

Q3 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

- Alberto Valerio, Analyst
- Bruno Amorim, Analyst
- Dan J. McKenzie, Analyst
- Helane Becker, Analyst
- Matthew Fallon, Analyst
- Renata Faber, Analyst
- Savanthi N. Syth, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Hello, everyone, and welcome to Azul's Third Quarter 2018 Results Conference Call. My name is Larissa and I'll be your operator for today. This event is being recorded and all participants will be in a listen-only mode. And we will 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 proceed.

Andrea Bottcher {BIO 20316630 <GO>}

Thank you, Larissa and welcome, all, to Azul's third quarter earnings call. The results that we announced this morning, the audio of this call and the slides that we'll 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.

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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 the call, we will discuss non-IFRS performance measures, which should not be considered in isolation.

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

David Gary Neeleman {BIO 687871 <GO>}

Thanks, Andrea. Okay. Welcome, everyone, to joining us for our third quarter 2018 earnings call. As always, I want to start by thanking our crewmembers at Azul for creating this great result for us. They are truly amazing and they do amazing job every day.

We're relieved that the Brazilian elections are finally over and that the macroeconomic environment in Brazil is more stable. And we're very optimistic with the new administration. They seem to be taking all of the steps to promote economic development in the country. I've always been a great believer in Brazil. It's a huge country with a lot of potential. We've had a couple of tough years, but the future looks bright.

Now, going back to the third quarter results, once again, we demonstrated our resilience in an extremely adverse fuel and currency environment while successfully executing on our long-term margin expansion plan. On the operational front, we continue to rank as the most on-time airline in Brazil and are also among the top five in all the world. Incredible. An incredible accomplishment.

I'm proud to report that last month, we were voted the best airline in Latin America by Kayak customers, a leading travel research engine, sweeping all categories: boarding, comfort, onboard service, entertainment, and most importantly, crewmembers who really make it happen.

We're also recognized by (00:03:00) which is - its complaint here, which is the Brazil's consumer economic advocacy website for having the highest standard of customer satisfaction and the fewest customer complaints year-to-date of all the other airlines. I couldn't be more excited about the quality of our service and our future growth opportunities.

Through our fleet transformation plan, which we've talked a lot about, as we told you many times, we're replacing the E1s with A320s and we have - they have similar trip costs with 56 more seats. And also the E2s that have 18 more seats with a much lower trip cost than the E1s. And this is why we are actively marketing the E1s to accelerate that process and it's going well.

We've built an unbelievable network. And now every new generation aircraft we add strengthens our airline even more by reducing our unit costs. On a fuel and neutral basis, our CASK, and John will talk more about this in detail, would have been down 6.8%. It's

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incredible. I mean, to be down 6.8% year-over-year, I don't think - I've never seen that from any other airlines. And that's, obviously, because these neos have such lower cost.

The performance of the A320neos in our network has surpassed all of our expectations. Adding the neos for the sixth quarter in a row, we have increased capacity and RASK. These aircraft are flying an average of 14 hours a day and are bringing up our fleet on jet utilization rate to 12.6 hours a day while improving connectivity across the airline.

At the end of the quarter, we had 17 A320neos flying in only 27 out of 218 markets, representing 27% of our total capacity. And these planes have a 29% lower unit cost. Every single one of these is desperately needed and we'll continue to do so for many years to come. When it arrives, we stick it where it's needed and we have so many needs for this aircraft. It's a real party here every time when it's delivered.

No other airline in the world is transforming its fleet as significantly as we are, replacing 118-seat aircraft with next generation 174-seat airplanes. And then starting next year, our fleet transformation accelerates when we started adding the E2s mid-2019, so that those will come at a very rapid pace once they start coming. With both these generation aircrafts, we are creating a competitive sustainable advantage, which will continue to drive margins higher and allow us to offset any future macro headwinds we may encounter.

In summary, we are confident on our margin expansion plan that we told you from the very beginning. When we were on the road show that was our message and it hasn't changed. And we will continue to communicate that message. And as we build - on our way to building a more profitable airline with the best crewmembers, the strongest network and the most reliable operation, I couldn't be more excited.

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

John Peter Rodgerson {BIO 17734009 <GO>}

Thank you, David. And hello, everyone. I also want to thank our crewmembers for all their hard work during the past quarter. As you can see on slide 5, the core airline drove strong results in a tough macroeconomic environment. The 47% spike in fuel and the 25% depreciation of the real impacted our results by BRL 323 million (00:06:42) (00:06:43) or 16 margin points.

Thanks to our ability to raise fares and reduce costs through our fleet transformation, we were able to recover 11 margin points, reaching an EBIT margin of 7.1% for the quarter and a 28% EBITDAR margin while we recorded net income of BRL 117 million. We grew capacity by 19% in the third quarter, while also expanding our top line by 23% and our RASK by 2.7%.

