

Q2 2018 Earnings Call

Company Participants

- Julio Fontana Neto, Unknown
- Ricardo Lewin, Unknown

Other Participants

- Augusto Akihito Ensiki, Latin America Analyst
- Bruno Amorim, Equity Analyst
- Joshua Milberg, Equity Analyst
- Pedro Bruno, Research Analyst
- Rog rio Ara jo, Director and Equity Research Analyst
- Unidentified Participant, Analyst
- Victor Mizusaki, Research Analyst

Presentation

Operator

Good afternoon, ladies and gentlemen. At this time, we would like to welcome everyone to Rumo's Second Quarter of 2018 Results Conference Call. Today, the conference call will be conducted by Mr. Ricardo Lewin, Chief Financial and Investor Relations Officer.

We would like to inform you that this event is recorded. (Operator Instructions)

The audio and slideshow of this presentation are available through live webcast at ir.rumolog.com. 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 Rumo'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 Rumo and could cause results to differ materially from those expressed in such forward-looking statements.

Now I'll turn the conference over to Mr. Ricardo Lewin. You may begin the conference.

Ricardo Lewin {BIO 20342706 <GO>}

Good afternoon, everyone. And thank you for participating in Rumo S.A. Second Quarter 2018 Conference Call. Let's just start our presentation with Slide #3.

Before starting our presentation, I would like to comment on the truck drivers' strike and its effect on Rumo. This quarter, we posted 9% growth of transported volumes year-over-year. Despite this positive result, it was impacted by the truck drivers' strike in May, which prevented the normal arrival of trucks, especially at our terminal in Rondonópolis.

Our volume performance grew by 15% in April against the same period last year. And in June, that growth improved to 16%.

In May, our transported volumes declined 2% due to the truck drivers' strike. As already mentioned, volume in the Second Quarter '18 was up 9%, being a growth of 8% for agricultural products and 17% for industrial products.

This quarter, our fertilizer operations initiated its activities in our terminal in Rondonópolis, Mato Grosso, with volume growth in line with expected, showing that we are ready for the peak demand which typically occurs in the second half of the year.

In addition, we saw substantial growth of industrial product transportation, mainly driven by Fibria's new pulp operation and a higher volume of containers.

Port loading volume declined as an effect of lower sugar exports in the Second Quarter '18. Even so we increased 6 percentage points of market share in sugar transport to the Port of Santos.

Moving to the next slide, we can see Rumo's financial performance. Net revenues grew by nearly 11% in the Second Quarter '18, boosted by higher volumes and higher average yield as a result of better weeks of transported products.

A good operational performance and higher efficiency regarding cost and expenses enabled EBITDA to reach BRL 844 million in the quarter, up 15% year-over-year. Once more, we evidenced our capacity to increase volumes with cost efficiency. This quarter, fuel consumption decreased and fixed costs were diluted. As a result, Rumo's EBITDA margin reached 51% in the Second Quarter, up 2 percentage points versus Second Quarter '17.

Moving to the next slide, #5., we can see the performance breakdown of our business units. The North Operation posted another quarter of consistent results, advancing that our investment strategy and our activities in this quarter are succeeding. This is especially evidenced by the level of volume and the 60% EBITDA margin we are delivering.

These results came even in the scenario when our grain operations were affected by the truck drivers' strike. Given to strong volumes in April and June, that sustained total

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volume for the quarter. In addition, other cargoes, such as pulp, fertilizers and containers also saw a solid performance.

Moving to the next slide, we look at South Operation's result in the Second Quarter. South Operation's performance continues to evolve. This quarter, besides volume growth, it reached 30% EBITDA margin. Agricultural volumes, which advanced 11% year-over-year, added to a 9% increase in average yield. And efficient cost management drove the 22% EBITDA growth versus the Second Quarter '17.

Moving on to the next slide, we look at grains transported by our railway to the ports of Santos Paranaguá and São Francisco do Sul.

