positions across Brazil. We're the number one or number two carrier in the key markets that represent approximately 80% of the Brazilian economy.

Now you can see that GOL has the highest level of non-passenger revenues, as you can see on slide 8. GOL Smiles subsidiary closed the third quarter of 2016 with net revenues of BRL 398.3 million, an increase of 14% over the third quarter 2015. Operating income was BRL 163 million, representing an operating margin of 40.8%, which was 5.7 percentage points higher than the same period in 2015. Net income in the third quarter of 2016 was BRL 145 million, representing a net margin of 36%.

The quarter's results at Smiles reflect 11 billion of redeemed miles, a 2.2% increase over the third quarter of 2015; 12.2 billion miles accrued excluding GOL, a 5.7% increase over the third quarter of 2015; BRL 305 million of billings excluding GOL, a 3.6% decrease over the third quarter of 2015; and 1.5 percentage point increase in the burn to earn ratio to 79.6%.

In third quarter 2016, GOL's cargo revenues were BRL 77 million and were BRL 332 million in the last 12-month period despite the reduction in ASKs. Other revenues were BRL 225 million. 100% of our fleet is configured with GOL+Comfort seats, which are producing additional revenues. And in the third quarter 2016, GOL sold 13,800 products on board perte (15:28).

Flip to slide number 9, as you can see, we had a good quarter. We saw third quarter profits increase to BRL 66 million, representing a net margin of 2.7%. Our third quarter EPS was BRL 0.19. We were happy with the third quarter earnings results. They were in line with consensus and in line with our expectations and the guidance we provided last quarter. I would like to commend also all of our hardworking employees on a very solid quarter, especially with the very challenging environment.

Net revenue in the quarter decreased BRL 88.2 million to BRL 2.4 billion, primarily due to a 20% decrease in seat availability. Total net revenue increased BRL 77.2 million in the nine-month period of 2016 compared to the same period of 2015. Year-to-date revenues reached BRL 7.2 billion, representing an improvement of 1.1% compared to the first nine months of 2015.

In 3Q 2016, EBITDAR, profit, was BRL 600 million in the quarter, representing a 25% EBITDAR margin. EBITDA, profit, was BRL 334 million, representing a 13.9% EBITDA margin. Third quarter 2016 EBIT was BRL 232.6 million. Nine-month 2016 EBIT reached a profit of BRL 498.3 million, representing a margin of 6.9%, which was an 8.1-percentage-point improvement over the same period of the previous year.

On slide 10, you can see these results were driven by a 1.2-percentage-point increase in load factor to 79.8% and strong passenger numbers at 8 million, while our average fare increased by 15.8% to BRL 258 per passenger.

In the third quarter of 2016, GOL's airline operations reduced capacity by 6.7% to 11.5 billion ASKs and increased passenger revenue per seat kilometer, or PRASK, by 3%, permitting a total RASK improvement of 3.3% in the quarter. The 20-percentage-point reduction in available seats above the 6.7% ASK reduction is primarily due to the increase in stage length, which is part of the new route network fully implemented in May 2016. GOL's constant focus on improving revenue management helped drive a yield increase of 1.5% over the third quarter of 2015.

In the nine months period ending September 30, 2016, yield was up 9.5% and PRASK increased 9%. At BRL 0.188, total operating cost per seat kilometer, or CASK, reduced 6.4% over the same quarter of 2015. The CASK, excluding fuel, decreased 3.0% in the quarter-over-quarter comparison. Combined with the RASK increase, this permitted an increase in the gains from the operating profit from operation to BRL 0.0203, representing a significant improvement when compared to the same period in 2015.

In the quarter, consolidated CASK was BRL 0.13, ex-fuel, a decrease of 3% in the quarter-over-quarter comparison. This decrease in cost per seat kilometer was driven primarily by the following factors: A) a BRL 0.002 or 8% increase in aircraft leased expenses per ASK, driven by the increase in the number of aircraft under operating lease contracts from 98 in the third quarter of 2015 to 101 in the third quarter of 2016, partially offset by the 8.3% Brazilian real appreciation; B), a BRL 0.001 or 8.7% decrease in maintenance expenses due to the Brazilian real depreciation and reversal of provisions related to aircraft returns; C), a BRL 0.001 or 4.1% increase in salaries expenses due to an 11% increase in wages from the collective bargaining agreement, partially offset by a 9.4% reduction in head count, result of natural turnover that was not replaced.