On a stage-length adjusted basis, our RASK increased 8% year-over-year. CASK ex-fuel decreased 1.8%, controlling for currency and fuel, as David mentioned earlier, CASK would have been down 6.8% year-over-year. We received our 17th A320 in the quarter and the

A320neos represented 27% of our third quarter capacity. The E2s coming next year will help us further accelerate the fleet transformation.

Moving on to slide 6, you can see that fuel and currency had a negative impact on our results in the third quarter, which represented 16 margin points. Thanks to our margin expansion strategy and Abhi's ability (00:07:51) to recapture revenue, we recorded an operating margin of 7.1%, recovering 11 of the 16 margin points during a very challenging macroeconomic environment.

Moving on to the revenue performance on slide 7, we continue to benefit from a healthy demand environment and robust ancillary revenues. Considering that our average days length increased 11% in the third quarter, our RASK adjusted for this increase rose 8%. Our network advantage allowed us to grow capacity by 19% while increasing average fares by 11%, and at the same time, increasing load factor. Once again, we increased capacity yield and load. This shows the network really needed the A320s.

Moving on to slide 8, our loyalty program TudoAzul maintained a strong growth pace during the second quarter, reaching 10.5 million members. Gross billings ex-Azul went up 36% year-over-year with the majority of this increase coming from our TudoAzul Clube and our banking partners, further increasing our share of the Brazilian loyalty market.

As you heard us say all along, our decision not to spin-off TudoAzul proved to be the right one. Our competitors have all backed away from having a separate loyalty company. We now have 17% gross billings share, up from 14% just one year ago and still well below our fair share of this market.

On the right hand side of the slide, you can see that our cargo business is also performing well. Revenue increased 63% year-over-year. In October, we deployed our first dedicated cargo airplane into our network and it's already flying with a 90% load factor. Clearly, our cargo team earned the right to get these planes into our network.

Moving on to balance sheet on slide 9, I'm proud to report that we ended the quarter with an even stronger liquidity position, representing 46% of our last 12 months revenue while also reducing our total debt position by \$100 million. Taking advantage of our comfortable liquidity position and high credit rating, we eliminated all restricted cash in the third quarter.

Even with the strong depreciation of the real, we ended the quarter with leverage at 4.2 compared to 4 in the third quarter of 2017. This result reflects our decision to hedge 100% of the principal and interest payments for the \$400-million-denominated bond issued in 2017 protecting ourselves against currency risk.

Our low currency exposure is reflected on slide 10. Only 33% of our balance sheet debt 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 long dollar. Our assets denominated in foreign currency, namely our cash deposits and maintenance reserves abroad and our investment in TAP surpassed our dollar-

denominated liabilities, and that excludes aircraft, engines, and spare parts, which are not restated to the exchange every quarter but are also priced in dollars.

For this reason, in times of weakening currency, we have strong assets denominated in foreign currency that naturally protect Azul. We are not nearly as impacted as our competitors. This reaffirms our position as the airline with the strongest balance sheet in Brazil.

Moving on to slide 11, we've been proactive in adjusting our capacities to the changing fuel and currency environment and have kept our growth at the lower end of our guidance. As a result, we expect our operating margin for the year to be around 9% and our CASK ex-fuel to decrease around 1% year-over-year. We expect to release our 2019 guidance together with our 4Q results in March, which will also include an estimate of the impact of IFRS 16. We've done a preliminary analysis and expect to see a large increase in EBIT compared to the current accounting standards as well as a significant reduction in debt and leverage.

We will continue to execute on the pillars of our margin expansion plan shown on slide 12. Our goal of reaching an operating margin of 15% by 2020 has not changed. Our fleet transformation strategy is working and now that we have a more stable macro environment in Brazil, we are even more confident on our ability to expand margins over the coming years. We have built the strongest network in Brazil. We have a solid balance sheet and have great customer service. I couldn't be more proud of our 11,000 crewmembers.

With that, I'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 afternoon, guys. So, good results here. I know you don't like to provide kind of RASK broken out by domestic and international but if you would mind providing some color on maybe kind of yields, demands in the two different areas, just generally how it trended in 3Q and what do you think as we go into 4Q?

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

Hey, Savi, Abhi here.

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

Hey.

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

So yeah, I would say that the strong overall RASK increase of 8% adjusted for stage, I would say, was mostly driven by strength in the domestic market. So I'll talk about that first and then talk about international. It's hard to believe the World Cup was in this quarter, (00:13:44) like a lifetime ago. But we saw a strong balance in bookings post World Cup, very good August and very good September domestically. September was one of our highest domestic RASK ever in the history of Azul, which is surprising to me, frankly, given the fact that we have 17 A320neos flying, which mathematically should bring the RASK down, so very strong on the domestic side.

