

Q1 2018 Earnings Call

Company Participants

- Joao Arthur Souza, Head of Finance
- Phillipe Casale, Investor Relations Executive Manager

Other Participants

- Petr Grishchenko, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Cosan SA's First Quarter of 2018 Results Conference Call. Today with us, we have Mr. Phillipe Casale, Investor Relations Executive Manager; and Mr. Joao Arthur Souza, Head of Finance.

We would like to inform you that this event is recorded and all participants will be in the listen-only mode during the company's presentation. After Cosan's remarks, there will be a question-and-answer session for industry analysts. At that time, further instructions will be given. (Operator Instructions) The audio and slide show of this presentation are available through a live webcast at ir.cosan.com.br. The slides can also be downloaded from the webcast platform.

Before proceeding, let me mention that forward-looking statements will be made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions of Cosan's management and on information currently available to the company. They involve risks, uncertainties and assumptions because they relate to future events, and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of Cosan and could cause results to differ materially from those expressed in such forward-looking statements.

Now I'll turn the conference over to Mr. Phillipe Casale. Mr. Casale, you may begin the call.

Phillipe Casale {BIO 20025617 <GO>}

Good morning, everyone, and welcome to Cosan SA first quarter of 2018 earnings conference call. I will start the presentation talking about the results from each business unit and then we will discuss the consolidated numbers. We can now move on to slide

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number four and look at Raizen Combustiveis, our fuels division. Before we start, I would like to remind everyone that on April 24, Raizen Combustiveis financed the acquisition of Shell's downstream business in Argentina for a total amount of \$950 million, of which \$100 million was paid on the date we announced the transaction. We expect the closing of this transaction in the second half of this year when we will pay the remaining installment subject to adjustments of change in working capital and by the amount of debt -- net debt in the closing date.

And now, talking about the results proper. During the first month of the year, we could see the evidence of the challenges presented by Brazil's economic recovery. Once again, the consistency of our strategy and the focus on expansion and long term relationships with our service stations network yielded results with above industry sales volume performance. There is still high unemployment rate and the pace of economic recovery had impacted the sales of Otto-cycle during the quarter.

Brazilian sales volumes of gasoline equivalent adjusted by the energy parity fell by 4% year-over-year in Brazil according to the Plural database, formerly known as Sindicom. While Raizen's sales volume declined by 3% year-over-year in the same comparison basis. It is worth mentioning that the sales mix was strongly influenced by the change in gasoline pricing dynamics in the Brazilian market and sharply increasing biofuel demand in the quarter. As a result, Raizen ethanol sales grew 55% in the quarter, while gasoline sales fell 13%. For diesel, Raizen sales remained strong and increased by 6%, well above the Brazilian market, which has a 1% expansion. Here I would like to highlight that Raizen has a higher exposure to the agribusiness, which continues to perform well and leverages the sales performance for our clients, as well as new contracts signed within this market segment.

Regarding the aviation segment, while we still have a low comparison basis, sales volume increased by 8% following the market trend and increase in the number of departures. As such, Raizen's total sales volumes increased by 3% year-over-year, while volumes for the Brazilian market were flat.

Regarding the financials, adjusted EBIT increased by 6% in the quarter. We insist on focusing on the EBIT, as the first assessments of business performance, as it reflects the ever improving management of assets, including the invested capital. As a reminder, return on invested capital is the general performance metric of choice. Adjusted EBITDA grew 7% year-over-year reaching BRL732 million. This growth reflects not only the higher volumes sold, but also the gains from our supply and commercialization strategy.

It is worth mentioning that these strategy goes way beyond import, it involves inventory optimization, efficiency in logistics, trading, et cetera. As a reference, Raizen's first quarter of 2017, the results were positively impacted by fuel imports, partially offset by negative pricing dynamics on inventories during the period. The effect this quarter was the opposite. So in the first Q '18, the impact from imports was considerably smaller and that was offset by the gains on fuel inventories, especially in ethanol.