Fuel in the quarter was BRL 1.96 per liter, representing an 8% decline when compared to the third quarter of 2015. It was the lowest level since the first quarter of 2011. It is worth noting that GOL decreased by 11.4% the number of liters consumed per RPK compared to the LTM period ending the third quarter of 2016 versus the LTM period three years ago, as a result of constant initiatives to improve our fuel operating efficiency.

On slide 11, our balance sheet improved and we had a net total liquidity position including accounts receivable and Smiles cash of BRL 1.8 billion. Our total debt reduced by BRL 3 billion during the year. Our net leverage including off-balance sheet aircraft leases is near 7 times.

Moving to the next page, our forward bookings and load factors continue to rise although we caution that this will have an impact on average fares and (21:06) yields. In order to capturing opportunities during the high season, we are adding 49 new routes in the fourth quarter of 2016 and first quarter 2017. I'd like to point out that we operate in nine countries around South America, and we see growth in a lot of these destinations and countries this summer including Argentina and Chile. Our oil exposure for the next three months is 27% hedged at $49.25 per barrel WTI.

On slide 13, last year, our load factor increased by 0.3 percentage points to 77.2%. In the current year, we see that figure increasing to 78%. Despite strong comparative numbers, you can see that we had strong load factors throughout three months. On a comparative basis, we are between 2 percentage points and 4 percentage points better booked now than we were in the same time last year for the remainder of the year.

Slide 14; since 2011, GOL has worked to lead the industry in rational and profitable capacity growth. In the adjustment of industry capacity to match demand, not all competitors have cut capacity and reduced frequencies on destinations and routes in Brazil. Some competitors have continued to cut capacity and reduce frequencies. Other competitors have continued to add capacity in spite of their higher operating costs. And this has had a big impact on sector profitability.

Slide 15; the outlook for the remaining of fiscal year 2016 is that we will see our load factors increasing by 1-percentage-point to 78%, and traffic is expected to reach 33 million passengers in the year. Ex-fuel costs will be down, and average fares will be slightly up in the fourth quarter. We have very limited visibility into the first quarter of 2017.

So, as a result of all this, we are happy to increase our guidance to the upper end of the range. Our previous range was 4% to 6%. We will now be at the upper end of that range. This, of course, is highly predicated on closing bookings for the remainder of the fourth quarter.

Moving to slide 16, for the full-year 2016, we expect to achieve a capacity reduction of 8% in ASKs and 17% in both total seats and volume of departures. As mentioned, we expect to achieve the top end of our operating margin range at approximately 6% for the full year.

To finalize, I will turn the fleet on slide 17 and quickly walk through that. We ended the quarter with 135 aircraft and we'll finish this year with 94 800s and 28 700s in our fleet. Next year, we will reduce by two 800s and reduce by three 700s for a total reduction in fleet next year of five aircraft. In 2018, we will resume fleet growth and begin our fleet replacement with the delivery of our first MAX aircraft.

Okay. I guess, we'll now move to the Q&A. Thank you very much.

Q&A

Operator

Thank you. The floor is now open for questions. Our first question comes from Michael Linenberg of Deutsche Bank. Please go ahead.

Q - Michael J. Linenberg {BIO 1504009 <GO>}

Yeah. Hey, Kakinoff. Hey, Richard. Just a question on the press release where, in the domestic market, it talks about how capacity was – domestic supply decreased 4.3% in the September quarter and it's down 5.7% from January to September of 2016. And it goes on to saying that same sentence with the aim of reducing the supply by 8% for the year.

Now this is in the domestic section. So that would imply that your fourth quarter domestic supply is going to be down 12% to 15%. Is that right, or is that 8% for the system rather than domestic? I'm just trying to get that right number there.

