

Q3 2017 Earnings Call

Company Participants

- Lino Lopes Cancado, Executive Officer
- Paula Alves, Unknown
- Pedro Zinner, CEO, Chief IR Officer & Member of the Executive Board
- Unidentified Speaker, Unknown

Other Participants

- Antonio Rodrigues Dos Santos Junqueira, Analyst
- Felipe Lima, Analyst
- Pedro Luiz Manfredini, Research Analyst
- Unidentified Participant, Analyst

Presentation

Operator

Good afternoon. And thank you for waiting. Thank you, -- to the ENEVA conference call to see the results regarding the Third Quarter of 2017. Today, with us, we have Mr. Pedro Zinner, CEO and Investor Relations Director.

(Operator Instructions) This event is also being simultaneously broadcasted through the Internet via webcast. (Operator Instructions) The replay of this event will be available after the end of this call. (Operator Instructions)

Before we start, we would like to clarify that forward-looking statements during this conference call regarding business prospects of ENEVA, projections and financial and operating targets are assumptions of the company's board as well as available information. Future considerations are no guarantee of performance. They involve risks, uncertainties of assumptions because we are talking about future events; and depend on circumstances that may or may not take place. Investors should understand that general economic conditions, industry conditions and other operating factors can affect the future performance of ENEVA and results -- in results materially different than those expressed here.

We would like to give the floor to Mr. Pedro Zinner that will start the presentation. Please, Mr. Pedro Zinner, you may proceed.

Pedro Zinner {BIO 17260844 <GO>}

Good -- thank you very much. Good afternoon, to everyone. Thank you very much for participating in the earnings release on the Third Quarter of 2017 of ENEVA.

Today, we have the VP of Operations of Exploration and Production; Flavia -- and investor relations; and Paulo Alves (sic) (Paula Alves), Controller of the company.

Before we start, I would like to read the disclaimer on Slide 1. And we will go to Slide two now.

During the Third Quarter of 2017, we continue improving the company's operational and financial management, which was -- in an adjusted EBITDA of BRL 371 million, with growth up 16% compared to the Third Quarter of 2016. We would like to highlight the result of this quarter, the increase in gas sales volume with greater dispatch in Parna ba plant; high availability of Itaqui and, for the second consecutive quarter, outperformed the contracted demand; and the successful strategy to hedge for compensation costs due to unavailability in the generation segment.

We ended the quarter with a consolidated cash flow of BRL 690 million. While we've continued with leverage reduction, we reached a net debt-EBITDA ratio of 3.5x. And at the end of September, we consolidated our position in the Parna ba basin through the acquisition of 5 exploratory blocks in the 14th round of the national oil agency. Finally, we concluded in October a public offering of shares and raised BRL 835 million in primary resources, a fundamental step in the process optimization of our capital structures.

In the following slide, we will present some details of our consolidated performance.

Going to Slide 3. We had regulatory advances during the quarter, recognizing this as a model that should be copied by the country. The 10-year plan, the relevance of the TPPs and the Brazilian matrix, the adoption of the grown horizon for reserves for new energy auctions and the advances regarding the review of penalties due to lack of fuel. These are some of the very few events upgrade that acts within the regulatory environment attained in the last quarter.

When we go to Slide 4. With the beginning of the dry season, we have thermal dispatch. The average generation increased 14% in comparison to the same period of last year, reaching 1,725 megawatts average. In accordance with the expected seasonality throughout the year, the dispatch level that I'll note accounts were at a range of 99% to 100%. The average generation in (the acquired) TPP was 99.5%, 9% higher than the Third Quarter of 2016. The (coals have known) the increase. And the volume of energy generated was 27%. For the Fourth Quarter, we expect a slight slowdown in dispatch levels with the onset of the rainy season, which usually appears in the last months of the year.

When we go to Slide 5. The availability of the Parna ba Complex plants were impacted by planned shutdown for the installations of tie-ins and the installation of gas collection and treatment facility to receive the pipeline from the Gavi o Caboclo and Real fields. Parna ba I and III were shut down from August 28 to September 10. Parna ba IV, our only

TPP with an energy trading contract in the free market, was shut down for most of the quarter, restarting operations in September. ENEVA purchased the energy needed to honor the commitments made in the current bilateral contract of Parna IV. On November 1, the first gas was produced in the field of Gavião Caboclo.

