

Q2 2017 Earnings Call

Company Participants

- André Dorf, Chief Executive Officer
- Gustavo Estrella, Chief Financial & Investor Relations Officer

Other Participants

- Monica Busch, Senior Regional Manager-Brazil & Southern Cone
- Vinicius Tsubone, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and thank you for waiting. Welcome to CPFL Energia's conference call about the Second Quarter of 2017 Results. Today with us we have Mr. André Dorf, CEO of CPFL Energia; Gustavo Estrella, CFO and Investor Relations Officer; as well as other executives of the company.

The presentation for download may be found at the CPFL Energia's Investor Relations' website, www.cpfl.com.br/ir. We would like to inform you that all participants will be in listen-only mode during the company's presentation. Afterwards, we will have a question-and-answer session and further instructions will be given. We would like to remind you that this call is being recorded.

Before proceeding, we would like to clarify that forward-looking statements that might be made during this call related to the business perspectives of CPFL Energia, operating and financial projections and targets, our beliefs and assumptions of the company's management, as well as information currently available. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties, and assumptions as they refer to future events and therefore depend on circumstances that may or may not occur. Investors should understand that general economic conditions, industry conditions, and other operating factors may affect the future performance of CPFL Energia and may lead to results that differ materially from those expressed in such forward-looking statements.

Now, we would like to turn the floor over to Mr. André Dorf. Mr. Dorf, you may proceed.

André Dorf

Good morning, everyone and welcome to another conference call about, now, the second quarter of 2017. We are with Gustavo Estrella, CFO, and our Investor Relations

team, and some representatives from other areas of the company and we will be available to answer questions after the presentation.

As usual, we start with the highlights, slide number 3. These are the highlights of the quarter. Our sales in the quarter in the concession area went up 0.5%, with a different performance between captive and free market. And we will see later on that the sales in the captive market dropped almost 7%, whereas sales to the free market customers went up almost 20%.

We also saw a reduction in the contracted demand, minus 1.2%, a drop of 1.2% off-peak, and above 2% peak. Increase of 33% in our net operating revenue and 6% in our EBITDA very much because of the integration of RGE Sul. And we also had an excessive volume of investments made in the quarter, almost BRL 700 million invested in this period.

And our net debt closed the quarter at BRL 13.6 billion. So our leverage is 3.28 times net debt-EBITDA ratio. Also we had the RGE tariff adjustment in June with the average effect of 5% to be seen by consumers. And also we had good news in terms of the early start-up of Pedra Cheirosa Wind Complex, 48 megawatts of installed power, and also the early start-up of Transmissão Morro Agudo in July, both projects according to schedule and according to our budget - on schedule and on budget. Besides, we had an update in the process of the sale of control of the company to State Grid, changing the characteristic of the Tag Along Tender Offer. So now we have the Tag Along Tender Offer. So each minority shareholder will be able to decide to sell their shares for the same price as the controlling shareholders.

And I would like to highlight the last bullet which has to do with the public consultation. Today, we are right in the middle of a period in which the Ministry of Mines and Energy is in a consultation about many improvements in the legal framework of the electric sector, and we understand that these are very positive proposals, and with the special attention to the transition periods for these new proposals, but CPFL is actively participating in all debate with the associations, with the government and with the other agents and companies in the Brazilian electric sector. So there is a chance for improvement that we have now. And we are very motivated by that.

On the next slide, number 4. We have a snapshot of our EBITDA in the quarter, BRL 1.027 billion on the left in the pie chart, and we can see that the Distribution segment accounted for 44% of this EBITDA. Generation accounted for 50% if we add Conventional and Renewable and the remainder Commercialization, Services and others.

And breaking down by business, starting on the right by Distribution, we can see or we recorded practically a stability in the quarter, which brought us a growth of 3.5% in the year-to-date for the half year, comparing the first semester of 2017 with the first in 2016, because of the inclusion of RGE Sul in our portfolio. Conventional Generation, a growth of about 15% in the quarter and also in the half year, basically because of the adjustments of the contracts.

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Renewable Generation growing by 21% in the half year, almost 6% in the quarter. And here, we highlight the coming onboard of the wind farm and the sale that happened in the free market along 2016 and 2017, and the non-recurrent fact in the first half of last year, that was not repeated in 2017. So these are the main effects in renewable energy.

In Commercialization, Services and Others, we have the effect of prices and volumes in the delivery of services and the marketing of energy. So, it was the growth of the activity itself.