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

Hi, Michael. Good morning. This is the system as a whole. So, the country (26:02), there is a clear crisis in the Brazil market. Purposely, we believe that the demand came to a sort of stability from July on this year in comparison to last year, but it's still too early to assume that we're going to have a demand increase over the following weeks. So, the data you got is related to the system, and the message behind is there is no further deterioration to the positive side, but on the other hand, we do not know exactly when we're going to find improved demand.

Q - Michael J. Linenberg {BIO 1504009 <GO>}

Okay. Great. And then just for 2017, I think the view is that the Brazilian market is going to grow 3% to 4%. What – go ahead.

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

Following on my speech, this is not any kind of guidance. I'd just like to highlight on statistics. So, I mean, there is a factor of 3 times around the three terms when you compare the Brazilian GDP and the demand for the airline industry in Brazil. So, the official forecast to the next year is 1.5% positive GDP that was delivered by the government.

So, following the historical figures, we could calculate a plus 4% to 5% additional demand, but this pretty much depends on how disciplined will the capacity be. I mean, this potential growth could be translated into better use or additional demand. We do not know how the market is going to react. Okay?

Q - Michael J. Linenberg {BIO 1504009 <GO>}

And you don't have an early view on what you think your capacity plan will be for next year as of now, right? I think you said that you were still going through all the numbers.

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

Richard is going to add on some...

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yeah. As you've seen, we're reducing five aircraft in the fleet next year. So, obviously, there is a reduction there. But part of that will also depend on how we configure the network and the productivity in the aircraft. We're operating at this 11.4 block hours a day of utilization. In the context of our planning next year, we want to increase that, but that, I think, we'll give a better view on that when we present more than details for next year in the call we do in February. So, you'll have to stay tuned.

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

Michael, final message. Disciplined capacity is the name of the game at least here, okay? So, please keep it in mind.

Q - Michael J. Linenberg {BIO 1504009 <GO>}

Absolutely. Okay. Great. Thank you, gentlemen.

Operator

The next question comes from Duane Pfennigwerth of Evercore. Please go ahead.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Hey. Thanks for the time. Just with respect to your BRL 0.13 or BRL 0.132 CASK in the third quarter, if we assume a stable currency, which obviously is a big assumption, is that a level you feel like you can keep going forward? And specifically with respect to the fourth quarter, typically, you see this big increase sequentially from 3Q to 4Q. What are the reasons that we would see that BRL 0.132 kind of trend higher, because it feels like a level you could sustain?

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yeah. Duane, obviously, the key point is the exchange rate which we're planning on stability, and the combination of the other initiatives that we kind of described indicate that assuming exchange rate stability, which is related to the macro situation, we should be able to maintain it in that range.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

So, the year-over-year decline in the fourth quarter could be double digits.

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yeah. On the ex-fuel, most of the effects, we have some inefficiency in that number as it relates to the aircraft that we still have in return. At the end of the quarter, at the end of Q3, in the fleet reduction, we had 11 aircraft that are in the return channel. In other words, they're out of Brazil. They're out of our network. But we're still paying the monthly rental costs on that. So, there's a little bit of inefficiency on the cost side.

We think that the objective is to have all those returned by the end of December. Our current planning is probably we have two that will probably still be in the desert that haven't been picked up by their new operators yet. So, there is a little bit of inefficiency there on that CASK with respect to the aircraft component and how that will impact that overall CASK number.

On the other side, all the kind of the one-time effects for the fleet restructuring have pretty much run through the system. The only inefficiency we have left in the aircraft that we're paying rent on that are not producing revenues for us. So, I think that's how you can approach it as one of the key drivers of that non-fuel CASK is the aircraft component, which has both components, the dilution in terms of the productivity and then the exchange rate component. So, I think that's consistent with what you're thinking of.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Okay. And just to clarify that, the 11 aircraft, were they parked in the cost structure in the third quarter, or is there some incremental inefficiency 3Q to 4Q?

A - Richard Freeman Lark {BIO 3484643 <GO>}

No. As I said, the rents on those aircraft is in our 3Q numbers. And we hope to have nine of those totally returned by the end of the year. So, some of that cost will be in the fourth quarter CASK, if you will.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Okay. And then just lastly, in the non-op below the line, it looked like you had a BRL 230 million gain related to a discount obtained on your senior notes. Is that likely to be a recurring gain, or was that just in the third quarter? Thanks for taking the questions.