In the coal assets, we have to highlight the availability of Itaqui. For the second consecutive quarter, the availability exceeded the contractually anticipated 95% in a month. In Pecém II, the availability was also affected by scheduled maintenance shutdown from June 22 to August 10.

Now Slide 6, analyzing the financial performance of the company.

The company's net operating revenue increased 37% in the Third Quarter, reaching BRL 885 million (sic) (BRL 858 million), positively impacted by the inflation readjustment on the fixed revenue of the energy trade contract and by higher dispatch in our plant. Now the adjusted EBITDA totaled BRL 371 million during the period vis-à-vis a growth of 16% on the Third Quarter of 2016. Contributing positively to the EBITDA of the quarter: the higher dispatch of the plants, with consequent increase in the volume of production of natural gas; the continuous optimization of fixed costs in the generation plant; the de-contracting of Parnaíba II through offset mechanisms of excess and deficit and subsequent re-contracting at an approximate 40% higher price; and the successful strategy to hedge the costs associated with offset due to unavailability.

The EBITDA -- adjusted EBITDA margin dropped 43% (sic) (to 43%) during the Third Quarter, impacted by the reduction in the Itaqui margin despite the increase in the fixed margin of this plant with the reduction in O&M fixed costs and a small reduction in the loss per megawatt hour in dispatch. By and large, the total margin was negatively impact given the higher volume of energy generated.

Now when we go to Slide 7. Analyzing the evolution of the EBITDA by business segment, we know there's the contribution of BRL 31 million in the Parnaíba Complex, with a highlight to the upstream given the higher volume of gas sold explained by the higher dispatch; and BRL 12 million from the trade segment, considering the increase in the volume of energy sold, 2x higher than the volume of the Third Quarter of 2016 and the growth in the sales margins. The holding, in turn, had a negative contribution to EBITDA of the company, impacted by the new allocation of corporate costs derived from the integration between PGN, our upstream assets; and ENEVA. It's worth highlighting that the increase in the costs of the holding company was accompanied by a reduction of costs at PGN.

Now moving on to Slide 8. In this slide it's possible to have a more detailed view of the Parnaíba Complex. The increase in dispatch in the Third Quarter of the year positively impacted the EBITDA in the period, resulting in a growth of (6% to BRL 338 million).

Adjusted EBITDA in the gas generation segment reached BRL 161 million. It's a growth of 10% when compared to the amount registered in the Third Quarter of 2016. It was positively impacted by the re-contracting of Parnaíba II, which more than offset the

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effects of a higher allocation compared to the Third Quarter of 2016; and also impacted by the successful strategy of penalties -- hedge for penalties due to unavailability. The reduction in the adjusted EBITDA margin for gas generation is justified not only by the higher generation given that the plant is meant to be dispatch neutral; but also for the fact that, in the Third Quarter of 2016, we accounted for BRL 18 million regarding the recalculation of past revenues, according to a new resolution, 658. And there was a discount of BRL 8.5 million in the variable lease of Parna ba, according to the PGN agreement for replacement.

In the upstream segment, the provision of natural gas in the period raised 9%, due to the larger dispatch, to 0.6 billion cubic meters. As a result, adjusted EBITDA in the upstream segment in the third Q '17 reached BRL 172 million, with a growth of 23% -- BRL 182 million actually. Considering the accumulated production and the diversification of reserves, the remaining reserves at the end of September amounted to 17.7 million (sic) (17.7 billion) cubic meters.

Moving on to the next slide, looking at the performance of coal-fired plants. Itaqu 's EBITDA increased 6% in the Third Quarter of 2017, reaching BRL 44 million. The Itaqu  plant was positively impacted by the reduction of fixed operating and maintenance costs through the insourcing of previously outsourced services. Although ongoing initiatives to increase the plant's operation efficiency have been reflected not only in the higher availability but also in the reductions in the quarter of the loss per megawatt hour in the dispatch, the higher dispatch level in the Third Quarter of 2017 exerted a downward pressure on the EBITDA margin.

