

Q3 2017 Earnings Call

Company Participants

- Guilherme Lelis Bernardo Machado, Investor Relations Officer

Other Participants

- Luiz Felipe Carvalho, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Cosan S/A's Third Quarter of 2017's Results Conference Call. Today with us, we have Mr. Mario Silva, CEO; Mr. Guilherme Machado, IRO; Mr. João Arthur Souza, CFO; and Mr. Phillipe Casale, Investor Relations Manager of Cosan S/A.

We would like to inform you that this event is recorded and all participants will be in a listen-only mode during the company's presentation. After Cosan's remarks, there will be a question-and-answer session for industry analysts. At that time, further instructions will be given. The audio and slide show of this presentation are available through a live webcast at ir.cosan.com.br. The slides can also be downloaded from the webcast platform.

Before proceeding, let me mention that forward-looking statements will be made under the Safe Harbor of the Securities Litigation Reform Act of 1996 (sic) [1995] (01:06). Forward-looking statements are based on the beliefs and assumptions of Cosan's management and on information currently available to the company. They involve risks, uncertainties, and assumptions because they relate to future events, and therefore depend on circumstances that may or may not occur in the future.

Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of Cosan, and could cause results to differ materially from those expressed in such forward-looking statements.

Now I'll turn the conference over to Mr. Machado. Mr. Machado, you may begin the call.

Guilherme Lelis Bernardo Machado {BIO 17920567 <GO>}

Good morning, everyone, and welcome to Cosan S/A third quarter 2017 results conference call. Before starting the presentation talking about each business line and the consolidated results, I would like to remember the shareholder movement that happened

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at Comgás S/A level. As already announced through the Material Fact last month, Shell decided to exercise its put option it had against Cosan Limited, CZZ, dated from 2012, converting to stake in Comgás of approximately 17% into shares of Cosan S/A, CSAN3 shares. This transaction, as you know, is subjected to the antitrust commission here in Brazil, CADE. And when completed, CZZ will receive 21.8 million shares of Comgás and deliver to Shell 20.3 million shares of Cosan S/A, CSAN3 shares, plus two cash installments.

Also worth to remember that on October 10, CZZ offered to Cosan S/A the possibility to acquire this stake in Comgás at the same conditions agreed between Shell and CZZ. This operation was analyzed and approved by the Independent Board Members of Cosan on October 16. And when approved by CADE, transactions will happen simultaneously.

As a consequence, the stake of 63% that Cosan S/A holds in Comgás today will increase to almost 80%. And, finally, on this topic in last Tuesday, November 7, Comgás declared dividend in a total amount of BRL 700 million. And when the transaction is approved, the mentioning amount will be adjusted for the payment for Shell of these dividends.

So now let's move forward to chart number 4, talking about Raízen Combustíveis' results. In this quarter, the fuel market was impacted by important events such as the tax adjustments on the main products, and we saw more often price adjustments practiced by Petrobras. Additionally, we see some signs of recovery in some segments of the economy with improved industrial production, increasing in sales of light and heavy vehicles, and also the reduction of interest rates.

According to ANP, diesel sales in the country increased 2% in the car in the quarter. In the Otto cycle, there was a drop of 1% in sales. However, when measuring, the equivalent gasoline sales were stable compared to the same period in 2016.

Looking specifically to our results, Raízen Combustíveis once again performed above the market average and grew 4% in the total volume sold compared to the same period last year, while the Brazilian market only grew 1% in total volume sold, looking for the sales in the ANP basis. In the Otto cycle, our total volume sold grew 2% compared to the third Q 2016. The same comparison in gasoline equivalent showed an increase of 3% as a result of higher gasoline sales, which grew 5% against 8% drop in the ethanol sales.

The diesel sales grew 8%, driven by the increase in the demand for B2B customers, mainly related to agri industry. Aviation dropped at 3% in the volume compared to the same period of last year, reflecting the reduction in number of departures of main customers. However, compared to the second Q of 2017, there was an increase of 7%.

