Q3 2016 Earnings Call

Company Participants

- Paula Kovarsky, Investor Relations Officer

Other Participants

- Isabella Simonato, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Cosan S/A Third Quarter of 2016 Results Conference Call. Today with us we have Mr. Mario Silva, CEO; Ms. Paula Kovarsky, IRO; Mr. Joao Arthur Souza, CFO; and Mr. Phillipe Casale, Investor Relations Manager of Cosan S/A.

We would like to inform you that this event is recorded and all participants will be in a listen-only mode during the company's presentation. After Cosan's remarks, there will be a question-and-answer session for industry analysts. At that time, further instructions will be given. (Operator Instructions) The audio and slideshow of this presentation are available through live webcast at ir.cosan.com.br. The slides can also be downloaded from the webcast platform.

Before proceeding, let me mention that forward-looking statements will be made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Cosan'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 Cosan and could cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Ms. Paula. Ms. Paula, you may begin the call.

Paula Kovarsky {BIO 15363001 <GO>}

Good morning everyone and welcome to Cosan S/A's third quarter '16 results conference call. As usual, we will present each business line of Cosan S/A first, and then the consolidated results. But first, let's have a look at slide three, which shows our business portfolio, the ones [ph] we had an important change this quarter.

As announced last Friday, November 4th, we concluded the sale of a stake in Radar to Mansilla Participacoes Ltda, a vehicle of TIA, upon the payment of 1,041 million to Cosan, net of dividends distributed by Radar. This is an important step towards increasing further our focus on the core business, Raizen Combustiveis, Raizen Energia, Comgas and Lubricants, targeting the optimization of our portfolio, and in pursue of higher returns to our shareholders. Cosan kept 3% stake in Radar given its expertise in farmland management in Brazil.

Radar net income was, for the quarter, under discontinued operations this quarter, and as of fourth quarter '16, Radar results, in proportion to their remaining stake, will be reported as equity pickup. The net result of the sale will also be recognized next quarter.

Let's go now to slide four with the results of Raizen Combustiveis. Following the trend observed in the recent quarters, we confirmed the effectiveness of our growth strategy grounded on the expansion of our distribution network through conversion of independents, especially white flag stations.

Otto cycle volumes were stable compared to third quarter of last year, versus a 1.4% drop in market volumes, the source is the ANP. The same comparison in terms of gasoline equivalent, i.e., adjusting for the energy efficiency, which we believe to be the more accurate way to understand the market dynamics, points to an increase of 3% for Raizen. The outperformance of the market reflects the net addition of 344 stations to our network over the past 12 months, and our continuous focus in strengthening our long-term relationship with our retailers.

About Diesel sales, our volumes behaved in line with the market considering ANP data again with a decrease of approximately 4%. When compared to SINDICOM data, which is the Association of the Large Fuel Distributors, we outperformed our peers because SINDICOM's volumes dropped 9%.

Adjusted EBITDA reached BRL736 million in the third quarter of '16, 29% higher over the same period of last year. The main drivers here were, better sales mix with more gasoline and gains related to the optimization of the supply and commercialization strategies including our imports.

Note that, this year we had a different dynamic for ethanol prices. Last year ethanol prices started to go up more strongly in the fourth quarter, but this year, the usual price hike that happens as we move towards the inter-crop period actually ended up happening earlier, explaining the gains related to the inventory management this quarter.

Moreover, we had a concentration of import cargo arriving this quarter, both yearly and sequentially. We'll remain focused on the optimization of our capital investments, including the management of working capital. We therefore reiterate our view that the EBIT evolution is a more accurate way of measuring our business performance. And once again, EBIT growth will overcome EBITDA growth.

About the investments, Raizen Combustiveis invested BRL192 million this quarter aligned with the budget, and we keep on looking for good opportunities of conversion in the market in order to keep expanding our network of service stations.

Let's talk about Raizen Energia on slide five. Just to remind you that this is the second quarter of the '16-'17 crop year. The crushing this quarter reached 25.7 million tons, growing 6% compared to last year, as the weather was drier. In fact, the drier weather benefits the crushing, but it reduces the sugarcane field density by affecting growth. The TCH therefore was 13% lower compared to third quarter of 2015, reaching 78.4 tons of sugarcane per hectare. The average TRS was 135.5 kilos per ton in the third quarter of '16, against the 136.4 kilos per ton in the same quarter of last year.

Combining both indicators, which is the way we like to measure productivity, the TRS per hectare was 14% lower this quarter, reaching 10.6 TRS per hectare versus 12.3 TRS per hectare last year. The production mix remains focused on maximizing sugar production with a 59% sugar this quarter, in line with the commercial strategy for the year. Crushing year-to-date is 11% higher compared to the same period of last crop, reaching 48.1 million tons.

