Q2 2018 Earnings Call

Company Participants

- Abhi Manoj Shah, Chief Revenue Officer
- Alexandre Wagner Malfitani, Chief Financial Officer & Investor Relations Officer
- Andrea Bottcher, Investor Relations Manager
- David Gary Neeleman, Chairman
- John Peter Rodgerson, Chief Executive Officer

Other Participants

- Bruno Amorim, Analyst
- Dan J. McKenzie, Analyst
- Matthew Fallon, Analyst
- Renata Faber, Analyst
- Savanthi N. Syth, Analyst
- Victor Mizusaki, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Hello everyone and welcome to Azul's Second Quarter 2018 Results Conference Call. My name is Roberta, and I will be your operator for today. This event is being recorded and all participants will be in a listen-only mode until we conduct a question-and-answer session following the company's presentation.

I would like to turn the presentation over to Andrea Bottcher, Investor Relations Manager. Please go ahead.

Andrea Bottcher {BIO 20316630 <GO>}

Thank you, Roberta, and welcome all to Azul's second quarter earnings call. The results that we announced this morning, the audio of this call, and the slides that we will reference are available on our IR website. Presenting today will be David Neeleman, Azul's Founder and Chairman; and John Rodgerson, CEO. Alex Malfitani, our CFO; and Abhi Shah, our Chief Revenue Officer, are also here for the Q&A session.

Before I turn the call over to David, I'd like to caution you regarding our forward-looking statements. Any matters discussed today that are not historical facts, particularly comments regarding the company's future plans, objectives, and expected performance, constitute forward-looking statements. These statements are based on a range of assumptions that the company believes are reasonable, but are subject to uncertainties and risks, that are discussed in detail in our CVM and SEC filings. Also, during the course of this call, we'll discuss non-IFRS performance measures, which should not be considered in isolation and are discussed in detail in our earnings release.

With that, I'll turn the call over to David. David?

David Gary Neeleman {BIO 687871 <GO>}

Thanks, Andrea. Welcome everyone for – and thanks for joining us for our second quarter earnings call. As always, I'd like to start by thanking our crew members who work hard every day to provide our customers with the best travel experience in the industry. I'm extremely pleased to report that we continue to run the best airline operation in Brazil. We remain the most on-time airline and have recently received several awards a testament to the excellence of our customer service. For the eighth time in a row, we were awarded by Skytrax the Best Regional Airline in South America and also the Best Airline Staff in the region. We were also recognized by consumidor.gov for having the highest standard of customer satisfaction and fewest customer complaints.

Every time I fly Azul, I get more excited about the enthusiasm of our crew members, the quality of the service, which I think bodes really well for our future growth opportunities. As you know, we are going through a fleet transformation process by adding larger jet next generation aircraft. They are extremely fuel-efficient and have the lowest trip cost. That is also the best way to combat the fuel and currency headwinds we saw in the second quarter. This is why we've recently announced an additional order for 21 E2s, increasing our total firm orders for this type of aircraft to 51.

With the need to replace all of our current E1 aircraft, this order guarantees that Azul will have the newest, most fuel-efficient fleet in the industry. With the lowest CASK and the lowest trip cost, which is an unbeatable combination. As you know our A320neos have 56 extra seats compared to the E1s with a similar trip cost, contributing to a cash reduction of 29%. The E2 story is very similar. It has the lower cost of ownership, less fuel burn, lower maintenance costs and an increased revenue potential from 18 additional seats. This results in CASK reduction of approximately 26%. Moreover, the E2 has a trip cost that is 14% lower than the E1.

So we're basically getting more seats for free and paying much less for each flight, which is astonishing. Because the cost and revenue benefits of the E2 over the E1 are so significant, it makes total sense to aggressively remove the E1s from our fleet earlier than planned. I have set an ambitious goal for our team to have this portion of the fleet transformation completed by the end of 2021. We're working hard on it and we will share more details with you soon.

This is absolutely possible because the E1 to E2 transformation process is significantly easier for Azul as it has the same type training for our pilots or same type training, so our pilots can fly both aircraft at the same time. It's just plug and play. Our first E2 scheduled to arrive next June - in June of next year when we'll start seeing this margin expansion benefit in this fleet pack.

In summary, we continue to focus on our margin expansion plan that we have communicated with the market. We are well on our way to building a better company for our crewmembers and our customers and our shareholders.

With that, I'll pass the time to John who will give you more details on the second quarter results.