Moving to results. Adjusted EBITDA reached BRL 894 million in the quarter, an important 21% increase compared to the same period last year. This growth continues reflecting the effectiveness of our supply strategy in products and marketing, as well as an increase in sales volumes.

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In this quarter specifically, we also saw an important gain in inventories obtained by price dynamics in the period. It's worth to mention that we treat these inventory gains and losses, when happen, as a recurring part of the business since they are part of the supply and the marketing strategy. The adjusted EBIT increased 22% in the quarter, reaching BRL 724 million.

Looking now to the last quarter of this year, the expectations that we are going to have an adjusted EBITDA similar to the fourth quarter of 2016, and in line with what we have for the guidance of the year, close to the top of the range. And just remember that since July, we have seen almost daily adjustments in diesel and gasoline prices practiced by Petrobras, as I have already mentioned. And at the end of the year, the ethanol dynamics of price volatility can impact the results and we're going to monitor these effects throughout the final quarter of the year.

Moving to the CapEx. Investments totaled BRL 185 million, a decrease of 3% compared to the third Q of 2016. We closed the third quarter of 2017 with 6,138 Shell services stations and net additions of 70 stations in the quarter, in line with the strategy of expansion, focusing on finding best location and assets with the average throughput in line with the current profile of our network.

Now, moving to the chart number five. Let's talk about Raízen Energia. The weather that was drier in the third quarter of 2017, which is the second in the crop year, make it possible to improve the harvesting and the crushing, which reached 28.3 million tons of sugarcane in the third Q 2017, a 10% growth compared to the third Q 2016. The sugarcane productivity reached 10.3 tons of TSR (sic) [TRS] (08:36) per hectare, reflecting the lower concentration of rainfalls in the period, which negatively affected the tons of cane per hectare, which was partially offset by the improvement in the TSR (sic) [TRS] (08:52).

Raízen production mix in the period was 57% dedicated to sugar, compared to 59% in the third Q 2016. It's important to remember that this mix is a reflection of the frequently analysis of the profitability by product that is in the current price levels. The anhydrous and hydrous ethanol are already generating more profitable results compared to sugar, which create opportunities for the optimization of this mix.

The increase in production, coupled with the company's commercialization strategy, enable a higher sales volume in the third Q. Looking for each product specifically, sugar sales in the third Q 2017 grew 17% with emphasis in the foreign market and the higher commercialization of own products. The average sales price in reais already adjusted by the hedge account effects, and currency hedge on sugar prices were 5% higher than in the third Q 2016.

Looking for ethanol, sale volumes were 27% higher than the third Q 2017, with more relevance in the domestic market where the volume was 70% higher than the same period of last year. As in sugar, there was an increase in sales of own products. The average ethanol price was slightly lower than prices perhaps in the same period of last year, but in line with the market looking for the result basis.

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And talking about energy, the higher availability of the gas provided as a function of higher crushing in the period, had a greater production of electricity, which, together with an increasing product trading activity, generated 28% increase in the third Q 2016. Average electricity prices grew 28% and reached 261 megawatt hour in the period - reais per megawatt hour in the period.

Before talking about the EBITDA, I would like to highlight once again the results from Raízen team efforts in terms of cost and operation efficiencies. The evolution of the unitary costs of own products is - in equivalent, sugar was 8% lower, reaching BRL 182 per tonne in the third Q 2016 due to the continuous efforts on efficiency in both agriculture and industrial operations.

In addition to this reduction, it's also explained by the lower cost of CONSECANA index, on average 8% lower, an indicator that, as you know, affected the cost of land leasing and sugarcane from suppliers, and also the greater dilution of fixed costs given the higher volume sold. Even excluding the effect of CONSECANA, the unitary cost was 3% lower compared to the third Q of 2016.

Moving to the adjusted EBITDA graph in order to facilitate the understanding and comparability of Raízen Energia results, since last quarter, we have incorporated the effect of the foreign currency hedge designated for sugar exports into the EBITDA, in addition to the usual adjustments that you have been following. That is the adjusted EBITDA came to reflect a more accurate operation of cash generation price.