In Second Quarter '18, Rumo's market share of grains transported to the Port of Santos went down 2percentage points. During some periods of the quarter, exports at the Port of Santos increased over 20% versus the Second Quarter '17. But our capacity allowed growth of only 15%. As a result, we lost that market share in this quarter.

Starting this quarter, we'll also report Rumo's market share at the Port of Paranaguá and São Francisco do Sul. In Second Quarter '18, we gained 6percentage points market share at these ports, which, in addition to the favorable second crop, contributes to explain the good volumes delivered in the quarter.

Moving on to the next Slide #8, we discuss our Container Operations performance. Our Containers Operation delivered positive results, boosted by our restructuring strategy. We diversified cargoes, service routes with higher average distance, in addition to an efficient cost management.

The 6% growth in transported volume and 22% in average yield, coupled with cost dilution, resulted in a significant improvement of EBITDA and margin.

Now let's take a look at the company's consolidated indebtedness position. Our leverage remained at 2.6x broad net debt-to-EBITDA ratio. It's worth mentioning that our gross debt decreased from BRL 12.1 billion to BRL 10.9 billion due to prepayment made in the quarter.

Moving to the next Slide #10, we look at consolidated financial results and cash flow. This quarter, our financial result was impacted by nonrecurring events. The mark-to-market of senior notes hedge instruments as a result of interest forward curve fluctuation impacted results by BRL 80 million. It's worth mentioning that this has no cash effect.

With the prepayment of risk-profiling debentures, the expenses of BRL 22 million already paid in the moment of its contracting should be recognized now instead of being deferred over the course of the debt useful life.

To amortize instruments, which were approximately 140% of CDI, we incurred a fee with cash effect totaling BRL 16 million.

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Moving to the next slide, we present the most relevant operating and financial performance indicators. This quarter, our operating ratio was in line with the Second Quarter '17, reflecting improved EBITDA margin and higher depreciation, which in turn coincided with higher level of investment. Greater energy efficiencies drove the 7% improvement in diesel consumption as measured in liters per GTK, mainly evidenced in the gains from renovation of our locomotive fleet and a better cargo mix. When we look at the rail accident index, we saw a 6% decrease in the rail accidents against the same period last year.

Personal accidents were in line with the international railways benchmark, with a 16% reduction in the Second Quarter '18 versus the Second Quarter '17.

The cycle time of railcars was particularly affected by the truck drivers' strike in this quarter.

Moving to the next slide, we will discuss our most recent market projections. Agroconsult again revised its projections for the '17, '18 soybean crop, indicating a 4% increase in Brazilian production and in the State of Mato Grosso, confirming a record crop. Concerning the corn crop, a 17% reduction is expected in the Brazilian production and a 10% increase in the Mato Grosso production.

A positive scenario for soybean trade extended its export period, which, coupled with corn carryover inventories, contribute to offset lower grain production already estimated for the second half of the year. In addition, we can see in Slide #13 that 2018 average road freight prices are above 2017 prices, as evidenced by IMEA figures. As this scenario continues, our competitive view improved even more.

Now moving to the next slide to present our guidance for 2018. Our guidance for the year remains the same. We are firming our already disclosed projections.

With this, I finish our presentation. I'm here with our team and will remain at your disposal for any clarifications. Thank you very much.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Josh Milberg, Morgan Stanley.

Q - Joshua Milberg

I was hoping you guys could elaborate a little bit further on just how you're seeing the second half volume outlook. You mentioned that the grain crop scenario looks very good for you guys. But what one doubt is, obviously -- one obvious doubt is to what extent soy volumes -- better soy volumes can make up for lower corn production? And also with higher road freight yields, are you now seeing some signs that trading companies will opt

to ship volumes with you in the Fourth Quarter rather than using truck transport at a higher cost in the Third Quarter? That's my first question.

A - Ricardo Lewin {BIO 20342706 <GO>}

Josh, thank you for participating in the call. Well answering your questions, the point is the Second Quarter seems to be very good for us. The demand is coming very, very -- the Third Quarter, sorry, seems to be very strong. The demand is coming very strong. So the projections that Agroconsult did seems to be very real, okay. So this was your first question. Regarding your second question, the question was if the demand would go to the -- more strongly for the Fourth Quarter, is that right?

