Q2 2015 Earnings Call

Company Participants

- Carlos Aníbal de Almeida Jr., Executive Officer-Pulp and Paper Business Unit
- Marcelo Feriozzi Bacci, CFO & Director-Investor Relations
- Walter Schalka, Chief Executive Officer

Other Participants

- Alan Glezer, Analyst
- Caio Ribeiro, Analyst
- Lucas Ferreira, Analyst
- Marcos Assumpção, Analyst
- Thiago Lofiego, Analyst
- Viccenzo Paternostro, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and thank you very much for waiting. Welcome to the Earnings Conference Call of Suzano Papel e Celulose to discuss the results of the second quarter of 2015. The participants will be on listen-only mode during the presentation of Mr. Walter Schalka, CEO of the company. After that, we will initiate the question-and-answer session, when further instructions will be provided. I would like to emphasize that each participant is entitled to ask only two questions.

We would like to inform you that certain statements in this presentation may constitute projections or forward-looking statements based on future expectations. Such statements are subject to known and unknown risks and uncertainties that could cause the expectations expressed do not materialize or the actual results to differ materially from the expected results.

These risks include changes in future demand for the company's products, changes in the factors that affect domestic and international product prices, changes in cost structures, changes in the seasonality of market, pricing actions by competitors, foreign currency fluctuations and changes in the political and economic environment in Brazil, in emerging market and internationally.

Now I would like to give the floor to Mr. Walter who will begin the call.

Walter Schalka {BIO 2099929 <GO>}

Good morning, everyone. It's a great pleasure for me to be here with you, and thank you very much for participating in this earnings conference call to discuss the results of the second quarter of 2015 of Suzano Papel e Celulose.

Here with us today is Mr. Carlos Aníbal, our Commercial Officer both for Paper and Pulp; Marcelo Bacci, our CFO and IR Officer; Alexandre Chueri, our Forestry Business Unit Officer; also Mr. Carlos Griner, our Human Resources Officer; and Ernesto Pousada, our COO, our Officer for Logistics, Supply and Industry. I would also like to mention Michelle Corda, the manager in charge of Investor Relations. At the end of the presentation, we will be available to take your questions.

I would like to begin the presentation on slide number one, the focus as to operating cash generation of the company, our EBITDA in the last 12 months was R$3.3 billion but we understand that EBITDA is not the most adequate metric for our industry. The most adequate metric is operating cash generation and we are pleased to inform you that we had almost R$2.1 billion of operational cash generation in the last 12 months. This KPI is very relevant and, as such, as of last year we now use this as one of our main KPIs when it comes to variable compensation to our officers. The main objective of the company is that in time we want to grow gradually our return on capital employed to our shareholders.

To that end we understand that given the high level of sustained CapEx in the industry, the operational cash generation becomes the leading factor. This very strong cash generation allowed us to reduce our debt and net debt in the last quarters – the growth in net debt in the last quarters. We have to celebrate because our net debt over EBITDA ratio was 3.3 times and this represents a significant reduction in the last eight months. After the end of the Imperatriz project, it was 5.2 times, and now the ratio is 3.2 times, or 2.9 times if we consider in dollar terms and is downward projection should continue to occur due to the gradual EBITDA increase that we have been experiencing quarter-on-quarter.

I would also like to mention another important measure, which is a reduction of the net debt of the company going from R$15.3 billion to R$13.9 billion. We have adopted a program of cash reduction to allow for a reduction of interest arbitration that we had and so today our gross debt is R$13.9 and net debt is R$11 billion.

In addition to that, with the liability management program of the company, we were able to reduce the debt cost. In June of this year, the debt was a little bit below of 90% CDI, the real denominated debt and the dollar denominated debt was 4% a year.

Throughout the quarter, now going to slide number four, we develop further liability management actions, and there were two very important aspects. One was a syndicated loan operation, the cost of LIBOR plus 2% with a term of five years and CRA of R$675 million. The cost was 101% of CDI with a total term of four years. With that, we were able to prepay the debt in a total amount of R$3.3 billion debt which had a higher cost. And because of that, we were able to lengthen the debt maturity profile while at the same time we were able to reduce interest rates. This will allow us to promote a reduction of around R$70 million a year in our financial expenses. And this was a continuous process and we are calling this process of liability management, the wave number four of the liability management program and we are also introducing other managers. This is a pursuit of the company to reach a cost of capital that is more adequate to the company, with the (06:48) of the debt maturity profile.