Another important point in this is that since the previous quarter, the second quarter of 2017, all new derivative instruments designated for the protection of sugar exports has been accounted into hedge accounting, so that in the future, all instruments, products and sugar exports will be normalized in EBITDA.

Talking about the numbers, adjusted EBITDA reached BRL 1.4 billion in the third Q 2017, 50% higher than the same quarter of the previous crop due to higher sales of own products and better sugar and electricity prices in BRL, as well as the lower unitary cost of sale. In this quarter, the average foreign exchange rates for sugar exports was BRL 3.86 per dollar versus BRL 3.14 of average foreign exchange in shipment. As a result, we had a positive (sic) [negative] (13:33) effect of BRL 296 million, which was recognized in the financial results until the closing of this quarter related to the foreign exchange hedging instruments used to establish the revenues in reais.

It's worth to mention that the basic assumption of Raízen hedging policy is to protect the commodity and current exchange rate always looking at the prices in reais. The adjusted EBIT per TSR (sic) [TRS] (14:07) increased by 52% in the quarter for the same reasons that I have already mentioned.

Now, let's move to the sugar hedge graph. We reached almost 90% of the total volume to be exported in the 2017-2018 crop, protect at an average price of BRL 0.66 per pound, higher than we have seen in the spot market. In compliance with our hedging policy, we have a lower volume when compared with the previous quarter for the upcoming 2018-

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2019 crop. As you know, our strategy is to protect cash flows. We're talking about hedging and seeking to attenuate price volatility to the business. We're focused on increasing efficiency in our operations and manage invested and working capital continuously seeking better returns.

Moving on to the last graph, CapEx. Investments for the period totaled BRL 423 million here, disregarding the disbursements for the acquisition of the two Tonon mills of the acquisition that Raízen made of the two Tonon mills, totaling BRL 823 million. So this increase of 12% is mainly due to a higher investment in biological assets, given the increase in harvest and, as a consequence, a higher expenses in land treatment and renewal of sugarcane fields, and acceleration of monetary investments in projects related to health, safety, and the environment, as well as sustaining.

Completing the Raízen section, I'd like to move to chart number 6 talking about Comgás. As you know, since Comgás already presented third Q 2017 results last Wednesday, let's go straight to the highlights. This was another part of expansion in sales volumes. And I highlight here sale volumes growth in all segments. With a gradual recovery of activity in the main sectors, in addition to the new customers, there was growth of 5% in the industrial volume.

Also, residential and commercial segments presented a 5% volume growth, reflecting the connection of more than 101,000 new homes and 810 new business in the last 12 months. As a consequence, the normalized EBITDA increased by 6% compared to the same period last year due to higher natural gas sales and the correction of the adjustments of margins for inflation in May this year.

The IRFS EBITDA drop at 6% reflects the return of the regulatory current accounting approximately BRL 9 million in the third Q 2017, which closed the quarter with a total balance of BRL 259 million in favor of declines. Comgás invested BRL 126 million in this quarter, 20% higher than the same period last year and in line with the guidance for the year.

Moving to chart number 7, let's talk now about Moove, our lubricant business. As we saw in both Raízen Combustíveis and Comgás results, the best indicators of the country's economic activity also boosted Moove's figures in the third Q 2017. We grew 11% in volume sold in Brazil, once again above the market average, reflecting the company's commercialization strategy focused on increasing the customer base and participation in automakers market in the country. We also had good sales performance in the other countries that we operate, also driving 11% growth in total volume. EBITDA in the third Q reached BRL 44 million, 23% higher than the same period last year due to the higher volumes and a better sales mix.

Looking to the right side of the chart, let's talk about the Cosan Corporate expenses. General and administrative expenses totaled BRL 40 million, slightly above the third Q of 2016 and in line with the expectations for the year. Other operating expenses composed of legal expenses and consultancy services totaled BRL 13 million in the third Q 2017, as there was a lower concentration of expenses in the period.

