

Q2 2018 Earnings Call

Company Participants

- Phillipe Casale, Investor Relations Manager

Other Participants

- Augusto Ensiki, Analyst
- Lucas Ferreira, Analyst
- Vicente Falanga Neto, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Cosan SA Second Quarter of 2018 Results Conference Call. Today with us, we have Mr. Phillipe Casale, Investor Relations Executive Manager; and Mr. Joao Arthur Souza, Head of Finance. 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 slide show of this presentation are available through the 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 Mr. Phillipe Casale. Mr. Casale, you may begin the call.

Phillipe Casale {BIO 20025617 <GO>}

Good morning, everyone, and welcome to Cosan SA Second Quarter 2018 Earnings Conference Call. As usual, I'll start with the presentation, talking about each of Cosan SA business lines and then address the consolidated results. It was a quite challenging

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quarter for the country as a whole. The truckers' strike caused losses in several sectors of the economy, directly reflected in 2018 expectations for economic growth and inflation in Brazil. Once again, our businesses were tested, and the quick resumption of operations was essential to minimize the strike effects.

Let's move to slide four, starting with Raizen Combustiveis, where impacts were more severe. And first, I would like to further elaborate on that. The reduction of diesel prices, following the government request, resulted in a loss of BRL200 million at Raizen. Such loss reflects the pass through of the discounts applied to existing diesel inventories at that time. As a result, our diesel commercialization margin was negatively impacted. In addition to that, Raizen incurred an unplanned operating and logistics expense. Also, we estimate a 4% loss of sales volume due to the truckers' strike.

Moving to the quarter figures. Sales volume came in 2% lower than the same period last year. The main impact was in motorcycle, where sales dropped 9% already adjusted for the energy parity or gasoline equivalent alternative fuel. I would like to point out that the demand for ethanol remains high and grew 37% in the quarter. Diesel sales increased 3% even with the impact of lower traffic. As we mentioned in the previous quarters, the better diesel performance is a result of higher demand from agribusiness' clients and new B2B contracts.

Sales volumes in the aviation segment grew by 10%, in line with the sector's upturn. Adjusted EBIT came to BRL377 million, 4% lower than the second quarter of '17. We prefer to focus on EBIT, which seems to be the best way to analyze the business performance to see if it reflects efficient management of assets and invested capital. Adjusted EBITDA in second quarter '18 was 3% lower, which is BRL541 million, impacted by the truckers' strike, as I mentioned before. The gains from our supply and commercialization strategy before the strike and the efficient refueling of operations contributed to mitigate part of the strike impact in the quarter.

I want to highlight that this efficiency has resulted in a faster resumption of our customers and the sellers' operations, reinforcing our focus on long-term relationships. Now referring to investments at Raizen, the total investment, which is BRL203 million in the second quarter 2018, including investment in maintenance, conversion of new stations and renewal of existing contracts. We ended the quarter with 6,360 Shell-branded stations, with a net addition of 292 stations in the last 12 months and 31 stations in the quarter, just to remember that this is in line with our expectations for the year.

Now let's move to Raizen Energia on slide five, and this is the first quarter of the '18, '19 crop year, which started with drier weather, allowing for a growth of 16% on sugarcane crushing. Productivity reached 9.6 tons of TRS per hectare, a 4% drop due to lower rainfalls. As you may know, the drier weather contributes to increasing the TRS, but negatively impacts the quarter yields as measured by the TCH, the tons of sugarcane per hectare. Mix of production continues privileging ethanol, which is 52% mix to the biofuel this quarter.

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We continue assessing each product profitability to determine our plans for the year. Concerning the impacts of the truckers' strike on Raizen Energia, I would like to point out that all the news has interrupted the activity for a few days, but the impacts were minimized since crushing volume was accelerated after the interruption of operations. A few sales of own products had to be rescheduled without compromising the expectations for the crop season.

Let's now talk about sales volume of each product, starting with sugar, where sales came in 30% lower this quarter, especially own products, reflecting the sales strategy for the year. As expected, average sales price in BRL came in 31% less compared to the same period last year, following a sharp drop in commodity prices. Now the ethanol sales also dropped this quarter, yet production grew 48% but were in line with the sales strategy for the year as well. Ethanol average price improved 5% versus the same quarter last year, in line with the ESALQ average price. ESALQ, as you may know, is the main reference price for Brazilian nationals.

