Q3 2017 Earnings Call

Company Participants

- Nora Lanari, Head of Investor Relations
- Roberto Antônio Mendes, Chief Financial Officer and Investor Relations Officer

Other Participants

- Leandro Fontanesi, Analyst
- Lucas Barbosa, Analyst
- Lucas Marquiori, Analyst
- Pedro Bruno, Analyst
- Pedro Furtado, Head of Investment Analysis
- Pedro Pinto, Analyst
- Stephen Trent, Analyst
- Vitor Sanchez, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to Localiza Rent a Car Conference Call of the Third Quarter 2017. Hosting the event today are Mr. Roberto Mendes, CFO and Ms. Nora Lanari, Investor Relations Officer.

We would like to inform that the numbers in this presentation are stated in million of Brazilian real and based on IFRS. The presentation will be recorded and all participants will only be able to listen to the conference call during the company's presentation. Immediately afterwards, we'll start the Q&A session for analysts and investors when further instructions will be provided.

The conference call audio and the accompanying slide presentation are being broadcasted simultaneously over the Internet at the address, www.localiza.com/ir. The slide presentation can be downloaded at the same address by clicking on the banner 3Q17 Webcast.

Before proceeding, we would like to clarify that any statements made in the conference call concerning the business outlook of the company, forecasts, as well as operating and financial targets represent the opinions and assumptions of the company's management which may or may not occur. Investors must comprehend that economic conditions and other operating factors may affect the company's future and lead to materially different results from those stated in this call.

To start the third quarter 2017 teleconference, I'll turn the floor to the CFO, Roberto Mendes.

Roberto Antônio Mendes {BIO 7289124 <GO>}

Good afternoon, and thank you for attending our conference call. The third quarter 2017 was spectacular in growth and profitability. Our fleet which totaled 151,000 cars in the second quarter exceeded 185,000 cars. We are committed to excellence in execution to leverage our competitive advantages with the goal of consolidating the car rental market in Brazil.

In slide number 2, we present the operational highlights of the third quarter 2017. In Rent a Car Division, volume grew impressive 35.9%. In the Fleet Rental Division, the volume grew 15.3%. 23,941 cars were sold for fleet renewal. In the last 12 months, Rent a Car fleet increased by 39,000 cars and Fleet by 10,000.

Slide number 3 brings the financial highlights of the third quarter. Consolidated net revenue on a comparable basis grew 39.2%. EBITDA and EBIT adjusted by the one-time costs followed growth increasing by 31.8% and 40.5%, respectively. Adjusted net income for the quarter was BRL 139.5 million, reaching a new record, the third in a row in this year.

On slide 4, we present the main milestones of the integration of Hertz Brasil operation. We concluded the closing of the deal and started operating the combined brand on September 1 in a smooth transition for our customers and customers coming from Hertz.

On slide number 5, we present the one-time costs of Hertz Brasil integration and 17 franchised branches. In the third quarter 2017, we had an impact of BRL 21.5 million, of which BRL 8.8 million refer to non-recurring costs and expenses of Hertz Brasil acquisition and BRL 12.7 million refer to the integration of 17 franchised car rental locations.

EBITDA and EBIT were impacted by BRL 21.5 million in the third quarter of 2017 and the impact on the net income amounted to BRL 16.3 million. In order to preserve the comparability of the results hereby disclosed with previous quarters, we are presenting adjusted EBITDA, EBIT and net income of the third quarter 2017 and nine months 2017 profits, net of one-time costs incurred. We still expect to incurring expenses of BRL 60 million in the net – in the integration of Hertz Brasil in the fourth Q, 2017.

In order to present the detailed results of the third quarter, let me give the floor to the Investor Relations officer, Nora Lanari.

Nora Lanari {BIO 18838335 <GO>}

Good afternoon. Thank you, Roberto. On slide 6, we detail the growth of the Car Rental Division. As Roberto mentioned, in the third Q, 2017, the number of car rental days grew by impressive 35.9%. Net revenue increased 30.4% impacted by the decrease in the average rental rates shown in the next slide.

