Q3 2018 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

Other Participants

- Bruno Amorim, Analyst
- Dan J. McKenzie, Analyst
- Duane Pfennigwerth, Analyst
- Joshua Milberg, Analyst
- Mike J. Linenberg, Analyst
- Roberto Otero, Analyst
- Savanthi N. Syth, Analyst
- Stephen Trent, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the GOL Airlines Third Quarter 2018 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.b/ir and MZiQ platform at www.mziq.com. Those following the presentation via the webcast may post their questions on the platform and the questions will either be answered by 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 assumptions of GOL's management 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 begin.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Good morning, ladies and gentlemen, and welcome to GOL Airlines third quarter conference call. I am Paulo Kakinoff, Chief Executive Officer and I am joined by Richard Lark, our Chief Financial Officer.

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

Good morning. Good to be with you today.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

This morning, we released our fourth quarter figures. Also, we made available on GOL's investor relations website three videos with our results presentation, financial review, and brief Q&A.

We improved our operating indicators. In the quarter, GOL's RPK increased by 2.2% from BRL 9.6 billion in the fourth (sic) [third] (00:02:40) quarter 2017 to BRL 9.9 billion this quarter, driven by a 4.5% increase in the number of transported passengers. Strong demand allowed GOL to continue driving pricing through dynamic revenue management. Average yield per passenger increased by 6.5% quarter-over-quarter, reaching BRL 0.274.

Supply growth ASK increased 3.7% compared to fourth (sic) [third] (00:03:07) quarter 2017, driven by a 0.2% increase in take-offs and a 4.8% increase in seats. The average load factor was 79.1%, a decrease of 1.1 percentage points compared to the same period in 2017.

We continue to drive strong revenue growth. The combination of higher demand and optimized pricing resulted in net revenue for the quarter of BRL 2.9 billion, an increase of 8.3% compared to the fourth (sic) [third] (00:03:39) quarter 2017.

Net RASK was BRL 0.232 in this quarter, an increase of 4.5% over same period 2017. Net PRASK increased 5% quarter-over-quarter, reaching BRL 0.217.

Average fares increased by 4.2% from BRL 299 to BRL 312. GOL's 2018 guidance is for net revenues of approximately BRL 11.5 billion.

The GOL network serves high-yielding routes and has the leading share in the corporate client segment. We have the largest share of business traffic in the country. The recently received two Boeing 737 MAX 8 that are already operating in our fleet provide us reduced operating expenses and in the near future, we will extend the range of our network, allowing us to serve new markets in South America, the Caribbean and the United States.

With that, I'm going to hand you over to Rich, who is going to take us through some other highlights.

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

Thanks, Kaki. First, we'd like to comment about our controlled cost environment. Total CASK in the third quarter was BRL 0.218, 11.5% higher than in the same period in 2017 due to the increases in jet fuel prices. On an ex-fuel basis, CASK fell by 3.4%. GOL remains the cost leader in South America for the 17th consecutive year.

When average prices of jet fuel increased by 3.7% in this quarter over the second quarter of 2018, the combination of stronger pricing, higher demand and operating result, gains on fuel hedging permitted GOL's EBIT margin to reach 6.2% in the third quarter of 2018.

Our operating income EBIT was BRL 180.5 million in this quarter and EBITDA margin was 12.3%. EBITDAR was BRL 651 million, a 22.5% margin. GOL's 2018 guidance is for an EBIT margin of approximately 11%.

Second, we want to highlight our cash flow management. The combination of operating cash flow generation of BRL 461 million in the quarter and stable cash liquidity improved the company's financial flexibility. Total liquidity, including cash financial investments, restricted cash and accounts receivable was BRL 3 billion, an increase of BRL 872 million versus the third quarter of 2017.

Third, we would like to share the continued success of our liability management and refinancing. In spite of depreciation the real against the dollar in the quarter causing a net exchange and monetary variation loss of BRL 187 million, our net debt excluding perpetual bonds to last 12 months' EBITDA ratio was 3.2 times as of September 2018, improving versus year-ago metrics of 3.4 times. Continuing our work with an aim to deleverage in October, GOL's successfully concluded a liability management and refinancing exercise on its debentures issued by its wholly owned subsidiary, GOL Linhas Aéreas, GLA.

We fully amortized the total amount of BRL 1 billion and issued a new single series of non-convertible and unsecured debentures in the amount of BRL 888 million, resulting in a net indebtedness reduction of BRL 138 million. The new debentures were issued at a yield of 120% of the Brazilian CDI interbank rate, which is approximately 7.68% in reais, with quarterly interest payments of approximately BRL 17 million and semi-annual principal payments of approximately BRL 148 million, with final payment to be made on September 28, 2021. It's worth mentioning that the yield on new debentures is substantially below that of the fully amortized debentures, which carried a rate of 132% of the CDI rate. We believe this is further evidence of the market's improved view of GOL's credit profile.