If you look at our corporate revenue for the first nine months of the year, (00:14:14) the corporate travel agency revenue, we grew the most in revenue and we also grew our average fare the most, even though we already have the highest fares. So, I would say strong domestic environment. It continues today, October was good as well other than a small interruption due to the elections. November has picked up nicely. So - and that continues to be our focus.

It's the A320s are all flying domestically other than one route. The E2s are all focused domestically, so, that's really our focus the next two, three, four, five years. I really see a lot of opportunity on the domestic side. And so, that has driven most of the RASK increase overall.

On the international side, dollar did impact demand. You heard that from other airlines as well that talked about the Latin region. So, it's not too surprising. And we've adjusted capacity accordingly. So, we've made strong capacity adjustments. If you look at the tapes (00:15:12) September, October, November, we're down pretty significantly in international capacity and we've extended those cuts out through May of next year just to give it some time to rebound because it's such a longer booking curve. And then June and beyond next year, we will look to see if it makes sense. So, I'm very confident with the international capacity. We've made the right adjustments. It's a good base level of capacity.

And if you look at our traffic results, our international has held up better than the other players in the region. We had an 87% load factor in the third quarter even with the dollar very high. So, I would say international, it's stable, and we've made the right adjustments to account for the impact of the currency. But I'm really excited about domestic demand. It did well in the third quarter, it continues to do well, and that's going to be our focus going forward.

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

Super helpful. And if I may, just a follow-up on the cargo. Could you provide an update on the JV and the - I think you have one already but maybe two dedicated freight are coming. Would you put that into service even before the JV commences or just what's the plan on the cargo side?

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

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Yeah, Savi. We already have the one cargo plane in operation. It's going really well. As I mentioned, it has a 90% load factor. And so, what we've been able to do is we stopped fully flying our A330s domestically because of a couple of big cargo contracts that we had. And so we're very excited to have those.

The government has changed. The president of the (00:16:45) in the last month has changed three times. But I was – most recently with the new president that was just appointed last week, he's very much in favor of the deal.

So, we need to let the process play out with the antitrust. But we provide a great service to the (00:17:05) and we'll give them a significant cost reduction from what they're paying today. And so I think everybody's in favor of it, and I think the new government is very much in favor of privatization. And so I think the election certainly helped the joint venture going forward. So, we're excited, but we had the plans to get these cargo airplanes independent of that because we've got some great contracts with some partners of ours and they're going extremely well.

As you've seen, we grew cargo in the quarter by 63%. And so it's pretty exciting the type of cargo business that we've built.

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

(00:17:35) one airplane flying now and then the second we're sort of planning (00:17:39)...

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

In December.

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

...in December.

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

All right. Great. Very helpful. Thanks again.

Operator

Our next question comes from Renata Faber with Itaú BBA.

Q - Renata Faber {BIO 6774036 <GO>}

Hi, everyone. Thank you for the call. My question is regarding the IFRS 16 and the effect that is going to have on your balance sheet?

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

Yeah. Hi, Renata. So, we've done the work and we have the preliminary results. What we're planning to do is we want to dot the I's and cross the T's and also get the blessing

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from our orders that we're going in the right direction. But, you can - I mean, it's pretty straightforward. You can see that - we have a more rents than anybody else and the rents are going to get capitalized, right, because with IFRS 16, everything that is an operating lease gets treated as a finance lease, right?

So, the benefit to EBIT and the benefit to debt and to leverage to Azul should be higher than two airlines that have less rent expense. Also, we still expense a lot of our maintenance, right, and that also gets capitalized. So, there should be a big impact to EBITDA and debt and leverage as I mentioned, and we'll provide that once we know the numbers with certainty.

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

Renata I (00:19:04) just want to add to Alex's comment, that these been off-market leases that we have on the EIs, they go away over the next two, three years, so when we capitalize these and put them on the balance sheet next year, some of these are going on for one year, two-year, three years and say, the impact on our leverage is very minimal. And so, we're actually going to get it good guy in EBIT and a significant good guy on leverage. And so, that's something that we're excited about.

Now, when we talk about getting to a 15% operating margin in 2020, that's independent of the IFRS changes. So that's IFRS is only going to make those numbers look better. But - so we're pretty excited about the changes. It's going to kind of level the playing field for everybody, and so everybody will be accounting for maintenance the same way, accounting for aircraft rent and get the same way. And so, it'll be exciting to kind of show our numbers next year in comparison to all airlines in the world.

