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Bloomberg Transcript

Q3 2017 Earnings Call

Company Participants

- Paulo Sergio Kakinoff, President & Chief Executive Officer
- Richard F. Lark Jr., Executive Vice President, Chief Financial Officer and Investor Relations Officer
- Unverified Participant

Other Participants

- Felipe Vinagre, Analyst
- Michael J. Linenberg, Analyst
- Raymond Wong, Analyst
- Savanthi N. Syth, Analyst
- Stephen Trent, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to the GOL Airlines Third Quarter 2017 Results Conference Call. This call is being recorded and all participants will be in a listen-only mode during the company's presentation. After GOL's remarks, there will be a question-and-answer session. At that time, further instructions will be given. This event is also being broadcast live via webcast and may be accessed through GOL website at www.voegol.com.br/ir and the MZiQ platform, where the presentation is also available. Participants may view the slides in any order they wish. The replay will be available shortly after the event is concluded. Those following the presentation via the webcast may post their questions on the platform, and their questions will either be answered by the management during this call or by the GOL Investor Relations team after the conference is finished.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumption of GOL's management and on information currently available to the company. They involve risks and uncertainties because they relate to future events and, therefore, depend on circumstances that may or may not occur. Investors and analysts should understand that events related to macroeconomic conditions, industry and other factors could also cause results to differ materially from those expressed in such forward-looking statements.

At this time, I will hand you over to Paulo Kakinoff. Please go ahead.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Good afternoon, ladies and gentlemen, and welcome to GOL Airlines third quarter 2017 results presentation. I am Paulo Kakinoff, Chief Executive Officer. And I'm joined by Richard Lark, our Chief Financial Officer.

Richard F. Lark Jr. {BIO 427746 <GO>}

Hi. Good afternoon, everyone.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

This morning, as you saw, we released quarterly numbers. Before I take you through the highlights, I want to state how enthusiastic we are of our results. These figures show that the plan that we put in place nearly two years ago is bearing fruit, thanks to the effort of our committed and hard-working GOL team.

Turning to slide number 2, our net revenues continued to exhibit strong positive momentum, reaching BRL 2.7 billion in the period. This represents an increase of 13% compared to the same period quarter last year. Of note, we achieved this revenue growth and consolidated our leadership position in the market with 36% total share according to ANAC, while keeping our operating fleet at the same level as in year ago at 116 aircraft, and reducing our total fleet from 135 aircraft to 120. This allowed us to drive margins significantly as you will see shortly.

Recurring operating income in the third quarter was BRL 327 million, an increase of 49% compared to the same period in 2016. Recurring operating margin was 12% in the period, an improvement of 2.9 percentage points. Let me just take a moment to highlight here our continued solid performance. This is the fifth consecutive quarter of operating profit for GOL. Quarterly recurring EBITDA totaled BRL 463 million, a margin of 17%. This represents an increase of nearly 45% as compared to the fourth quarter (sic) [third quarter] (04:09) 2016, an improvement of over 3.5 percentage points in margin.

I'd like to focus for a moment on net income, highlighting that net income in the period was a gain of BRL 328 million after the minority interest. This represents a net margin of 12.1%. Such result obviously represents a significant improvement in comparison to our net loss of BRL 0.9 million in the fourth quarter (sic) [third quarter] (04:44) 2016. Net cash flow, too, was positive at BRL 348 million.

Operationally, our load factor for the quarter increased by 0.4 percentage points to 8.2% (sic) [80.2%] (05:00). And our average yield per kilometer (sic) [passenger] (05:03) increased 8.6% to BRL 0.249, resulting in a RASK of BRL 0.226, an increase of 8.3% over third quarter 2016. Excluding nonrecurring expenses, which totaled BRL 4 million in the quarter, the total CASK was BRL 0.199, an increase of 5% when compared to the third quarter last year.

Turning to slide 3, our current network (05:37) 2016 was designed to serve higher yielding routes and capture a bigger share of business traffic. Today, we have the largest share of business traffic in the country, and thus feel good about our prospects in the segment as the economy and business demand continue to strengthen. On the left, just to reinforce that I mentioned earlier regarding fleet. As you can see, after the capacity rightsizing we carried out in 2016 to adjust for Brazil's adverse macroeconomic conditions, we have maintained our fleet flat at a targeted size for 2017.

However, we have continued to drive aircraft utilization and expand our average stage length, allowing us to grow the number of flights by 2% from the year ago period, and increase ASKs by 4.5%. During 2018, we expect to continue to focus on optimizing the utilization of our fleet. We also expect to derive productivity gains from the already announced reconfiguration of the 737-800 fleet, which will increase the number of seats on those aircraft by 5% from 177 to 186.

On slide 4, I repeat this every quarter, but I cannot highlight it enough. We are the only airline that operates in two low cost carrier model in the year. We have a standardized single fleet which allows us to obtain lower crew costs, (07:13) spare parts management, and higher utilization. GOL has the lowest unit cost in Brazil, a full 21% lower than of our peers. This makes us – our business uniquely resilient and with the highest defensive power in comparison to anybody else. As you can see, a number of other features ensure our position as the most competitive airline in Brazil, such as market share leadership in difficult to penetrate markets, vast (07:46) network for business travels, and continued technology investments to enable best experience for GOL customers.