The average rental rate this quarter was 4.6% lower than the same period of the previous year, but already stable in relation to the second quarter of this year. The utilization rate also remained stable at 74.3% compared to second Q, 2017.

Slide 8 shows the Rent a Car branch network. Hertz Brasil locations were not included here. In the nine months of the year, the owned car rental locations network was expanded by 38 branches, including integrated franchises. We have a total of 507 branches in Brazil and 70 more in six other South American countries. We expect to keep seven Hertz locations open, operating the combined brand.

In the Fleet Rental Division, slide 9, volume and revenue grew 15.3% totaling BRL 188.5 million in the third quarter. The merger of the Hertz contract contributed about 3 percentage points this quarter. That is, even without considering the integration of the operations, the pace of growth has accelerated in the year in the Fleet Division.

Going to the next page, in the third Q, 2017, we see the addition of 57,213 cars to the fleet, of which 49,051 cars were purchased and 8,161 (sic) [8,162] (07:22) came from Hertz Brasil. 23,941 cars were sold resulting in an increase of 33,272 cars in the fleet. The net investment was BRL 1,310 million, of which [ph] BRL 286,500 (07:40) was related to the book value of Hertz Brasil cars.

Slide 11 shows the expansion of Seminovos network. In the last 12 months, we have opened 14 stores to support the growth of Car and Fleet Rental. Today, we have 93 points of sales. New stores will be added until the end of the year.

Slide 12 shows that Localiza system closed the nine months of the year with 185,390 cars, a growth of 36.1%. 39,324 cars were added to the Rent a Car Division and 10,218 to the Fleet Rental in the last 12 months.

Consolidating the Car and Fleet Rental divisions with the Seminovos, we show on slide 13 the consolidated revenues which increased 39.2% in the quarter. The rental divisions grew 25.4% and the Seminovos grew 51.5%. This revenue increase in Seminovos reflects a 37.8% volume growth of cars sold and 10% growth in the average sale price.

On slide 14, we provide the consolidated EBITDA without one-time cost effects for comparison purposes. EBITDA increased 31.8% in the quarter. The EBITDA margin in the Car Rental Division adjusted to exclude the effects of one-time costs of Hertz was 32.2% in the quarter, in line with the third quarter 2016 margin. The margin of this quarter was impacted mainly by the concentration of mobilization costs due to the strong fleet growth in this quarter and the increase in marketing and communication expenses.

In the Fleet Rental Division, EBITDA margin stood at 63.4% in the third quarter, down 1.1 percentage point when compared to 3Q 2016. The lower EBITDA margin mainly reflects the impact of the lower interest rates and depreciation based on (09:57) to price of the new contracts of this division. EBITDA margin of Seminovos in the third Q, 2017 was 6.6%, 1.7 percentage points higher when compared with 3Q 2016 benefited by greater sales efficiency which brought SG&A down to 6.8%.

On slide 15, we see the annualized average depreciation per car in the RAC of BRL 1,351, an increase of BRL 100 when compared to the average depreciation of 2016. In the Fleet Rental Division, depreciation was BRL 3,105, a reduction of BRL 609 compared to the average depreciation of 2016. Due to the longer operational cycle, car depreciation in this division has benefited by the increase in new car prices throughout its operational life.

Slide 16 brings the adjusted consolidated EBIT of third Q, 2017 which reached BRL 263.9 million, an increase of 40.5% when compared to 3Q 2016. In the quarter, the adjusted EBIT margin of the Car Rental Division was 34.4%, an increase of 6.3 percentage points. In the Fleet Rental Division, EBIT in 3Q 2017 was 53.1%, an increase of 1.7 percentage points. The improved EBIT margin in both business divisions reflect lower depreciations per car in the quarter compared to 3Q 2016.

To conclude this explanation on DRE (11:47), the next slide brings recorded – a record adjusted net income, a growth of 34.3% year-on-year. Net income totaled BRL 139.5 million in the quarter due to an increase of BRL 18 million in EBITDA, which was partially offset by BRL 25.7 million increase in financial expenses and an increase in income tax due to increase in income before taxes. Financial expenses increased despite a decrease in interest due to the increase in net debt in the period.