John Peter Rodgerson {BIO 17734009 <GO>}

Thanks, David, and hello everyone. I also want to start off by thanking our crewmembers for all their hard work during the past quarter. As you can see on slide 5, our adjusted EBITDAR increased 11% in the second quarter and we recorded an adjusted net income of BRL 238 million, a record for a second quarter. Our operating results were impacted by the 20% increase in fuel and the 12% depreciation of the real. Excluding special items related to the sale of six E-Jets and the truckers' strike, operating margin totaled 3.7% compared to 5.8% a year ago.

We grew capacity by almost 19% in the second quarter, while also expanding our top line by 20.5% and our RASK by 1.6% on an adjusted basis. Even with the 20% increase in fuel and the 12% devaluation of the real, total CASK increased only 3.9%. CASK ex-fuel was basically flat and on an exchange rate neutral basis would have fallen 5.1%, a strong indicator that our fleet transformation strategy is working as expected.

As David mentioned at the beginning of the call, our decision to replace older planes with more fuel-efficient aircraft makes even more sense in the current environment. The A320neos represented 24% of our total capacity in the second quarter and will account for 30% by the end of the year. The E2s coming next year will help us accelerate the fleet transformations even further.

Moving on to slide 6, you can see that fuel and currency had a negative impact of approximately BRL 160 million in our second quarter operating results, which represents almost 8 margin points. Thanks to our margin expansion strategy and the ability of Abhi and his team to recapture revenue, we recorded a recurring operating margin of 3.7%, recovering 6 of the nearly 8 margin points. We offset 85% of the fuel and currency headwinds during the [Technical Difficulty] (00:07:12 -00:07:31) quarter, our RASK adjusted for this increase rose 8.1% year-over-year. Our network advantage allowed us to grow capacity by 19%, while increasing our average fares by 16% and at the same time maintaining a stable load factor. Once again, we increased capacity, yield and RASK at the same time, this show how much we needed the larger aircraft in our network.

Moving on to slide 8, our loyalty program TudoAzul maintained its strong growth pace for the second quarter, reaching almost 10 million members. Gross billing ex-Azul went up 38% year over year with the majority of this increase coming from TudoAzul Clube and our banking partners, further increasing our share of the Brazilian loyalty market. We now have 18% gross billings share, up 14% just one year ago and still well below our fair share of the market. Unlike other airlines in Brazil, TudoAzul is wholly-owned by the company. This means that we have no tax inefficiencies and benefit 100% from the cash flow generated by this high growth, high margin business.

On the right side of the slide you can see the cargo business is also performing extremely well. Revenue increased 64% year over year, mostly driven by the larger cargo compartments of the A320neo and the growth of our international capacity. We're excited to deploy dedicated cargo planes next quarter. Clearly our cargo team earned the right to get these planes into our network.

Moving on to the balance sheet on slide 9, I'm proud to report that we ended the quarter with a solid liquidity position of BRL 3.8 billion, representing 45% of our last 12 months' revenues. Even with a 12% depreciation in the real, we ended the quarter with leverage up BRL 4 billion compared to BRL 4.5 billion in the second quarter of 2017. We use the industry standard of adjusted net debt to EBITDA, which capitalizes all of our leases at 7 times and includes all of our debt. This result reflects our decision to hedge 100% of the principal and interest payments with $400 million denominated bond issued in 2017, protecting ourselves against currency risk. At the end of the second quarter, this currency swap was recorded a net asset of BRL 210 million under the long-term derivative financial instruments. Alex, our CFO deserves all the credit for the test.

Our low FX exposure is reflected on slide 10, only 32% of our balance sheet is denominated in U.S. dollars and virtually all of our working capital debt is denominated in local currency. Additionally as you can see on the right side of the slide, we continue to be low on dollar. Our assets denominated in foreign currency, namely our cash, deposits, and maintenance reserves abroad, and our investment in TAP, surpass our dollar-denominated liabilities. And that's excluding aircraft engines and spare parts, which are not restated to the exchange rate every quarter, but are also priced in dollars. For this reason, in times of weakening currency, we are not nearly as impacted as our competition. This reaffirms our position as the airline with the strongest balance sheet in Brazil.

Moving on to slide 11, the move in currency in fuel represents an increase in cost of BRL 800 million to BRL 900 million in 2018, representing a swing of up to 9 margin points. However, as you know, we have a multi-year margin expansion plan. Also we continue to see positive demand environment backed by the strength of our unique network as you saw on our July Traffic Reviews. Therefore, we're confident that we can offset most of these headwinds as a result of projecting an operating margin of 9% to 11% for 2018 excluding the impact of non-recurring events.