Turning to slide number 5, we not only are the low cost carrier, but we are a low cost carrier that provides an extraordinary level of service. Per our full year revised projections, we expect to close the year close to flat in ASKs versus 2016. We project an average load factor of close to 79%. CASK, ex-fuel, of BRL 0.137, and an EBITDA margin 14% together with an EBIT margin for the full year of 9%. Earnings per ADS after minority interest are expected to be between $1.25 and $1.40.

As you know, most of these figures are on the positive end of the ranges we have originally guided to. Leverage, as measured as net debt over last 12 months EBITDA, is expected to be close to 3.4 times, showing continued improvement in our balance sheet. Key risks to our guidance are external shocks, as well as unexpected growth in capacity by competitors, which will affect market fares.

With that, I'm going to hand you over to Rich, who is going to take us through the quarterly financial presentation. Richard, over to you.

Richard F. Lark Jr. {BIO 427746 <GO>}

We had a solid September quarter, as you can see on slide 7. We achieved an EBITDA margin of 17% and an operating margin of 12%. As Kakinoff already mentioned, this is the fifth consecutive quarter of operating profit for GOL. Our net debt at the end of September was BRL 4.3 billion, down BRL 523 million from June 2017. In the quarter, our operations had a 4.5% increase in capacity, and an increase of 9.2% in passenger revenue per kilometer or PRASK, generating a RASK growth of 8.3%.

Turning now to slide number 8, we note that even with the industry environment so difficult in the short term, strong demand for (10:15) services here at GOL since the launch of our new network in May 2016, we've increased our load factors by about 2 percentage points. For the fourth quarter of 2017, we expect occupancy rates to be in the 80s.

On slide 9, you can see that our profitability calculated by EBITDA was positively affected by the 8.3% growth in RASK and a 5% increase in returning total CASK. The ex-fuel CASK had an increase of 7.1% in the same comparison mainly due to the annual profit sharing provision made in the third quarter of this year versus last year's provision that was made in the fourth quarter; also, an increase in the purchases of miles from partners, the presence of sale leaseback transactions in the third quarter of 2016, and increased depreciation and amortization due to increased capitalization of engines.

Excluding these effects, GOL's total CASK in the third quarter of 2017 was flat versus the third quarter of 2016. As a consequence, our recurring EBITDA increased to BRL 463 million in 3Q 2017, with a margin of 17%, an improvement of BRL 143 million compared to the third quarter of 2016. The EBITDA per available seat kilometer increased to BRL 0.382 in this period 2017.

Our net financial results for the quarter were positive by BRL 29 million, as can be seen on slide number 10. We had BRL 297 million financial revenues in 3Q 2017, of which BRL 242 million were noncash exchange in monetary variations, offset by BRL 269 million of financial expenses. In the same period of last year, we recorded BRL 264 million in net financial result, and a BRL 365 million financial expense, of which BRL 36 million were exchange rate and monetary variations also without cash effect. Therefore, netting this out, financial expenses were reduced by BRL 65 million in relation to the previous year, and as a result of better cash management, less factoring of receivables, and savings in cash to pay off and reduce our debt.

The significant increase in liquidity is discussed in more detail on slide number 12. On slide number 11, we detail the change in net income after minority interest between the third quarters. It is evident that most of the components of this variation were making positive contributions to improved net income, which is a consequence directly of the company's operational improvement. We therefore reported earnings per share of BRL 0.94 per share and $1.49 per ADS for the third quarter of 2017.

Operating cash flow generation was positive by (sic) [positive at] (13:21) BRL 589 million as can be seen on slide number 12. The operating cash flow margin was 21.7% in this quarter. Total liquidity at the end of the September increased BRL 348 million over the position at the end of June. Out of the operating cash flow, funds were used in investment activities at BRL 201 million and financial activities of BRL 40 million. In summary, this slide shows that the surplus of operating cash flow is in excess of our investing cash flow, and it is being used to serve the financing cash flow, i.e., our debt service and reduce the overall debt level of the company.

In the chart to the left on the slide 13, you can see the evolution of our total liquidity for the second quarter. We had BRL 2.1 million in cash, cash equivalents, short-term investments, restricted cash and accounts receivable at the end of the September quarter. In the chart on the right, you can check the evolution of our net debt and the respective leverage over the last 12-month EBITDA, which, excluding our perpetual bonds which don't have a fixed maturity, is at 3.4 times LTM EBITDA.

Slide number 14 shows the history of some indicators of leverage, coverage, and liquidity for the past five quarters. General improvement of all credit indicators can be verified.

And to conclude today's presentation, I would like to review our fleet plan on slide number 15. We currently own a fleet of 120 Boeing 737 NG aircraft, of which we operate with 116, and the other four are on subleases outside of Brazil. In 2017, we will maintain the current fleet size. And in 2018, we will begin aircraft replacement with the delivery of our first five Boeing 737 MAX 8 aircraft.

In summary, we remain laser-focused on disciplined capacity management, maintaining our absolute cost leadership and being the airline of choice for our customers, and also continuing to prudently manage our balance sheet and liquidity.