Slides 18 and 19 show the free cash flow. BRL 366.4 million were generated from rental activities in the first nine months of 2017. BRL 1 billion was invested in the company's growth through the fleet increase and acquisition of Hertz Brasil. We bought 108,271 cars over the first nine months of this year.

Slide 20 shows the net debt, which increased 55% in the year due to strong growth in the volume of car and fleet rental, demanding an increase in the fleet.

In terms of indebtedness, slide 21 shows that Localiza continues to maintain a strong cash position and a comfortable debt profile, consistent with the company's growth scenario. The figures already include the latest issuance of Localiza fleet in the amount of BRL 350 million factored in October at CDI rate plus 0.3% and a term of seven years. We are attentive to the opportunities in the debt market, always looking for better terms and debt cost. Considering this last issuance, the pro forma cash position would be BRL 2.3 billion.

Slide 22 shows that the company continues to have solid debt ratios. Indebtedness is adequate to the company's capital structure and reflects our conservative financial management even at a fast-growing environment.

Finally, the last slide shows return on invested capital. In the nine months, our ROIC was 15.9%, 0.5 percentage points better than last year. The cost of post-tax debt 2 two percentage points contributing to a spread of 7.7 percentage points, an increase of 2.5 percentage points compared to last year's spread.

Okay, let's now move to the Q&A session.

Q&A

Operator

Ladies and gentlemen, we will now begin the Q&A session. First question from Lucas Marquiori, Banco Safra.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Hello, two questions on my side. First, it's about the growth in volume. Again, you had a strong growth coming from a strong basis from last year expanding to 36%. There was the Hertz effect, but you also expanded in the third quarter. This acceleration in growth from the second to the third quarter, is there any new industry, any new factor? Is that incorporation of corporate customers still from individual customers? Could you give some color on these acceleration of the RAC growth from the second to the third quarter?

And the second question, if you could give us an idea of up until when the average rate fall will continue. Just for modeling purposes, if you could give us an idea on that. Thank you.

A - Nora Lanari {BIO 18838335 <GO>}

Hello, Lucas. Thank you for your questions. Well, with regard to the volume, we see a trend of strong volume. All lines of business are growing at different rates, but all of them with positive figures. So, we don't see any significant change in terms of what we have been showing so far. We believe that this warming up of the economy is helpful, but it won't change the trend.

As for the average rate, it's very close to the second quarter this year's 74% and the utilization rate is also in the same manner. Of course, this reflects not only our price policy, but also the business mix. Since we're growing strongly in all lines of business, this mix can have an impact on the average rate from now on. But we don't see any trend of additional drop because the level of the second quarter and third quarter are very similar. I would just like to remind you the fourth quarter is the end of the year and it changes a bit during to the summer vacation period.

Q - Lucas Marquiori {BIO 17907247 <GO>}

Okay, Nora, thank you.

Operator

Our next question comes from Pedro Pinto from Credit Suisse.

Q - Pedro Pinto {BIO 3831505 <GO>}

Good morning. Thank you for the opportunity of the questions. My question is about Hertz. Could you add some color to the operation in terms of occupation and the tariffs they're different from those that you commonly practice? And this also is about the store, you are going to keep only seven of the stores. How do you see the synergy using Hertz brand?

A - Roberto Antônio Mendes {BIO 7289124 <GO>}

This is Roberto speaking, Pedro. Thank you. Well, let's separate all the areas in terms of capture of synergy of Hertz. First, the fleet area. All contracts in terms of Fleet Rental Division that came from Hertz came to our system. So, we started operating all these cars in our system and this is why it's easier for us to measure the impact coming from this new demand from Hertz contract.

In terms of Rent a Car, the operation was different. As of the September 1, all contract from any customer coming to our system either over-the-counter or with the reserves started entering Localiza system, so it was much harder, even impossible for us to measure the impact coming from the acquisition of Hertz Brasil operation. We made an estimate according to the number of cars that came from Hertz operation, but that could be serving either Localiza's or Hertz customer from the whole country as well as from the interior of the states, so it's hard to say how many customers came from each operation.