We also think it's prudent to revise our capacity growth, ranged at 16% to 18%, down slightly from 17% to 20% by making adjustments in both our domestic and international networks. We continue to replace older generation aircraft with A320neo, which, as David mentioned, are key to combat rising fuel prices and the weakening of the real. As a result, we expect CASK ex-fuel to decrease between 1% and 3% year-over-year even with even with the devalued currency. Our plan of having a 5 point margin expansion to 15% from the time we went public has not changed. Before the devaluation of real, we were ahead of schedule, but we're still on track and feel confident that the pillars of our margin expansion plan are working just as expected.

With that, we'll turn the call over to the operator for Q&A.

Q&A

Operator

Ladies and gentlemen, thank you. We will now begin the question-and-answer session. Our first question comes from Savi Syth with Raymond James.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Hey. Good morning. I just wanted to follow up on the kind of the revenue environment, which seems strong and I was wondering if you can talk about, I think it was really strong before the truck drivers' strike and maybe a couple of weeks after strong, but then it kind of weakened. And just curious what you're seeing today clearly had a good recovery in fuel in the quarter and just wondering your thoughts on how that's continuing and if you can give a little bit more clarity any color on domestic versus international that would be great? Thank you.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Hey, Savi. This is Abhi here.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Yeah.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

So, yeah, you're right. I mean, I think we started the second quarter in April with a strong demand environment combined together with really good fare and capacity discipline. Of course, that was interrupted by the strike and then the World Cup. But we've seen a good recovery after the end of the World Cup, July recovered nicely in the last two to three weeks there and we had a very, very strong start to August. So, I feel good about the demand environment that I'm seeing. Fare discipline is also very strong and I've said this before. I think the capacity environment and the fare environment are the best that I've ever seen basically. And so, I think that's really setting the industry up nicely for the second part of the year.

So, our July traffic was strong. We had a good domestic and good international performance as well. Domestically corporates and agency demand is what's driving most of the top in year-over-year RASM and expect that to continue. When we had the strike and the World Cup, we sort of expected that there would be some repressed demand. We experienced that in the previous World Cup as well. So, I feel like that that is coming back nicely online now for the second half of the year, which is seasonally the best part of the year. So I feel good about domestic coming back strong, driven mostly by corporate, by agencies and by close-in demand.

On the international side, it's steady, as you could see on our Traffic Release. Probably the one soft spot is Argentina, where luckily for us we have lower exposure, two to three daily flights at most and so that, we're pretty well-hedged against that. Europe is doing well and the U.S. is steady. Nevertheless we have made some capacity adjustments for international for the second part of the year. Between August and November our international capacity down 12% just to be prudent given the currency and the fuel situation.

But overall, I feel good about it and I think domestic is really going to come back strong in the second half of the year backed by good fare and capacity discipline.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

That's helpful. And if I may follow-up on the domestic you're kind of moderating growth as well. Just any color on the type of markets where you're moderating that growth?

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Yeah. We are. Also between August and November we're going to cut our domestic by 5%. Basically for the entire period overall we're cutting 7% of capacity, which takes our guidance - really our expected capacity for the year from something very close to 20% to something very close to 17% for the whole year. It's a mix of domestic and international. Domestic we - it's a market that are obviously not doing well on a P&L basis, number one. If things that are not in and out of our hubs, so any market that overflies a hub or under-flies a hub; it's probably the first to go. So, it's such a market primarily outside our hub and internationally it's for example we're cutting the day time for Lauderdale flight, so we're keeping night time flight-only and reducing some frequency to Northeast of Brazil to Florida. So, if anything that's sort of not core to our hub strategy is what we're cutting.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Very helpful. Thank you.

Operator

The next question comes from Michael Linenberg with Deutsche Bank.

Q - Matthew Fallon {BIO 16763664 <GO>}

Hey, guys. This is actually Matt on for Mike. How are you?

A - David Gary Neeleman {BIO 687871 <GO>}

Good afternoon, Matthew.

Q - Matthew Fallon {BIO 16763664 <GO>}

You mentioned at your Investor Day the capacity discipline in the Brazilian domestic market was the best you've seen in a decade. Is that still the case? Any irrational or aggressive actions on the capacity or pricing front domestically?