Now on slide number five, I would like to refer to our EBITDA. We had a record-high adjusted EBITDA of R$959 million with 40.2% margin. But as far as our policy of total transparency with the market and humbleness, we believe that we are below our full potential of R$60 million. And this difference is explained by some factors and most of them are non-recurrent.

One of the factors is the fact that we had a startup of a new digester which has started on May 15th according to plan. And this is just to remind you this digester replaces the other five digesters that we had at Suzano. So we replaced five old ones by one new digester. The learning curve was a bit longer than expected for the new digester. But the good news is that this is already solved. It was solved as of June but we didn't capture any benefit in the second quarter but certainly the benefit will be more clearly apparent in the third quarter because now the digester then will be running according to plan.

The second effect that we had in the quarter was the effect of energy. In April and May, there were different energy prices between market in North and Southeast. And this led us to have a difference in energy capture between what we sold in the North in our Maranhão unit and what we bought in the submarket in the Southeast to our Suzano unit. This has been solved in June. But as of July, there was a drop in energy prices in all submarkets and those will certainly affect us in the third quarter.

We also have the adjustment of the long-term incentive plan in Portuguese ILP and this is based on the price of shares as we had a significant increase in the price of this stock. The other side of that is that we have to make increases in our allowance for doubtful debt in the quarter. We also made adjustments in the allowance for doubtful debt when it comes to commercial expenses related to paper domestic market. We are taking all necessary adjustment measures to be able to take full advantage of our full potential. And the company is totally immersed in this process of continuous operational gain.

Now speaking about pulp on the next slide, the good news is that the market is highly demanding pulp. In the last 12 months, we sold almost 3.4 million tons of pulp and our production in the second quarter was higher when compared to last year's production. And our sales production was also much higher, 16% higher than that of last year. Our inventory reduction was 60,000 tons during that period. This is very positive. Inventories are at very low levels, which allow us in a timeline to expect further reduction during the period.

In terms of paper, what is happening is that we had a production loss related to maintenance downtime in Suzano. This was a one-off situation and only happened in the second quarter and we also have a lower domestic market sales of about 6%. And you might remember that in the first quarter of this year, we referred to a drop of 12% in the first quarter but this now had been reduced down to 6% in the second quarter. Therefore, we believe that we will have less significant drops now already in the third quarter.

Also, there was an increase in the average net price that was flat versus the first quarter of last year. The difference in the volume of paper production is now being allocated in the domestic market because the volumes are growing to offset reductions in the foreign markets. The cash cost now on slide eight, we had an increase from R$565 to R$626 in this quarter vis-à-vis the same quarter of the year before. We will see the evolution in years wood (11:54) is the main impact that we have in the cost equation and energy is the other element.

With wood, we have the advanced purchase of third-party wood to supply Mucuri. This was a deliberate decision by the company and very positive to shareholders. That refers to the decision we made to purchase our wood from third party. Another important element is the average distance increase at Maranhão mill. This is here to stay and it will not be reverted in the short run.

Now referring to energy. There was a difference in price in the submarket as I mentioned before, and also we had an overhaul downtime, something that happens once every seven years that is for turbine number five which lowered the volume of exported energy during the quarter. The turbine resumed operation on July 15, and therefore after that, the volume of energy will increase again in the third quarter of this year. We had two downtimes in the quarter, so we should not expect to have any more downtimes in their next stop (13:14) and more consumption after they are resumed.

The company continues to focus on cost and expenses discipline. We had a record high revenue in the last 12 months. We had 2.69 and our revenue R$8.7 billion. So despite all of the effects that we mentioned before in taxes, our nominal COGS between June 2014 and June 2015 is still low, meaning that despite all of the effects we had with wood and energy, our cost in nominal turns continues to drop. And this is a very positive element. And admin expenses (14:01) reached an even lower level accounting for 8.8% (14:09) over sales. Therefore the focus of the company and the company's discipline to manage costs and expenses continues to go on and this will give us ever more positive results from now on.

Now referring to investments in the last six months. It was R$945 million and we are now revisiting our CapEx growth for this year for something close to R$1.8 billion – R$1.7 billion and R$1.8 billion. Part of that refers to purchase of wood from third-parties which is quite positive and this will be explained further in the next slide. This is a decision made by the company in view of the positive signs from the market concerning exchange variations and price of pulp. And therefore, we decided to advance the purchases of wood from the third-party to avoid any drastic variation.

In addition, we are engaged in several retrofitting projects in our facilities. The most recent project approved involve the retrofitting of the digester of the Limeira unit, also the retrofitting of the biomass boiler of the Limeira unit and also the purchase of light carrier

(15:48) for vehicles. These are continuous program of the company. And we will continue to pursue these programs in the next quarters.