This transaction is additional deleveraging of GOL's balance sheet and better matches GLA's operating cash flow generation with the amortization of its liabilities. The issuance reduced the company's cost of debt and improved its credit metrics. Considering the debenture issuance, the average interest rate is 7.7% for local currency debt and for dollar-denominated debt, the average interest rate for the company is 6.8%.

And to finalize, we present a preliminary quantitative analysis of certain indicators based on currently available information as of and for the last 12 months period ended September 30, 2018, considering the new standards of IFRS 16. The International Accounting Standards Board, IASB, has recently issued IFRS 16 as a new accounting standard which will become mandatory on January 1, 2019. As a result of the mandatory adoption of IFRS 16 as of January 1, 2019, we have analyzed the impact of this accounting standard on us, and our preliminary evaluation shows an estimate of a significant reduction in net debt as well as an improvement in the net adjusted debt-to-LTM EBITDA ratio. Our preliminary evaluation showed that total adjusted debt will reduce by BRL 1.7 billion to BRL 2.7 billion, and that our annual EBIT margin will increase by 4 to 5 percentage points.

Looking forward to the end of this year and 2019, we expect to confirm a scenario of continuous improvement for the Brazilian economy and the aviation industry in our country. We have maintained a commitment to financial discipline managing the effects of the Brazilian currency through our efficient capacity management and dynamic yield management.

EBITDA and EBIT margins in 2018 are expected to be around 16% and 11%, respectively, and our revised guidance indicates earnings per share before currency gains and losses is expected to be between BRL 0.05 and BRL 0.25. Leverage measured as net debt excluding perpetual debt over EBITDA for 2018 should be slightly better than 2.6 times, reflecting our commitment to reduce leverage in our balance sheet.

For 2019, we expect our domestic capacity growth to be between 1% and 3%, and non-fuel CASK to be around BRL 0.14. We also project an EBITDA margin of around 17% and expect to end the year 2019 with leverage of approximately 2.5 times.

Now, I would like to return to Kakinoff.

Paulo Sergio Kakinoff {BIO 5160310 <GO>}

Thanks, Rich. In summary, we're working hard to maximize our results this quarter. This quarter was particularly challenging due to the accelerated appreciation of the U.S. dollar against the real, a trend that has already begun to reverse; and due to the higher jet fuel prices. Our commitment to continuous improvement in our results has proven that our strategy of offering a differentiated, high-quality product while relentlessly focusing on cost efficiency is bearing fruit.

We remain focused on offering the best experience in air transportation, exclusive services to our customers on new modern aircrafts that connect our main markets with the most convenient schedules. We remain attentive to very disciplined capacity and further (00:11:17) management of our balance sheet and liquidity, maintaining our cost leadership and continuing as the preferred airline for our customers, while driving sustainable margins and returns for our shareholders.

To finalize, on October 14, as previously discussed, we announced our intention to effect a corporate reorganization, including the merge of Smiles. The reorganization seeks to ensure the long-term competitiveness of the group, aligning the interests of all stakeholders, reinforcing capital structure, simplifying corporate governance, reducing operating, administrative and financing cost and expenses, and increasing the market liquidity for shareholders.

It's also worth noting that in accordance with the company's commitment to the highest standards of corporate governance, the restructuring will fully comply with all applicable rules and in particular, Opinion Number 35 of the CVM. In this sense, an independent committee appointed by the Smiles Board of Directors will negotiate the terms of the transaction with GOL's management. GOL's management will not appoint the members to this committee, which you have complete discretion to analyze all the merits of the transaction.

In addition, the committee will also issue a recommendation to Smiles Board of Directors. In this way, the terms of the reorganization depend directly on negotiations that we wish to occur and which, as soon as they are defined, will be duly communicated to the market.

Now, I would like to initiate the Q&A session.

Q&A

Operator

Thank you. The floor is now open for questions. The first question comes from Michael Linenberg with Deutsche Bank.

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

Hey. Good morning, everybody. Two things. One, in your guidance for capacity growth next year, the 1% to 3% for domestic, is that – so that's ASKs. How does that compare to seats? And maybe you could even throw in departures. I'm just trying to get a feel about whether or not you're going to be benefiting from sum-up gauging or if it's more stage length. It is nonetheless a modest growth rate. Thanks.

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

Hi, Michael. It's Kakinoff here. Our 5% growth...

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

Hi, Kakinoff.

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

Hi.

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

Yes.

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

...is 5% growth and it considers basically the - it's 100% related to seats, too, and it's target to address the 1% to 3% demand growth in domestic market and also to - it includes a combination of high stage length (00:14:33) in international markets.

So, if you're talking domestic only, it means 5% demand growth expectation. This is what we have considered. And therefore, we are targeting 1% to 3% domestic ASK growth.

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

Yeah, Mike. What we did is - you probably saw that we reduced the guidance on the fleet by one aircraft. We took it down by one aircraft, but we kept the same overall capacity growth, and that's really two effects. One is the effect of the MAX coming in, which has a greater ASK productivity, produces more ASKs, it's got nine more seats and has a little bit longer stage length.