A - David Gary Neeleman {BIO 687871 <GO>}

Yeah. Hey, Matt. I feel good about capacity to be honest. I think that – I've talked about this before, but there's really been the structural change I think in how airlines in Brazil are allocating capacity. We're not seeing airlines go after each other. We're not seeing them chase each other in markets that frankly they should not be in but they don't have any chance of making money. I think airlines are focusing where they are strong and where they can make their network stronger. We're certainly doing that with the A320s. And you can see in our traffic, we're putting them in our network. We're seeing great traffic growth, connectivity growth. And I think we've set an example to the market as to how to allocate the capacity, where it makes yourself better. And I'm seeing that across the board in airlines really playing where they are strong. So I think that's a very, very positive sign for the industry. And I think it's a structural change from what we had a couple of years ago.

Pricing as well I think that whether it's fares or ancillary, I see airlines taking advantage of the opportunities, showing discipline in the market and really looking forward to taking advantage of the good demand that we usually have in the second half of the year.

A - John Peter Rodgerson {BIO 17734009 <GO>}

And Matt just to highlight, if you take a look, we were actually down in departures in the first half of the year, minus 2%. So it's really the upgauging, it's the fleet transformation, it's getting these assets that have more seats, utilizing them 14 hours a day, reducing our CASK, and so it's a right type of growth that you would want in our existing markets that have been stimulated. And once again, Abhi continues to increase capacity and he's spending RASK. And that's really a powerful combination because of what we're going to see on the cost side.

Q - Matthew Fallon {BIO 16763664 <GO>}

Great. Just as a follow-up. What kind of impact are you seeing if any from the upcoming Brazilian election on either business or leisure traffic in Q3 and is there anything you can quantify or?

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Yeah. So, as I said before, the demand right now is strong. I would say that it's a little bit early to see the effect of the elections. It's going to be towards the end of September and mostly in October. So I think we'll know more when we get closer. It is a distraction clearly. But, at the same time, I think we also have some repressed demand from the strike and the World Cup. So right now, we're seeing good trends and I think because so much of it is corporate that tends to be close-in we'll have a much better idea as we get closer to October.

Q - Matthew Fallon {BIO 16763664 <GO>}

Thanks, guys.

Operator

The next question comes from Renata Faber with Itaú.

": Hi. Thanks everyone for the call and congratulations on the results. And thank you, David for talking about the economics of the E2 if I'm not mistaken I believe this is the first time you talked about that and there was plenty of interesting information on what you said. So I'm sorry to ask you to repeat it, but could you please talk again about how the E2 will have [indiscernible] (00:20:33) increased margins? "

A - David Gary Neeleman {BIO 687871 <GO>}

Yeah. Sure. Thank you very much, Renata. I'll take that question because, it's a real passion of mine and I think I've got E2 idols right now and I'm really excited about it. This math is really pretty simple. It's not difficult. We've got a lot of our E1s when during crisis times - during 2007 and later and we didn't have the credit that we do have today. And so we ended up paying a lot for these E1s, particularly on sale leasebacks and the financing. So now we have a whole different situation with the company and so we bought the E2s and the financing is less, the plane is at a very attractive price. And so the first category is we have a lower cost on the airplane by a significant amount. So that's number one.

Then number two, these new E2s have new generation engines on them. And the fuel burn savings is there, it's absolute, the capacity is growing on, it's like 13%, 14%. And so that's absolute - that's it.

Then you move to maintenance, we have a deal for the engine maintenance than we do currently. So, that's a big portion of the maintenance cost, the seat check intervals are longer, then you have this period of warranty, and kind of maintenance honeymoon that goes on for up to five years. And so our maintenance cost will be significantly lower permanently, not just in the first five years.

And then we've got 18 additional seats. And so with the high load factors we have, we assume that we sell half of those seats and have a pricing come up with a number, and we add all that together, and we're tying although we'll just magically be able to snap our fingers today and say, let's all of our 63 new ones were E2s, and we have those flying today, we believe that difference in margin, it's astounding number, it's a 9% difference of margin...

A - John Peter Rodgerson {BIO 17734009 <GO>}

9 margin points.

A - David Gary Neeleman {BIO 687871 <GO>}

9 margin points. So 9 margin points of where we are today. Now obviously things can change as far as fuel price and all that kind of stuff, but I'm saying today apples to apples,

what that airplane will be, our cost of that airplane just what we have today with 9 margin points. That gives us a tremendous amount of flexibility and cushion, obviously even if it was 5 margin points and we were able to lower fares and stimulate more traffic, or fuel spikes up, we've got the most fuel efficient plane in the industry, (00:23:17) there is a weekend we have a plane that costs us a lot less money. So we're spending less money on maintenance, which is dollar denominated. So that's why I (00:23:26) if it's impairment, so what we have to do, we are working really closely with Embraer to speed up the production that has been coming in sooner, and that's why we set this target that all of the E1s gone by the end of 2021. And so you'll start seeing that benefit next year as the plane start arriving in June. So I couldn't be more excited.