On the next slide, number 5, we have the energy sales in the Distribution segment. Starting by the highlights, we had an increase in sales in the concession area of almost 16%. And RGE added 2,000 gigawatt hours in sales. And if we disregard the effect of the integration of RGE Sul in the figures, stable sales practically with a 0.5% growth for the period. We also had a reduction in the load measured in the same concession area, 1.8% reduction. Reduction in the contracted demand as well between 1.2% and 2%, off-peak and peak. And the good news about losses is that we had a slight reduction in our losses to 8.84% in the second quarter of this period.

The same information is here, on the upper-right, the load in the concession area. And I mentioned, net of the effect of RGE Sul, it dropped almost 2% with a major difference between free clients and captive clients, some growing by almost 19% and the captive market having a drop of almost 10%.

And on the lower part of the slide, on the left, so we start to tell you about sales in the concession area, a 15% growth; effect of the RGE Sul. So I think we should look at the chart in the middle that excludes the effect of RGE Sul. So now we have comparable periods. So we have stability of 0.5% that I mentioned a while ago.

So if we look at the right, lower right, sales per consumption segment and now net of RGE Sul to make the periods comparable, we can see a slight drop in residential. Remind you that we have the effect of temperatures in the first half of last year, basically in April the effect was very much big, so we had a very warm April last year. So this more than explains the drop in the residential consumption and consumption in the commercial area as well. And in industrial, a slight reaction in the quarter, 2017, 1.3% increase in sales in this period.

Now on slide number 6, we talk about delinquency in the second quarter. The first chart showed the ADA evolution as a percentage of the gross revenue. A slight reduction vis-à-vis the previous quarter, but practically stable, and already a slight recovery, vis-à-vis the more critical periods of the crisis. We can see here a degree of stability between the second quarter of 2015 and the 2017, something around 0.7% of the gross revenue.

On the left, on the lower left, we see the total past due those, about 90 days as a percentage of gross revenues in the last 12 months. We can see here a slight decrease as well and we believe it is a little bit too early to talk about the recovery in the market environment. So, we see an improvement in the margin. Nevertheless, it's a little bit too early to say that this (11:43) our collection actions continue at full speed. On the right,

lower right, we see the number of disconnections that we made in the quarter and the figure is much higher than the track record of the company in this regard.

And on slide number 7, we go from distribution to generation. So our performance in the second quarter of 2017 show we had an early commercial startup of Pedra Cheirosa Wind Farm or Wind Complex on budget and on schedule.

We also had and we still have for some reason an unfavorable hydrological situation and this has been impacting the volatility of our spot price and we see a high volatility in the spot price and some concern with the hydro situation already. Likewise, we had unfavorable wind situation in the period, the speed of the winds and this brought our wind generation to a level below P50.

Starting on the upper right, we see a slight increase in our installed capacity in the period. So, it grew almost 4%. And here, the startup of these wind complexes, ACL and Pedra Cheirosa. And we see the evolution of the spot price with a high volatility very much explained by the reservoir levels that you can see on the lower left. So you see the interconnected system, the national (13:33) interconnected system. So the projection of ONS (13:35) for August, 32% - almost 32% of the level or the capacity of the reservoirs and much lower than the historical averages. And more stressed difference on the right, which is the Northeast reservoir levels with the projections of 11.5% for this period, also much lower than the historical curves of the previous years.

Now, I would like to turn the floor over to Gustavo Estrella, our CFO, and he will be talking about our results.

Gustavo Estrella {BIO 18109709 <GO>}

On slide number 8, this shows the results of the second quarter of 2017. IFRS and also IFRS net of RGE Sul, so that we can have a more comparable basis. Starting with the IFRS, an increase in net revenue of 33.1%, or BRL 1.482 billion; an increase in the EBITDA of 6.3%, BRL 61 million; and a drop of net income of 48%, BRL 117 million. And on the lower part, so we show the effect by each one of the businesses of the group.

We see in Distribution, practically stable. The result of the discounts and (15:09) this reflects the stability of the market, as André said. Very close to zero growth in energy consumption vis-à-vis 2016, and this can be translated into stability of results, so the main effect. We already have the effect of the RGE Sul here, BRL 26 million, an effect of the exchange rate variation of the Itaipu and it has no impact on the results. So we have BRL 43 million positive. And another important effect is the correction of the financial assets of the - concession. This initiative is restated by IPCA, and that we have a lower IPCA vis-à-vis 2016. We also have the restatement of this asset which is lower, BRL 35 million.