Q - Renata Faber {BIO 6774036 <GO>}

Okay. Thank you. And a question for Abhi. Abhi, you said that most of the RASK improvement came from the domestic market. Now that the BRL is appreciating, probably the economy will start to do better. Do you also see room to increase yields in the international?

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

Yeah, I definitely see room to increase yields, and I think that's going to happen slowly over the next couple of months as the currency stabilizes at this level. I think our customers will get more confidence in the currency being stable and that's going to drive more demand back towards international. So, yes, I definitely see room for yield expansion. It is a longer booking curve, so it does take longer to realize those benefits in the flown data, which is why we've got our capacity all the way out through May of next year, to give ourselves and the market some time to recover. And then I think, perhaps to June, July of next year, if this trend of improvement continues, then perhaps we'll look at adding some more capacity internationally. But for now, we will let the market recover, let the market develop and I think the yields are going to be the way that, that happens.

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

And (00:21:09) it's important we cut capacity from our expectation because of Airbus delays. And so, I think, as you look at it, it's not like we're burdening ourselves with additional aircraft rent that we're not flying. And in fact, Airbus has been delayed significantly on the A330neo program and that's actually - it could be a benefit to us in a weaker international environment. So, those get moved to the right a little bit. So, I don't want you to think that we're burdening ourselves with aircraft that we're not fully utilizing.

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Q - Renata Faber {BIO 6774036 <GO>}

Okay. Thank you.

Operator

Our next question comes from Bruno Amorim with Goldman Sachs.

Q - Bruno Amorim {BIO 17243832 <GO>}

Hi. Good afternoon. I have two questions on tax benefit. The first one is what to expect for 2019 in terms of payroll taxes. Any change vis-à-vis what you had to play or not in 2018? And second on the tax benefits on some of the states where you operate in Brazil, any you expected change in those benefits on to the new administration in Brazil from January on? And also any color you could give us in terms of the amounts of those benefits currently will be helpful as well. Thank you.

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

So, Bruno, it's Alex here. So, on the payroll tax burden, I didn't know it was expected to come back in, but right now we're not paying it, right, we're in the incentive mode still. With the change in government, I think there is something that we thought it was almost a certainty and was actually included in our guidance originally. Now we don't know, right. So, I think, it's a new government. We have to see how they're going to go about taxes in general. And so, when we put out the guidance for 2019, hopefully we'll have a clearer view and then we'll communicate accordingly whether the burden is in or not.

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

And Bruno, on your second question on the individual tax agreements we have in each state, I think, it's important to highlight to everybody that we fly to 101 destinations domestically in Brazil. Nobody comes even close to what we do. And so when we sit down with the governor and have a lot of air service in their state, it's essential for economic activity. And that's something that we're proud of that we've done, it's a great partnership that we have with the state. And so, we don't see that change and we see it actually enhancing. We're the only ones in Brazil with a diversified fleet that's flies the ATRs, that flies the E-Jets and flies the A320s domestically. And so, we're bringing essential air service to a lot of different places. And so, every time we go into a state, it's net positive for them from a tax base perspective.

Q - Bruno Amorim {BIO 17243832 <GO>}

That's clear. Thank you very much.

Operator

Our next question comes from Dan McKenzie with Buckingham Research.

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

Yeah. Hey, good morning. Thanks, guys. If I - question, with respect to the IFRS 16 impact, we'd continue to model the FX volatility in that particular line item, it doesn't change that. Is that - just as a housekeeping question, please?

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

I'm not sure we understand. I mean, it's going to go on the balance sheet once, but there should not be volatility from a P&L perspective. But the debt on the balance sheet will adjust up and down, Dan. But whereas now, my aircraft rent goes up and down based on FX, you'll see a lot more stability as it relates to our EBIT margin, if you will.

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

Yeah. I think the way to think about it, Dan, is it's just like a finance lease, right. So, today, we do have some adjustment on the finance leases on the liability side, because that that gets repriced every quarter and the asset doesn't. And that's why, as you know, the whole industry doesn't pay a lot of attention to net income. Obviously, it's an important metric, but it carries a lot of noise, right, a lot of non-cash impact every quarter. And that's going to get somewhat a similar kind of effect on the off-leases which will now be treated as financing.

Yeah so, it's our expectation, like John mentioned, we're looking forward to the change because I think it'll provide a lot more standardization and more of a level playing field to look at airlines that have financed leases and off leases in a similar way and make sure that everybody is accounting for it similarly. But I think, the same way that the whole industry focuses a lot on EBITDAR. Maybe they'll focus a lot on EBITDA or EBIT, right? But there will still be noise on the net income line. I mean, EBIT and EBITDA will still be sort of the more stable numbers that will provide a better view at how well the airline is effectively operating.