A - Abhi Manoj Shah {BIO 18968426 <GO>}

(00:23:51) weekend driving us crazy.

A - David Gary Neeleman {BIO 687871 <GO>}

Yeah. And I've told investors that as I haven't sold a single share of stock, why would I when I see that coming. So I'm very excited about it.

A - John Peter Rodgerson {BIO 17734009 <GO>}

And so we're going to work to try to accelerate this. It is a very exciting thing, especially kind of given the additional fee to lower fuel burn. We've got a great price from Embraer. So we're very, very excited about it.

A - David Gary Neeleman {BIO 687871 <GO>}

And it's a nice thing (00:24:17) June, in spite of our CASK on E1 really it's remarkable with these things we have to focus on. So when we kind of get all of the assets, and then we got A320neos coming too on top of that, so very exciting this.

Q - Renata Faber {BIO 6774036 <GO>}

Okay. Thank you.

Operator

The next question comes from Dan McKenzie with Buckingham Research.

Q - Dan J. McKenzie {BIO 15071178 <GO>}

Hey, good morning. Thanks, guys. Corporate business is good. Wondering if you can talk a little bit more about the leisure side of the business? So on the one hand it's seasonally slowest time of the year for leisure traffic. On the other, we've had some pretty sharp swings in foreign exchange and surely that that impacted that part of the business. So I guess, the question really is two-fold here. First, to what extent was leisure demand impacted by moves from foreign exchange to the extent that you can peel that out? And then secondly, how long does it typically take for pent-up demand to typically return?

A - Abhi Manoj Shah {BIO 18968426 <GO>}

Hey, Dan, it's Abhi here. So overall Azul historically has been pretty small in the leisure market and the reason has been we haven't not had the right airplane to really have a big position in that market, we're starting to now with the A320neos. We have 15 A320neos today. By the fourth quarter, 30% of our capacity would be A320neos. So, what's happening with the A320neos is two-fold. We're putting the A320neos in our network really connecting our hubs, so Campinas to Recife, for example. Salvador a little bit, some – we're able to enter some leisure markets like Fortaleza where historically we've got very, very low presence. We're obviously seeing a very good market reaction to that.

We're seeing unit revenue reductions much less than what we had talked about on the IPO road show in a sub-10% compared to a cap reduction of 29%. And so, a part of this leisure demand, we're able to access that type of demand that we didn't have before. We're able to stimulate local demand out of our hubs whether it's Campinas, whether it's Belo Horizonte or Recife, and we are able to drive a lot more connectivity in our network. To give you an example, when we put in all A320s between Campinas and Recife, we had an increase of 77% of connecting traffic, because it's not just a leisure that's using this airplane and these routes, we have 50 destinations on one side and 40 on the other. The route to VCP Recife has 500 different O&Ds that flow over that route.

The route VCP Belo Horizonte had 800 different O&Ds. So there's leisure demand that's helping us with this airplane, but it's also the base of our network, the breadth that we have and the platform that's really strong.

So, I would say that because we have so much connectivity, I think we're seeing good results with the A320s with some local stimulated leisure demand, we're also driving incredible connectivity through our network. Does that make sense?

Q - Dan J. McKenzie {BIO 15071178 <GO>}

Yeah. I understood. And I guess just to follow up on that, Abhi. what's the biggest leading indicator for a leisure demand. Is it simply commodity prices or is it some other measure of employment or commercial activity as you just – I know it's kind of a smaller part of your business, but as you think about turning out on this part of the business what are the leading sort of indicators that you look at?

A - John Peter Rodgerson {BIO 17734009 <GO>}

Hey, Dan. This is John. Just the exchange rate be valued quite a bit, but the mood in Brazil is actually very positive. I mean, if you go back to 2015, 2016 when the impeachment was going on people were fearful of their jobs and that's not the case right now. I mean, there's good underlying demand. People are traveling, companies are hiring. The fear was in 2015, 2016 is I'm not going to have my job tomorrow. So leisure really dried up and corporate also dried up, but it's a completely different feeling that we're seeing right now in the country. It's just a – there is a just a different vibe. Now of course the exchange rate puts pressure on some international flying sort of Disney World and things like that, but it's not nearly what it was before. And there is actually good underlying demand in the country.

Q - Dan J. McKenzie {BIO 15071178 <GO>}

Understood.