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Moving now to chart number 8. Let's talk about the consolidated results of Cosan S/A on a pro forma basis. The improvement of operating performance in all business, as we have discussed, boosted the pro forma adjusted EBITDA growth to 30% in the third Q of 2017, which reached BRL 1.6 billion.

Cosan presented a net income of BRL 500 million in the quarter, 53% above the third Q 2016. When applied in same adjustments to the EBITDA, the adjusted net income more than doubled in the current period compared to the same period of previous year, reaching BRL 540 million compared to BRL 188 million in third Q 2016. The lower financial expenses in the quarter contributed to the strong growth of the net income in the period.

Pro forma CapEx reached BRL 450 million, 3% higher than the same period of previous year, in line with the investments expected for the year. And lastly, the pro forma free cash flow to equity showed a cash consumption of approximately BRL 520 million in the period, which we'll explore moving forward.

Moving to chart number 9, let's talking about the consolidated net debt and leverage of Cosan. The pro forma gross debt that is including 50% of Raízen debt dropped 3% in the third Q 2017 compared to the previous quarter. This slightly reduction is mainly explained by the principal amortization of debt in both Raízen Energia and Comgás. Pro forma net debt, which include bonds with preferred shareholders, ended the quarter at BRL 9.8 billion, up 2% compared to second Q 2017. This effect reflects the reduction of 9% in the company's cash and cash equivalent balance, which were basically impacted by the cash disbursement in the acquisition of the two Tonon mills by Raízen Energia.

But even after the conclusion of this acquisition, the company pro forma average remained stable at 2.1 times pro forma net debt to adjusted EBITDA, both taking to account the numbers on a reported basis when normalized by the current account affecting Comgás. It's important to remember that there is seasonality in pro forma leverage since the working capital cycle in Raízen Energia tends to oscillate throughout the crop year.

The pro forma average cost of debt increased in the quarter to 105% of CDI. If we consider the account number that is excluding Raízen, the average cost goes to 110% of CDI. It's worth to mention that we have fixed cost debt, which is now compared to a lower CDI.

Looking for the free cash flow to equity, let's highlight the main effects. First, a 35% drop in operational cash flow, finishing the third Q 2016 comparison basis consider a positive impact related to the working capital dynamics in the fuel distribution business. Second, a high consumption in the cash flow for investments, mainly impacted by disbursements of BRL 378 million in the third Q due to the acquisition of Tonon by Raízen Energia, and a strong comparison basis since the third Q 2016 included, as you remember, the gains from the sale of STP business in Raízen Combustíveis.

And lastly, in finance in terms of quarterly comparison, there was higher cash consumption explained by the positive net effects in the third Q 2016 regarding Cosan

debt restructuring process, which include the issuance of the 2027 bond with an additional funding of \$150 million in the period. These combined effects result in the free cash flow to equity cash consumption of BRL 520 (sic) [519] (23:29) million in the period.

Now, let's move to the last chart of the presentation and talk about the guidance. As we've shown in our earnings release report, we're updating the guidance for 2017 year with specific adjustments that we're going to highlight here. First, talking about the business lines, and then talking about the consolidated figure.

At Raízen Combustíveis, we have not changed anything. After the first nine months of the year, we expect to deliver the EBITDA within the guidance range targeting the top of the range. But once again, price volatility in the quarter is something that we're going to monitor, and this is the best estimate that we have now, targeting to reach top of the guidance.

Speaking in the Raízen Energia, and always remember that the guidance here follows the crop year. We remain confident in delivering the EBITDA within the guidance range for the crop year despite the challenges related to the scenario of sugar prices in the international market. With the acceleration of production in the third Q 2017, the correction for the crop year is pointing to the high range of the projections. And also, the expectation of electricity commercialization will also be higher due to the optimization of production and the greater trading opportunities in this crop year.