With that, back to Kakinoff for questions.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Before moving the presentation to the Q&A, please let me update you on the recent improvement and developments regarding our product services and operations. Due to our already mentioned single fleet type operation, which simplifies our daily business, we have achieved a superior level of schedule reliability at the level of 98% of our flights being completed, and over 95% of them departing on time. As we continue to capture the larger share of business customers, we remain focused on continuing the schedule reliability improvements. We also remain focused on offering the best air travel experience overall. We design our route network to provide integration and interconnectivity and to offer frequent flight schedules in the main business markets.

Our modern fleet has been reconfigured with eco leather seats and Wi-Fi on board. We expect to finish the fleet-wide Wi-Fi retrofit by mid-2018. At the moment, we have already 66 aircraft equipped with such device. We have been a pioneer in driving technological solutions, such as the Selfie Check-in, an exclusive feature (17:00) of GOL. We increasingly cater to the world's customer taste and demands, offering differentiated products such as our GOL+Comfort seats and expanding our onboard service menus. Safety, as always, remains our number one value. In addition to our historical FAA certification, our Aircraft Maintenance Center in Cofins, Minas Gerais; and our Galeão base in Rio de Janeiro recently obtained EASA, European Aviation Safety Agency certification. This ratifies our standard of excellence in aircraft and component maintenance and services, and underscores our commitment to ensuring that our processes, manuals, and maintenance training programs are in line with world's best practice.

So, before opening the session for our Q&A, I would like to address one that we have already received by e-mail just this morning.

Unverified Participant

What is the expectation in terms of revenue increase and flight offerings for the new hub in Fortaleza?

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

The Fortaleza hub is expected to generate BRL 160 million in additional revenue in year one, 12 months after starting activities, which is supposed to begin in May next year; and BRL 200 million when it reaches maturity in year three. There will be 25 daily flights, and this is even more important than the expected revenue increase, is the new market created for GOL customers to travel abroad without any kind of need to travel to São Paulo or Rio de Janeiro. Both Air France-KLM and Delta will benefit from this greater connectivity with GOL's passengers from the North and Northeast of Brazil. This will generate new demand, which is in line with our 2004 to 2011 track record with the so-called GOL Effect.

And now, I would like the operator to open the floor for further questions of today's call.

Q&A

Operator

The first question comes from Duane Pfennigwerth with Evercore. Please go ahead.

Q - Raymond Wong {BIO 19495692 <GO>}

Hey, guys. This is actually Ray, on for Duane. My first one is how much more utilization is leftover to recover from the 12.3 hours per day that you're at? And assuming that optimal utilization level into next year, where would that get us on capacity growth?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Hi. Morning. I'm not sure if I totally understood the question, but we're basically at a level of utilization that we want to be at going forward, roughly this 12 hours. As we go forward, obviously, that's reflected in the productivity we're starting to get, going forward, on a quarterly basis. As Kakinoff mentioned, next year – in the second half of next year, we start to – the fleet replacement with the 737 MAX 8, which in addition to the 15% lower costs on fuel, we'll also have a slight increase in capacity by about 3% to 4%.

And so, that activity, as it relates to the exchange (21:03) on the MAX, increases the ASK productivity by each aircraft by about 3% to 4%. At the same time, we're also going to be reconfiguring the existing fleet of the NGs on something similar. So, the short answer (21:18) basically is that going forward, with the events which is significant for us, which is the MAX coming in to the fleet in July of next year, it's roughly a 3% to 4% increase in – a reduction in the costs, but we're keeping that utilization roughly – at this roughly 12 hours across the entire 700-flight a day network.

Q - Raymond Wong {BIO 19495692 <GO>}

All right. Thanks, Rich. And how much did bag fees contribute per passenger in 3Q and where do you see that ramping to?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Yeah. It was started in July at GOL. And as you probably know, we still had the heritage of the tickets sold based on the previous regulation. So, the contribution was, at the moment – or in the third quarter, is still low. We do not give any (22:17), specifically on that line. We just say that it's a promising additional fund – source of revenue, but we still do need another quarter to measure the full effect of that.

Q - Raymond Wong {BIO 19495692 <GO>}

Great. And if I get one last one in here, ex-currency, how do you guys see the trajectory of non-fuel costs into 2018?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

How do we view the trajectory of non-fuel costs in 2018? Well, what I would help you on that is that kind of like in t what I just said, the main impact for us, which is structural cost advantage, relates to what we're doing with our fleet management. So, as you highlighted correctly so, there's roughly 12 hours of aircraft utilization that we're at is the best practice number. It's among one of the highest in the world and allow us to get to an enormous (23:11) fixed cost dilution. The MAX coming into the fleet in the second half of next year puts an – it's about a 15% cost reduction.

But as we're phasing in the fleet gradually over a period of around 10 years, it works out to about a 3% to 4% annual cost reduction in the overall fleet. And so, that, combined with our very, very low fixed costs, we have some of the lowest fixed costs of any airline in the world, when you factor that into the business model that we have, which is a single fleet type, highly integrated network, it roughly offsets any expected increase we could expect on inflation.

As you know, inflation is kind of running now in Brazil at record lows. So, it's allowing to – us retain a lot of value, inflation kind of in the 3% to 4% range. And so, this increase on the productivity side of the production of ASK, production of the aircraft, is significant. It will more than offset any cost increases we should get with respect to inflation.