The next slide, slide number 11. I would like to call your attention to this slide because this is relevant to your analysis. This slide shows a comparative analysis. On the upper side of the slide, we have our cash cost in 2012 and then the cash cost in the last six months of 2015. As you can see that cash cost has progressed. The CAGR or the average annual growth is 1.8% a year which was much lower than inflation in the period but more significant than that is the fact that despite this growth below inflation, the wood cost was up by R$84. So we grew R$31 in terms of the total cash cost and wood cost accounted for R$84 from the total cost.

So out of all the costs, we have a nominal drop of R$53 despite inflation and despite the exchange adjustments that we quoted in the six months of 2013. Therefore this is the focus and the discipline of the company towards reducing consumptions in the different mills. And this is part of a continuous program. We do that through two ways. One is a program where the managers have total independence to bring about new ideas. And on the other side we also have more encompassing structural programs that are in place in several mills.

Now speaking about wood, and this appears on the lower part of the chart. All of the effect is concentrated at Mucuri mill. For strategic reasons, we were not giving you any disclosure about how we were operating and purchases of wood from third parties. And the reason for that is that we still have to buy wood from third parties for the future. As we're almost concluding that purchase of third-party wood, we now today are able to give you the disclosure about the fact that Mucuri – in Mucuri, we went from 98 kilometers of average radius in 2012. The structure of radius is 95 kilometers. So we were above the average radius. And today, it's 298 kilometers in Mucuri. And this has been impacting our cash cost. And that's why the cash cost as you can see on the upper side of the chart would impact wood (18:46) in a very relevant way.

So we went from 45% of wood from third parties and arrived at 62% of wood from third party in this lower chart in the first six months of 2015. What I can tell is that after the second half of the year, this will drop dramatically. We will experience a dramatic drop. Therefore, we decided to buy more wood from third parties and the situation will become more aggravated in the third and fourth quarters of this year. Meaning that we will be bringing more wood from third parties to be able to preserve our forest and therefore have a drastic drop of wood from third parties and also the average distance. We made all of the analysis. And the return on employed capital is therefore very significant to our shareholders. And so the good news is that good productivity gains that we are able to get at Mucuri. In a gradual fashion, we will be able to operate below our structural cash cost in the company for a certain time.

So next year, we will expect a drop for less than half of third party wood purchases vis-à-vis this year in terms of longer distances. And in addition to that, we will also have significant productivity gains in our forestry operation at Mucuri. So we really wanted to disclose these figures. And I would like to reemphasize that we couldn't disclose it sooner because we still had to buy more wood from third parties. And we were afraid that by disclosing it too soon, this could impact the prices of wood. But as we almost bought everything we needed, now is a good time to disclose the numbers. This is a very important chart because this really shows how the company is performing and how important cash cost is for us from now on.

We are making good progress in terms of our industrial cash cost. We also made significant strides towards our harvesting cash cost and third party wood at Mucuri and the average distance improved. The good news is that in a very short period of time, all of these will be reduced and this is quite positive. And just for your knowledge, this really impacted our CapEx because buying more wood from third parties impacts OpEx – so impacts our CapEx and our OpEx because we have to pay more for transportation cost, but the short-term combination more than offset the benefits that we will be able to have in the long term.

The next good piece of news I have for you is a third area where we will be working with. As I said before in our strategic pillars, one of the pillars refers to a gradual reduction in our structural cost. The second important pillar of the process refers to search of new business that can have a good scalability, possibilities for their future, business that are adjacent to the ones where we're already operating and the asset base is higher than our current asset base.

The next that we have in mind is lignin. If you look at the lower part of the chart you will see the manufacturing – the production process of lignin. The tree consists of lignin pulp (22:47) and we extract lignin. And we produce black liquor and we put in the recovery boiler for burning and energy recovery. The idea now is to take this lignin and turn it into chemical products that can replace the carbon chain of oil. What we're doing is quite positive. We already have several applications such as rubber, phenolic, resins, cement, additives which would help a return that surpasses the return of energy in our Limeira unit. We anticipate a scale up of 20 months on the pilot plant. We had a very small plant of one ton a day. And we will upgrade it to a plant of 20,000 tons a year. And this capacity will happen in the next 12 months with a CapEx of R$70 million approximately.

This is quite significant because it accounts for three times more the sale of energy that we have in terms of return on capital employed. The good piece of news is that this project as other (24:05) projects in the project of FuturaGene and the three adjacents that we already have today, we have high scalability. These are projects that allow us to bring higher volumes in the future, especially in lignin. Our (24:21) in all of the plants if we fully operate with investments in all plants, we will be able to have approximately 185,000 tons of lignin. This is a new target. This is an innovation at Suzano. This is part of our DNA and this is part of our complete (24:40) innovation program and we are now introducing this new program to the market and that was a decision by the board.