A - Richard Freeman Lark {BIO 3484643 <GO>}

No, that was in the third quarter. As you know, we finished an exchange offer where, on a net basis, we obtained a reduction in debt, so that's a one-off in the Q3.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Thanks, Rich.

Operator

The next question comes from Savi Syth of Raymond James. Please go ahead.

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

Hey. Good morning. I'm just wondering if you were able to quantify maybe the benefit you got in 3Q 2016 from the Olympics then. And just along those lines, on the booking trends, the improvement that you're seeing on a kind of this time last year and how much is booked, is that a change in strategy going forward or is that a strategy that was put in place already and the incremental improvement that you're seeing now is really demand coming back?

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

Hi, Savi. It's Kakinoff here. Good morning. Actually, the Summer Games didn't help as much as the soccer games two years ago. So, it was pretty much concentrated in Rio de Janeiro. Surely to us, quite interesting in that (33:56) the shuttle service connecting São Paulo to Rio de Janeiro and vice versa, but to the remaining network, I would say, the Summer Games were somehow negative.

This is, at best, a sort of neutral effect, which could be considered good because it could be negative considering how much these games could impact the traffic, but, I would say, it's more clear to say that's a neutral effect.

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

Got it.

A - Richard Freeman Lark {BIO 3484643 <GO>}

In terms of your second question on the increase in load factor demand versus network, it's really a combination of both. Obviously, we adjust the network as a function of the seasonality, we go into our summer season here, which has a lot of traffic in December and January related to kind of vacation destinations. So, we have around about 50 new frequencies added in there to capture that demand, number one. And that relates to the network changes also that were put into effect in May when we redid the network to adjust for our new fleet size.

We don't see anything significant on the demand side overall. There's been a little bit of uptick in the corporate demand versus what we had seen previously. But the VFR traffic still is suffering from the effects of the economic situation in Brazil. So, in terms of the combination of demand versus network, it's really more based – the increase in load factor is based on more our route network combined with what we're doing for the summer season here in Brazil.

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

That's helpful, Rich. And maybe I can ask you, on the interest expense, I'm a little bit surprised by the level in 3Q when I compare it to what we saw in 2Q, and especially kind of the debt restructuring that happened. Was there something in 3Q, and that should come down, or is that a good level going forward?

A - Richard Freeman Lark {BIO 3484643 <GO>}

Surprised in what sense?

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

It seems high. So, in 2Q you're like BRL 100 million to BRL 180 million in interest expense, and in 3Q, it was closer to BRL 200 million. I would have expected that to be in line or lower.

A - Richard Freeman Lark {BIO 3484643 <GO>}

No, there's nothing out of the ordinary. We have, I think, part of it probably relates to you might be seeing some exchange rate – no, I guess, you wouldn't be seeing exchange rate effects there. I mean, a big chunk of our capital structure today is – we have about BRL 1 billion of debentures denominated in reais, which are fairly high cost. Maybe in your analysis there that is a larger part of the overall debt now, but there's nothing extraordinary there at all.

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

All right. Got it. Thank you.

Operator

The next question comes from Josh Milberg of Morgan Stanley. Please go ahead.

Q - Joshua Milberg

Thanks very much. Good morning, everyone, and thank you for the question. I just wanted to go back to the issue of the fourth quarter margin outlook. I think, as was noted on the Portuguese call, your updated guidance for the year does imply a pretty low level for the fourth quarter. And I got that that response in part to FX and fuel volatility, but was just hoping you could elaborate further on other variables that are behind your expectations there, since I think you mentioned earlier on the call that you're seeing pretty good fare trends coming into the fourth quarter.

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yeah. Hi, Josh. It's a combination of that. I mean, obviously, we have our own assumptions on exchange rate and oil prices, as all of you guys have. We all use our own independent assumptions on that. And we have our assumptions on the demand environment, December, how that can impact yields. And based on our assumptions on the exchange rate to oil price dynamic, that's how we come up with those numbers. Having said that, I guess to some extent, we'll see what happens after tomorrow. But it seems as if we may have softer on oil, and so that could potentially help positively.