So, today, Hertz and Localiza's customers are all on the same customer base, and it's hard to say the occupation rate because it's the same customer base with a tariff rate, this average rental rate, so there is synergy. Of course, some people were Localiza and Hertz customer at the same time, individual that used to rent cars from both companies now are renting only from Localiza. We don't know why they're – I mean, they're staying because they used to rent from Hertz and now the option is Localiza, if they continue to be customer. So, there is an inbound and outbound movement also from abroad, we signed customers abroad as well. So, this is what we obtain in terms of revenue and we're able to calculate and show you.

Q - Pedro Pinto {BIO 3831505 <GO>}

Okay, understand.

A - Roberto Antônio Mendes {BIO 7289124 <GO>}

In terms of cost, just to complete your answer, Pedro, we are making reductions on the structures either in personnel or in locations where there is an overlapping of branches. So, our costs are being captured by cutting unnecessary costs and overlapping costs. But that's already net of one-time costs that we mentioned BRL 8 million and we're going to spend another BRL 60 million estimated with the termination of labor contracts, as well as rental contracts or lease contracts. It's all included in this integration effort.

A - Nora Lanari {BIO 18838335 <GO>}

Pedro, just to add, of 100% of Hertz customer, there was an overlap of 60%, but 40% were customers who have never rented from us.

Q - Pedro Pinto {BIO 3831505 <GO>}

Okay. Thank you. Just one additional question. I remember in the last call you commented on the purchase of franchisees whenever there is an opportunity and it was anticipated, but non-recurring ones this quarter. What is this decision-making process in terms of purchasing franchisees? Do you intend to buy in the future as well? Just for us to have an idea of the impact from now on.

A - Nora Lanari {BIO 18838335 <GO>}

Pedro, buying franchisees is part of our business. Whenever there is an opportunity, we buy franchisees. In this quarter specifically and usually it was a decision of the franchisee, we don't impose that franchise purchase. It depends on them. It's either because they want to invest in something else or et cetera.

We provide this exit option for franchisees. It's part of our business costs. In this quarter, it was most significant because it was a big one-time figure. But every year we buy franchisees and since there was a most significant picture, we decided to highlight it because it had a higher impact of BRL 2.7 million in cost. From now on, maybe it won't be the same volume, but more diluted throughout the year as we had for previous years.

Q - Pedro Pinto {BIO 3831505 <GO>}

Okay. Thank you, Nora.

Operator

Pedro Bruno from Santander is asking the next question.

Q - Pedro Bruno {BIO 19082978 <GO>}

Good morning. First question is about Seminovos, it again delivered a strong margin. Also maintaining the trend of the second quarter, just a change in gross margin, SG&A. My question is which is the expected level considering the average term after adjusting depreciation of this margin of Seminovos considering the stronger addition of SG&A and the scenario for used vehicles now.

A - Nora Lanari {BIO 18838335 <GO>}

Thank you for your question, Pedro. We believe that this quarter is a good one, of course we – that would change according to the change in the prices of new cars that we'll reflect in the used-car prices. But we believe this is a good level to see the margin of Seminovos converging to historical 2 to 3 percentage points, which is normalized between current level.

The faster it happens, it will go to ROIC (24:38) because it's a shorter circle. In fleet, it will happen in the medium term because the contract is at two to three years. So, many of the cars are depreciated with new cars come in with lower depreciations, they will be sold at a lower EBITDA margin when compared at historical levels.

In terms of SG&A, you're right, we were able to bring it down to 6.8% in Seminovos. But we've been growing strongly at RAC and Fleet. So, we will need to open new stores and we expect additional gains in terms of SG&A, we're looking for increase in productivity all the time, but we'll open new stores, so we don't expect a strong change in level of SG&A from now on.

Q - Pedro Bruno {BIO 19082978 <GO>}

It's very clear, Nora. Thank you. Just one more question regarding cost of RAC. You mentioned the cost, an increase in communication costs, communication expenses, could you give us an idea of the dynamics of these costs in the third quarter? Would that remain normal? Just to help us think about the margin for the 4Q for RAC and also for next year. Thank you.