With that, I conclude our presentation. And myself and my team are now available to take your questions.

Q&A

Operator

Our first question comes from Caio Ribeiro from BTG Pactual.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Good morning, everyone and thank you very much. I have two questions. First if you can comment on the short-term scenario for pulp now looking towards the next few months, how do you see demand in the different regions and whether you also see any room for further price increases? Also could you please comment on the yuan depreciation from China that we saw recently whether you see any impact on the supply and demand landscape?

Secondly, about the paper market, how do you see the evolution in the short run and what are the expectations in terms of closing the domestic demand for this year and whether you see any room for increases in paper?

A - Carlos Aníbal de Almeida Jr. {BIO 6275986 <GO>}

Good morning, everyone. This is Carlos Aníbal. Thank you for your question, Caio. Currently, our view is very positive in terms of the basics because they will support the current prices in our market. The global demand grew by 4%, eucalyptus grew 19% and inventories are at their very lowest, 31 days even though there is no new capacity in the last few months, but there is one thing that may change the market dynamics in the next few months, which is the situation at Rizhao (26:51).

I will just briefly comment on the different elements and basics and, at the end, I will refer to your question about renminbi. So in the second quarter, we experienced a growth of 2.7% of pulp demand growth, an increase of 3.2% growth vis-à-vis the first quarter. So the year-to-date growth is 4%. We also see a strong demand of pulp from eucalyptus. In the last six months, the growth was 10%. China performed well in the first half of the year, growing 2% vis-à-vis the same period of last year. Eucalyptus is the highlight because it grew 17%. In July, demand was quite robust in all regions and the volumes performed as expected in the area we had the closing of the business in August. So once again, we have a very positive reading of this market.

When it comes to supply in the first half of the year, we had an average rate (28:07) of two percentage points above the numbers of the same period of the last year before. Hardwood in June in terms of CapEx was about 101% and this shows the current perception of a robust performance of eucalyptus pulp.

In the Northern Hemisphere, the numbers, contribute to our lower inventories. Rizhao (28:37) is a plant of 1.6 million tons located in Shandong (28:41). Two lines, one line of 1.5 million that started up in the last quarter of 2010. The plant is located in the midst of a city. The plant is supplied by water coming from artesian well. The region has been severely affected in the last few months for a lack of rainfall and, as a consequence, the availability of water was quite low. So, today the local model is trying to deal with this low availability to supply the population. Therefore, the local government decided to stop various small line of 300,000 tons in the first part of June and the second line of 1.5 million in the second half of the month. There are a lot of rumors about the starting up again of that unit whether operations will be resumed by October until they conclude the construction of a new canal that will pump water into the region but there is also another rumor that says that the plant should be resumed any minute because of a strong rainfall of the last few days.

But again, there are many uncertainties, but I believe that what is more important regardless of the plant in China is that the investments will be able to support all of the prices, the current prices. And the other aspect is that we are closing businesses in China at price levels that were part of our plan. Inventories again are low in all chains. The industry and producers have low inventories. Our clients have low inventories, 38 days of short – short, with my understanding is a very low number at the end of June. So 38 days is the lowest number in the last five years. I think we had four million tons to five million tons in addition that should probably increase that number balance of inventories of short wood. So it once again is a very low inventory level. We had a reduction of 60,000 tons of inventories in the first half of the year. In the second quarter we sold everything we produced. We are operating with inventories at very low levels, much lower than we would like to be operating with. Current prices today are 810 the gross price in Europe, 700 in Asia, and in U.S. So once again this is a positive reading. Prices are supported by all fundamentals in China in the last few days. We had an increase of about $20 to $30 of prices in the stock market of short wood and that was also due to (31:42).

Now about yuan, the Chinese currency, we had 2% to 4% depreciation in the past few days and pulp and paper prices are managed according to supply and demand, as it happened at the beginning of the year, the (32:00) prices changed. So I don't see any short run any impact from the depreciation of the renminbi. Well, we will have differences in the Chinese prices but we would benefit from imports. China, exports more than 10 million tons of paper.

So in the short run, well, I don't see any major impact coming from renminbi but it is important that we keep monitoring this relationship between hardwood and shortwood. And also, it's important that we monitor the margins of paper producers. We haven't seen any – we haven't experienced such significant pressure as we are seeing today. In the case of paper, demand continues to be impacted by the macroeconomic situation and this was mentioned earlier on in the presentation. There was a drop of 7.5% in the demand of the products that we sell.