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

That's great clarification. Appreciate that. Thanks. And then, I was a little bit late joining the call, I'm not sure if you talked about or updated the fleet transition. Just the percent of - if we factor in the E2s, the percent of the fleet that would be up-gauged at the end of 2018 versus 2019 and in 2020.

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

So, Dan, we're working actively on that. We don't have news at this point. But we're going to be ahead of plan from what we have previously kind of committed to the market as we as we exit out our E1s and pull forward E2s. And so, we'll give you more detail the next time we catch up on that because I want to make sure we close out some of these agreements.

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But we're ahead of schedule from where we wanted to be, and that's what makes us so excited about the future. The airline today is performing really, really well. Imagine what it's going to look like when our entire fleet is A320neos and E2s. They're 29% lower seat cost, the same trip cost and the E2s have 26% lower seat cost. It's going to be a phenomenal transformation and it's going to happen over the next couple of years.

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

Dan, just (00:27:20) a little bit (00:27:21), this is a brand-new airplane which is being certified. It's just engine. So obviously, we're not worried about the performance of it. But getting the (00:27:30), and everything settled. We don't know exactly which month we're going to receive the first one. It's moving one month this way or that way and then how many we can receive in the year, but we're committed to taking absolutely as many as Embraer can deliver us in our spec and the way we want it for our customers.

So, we don't want to take deliveries and have to redo the airplane once it comes in. So, it may move one month the other way. So, Embraer is motivated to deliver as many planes as they possibly can, so they're working really hard to make the plane exactly the way we want it and give us as many as they possibly can give.

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

And we have natural leases that were coming off next year, six to eight that were coming off-lease anyway next year. And now that we're actively remarketing, we're going to accelerate that further.

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

Very good. Appreciate that. If I could just squeeze in maybe one or two last ones here. Abhi, there's been a lot of stock market, a lot of macro volatility in Brazil, and I'm just wondering if you can provide a little bit more granularity with respect to demand volatility. Even as good as the RASK was in the third quarter, I have to believe that there was a lot of travel that didn't take place. And I'm wondering if there's any pent-up demand that could potentially manifest in the fourth quarter here in early 2019 as FX stabilizes, I guess that's really one.

And then, just kind of following up on a couple of other prior questions, just legislative priorities under Bolsonaro, I know that you guys talked a little bit about tax, talked about other things, but are there other legislative priorities under Bolsonaro that you guys are watching that could potentially impact the business directly or indirectly next year?

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

Hey, Dan. So, I'll take the first two about the demand. So, I mean looking back to the third quarter, it was pretty smooth post-workup. So, if you go back even further, you remember the truckers' strike and then the World Cup, which sort of ended through the middle of July. From then on, it was pretty smooth. And there definitely was repressed demand. Prior to that, that came strong end of July. August was very good and September as I said, was one of our highest ever domestic RASKs in our history.

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And being more current, October was also good, but we had the elections the first round and second round, which in those weeks in particular, you saw a little bit of drop-off in demand, mostly due to the distraction effect or sort of people not wanting to travel during the election week. That I do expect will bounce back as I think it will now in November and towards December.

So, (00:30:11) the third quarter there was repressed demand from the trucker strike and the World Cup which came in strong. I think what we're seeing now is some repressed demand from October in terms of the election, but that's coming in nicely as well. And the forward curves are building strong for November, December.

One thing that jumped out at me is our load factor, I've never been a load factor guy. We've never had load factor targets. But our load factors are probably higher than they've ever been. And one reason is that the A320 is driving great connectivity throughout our network. And that's helping the smaller routes the E-Jet routes, the ATR routes. And as I look ahead, that load factor momentum is continuing into early next year which is giving us a lot of confidence to be aggressive on the yield side. So, I expect that momentum to continue in terms of demand domestically.

Internationally, I think, it's going to recover as well, mostly on the yield, our load factors are already 85%, 86%, 87%. And I think that those yields will recover as the currency stabilizes over the next couple of weeks and months.

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

I think Dan, I'll pass it off to Alex to answer your question on the reforms. But keep in mind, fuel is down significantly over the last 60 days and the currency has also strengthened a lot over the last 30 days since the election. So, those are also two big benefits that we'll be seeing as we move forward and that's kind of what brings a lot of the optimism in.

The country seems to be back to work. People are pretty excited about the future and it just needed to have the election get behind us, so everybody now focused on moving forward. I think, the country really has come together and the current government is talking about reforms and the new government that's formed is also talking about reforms.