A - Nora Lanari {BIO 18838335 <GO>}

Pedro, as you can see, we've been growing a lot in the last 1 1/2, 2 years, individuals and retail demand, this is different investment in terms of marketing. So, we believe that this level will be more normal for marketing and communication expenses from now on. Of course, it will depend on the purchase of cars, but the third quarter was atypical in terms of the speed in that regard.

Q - Pedro Pinto {BIO 3831505 <GO>}

Okay. Thank you.

Operator

The next question comes from Leandro Fontanesi, Bradesco BBI.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Good morning. My first question is about leverage. Nora, you mentioned that it is at a healthy level, but we see that it's a higher level. Just for us to understand, do you expect to remain at this higher level or if you could comment maybe a bit on leverage?

A - Nora Lanari {BIO 18838335 <GO>}

Thank you, Leandro. Leandro, leverage has not increased, instead it was very low. 2.3 leverage ratio is quite healthy. We are comfortable with this level. In terms of covenant, it's 4 times the EBITDA.

A - Roberto Antônio Mendes {BIO 7289124 <GO>}

So, we're always looking for a comfortable cash position, a long debt profile and the combined figures about that allows us to preserve the current rating with the three agencies, they evaluate our risk. This provides us great competitive advantages and it's very important to keep it that way.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Okay. Thank you. A second question, could you please comment a bit on the Rent a Car? What are the segments that are growing more if Uber is still very busy and then this flex in the (28:20) individuals? If you could give us a fix, some highlight on what's growing more.

A - Nora Lanari {BIO 18838335 <GO>}

This is Nora. We don't want to give any guidance on that. All segments are growing. We don't see any change for the beginning of the year. All segments are growing higher or lower depending on the base.

Q - Leandro Fontanesi {BIO 20270610 <GO>}

Okay. Thank you.

Operator

The next question comes from Vitor Sanchez from Morgan Stanley.

Q - Vitor Sanchez {BIO 20765535 <GO>}

Good morning, Roberto and Nora. I would like to understand a bit more about the expected growth for RAC. The fourth quarter in 2018 maybe now that we have more competitors accelerating a bit, how do you see that coming?

And the second question is about depreciation. Looking at the price of cars sold, we see a growth, strong growth year-on-year for the third quarter. We would like to understand what is your expected growth for cars sold, considering your current depreciation. Thank you.

A - Nora Lanari {BIO 18838335 <GO>}

Thank you, Vitor. This is Nora. In fact, we're able to accelerate the growth rate in the third quarter, which brought us the more complicated comparison basis. Prospects are good, we have competitive intelligence, but the comparison basis is harder. The fourth quarter is usually a good one for Localiza due to summer vacation, but we're comparing to last year's quarter, which is a very tight basis. We see a significant potential market for individuals, we see a reaction in the economy putting more impact or increasing the corporate segment as well, but as I told you, the comparison basis is more complex.

As for depreciation, you see that an increase in the price of cars sold, and the good part of that refers to the mix and also the age of cars sold, which has dropped a bit in the second quarter and it's pretty much the same in the third quarter. So, there is a net effect. And this is why we say that one quarter is not so relevant in terms of pricing. It depends on which cars you're buying and selling.

What we believe is that price of new cars has increased probably closer to the inflation in the period, and we're being able to capture that in the sale of Seminovos in used cars. Of course, depreciation is adjusted for that and also to a bit lower sales. We believe that depreciation rate will remain pretty much the same in the next quarters, and we see a pretty healthy market in used cars, Seminovos.

Q - Vitor Sanchez {BIO 20765535 <GO>}

Could you tell us a bit more on RAC for 2018, what is your expected growth?

A - Nora Lanari {BIO 18838335 <GO>}

Well, we cannot give you any guidance, Vitor. But what I can say is that you see the size of our fleet currently and the size of the fleet, we see some reasonable growth for next year, but it still depends on the penetration in this segment of individual. Car rental, we see a significant cultural change in that area.

And also, the expected growth of economic activity, that will depend on the GDP and investments made. But since next year is an election year, we see a strong bet on increase, but let's see how growth will be and we'll be ready to capture any opportunities for growth.