Well, it was lower than the 12% that we posted in the first quarter. There was also a better performance in our market. In terms of printing and writing paper in the second quarter, the performance was very positive. (33:21) part of the volume of the National Program of Textbooks (33:26) and particularly we may see a stronger trend in the next few months which refers to gains of market share. So we gained market share in the second quarter but we believe that we will continue to gain more market share in the forthcoming quarters.

Imports came down by 31% in the last quarter vis-à-vis the second quarter of the year before. In July, coated paper, which was the bulk of our exports, imports was down year-to-date by 35%. July 2015 and July 2014 had a 57% reduction. So once again, we are prepared to absorb this decrease – increasing our sales and as a consequence we will then increase our market share. We are also taking advantage of the good exchange momentum. We grew volumes in the second quarter vis-à-vis the first quarter of this year and also vis-à-vis the second quarter of 2014. Therefore for the third quarter in terms of exports, we anticipate stronger exports, stronger than the second quarter and stronger when we compare to the third quarter of the year before. We are announcing a series of price increases.

As of August 1st, we increased the creditors' line by 9.5%. As of September 1st, we will also increase by approximately 10% non-coated paper to (35:11). And as of September, we will also increase the prices of paperboard. Therefore our strategy is well elaborated, looking our matrix product channel. And this is aiming at having a successful operation as we had increases there (35:30). We see the need coming from demand. But we can support this increase in the domestic market and this also brings about another addition on incentive coming from exports, more exports.

So the at the current exchange rate, we have a large volume of our export base on this current exchange rate. But we still have more in our domestic care (35:57). Therefore, we see good opportunities to be more rigorous in this implementation. We won't be able to immediately capture all of this potential. But there is a deployment curve that we'll certainly assure us the gradual recovery of our prices in the next month and next quarters.

We had a gain of 5.5% in the second quarter versus the second quarter of 2015 in the domestic market. This gain could have been higher if were not for the mix that we had. We had a great variation in our sales mix. So paper on the demand side, we do not anticipate I mean any improvement at least for the moment. And our view is that our chains (36:46) are still working with very low visibility in terms of future demand. That's why I would rather not be committed to any demand projection for the end of 2015. But on the other hand, we will certainly pursue greater discipline to start implementing the announced prices.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Thank you very much. It's very clear. Thank you.

Operator

Our next question is from Mr. Lucas Ferreira from JPMorgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Good morning, everyone. I also have two questions. And the first refers to production cost. It is very clear that R$60 million, it's a one-off impact liquidated – settled in the quarter and so the costs should come down in the second half of the year. I think this is the major reading. I just want to understand whether my reading is in the fact that now the spot price is close to R$100 and lower now in the second quarter – at the end of the second quarter and the impact coming from the exchange rate. So my question is can we conclude that your cost of production of pulp should be nominally lower in the second half of the year?

A - Walter Schalka {BIO 2099929 <GO>}

Lucas, this is Walter. No, our costs should still rise in the second half of the year. And the reason for that is what I explained earlier during my presentation. It's because we will still bring more wood from third parties at Mucuri and this will affect our cash cost through wood. In terms of chemicals consumption, we are evolving. This will bring us an increase in the second half of the year. The cash cost is up next year. We experienced a significant drop as of the second half of next year because we had a significant amount of third-party wood, but we will see a one-off increase in the cash cost in the second quarter stemming from a larger volume of third-party wood. Well, we have available wood to cut and use at Mucuri but what we want is to preserve that Mucuri wood to reduce the average radius quicker next year.

And in terms of energy, as you've mentioned it's something that depends on pricing. And in terms of energy volume, our export position is wide (39:31) prices of energy. Apparently in July and August, prices just fell. It's about R$130 per megawatt. We do not know how it will perform because it varies week on week. But we are now buying future energy to our Suzano unit, taking the advantage of the current situation of the market right now. So we're buying future energy to preserve our exports going to market in the next coming years.

Q - Lucas Ferreira {BIO 16552031 <GO>}

I have another question related to working capital in this quarter. I think great part of that was due to your receivables, account and (40:14) exchange variations, et cetera. Can you elaborate more on that, or what do you expect for the second half of the year or you anticipate differences, any other variation?

A - Marcelo Feriozzi Bacci {BIO 17648865 <GO>}

Hi, this is Marcelo Bacci. This is really the effect both the exchange rate and the price in the case of pulp are rising. And this is causing working capital to perform as such. Considering current market conditions, this should continue in the third quarter but for these reasons and this also means that we will have better profits in our business.

