

Q2 2019 Earnings Call

Company Participants

- Andre Gomes, Regulation Officer
- Gustavo Estrella, CEO and Chief Planning
- Unidentified Speaker, Unknown
- Yuehui Pan, CFO and IR

Other Participants

- Marcelo Sa, Research Analyst
- Thiago Silva, Research Analyst

Presentation

Operator

Good morning. And thank you for waiting. Welcome to CPFL Energia 2Q '19 Earnings Results Call. Today we have with us Mr. Gustavo Estrella, CEO of CPFL Energia; and Mr. Pan, CFO and IR officer as well as other officers of the company.

The presentation will be available for download at the website, www.cpfl.com.br/ir.
(Operator Instructions) It's important to mention that this call is being recorded.

Before proceeding, let me mention that forward-looking statements are being made under the safe harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of CPFL Energia management as well as on information currently available to the company. Forward-looking statements are not guarantee of performance. 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 CPFL Energia and cause results to differ materially from those expressed in such forward-looking statements.

Now I will turn the conference over to Mr. Gustavo Estrella. Please Mr. Estrella, the floor is yours.

Gustavo Estrella {BIO 18109709 <GO>}

Good morning, everyone. Thank you, very much for being with us in this call for the Second Quarter of 2019 for CPFL Energia.

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I will start on Slide #3 where we have a few highlights for this quarter. The first one is an increase of 0.9% in the load of our concession areas. I think it is important to say that we did have a migration movement for a free client to the National Grid, the direct connection to the National Grid. So this 0.9% in the same comparison base will be around 1.5%, which is more or less of what we have had in terms of load increase in the concession area in the past few years. We'll talk more about that in the coming slides.

The second highlight is about our EBITDA. We have reached BRL 1.5 billion, a growth of 9.9% vis-à-vis 2018. The net income of BRL 574 million, up 27.4% vis-à-vis the Second Quarter of 2018. Here we have an important variation in our net debt. We are reaching a net debt of BRL 11 billion. And our leverage, which is an indicator of net debt over EBITDA, is of 1.93x. And once again, I should highlight that this figure is already impacted by the results of our IPO -- or re-IPO in June, where we had BRL 3.7 billion coming into the company's cash. Investments of BRL 521 million, also up 23.5% vis-à-vis 2018. Here our forecast for 2019 is a total investment of BRL 2.2 billion for the whole year of 2019.

An important impact also was in the tariff adjustment of RGE, now combined to RGE South, with an important increase in our Parcel B, which basically had a transfer of the IGP-M rates. So we reached a growth of 7.14% in Parcel B of our prior RGE and 9.10% of RGE South, 2 important impacts with the growth in Parcel B.

And finally, this is the effect of our re-IPO. As I said, in June, we had funds come into the company of BRL 3.7 billion at BRL 27.5 per share in the period of a little over one month, we had a variation in the share prices of almost 24% starting on June 12, which was the pricing. And also with a daily volume of trading of BRL 109 million, very significant to the company.

Turning to Slide #4. We have our energy sales. As we have mentioned, our load in the concession area had an increase of 0.9%, adjusting the impact of the migration of our client to the National Grid. And this client has zero margin. Therefore, it does not affect our results. But that affects the perception of growth in energy consumption. So in comparable basis, the load is actually growing 1.5%.

In sales, there was a drop of 0.8%. And this is an important effect in this quarter. It was the billing calendar effect. The billing calendar did cause a negative effect on sales. But I think the most important figure is really the load, which is what is affecting the non-billed invoice. That's what's affecting the company's results this month. So when we analyze sales by segment -- and this is the figure that really has to do with the 0.8%. And we do have a negative performance in residential, industrial and others.

And we have a chart on the bottom right of this page. We show the billing calendar effect, the temperature and the migration to the National Grid. If we make the adjustments in each one of these segments, you can see that the residential area goes from a drop of 1% to a growth of 1.9%. If we adjust the billing calendar and the temperature and if we hold the same analysis for the industrial area, it will go to a growth of 1.4%. And the commercial area from 0.5%, it would grow 2.4%. So it's important to make this type of

adjustment so that you can have a consistent and realistic overview regarding energy consumption, which is maintaining at 2% level as we have had for the past two years.

Also important is to talk about losses. Losses are basically stable vis-à-vis 2018. We also have had challenges in the macroeconomic scenario in which the country finds itself today in terms of losses control. So we are maintaining losses. But these are still above the regulatory losses. So we do face a challenge there. I will talk further on about delinquency. But losses is a challenge for us right now.

And now, we have the profile of our market. 38% of the market comes from the industrial area, followed by 29% coming from residential area, commercial area 17% and others also 17%.