Q - Joshua Milberg

Yes, I mean, just whether the situation with higher truck yields bodes well for the Fourth Quarter just on the idea that trading companies could hold off on shipping some volume and wait until the Fourth Quarter so that they're getting better pricing with you.

A - Ricardo Lewin {BIO 20342706 <GO>}

Yes. I confirm exactly what you are seeing. This is the scenario. Although I can tell you that the soybean crop has been postponed a bit. So -- and this is part of your first question also -- has been postponed. So it has been very strong also in the Third Quarter, okay. Regarding the corn, it has been a bit lower as the information that we tell from Agroconsult. However, the soybean has been postponed and other things that can increase the corn crop or demand for the Fourth Quarter is that the internal market has been -- the demand in the internal market has been lowered. So the exports will be even higher than we thought even with the decrease of the crop or crops.

Q - Joshua Milberg

Okay, Lewin. That's very helpful. And my second question is just on your contract renewal process. And just wanted to know if you've begun negotiations with the trading companies and how much you think maybe the move up in truck freight prices has strengthened your hand in that negotiation process? And another related doubt was just, I think, in the past you talked about stable pricing into 2019 and if that's still your expectation?

A - Ricardo Lewin {BIO 20342706 <GO>}

Josh, well, for this question, I'd say that the truck drivers' strike helped us regarding the negotiation of the next conference, okay. After the strike, some companies decided to participate in negotiations. So we advanced very well from negotiations. And for closing this contract, we are -- clients are waiting for scenario of commercialization of next year, as they still have some doubts regarding the minimal freight policy, okay. But it's going better than we thought. And we are really confident that the railway will be the best solution both in terms of price and in terms of guarantee of transportation of the grains.

Q - Joshua Milberg

And Lewin, in terms of price, I mean, your expectation is still for stable pricing in real terms, of course, in 2019, if you can comment?

A - Ricardo Lewin {BIO 20342706 <GO>}

Josh, I'd prefer not answering for this question as we are in the middle of the negotiations. So up to now, we -- I cannot disclose that.

Operator

The next question comes from Bruno Amorim, Goldman Sachs.

Q - Bruno Amorim {BIO 21628005 <GO>}

So I have a question on 2019 as well. But what I'd like to understand is to what extent is your guidance or your indication for double-digit volume growth in the upcoming years. To what extent does it depend on the size of the crop? I understand there is some room for you to keep growing because of market share gains. But at which point would the size of the market eventually represent a risk for this growth expectation? For instance, if this total size of the crop for soybean and corn is flat in 2019, is it still possible for Rumo to grow by double digits in volumes?

A - Ricardo Lewin {BIO 20342706 <GO>}

Bruno, good question. Actually, although we are foreseeing good crops -- actually, not we. But the consultancies are foreseeing a good crop, both for corn and for soybeans to 2018 and 2019 crop -- grains, we do not depend too much on the growth of the market, okay. We depend more on the increase of -- the improvement of our capacity that's doing very well with investments that we are doing. However, it's important not to forget that we are growing in other products, not only in grains. So -- and we -- the increase of demand of products, such as fertilizer, such as pulp and paper, has improved a lot of our volumes, okay. We also do not depend on the growth of these products. But as you know, we are improving our capacity to transport this product. One of your projects you know is the project of the discharging of fertilizers in Rondonópolis. And the other is the project with Fibria. So the demand there is more a question of increasing our capacity.

Operator

Our next question comes from Victor Mizusaki, Bradesco BBI.

Q - Victor Mizusaki {BIO 4087162 <GO>}

I have 2 questions. The first one, that's a follow-up on the topic about the fertilizer project. Given all the, I mean, situation with the minimum road freight price, I'd like to know if it would be possible for you to accelerate the ramp-up of this project or even maybe anticipate the expansion capacity of this project for fertilizers? And the second question with regards...