So, with that said, that roughly equals out (24:27) to a roughly a flat to slightly improving, slightly reducing overall ex-fuel CASK. Having said that, in the ex-fuel CASK, you also have the productivity effects of the, if you will, the increased size of the number of seats on these aircraft, which also has a increase on the other side, allows us to product more revenues. And so, the right way to look at that is also on the margin side of the equation.

So, we also have a potential margin expansion on the revenue side to the extent that we can use this productivity, maintaining similar ASKs. We can have a significant margin expansion just because of the simple activity that we're doing on the fleet replacement combined with this very high utilization. So, that's how it kind of, if you will, guides you on how to think about our costs next year. We don't anticipate any extraordinary effects other than the normal effect to the business. As you guys have been following our results for several quarters now, many quarters, you know that in the 2016 to the beginning of 2017 period, we had a lot of extra costs related to the transformation of the company.

The reorganization of the network to make it more profitable, the elimination of 29 aircraft from the fleet over a long period of time, basically that – those costs and transformation effects have already run through our company. And so, it's a right-sized network, a right-sized fleet. And you're starting to see some of that in the results. But we do expect to kind of get this steady structural cost reduction going forward, which we think is only going to increase our competitive advantage over the cost differential that we already have versus the competition, which is in excess of 20%.

Q - Raymond Wong {BIO 19495692 <GO>}

Appreciate the answers. Thanks a lot.

Operator

The next question comes from Felipe Vinagre with Credit Suisse. Please go ahead.

Q - Felipe Vinagre {BIO 19282922 <GO>}

Hello, Kakinoff and Rich. Thanks for the opportunity to ask. I have three quick questions. The first is on the capacity. If you have any expectations or preliminary expectations for next year in terms of ASKs and departures (26:50), et cetera. The second is on the other revenues. Even though I understood that is at ramping up, still, phase of the bags, of the checked-in bags, but even so, the revenues – the other revenues this quarter, they were below the first half levels, which was not the case from a seasonality perspective in the previous two years. So, want to see what drove that. And the third and final, on the fuel costs, so how to compare the marginal costs after the rise in fuel prices versus the third Q average? And what do you expect in terms of the ICMS, the tax? What outcome to expect from the Congress and from this regard? These are my three questions. Thank you.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. Hi, Felipe. Good afternoon. Yeah, I'll start with the question on that, but in terms of ASKs, I mean, we're basically keeping, as you know, as we've spoken, our capacity growth today is zero. So, unless we get some clear signs on demand growth, on volume growth, that's our capacity growth plans going forward. And we don't expect to grow capacity more than GDP growth. We expect to track capacity at or below GDP growth. Secondarily, just your second question here – sorry, Felipe, I just got distracted here for a second. Your second question?

(28:16)

Q - Felipe Vinagre {BIO 19282922 <GO>}

Second question was on the other revenues. So, it was below the first half levels. I know that there is the bag that you're ramping up, but what drove the third Q to be below the first half levels in the other revenues, which was not the case in the previous two years?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

This is basically the seasonality in the quarter where we have July is a higher weight regarding - weight on the results with more leisure travelers than business travelers and paying less additional revenues for that. So, it's nothing surprising, and it does not denote any kind of new trend.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. I mean, I guess I didn't understand your question because our - all of our other revenues are increasing year-over-year. I mean, the cargo business, as we've highlighted, as well as the other revenues, they're growing ahead of GDP growth. The year-over-year comparison, they grew around 7%. And cargo also growing at 7%, which is a leading indicator of economic growth for us. They're tracking at 7%. So, that's why I didn't totally follow your question about a decrease in other revenues.

Q - Felipe Vinagre {BIO 19282922 <GO>}

The decrease versus first half because the first half, this trend was already there. So, they were growing also even more than you grew in the third Q. But I think Kakinoff, he addressed...

(29:33)

A - Richard F. Lark Jr. {BIO 427746 <GO>}

You have effect of seasonality. Also remember that the full network restructuring, and the company, if you will, the rightsizing of the company from a network side was finished in May of 2016. And then, the last aircraft kind of went out (29:50) through the system in April of 2017. And so, it makes the apples-to-apples comparison more difficult. So, really, the Q3 of 2017 is the first kind of pure comparison of quarter to quarter of the new GOL, if you will, of our new GOL.

On the fuel side, I mean, on the, we - a lot of people ask about ICMS. I mean, the - if there is a voting on that where they will reduce the maximum value-added tax rate across all Brazilian states to approximately 12%, that would be in excess of BRL 100 million cost reduction for us, which should also give us additional cash flow to dedicate to increasing service and other types of markets, which normally are not profitable to have those services. We don't know when that will effectively go for voting in the Congress. It's been delayed many times. We think that if it goes for a vote, it would be approved. But we don't have any indication of when and if that would happen.

And we're managing - your question on the fuel cost overall, obviously, there's the volatility - the normal volatility on oil price is up and down is not causing us to change our view in terms of what we're working with prices. But unlike (31:18) this year - this year, we expected around a 12% increase in the price per liter. We've had less than that. We're thinking about something probably in the range of the low single digits on price per liter increase maybe on the range of 2% to 3%.