In the domestic market, we're keeping the 1% to 3% domestic ASK growth for GOL, which is a little bit under domestic demand expectations that we have, which are around 5% based on this roughly 2 times the elasticity of Brazilian GDP, which we expect to be about 2.5% this year.

So, as we expect demand to be growing a little bit above that at around 5%, we're - this 1% to 3% capacity growth domestically is what's required to serve demand of the market and keep good rationality. And then, the difference on that, the second point is what we're doing internationally where we have a much larger relative expansion internationally because, as you know, we're doing additional service starting next week to Miami and Orlando. We're also adding Quito, which will be in there next year, as well as Cancún in Mexico. And so that's giving us that additional growth relative and this is possible because of the MAX.

And so, the overall 5% to 10% capacity growth, the delta above that on the overall GOL integrated network is on the international side. But it's also giving us some - a little bit more diversification on the market side of the equation in terms of the markets that we're serving away from just pure Brazilian demand, which also has a dollar billing component as we've discussed.

A - Operator

Yeah.

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

Okay. No, that's helpful. Then, Rich, my second just to you on the gain on the sale of aircraft we saw in this quarter. Presumably, we're going to see that in the fourth quarter as well. As I recall, I think you mentioned that you were able to take advantage of that probably from multiple quarters. Is the amount going to be similar to what it was in the third quarter? And I'm trying to get to what - like the margin guide for the year. Is it a similar number or is it going to be a bit less or more? Can you just - any color around the size of that potential gain. I understand or appreciate the fact that the transaction may not have yet closed, but anything that can get us like roughly to what you think it could be based on aircraft that have been positioned...

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

Oh, sure. Yeah, sure. We have 60 days left in the year so we still have a lot of work to do here. But, yes, it's a - as you're saying, we're transforming the fleet. We've got NGs going out.

A - Operator

Yeah.

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

A combination of owned NGs and leased NGs going out and then new MAXs coming in. So, it's part of the fleet transformation, which will continue over the next 10 years.

But as we're disposing of the NGs, there's two components. One, it depends on the market, which we're seeing a very good market now for our types of NGs, which are these midlife NGs, really good demand. And then also the other - that's a positive. The negative for us is that we can only do the fleet transformation to the extent that it matches with MAXs coming in.

And you know our fleet plan with the MAXs coming in. And so we're tying the exit of the NGs with the entry of the MAXs. And then we have a gap there. We have to negotiate a short-term operating lease, if you will - short-term sale leaseback, if you will, on the NG that's going out or we got to do some direct operating leases on MAXs - on MAX 8.

All those things are in the works. But to answer your - all those things are in the work for the fourth quarter as well as for next year. We're working hard to try to accelerate the fleet transformation because it gives us huge gains on the productivity side of the equation as well as cost reduction and fuel savings.

That being said, if we're successful in the next 60 days here, we should have a continuance of the fleet transformation, which would produce equity income similar to what we saw in the third quarter.

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

Okay. Great. Super helpful. Okay. Thanks, everybody.

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

(00:19:22)

Operator

Okay. The next question comes from Roberto Otero with Bank of America Merrill Lynch. Please go ahead.

Q - Roberto Otero {BIO 16689399 <GO>}

Hi, Kaki. Hi, Richard. Thanks for the call. Just one question from our side, if you could walk us through the onetime effects in the operating income this quarter and what to expect for the next few quarters? That's it. Thank you.

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

Yeah, sure. Hi, Richard (00:19:48). It's not - part of the - in addition to the income we're generating from the business we have which sells tickets and transport passengers, the GOL we in various business, the airline operating company, if you will. In addition to that, what I just was talking with Michael was the aircraft asset business that we have, which is also part of our portfolio, and that we had around BRL 109 million of operating income on our fleet transformation disposal of our own Boeing 737 NGs.

The other effects, that's about BRL 109 million in third quarter operating income from our asset management business, the aircraft asset management business. In the other business we have, which is the loyalty program business, we had around BRL 60 million of onetime profits and income which had about a BRL 39 million positive impact on EBIT on operating income, which was due to the reversal of five years of the PIS/COFINS taxes on revenues, which was a reversal of the application of those PIS/COFINS taxes on the breakage at our Smiles subsidiary. That created a total net income increase onetime of BRL 60 million. And of that, BRL 39 million hit operating income, positive.

Q - Roberto Otero {BIO 16689399 <GO>}

Okay. That's clear. Thanks, Richard.

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

Okay.

Operator

Okay. The next question comes from Duane Pfennigwerth with Evercore ISI. Please, go ahead.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Hey, thanks. Just with respect to your 2019 guidance, Rich, can you talk about the underlying FX assumption that you expect in 2019? On the reduction in net financial expense from 2018 to 2019, is that already in the bag or is that based on refinancings that you expect? And then, lastly, for the full-year 2018 earnings per ADS guidance, what is the assumed FX gain, if any, in the fourth quarter? Thanks for taking the question.