A - Alexandre Wagner Malfitani {BIO 2519089 <GO>}

Yeah. I think – Dan this is Alex. We look at business confidence and consumer confidence, I think those are good indicators of underlying demand. The trend in unemployment I think is important. Unemployment is, we believe, still high, but it's trending down slowly. And I think that helps consumer confidence, so I'd say it's a very different story for you to decide to take your family to Florida, if you think you're going to lose your job. But if you're feeling pretty confident that you're going to keep your job and you're going to have decent level of income, it's cheaper to fly to Florida actually and spend your vacation there than to sometimes spend your vacation down here, right. And it's also cheaper to buy whatever you want to buy in the U.S. right. I'm an iPhone user and I have had a few iPhones, but I've never bought an iPhone in Brazil. And for me to buy an iPhone in Brazil, the exchange rate has to go to 7. And if the exchange rate goes to 7, it doesn't make sense for you to buy an iPhone in Brazil, you buy it in the U.S. But just flying through U.S. and buying your iPhone there, you pay for the price of a ticket. So, I think that's what happening. Obviously it's more expensive to go to Disney World with an exchange of 3.80 than 3.20 but if you're feeling confident about your prospects, no, I don't think that affects your decision.

Q - Dan J. McKenzie {BIO 15071178 <GO>}

That's great perspective. Thanks, guys.

Operator

The next question comes from Victor Mizusaki with Bradesco BBI.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Hi. I have a few questions. The first one with regards to the losses of the E1. Is there any risk profile additional E2 or the risk of potential liability that can show up if the replacement of – between replacement of E1 by E2? And my second question with regards to your guidance, when we take a look on your guidance forecast H2 for the full year you talk about the reduction of minus 1% to minus 2% but year-to-date it's at 2.6%. So the big reduction in the second half is due just a matter fact the introduction of the A320 or is there anything else here?

A - Alexandre Wagner Malfitani {BIO 2519089 <GO>}

Hey, Victor. It's Alex here. I wouldn't call it risk of additional E1s because David mentioned the replacement of E1s to A320neos and E2s is very positive, right. And there may be an accounting effect from selling aircraft at a different price from where it's carried in our books. But the six E1s that we sold we actually generated cash, because the market value of the aircraft was higher than the debt value that we had outstanding. So we generated cash and then it's going to generate all of the benefit and additional revenue and reduce CASK that David explained, right. So, we're going to continue to look for opportunities to remove E1s from the fleet and accelerate the entry of E2S and A320neos. And if there is a book impact to what I would agree with you called it out as we did this time. But like I said, it should definitely be very beneficial and very accretive decision in terms of P&L.

A - John Peter Rodgerson {BIO 17734009 <GO>}

And we understand that the faster we get there, the more competitive we are, and then margins go up significantly. And so that's why David is kind of going crazy in Brazil, because, to move faster, move faster, move faster, because he understands that the quicker that we can replay – David has mentioned it, but I want to highlight it, we're paying for some of the sins in the past which is being a startup airline in Brazil, during the financial crisis, flying E1s, that wasn't a very liquid asset. And so that would naturally all going to go way over the next three to four-year period. But David is just saying, hey, let's bring into the left guys and we'll turn faster.

A - Alexandre Wagner Malfitani {BIO 2519089 <GO>}

Yeah. And then on CASK guidance, which really both new E2 or the new A320neos that are coming in the second half but also the run rate of the A320neos that we took before, right. So what we said, we've had 14% of our ASK is coming from next-generation aircraft in 2017. And we're going to have 27% this year. But in Q4 we'll be closer to 30%, right. So you'll have almost a third of our capacity coming from next-generation aircraft in Q4 which has a much lower CASK than what we used to have in the past. So yeah, that's where you're going to see the reduction in CASK.

So I think, that's already happened, right. We talked about the total CASK reduction that we would have had adjusting for FX. So I'd say the FX kind of clouds the benefits that we're getting from A320neos. But, once you adjust for that, you definitely see a huge reduction in CASK from the next-generation aircraft.

Q - Victor Mizusaki {BIO 4087162 <GO>}

Okay. Thank you.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Thanks, Victor.

Operator

The next question comes from Bruno Amorim with Goldman Sachs.

Q - Bruno Amorim {BIO 17243832 <GO>}

Hi. Good afternoon. I have just a very quick question on the price of jet fuel WTI, you said you buy 40% additional A320neo release, FX depreciated by 12%. Can you instill the price for just fuel per liter rose by just 20% in the quarter? So just wanted to understand to what extent this fuel price was impacted by fuel hedges and what should we expect going forward in a scenario of stable oil price and FX as the hedge is currently in place, remain less relevant. Thank you.