Like I said, we originally started the year expecting – at the end of last year, we had this conversation, we were thinking maybe $63 for WTI at the end of 2017. That was substantially revised down. Now, folks are talking – talk about $63 again. But we ended up this year with a combination of our efficient management on the operating side because it's not just about the price, it's also about what we're doing to reduce our fuel consumption. Next year, as I mentioned, when the MAX comes in, the apple-to-apples on the MAX, it has a 15% lower fuel consumption. We've got five coming in next year.

The MAX is already operating with other airlines around the world that are big operators of the 737 MAX 8, like Southwest, for example. They've been operating their MAXs since July. And they've already said that it's been as advertised, the 15% fuel economy coming in there. So, that's going to have a significant offsetting effect on our side versus any potential increases in fuel. But at this point, we're not expecting anything more than perhaps a 2% to maybe 3% increase over – with these effects on the operating side over the roughly BRL 2 per liter that we've been managing thus far this year.

Q - Felipe Vinagre {BIO 19282922 <GO>}

Okay. Thank you. Thank you, Richard. Thank you, Kakinoff.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

Operator

The next question comes from Steve Trent with Citigroup. Please go ahead.

Q - Stephen Trent {BIO 5581382 <GO>}

Good afternoon, gentlemen. And thanks very much for taking my questions. Actually – the first one's actually a follow-up on Felipe's question. I'm just trying to understand 2018, appreciate how you said you want to increase capacity in line with GDP and maybe it's going to stay flattish. But I look at slide 15 and you're going from 115 planes this year to 121 next. You're increasing the number of seats by 5% on some aircraft. And I'm just trying to understand that – on the 737-800 MAX coming in, how you're going to maintain stable capacity if you're going to keep blackout (33:57) utilization at the current level.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Well, it's a good question. Thanks for asking. I'll try to give you a legitimate answer. The incremental growth for us over our domestic market is all being focused on international, which is a new addressable market for us. One of the benefits of the MAX is it has a range of about 1,000 kilometers longer, an hour longer. That allows us to open up new markets that we're not able to serve today; markets in South America, on the west coast of South America, also up into Central America and Southern Mexico and also South Florida. As Kakinoff mentioned as well, we will be doing some additional activities on feeding traffic with Air France and KLM at the Fortaleza hub, which is going to be huge and a lot of (34:50) coming in there.

So, all of this – the MAX opens up these new markets for us, which are new sources of revenues. We expect with the MAX to grow the international revenue portion of our overall mix from around the 14%, 15% today to around 20%. And so, it's really – for us the – when I say the numbers I was telling you (35:10) before are really primarily related to the domestic capacity growth because that's what everybody is most focused on that we keep demand growing slightly ahead of supply overall in the market, focused on stability in the cash flows and the business model for the whole sector to get this sector as healthy as possible, so that we can get back on a growth path and start increasing service and start stimulating demand in the overall market over the long term because Brazil still has a very low penetration of air travel at (35:45) per capita per year compared to developed markets that are 8, 9, 10 times higher than Brazil.

But basically, it's all focused – for us the MAX is a game changer for us, not just on the cost side as I was mentioning, but also on the revenue side. The increase in the stage length and the range of these aircraft is going to allow us to open up some new revenue markets for us and take this GOL product, which has been transformed over the past couple of years, into these markets. But obviously, always focused on business customers out of Brazil, always focused on leisure Brazilian traveling to these markets, and always focused on these primary markets where Brazilians are already traveling regularly. But thanks for that question.

Q - Stephen Trent {BIO 5581382 <GO>}

Appreciate the color, Richard. In that regard then, when I look at more planes next year, larger planes, and throw in an increase in average stage lengths, therefore your system-wide capacity should be something north of flat even though you might keep domestic capacity flat. And I'm wondering if that's a fair assessment.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

No. We don't really kind of talk about two different businesses – but no, we will have an increase in the – the capacity growth on the international side, our market share on the international side will increase. We have not yet provided specific guidance numbers on 2018. And remember as well is that when MAX starts to come into our fleet in July of next year, the Fortaleza hub will start operating in the second quarter of next year. So, it's a little bit early. But we'll give people – we'll give you, folks, visibility on that at the beginning of next year.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. Appreciate that. And just curious on maintenance coming in still very low, any color on whether or not you capitalized any maintenance expense like you did in 1Q? And two, how this was achieved when you're in the process of retrofitting some of your planes and putting Wi-Fi on them and that kind of thing?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

You're going to make my life more difficult with the maintenance guys because we think our maintenance cost is pretty high. We've been - the last - we're kind of in the - let's call it year three to four of a extraordinary maintenance cyclical, where our maintenance expenses have gone up because we've been doing a lot of refurbishment of engines. And as we got into the fleet returns, which, with this massive reduction in the size of the fleet in 2017, we had a lot of additional costs that needed to be incurred to be able to return those aircraft.

And so, we've obviously provisioned and paid for all those costs. But we're still running them through the system, especially on the engine. And so, 2020 is probably the last year that we have these above-average maintenance expenses, and then probably in the second half of 2020, we reduce down to a more normalized level of maintenance expenses. But that number there is very stretched both on the operating side as well as the - as you said the CapEx side, which relates to a portion of the maintenance expenses that were capitalized because the benefit is realized over a five-year period.