We have a lag, so you have to be careful with the lag. If there is a reduction in oil, it can take up to 60 days for that to work itself into our costs. So, it won't necessarily give us a big bump on Q4. It might help us in Q1 a bit.

But on the demand side, we were being very cautious because we've taken a lot of capacity out of the system. And in the third quarter, you saw that impact a little bit on the yield very slightly. Obviously, there is the seasonality in there. So, we did see a positive effect of all those capacity that we and some of the others have taken out of the system.

But it's not 100% clear to us if that's going to continue as some of the competitors have additional capacity to come on, and they're going to have to try to fill those aircraft with passengers, which come out of a market that is 15% and 20% lower than it was this time two years ago.

So that, for us, is a big question mark. And we really need to be cautious with respect to that because the visibility we have on that is for increased capacity to becoming on in certain areas, but...

Q - Joshua Milberg

That's already in the fourth quarter, Rich. No, the additional competitor capacity, you think that that's something that could be a source of that?

A - Richard Freeman Lark {BIO 3484643 <GO>}

We can't predict what competitors are going to do with their pricing environment in December. Our forward bookings from a load factor perspective, we shared those with you. So you can kind of look at that. The yield component will be equilibrated by the competitive behavior of the other guys, everybody combined. So, we're at the beginning of November now, so it's a bit too early to really predict what kind of behavior you're going to be seeing on that. So, we'll have to see what happens.

I mean, to the extent that everybody is disciplined on capacity, we should see a solid yield environment, December, January, but it would be too early to tell on that. So that's why we're being cautious. We don't have a whole lot of visibility very far in the future what's going to happen on the yield environment.

Q - Joshua Milberg

Okay. Fair enough. And, Rich, I was also hoping you could comment on where you think you'll need to be margin-wise to be breakeven from a cash flow to equity standpoint next year, taking into account your minority interest. I think that was something that was also raised on the Portuguese call. And one element of that I was hoping to get some color on was just what assumptions you have for maintenance CapEx over the next couple of years?

A - Richard Freeman Lark {BIO 3484643 <GO>}

Well, the maintenance CapEx is minimal. We're not engaging in – GOL has made an enormous investment in its platform over the last couple years in technology and so on. When you say maintenance, you're talking about maintenance of the CapEx or spending on maintenance expenses on the aircraft?

Q - Joshua Milberg

No. I'm talking about the CapEx.

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yes. You could use something in the range of BRL 150 million per year in terms of what the maintenance CapEx is. In other words, for us to maintain our investments in hardware, software and peopleware, again, GOL has already made an enormous investment over the last couple years in technology and in terms of – pretty much across the board from the customer experience on apps, website and on-board activity and so on to our back-end, which is our ERP system, our controls and all the systems that we use to do the performance management. All that investment is behind us. And we're looking at roughly BRL 150 million a year to maintain that.

The other part of your question was, will you repeat that please?

Q - Joshua Milberg

Yeah. I was just to get a sense of what you think you need to do margin-wise to be breakeven from a cash flow to equity standpoint?

A - Richard Freeman Lark {BIO 3484643 <GO>}

Well, when you say cash flow to equity, you're saying what to – what does that mean, cash flow to equity?

Q - Joshua Milberg

I'm saying EBIT, EBITDA, less interest, less maintenance CapEx, less taxes, less minority interest. To be at a level where sort of you're generating your breakeven really from a cash flow standpoint.

A - Richard Freeman Lark {BIO 3484643 <GO>}

Well, from an operating perspective, we're already at that level. We have seasonality in the business. So, for example, in our business, we see generally between carnival and end of May, we have a drop-off in demand and margins reduce. But overall, this level that we're right at now is a breakeven level of cash flow. But obviously we have seasonality in the business.

When you look at the airline sector in general, you have the various levels. And it's not us specifically. It's really the structural thing for the airline business. And when we talk about cash to equity, it's only when you're plus above 15% operating margin that you can start to entertain paying dividends, in any way, you could actually be thinking about paying dividends. Not that we would do that. In the past, this company has only paid dividends when it got above kind of an 18% operating margin, up in that range. And so, I'd say when you talk about cash to equity, I mean, us paying dividends to shareholders is not something we foresee in the future here in the next couple years.