On cogeneration, with higher biogas availability due to the higher crushing and the trading volume, the energy power sales increased 42%. A higher PLD, which is the spot price, has contributed to a better price in the quarter, which reached 237 megawatt hour. Before discussing EBITDA, I would like to highlight the unit cash cost in sugar equivalent, which dropped 11% in the quarter, reflecting lower CONSECANA prices in the period and our ongoing pursuit of operational efficiency and excellence. Raizen's adjusted EBITDA went down 39% to BRL488 million.

As usual, we excluded effect of biological assets variation, the debt hedge accounting and the foreign exchange effect on sugar exports, all of them detailed on our earnings release. The decrease reflects in lower sales volume in sugar prices, partially offset by improved ethanol and cogeneration prices, besides the lower cash cost per unit. Despite the lower result in the quarter, we remain confident that we will deliver on the results projected for the year in our guidance that is out in the market.

Let's move to sugar hedge. As you can see, we advanced since last earnings release, mainly due to the US dollar appreciation. For the current crop '18, '19, we have got nearly 50% to 55% of the total sugar to be exported hedged at an average price of BRL50 per ton. For the next crop '19, '20, we hedged approximately 10%, with an average price of BRL54 per ton. We foresee sugar prices continuing to be in pressure in this short term, still reflecting strong production from other countries, such as India and Thailand, resulting in an expected overall crop surplus. Now the magnitude of this surplus will depend on the size and the mix of the huge crop, which should have more ethanol production and significant impact on productivity due to the drier weather. Finally, on CapEx which totaled BRL481 million, reflecting higher investments in plenty, in view of sugarcane fields due to the larger harvest area in the period and also intercrop maintenance.

Now let's move to slide six and talk about Comgas. In that Comgas result released its results on last Tuesday. I'll go straight to the highlights here. The truckers' strike caused no major impact on Comgas results since the company distributes piped gas. However, a few of our industrial clients had their production affected, which reduces natural gas consumption during the strike. Even so Comgas reported a 2% year-over-year growth in

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the industrial volume as a result of the focus of the sales team to increase volumes in this segment. This quarter, we continued to focus on the expansion in residential and commercial segment, with higher per unit margin.

Commercial volumes grew by 5% compared to the second quarter of '17, driven by the net addition of 1,300 clients. The residential segment saw 2% sales decrease due to a higher average temperature in the period, but we sustained at the same level of fuel experienced over the last 12 months, adding 108,000 new clients. Comgas EBITDA normalized by the regulatory current account effect grew by 7% to BRL491 million this quarter, driven by the higher volumes sold and margins adjusted by inflation as authorized by the regulatory in May 2018. This quarter, Comgas reported a return of BRL116 million from the regulatory current account to clients, thereby reviewing the balance of this account at the end of the period. IFRS EBITDA came in 10% lower. Comgas investments totaled BRL130 million in the second quarter '18, in line with years planning for this line in Comgas.

Let's move to slide seven, starting with the results of Moove, our lubricants unit. We moved forward with our international expansion plan. In this quarter, we entered the markets of Argentina, France and Portugal. Our business model is similar to what we have employed in other countries, focused on the sales and distribution of products to several parts of clients with marginal investments. The truckers' strike had no major impact on our lubricants business. There were no shortage from key clients or our distributors' network due to the decentralized supply and logistics model that we operate in Brazil. Finished-lubricants sales volume both in Brazil and international operations reached 11% growth versus the second quarter '17. Our better sales mix drove a 24% EBITDA growth, which reached BRL66 million in 2Q'18 -- in 2Q'18.

Now let's turn to Cosan Corporate. On the right side of the slide, the general and administrative expenses were lower, following the trend seen in the previous quarter, with a reduction of 2% compared to the same period last year, and the other expenses also declined due to a lower concentration of costs with consulting firms and various legal claims.

Let's move to slide eight, represent the consolidated results of Cosan SA on a pro forma basis, which considers 50% of Raizen results. The impact of the truckers's strike that I mentioned on the Raizen Combustiveis and the lower sales volume at the Raizen Energia drove the 8% decrease in adjusted EBITDA, which reached BRL1 billion in the quarter.

Besides the effect that I've just mentioned, the Cosan financial expense were negatively impacted by the Brazilian real depreciation against the US dollar, specifically the unhedged amount of the perpetual bond. It is worth mentioning that this is a non-cash impact and, as a result, Cosan's loss in the quarter was BRL64 million. The year-to-date, the net income reached BRL281 million.