A - Ricardo Lewin {BIO 20342706 <GO>}

Victor, sorry to interrupt you. But the call is not that good. Could you repeat the first question, please?

Q - Victor Mizusaki {BIO 4087162 <GO>}

Okay, okay. Now with regards to the fertilizer project, is it possible for you to accelerate the ramp-up of this project or even increase the capacity of this project?

A - Ricardo Lewin {BIO 20342706 <GO>}

Yes. Well regarding the fertilizer project, we are doing very good. There is no need to accelerate as we are already in what was foreseen, okay. We started the project in April. So in the three months of this quarter, we improved the volume. And we are already in the level that we'd like to reach, okay, to face the peak of consumption of fertilizer that happened in the second half of the year. I reinforce what I said to the market before that we intend to do the 1 million tons in the first 12 years of...

A - Julio Fontana Neto {BIO 3872510 <GO>}

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A - Ricardo Lewin {BIO 20342706 <GO>}

1 -- okay, Julio is correcting me here. That's a bit more than I said, more than 1 million tons in the first 12 months of operations.

Q - Victor Mizusaki {BIO 4087162 <GO>}

But Lewin, I mean, would it be possible, for example, to handle a demand for, let's say, 3 million tons of fertilizers in the first year? Because, I mean, per all the guys, they are willing to shift from roads to rail.

A - Ricardo Lewin {BIO 20342706 <GO>}

We do have capacity to do this. But remember, Victor, that we have a ramp-up for this project. When we say 3 million tons of capacity, that will happen in two years, okay? But we do -- if we need more than that, we do have capacity in this project to do more than that. But don't forget the ramp-up, okay?

Q - Victor Mizusaki {BIO 4087162 <GO>}

Okay, okay. And my second question with regards to the BNDES funding this BRL 2.9 billion. Can you confirm the terms for this debt? And the second part of this question, I cannot start to respond on behalf of BNDES. But can we say that the decision basically shows that they believe that the renewal or not of the -- of Malha Paulista is something that in the future should not have any major impact on your financials?

A - Ricardo Lewin {BIO 20342706 <GO>}

I will start with your -- the second half, okay. So part of the debt was approved by the investment in North corridor, okay. So remember that we have more than 70 years of

concession. And part of the continued was approved to the South at -- in a term that's shorter than the concession, okay. So let me give you more details on that. And it will be clear for you. So for the -- BNDES approved BRL 2.89 billion, okay, from which BRL 2.23 billion is for the North corridor, okay. The term is 12 years with two years of grace period, okay. For the south corridor, it was approved BRL 650 million with nine years and one year of grace period. So you can see that for the North corridor the term is okay as well as for the south corridor.

Operator

The next question comes from Augusto Ensiki, HSBC.

Q - Augusto Akihito Ensiki {BIO 15988025 <GO>}

Still I'm following up on the BNDES debt. I missed if you mentioned what the rate was for that. And secondly, when will this be coming into -- or when will it be disbursed to you guys? And the second question and apologies if this has already been addressed, I just wanted to ask you a bit about your margins. You guys finally broke -- you broke over 50% of EBITDA. If you could kind of just give us a little bit more detail into what's driving or what's been contributing to your margin growth, how sustainable it is going forward. And where we can see this going, I guess, in the next 2, three years?

A - Ricardo Lewin {BIO 20342706 <GO>}

So Augusto, sorry if I don't answer anything because the call is not that good. So if I don't answer, please, you can make additional questions afterwards. But first, regarding the disbursement, we just need to go through the regular process of BNDES right now that we need to -- we have some conditions. But -- regular conditions. So disbursements can happen in some months, okay. We already have more than BRL 1 billion that we already invested and can be disbursed, okay. Does that answer your -- the first part of the question?

Q - Augusto Akihito Ensiki {BIO 15988025 <GO>}

Yes. It does.