About each product sales. The sugar sales volume dropped 14% offsetting last quarter's acceleration. The prices remain higher in BRL terms. And most of the successful earliest part of the crushing season in March led Raizen to start the first quarter close to full capacity, full crushing capacity in some of the mills, opening room for much higher sales of own products, which were a bit compensated this quarter.

Ethanol sales volumes were 12% higher with better prices. The anticipated price hike at least compared to the previous crop reflect sugar price peak, which led producers to shift their production to sugar as much as possible at the expense of ethanol, squeezing the supply and demand equation.

In Cogeneration, we had higher availability of biomass, offsetting lower average prices before reduction in spot energy prices.

Unit cash cost in sugar equivalent excluding the effect from the higher cost of third-party sugarcane, CONSECANA, grew only 3% compared to third quarter of '15, below inflation in the period and reflecting efficiency gains in production. The EBITDA adjusted for biological assets and hedge accounting dropped at 6% in compared to the second quarter from last crop, mainly due to smaller sugar sales volumes reaching BRL71 million.

Better sugar prices as we stated in previous quarters, part of the gains related to the exchange rates when setting sugar price this year, we'll end up falling below the EBITDA line. The average exchange rate of currency hedges was up 378 reais to the dollar, while the average exchange rate of shipments was 324 this quarter. The negative effect on revenues was about 140 million, and if we were to add back the 140 million for comparison purposes, the EBITDA would have grown 11%.

The EBIT per TRS decreased 3% [ph] compared to last year, reflecting the dynamics of the EBIT with lower sugar sales, as already explained. But when we compare the first six months of this crop year, the EBIT per TRS reached BRL110 versus BRL105 in the previous crop, implying a 5% increase.

Our hedging strategy. At the end of the quarter, we had 3 million tons of the '16-'17 crop year hedged at an average price of BRL0.59 per pound, this volume is equivalent to almost all sugar to be exported throughout the season, over 90%. For the next crop, the '17-'18, we have 1.4 million tons of sugar hedged at an average price of BRL0.70 per pound, and this is approximately 40%, 45%.

As you may see, the actual rate of our hedging this quarter benefiting from a favorable combination of commodity prices and exchange rates. We invested BRL354 million, 54% more compared to last year, reflecting higher expenditures with planting and other projects, and the CapEx added up to 1.5 billion year-to-date in line with the last season, so there is a bit of seasonality between first and second quarters of the crop year.

Coming now to Comgas on slide six, just as a reminder, Comgas reported on October 28th, so I'll go -- I will go through the highlights only. This was another quarter of growth in residential volume 19%, as a result of the connection of 114,000 new houses over the last 12 months, the end of the hydro crisis and slightly lower temperatures compared to the same period of last year. The commercial segment grew 6% in the period, this was the connection of about 1,000 clients [ph]. Industrial volumes, however, kept on suffering with the weaker industrial activity dropping 4%. The worst performing segments were construction, chemical, petrochemical, ceramic and steel.

We note however that the shock [ph] was less this year than what has been observed in the past few quarters, so we had 11% year-on-year drop in the first quarter of '16 and 8% in the second quarter. Excluding thermal power generation, sales volumes contracted about 2%.

Normalized EBITDA grew 18% compared to the third quarter of '15, reflecting richer sales mix, residential and commercial, and the tariff adjustment of last May. As a reminder, although both cash cost and tariff to the consumers will reduce, we expect may the regulator grants will be annual pass-through of inflation to margins as provided for by the concession contract.

IFRS EBITDA grew 28% this quarter, due to the sharper reduction in the cost of gas and the consequent backlog in the regulatory current accounts regarding -- in favor of the consumers, contributing to higher cash generation.

Comgas invested 103 million this quarter, mainly in the expansion of the gas distribution network and addition of new customers. In the slower pace compared to last year, but consistent with the past few quarters, and reflecting the review of the company's strategic performance in the few segments.

We can go to slide seven. Note that the slide used to show results from Radar, but as previously mentioned, from this quarter onwards the result of this operation will not be part of the consolidated EBITDA. It will be reported as discontinued operation.

Starting with Lubricants, which includes our operations in Brazil, as well as Paraguay, Uruguay, Bolivia, besides England and now Spain. Regarding Brazil, the market keeps on shrinking, about 6% this quarter compared to the same period last year. Cosan Lubricants had a similar performance. Let's not forget that our focus here is on industrial and automotive segments, which remain heavily affected by the weaker economic activity.