Now turning to Slide #5, we talk a little bit about the weather and the macroeconomic scenario. We have the 2 main impacts in our market and they are related to weather. The first, rainfall especially in the South region, which is affecting significantly our irrigation market. You can see in the month of April and May, we have a rainfall volume that is higher than all-time averages. Therefore, we have an energy consumption related to irrigation that is lower than what we expected.

And also talking about temperature, we have a very specific effect in the South region, where we have an average of temperature in this quarter of almost 1 degree higher than the all-time averages. Therefore, consumption, especially residential and commercial related to heaters, also that allows us to have a lower energy consumption.

In the bottom part of the slide you see that we have a scenario of a slow economic recovery. The unemployment rate is still high, around 12%. Industrial production, there was a drop in the Second Quarter of 1% and retail sales with a shy growth of 0.8%. So all of these combined can somehow explain energy consumption at low levels, close to 2% as we had in this quarter.

Turning to Slide #6 to talk about delinquency. As I said, we also have a major challenge when we talk about delinquency. In comparison to 2018, we had a growth of 53.7% of our ADA in the results from BRL 41 million to BRL 64 million. And also, there is a shy or a slow drop vis-à-vis the First Quarter of 2019. But this is a subject that's really taking up our time. And we are dedicating a lot of attention to control delinquency. And as we can see, the main action regarding collection is to disconnect energy. So you see that there is a significant growth when we compare that to 2018 of over 30%. And not even that has been enough to control our delinquency. Of course, that increase in the disconnections is recent. So we expect that it does bring positive impacts over the next months.

And on the bottom, basically doing a benchmarking with other companies, we see that in general there is an upward trend in delinquency not only in our concession areas but also in other concession areas as well. That's something that's general that's happening.

On Slide #7, talking about hydrology. The expectation to close the reservoir levels for August now should be close to 44%. The all-time average is around 54% for the same

month, August. We're a little bit below. But this is not a concerning scenario, at least not in the short term. We're seeing here as an expectation for the next three months. So we should have rainfall that is lower than the average. This is already happening. For the Southeast in August, we should have around 80%. And in the South region 40%. So this is a point of attention. And it should bring the short-term prices to higher levels. But this is not a major concern as of now.

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To the right, we have what we expect for GSF. And remember, these are the most critical months for GSF, from July to September. And we should reach something close to 45%. But in the year average, it should be 15% to 16% for 2019.

Now on Slide #8, we have our performance on Renewable Generation. We have here our 3 main sources. The first of them, the biomass, has a positive impact of 21 gigawatts hour, basically thanks to better weather conditions that allowed us to have a sugarcane crop with a higher bagasse production so that we could have also higher generation than 2018. In our SHPPs, we have an increase of 132 gigawatt hours, thanks to Boa Vista 2 that allowed us to have a greater generation capacity when compared to 2018. And finally, in the wind area, we had a drop of 67 gigawatts hour basically because of lower wind performance. We still have winds lower than the ideal curve and that is affecting generation in this quarter.

I will now turn the floor to Mr. Pan. And he's going to go into the details about the financial results for this quarter.

Yuehui Pan {BIO 20609514 <GO>}

Thank you, very much. I will try to speak Portuguese. And I hope you may understand it. We have reached our EBITDA in the Second Quarter. From 9.9%, it has increased. We had an EBITDA of BRL 873 million in the Second Quarter in the Distribution segment, an increase of 13.8% in the comparison to the same period of '18. The main effects have been BRL 235 million in market growth. And there is a variation of 0.9% in the net load of losses. And also, there was an increase of tariffs because of adjustments in the IGP-M in Paulista and Piratininga as well as the application of the fourth tariff review cycle for RGE in June of 2018.

We also had a higher restatement of the financial asset of the concession in the amount of BRL 63 million, thanks to a higher IPCA. On the other hand, we had a positive effect of BRL 93 million in the Second Quarter of 2018. That was because of the new regulatory asset base adopted with the tariff review. This has not repeated this year.

And finally, there was an increase of BRL 86 million of PMSO. And we should highlight here expenses with asset write-offs as well as stemming from CapEx which are not related to inflation BRL 25 million; ADA, which has increased BRL 22 million because of the delinquency increase; also, expenses that have been impacted by inflation corresponding to BRL 17 million; legal and judicial expenses BRL 8 million; and expenses with Private Pension Fund BRL 6 million.

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In the Conventional Generation segment, we had an EBITDA of BRL 334 million in the Second Quarter, an increase of 11.8% in the comparison to the same period of 2018. The main effects were: the inflation transfer to contract prices BRL 22 million; and a higher volume of hydro and thermal generation amounting BRL 13 million.