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

You mean, three questions. Yeah. Let me go through the three questions here. And if you could just repeat number one and number three as I was - your first question, I understood was, what's our FX assumption for 2019 overall, correct?

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Yes.

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

Yeah. We're assuming that we're going to be at something close to 3.6% (00:22:40) by the end of this year. That's in our planning and how we're working, and we assume it's kind of going to be bouncing around that level for next year, perhaps with a slight appreciation to a 3.5% (00:22:51) level. That's based on our view on Brazilian economy and oil prices and how we do our risk management. I'm sorry, Duane, I blanked on your second part of the question.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

That'll be, in 2019, you have I think about BRL 300 million of reduction in the net financial expense, basically net interest expense. Is that kind of the run rate you're at today or is that based on transactions that you expect to do in the future?

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

Yeah, sure. Yeah. Let me walk you through that. Because this year, we have an enormous amount of exchange rate variations caused by the dollar appreciation. If you - this year, 2018 full-year, we're expecting to have around BRL 800 million of net financial expense, excluding the exchange rate variations. Exchange rate variation should probably end up being around BRL 600 million negative in the full year results of 2018. Okay?

And meaning, so the total number there is going to be about BRL 1.4 billion, BRL 800 is actual net financial expense that we actually paid. And then, the other component is the variation effect which has - it's basically, if you will, the exchange rate variation on our net spread of assets minus liabilities on the balance sheet, given that our aircraft assets are not denominated in dollars, and therefore they depreciate in an appreciating dollar environment.

Now, (00:24:33)...

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Yeah. I don't - sorry, I don't mean to cut you off, but just the - understanding that variation and how the assets don't get marked, but the debt does. But just for net interest expense portion of that, I believe you're expecting a decline year-over-year 2018 to 2019...

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

Yeah, I was flipping to that. What I was going to say is that, from that starting point for next year, given what I just described on the exchange rate scenario where we expect to finish the year and we're expecting to be throughout the year, we would expect minimal positive or negative exchange rate variations on the balance sheet for next year.

And so, the rest of that, that roughly BRL 500 million, is that we're guiding for next year of net financial expense is pure actual net financial expense which is the effect on the balance sheet. And yes, that is declining by about BRL 30 million (00:25:30).

I just wanted to separate it from view. There's no - none of these exchange rate effects on the balance sheet in that number just kind of sets that aside help you (00:25:38) understand how that goes in 2018 also. But in 2019, that's a combination of two factors. One, it is continued deleveraging where we expect to take about another - a slight deleveraging overall. As you saw, we just announced a further amortization of one of our Brazilian real-dominated debts, which we're going to be amortizing next year an additional BRL 300 million during the course of the year. We also reduced the interest expense on that significantly. And so, that's one component. The other component is, as we roll off - as we do these aircraft sales in our own portfolio, the financial leases roll off. And we're negotiating good deals on the Boeing 737 MAXs coming in that for next year, we've all done - we've done in a sale leaseback mode and in operating leases.

And, of course, all of these is pre the IFRS 16 effects, which we can talk about separately if you want. But that roughly BRL 300 million reduction is a function of deleveraging in a couple of different categories on our balance sheet, as well as the reduced interest rates that we've been able to negotiate on some of our debt instruments.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Okay, Rich. And then, maybe, if I could just sneak one more in. I know, it's just a short amount of time, just a very few days, but could you compare bookings trends leading into the election versus bookings trends after the election? Are you seeing any acceleration or pickup in activity?

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

Yeah. Well, basically, among the business (00:27:15), there is a slight improvement, which is mixed with the high season typical growth in our demands. So, we believe that this is a kind of new trend. As I said, SKU is valued (00:27:31), but definitely growing. We are quite positive on that.

Q - Duane Pfennigwerth {BIO 7329167 <GO>}

Thank you, guys.

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

Thank you.

Operator

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

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

Hey, thanks for the call. Just a few quick follow-up questions from me. First is on the NG side, how many aircraft are left to – that you can sell over the next few years? And second, on the sale leaseback of the Boeing 737 MAXs, do you have any idea of kind of what that can contribute next year? Because I'm guessing that will be kind of a positive impact as well as to (00:28:14) the other operating income?

And then, just on the sort of a third question, just on – to follow up on the 4Q trends, it seems like your kind of guidance on revenue would imply RASK kind of really sequentially improving quite a bit. I know the load factor is definitely helping in that direction. Any additional kind of thoughts on that would be greatly appreciated.

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

Sure. Savi, sure. We – I'll just take those three questions. Yeah, on NGs, we finished the quarter with 25 in the port – of owned NGs in the portfolio. And as we've guided, we're in the process of disposing of those over the next two to three years. If we can find ways to accelerate the exchange to the Boeing 737 MAX with not increasing the fleet plan but just increasing the participation of the Boeing 737 MAXs in our overall fleet, we'll do that and we have the flexibility to dispose of those 25 NGs faster if we want to.