This kind of started in 2015. And 2020 will probably be the last year that we have these higher-than-normal maintenance expenses. But thanks for pointing that out, it's not as clear because we're in kind of an abnormal cycle now in the maintenance where they have - if you look it on an operating expense basis, where they've ticked up (39:29) as high as kind of 5% of total revenues, that's probably about a 1.5% (39:33) higher on a margin basis than they would normally be in a normalized situation. So, in 2020 - 2019, we're still going to have probably - part of the (39:44) yield will be affected by these extraordinarily high maintenance expenses on the engine refurbishment. But in 2020, we'll get that 1.5% (39:53) margin back to us.

Q - Stephen Trent {BIO 5581382 <GO>}

Appreciate it. It looks a little low versus other guys that are running just 73s (40:00). And just one last question from me, on slide 19...

(40:06)

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Maybe you can give me a benchmark that I can use and we can even (40:11) push our maintenance guys even further. What company are you using there?

Q - Stephen Trent {BIO 5581382 <GO>}

Perhaps we could take that offline, Richard. If you wouldn't mind, just slide 19, just curious about what you guys were trying to convey in that slide, it looks like the way you are presenting ASKs over operating aircraft is going to create a positive bias for carriers that use larger planes, and just curious if that's reasonable.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Well, thanks for directing people to a slide in the appendix that we provide here. He's talking about a slide that's in the appendix that we didn't present. This slide here shows a competitive advantage for our airlines, it's on Page 19 in the webcast presentation, so going back to that. Basically, this information here shows GOL benchmark versus what we consider to be other best practice LCCs, and then also the Latin American companies in our universe. And this is Q2 data that's been improving.

So, this is the (41:18) the ASK production per aircraft. So, basically how many ASKs, which is your revenue generating units in our business, this is what produce revenues for us. And one of our big benchmarks is Southwest Airlines which is we benchmark a lot against. They're very similar business model in the U.S. market which operates 737. They're also moving to the MAX, and a lot of similarities there. So, we have a similar utilization versus Southwest. Obviously, some of the other companies, like LATAM, have long-haul businesses which change a little bit with the calculation (41:58) long-haul business. And obviously, Ryanair is kind of the extreme case with very, very high productivity per aircraft. But this is the key factor in our business. When you look at things like returns, what really drives this is how efficient and productive our aircraft can be.

And of course the challenge in Brazil is to allocate those aircraft on a nationwide network which is a challenge in a continental country like Brazil, such that you get that sweet spot where you can operate with that single aircraft type, where you can operate the same pilots, the same flight crews, and keep your costs streamlined as possible. So, I think we use this a lot internally and we like to kind of share with people how we're thinking about our business in terms of driving improved productivity and operational efficiency. And we obviously compare very favorably versus the universe. But as I've been pointing out, we're working on increasing that, especially as we transition to the MAX.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. Appreciate your answers, Rich. I'll let someone else ask a question. Thank you.

Operator

The next question comes from with Savi Syth with Raymond James. Please go ahead.

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

Hey. Good afternoon. Just a question on the profit sharing adjustment, like, how much of the 7 points was related to profit sharing because I know – based on your guidance, fourth quarter has to come down quite a bit, might be 8%. Nonfuel, CASM-Ex, has to come down. And my guess is a lot of that is driven by the timing of the profit sharing. So, I was just wondering how much of that – how much of the 7 points was related to profit sharing? And how much of a tailwind it's going to be for the fourth quarter.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. Sure. No, that's a good question. I mean, we're trying to simplify some of the points here. But we can give the detail as needed. We had about BRL 65 million of profit sharing in the quarter. It's normal for the year, but this year – last year, it was done in the fourth quarter, this year it's in the third quarter. This relates to visibility on targets. We use a balanced scorecard system here at GOL. And so, the math usually (44:13) tells us. And so, based on our results, we then start to create the provision as it relates to this profit sharing across the company for all employees. And so, that's obviously not comparable. In the full year, it's already incorporated in our guidance. And the guidance we're providing for the full year already incorporates that.

The other effects were, you know, in third quarter of 2016, we had BRL 25 million of gains on sale leaseback transactions, which were in the operating line. And as we're simplifying it, you kind of have to back that out of the Q3 to do direct comparison. We also had about BRL 15 million of expenses on the launch of the new GOL #NOVAGOL, which was launched in Q3. And that campaign was designed to advertise the customers, the new GOL product, which is now the leading product in Brazil in terms of the best service and investments that you made in (45:21) last three years, this is the first time we've been advertising it. And so, that is an investment in the brand, obviously.

And then, finally, we had about BRL 20 million of expenses from passengers traveling on GOL that were using miles programs of other companies with which we have partnerships, which obliges us to then go by – basically, there's a cost there between us and these partners. (45:46) Smiles programs another (45:50) airline. And so, when you roll those out, those four line items, the profit sharing, the sale leaseback, advertising campaign for the new GOL and the miles brought from partners, basically both the ex-fuel CASK and the total CASK were roughly flat in the quarter-over-quarter comparison.

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

That's very helpful. Thanks. And just along those lines, is bag fees – does that show up in passenger revenue or in other revenue?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Say that again, sorry.

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

The bag fees that you'll be getting as a result of kind of starting to charge for bags. Does that show up in passenger revenue or in other revenue?