For CPFL Renewable, we had an EBITDA of BRL 251 million in the Second Quarter, which corresponds to a drop of 1.9% in the comparison to the same period of 2018. And the main effects here were: a first award in tax credits recovery in the Second Quarter of 2018 amounting BRL 17 million; lower wind farm generation corresponding to BRL 16 million; the end of the grace period in the O&M contract of the wind farms of Campo dos Ventos and Sao [ph] Benedito; also, seasonality of contracts they have brought a gain of BRL 28 million, thanks to a higher allocation of energy in the Second Quarter of 2019. And remember, this effect should be offset in the upcoming periods; and also, lower expenses with GSF.

In the segment of Commercialization, Services & Others, we had an EBITDA of BRL 46 million in the Second Quarter, down 2.3% in the comparison to 2018. And the main effects were: in Commercialization, a drop in the EBITDA margin because of a lower commercialized volume; and in Services, on the other hand, new contracts and a higher operating efficiency have allowed improvement in the results, corresponding to BRL 11 million.

So finally, our net income was BRL 574 million with a variation of 27.4% when compared to the Second Quarter of 2018. In addition to the variation of BRL 135 million in the EBITDA, the main effects were: in the financial results, an improvement of BRL 34 million mainly because a drop in the net indebtedness, which already is adjusted by sartorial[ph] financial assets and liabilities with a benefit of BRL 22 million; and the revenue coming from fines and interests coming from late payments. It's important to highlight that the lower ADA or higher ADA is offset by a greater financial revenue. Depreciation has varied BRL 6 million. There was an increase in taxes because of the improvement in the results.

So now let's turn to the next slide. On the first chart, we show the financial covenant index variations. In this calculation, the net debt is adjusted according to the equivalent stake of CPFL Energia in each one of its subsidiaries. So considering that the pro forma net debt totaled BRL 11 billion and pro forma EBITDA for the last 12 months reached BRL 5.7 billion, the ratio pro forma net debt/EBITDA at the end of the Second Quarter of '19 has reached 1.93x. We should highlight that if we were not to consider the offering of the re-IPO, the net debt would be BRL 14.6 billion and the ratio would be 2.57x.

In the second chart, we show gross debt and the breakdown by indexer. As we can see, 64% of the debt is linked to the CDI, which explains that performance in the third chart, where we can see the reduction in the cost of CPFL Energia debt.

In the last chart, we have the cost of the debt for CPFL Renovaveis. In May, CPFL Renovaveis issued debentures in the amount of BRL 838 million, which have been allocated to prepayments of most -- or more expensive debt in order to get in line to CPFL Energia costs.

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So let's talk a little bit about re-IPO. The total offer, 134 million; total offering, BRL 3.7 billion. We had 58% of investors in Brazil. 42% of investors were foreign. Almost 4x the subscription.

So now we should have in -- participating here at least one independent member as the Novo Mercado Regulation defines. CPFL now has 2 independent members. The committee meetings can only be held validly with the presence of all 3 members of the Related Parties Committee. So this is to show the market the concern about the subjects on corporate governance with accountability and transparency.

So we have created a new department called corporate governance. And the Director responds administratively to the Chief Legal Officer and functionally to the Board of Directors. On May 21, CPFL has announced a payout ratio minimum of 50%. To pay more than 50% is going to depend on a balance between growth and yield.

Thank you, very much.

Questions And Answers

Operator

(Operator Instructions) Our first question is from Thiago Silva, Santander.

Q - Thiago Silva {BIO 19419043 <GO>}

Congratulations on the results. I have 2 questions. The first one is about the restructuring of the company and generation. Can you give us a guidance on how this is going and what can be done in the balance or in the year-to-date cycle losses?

And second question is the growth via M&A. Just recently, the governor of the state of Rio Grande do Sul mentioned that CEEE is ready to be sold. They need no further approvals. And obviously considering the synergy you have and the location, I would like to know if there are ongoing negotiations. I know this is confidential. But I would like you to talk a little bit about M&A in general and specifically on something on this initiative.

A - Unidentified Speaker

Thiago, thank you very much for your questions. Let's start by generation. We are still following this restructuring plan. And the most important action in the short term is the integration of CPFL Renovaveis into the CPFL Energia Group. This is already happening. We have an important date. We had it last week, on August 5, where we in fact started the integration process. And some employees came to Campinas, leaving Sao Paulo.

So we want to conclude over this year, still in 2019, this integration basically of our employees, all the processes and systems of the company so that we can have integration process, minimizing any possible risks in both companies' operations specifically CPFL Renovaveis. Remember, we are still in the process of signing the SPA,

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which is the purchase and selling contract of operations that we have now with the State Grid. So the idea is to conclude that in the coming weeks. And after that, we should concentrate the share of CPFL Renovaveis in CPFL Energia so that we could then further on evaluate the upcoming stages of integration and restructuring process.

So remember, CPFL Renovaveis is a listed company. So all the requirements of CVM and the stock exchange market will be respected over the process. But the process is -- the idea is that over 2020, we are able to conclude this restructuring process. So I would say that in the very short term, our main focus is on the reintegration of CPFL Renovaveis into Energia, obviously maintaining all activities of the different companies throughout this period.