But going back on the other end, in terms of being able to meet operating expenses and interest expense of debt (44:42) service, basically, with the results of the restructuring plan, as you've seen, we have about 18 months of runway before we get into some of the large amortizations. And so, 18 months is a long way off. Where we're at right now, our operating cash flow, plus what you just highlighted in terms of the minimum maintenance

CapEx, it's sufficient for us to also cover the financial obligations on a kind of a run rate basis for the next 18 months.

And so, one of the objectives of the restructuring plan as we've articulated, was basically being thinking of (45:22) to guarantee that runway so that we could see the positive effects of the capacity management on the operating side of the equation. In other words, to be able to pay all the obligations through cash flow generation and not counting on external resources or external capital. And we've basically achieved that. As I said, we have a little bit of inefficiency with the return of aircraft that are still in the system. But when we get through that, this massive restructuring that's been done to put us at this level to better match the market with the book from a supply-demand perspective, I mean, that's pretty much done. So, what we just need going forward to maintain that, as I've said, it doesn't entirely depend on us. We just need a rational capacity management going forward and then we're okay. But because of our cost advantage which is derived from the Boeing 737 and because of the way we operate that on a highly integrated network, we also feel that we're very well protected to the extent there is any negative effects in the demand environment or any overcapacity effects next year that negatively affect the yield environment and would reduce our margin and our cash flow, we feel like we're pretty well protected against that from a defensive perspective.

But I think we already have good visibility on that kind of in April, May of next year once we get through – have a little bit of an uptick here in November, December, January because of the high season. We'll see that, and then we'll get the downtick post Carnival until, call it, April-May. And so, I think in May, we'll have good visibility on that.

But, for us, in terms of our plan, from a, as you said, from a cash to equity perspective, this range that we're operating right now is sufficient. But we're a whole another level away from thinking about returning capital to equity in the form of dividends or otherwise. We're pretty long away of that. You see it in this company. So, like, if you look back historically, in the historical GOL data, you've got the numbers to see at what point what the trigger was to be able to pay dividends, and it's kind of close to 18% margin where you've got enough to be able to pay dividends and return that to shareholders, but we're a long way away from that.

Q - Joshua Milberg

Okay. Thank you very much.

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

Thank you.

Operator

The next question comes from Ravi Jain of HSBC. Please go ahead.

Q - Ravi Jain {BIO 16135293 <GO>}

Hi. Good morning. I have a quick question on the international capacity. The international ASKs has been coming down over the last few quarters. Do you see some potential to increase that over the next 12 months, 18 months? I mean, where do you see this in the longer term in terms of international versus domestic capacity? Thank you.

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

Yeah. Hi. From our perspective, I mean, GOL alone no (48:40), we would not think that we're going to add any capacity. I mean, it could be marginally due to the seasonality. But we got the information that some of our competitors, they are supposed to add at least eight aircraft each over the following 12 months, which would bring us a plus 4% additional capacity in the market. This is based on the information available in the market.

Q - Ravi Jain {BIO 16135293 <GO>}

Thank you. That's helpful.

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

Thank you.

Operator

The next question comes from Stephen Trent of Citi. Please go ahead.

Q - Stephen Trent {BIO 5581382 <GO>}

Good morning, gentlemen, and thanks very much for taking my questions. Just two for me quickly. First, if you have any view on what we might or might not see in terms of Brazilian governmental policy initiatives. Jet fuel kerosene, do you think there's the resistance that seems to be coming from the state of São Paulo could intensify with respect to current FX levels, giving you guys more help than it did six months ago?

And the second question, just wanted to get your take on some stuff we've seen on the corporate governance front and whether you guys are confident and comfortable that you're satisfied with your internal controls. Thank you.

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yeah. We're 100% satisfied with our internal controls and vis-à-vis what's happened, the company has already brought a lot information on the policies and procedures with respect to that. So, in terms of your second question on the government help and so on, Kakinoff can complement, I mean, we don't expect any specific help from the government. I mean, we were operating on the basis that we're operating now. As you mentioned, there were some, I guess, press announcements on potential reductions in taxes on fuel. We don't expect anything there in the short-term, probably not even in the medium term, so don't count on that.