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

It is in other revenue actually. In that case, we are in the breakthroughs – hi Savi, this is Kakinoff speaking. You have two effects. You have the fees paid by the customer that firstly, option for a light fare, which has no rights for carrying luggage. And then, later, he decided – here, she decided to pay for it, and have also the upselling of the flexible fares. Those are giving the customers their rights to carry and to dispatch one luggage. So, in both cases, we have – we expect to have positive effects. The second one is included in the passenger, in the regular passenger or the PRASK, I mean, the revenue coming in purely from passenger side. Okay?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Yeah. Yeah. And, Savi, this is important. Next year, there's going to be a change in – I think accounting for most airlines, under IFRS (47:32) where these revenues will then be accounted for as passenger revenue. In other words, they'll be transferred over to PRASK or PRASM. And I believe this is happening globally with all the airlines. And so, in our December – if we see our December 7 public meeting here at GOL, we're going to basically present how those impacts – how our results would look by including these non-passenger revenues.

Basically, almost all of non-passenger revenues are going to be included in passenger revenues, and so that the real apples-to-apples comparison among all the airlines very clear and transparent. I know you're probably looking at this in a lot of the other airlines already in the US, but we're also preparing for that change. We're going to present that in our meeting December 7 here at GOL, our public meeting with the investor community.

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

Okay. Great. And then, just one last question. On the sale leasebacks that you've done, do you expect to next year when those going to affect, are there going to be gains or losses related to that?

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Fleet management, we always manage a portion of our fleet in sale leaseback to take advantage of market conditions and our purchase price with Boeing. As an operator, we buy the lower cost and less sourced (48:57). And so, a portion of our fleet we use to manage in that modality. What we do in our sale leaseback, we try to hit the absolute – negotiate the absolute lowest possible lease rate because it's important for us to have the long-term cost as low as possible. But that, as a result of the calculations producing some gains and some cash backup (49:19). So, we will have – as we manage regularly our fleet overall, we will – yes, we will have cash flow and gains – economic gains related to sale leaseback. It's a permanent part of our business model.

One of the reasons why it was explained (49:40) in 2016 is there was an excess – there was an abnormal amount of fleet returns. We also sold nine aircraft. And so, that was a very heavy amounts. And so part of that was explained separately. But one way of looking at that, it really is a permanent part of the business, although it can make difficult the quarter to quarter comparison in the quarters that it's happening. And so, we will have that going forward, yes. And we'll explain that and highlight that as needed going forward, so you can have the correct overall competitive cost comparisons.

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

All right. Thank you very much.

Operator

The next question comes from Mike Linenberg with Deutsche Bank. Please go ahead.

Q - Michael J. Linenberg {BIO 1504009 <GO>}

Yeah. Hey. Good afternoon, gentlemen. Question here. Kakinoff, you talked about with the new branded fares, it was very early, but do you have a sense on what percent of your (50:45) who are buying (50:47-50:52).

(50:54)

A - Richard F. Lark Jr. {BIO 427746 <GO>}

With the new first bag fees, what portion of the customers as opposed to buying the fare – because the lowest fare we have now is without the bag fee. And the next fare we have has the bag fee and how many are actually upgrading to the fare with the first bag included.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Considering the current trends, we do expect something around 25% of upselling.

Q - Michael J. Linenberg {BIO 1504009 <GO>}

Okay. Very good then. And then, Kakinoff, you had also – when you were talking about GOL's share of business traffic, it being the largest in the country, you did indicate that you felt pretty good about prospects for business travel looking forward. And I know that things have started to improve. Can you provide some additional color on what (51:45) maybe indicated (51:48). We're seeing not just anecdotes here, but maybe the makings of a good trend as it relates to business travel demand.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

By answering to you, I am just sharing our view regarding the statistics. I mean, considering the statistics, I'm not delivering any kind of new guidance. But just to give you an idea. Traditionally, the elasticity factor is two times. So, considering a GDP growth of 2.5% next year, we could easily consider a range between 5% to 6% of additional business travel demand next year.

(52:28)

A - Richard F. Lark Jr. {BIO 427746 <GO>}

I think this year currently we're kind of seeing, on a volume basis – on a volume basis, we're seeing kind of flat to slightly positive volume growth on the corporate side. But we have achieved much better pricing in that segment, which is reflected in the profitability overall. So, I think that reflects the economic conditions being more positive, but we have not yet seen – it's not in these numbers today, in other words, in our recent quarters, any significant increase in purchase volume, but we have seen improvement in the pricing power and the activity and business demand indirectly from that perspective, yeah.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

This is basically the outcome of having a better (53:21) network towards the business (53:24). I mean, as we change the network, we are more present in high used (53:30) routes.

Q - Michael J. Linenberg {BIO 1504009 <GO>}

Great. Helpful. And then just, Rich, to you, when I go back and look at guidance in early October, I think you are guiding for RASK up about 6% and it looks like the number was above 8%. And then, there was also, like - it seemed like the cash cut, I think, it was plus 3.9% (53:49) and you came in a bit higher. And I know - with Savi's question, you answered a lot of different things and you have that profit sharing in the third quarter.

Is that what drove the big differential? I mean, it seemed like that there was a sizable differential on where cost guide was and where it came out. And you listed a whole bunch of things that you had to adjust year-over-year and maybe it wasn't in the original guidance. And I'm just trying to reconcile the differences between - and by the way your results are good. I'm not trying to be critical here. I'm just trying to figure out how we were off (54:18).