But right now, I think you should expect that those should be kind of – to come out of the fleet over the next 24 to 36 months. And it's important to emphasize that that is a regular component of our business model in that business. As we dispose of NGs, we're also taking on the Boeing 737 MAX portfolio. We're also going to be adding some financial leases – using the finance lease mechanism within the Boeing 737 MAX portfolio also, which will also create that income from – for us over the cycle.

And as you were mentioning, for next year, our entire delivery schedule for next year on the Boeing 737 MAXs was done in that sale leaseback format. And yes, we will have – we will also have some operating gains as we receive those aircraft in the fleet next year that will also impact positively operating income. As you know, we don't disclose the prices on those deals, but it should be similar to what we experienced historically.

And then, finally, on the fourth quarter, yes, I could – a couple of points. I mean, the fourth quarter PRASK if you will, year-over-year. I can also help you sequentially, year-over-year, we expect it should be up around 5% to 6% on load factors as we've guided kind of in the low 80s, 80%, 81% which would give us a RASK of kind of a 45% increase versus the fourth quarter of last year. And that's a slight increase over the third quarter. Remember, in Brazil, in November, December, January, February will be kind of -it's another high season for us because we now go into our - if you will, our summertime which is the peak in January, high leisure traffic. And then Carnival is not in the month of February this year. So, February should extend with that high VFR and leisure travels. So, we start to get a pickup in overall demand here over the next four months seasonality-wise.

But on the fare side, on the yield side, we do see some slight improvements in that, even given the big increases that we've had in the last five or six months. We're being successful in keeping good pricing power, especially as we get into the high-demand season which will run kind of until February.

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

Yeah.

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

Thanks. Just to follow up on the sales leasebacks, what's kind of been the historical rate? I'm just kind of curious.

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

Yeah. I was just saying, we don't as - we don't disclose the numbers that we're negotiating with on these deals. So, you have to wait and see in the - as we realize those gains going forward in the portfolio. Obviously, they're positive based on our prices and our contracts and our -in the way we negotiate these deals. We generally focus on, when we do a sale leaseback, minimizing the lease rate, because our focus is on having the absolute lowest operating cost for ASK. And then, it's the difference on that ends being the up-front cash that we realize on the sales.

All very helpful. Thank you.

Operator

Okay. The next question comes from (00:32:59) with Bradesco BBI. Please, go ahead.

Thank you. I have two questions here. The first one, in the press release, you mentioned about the IFRS 16 that we will be implement (00:33:13) next year and your adjusted net debt could drop like BRL 1.7 billion to BRL 2.7 billion. So, that's a lot. So, I don't know if you can give any color on the potential implications for growth if it's, for example, if it's possible to refinance your bonds in order to reduce the current spread?

And my second question, just a follow-up on forward booking for - in Q4. We can see a load factor going up here in your presentation. And then, now, we have a scenario of falling FX rate. So, can we assume that you have all these, let's say, revenues at a much higher FX, and then for Q4, we'll likely see a very strong EBIT margin?

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

Hey, good morning, Victor (00:34:00). On the first question, yeah, we provided some preliminary evaluations on the impacts of IFRS 16. We've been getting this year a lot of questions on that issue, and we have finalized all the preliminary analysis. Now, that has to go into the full-year audit. These numbers will become official as of January 1, and we will present the 2018 numbers as well. But based on the initial results of that, which has involved consultants as well as our own team, we estimate a reduction in adjusted net debt of BRL 1.7 billion to BRL 2.7 billion.

And then, the counterparty on the operating income side of plus 400 to 500 basis points on the EBIT margin. And the numbers we provided in the release are the pro forma numbers on the last 12 months ended September 18, 2018. As if we – as if that was applied on the balance sheet today – on today's balance sheet, you would then see – if converted to IFRS 16, you would see BRL 1.7 billion to BRL 2.7 billion adjusted net debt reduction.

And, of course, on the load factor in the currency – if I understood it correctly; if not, please repeat it – I think we should expect to see the high correlation of domestic market yields with currency with U.S. dollar as historically when we have rational capacity management or with capacity growing below demand in our market. We have a pretty good, very high correlation, 70% correlation of Brazilian yields with the U.S. dollar, almost a dollarized (00:35:54) revenue, if you will.

But it's very important there to have capacity growing below demand, and that's why we're very focused on that in our work. We expect domestic capacity next year to be growing on average at 5% year-over-year in our domestic – I'm sorry, domestic demand growing at 5%, and our domestic capacity plan is a 1% to 3% growth which should allow us to continue to get a pretty good recapture.

Having said that, in the short-term, given that we're in the seasonality cycle of increasing demand, November, December and January. January is only second to July in terms of demand. We should see some good buoyancy in fares and yields even if the Brazilian real is appreciating versus the U.S. dollar, now that a fair amount of the political uncertainty is resolved. But if that wasn't exactly the question, please ask me.

Q - Operator

Yeah. No, that's it. And, Richard, just a last question. Think about your guidance for next year. You do not have any of these impacts related to the IFRS in your current guidance for next year, right?