As a main point, it was the reinforcement of our collection actions. As André said, we have good use (16:23), stability with the downward trend of our delinquency. But this still requires a major effort in our collection efforts and this cost us BRL 24 million in this quarter.

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In Conventional Generation, a total variation of BRL 38 million with a price adjustment of the contracts of generation, a more stable result and basically because of the price increases that were transferred.

And we also had the financial adjustments. The UBP of our generating companies also restated by the IPCA. So we are talking about a liability here. When you have a lower IPCA, of course, you have a correction of this liability, which is low as well. So a positive variation of BRL 12 million vis-à-vis 2016 year-on-year.

Renewable Generation, total variation of BRL 12 million. And here, we already have the impact of the start-up of the wind farms at the end of last year, and this brings us an increase in our EBITDA of BRL 28 million. And this effect is partially offset by the reduction of the energy production with lower winds and also vis-à-vis 2016. So we have BRL 30 million left.

And the non-recurring effect that André mentioned, which was the penalty occurred in 2016, and that did not happen again in 2017. So you have a positive impact of BRL 38 million coming from this item.

A variation of BRL 9 million in Commercialization, Services and Others with a concentration of contract at the end of last year. And this thing has (18:40) a positive impact in our volume and also margins because of the volatility of the stock price during the first half of this year.

Now, talking about net income. We have a negative variation of BRL 117 million and the financial result with a negative variation of BRL 154 million. And it is important to highlight here that we already start benefiting from the reduction of interest rates in Brazil. Three-fourths of our debt is pegged to the CDI. So this has a positive impact. And this should be the scenario that we expect by the end of the year. With further drops in interest rate, we should have positive variations in our financial result as well.

And this amount ends up being offset for non-cash effect, and the first one is the exchange variation of Itaipu. With the positive variation that we have, the EBITDA that we give back here, BRL 43 million, also a negative impact of our hedge for our generation farms with a swap. So we had a very positive impact last year with the increase in the exchange rate, and now it is the opposite because of the drop in the exchange rate of 2017.

So year-to-date, it is positive. But in this quarter, we see a negative effect of BRL 39 million. Another important effect is the mark-to-market. So last year with a lot of volatility in the market, in the interest market in Brazil, we had an effect - a positive effect of mark-to-market in 2016, and with stability and the drop in interest rates in 2017, we have a negative effect. And year-to-date, this effect is very positive, but this quarter, it is BRL 33 million.

And just to add the effects on the financial result, we have the consolidation of RGE Sul consolidation, BRL 29 million in our financial result. And of course, the impact of the debt regarding the acquisition of this asset with an impact of BRL 49 million on our result.

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Now, on page number 9, talking about our indebtedness. So our indebtedness closes the quarter with BRL 13.6 billion, our net debt, with stability in our leverage with 3.28 times net debt-EBITDA ratio, with the expectation of an improvement in result and a resumption of the economy, so the trend is to improve results bringing us a lower leverage in the next two quarters.

So, we have three-fourths indexed to the CDI or pegged to the CDI, no exposure here in foreign currency as we have never had. And on the left, we see already the positive impact on the financing cost of the CPFL debt, so 10.6% nominal rate and 7.4% real rate. Once again, a positive trend regarding reduction in our financing cost for the next few quarters.

Now slide number 10, our debt amortization schedule and our liquidity position. And as we always stress, this is an important pillar for the company, the preservation of our liquidity. So, our cash balance today is practically enough to cover all the short-term maturities and up to 2018, a very comfortable situation regarding cash of the company.

On page 11, we have our Pedra Cheirosa Wind Complex. As André said, the start-up one year before schedule, so it's already sold (23:17) with the long-term PPA. Because of this early start-up, we should be selling energy in the spot price bringing a positive impact on our result in the next few quarters as well.

On page 12, our Boa Vista II (23:39) SHPP expected to start up in 2020. And this project, as you can see in this picture, the construction work has already started and financing being negotiated with BNDES.

And here on page 13, we have an update of the two tender offers that we are having both CPFL Renováveis and CPFL Energia with the Material Fact published on July 20 we published. By a decision of the shareholders, we migrated to a mandatory tender offer and which is being analyzed by the CVM.

So with that, we finished the presentation. And now, we're open for questions.

Q&A

Operator

Ladies and gentlemen, we will now start our Q&A session. Our first question is from Mr. Vinicius Tsubone from HSBC.