Operator

Our next question is from Marcos Assumpção from Itaú BBA.

Q - Marcos Assumpção

Good morning, everyone. My first question refers to the wood balance Maranhão. You talked a lot about Mucuri but can you give me any visibility in terms of the percentage of third party wood and the average radius for 2015 and 2016? How should we expect the progress to occur?

And also I would like Carlos to talk a bit allowance for doubtful debt you referred to the domestic market. Therefore, we are talking about paper prices. Is the ADD increase more focused on this first half of the year or do you think that this will continue and we should be alert? And also I would like you to compare that with other critical moments that occurred in the domestic market, or whether this is a normal level and we shouldn't be so concerned?

A - Walter Schalka {BIO 2099929 <GO>}

Marcos, good morning. This is Walter. I will talk about wood in Maranhão, and thank you for your question. Wood in Maranhão, we have a contribution from third parties in the second quarter of 30%. And this number from third party should continue to be the same in the next quarter. There is nothing that indicate any changes. The trend is very similar. And the average radius in Maranhão shouldn't change in a significant way in the next coming quarters.

We are increasing our forestry base in Maranhão. We are planting closer. And this is something that we will be able to get the effects further on. But in the short run, we do not see any relevant effect in Maranhão

A - Marcelo Feriozzi Bacci {BIO 17648865 <GO>}

This is Marcelo, Marcos. Referring to allowance for doubtful debt, we only have some one-off situations thus far. There was an increase in ADD about R$6 million in the first half of the year which is not very relevant but this is a matter of concern to us. The chain has been pressured by lower volumes. We have low availability of credit in the market for all kinds of credits, especially regarding midsize companies in the paper industry. Therefore, we've been concerned but we haven't noted any relevant effects to-date but this has meriting our attention.

Q - Marcos Assumpção

Very well then. I just have a follow-up question about wood, Walter. Looking forward and taking into account your current forestry base, so is this a normal level in terms of third party wood, 30% from third parties and the remaining would be your own wood or you think that this ratio should change if you look at the mid to long range?

A - Walter Schalka {BIO 2099929 <GO>}

No. I think, yeah, this is the normal range, maybe a little bit less wood from third parties, but this is a normalized figure.

Q - Marcos Assumpção

Just one last follow-up. With this current profitability level that we see today at Suzano and in the industry as a whole. With the cash generation that you carefully have, how do you see your return on invested capital of the company? I remember that you questioned the return of the industry but do you believe that at these levels, the return is satisfactory?

A - Operator

Well, return of employed capital currently are very positive. Well, we have to understand capital employed as being something that is denominated in reals but part of it should be denominated in dollars because they refer to investments denominated in U.S. dollars, but we are pricing it in reals. And then, the capital employed of today at the exchange rate and the pulp price that we have today, the returns are very positive, but the issue refers to how sustainable this is in the long run. We are adopting a very clear strategy and also quite positive to the market.

And first, that refers to a continuous reduction of our costs throughout time therefore we do believe, that we still have room for further cost reductions and we are working in projects to meet that goal, both in terms of forestry coming from harvest and forestry logistics, as well as, on the industrial side and others. So therefore, we are deploying several actions. On the other hand, we have to look for adjacent businesses that will add value to our asset base. A combination of all of these activities would provide us with a less volatile return on employed capital. Currently, this is very positive but we have to be humble enough to understand that considering the industry as it is today, we have to look for sustainable growth instead of only celebrating one-off situations. And good returns of capital deployed, we have to get to be prepared for the future, that's why we are very determined to go into that direction.

Q - Marcos Assumpção

Thank you very much.

Operator

Our next question is from Viccenzo Paternostro from Credit Suisse.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

Good evening, everyone. And thank you for the question. My first question refers to CapEx. CapEx related to wood and Mucuri mill. I don't know whether you can give me more details about how you calculated that CapEx and how can we calculate that in terms of positive returns. You increased by R$300 million your CapEx and it refers to the purchase of wood.

So is it possible to say that in the next few years, we will see lower CapEx, because you will no longer have to buy wood in the future or can you also give me an idea of how much that will be responsible for reducing the cost in Mucuri. So this is my first question. Thank you.

A - Walter Schalka {BIO 2099929 <GO>}

Viccenzo, this is Walter. Good morning, and thank you for the question. The additional investment of wood in Mucuri is about R$100 million, in addition to, I mean, it's higher than what was anticipated before. Our sustained CapEx will still remain in the same level of R$1 million or R$1.1 million. So, this is our sustained CapEx and this is for current and it will continue to happen.