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

Yeah. And I think, there's so much optimism here because obviously if the reforms happen and we have a lot of confidence that they will happen, it will be very beneficial to Brazil. And the best thing for Brazil in general and specifically for our sector is for Brazil to grow again, right. Brazil went through a deep recession for a couple of years. We still haven't kind of snapped back to even what we were prior to the recession. So, there's still some room to grow until we get back to that level.

And it's what David identified kind of 10 years ago when Azul started, right. There's big potential in the country, it's huge. And over the last 10 years, the industry has doubled in

size, but average GDP growth has only been 1.5%, right. So, you can just imagine how this industry could do if GDP starts growing to 2%, 3%, 4% as Brazil should be growing as an emerging market and with all the potential that we see here.

So, that's - I mean, if you ask us, the list of things that could be reformed that would be beneficial to the country is huge and I think that's what the new government is seeing as well. There's a lot of opportunity. There's a lot of potential and I think it will be just a question of them to start coordinating, start aligning and negotiating well with Congress and start pursuing all of these opportunities.

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

That's terrific. Thanks so much. I'll pass it on the next guy. I'm excited to watch the reforms myself. Guys, have a great day.

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

Thanks, Dan.

Operator

Our next question comes from Matt Fallon with Deutsche Bank.

Q - Matthew Fallon {BIO 16763664 <GO>}

Hey, guys. Matt on for Mike here. I know you addressed this briefly, but could you give us a little more color on what impact the A330-900neo delivery delays have on your capacity allocation and network plan?

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

Yeah. Hey, Matt. So, initially, we were looking at getting A330neos in service towards the end of this year. We were obviously informed along with other operators that the airplanes would be delayed towards the end of January, if you will, which would be past our high season, our summer season. And so, in that case, we said, well, let's just see now, we're delaying it a little bit further because we don't want to take those airplanes in the middle of the low season. So, in that case, we push them to the right closer to the next high season which is in the June-July timeframe.

So that has delayed the start of a couple of new markets which in this currency environment we're perfectly comfortable with. And we will now time them to take advantage of the next high season that sort of are the southern winter, the northern summer, if you will, around the late May-June timeframe. So, it's still not clear whether we'll get one or two A330s and kind of is still a little bit influx, but I expected the first A330neo routes will only start service late May, in that early June timeframe.

Q - Matthew Fallon {BIO 16763664 <GO>}

Thanks. I have two quick follow-ups. One, could you give us a read - early read on 2019 capacity? And the second is this 70% recapture rate (00:35:21), should we assume this

type of performance can continue in Q4 and beyond? Thanks.

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

Yeah. In terms of capacity for 2019, I think, it will be similar. I think you will see domestic a little bit more representative. So, I think, this year domestic was 8% to 10%. So, next year will - this year, I think it's closer to 8%. I think next year, it will be closer to 10%. And international will be in the 40-ish percent range for an overall capacity growth of around 18%, something like that.

This year, our initial guidance was 18% to 20% and then we brought it down to 16% to 18%. So, I would say, a very similar capacity growth overall. A little bit more biased towards the domestic side. That's where our focus is. That's where I think the opportunity is anyway. And I think - because we're going to have the A320s as well as the E2 is starting to come in.

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

We know about that, that's all coming from up-gauging, right. It's one aircraft out, one aircraft in and better utilizing the assets that we have. And Abhi talked to the recapture rate, but keep in mind that in the third quarter, we paid the highest fuel price we've ever paid at Azul. And then the exchange rate was the highest we've ever seen sustained in the quarter. I think, it hit 4.15 in the quarter, but it averaged just under 4. And so, we're obviously in much better place right now. But Abhi can talk to the demand environment and his ability to recapture.

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

Yeah. So, in terms of our recapture, there are two parts to this, one is revenue recapture, which is average fares, ancillary, fees, all those kinds of things, and basically RASK. And the other part is what we're getting in terms of what I called margin recapture, which is the efficiency that we're getting with the A320s and the E2s next year. So, for us, it goes very much hand in hand, because RASK, of course, is affected by the capacity that we're putting in. That's very, very efficient and low unit cost capacity.

Overall, I do expect similar or better percentages in terms of recapture. Yes, the mix between sort of RASK and CASK could vary as capacity growth changes, as we get more A320s, as we get more E2s. And we really are able to lower our unit costs with those super-efficient airplanes. But overall, yes, I do expect similar or I think, we want to do even better in terms of overall margin recapture.

Q - Matthew Fallon {BIO 16763664 <GO>}

Thanks for taking my questions, guys.

Operator

Our next question comes from Helane Becker with Cowen.