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

I think, maybe, we have a bad audio here, Victor (00:37:18). I'm sorry, I can't – I couldn't get the question.

Q - Operator

Your guidance for next year, do you incorporate the impact of the IFRS 16 or it may change because of the IFRS 16 next year?

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

No, no, no. I'm sorry. Now, I get it. I get it. No, we have not yet shifted our reporting methodology to the IFRS 16. We'll only do that with most - with the first quarter of 2019. And so, probably, what we'll do when we provide our fourth quarter numbers and whenever we talk about next year, the historical will still be in the current format. And then, the first quarter will be the first quarter that we will present fully retroactively adjusted to the IFRS 16 methodology for this particular issue.

But on February 28 next year, when we disclose our full-year results, we'll also be providing what the actual 2018 audit confirms in terms of the IFRS 16 calculations, so you have a pretty good view on how that would impact. But given that our overall growth in assets and liabilities between where we are now next year is minimal, the impact will be similar, within the range that we're providing for you guys.

Q - Operator

Okay. Thank you.

Okay. The next question comes from Bruno Amorim with Goldman Sachs. Please, go ahead.

Q - Bruno Amorim {BIO 17243832 <GO>}

Yes, sure. So, a quick one from my side. So, could you please just remind us to what extent, if any, goes to benefits from payroll tax reductions and what you expect for 2019? Thank you very much.

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

(00:39:06) you're asking about additional payroll tax reduction? We don't - we currently don't expect any changes from where we are right now in terms of that. I think, you're talking about the potential loss of the current situation?

Q - Bruno Amorim {BIO 17243832 <GO>}

Yes.

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

We don't have any updates on that, no.

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

Yeah. There is no horizon in the governance (00:39:22). We need to wait into the next year's - I mean, a political environment to understand it whether this kind of positive view is going to stay or not.

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

Yeah, we're just learning the process now of the change in your government. And so, in January, the new administration will assume. And then, we (00:39:39) on a lot of these tax issues and institutional issues across Brazil. I think we'll have to wait until January to get more clarity on that. Anything that comes up between now and then would be speculative because with many issues, the government going out is not allowed to affect changes. And so, we'll have to wait until the new government comes in and see what, if anything, changes to policy will be. And so, I expect we will be talking about that in March when we talk about our fourth quarter results.

Q - Bruno Amorim {BIO 17243832 <GO>}

Okay. Thank you very much.

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

Thanks for the question, to remind us that we will be talking about that in March.

Operator

Okay. The next question comes from Stephen Trent with Citi. Please, go ahead.

Q - Stephen Trent {BIO 5581382 <GO>}

Good morning, guys, and thanks for taking my questions. The couple of mine have been answered. Just one or two follow-ups for you. I'm just curious, in terms of the domestic market, what you're seeing from your other competitors. There seems to be one relatively small competitor where its financial health is maybe a bit of a question mark.

And then, the second question, may be very early at this stage, but if I'm not mistaken, João Doria is going to be the next São Paulo Governor. And any early read from him with respect to whether São Paulo might take a second look at its jet fuel taxation?

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

Hi, Steve. It's Kakinoff here. Actually, we have no reading on the new São Paulo's Governor policy on it. Basically, we know that he is already trying to make the most of the particular assets than São Paulo has at some of the airports. Those could be incentivized if you host more flights. But honestly, we didn't see any kind of information or even any input which could be understood as our capacity to read the new governor's policy lines (00:41:57).

And regarding the competitors, we do see a more rational behavior. We couldn't say that it's as rational as it should be. But I believe that the market will behave accordingly over the next months, maybe because some of the models, at least on our point of view, they are simply not sustainable. So, I think that this is kind of likely landscape scenario for the next period.

Q - Stephen Trent {BIO 5581382 <GO>}

Okay. Let me leave it there. Thanks, Paulo.

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

Thank you.

Operator

The next question comes from Dan McKenzie with Buckingham Research. Please, go ahead.

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

Hey. Hey. Thanks. Good morning, guys. At the risk of kicking a dead horse here and going back to some of your – the prior question that come already, but you've got a lot of new U.S. investors that really don't track the local Brazilian news or economy. It seems, as you pointed out, the country is on the cusp of a lot of change that implies a better operating environment since like your outlook factors in a tiny bit of this. So, first would you – yeah, it seems like, would you agree with respect to the outlook?

And secondly, and I know you don't want to speculate on reforms getting passed, but is there a consensus view on if they're likely to get passed at this point or is it just simply too tough to call? So, again, just trying to get at this idea of perhaps the operating environment next year being more likely to surprise on the upside or if the outlook for 2019 is really just sort of factoring in steady state?