Moving to slide nine, and before discussing our indebtedness, I will highlight the cash flow in the quarter. The lower operating cash flow reflects the impact we already mentioned at both Raizen and Comgas. The cash flow from investments were impacted by the first

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installment of \$100 million for the acquisition of Shell's downstream asset in Argentina, which is a Raizen Combustiveis acquisition. The cash flow from financing activities, the main impact was a buyback of Cosan shares that was equivalent to BRL598 million.

In the first six months of 2018, the free cash flow to equity totaled BRL1.1 million compared to BRL752 million in the same period last year. Pro forma gross indebtedness was up 8% in this quarter and reached BRL15.6 billion is the new debt issued at Raizen and at Comgas. The average cost of indebtedness on a pro forma basis, which we've again included in Raizen, stood at 108% of the CDI. The cash position remains strong, but gross indebtedness increase resulted in a higher leverage compared to last quarter, which reached 1.8 times pro forma net debt to EBITDA, and this EBITDA is normalized by the regulatory current account at Comgas. Just like in the last quarter, this leverage ratio is below what it used to be. In the long term, the normalized level should be between 2 times and 2.5 times net debt to EBITDA. Important to mention as well that we also distributed BRL450 million in dividends at Cosan SA this quarter.

Let's move to the last slide in our presentation, and to finish, I will show again the guidance for the year. There was no change in the EBITDA expectations, either the consolidated or in the business. At Raizen Combustiveis, we remain confident that the consistency of our strategy will result in delivering our guidance regardless of the impact of the truckers' strike. At the Raizen Energia, our sugar and ethanol business, the drier weather had impacted the sugarcane availability, and for that reason, we are lowering the range to -- 60 million tons to 63 million tons of sugarcane for the crop year. However, the better TRS -- or, I'm sorry, the best TSR will support the guidance of production for -- of sugar and ethanol. I'd like to emphasize that despite the challenge seen in the first semester, as I mentioned before, there was no change in the EBITDA range for the year, as we keep focus on delivering the results that we provide through the guidance to the market.

Thank you all, and now 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 analyst. (Operator Instructions) First question, Vicente Falanga Neto, Bradesco BBI.

Q - Vicente Falanga Neto {BIO 16406266 <GO>}

Hi. Good morning, everyone. Thank you very much. We had two questions basically. We noted that Raizen was a company that reported the best EBITDA per cubic meter when excluding the negative impacts of the truckers' strike. To be more specific, Raizen reported around BRL120 per cubic meter, while your key competitor posted something closer to 95. We were just wondering what do you think explains such a positive gap. And what do you think are the sustainable margins for the remainder of the year and maybe next year? Then our second question, we noticed that there was a high consumption of working capital in the quarter. It seems to us that it's basically inventory buildup for sugar

and ethanol, but we were just wanting to check if we're not missing anything else? Thank you very much.

A - Phillipe Casale {BIO 20025617 <GO>}

Vicente, thank you for the question. The first one, in regards to the fuel business, we had been mentioning this in the business call as well. There's a clear view here that the consistency of our strategy in terms of our commercialization and the supply strategy in terms of the relationship with our retailers, this is what is sustaining a better performance when comparing -- when compared to the average of the industry. And it should be the same. We should keep the same pace in terms of our strategy for the long run, right. This is the strategy that was happening when this company was formed back in 2011, and we haven't changed anything since then.

So we've got to keep the focus, keep privileging the relationship with our network and keep always looking at our supply and commercialization strategy to help in improving our results. In terms of the consumption of the working capital, as we mentioned, yeah, on the Raizen Energia, this is the worst quarter in terms of working capital due to the beginning of the crop. This, of course, is part. There's also the dynamics on the -- on Comgas due to the regulatory current account. So these two were the main impacts on the working capital in the quarter.

Q - Vicente Falanga Neto {BIO 16406266 <GO>}

Just a follow-up. So we should expect this to normalize on the following quarters?

A - Phillipe Casale {BIO 20025617 <GO>}

Yeah. Depending and aligned with our commercialization strategy, the first and the second quarter of the crop usually are the ones that you have the highest pressure on the working capital, right, and then on the third and the fourth quarter, again, depending on the commercialization strategy, you have different dynamics.

Q - Vicente Falanga Neto {BIO 16406266 <GO>}

Got it. Thank you very much, Phillipe.