The difference between those CapEx and the total CapEx comes from two different lines (48:13). One refers to purchases of third-party wood and we have a high number this year. And in addition, we are also adding another R$100 million. And the other part which is not irrelevant but quite relevant refers to the retrofitting of our operations, that will bring a return on capital employed of at least 20%.

In order to capture that in your model, I think you may consider that we have approximately today a wood consumption in Mucuri of about 6.5 million cubic meters a year and this 6.5 million cubic meters a year also consider the average distance from 2012 until now by 200 kilometers, it was increased by 200 kilometers. But once it comes down with time, we will go down, decrease another 200 kilometers. Therefore that we will come down by 200-some kilometers in terms of reduction. If you analyze the impact of that, you will then have the impact of the cash cost at Mucuri and this will also have an impact on the total cash cost of the company.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

In terms of CapEx just to clarify, I think that the number was R$1.5 million and about R$1.1 million was recurrent or sustained and there was R$400 million in high return projects that you talked about so now the number is R$1.7 million or R$1.8 million, so R$100 million refers to wood and the difference refers to new high return projects, right?

A - Operator

Yes. It was one pipeline 530 (50:12) and now is R$1.7 million or R$1.8 million depending on the volume of wood and the speed of which the projects are deployed. And the difference between one 530 (50:26) to this new level means – some part comes from wood and the other part comes from other projects with high returns.

Q - Viccenzo Paternostro {BIO 17670256 <GO>}

My second question is about the capital allocation. After I did some calculation and assuming that the exchange rate will be as it is today and by the end of the year your debt level is low, so for next year debt level – I mean you still expect to have high cash generation. I just want to understand whether you can tell me something about your priority cash or allocation of cash, whether you have some project in line, or if you have any project being current, analyzed or whether you intend to pay the most expensive debt or increase dividends. I just want to have an idea about your cash generation for next year.

A - Marcelo Feriozzi Bacci {BIO 17648865 <GO>}

Good morning, Viccenzo. This is Marcelo. Yes, we will see an acceleration of the net debt over EBITDA ratio. So next year, we are focusing on the strategic areas. First, additional projects that can be deployed to improve the long-term return of our assets, bottleneck, et cetera. We are looking into several alternatives that can be implemented next year. Also we see some investment alternatives that can help us to reduce even further the average radius of our operations. We will continue to invest in adjacencies in projects like lignin that was announced today and that investment will take place next year.

So projects of this magnitude, this is what we are looking at. In our radar, we do not intend to do (52:38) or line duplication or anything like that because we still believe that the risk/return ratio of this project is not adequate yet. And if we had adequate market conditions, the return will be good. The slight changes in market conditions can really change the return and it could differ materially from what we may have expected. Increase in dividend is another possibility. The trend is that we will recover in time a dividend payout that would be more in keeping with the historical dividend yield of the company. In the last three years, we paid out very low amount. Thank you very much.

Operator

Our next question is from Thiago Lofiego from Merrill Lynch.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you. And good morning. I have two questions. Concerning cost, how much of the variation of R$61 per ton in your cost with no downtime is recurrent? If you can give me the numbers in real per ton. And how much of the downtime costs, which was R$36 per ton, how much of this R$36 is out of the curve for a downturn? I would just like you to elaborate more on that.

And now revisiting the average radius, can you please reinstate the actual number for the average radius for Mucuri and whether you can quantify the impact? And my last question, if you allow me refers to capital allocation, going back to Viccenzo's question, now the acquisition in other non-pulp market, is there a possibility that you will look at other paper markets in Brazil. I just want to understand your rationale.

A - Operator

Good morning, and thank you for your question. You're talking about our cash cost. I would just like to elaborate on that. Our cash cost was R$626 in this quarter, R$594 year-to-date. The cash cost in the third and fourth quarters of this year should increase. And the only two reasons, and the main reason are increases in the average distance in Mucuri and the decrease in energy prices. These are the main reasons. And as of the third quarter of next year, we will see a drastic drop in the average distance of the Mucuri forest. We acquired third-party wood and we will start cutting early this year, in the end of early next year and the end of this year. And then as of the second half of next year, we will have very little wood to acquire. That's why we should expect a very strong drop as of the second half of next year in the cost of wood at Mucuri and the cash cost of Mucuri and the general cash cost of the company.

So I would like to reiterate that this is a deliberate decision of the company in terms of the wood operation because further on we will experience a significant drop. Our restructural cash cost is certainly lower than the cash cost that we have today. Today's cash cost have a significant burden coming from wood in Mucuri and this impacts our cash cost. That's why we see an evolution from 2012 to-date in terms of capital allocation which was also part of your question.