A - Ricardo Lewin {BIO 20342706 <GO>}

Okay, good. The second part of the question is regarding the sustainability of the EBITDA margin, okay. Regarding that, I can tell you that this is sustainable, okay. And that can even increase for 2 reasons. First, we are still investing in the improvement of the (inaudible) of the company. There are still opportunities of cost reduction in the company for both the North and the South corridor, okay. Remember that the margins of the North corridor are even higher than 50%, okay, goes around 60%. While the South corridor, the margins are a bit lower, something around 30%, okay. So we do have room for more improvement than the number that you've seen in the results.

Q - Augusto Akihito Ensiki {BIO 15988025 <GO>}

So long term, I mean, can you get that South -- the margin for the South Operation, South corridor closer to what the North side -- North Operation is doing?

A - Ricardo Lewin {BIO 20342706 <GO>}

No. Actually, there is room for improvement. But it will never be the same size of the North corridor, okay. This is a physical question. The North corridor has 1,700 kilometers in just one single line, okay, while the South corridor, the largest -- the average distance is something around 700 kilometers. So for simple reason, this never -- it will never have the same margins, okay. Even though we try to improve the South corridor, improve the products that the market already know and the process that we have in South, that we improve the efficiency, improve the volumes in this corridor as well as reduce the cost, operational costs and fixed costs.

Operator

The next question comes from Rog rio Ara jo, UBS.

Q - Rog rio Ara jo

I have a couple of questions. The first one is a follow-up on volume growth in upcoming years. We now start to see a higher comparison basis as Rumo accelerated its volume growth in Third Quarter '17. We -- so we should take into consideration the fertilizer project. We would say that it will represent about 4% growth year-over-year in the second half of this year. So my question is, how much volume growth we can see in the second half of this year, if this can still be double-digit or not. And also what is the level of growth you are estimating for 2019? That's my first question.

A - Ricardo Lewin {BIO 20342706 <GO>}

Rog rio, thanks for your question. The answer is yes, we expect double-digit growth in the second half of this year. And actually, if you consider a linear growth in the guidance that we provided to the market, it's just a question of taking into consideration what we did in the First Quarter and it's easy to calculate the Second Quarter. So I think that the best guess would be consider a linear growth into end of 2020. And you'll see that we can reach double-digit growth.

Q - Rog rio Ara jo

Okay. And my second question is regarding the concession renewal. So I think the documents are now in the hands of ANTT, the regulator. And should be channeled to (inaudible). Do you -- so do you have any expectations for when this should happen? And also, how much time it should stay there? Do you expect back and forth with (inaudible)? Or do you think that the major points of the contract is already well aligned with all the parties involved with? So how is your expectations for that process?

A - Ricardo Lewin {BIO 20342706 <GO>}

Rog rio, I'm a bit more optimistic than you are. I saw your report that you're think there's a lot of time for that. We are here in the company very optimistic regarding the

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approval this year. We continue optimistic, okay. We know that there may be some broad question there that can postpone. But for now we see that, that things are doing well, okay. So this is just to understand the process. The process is in ANTT, you're right. The technicians of ANTT already finished their analysis. That goes to what we call it (inaudible), okay, the agency and then goes to the directory of ANTT, that will send to the TCU, okay. This seems to be long. But it's not. It seems that very soon their report is going to TCU. For TCU, it foresees 45 days for the approval at TCU, okay. This is what is said legally for what it should do. But TCU can take more time to approve. So that depends on TCU doubt or TCU willing to approve the renewal, okay. So we continue to be optimistic in the approval for approving this year, although we understand that can bumps may happen in the process.

Operator

(Operator Instructions) The next question comes from (Natalia Serafin), Citi.

Q - Unidentified Participant

My first question is what is your take on the north-south railway. How are you viewing the potential of it in the launch of this project? And if you can talk more about the (inaudible) on the potential government projects.

A - Ricardo Lewin {BIO 20342706 <GO>}

Natalia, sorry, we do have some technical problems here. Could you repeat the question, please?

Q - Unidentified Participant

Sure. What is your take on the north-south rail? And how are you viewing the potential of it in the launch of this project? And if you can talk more about (inaudible) on other projects.