Operator

Next question, Augusto Ensiki, HSBC.

Q - Augusto Ensiki {BIO 15988025 <GO>}

Hi. Good morning. Thanks for taking my question. I'm sure, if you could give me a little bit more information on the ethanol, and apologies, this was already addressed. Given you have a little bit of supply glut on the ethanol side as well now, what's your current outlook for ethanol pricing? And is level for ethanol where you'd say, all right, maybe we need to go back to sugar, considering FX and then other positive effects on that side? Is there anything that would change your mind in terms of your sugar and ethanol mix and where you kind of see the dynamic going forward? Thank you.

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A - Phillippe Casale {BIO 20025617 <GO>}

Augusto, thanks for the question. Analyzing the profitability of each product is something that Raizen does on a daily basis here. This is basically what defines what's going to be our production and where are the opportunities in terms of trading. And this is going to be something that we'll be thinking for the year, be thinking for the year, okay. So right now, there is no doubt that the ethanol is elevating more than the sugar. That's why we are shifting all the production to ethanol. This quarter, we have produced 52% of ethanol and 38% of sugar. And this should be the same pace, of course, limited to the setup of our mills and the flexibility that we have for the rest of the crop year. I think you asked about the higher demand as well, right, high demand of ethanol right now?

Q - Augusto Ensiki {BIO 15988025 <GO>}

Yeah.

A - Phillippe Casale {BIO 20025617 <GO>}

Yeah. So what we have been seeing since the beginning of the year is that the demand for ethanol is increasing a lot. When you look at the fuel distribution business, the ethanol volume, in spite of the truckers' strike, grew 37%. Of course, apparently, it is below the 70%, right now more close to 60% actually. So this is, hence, why the consumption of ethanol in some states in Brazil. And this is what is driving the demand also for ethanol. And in terms of the supply, this is going to be a crop with much more ethanol. So the supply side is also important to this dynamic by the end of the year. So more ethanol in the beginning and the mid of the crop, and demand should still -- for ethanol specifically should still higher if we look at the same process that we have in the market right now.

Q - Augusto Ensiki {BIO 15988025 <GO>}

Thank you very much for that and I appreciate it.

Operator

Next question Lucas Ferreira, JP Morgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Hi, Phillippe. Just wanted to clarify two points. First, you mentioned in the Portuguese call that you expect net debt to EBITDA of the company to be closer to 2.5 times through the end of the year. Just wanted to understand if the main driver of this increase is acquisition in Argentina or if you guys planning maybe more dividends or any other cash outflows that could be impacting this increase from the 1.8 times you're currently at. And the other question that I have is regarding the outlook for the crop now. Since we're seeing rainfall in the state of Sao Paulo coming back, if you're seeing any change in the outlook for -- if you have heard any change in the outlook for ATR productivity and even costs for the business in the remainder of the crop? Thank you.

A - Phillippe Casale {BIO 20025617 <GO>}

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Lucas, thanks for the question. In terms of the leverage expectations we share on the call here in English as well, the normalized level that we look for the long run in Cosan are the range actually between 2 times and 2.5 times. We were last quarter 1.5 times and this quarter 1.8. And one of the main impacts was the credit light sale that we did in the first quarter, which impacted the EBITDA. And for the rest of the year, we have a few that are going to happen. One of them is the obligation, we have with CZZ in terms of the Comgas stake purchase that we did, which is around BRL150 million -- BRL350 million, \$100 million something.

And also, with the conclusion of the Shell acquisition in Argentina, which is being done by Raizen Fuels and is expected for the fourth quarter of the year, should also impact on the leverage for 2018. But what we want the market to keep in mind is that the normalized level, there is a range there that should be between 2 times to 2.5 times. I think 1.5 times and 1.8 times that we've just delivered this quarter was specifically due to the credit light sales that impacted the results in the first quarter.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Thank you.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I would like to invite Mr. Phillippe Casale to proceed with his closing statements. Please go ahead sir.

A - Phillippe Casale {BIO 20025617 <GO>}

Just to correct myself here, the amount that we'll -- the obligation that we have with CZZ by the end of the year is BRL250 million, not BRL250 million [ph] as I mentioned. So this is the obligation we have by the end of the year. And thank you all for being here in this conference call, and I'll see you on the next opportunity.

Operator

That does conclude the Cosan's audio conference for today. Thank you very much for your participation. And have a good day.

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