Q - Helane Becker {BIO 1504163 <GO>}

Thanks very much, operator. Hi, everybody. Thank you so much for the time. Just a quick question. I think this morning you announced a codeshare agreement with Copa. And I'm just kind of wondering two things, one, you have fairly high load factors and so, what do you think the exchange in passengers will be? What - do you have any expectations for revenue benefits from the codeshare - A, from the codeshare and B, from the frequent flier exchange. So, maybe you could talk about that a little bit.

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

Yeah. Hi, Helane. Thanks. Yes, so, this morning we did announced our codeshare with Copa and a bilateral frequent flyer agreement. But well, I'm very excited about this agreement. We've been talking to them for a while. Copa is a great airline, they operate more than 70 weekly flights into Brazil to 9 different cities. And so, there's a lot of places that we can connect that are just not sort of the two main international airports in Brazil, São Paulo and Rio.

Belo Horizonte, one of our biggest hubs. They fly Recife, one of our biggest hubs, and all of the other places. So, in terms volumes, I think it's going to be on par with the other codeshares that we have. We don't break it down by individual codeshare, but it's incremental demand and it's incremental demand in sort of our spoke cities: Belo Horizonte, Recife, Salvador, Fortaleza, all of these kind of cities that Copa flies where they can really use the connectivity that we have, that's the benefit. So, for us, it's incremental demand in these cities and for Copa, it's additional connecting option for their customers as they're fly into Brazil. So, I really, think it's a win-win.

In terms of loyalty, customers love using their points and we really want to allow them to use their points in our partner. So, today, our TudoAzul customers, in addition to Azul, can use their points on TAP, can use their points on United. And Copa is going to be a great option for them, whether it's the Latin America, whether it's the Caribbean or even some parts of the U.S. So, I think, it adds to the portfolio of loyalty redemptions and I think it makes the program that much stronger.

Q - Helane Becker {BIO 1504163 <GO>}

That great. Thank you. I appreciate your help with that.

Operator

Our next question comes from Alberto Valerio with UBS.

Q - Alberto Valerio {BIO 20716048 <GO>}

Hello, gentlemen. Thank you for taking my questions. I have three one on my side. The first one, it will be, if you could give some color on the reverse provision that it was in the results today?

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

The other operating expenses. The reversal also on the provisions.

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

Yeah. So, Alberto, as you know, other operating expenses is kind of a mixed bag. It's kind of a catchall. There are a lot of different line items in that account. Some of them going up, some of them going down. A lot of them are sort of administrative and one-time, they're not completely tied to the operation. But out of the ones that I think are most relevant this quarter, we revised some provisions for liability claims, some taxes, and some cost of redelivering (00:41:40). So, I think, there was about a BRL 20 million number that sort of the most relevant line. Like I said, a lot of things going up or down, but I think the most relevant would be a BRL 20 million expense that we decreased.

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

But it all sums up to the BRL 20 million and there's a bunch of little stuff in there.

Q - Alberto Valerio {BIO 20716048 <GO>}

Okay, perfect. And I also saw some civil lawsuits that were reported. This would be (00:42:08) some time?

A - Operator

There's some that happens occasionally. I mean, customers love us as you see from all the awards and recognition that we get. But every now and then, we mishandle a bag and that becomes a point. So it's not a - there's an expense line item that's recurrent on our operating P&L and we periodically look at this to see if they are going up or down. And like I said, they don't necessarily - your customers have until five years to enter a claim, and so there's not necessarily a big tie to capacity or passenger numbers, right. So, there's a little bit of (00:42:57) there, sometimes it goes up, sometimes it goes down. This quarter is one, it was a line that went up more significantly than the rest.

Q - Alberto Valerio {BIO 20716048 <GO>}

Perfect. Just my last one, sorry for that. Probably one on the oil price. I saw that in this quarter, you had high (00:43:15) in the jet fuel than the Brent oil. And in the latest quarter and the first quarter and second quarter was opposite. What we can expect for the next quarter and next year?

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

So, the main thing is, there's about a 45-day lag between any impact that you see on international jet fuel prices, as well as foreign exchange, right. The 45 is an average number, because what happens is Petrobras is sort of the sole supplier of fuel to all the distributors here in Brazil. They have a fixed price for the full month and that price is somewhat tied to the behavior of jet fuel prices internationally as well as FX for the previous month, right. So, on average, you have about a 45-day lag.

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So, I think even in October, we were still paying a fairly high fuel price. November will be a little bit better, but it will still be higher than what you see on your screen today. And probably in December, we'll get the full benefit of the improvement that you've seen both on FX and on fuel. And am assuming that the international prices stay flat. So, that's where our local jet fuel prices would stabilize as well. (00:44:38), if it goes up or down, there's always going to be this 45-day delay until we see the impact on average.

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

It really helps if it's going up, but it...

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

You don't get the full benefit, if it goes down, but we'd rather - it works out fine for us both ways?