I think in terms of other issues...

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

We have engaged in those discussions with the government via our association, the ABEAR. I'd say the conversations are always promising ones, but we do need to find, I mean, the right environment to properly address such type of request.

Brazil is still under a turmoil. We cannot give you any kind of forecast when we could finally get some tailwinds coming from better or improved taxations regarding or towards the sector, toward the airlines. There are several discussions. I think they might be promising ones, but we cannot give you, at the moment, any kind of precise forecast on this.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. Very helpful.

Operator

The next question comes from Pablo Zaldivar of GBM. Please go ahead.

Q - Pablo Zaldivar {BIO 20206792 <GO>}

Hello. Good morning. Thank you for taking my question. My first question is regarding your new fleet plan. You're looking a reduction of around five aircraft for the next year. Now, could you tell us how many of those aircraft are owned by you and how many are financial leases? And should we expect you think that in terms of income from the return of aircraft like we saw in the quarter for the next year?

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

The first one to be reduced next year, they are all operating leases, and we are going to then achieve 117 aircraft.

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yeah. I mean, I guess, the financial leases are aircraft that we own. So, as you said, what we own and what's financial. The operating leases of aircraft are what we don't own. And so, for example, you take the fleet numbers we had at the end of Q3, 34 are finance leases which are aircraft that we own, and the other 101 are operating leases which are aircraft that we don't own.

Q - Pablo Zaldivar {BIO 20206792 <GO>}

But regarding the income during the quarter, it's (53:31) like BRL 13 million in the first line as a positive effect from the return of this lead aircraft. What should we expect in the next year by returning these five aircraft?

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

Sorry, could you please repeat it?

A - Richard Freeman Lark {BIO 3484643 <GO>}

We didn't understand the question. You were asking because we're returning five aircraft next year, which we provided that. What's your question related to the return of the five aircraft?

Q - Pablo Zaldivar {BIO 20206792 <GO>}

Yeah. During this quarter, we saw an income of around BRL 13 million due to that return of aircraft. So, I guess that during the next year, you should repeat a similar or some amount due to the early return of leased aircraft. So, could you give us some guidance on what to expect?

A - Richard Freeman Lark {BIO 3484643 <GO>}

I see. Yeah. I mean, obviously, how we finance our fleet expansion involves sale leasebacks. And depending on what we negotiate, we may or may not generate some gains from the sale leaseback, but it really depends because sale leaseback is a combination of a sale and then a leaseback. And so, I mean, generally, we look for the lowest possible lease rate versus trying to maximize the gains. So, the right assumption to use there would be zero gains, because we're looking to kind of guarantee the lowest possible lease rate for our future cash flows. But it really depends. It also depends on the timing of the market. I mean, you're right to assume that we should expect gains because the Boeing 737NG is a highly sought after aircraft on a global basis because of its very low operating costs. And we also have a very attractive price as we buy a large volume from the OEM Boeing.

And so, but I think the right assumption to use there would be zero. We can't really predict the results of negotiations with lessors. But it's a good question, I think. It's an interesting question, but I think you should use zero for your assumption there.

Q - Pablo Zaldivar {BIO 20206792 <GO>}

Okay. Thank you very much.

Operator

The next question is a follow-up from Savi Syth of Raymond James. Please go ahead.

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

Hey. Thanks for taking my follow-up here. I just had a question with – clearly, GOL has been focusing a little bit more on getting more written premium products over the last few years, and I think that's reflected in your increasing corporate share. But I was wondering if you could talk a little bit about how your fares versus the industry has been trending in that. Are you starting to see more and more of a premium and then if we should expect that to continue?

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

Hi, Savi. Actually, we have attracted more business travelers, and they are paying higher fares than the leisure ones, so that has happened. And we can monitor this improvement via the ABRACORP report, ABRACORP is the Brazilian Association of the Corporate Agencies or (56:58). We have included our market share there. And by doing so, we have attracted more business travelers. This is the best output we could get from the investments made over the last few years. And I think that we can improve those figures even more after getting our aircraft equipped with the Wi-Fi and other improvements that are already ongoing.