A - Richard F. Lark Jr. {BIO 427746 <GO>}

The connection we have here I think is muffled. I don't know if it's your phone or our phone. I think it's your phone. But...

Q - Michael J. Linenberg {BIO 1504009 <GO>}

I think it's my phone.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

I think you're asking about - well, I'm not sure if I got the question. But we're basically tracking - we're expected to be on the plus side overall. The only - I mean, there's nothing additional including - basically exchange rate and oil price loss are kind of working the normal offset fashion. And so, we have nothing necessarily extraordinary happening on the cost side that - it's like we're doing a little bit better than our overall guidance for the year that's why we updated it a little bit there. But it's a pretty tight management of that year.

And we're not - I'm not sure if I - I didn't get all the details of your question. But if it was - in terms of where we're going with cost, we expect to gradually improve at these levels as it relates to what I described based on the fleet dynamic. That's the main source of our cost reductions going forward. But also are doing a lot of blocking and tackling on a whole variety of issues in the supply chain and so on. And we're also doing a lot of work with suppliers on payment terms. So, one of the big sources of operating cash flow - which nobody really asked (55:41) a question on today (55:42) is - has been us having better payment terms in the supply chain, which has allowed us to some extent replace very expensive bank financing with more operational finance.

And that is the – the operating profitability plus the combination of what we were doing with our working capital is one 100% of the sources of the increasing operating cash flow. And as we said, that is basically – as CapEx is matched with low-cost financing. All that's going towards increasing cash cushion and debt service, effectively, it's cash to equity. I don't know if I exactly answer your question, but if you want to back you can repeat it. I just didn't get a portion of it in there.

Q - Michael J. Linenberg {BIO 1504009 <GO>}

No. That's helpful. And I apologize for the (56:29) connection. No, that's fine. Well, thanks, Rich. Thanks, Kakinoff.

A - Richard F. Lark Jr. {BIO 427746 <GO>}

Thank you.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Welcome.

Operator

A follow-up question from Savi Syth with Raymond James. Please go ahead.

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

Hey. Thanks. Just one question on unit revenue, I mean, unit revenue growth has been really strong now for several quarters. And I know this is a little tough question to answer, but how should we think about it kind of going forward? Is there a point in time where we see (56:59) the tough comps get tougher. And I'm also thinking, while it's margin accretive, but maybe kind of the international growth that you're thinking of next year, especially stage length increasing, that starts to pressure unit – the amount of unit revenue growth that you can have. Any help you can give on kind of thinking through the kind of unit revenue expansion here?

(57:22)

A - Richard F. Lark Jr. {BIO 427746 <GO>}

A couple of points. I think one of the things important I'll mention is that GOL over the last four or five years has invested heavily in the most attractive product for business passengers, which is our higher-yielding traffic. And then, as the network was restructured, it was refocused on our more profitable routes, slots. We have the leading share in all of the airports that matter in terms of where the business traffic is, and it's a significant hidden asset, if you will. And so, the profitability is really being driven out of that. It's not a lot a question of increasing prices or anything like that. It's just a question of where the high value customers are.

And we have the combination of the product. And with that is the network and the punctuality and the service that all goes with that. So, we're capturing the increasing share of that passenger. And we still have a way to go on that in terms of growing that. The international piece, yes it does have the effect of the increased stage length. But within Brazil and the markets in like South America, Central America, a big portion of that is also focused on business traffic. And so, we don't see any – on a unit revenue basis, we don't see a negative impact because of that. And so, we expect to continue to be growing the unit revenues above inflation. At the same time, they were going to be growing our cost below inflation. So, that's how the math is going to roll out going forward.

And it's structural. It's structural because the network is our network that we're operating and these aircraft we're bringing in, they're about to embark on this massive fleet renewal which is significant. And so, they end up being structural. So, the short answer to your question will be that we expect these improvements to continue as we expand over the next couple of years in this sphere of the network and expanding internationally and the MAX. That's how I would answer that question.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

We would like just to emphasize what has been just said by Richard, Savi, repeating the (59:48). I believe that we have very good reasons to believe in a further positive trend regarding revenues, considering that we have deployed only 55% of our flight with the so called #NOVAGOL experience. I mean, (01:00:10) the Wi-Fi mainly and some other attractive products that we are about to implement in the near future. So, initially, we would have good reasons to believe that the company can become even more attractive to the high-yield customers and to everybody else who wants those features, not only desired by the markets, but even our competitors. They have decided to adopt some of these initiatives, probably noticing that they are bringing us additional value and consignatory (01:00:53) high-yield customers.

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

Very helpful. Thanks, guys.

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thank you.

Operator

A - Paulo Sergio Kakinoff {BIO 5160310 <GO>}

So, guys, just would like to thank you very much for joining us in our conference call, highly appreciated the attention that you have given to us along these years. And you have – most of you have followed the decisions (01:01:37) that are now giving us (01:01:42) of better results, better margins. We hope that you've found our presentation and the Q&A session helpful. Our Investor Relations team is available to speak, if you – as needed. So, thank you very much.

Operator

This concludes the GOL Airlines conference call for today. Thank you very much for your participation and have a nice afternoon.