International operations instead grew in volume about 27% in margin -- on average, but still total EBITDA at 14% in comparison to the third quarter of '15 with the decrease in Brazil sales volume and higher selling expenses.

On the corporate, general and administrative expenses amounted to 39 million in the quarter, in line with the third quarter of '15 where (inaudible) other expenses rose to 25 million on legal expenses related to contingents [ph] among other things.

Moving to slide eight where we present the consolidated results of Cosan S/A on a pro forma basis, i.e., considering 50% of Raizen results. Adjusted EBITDA grew 11% year-on-year, and which is 1.2 billion in the third quarter of '16, mainly driven by Raizen Combustiveis' and Comgas's better results.

Net income reached 328 million, reverting 17 million loss on last year's third quarter. And this is a reflection of better business performance, especially Raizen, and the recovery of Comgas's current account. The adjusted number was 189 million versus the 35 million adjusted loss last year.

The pro forma CapEx was similar to the same period of 2015, reaching BRL393 million, in line with the strategy of streamlining investments and focusing on results. The pro forma free cash flow to the equity reached BRL908 million compared to a cash burn of BRL135 million in the third quarter of 2015, and I'll dig into that number in the next slide.

So let's move to slide nine. As stated last quarter, and as part of the capital structure of management process targeting the lengthening of the debt profile, Cosan S/A issued $500 million bond maturing in 2027, and repurchased about 80% of the 2018 and '23 outstanding bonds. As the bondholders' adherence to the tenders ended up being higher than expected, we decided to do a re-tap of an additional $150 million, and that explains the slight increase in the gross debt this quarter.

The average cost of debt on a pro forma basis, Raizen -- including Raizen was 98% of the CDI, and a 101% if we exclude Raizen. And the average maturity of the pro forma debt is four years, eight years if we look at the holding level.

We're now ready to talk about the free cash flow to the equity, and the main drivers for the increase over the same period of last year were improvements in operational results with a higher EBITDA and working capital management in Raizen, and Comgas' higher EBITDA considering the regulatory current accounts.

We had a small flow of investments with the reduction of CapEx in Comgas, and the income in cash from the sale of STP, more than offsetting Raizen Energia's higher CapEx. And we have financial cash increase of $150 million from the issuance of Cosan's 2027 bond re-tap, minus BRL230 million from the Perpetual derivatives [ph].

A quick heads up regarding debt hedge here, the total amount of the gross debt remains hedged except from the principal of the perpetual bonds of $500 million. The perpetual principal was hedged back in 2013 when tendering was a possibility, now that the debt profile is equated to recent issuances and the repurchase of '18 and '23 bonds, we decided to keep the hedge only for interest payments for a certain period and for now the period of three years.

Last but definitely not least, we have again a leverage reduction this quarter. The net debt to EBITDA fell from 2.1 times at the close of the second quarter of '16 to 1.9 times now, due to the increase of the last 12 months' EBITDA and higher cash generation, and this is a very important achievement for us.

That being said, I'd like to call your attention to the 2.2 times net debt to EBITDA figure. The main difference to the 1.9 is the impact of the regulatory current account on Comgas, and the reason why we are excluding it from the calculation is that, because essentially a cash anticipation that would be reverted to customers in the coming quarters, and the regulator already announced an adjustment in the beginning of October. As you can see, our expectation net debt to EBITDA would go up, due to the Raizen Energia's working capital cycle ended up not happening again. We expect leverage to remain around current levels, looking at the number adjusted for the Comgas' current account for the 2.2. And the long-term view hasn't changed as we think that two times [ph] is a comfortable level of leverage for the company on a recurring basis, very adequate to our portfolio of assets.

Let's shift to the last slide, slide 10, where we restate our guidance with a few relevant updates. Raizen Combustiveis, we expect next quarter's adjusted EBITDA to be similar of the fourth quarter of 2015. Just to, I mean, clarify the end of dynamics here. This year we had a shift of ethanol price curve or an anticipation of the hike that usually happens closer to the inter-crop period.

Last year, the stronger -- the strongest pricing increase happened in the fourth quarter was a result (inaudible) gains. We therefore narrowed guidance -- Combustiveis' guidance to BRL2.65 billion to BRL2.7. And this is the adjusted number. If we add the non-recurring events of the last three quarters, the number is definitely higher.

The CapEx range was also narrowed to the high end of the original guidance, as we keep on capturing the good conversion opportunities offered by the market. About Raizen Energia, we narrowed the guidance range for crushing. The drier weather this year caused the TCH to drop faster than expected, affecting the sugarcane availability. And this is why we reduced our crushing range for the '16, '17 crop year to 59 million to 61 million tonnes.