Marcelo said that we will look at the other restructural projects towards the future, both in terms of forestry and industry. And it's possible to assume an increase in dividend payout because I think we have to remunerate our shareholders accordingly considering our cash generation. But even then, we will have a significant deleveraging. We will start paying the most expensive debt. The reduction of our cash level – we have a policy to reduce the cash level of the company, because while we have the Imperatriz project, we decided to have a higher cash position. But today given the fact that the company committed to deleveraging, this is no longer necessary. Therefore, we will probably reduce our cash position.

We are also looking at the redesign of the industry which is in the third pillar of our strategy. There are several alternatives about how we will allocate capital in the future. I've always been very clear with the markets saying that we would not look at M&A as long as two other preceding conditions were established. The first being an increase in the value of the share. We thought that the share is not really quite representative of the value of the company but now the value of the stock increased significantly. And certainly, I will not comment on what I think will happen to the price of the stock, because it's not up to me to say that.

And the other issue is, is that our debt position now is much better than what we had before. And this is – it's been happening gradually. We went from 5.2x and now it's 3x and with a relevant trend towards the next quarter. Therefore, our position will be much more comfortable as of next year and this will allow us to discuss more encompassing issues related to the industry redesign.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you very much.

Operator

Our next question is from Alan Glezer from Bradesco BBI.

Q - Alan Glezer {BIO 17508681 <GO>}

Good morning, everyone. And thank you for this opportunity. I have two questions. The first about paper. We've noted that 20% increase in sales in the domestic market this quarter; at the same time imports are falling.

I would like to understand whether you see any more room to gain share from imported products considering current measures were importers are squeezed with the current exchange rate, or whether you saw some movement from other players in terms of increasing prices as you said that you will do in August and September. The (59:35) prices will also go in that same direction? This is my first question.

The second question refers to the regional drop we saw increased of sales to Europe. Do you believe that this helped your effective cost and whether this should be maintained throughout the second half of the year? Thank you.

A - Carlos Aníbal de Almeida Jr. {BIO 6275986 <GO>}

Alan, good morning. This is Carlos Aníbal. Thank you for your question. We experienced a significant drop in exports, especially in July, specially coated paper, 67% vis-à-vis the same period of last year. Coated paper is the bulk of our export, so certainly we've been able to gain market share in the second quarter and we are considering the fact that we do believe that we continue to gain market share in the second half of this year.

Our contribution has increased. Our share has increased when compared to what we have last year. What I've been hearing from our clients and competitors is that some of them have already increased their prices. Therefore I think it's natural that they do it, especially the non-integrated producers. They are suffering with margin pressures due to a significant increase in the price of pulp in the last few months. In terms of pulp, we have a geographic mix and we experienced a growth coming from Europe and a decrease coming from Asia. That's why we have to look at that. Every quarter, there are variations due to our commercial strategy and our volume availability. Therefore I think that our expectation is that we will continue to operate with the mix – very close to the mix that we had in the last 12 months. There is nothing that could justify stronger contribution coming or stronger shares coming from China or Europe.

Q - Alan Glezer {BIO 17508681 <GO>}

Thank you. And congratulations for your results.

Operator

Now we conclude the Q&A session. I would like to give the floor to the officers of the company for their final remarks.

A - Walter Schalka {BIO 2099929 <GO>}

This is Walter. I would like to thank you very much for participating in this conference call. I would like to say that the company is very pleased with some of the results that we had this quarter. The operational cash flow of the company is growing significantly. The deleveraging of the company is also taking place. The progress in our operating unit is bringing about better results. Our investments as a whole have given us returns on the capital employed, even higher than what we planned. We are also progressing in terms of our relationships with our employees. We are training them, educating them, giving them better conditions in our plants. We are working in a very encompassing way to improve IT. We are introducing liability management progress. In terms of our relationship with our customers, we still see room for further improvement. Therefore, I am very pleased to see how the company is performing. But I'm also very humble to recognize that our results were below our potential in the second quarter, but we are working hard to change that situation, to revert that situation.

I believe that the transparency that we always pursued with shareholders, investors, analysts, banks and the society as a whole is what will certainly prevail in the company. And this has become a very positive move on the part of the company. So my final message is very positive. The company is going through a very positive moment and especially towards the future, we see very positive days.

Thank you very much for your participation. And Michelle and Marcelo will be available further on – later on to answer questions that you may still have. Thank you very much and have a good day.

Operator

Suzano Papel e Celulose conference call is now concluded. I would like to thank you very much for your participation.