Regarding our expectations for the next quarter and for the rest of the year, I would like to first mention that our guidance assumed on a more gradual recovery of the economy during the first month of 2018 and also price volatility. We believe that the strategic consistency will result in another year of delivering the results.

Talking about Raizen Combustiveis investments, we disbursed \$257 million during this quarter, including maintenance, investments, new service station conversions and contract renewals. We ended the quarter with 6,329 Shell branded stations in total, a net addition of 286 stations over the last 12 months and 57 net additions in the first quarter of 2018, in line with the expectations for the full year.

We will now move on to Raizen Energia on the next two slides. The 2017, '18 crop season ended in the first quarter. You'll find the information on the quarterly results on slide five and the full crop season on slide six.

Crushed volumes increased 3% year-over-year, reaching 61.2 million tons crushed -- of sugarcane crushed considering the 500,000 tons crushed in March of 2018. The increase is explained by the longer crushing period given the higher availability of sugarcane throughout the dry season. At the end of the crop, sugarcane productivity reached 9.8 tons of TRS per hectare, 5% lower, as a result of the lower rainfalls during this year. The weather conditions also negatively impacted TCH, which is the tons of sugarcane per hectare, partially neutralized by the TRS improvement.

Regarding sales volume of each product we have, and first, in sugar, sales increased by 11% quarter-over-quarter and 10% over the previous crop season, with the highlight being the increased sales of our own product. Average sugar sales prices in Brazilian reais were lower, both on a quarter-over-quarter and year-over-year basis, due to the strong drop in commodity price throughout the crop year. Differently from the dynamics for the sugar market, ethanol sales volumes grew by 60% this quarter and 27% year-over-year, mainly on trading and resale. The price volatility created new trading opportunities positively contributing for Raizen Energia results. Ethanol average price was 1% lower on 1Q '18 and 3% lower compared to the '16, '17 crop year. Average prices for the year were mostly stable at around BRL1.7 per liter.

Going to cogeneration, with more availability of sugarcane bagasse both from our own, as well as from third parties, power generation and sales grew both quarter-over-quarter and year-over-year. The volatility of the spot prices of energy also reflected in opportunities for us to resale and trade energy during the crop season. The average price for the crop a year was BRL242 per megawatt hour.

Moving on to costs on slide six, just as we did after last year's crop season, we would like to highlight our TOTEX indicator, which is the sum of maintenance CapEx and the operation expenses, or OpEx. You can see it, it represented on the graph on the lower left hand corner of the slide. The green bar reflects basically the higher volume of sugarcane that we bought from the market or third party sugarcane, offset by the lower CONSECANA costs in the period. The graphs, blue bar on its turn [ph] reflects our own costs. The 3% increase year-over-year basically reflects the higher expenses on biological

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assets and/or diesel costs, and also, the impact of inflation rates on our costs. The unit cost -- cash cost in sugar equivalent decreased by 4% this crop year, as a reflection of the lower CONSECANA index price during the period and also the efficiency gains that we have been capturing throughout the last couple of years.

On adjusted EBITDA, we are excluding, as we normally do, the impacts of the changes in biological assets, the debt hedging accounting and the exchange rate effect over the sugar exports. Especially this quarter, we are positively -- we were positively impacted by BRL54 million from the sale of a stake in one of Raizen's logistics terminal. All the aforementioned adjustments are detailed in our earnings release. And as a result, the adjusted EBITDA grew by 8% and reached BRL1 billion in the quarter. For the crop year, adjusted EBITDA reached BRL4.1 billion. I would like to once again highlight that even considering all the challenges we faced during the year, we were able to meet our guidance and deliver 11% EBITDA expansion over the previous crop year.

Regarding the sugar hedge on slide five, we have not moved further from the hedge position we had in the previous quarter. For the current '18, '19 crop year, we have approximately 30% to 34% -- 35% of the total sugar to be exported, hedged at an average price of BRL0.52 per pound. For the next crop year, 2019, '20, we have approximately 5% hedged at the same price level, but this movement was after the 1Q '18 closing.