Now about the M&A. First, specifically about CEEE. We are following the movements of the state of Rio Grande do Sul on this subject of CEEE privatization. We do not have any new information on this after they published the possibility. But just as every market, it's our expectation also that -- to see the government place in the company and the privatization process. So analyzing our strategy of focusing on growth specifically in the businesses in which somehow we have a leadership whether in Distribution or Renewable Generation. This asset because of its geographic location makes all sense in the world for CPFL. And we will assess it if this privatization process really comes up. And not only this one, I think the idea is really to look at the opportunities for investment and distribution that come up. We have an expectation that in addition to CEEE, to see other assets that might be on the market. And for each one of them, we will have focus and we'll analyze if it really makes sense to company. But I'm sure that group focus on growth and distribution.

Now talking about generation, this integration process of the generation arm. And also for us to be better prepared to address this type of growth, we have here, in addition to possible future M&As, also growing via new projects. We're also looking at opportunities to address that growth as opportunities come up. So I believe that growth is especially relevant and a priority to the group. And our radar is out there to check all opportunities that we might find in the market.

Operator

Our next question comes from Marcelo Sa, Itau.

Q - Marcelo Sa {BIO 16454581 <GO>}

I have 2 questions. The first one has to do with the regulatory act, in transmission. And the contribution period has already come to an end. And ANEEL will be publishing the procedures. And I would like to understand if you can discuss this. Or is this all in writing around the distribution side? Because I know have not seen any proposal yet in this regard about the WACC.

A - Unidentified Speaker

Thank you, Marcelo. And I will give the floor over to Andre Gomes, our Regulation Officer.

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A - Andre Gomes {BIO 20515895 <GO>}

In fact, today ANEEL has segregated the public hearings. So ANEEL is discussing generation and transmission. And we are waiting for the second phase to be opened for distribution. So in fact, it was a request on the part of the distribution segment in terms of separating the WACC from distribution and generation and transmission because they are different segments. So we met with (inaudible) the directors. We expect in the second half of the year to resume the discussion about the Distribution WACC. So there is nothing I could add to that.

Q - Marcelo Sa {BIO 16454581 <GO>}

One of the points of this discussion for the WACC generation transition that drew the attention of the market was the very small window, about five years if I'm not mistaken. And you were with (inaudible). Do you think this window could be expanded to 10 years? Or is it too early to say?

A - Unidentified Speaker

Now this is the reason why we ought to separate this discussion because of the rates in the Distribution segment because they are different from transmission and generation so that we could separate this and look at the distribution business separately as it has always been because in the WACC, you have to look at other segments different from the generation and transmission. So we have no details to give you. And we believe that in the second phase for distribution, we will be able to discuss also this issue of the window because we have not received any second phase -- or we have not talked to a second phase. So -- in the same way that there was for Generation and Transmission.

Q - Marcelo Sa {BIO 16454581 <GO>}

And I would like to understand now what you think about the prices for energy. You said that the rainfall expectation has worsened but not enough to have a very big impact on the spot prices for this year. So what about this for the next year? If we take a contract for 2021 or '22, what would be the price of energy today on the contract, let's say if you had to sign the contract today for these years, '21 and '22?

A - Unidentified Speaker

Marcelo, (inaudible) is going to answer your question.

As Gustavo said, we see this about 80% in the Southeast and the South in -- around 40%. And we have the reflex. We see the (inaudible). So we don't really talk about these prices. We do not disclose the prices that we are going with or we are working with. So the market doesn't have this practice in place. But no big oscillations regarding what has been negotiated in the last, let's say, 3 weeks for more long-term prices.

Operator

(Operator Instructions) The Q&A session has come to an end. I would like to give the floor back to Mr. Gustavo Estrella for his closing remarks.

A - Gustavo Estrella {BIO 18109709 <GO>}

Once again, I would like to thank you very much for your presence, for your questions. And in our evaluation, we are delivering a very consistent result in this quarter, with the major growth in our income and also in our EBITDA. And this is the conclusion of a very relevant process for the company relisting in June. And in fact, this addresses our perspective and prepares the company even better for further growth in the next few months.

So I talked about our integration, cogeneration process, which is very relevant. And we have been preparing the company to address this level of growth. And Pan talked about our dividend policy and the other changes but especially in our Related Parties Committee.

So very important steps towards corporate governance. And this is the way preparing the company to address this growth. And we're operating as we have always operated in the market, in a transparent and open fashion with a full disclosure of information and looking at the market as a major partner of ours in this process of growth and of new businesses as well.

So once again, I would like to thank you very much for your presence in this call and wish you a good day.

Operator

CPFL Energia's conference call has come to an end. Thank you, very much for participating. And we wish you a good day.

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