In Pec m II, EBITDA increased by 42%, reaching BRL 57 million, impacted by the optimization of fixed operating and maintenance costs.

Moving on to Slide 10 now. The company invested approximately BRL 79 million in the Third Quarter of 2017, an increase of 27% compared to the Third Quarter of 2016. Most of the resources, approximately BRL 62 million, were destined to the -- to continue the development campaign of Gavi o Caboclo and Gavi o Azul fields; and the resumption of the drilling campaign in the discovery evaluation plans of Morada Nova, Angical and Aragua na. We are right now continuing the connection of certified reserves for the production system. The first gas of Gavi o Caboclo field was produced on November 1. In the generation area, more than BRL 15 million were invested in the overhaul of turbines and operational improvements.

On Slide 11. The company had an operating cash flow, before interest, of BRL 206 million (sic) (BRL 226.2 million) in the Third Quarter of 2017, with a reduction of 28% compared to the Third Quarter of last year. Despite the significant growth in EBITDA, the operating cash flow was negatively impacted by the growth of accounts receivable balance resulting from the acceleration of dispatch in July of 2017. Consolidated cash position in the Second Quarter of this year reached BRL 690 million, an increase of 22% compared to the Third Quarter of 2016. The free cash flow for shareholders was BRL 16 million, impacted by the increase in investments in the upstream segment.

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Now in the next slide we see that 55% of ENEVA's debt is indexed to the CDI. And therefore, the interest rate drop that has been observed has generated a positive impact on the company's financial results. The weighted average nominal cost of the debt at the end of the quarter was 11.8% per annum. We can see that, in September 2017, the consolidated net debt totaled BRL 4.3 billion, equivalent to a net debt-to-EBITDA ratio of 3.5x, with an average maturity of 4.3 years. If we consider the primary resources raised in October, the net debt-to-EBITDA ratio would be 2.8x.

Now moving on to the final slide, we present here the amortization schedule of the gross debt at the end of September, compared to the estimated schedules, considering net funds coming from the stock offering and the early settlement of Parna ba II debt with Caixa Econ mica Federal. As we can see, we have already achieved the reduction of 24% in the total payments due until 2019. We see continuous improvement in the capital structure of the company. And today we have an indebtedness profile with amortization period that's much more suitable to the dynamics of our business.

Right now I, we have reached the end of our presentation. I would like to open for the Q&A session. Thank you.

Questions And Answers

Operator

(Operator Instructions) The first question comes from Felipe Lima from M3 Asset.

Q - Felipe Lima {BIO 21068545 <GO>}

I saw on your balance sheet a debt quite expensive amounting to IPCA plus 12%. Is there any schedule to advance that payment? And another question about that: Do you intend to have any hedge regarding the CDI as of January 2019?

A - Unidentified Speaker

Thank you, Felipe, for the questions. Well as -- your first comment is a point of concern for the company. And it -- regarding within the prospect of this IPO process, we started paying the debt related to Itaqu . And it probably take place until the end of this year, beginning of next year. This was one of the greatest concerns of the company and was part of the capital restructuring plan that was included in the IPO. As for your second question, today, there is no strategy related to hedge the CDI for 2018, '19.

Q - Felipe Lima {BIO 21068545 <GO>}

Can I then ask a second question?

A - Unidentified Speaker

Sure.

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Q - Felipe Lima {BIO 21068545 <GO>}

Is there -- the market has a fear which is quite in the curve starting in 2019 if which CDIs increasing highly -- going high above 2021 -- 10% for '21, '22. Since there is a significant percentage of your debt with respect to the CDI and understanding that ENEVA is not a financial company, you do have more interesting things to worry about. But wouldn't that be a concern of the company, to protect yourselves from an increase in financial costs? Because all this effort to improve the capital structure. And the company's management is focused on having a control over the company's debt. And I see your efforts in trying to gain efficiency at the plants. And this gain with a CDI at 10% can go down the -- could go down the drain. So to speak. With the higher % have impacted -- the CDI goes up even more. Do you intend to do anything about that next year?