Q - Vitor Sanchez {BIO 20765535 <GO>}

Okay. Thank you and congratulations on the results.

Operator

The next question is in English from Stephen Trent from Citigroup.

Q - Stephen Trent {BIO 5581382 <GO>}

Thank you very much, everybody, and I appreciate you taking my question. The first question pertains to Seminovos. You had indicated that you have plans to increase the number of stores. Any sort of broad indication where you might put stores at least geographically speaking? Or another way to ask, any indication where you see Seminovos activity and vis-à-vis the level of stores at a good level, maybe Metro São Paulo, for example?

A - Roberto Antônio Mendes {BIO 7289124 <GO>}

Well, the question of Steve in terms of number of stores and the expected direction, we believe we'll end the year with around 100 stores. There are some stores in the pipeline and we will open stores in new markets as well as in markets where we're present and we increase that presence. And the goal of that is to renew the fleet next year given the strong growth of RAC and Fleet this year. So, answering your question, Steve, we'll expect to open seven new stores next – until the end of the year both in new markets as well as markets we already operate, increasing our capacity.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. That's very helpful. And just one more from me. What sort of – and I apologize if I missed this, but any indication what you're seeing from your competitors in terms of how aggressively they've been pricing or – any color there would be appreciated.

A - Roberto Antônio Mendes {BIO 7289124 <GO>}

Well, we have seen the competitive environment relatively stable with some aggressiveness in terms of price. It's not an easy life for us necessarily, but we're ready for this competitive environment because we have solid cash position, a good indebtedness level position to grow. So, Localiza is well positioned in terms of growth. So, we're being able to capture the good part of this growth, but it's a very stiff competition environment.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. I appreciate the time. Thanks very much, guys.

Operator

The next question comes from Lucas Barbosa from UBS Bank.

Q - Lucas Barbosa {BIO 20412168 <GO>}

Good morning, Nora, Roberto. Congratulations. My question is about the spread KD (36:00). We see that it will probably drop even more. What do you expect in terms of ROIC for 2018? Will it be stable? Or does it make sense to discount – to reduce it even more giving more discount on rental rates to reach more market consolidation? Thank you.

A - Roberto Antônio Mendes {BIO 7289124 <GO>}

Lucas, this is Roberto. We'll always manage that to add value to shareholders. The higher the value, the better. Of course, not making the life of our competitors easier, we'll have to deal with other plates that keep turning and keep them turning and have shareholders happy at the same time.

You know our strategy, 7 percentage points is a very healthy figure, almost 8 now and as momentarily, it goes to 10 that creates an opportunity for the competition. So, we have to constantly manage these two moments causing things to be good for us and harder for competitors.

Q - Lucas Barbosa {BIO 20412168 <GO>}

Okay. Thank you very much, Roberto.

Operator

The next question comes from Pedro Furtado from Prada Assessoria.

Q - Pedro Furtado {BIO 2249867 <GO>}

Good morning, Roberto and Nora. Some of my questions have been answered already. One question about the current composition of your debt. You made some issuance on longer terms at lower cost, but on the other hand growth has been fast. So, do you study some repurchase of a shorter-term issuance which had higher spreads than they are currently?

A - Roberto Antônio Mendes {BIO 7289124 <GO>}

Well, we have to manage these two moments in time. If growth requires that, we cannot prepay debt unless this opportunity comes with a new issuance. At each moment, we'll assess both opportunities trying to extend the debt profile and reduce the cost of consolidated debt as a whole. Right now, I cannot anticipate any strategy in terms of prepayment.

Q - Pedro Furtado {BIO 2249867 <GO>}

Okay. Thank you, Roberto.

Operator

We now end the Q&A session. I would like to turn the floor to Ms. Nora Lanari for her closing statements.

A - Nora Lanari {BIO 18838335 <GO>}

Well, we would like to thank you all for participating in our conference call. And our IR team is available for any further questions you may have. Thank you and have a good afternoon.

Operator

This concludes Localiza Rent A Car audio conference for today. Thank you very much for attending and have a good day.