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

Yeah.

Q - Alberto Valerio {BIO 20716048 <GO>}

Perfect. Thank you very much.

Operator

Our next question comes from Savi Syth with Raymond James. Hello, Savi. Your line is open

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

Sorry about that. Just a quick follow-up on TAP, I just wondered, if you could give an update there. And just with fuel price going higher, is there any risk that some of those subleased aircraft being returned?

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

No. So the sub-leased aircraft are - we have a full commitment to the end of the lease term. And so, there's no risk on that.

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

In 2023.

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

Yeah.

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

(00:45:33)

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

Yeah. And I will say that's TAP is performing pretty well, (00:45:42) team over there has done and we're very excited about all the work that they've done. And that airline is going through a similar transformation. They're improving significantly the product, getting new aircraft and had opened up a lot of new destinations.

For those of you in the U.S. that want to visit Europe, go through the gateway in Lisbon, it's an unbelievable city. And one thing that we're finding, Savi, is that Lisbon is kind of the new Miami for Brazilians. And so, it's a hot spot for Brazilians and it's actually been - it's a very, very cool city to visit. And so, the guys at TAP that are running it are doing a fantastic job.

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

I mean, TAP is doing great to Brazil and Azul is doing great into Portugal. And we've got a similar - and our probably (00:46:23) most profitable international flight goes to Lisbon. So, it's a - and Portugal is just hot, right now. It's hot for people going to the U.S. that used to walk around the streets and say, (00:46:35) in Portugal? And people would say, no but it seems like a great place and now it seems like everyone is going to Portugal. And TAP has really benefited from kind of the euphoria over Portugal right now. It's a great place and anyone (00:46:49) been there, you're missing out.

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

Understood. All right. Thanks.

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

And if you have a significant position in Azul, we'll get you good fare as well.

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

Yeah.

Operator

Next question is from Dan McKenzie, Buckingham Research.

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

Hi, hey. Thanks for the follow-up time you guys. Hey, just one quick question regarding 2019, at this point, how are you thinking about foreign exchange for purposes of internal planning? Are you thinking that the help might appreciate from here? Or how should - maybe you provide some perspective about how you're - there's a lot of moving pieces here out, just wanted to know how you're thinking about things at this point?

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

Hey, Dan. We're in the middle of our - we're finalizing our budget right now. Normally, we use the focused survey as well as the forward curve, as kind of guidelines to determine

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what kind of effects we're going to expect for next year. And between now and when we'll actually publish our guidance, obviously, we'll again see where foreign exchange rates level out, as well as how confidence with the new government also materialize. So, between now and then, I think we'll have a better gauge on where FX is going to level off. But, it's normally very close to where both the focused survey which is a collection of market players here in Brazil, opinion on FX, as well as the forward curve, and that's normally what you can assume is the rate that we've used for our planning purposes (00:48:33).

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

Yeah, Dan, when we use our budget, we typically use a higher FX to challenge our people internally to lower cost, to be honest with you. But internally, don't tell them. I think, anything can (00:48:45) the Street is that it'll trade between 350 and 370 (00:48:47) next year. So, that's - I think that's where most people are kind of planning.

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

I mean, to be the biggest (00:48:55) in Brazil if you can get done is obviously pension reform. And there is a lot of talk about maybe not - I'm not putting an odds on it, I mean it could be very difficult, but even getting it done with this all, the current congress and the current president, try giving a fresh start to the new president, he starts January 1 and maybe he can get it, something passed. And obviously that will affect the exchange rate, if they're able to get a significant pension reform done. And we fully expect everyone voted to strengthen the real from where it is today.

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

Yeah. Right. Well, you have my condolences to all the employees there. But one final follow-up question here. With respect to the...

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

(00:49:37) back on. See if it's back on.

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

...with Brazilian post office, is there is a sense of timing for it, when you might have some more perspective about when the economic benefit might begin to manifest itself with the JV with the post office?

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

Dan, I think, as we go through the budget process now, you'll probably start to see something on our 2019 forecast for it. We're certainly not - we will not see any benefit this year, and it's most likely a Q2 2019 story as we move forward, as we sit out the new administration and make sure that they're onboard with the negotiated deal that we did with the previous administration at the Correios. But, all things indicate that they are and we're jointly working with antitrust authority CADE in Brazil currently. So, it's really a 2019 story.

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

Thanks for the time again, you guys.

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

Thank you.

Operator

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

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

Thank you for joining the call today and as always, feel free to follow up with Andre and myself, Alex, Abhi, any and members of our team. And we look forward to seeing you at the conferences over the next couple of weeks and giving you more details about Azul. Thanks, everybody, for your support. See you next quarter.

Operator

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

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