A - David Gary Neeleman {BIO 687871 <GO>}

Sure. Yeah, sure Bruno. Yeah, there are - it's a number of different factors kind of evolve at the same time. So we do have some direct hedges with Petrobras where we essentially predetermine the price of fuel that we're going to pay ahead of time and when we buy that fuel, we pay upon agreed price when we hedge it. You saw in our Traffic Release and fee on our ASK, the mix of international flying is going up significantly. There's no ICMS on international flying, and so that mix shifts more fuel consumption to fuel price per liter that doesn't have the ICMS burden. So that affects the blended price as well. We have begun additional flying in states where the state offers ICMS benefits if you fly the additional cities, so most of ours there is an example of small cities where we start flying and that benefits not just the fuel consumption that we buy in that city, but everything that we buy in the whole state, and also that helps as well. So and there's a little bit of a lag on between WTI and Petrobras prices as well, so it's a number of small effects that account for the different that you saw.

Q - Bruno Amorim {BIO 17243832 <GO>}

Okay, clear. Thank you very much.

Operator

The next question comes from Savi Syth with Raymond James. Hello. Ms. Syth, your line is open.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Thank you. Sorry about that. Hey, thanks for the follow-up question. I actually have two. On the fuel hedges following up on the previous one. Are you able to - given that your lock in prices, are you able to give some color as to what your fuel price looks like for at least third quarter or the remainder of the year?

A - David Gary Neeleman {BIO 687871 <GO>}

So the most of the hedges that we have now will affect below the line their financial hedges. So essentially you can consider that the price of the hedge that we have is the price at the end of Q2, that's what you've seen here in our financials and any fluctuation beyond that will affect the numbers based on that mark-to-market that we did at the end of Q2. And for the next 12 months, we have about 15% of our capacity hedged, which is roughly half of the maximum that we (00:37:20) we can have. So if you guys are interested to know sort of where we built the hedging position that would be kind of equivalent to about 2.05 to 2.10 in (00:37:33) at the end of Q2 that all gets mark-to-market.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

That's helpful. Thank you. And then if I may, any update on the Cargo JV and the timing and rollout of that?

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yeah, Savi, so we filed with antitrust authority, it's about 10 days ago and it seems to be progressing well. It should be a 90 to 120-day process and so we're anxious to hear back from them. So we're still very excited about that. And as you could see, Cargo continues to outperform, even TudoAzul and even Abhi's great revenue performance. So Abhi is kind of lagging behind.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

And then just one last question on the cost side. The cost guidance given the amount of pressure you're seeing was actually quite impressive. And I was just wondering, I know this year was supposed to be still high training costs related to pilots. Where are you finding the savings? Is it mostly driven by local, say, currency savings or I was just curious as to where you're finding the savings to kind of keep that cost guidance at such a level?

A - John Peter Rodgerson {BIO 17734009 <GO>}

Hey, Savi, at the end of the first quarter when we saw currency devalue and fuel go up, we kind of gathered around as a senior leadership team and started an initiative called Change the Business. And so we've got 44 different projects across the board that our senior directors are managing to take cost out of the organization and kind of improve the operational performance. And so that's a big reason why we're feeling very confident. I think at times like this when you do have spikes in fuel, you start to do new things that maybe weren't on the table before and so we're working aggressively at those, and that's part of (00:39:24) out kind of give more detail overall in the third and fourth quarter.

A - David Gary Neeleman {BIO 687871 <GO>}

Yeah. And a lot we talk about it – a lot of it is the ramp up of our A320neo capacity, and then the Change the Business initiative that John mentioned. And I think once you account – we're talking about the 29% reduction in CASK on the A320neo. I mean there's just so much efficiency both from the fact that it burns a lot less fuel, but one thing that is unique about Azul, a lot of companies will go through a change in fleet rather than some old generation jets to new generation jets, but they are only going to get the fuel benefit. We're getting the fuel benefit and we're getting upguaging, because we built a network over time that was actually asking for this size of an aircraft. So we couldn't have started Azul with large narrow bodies 10 years ago, but now we've built a network that has enough feed and enough traffic that can fill A320neos, and so we're going to get the double benefit of improved fuel burn and more economies of scale.

A - John Peter Rodgerson {BIO 17734009 <GO>}

As David mentioned, the miracle of Azul as we built what we built with the aircraft we've had, and so now that the new generation E2s are coming out, the A320neos, there is so much leverage on the business because of the aircraft that we had previously.