A - Unidentified Speaker

Well within the context that you raised, I -- the financial area of the company is thinking about it. And the way we see it, the risks that are part of our business -- due to quality of risks connected to cash policy. It is worth reminding that most of our contracts are indexed to the IPCA. So there is a correlation between the IPCA and the CDI. Part of the risks that you're talking about are somewhat mitigated by a natural hedge.

Q - Felipe Lima {BIO 21068545 <GO>}

Okay. And I would like to congratulate you on your successful strategy to hedge, protect the company financially speaking.

A - Unidentified Speaker

Thank you.

Operator

Our next question, Mr. Pedro Manfredini, ItaÃ° BBA.

Q - Pedro Luiz Manfredini {BIO 16314973 <GO>}

Just one question here. For you, has anything changed in the past weeks? We have varying weak rains, although this week it has rained above average. And the reservoirs are recovering. Has anything changed regarding dispatch when we see the off within the supply and the plants, for example? And there is another question that has nothing to do with reservoirs. And we would see the problem of efficiency. You want to better use the fiscal credits. I would like to know how this process is. And when could we see some type of advance regarding this plan?

A - Lino Lopes Cancado {BIO 20167891 <GO>}

Manfredini, this is Lino speaking. I will answer your first question regarding the dispatch plans and the impact of the rains slightly below what was expected. And this week, rains have started. And this is the period -- it's above the average of other years. Although we have had slight variations in the amount of rainfalls, the restrictions of the power system in the northern subsystem continue. With power, with installed capacity of the TTTs (sic)

(TPPs), it will be greater than the existing transmission lines. Our scenario, it is low during the Third Quarter -- First Quarter, low; and the Second Quarter close to 100%. It's something that we will repeat. The dispatch will be in average 50%, 55%.

A - Unidentified Speaker

My second question, Paulo (sic) (Paula) is going to answer.

A - Paula Alves {BIO 15055914 <GO>}

Well during the Third Quarter, we just incorporated with the BPMB. That is a company that had positive tax results and now uses the fiscal losses of the PGM (sic) (PGN). So today, we have one upstream operator and we better use the tax credits. And in addition to this, we're also carrying out a major structured effort to structure company -- our companies as a whole and to better use our credits. I know the BPMB -- so you've incorporated -- and you've incorporated the (BPMB PEG) and incorporated BPMB. And we had a tax savings throughout 2017 of approximately BRL 7 million. And we will have saved in the upcoming years between 3 million and 4 million a year.

Q - Pedro Luiz Manfredini {BIO 16314973 <GO>}

So you said that the other incorporations or the other restructurings will continue.

A - Unidentified Speaker

Yes. We will -- and now, in August, we incorporated 7 small companies. That did not majorly impact the company in terms of tax credits but simplified our corporate chart. And we want to continue restructuring the other companies during the upcoming years.

Q - Pedro Luiz Manfredini {BIO 16314973 <GO>}

Okay. And can I ask another question? In Parna ba IV -- I, Parna ba IV, I imagine that the results will be similar to the last bimester because of a trading operation, your free-market contract. And you do it through a trading company. And Parna ba IV works for that dispatch. I don't know what happened during the last quarter. But you didn't gain a lot with this operation. Can we expect something different during the next quarter in terms of gains?

A - Unidentified Speaker

You are right, Manfredini, because our -- we reaffirm the operation of Parna ba IV. So the only -- we're working one part of this quarter. During the Fourth Quarter, we will try to attain part of the arbitrage.

Operator

Our next question, Victor Hugo Menezes, Goldman Sachs.

Q - Unidentified Participant

Pedro, Flavia, this is (Lino). My question, about Itaquí. We see a substantial improvement in availability way above the regulatory levels in this quarter. The question is, how are your efforts to try to make this plant dispatch neutral?

A - Unidentified Speaker

Well there's a series of initiatives in course aiming to bring Itaquí to neutral level as of the second -- the first half of -- second half of next year; with investments of BRL 30 million, BRL 35 million to be made next year in this revitalization process and this revamping process to try to reach a neutral level. I think the most significant investment probably will be the revamping of the conveyor belt that will optimize most of this loss that we see in the plant. I think it's the most significant loss regards that. A lot has been done. But the end of first half of next year, beginning of the second half, we will see the results.