Q - Vinicius Tsubone {BIO 20139966 <GO>}

Good morning, everyone. Thank you for the call. I would like to hear more from you about the proposals for changing in the sector, how the company intends to contribute to have a more effective sector.

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A - Operator

Good morning, Vinicius. Before the public concentration to improve the legal framework, we were already working (26:16) on changes, reforms and modernization that we believe to be needed as a future vision for the Brazilian electric power sector. And that is, thanks to new technologies that are available to all nowadays, social changes also that will bring the change in the consumers' behavior that want to have more choices and also power to decide on everything that they use and consume not only energy and also market changes.

I believe that this improvement proposal that is under consultation brings a very interesting component of energy contracting model and a series of changes that will bring an impact (27:17) to all the different lengths of this chain in the sector. It's important to say that, for us, these proposals are consistent, are positive when we analyze the future of this segment, and obviously the ministry and all agents that are involved in the initiative.

We do have here a point of attention, which is the transition. We had a model, and the sector that has worked very well that brought us up to where we are now, we have energy provided to the population that - at a very good level.

The model has allowed us to have an expansion in the volume of investment that was very significant in the last 10 years, but now we have to look ahead, if this current model or the past model be applied and be useful in the future, and that's what we have to think about.

So, in our point of view, we have very positive points being addressed, and we are paying attention to that transition from a model that has worked so far, but, yeah, that does need improvement for the future. So we are actively participating on those discussions, so that the electric sector as a whole comes out with a consistent and modern proposal.

Q - Vinicius Tsubone {BIO 20139966 <GO>}

Thank you very much. And now, can I ask another question, please? How do you see the long-term price for energy, considering the reservoir levels today once they are getting closer to a more difficult level, as you have mentioned?

A - Operator

Well, the price has been showing some volatility. We do have a hydrology problem, especially in the Northeast. But thinking in the long term, everything will depend on the next wet period. So I believe the system will be stressed if we once again have an unfavorable wet period. I believe that does not - wet period that will - starting by the end of the year will determine the long-term prices at least for the next year. So it's difficult to say anything right now.

Q - Vinicius Tsubone {BIO 20139966 <GO>}

That's clear. Thank you very much.

Operator

Our next question is from Monica Busch from EDC.

Q - Monica Busch

Good morning and thank you for your presentation. You have mentioned the investments of BRL 698 million. Can you tell us more about investments? How do you see that from now on?

A - Operator

Yes. Good morning, Monica. Yes, really, we are in a very intensive year in terms of investments. We have concluded some important projects and CPFL Renováveis, and we have been investing in the regulatory basis in RGE in our south operations, so RGE Sul and also in Boa Vista. So these are important years so that we can develop our base. And they do require a significant volume of investment. So we are on schedule and we have an estimate for investments, which is about BRL 10 billion for the next 10 years, BRL 2.7 billion in 2017, and a total of around BRL 10 billion in the next five years. And most of that investment will be in the Distribution sector, considering that we have already delivered good part of the project for generation and transmission. So the bulk of it now is going to be towards Distribution.

Q - Monica Busch

Thank you very much.

Operator

We close now our Q&A session. I would like to turn the floor back to Mr. André Dorf for his final remarks.

A - André Dorf

Very well. I would like to highlight that the company, as I mentioned in the release, has been very much active in this first half of the year. We are going through an important control change. In addition to that, we have described several actions that we are working on in the company, and we did have important actions in order to face the effect of the economy in our market. So the disconnections, the collections efforts, we have gone an extra mile in the first half of the year in that sense as well.

In addition to that, we also had the integration of RGE Sul, very important operation for south, and that represents a great potential synergy in Rio Grande do Sul, if we add our assets from RGE - add to this RGE Sul asset now that is integrated, we could have synergies in the future. So we did have a great effort in that integration and also in the team's integration.

In addition to that, as I mentioned in Vinicius' questions, we are actively participating on the discussion to improve the market for the electric sector framework that also is taking

up attention of our main executives. That's very important for the future of the sector and that really demands great attention.

With all that, we were able to maintain our results consistent. In the first half of the year, our EBITDA has increased and we are looking for opportunities to improve in the company's management.

With that, I thank you all for participating in this call. Have a nice day and have a nice weekend. Thank you.

Operator

The conference call of CPFL Energia is concluded. Thank you very much for your participation and have a nice afternoon.

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