A - Richard Freeman Lark {BIO 3484643 <GO>}

I mean, you're right. And part of the increase in the GOL average fare is indeed from the benefits of a more premium service. I mean, GOL has the best pitch offered in the market, which is highly attractive to corporate travelers. The GOL+Comfort class service provides additional space between passengers. It's the first company with on-board Wi-Fi. The on-board service in terms of the buy-on board product goes into the premium component.

And so, some of the effect on the average fare increase is deriving out of the product, the additions to the product that have also happened over the last three years on a gradual basis, where, today, GOL, as Kaki was saying, GOL has the number one market share in transportation of corporate passengers. And that's a function of the on-board service and product and all the other facilities, the check-in, the apps and all that sort of investment that's been made in technology. So, part of the average fare increase is coming out of premium, a fare premium versus what had existed previously.

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

Got it. And helpful to know that it should maybe continue. And then just as a follow-up to a question before. Rich, are you assuming maybe a very greater moderation in kind of the RASK improvement? Because I'm having a hard time getting to your kind of full-year margin guidance if it wasn't for just even kind of more slowing in the year-over-year RASK growth.

A - Richard Freeman Lark {BIO 3484643 <GO>}

We're being cautious with the yield component as in December, it's more leisure travel, plus corporate travel. We've also added frequencies to capture the volume, but it's a lower yielding travel. And we just talked about the more premium fares that really applies to the corporate traveler. The leisure traveler is – majority of our seats are still put in at very low fares to also have an interesting product for the leisure travel and the bookings and so on that are happening now, and the December holiday season, have that impact on yields, number one, on our side.

Number two, what I mentioned is, we don't have a good visibility on the competitive environment, how it's going to relate to pricing as we see in the last couple weeks here leading up to December. So, that's really – the caution that we're using and the information we're providing to you is really based on those factors.

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

Well, that's fair. All right. Thank you.

A - Richard Freeman Lark {BIO 3484643 <GO>}

A>: Okay.

Operator

The next question comes from Victor Mizusaki of Bradesco BBI. Please go ahead.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Hi. Good morning. Just two questions. The first one, when we take a look on your fleet plan, the number of aircraft will likely drop to 117 from 122 this year. So, can you give us any color on what do you expect in terms of ASK reduction for next year? And my second question thinking about consolidation, do you think that there's room for further consolidation in Brazil given what we are seeing in Latin America.

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

Hi, Victor. We are not delivering any guidance on 2017 yet. Okay? But you probably got from our speech that we have no intention to increase capacity. It could happen – either increase our reduction marginally depending on seasonality.

Richard will give you (1:01:38).

A - Richard Freeman Lark {BIO 3484643 <GO>}

Yeah. I would just say, we were reducing our fleets by five aircraft last year. So, but on the other side, we're working to increase our asset utilization, our aircraft utilization, our block hours of production per day on the aircraft. And so, the ultimate amount of capacity reduction next year will depend on how efficient we're able to be, how productive we're able to be with those aircraft.

But for your purposes, if you assume we're staying at the 11.4 block hours, you can more or less use that five aircraft reduction to see how the year-over-year capacity growth could be lower. I'm not saying it will be lower, because, obviously, we're working to squeeze more out of our assets, our aircraft assets by increasing the aircraft utilization. And that relates to how we can figure the network, which is a very complicated activity. But we'll give you more visibility on that when we speak in February.

On your other question, it really doesn't depend on us. The second part of your question, the competitive environment that's happening, there's the capacity dynamic and I think it's hard for us to say whether or not that that would happen or not. And if it happens, I think, it depends on a variety of issues that aren't just within Brazil also, it also depend on what's happening in the South American environment, and to some extent, how that links into North America. And it's a complex equation.

So, I think, for our purposes, our planning for next year is that would not happen. And so, we're assuming that we have to work within the current competitive environment that we have today, but that's how I would approach that. As you're thinking about our performance for next year, I think that's the right way to think about it.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Okay. Thank you.

Operator

Excuse me. This concludes today's 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>}

Okay. Ladies and gentlemen, I hope you found that our Q&A session helpful. Our Investor Relations team is available to speak with you as needed, so please do not hesitate to call us. Thank you very much. Have you all a nice day.

Operator

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