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

Hi. In concerning our outlook for 2019, we are not considering any kind of boost in the economy, okay. But, if I may, I would like to share with you some of my personal view on what could go positively regarding our economy. First of all, this kind of combination of having a low inflation rate plus low travel rates (00:44:16) considered in Brazil is standard, okay? And even only a marginal GDP growth is something not only pretty powerful to sustain the demand, but also could be considered somehow new to – in relation to our history. I mean, if you go back in five decades, you're not going to find not even a single year where we were able to live with 6.5% prime rate (00:44:51) in Brazil, 4-plus-something inflation rate and then positive GDP.

This is the situation this year. And it's going to be added by also a quite new additional factor, which is political stability, at least this is the current outlook. For the first time in four years, we are supposed to get rid of pretty much volatile influences such as impeachment, change of the Congressman, and all these kind of turbulences. So, I believe that the past to leave or gather (00:45:34) more dynamic economy here. But at the moment, nobody knows exactly what's going to be the economy, the policies for economy by the beginning of the next government. And I personally, I am quite positive because there is this powerful combination and now it's added by more policy stability and...

(00:46:05)

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

Yes. In terms of our - it's a good question, because we're actually beyond the inflection of - inflection point on demand before this recent kind of back-up on the currency as it relates to the election. What I mean by that is that, last year was the - 2017 was the first year of growth following about six years of slowdown in contraction and recession. And so, when you think about the longer cycle, we're probably now - we're clawing our way on year two on what should be. There's a positive part of the growth cycle for the next three to four years until we get to the next term, if you will. And so, I think that's a good question to ask, because we're all feeling this out here in Brazil on a variety of sectors clearing our way out on the other side of this election cycle and how we address the challenges of the demand cycle as opposed to contraction cycle.

We've spent the last - since 2012, we've been gradually downsizing GOL. And then 2015, 2016, the final part of that was a reduction in assets and return of - yeah, we eliminated 29 aircrafts from the fleet, rightsized the fleet, rightsized the liabilities in kind of the 2016 period, to prepare for this growth cycle with the right demand supply scenario.

And now, we just kind of eliminated the uncertainty of - on the political side, and there's a lot of work that has to be done still. But, next year, we're going to be dealing with those new components in terms of what, if any, policy changes would be. And as Kakinoff mentioned, we've never had, in modern Brazilian economic history, this combination of inflation and interest rates at 4-plus, 7%. We've never had it ever.

And - but on the negative side, we still do have extremely high unemployment in Brazil, which has a big impact on demand on a variety of sectors including ours. And this is something that has been building for the last six years now. It's somewhere between the official numbers are 12%, real numbers are probably higher than that. And so, that portion of the economy, if you will, which brought us the more VFR client, visitors, friends and relatives, is still lagging for sure. And they're still, if you will, trying to recompose their coffers, pull up their coffers again with some income and savings.

But the Brazilian piece, as Kakinoff was mentioning - sorry, the corporate piece, the Brazilian business piece is really the key driver of our business, and that's our main customer. It's over 70% of our revenues and over 50% of our customers and 70% of our revenues are coming out of people traveling for business purposes which are driven by what's going on in the core economy. And Brazil also a very commodity, natural resources-driven. And so all these kind of components will play into what happens with demand next year.

Yeah. And this 5% demand growth will be tied to whatever GDP ends up being. We're working with roughly 2.5% and you can work with a 2 times elasticity on that. So I'll keep your eye on that. I would keep your eye on how GDP growth, which is the best leading indicator that we use here on what can happen with demand.

So, if GDP growth picks up to 3%, I think you could expect 6% or maybe more demand growth. So that's why I would - for folks not sitting with us here inside Congonhas Airport in a hangar seeing the flows and the massive traffic jam that's coming in here to

Congonhas Airport, tomorrow is a holiday here in Brazil and so we've got a lot of people traveling. And so, if you want to get into Congonhas Airport, you've got a bit of a traffic jam to get in here today.

But for those who aren't kind of seeing that here locally, that's how I would approach it then. I would kind of keep your eye on what happens with GDP estimates. It's the best estimate that the social science can predict on what's going to be happening with the animal spirits (00:50:33) here in Brazil next year. That's how I would answer that question.

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

Yeah. It's going to be fun to watch, that's for sure.

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

Yeah.

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

Just kind of an airline-specific question, where were you at with respect to discussions with Delta regarding a potential JV here? And at some point, what's the potential or not to include Aeroméxico?

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

Actually, we are – this JV stuff is considered just – or treated by us in a speculative way. So, we are having some ideas parsed on it (00:51:12). Clearly, there is a potential to have (00:51:16) be implemented. But there are still some regulatory issues to be solved.

I don't believe that's something to be deployed anytime soon. But Delta and growth (00:51:29), we have a long history of very positive and rich partnership and I think that's a natural development to have an even tighter relationship with them. But there are too many obstacles to be removed starting by the regulatory environment and also the network of both airlines in South America – Latin America (00:52:00) to be addressed before we could go on a more substantial discussion on JVs.

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

Interesting. Just out of curiosity, what's the potential for doing something similar with Aeroméxico or...