Operator

(Operator Instructions) Our next question comes from Antonio Junqueira from BCG Pactual (sic) (BTG Pactual).

Q - Antonio Rodrigues Dos Santos Junqueira {BIO 15403195 <GO>}

My first question is in line with Manfredini's question about the tax improvement in the company. I think we've discussed this earlier. It will be now worth discussing it again with more people online, regarding the management of debt that are at the holding company now. I know that you have a greater waiting period to -- for the holding company debt. But when you think that you don't have any tax bracket for that, it's naturally more expensive than some of the other. But it will be well ranked up considering that it doesn't generate any tax benefits. I would like you to explain that a bit. And regarding the hedge of ADOMP, I would like you to explain this a bit more clearly. What is the strategy if -- on the short term if the contract for these hedges are long term or medium term? Because -- these costs associated to ADOMP, will we have good news as we have this quarter?

A - Pedro Zinner {BIO 17260844 <GO>}

This is Pedro speaking, Junqueira. Well regarding the debt at the holding, you're right. This has been a discussion for some time now. It's a result of the company's proceedings. And although we don't incur in any tax benefit, it's a good level. In the point of view of the company, we're trying to efficiently manage our liabilities. With the drop in interest rates and within this liability and management profit, it would make sense to reassess with that at the holding company level. We took the first step to -- less expenses. So we had more expensive debts in the past. So it's part of our debt restructuring process to reassess and optimize this with a more active liability management structure. So this is your first point. The hedge is part of the strategy. And it's more active now when compared to what we had been doing in the past. When you look at our plan for 2018 for the outlook for dispatches and optimization of assets, we must make a decision regarding the ADOMP hedge strategy. That will be more active, undoubtedly.

Q - Antonio Rodrigues Dos Santos Junqueira {BIO 15403195 <GO>}

Well so in terms of ADOMP, it -- you make the strategy for the next year every year.

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A - Pedro Zinner {BIO 17260844 <GO>}

Yes. It's a more active position than we had in the past.

Q - Antonio Rodrigues Dos Santos Junqueira {BIO 15403195 <GO>}

Okay. Then my last question, if you could -- there's a lot of mismatching information in the press. Could you give us some color or opinion about the evolution of the transmission lines associated to Belo Monte?

A - Lino Lopes Cancado {BIO 20167891 <GO>}

Junqueira, this is Lino speaking. With regards to the Belo Monte lines, there are some news saying that the first coal was -- started its operations more in advance. Regard -- despite this advanced startup, this won't impact our vision because, even with the advanced startup and with the plants or the machinery that's already started in Belo Monte or installed in Belo Monte, there is still a problem with the transmissions, retransmission. So there is no capacity to outflow all this energy. And this causes an effect of a low dispatch in the first half of the year and then a high dispatch in the second half of the year due to this adaptation. So although they are starting up in advance in the first pull, we don't see much change in the outlook of dispatch for next year.

Q - Antonio Rodrigues Dos Santos Junqueira {BIO 15403195 <GO>}

Lino, I would like to ask another question regarding transmission. In this auction that we had at the end of the year, there are 2 lines that, when combined, seemed to replace a Bankova line. Is this the right interpretation? I think, last number, 2 and 3 -- or 3 and 4. I'm sorry. Is there any plan to replace that?

A - Lino Lopes Cancado {BIO 20167891 <GO>}

There are some lines in these auctions that are replacing part of the price of Bankova. Bankova was not one single line. There were several complementary works to reinforce the system of 500 kV that distributes energy to the Northeast of Brazil as well as an alternative path to the Southeast. So there are -- there is a part of the portfolio of Bankova that's already been subject to bidding. Nevertheless, in our discussions with several agents, we believe that the whole problem will not be solved until 2022, 2023.

Operator

(Operator Instructions) Since there are no further questions, I would like to turn the floor over to the company's management for their final remarks.

A - Unidentified Speaker

Well thank you very much for attending this call for the earnings release of the Third Quarter. And I hope to see you again in the next call, okay?

Thank you very much. Have a good day.

Operator

The conference call of ENEVA has now ended. We thank you all for attending. And have a good afternoon.

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