Q - Savanthi N. Syth {BIO 17476219 <GO>}

Okay. That's helpful. Thank you.

Operator

The next question comes from (00:40:59) with Citi.

Hi. Thanks for taking my question. I have two quick question from my side. The first one is, can you tell us more about the potential volume upside that could come from the alliance with the Postal Services and if you see (00:41:13) in the confirmation on these agreements? Thank you. Those are my two questions.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yeah. So I think we talked about this on previous calls, there's a logistics problem in Brazil and today Azul serves 100 cities domestically. We have seven to eight international cities and we have 200 stores spread all throughout the country and the Brazilian Post Office spends quite a bit of airfreight anywhere from BRL 600 million to BRL 800 million a year in airfreight and we believe that our joint venture could give them a significant reduction from what they have today and have those – have that mail fly in the belly of our aircraft.

And so, I think the big difference in Brazil is that today all of that mail is (00:41:57) and so it needs specific aircraft type, but that's not how it's done in Europe or the U.S. And so, the fact that we always have some excess space in the belly of our aircraft. And so if you think about we're growing our cargo business faster than we thought was possible and then you add in the partnership with the Brazilian Post Office and bringing in that incremental revenue that they provide and we're in 200 physical stores and they have thousands of physical stores throughout the entire country. And so, it's not like it is in the United States, you don't send packages via Amazon to your doorstep and so having physical pick-up locations is key.

And so, the opportunity that we're looking at is to provide a huge logistics solution for the country. And I just want to remind everybody, it's not in our guidance and this is upside in Azul case and so we're excited about the future here. And I think as you not only provide a logistics solution to Brazilian Post Office, you're providing a logistics solution for many other e-commerce players in Brazil and that's where a lot of the growth in our business is coming from.

A - David Gary Neeleman {BIO 687871 <GO>}

(00:43:07) are important and if that happens that's fantastic. Even if it doesn't, our network is going to provide that to our customers and people like Amazon and others that was in need there. The other people that need this logistics, the Brazil is sort of challenge and then no one is in a better position to help that than Azul.

Q - Operator

Okay. Thanks. And my second question...

A - David Gary Neeleman {BIO 687871 <GO>}

Yeah. Go ahead.

A - John Peter Rodgerson {BIO 17734009 <GO>}

I think she said, but we didn't hear? What was your second question?

Q - Operator

Okay. Yeah. I asked, you didn't hear. Sorry. My last question is quick, do you have any comment about the Norwegian Air Shuttle launch in Brazil to Europe flight (00:43:53)? Thanks.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yeah. Hi. So, Norwegian, it looks like it's going to fly from London to Brazil. It's not surprising, they fly to (00:44:03) they fly to Singapore, they fly to New York, so no it's not really surprise and it doesn't really affect us that much in any way, so international is out for them and that's it. Yeah.

Q - Operator

Perfect. Thanks for taking my questions.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Yeah. So we have a question on the webcast, I'll just read out here. So, the question is regarding the joint venture and progress on that. Of course yesterday Copa announced that they're in talks with United and Avianca on a Latin American U.S. joint venture. I can't comment on their joint venture, but regarding with Azul and United, as we said before, now that OpenSkies is singed, we are absolutely talking towards a U.S.-Brazil joint venture. These things take time to negotiate. We're in the process and they take even longer to get approved actually and it looks like the DOT right now has a pretty full docket. But nevertheless, there are opportunities for the customer for our joint business. So we're actively talking to them regarding a U.S.-Brazil joint venture with Azul and United.

A - David Gary Neeleman {BIO 687871 <GO>}

And this was always in the plan. When United made their investment in Azul even before OpenSkies was approved, we knew that this was a possibility. And so we kind of – we wrote that in the contract that we have with them and United has been a fantastic partner of ours and we love the fact that they bought a portion of the HNA shares a few months ago which shows their confidence in our business as we move forward and shows the upside that they believe in Azul.

Operator

Ladies and gentlemen, this concludes today's question-and-answer session. I'd like to invite John to proceed with his closing statement. Please go ahead, sir.

A - John Peter Rodgerson {BIO 17734009 <GO>}

Well, we'd like to thank everybody for joining us today and as always if you have any follow-up questions we're available. We'll be doing calls all afternoon and certainly follow-up with Andrea and we're glad to continue to deliver on our plan. Thanks, everybody.

A - David Gary Neeleman {BIO 687871 <GO>}

See you next quarter.

Operator

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