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

Yeah. We have – Aeroméxico is one of our partners. We are contracting with them (00:52:24) already for some years. We don't even start any kind of discussion related to potential JVs. Theoretically, yes, but at the moment, it's just merely a speculation.

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

Yeah. To complement on that, Dan, we have a unique component here among global low-cost carriers in our business model, the GOL business model. We have over 90 codeshares and interlines that are taking advantage of our network here in Brazil, which is the largest network in terms of capillarity.

So when you look at how we're working today globally, we sell tickets in 140 countries around the world and we're working with over 90 different airlines in a variety of formats - codeshare, interline - on our network, where today we're generating - over 6% of our total revenues are coming out of revenues generated from these partnerships onto the GOL network.

And so, it's a - there's a very global aspect to our business in terms of people at airlines around the world and people that want to travel to Brazil accessing our network and traveling, of which Delta and Aeroméxico are already part of that. And as Kaki said, we want to keep developing that business of - in terms of monetizing the value of our network and our position as the largest domestic carrier.

And the attractiveness of that also from the product side, we don't see any restrictions today at all with how global international airlines look at the attractiveness of our product in terms of doing the last-mile distribution here in our domestic network. And then also from our local customers, they're able to access what ends up being a very global network through the GOL website through these very large, almost massive number of codeshares and interlines that we've developed here over the last 15 years.

And that's a slight deviation from the pure low-cost carrier model, but it's something for our model. Like I said, it's generating over BRL 600 million in incremental revenues for us which have a very, very high contribution margin.

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

Yeah. Very good. Thanks for the time, you guys.

Operator

Okay. Attention, this is the final announcement for questions. The next question comes from Josh Milberg with Morgan Stanley. Please go ahead.

Q - Joshua Milberg

Kaki and Richard, thank you very much for the question. This is far afield of the results, but I was hoping you could give a little bit of your perspective on the issue of IMO 2020 and just whether that that's something that you think could lead to a meaningful shift in your fuel hedging strategy.

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

Yeah. The short answer is no, we don't see any impact of that in terms of what we're doing. Keep in mind that in Brazil, that basically all gets filtered through what we get through the Brazilian supply chain with basically jet fuel prices in Brazil being basically determined by the Petrobras mechanism, which is basically international price on the cost side. And so, we basically are paying international prices with a bit of a lag. So in there is – what's going on with WTI, Brent, the crack spread and then the U.S. dollar to Brazilian real exchange rate.

And so, to the extent that that increases international prices, we would see that impact all airlines here in Brazil and then that just goes into how we normally do the risk management, which is just kind of remembering – the course component for us on the risk management is it starts with a capacity decision in terms of keeping that in a position where we can keep a very high degree of pricing power. So, to the extent that over a period of time, we need to deal with increasing costs from oil prices, we have a high degree to pass those on to customers.

And so, with normal volatility, that kind of gets absorbed into the regular revenue management. And so, what we do on the hedging side of the equation, we basically try to protect against the shorter term volatility, for example, we're about 80% hedged here for the fourth quarter in the high 70s and we're about 50% hedged for the first half of next year in the high 70s. So that's to protect us against – if we get a big run-up in oil prices that we can kind of work them through the system on the revenue management side and remembering that that revenue management ability is only possible if we've got a rational capacity management.

Now, the other point I would add is that one of the reasons why we're investing billions of dollars in our fleet renewal with the Boeing 737 MAX is overall related to the fuel component. I mean, the MAX that we've already got two operating in our fleet today is delivering, as advertised, the 15% fuel economy.

And so, as we transform from the NGs to the MAXs, we're getting kind of an operational hedge, if you will, relative also to competitors on an absolute basis if the 15% cost reduction versus our current NGs. And when I say the 15% cost reduction, what I mean is when we say that a MAX – that we replace an NG and put in a MAX, that's a 15% fuel economy on day one.

Having said that, our competitors are – have a different productivity there. And so, this also opens up a further gap for us on the competitive side, which is our key tenet here at GOL to maintain a substantial gap, if you will, on the CASK side of the equation.

When all this kind of roll in (00:58:40), no, we're not kind of taking any specific actions to deal with the additional, if you will, costs or charges or taxes. They're going to be applied based on the shipping element, if you will, of fuel but we think we'll be able to manage that through the combination of the rational capacity management, dynamic yield management, and then complementing that with what we do on the hedging side. And the real victory for us is this is all happening at a time when we are transforming our fleet from the NGs to the MAXs. And so, we're pretty excited about that. And so that's all going to kind of get caught up in that.

So I think that IMO component, it obviously will be in our cost structure, but it won't – we don't think it's going to have any impact at all on the economics of our business.

Q - Joshua Milberg

Okay. Very clear. Thank you.

Operator

Okay. This concludes today's question-and-answer session. I would like to invite Mr. Kakinoff to proceed with his closing remarks. Please go ahead, sir.

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

Okay. Ladies and gentlemen, I hope you found our presentation and the Q&A session helpful. Our Investor Relations team is available to speak with you as needed. 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 day.