Our goal is to crush all of the available sugarcane until mid-November, early December, maximizing our production as well as the mix of mills. I'd like to remind you that this crushing does not include the nearly 3 billion pounds crushed in March that was computed in the last quarter of the past crop year.

Regarding EBITDA, we are lowering the guidance range to 3 billion to 3.3 billion due to the exchange rate dynamics we explained earlier. The original guidance for the '16, '17 crop year assumes an exchange rate of about BRL4 to the dollar hedged through financial instruments. In other words, this continues to be the reference for Raizen Energia's cash generation.

The EBITDA however reflect the exchange rate at the time of the sugar shipments. In the first two quarters of 2016, the positive effect of the exchange rate that impacted Raizen Energia's financial result was almost 300 million. I'm repeating myself here but just to be very clear, the guidance reduction has no impact whatsoever on the company's expected cash generation. For Comgas, we reviewed the IFRS guidance to 1.922 billion, reflect increase in the regulatory current accounts, and there has been no change to the normalized EBITDA or CapEx. For the normalized EBITDA, we are looking at the high end of the guidance, and for CapEx to the low end. There are no changes to the Lubricants guidance, plus please note that, we excluded Radar guidance from the table, as well as from the pro forma consolidated EBITDA.

Well, that's all I have today. Thank you all and let's move to the Q&A session.

Questions And Answers

Operator

Thank you. We will now begin the question-and-answer session for investors and analysts. (Operator Instructions) The first question comes from Isabella Simonato, Merrill Lynch.

Q - Isabella Simonato {BIO 16693071 <GO>}

Good morning, everyone. Good morning, Paula. I have two questions on Fuel Distribution efforts. If you could comment on how you view the new pricing policy from Petrobras and how does that change or increases the visibility that you have on both Fuel Distribution, sugar and ethanol business?

And second, on Fuel Distribution, how do you see the competitive dynamics going forward? And if it's reasonable to assume that the continuous market share gain that you've been having should continue throughout 2017 as well? Thank you.

A - Paula Kovarsky {BIO 15363001 <GO>}

Okay. About the pricing policy, I mean, to the first and most important thing that I'd like to say here is, the higher the transparency the better, this is something that the market has been longing for forever. We have a clear policy for prices. And if Petrobras continue to increase and decrease prices following what happened to oil and FX, I think this is definitely good news for the market.

And then, in terms of the impact for Raizen Energia, what happened is that, so far what we saw -- I mean to start with, we are not responsible for prices at the pump and this needs to be very clear. The second thing is, ethanol prices went up, so the change in gasoline prices at the pump was not so visible. And third, because some of states are actually increasing taxes, and this is why the reflect in the pump again is not so clear.

Again, I mean, one could speak about the very short term and say the gasoline prices went down, and this is arguably negative to ethanol, but I mean, once again, I think the space, the sugar and ethanol business has suffered so much from lack of transparency and gasoline prices for the last 10 years that we need to look at this as a positive thing, and that will increase in our predictability as well as volatility surprises, and this is not necessarily negative. Okay?

Regarding the competitive dynamics, as you said, again when we look -- when Petrobras reduces 10% diesel prices like they did last week, you can argue that the room for import is a little lower, and this is true. But again, the idea here is that, the prices moved very in line with the oil prices and in line with the fact, we think important [ph] -- is structural part of the country's supply for the next few years.

And we will continue to optimize our supply strategy, looking at the opportunities, I think the only message now is that we'll have to look at it even more carefully, because there's going to be volatility and this can be good, especially for a player like ourselves who invested in infrastructure over the last few years and we prepared towards better equipment to play in this new environment.

And on your last question, I would like to phrase it, if I may. There is no market share gain target for Raizen Combustiveis. What we are doing and I've been insisting this in the last calls, I mean, Raizen Combustiveis' growth strategy was established back in 2015 when we had the combination of Shell and Cosan asset completed in the two acquisition. The idea is that, we'll continue to target the good opportunities to convert independent, especially white flags, and as long as those opportunities are available, we'll continue to do.

We do believe the good opportunities are there. We expect to continue converting 300, 350 stations on a net basis over the next two, three years. And market share will only be a consequence depending on the strategy of our competitors. Okay?

Q - Isabella Simonato {BIO 16693071 <GO>}

Perfect, thanks Paula. Thank you very much.

Operator

(Operator Instructions) Thank you. This concludes the question-and-answer session for investors and analysts.

A - Paula Kovarsky {BIO 15363001 <GO>}

Well, thank you all for joining the call, and see you in the fourth quarter of 2016.

Operator

The Cosan audio conference is closed. Thank you and good afternoon.