Lastly, we revised the CapEx projection for Raízen Energia, specifically due to the inclusion of the maintenance investments in two mills of Tonon Group. It's worthy to mention that this guidance do not include the amount disbursed for the acquisition of these two mills.

For Comgás, as it was already presented by the company last week, the volume projection, excluding Thermo and normalized EBITDA, were updated. The increasing economic activity has enabled Comgás to distribute a larger volume of natural gas, which combined with the efficiencies in the business, have made the expectations of normalized EBITDA also increase to the range of BRL 1.67 billion to BRL 1.73 billion. The same applies for Moove. After three quarters of solid results, we revised the EBITDA guidance upwards to the range of BRL 160 million to BRL 180 million.

Finally, we are adjusting the range for the consolidated pro forma of Cosan as a consequence of the adjustments in the business, which now ranges in the EBITDA figures from BRL 4.9 billion to BRL 5.3 billion for 2017, reflecting the better performance of the business as I have already mentioned.

With this, I conclude the presentation. Once again, thank you for joining us for the conference call. And I turn over to you guys for the Q&A section. Thank you.

Q&A

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Operator

Thank you. We will now begin the question-and-answer session. Our first question comes from Luiz Carvalho, UBS.

Q - Luiz Felipe Carvalho {BIO 18040760 <GO>}

Hi, Guilherme, thanks for taking the question and just a quick one following up the Portuguese call. Well, we haven't been seeing Comgás delivering quite good results over the past, let's say, couple quarters and even more than that. And when I look to the tariff revision from other - I mean, regulated companies in the electricity sector and more recently with the same regulator than Comgás assessed here in São Paulo, suggest you had a quite flat, I would say, acquisition during the last tariff review. Is there any update that you can provide to us in terms of what you expect in terms of the core acquisition, and now that we have a new director appointed to be in charge of the tariff revision?

And second question, doing some quick calculation here on Raízen Combustíveis. When we analyze here to the potential stock gain, inventory gain that you had in the quarter, we've come something close to BRL 120 million, which would lead your EBITDA margin per cubic meter to close to BRL 117 per cubic meter. Is that something that we can look forward in terms of sustainable margins, or is there any other thing that you can flag to us? Thank you.

A - Guilherme Lelis Bernardo Machado {BIO 17920567 <GO>}

Hi, Luiz. Thank you for both questions. So, first, talking about Comgás, and I'm not trying to be creative in this answer here. What happens that as Comgás has already stated in their earnings call, they're waiting for the process with the agency and their official statement regarding the process of the cycle revision, which is something that we do not have any visibility when it's going to happen. So the company is preparing for additional discussions whenever the agency is prepared for that. So, important to highlight in the sense that although we have the FAPESB (29:40) process being conducted by the same regulator, we understand that is a totally separate discussion and business and industries are different. And I think that when we're solicited to join the process, we are prepared and nothing more creative in this sense.

Talking about Raízen Combustíveis, as we have been discussing with the market supply, the import process by Raízen Combustíveis is part of the supply strategies now. So, inventory gains and losses, when it happens, we consider to be normal course of the business, which is something, to be honest, that we cannot create a rule of thumb or create something as an average that we can guide to the market. It's going to happen when we have opportunities, and again, this is going to be part of our supply strategies. So it's something that is happening in order to supply the shortage that we have in our network as part of the business.

Q - Luiz Felipe Carvalho {BIO 18040760 <GO>}

Yeah. Just one related to the (31:00) tax increase during the quarter that in our calculation led to BRL 120 million gain, but that's okay.

A - Guilherme Lelis Bernardo Machado {BIO 17920567 <GO>}

Okay.

Operator

That concludes the question-and-answer session for investors and analysts. I'll turn the conference over to Mr. Machado to proceed with his closing statements.

A - Guilherme Lelis Bernardo Machado {BIO 17920567 <GO>}

Okay. I would like to thank you now for joining the call, and we'd talk to you guys in the next earnings conference call. Thank you.

Operator

That does conclude Cosan's third quarter of 2017 results conference call. Thank you. Have a nice day.

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