A - Ricardo Lewin {BIO 20342706 <GO>}

Okay. So I understand that you would like to know our opinion on (inaudible), is that correct?

Q - Unidentified Participant

Yes.

A - Ricardo Lewin {BIO 20342706 <GO>}

Okay. Regarding -- well, first, it is important to say that we do not have many railway projects here in Brazil. And as the largest company in the sector, we (inaudible) very deeply on our business projects. Regarding (inaudible), first, we know that there are a lot of problems for the project. I could spend a lot of time here talking on the problems. But basically, they have the competition of their 163, they have several environmental problems, social problems. They reach in a place that's not the best place to -- it's a bit far

from the sea. So it's a project that has a lot of challenges, okay. And we basically -- we do not have interest on this project. Regarding the north-south, we are extending the project. There are some inconsistencies in the studies presented by the government. But what I can tell you is that we do have interest in participating in a future auction of this railway, okay. And we will participate and feel the level that we think that creates value for our shareholders, okay. That's all I can say by now.

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Q - Unidentified Participant

Okay. And my second question is regarding to the (inaudible) operations. Are there other initiatives there (inaudible) that could continue to boost throughput?

A - Ricardo Lewin {BIO 20342706 <GO>}

Again, could you repeat, please?

Q - Unidentified Participant

Sorry, regarding the (inaudible) operations, are there other initiatives that (inaudible) that could boost the throughput or anything like this?

A - Ricardo Lewin {BIO 20342706 <GO>}

Not lot I can see right now. We are operating that well. Even with the truck drivers' strike, the company did very well. So there is no operational issue that can avoid us to reach our guidance. So this is the reason that we confirm our guidance for this year.

Q - Unidentified Participant

Just one last question. What is specifically driving Brado division EBITDA improvement? Is this related to some level of port improvements even if it is current effect levels?

A - Ricardo Lewin {BIO 20342706 <GO>}

Actually, the company is investing a lot in the transport, the part called (inaudible), okay, to improve the efficiency of the port. The important thing regarding port is that the company has created -- Rumo has created an environment in which all of the companies -- the trading companies that have terminals in transport, they -- now they truck that in the railway what didn't happen before. So even the trading companies are investing a lot to increase efficiency of the operations in the port terminal. So our investments plus the other terminal investments that they are doing is improving the total operational efficiency of the (inaudible) port. And we don't see any bottleneck for the next year in the port.

Operator

(Operator Instructions) The next question comes from Pedro Bruno, Santander.

Q - Pedro Bruno {BIO 19082978 <GO>}

My question regards the free cash flow generation and your expectations for the year. We were able to see that the working capital consumption of the First Quarter of the year was

not offset now in the Second Quarter. So maybe this will happen in the second semester, first, to get closer -- or for Rumo to get closer to a breakeven cash flow generation towards the end of the year. I would like to confirm if this is your expectations. Or what are your thoughts in that sense?

A - Ricardo Lewin {BIO 20342706 <GO>}

Pedro, thank you for your question. Unfortunately, we don't give guidance for the cash generation. Although I think that you could do the calculations, we keep our guidance for EBITDA, okay. Everybody knows that we are doing a very important process of liability management that intends to reduce the cost of debt, okay. And we have been successful to reduce cost, such as fuel consumption, fixed cost. So regarding the working capital, our projections are directed that in the next 2 quarters, the result is supposed to be positive that will help to compensate the result of the year. So this is what I can tell you. So we don't give guidance. But the company looks forward to have -- convert the cash generation. So we have a positive cash generation, okay.

Operator

This concludes today's question-and-answer session. I would like to invite Mr. Ricardo Lewin to proceed with his closing statements. Please go ahead, sir.

A - Ricardo Lewin {BIO 20342706 <GO>}

I would like to thank you all for participating in the call. It is always a pleasure to talk to our investors and analysts. Any doubts you have, we are -- all the IR team are available to talk to you, okay. Thank you very much.

Operator

That does conclude the Rumo's audio conference for today. Thank you very much for your participation. Have a good day. And thank you for using Chorus Call.

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