The strong decline on sugar spot prices we saw in the past few months reflect the larger production from other countries like India and Thailand resulting in an expected oversupply this year. The magnitude of this oversupply will depend on the size and the production needs of the Brazilian crop year that just started in April. The dynamics and the volatility of the commodity are probably well known by all of you. But regardless of the price condition, we continue focusing on having an even more efficient operation, optimizing invested capital and working capital and striving to improve the ROIC of the business, as we see in this crop year that just ended.

Finally, our CapEx reached BRL1 billion in the quarter, ending the crop year with BRL2.4 billion, in line with the guidance we provided. The most significant expenses during the year were mandatory outlays in health, safety and environmental protection, some early renewal on agriculture machinery and higher investments in the planting and land treatment on sugarcane fields. We have maintained the sugarcane renewal rate at around 15%, 16% on a recurring basis.

Let's move now to slide seven. And as Comgas has already reported results last Wednesday, I will go straight into some of the highlights. Comgas continues to benefit from industrial activity recovery, keeping the focus on expanding higher margin segments, which is the residential and the commercial one. The total sales volumes, excluding thermal generation grew by 6% with residential expanding by 18% year-over-year, as a result of the connection of 107,000 new clients over the last 12 months, also due to the lower average temperature on the period.

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Normalized EBITDA increased 14% in the quarter, reaching BRL437 million due to the higher volumes sold, stability in expenses and inflation readjustments on the margins. The IFRS EBITDA was 19% higher due to the movement of the gas cost and the consequent reduction of BRL16 million of the regulatory current account in favor of our clients with a remaining balance of BRL160 million in their accounts. Comgas invested BRL112 million in the quarter, which is in line with the CapEx plan.

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Let's now move to slide eight, and here I'd like to discuss, first, the lubricant business, Moove. The higher sales volume and mixed improvement, as well as the recent international expansion of our lube oil operations, and here I would like to mention Spain in 2016 and UK on the end of 2017 have supported the 19% EBITDA growth, which totaled BRL51 million in first Q '18. If we look into the right hand side of the slide at the corporate, we can see that G&A and other operating expenses reached BRL46 million, down by 30% year-over-year. I reinforce that these expenses refer basically to personnel expenses at the corporate level, consulting services and the result from legal discussions.

Let's move to slide nine to talk about pro forma Cosan SA consolidated results, which considers our 50% stake in Raizen. The better operational performance across all Cosan business lines resulted in 11% adjusted EBITDA expansion, reaching BRL1.3 billion. The quarterly EBITDA before any adjustments reached BRL1.2 billion, increasing by 22%. The net income reached BRL346 million, 68% higher year-over-year, helped by better operating and financial results that already reflect the fall in SELIC interest rate in Brazil and consequently the lower cost of debt. Investments grew by 19% and reached BRL759 million, in line with our budget across all business lines.

Finally, pro forma cash flow to equity reached BRL1.8 billion in 1Q '18, of which BRL1.3 billion were due to the sale of credit rights that occurred during the 4Q '17, but was only settled in January of 2018. Even after considering this transaction, the almost BRL500 million difference reflects the strong cash flow generation of all the business, especially in Raizen Energia that was positively impacted by the seasonality of working capital and sales dynamics throughout the crop year.

Going to slide 10, we can see that pro forma gross debt fell this quarter to BRL14.5 billion. I would like to highlight here the effective reduction of gross debt at the holding company Cosan SA, as we paid down BRL164 million off the 2018 bond that expired this year. The pro forma average cost of debt, including Raizen was 110% of the CDI. We saw a robust cash position, made even stronger by the significant cash inflow related to the sale of credit rights in the quarter, and our consolidated net debt fell 80%. As a result, leverage reached 1.5 times net debt to EBITDA on a pro forma basis, but of course, helped by this BRL1.3 billion of cash coming from the credit rights sale.

Before we look at the free cash flow to equity at the bottom of the slide 10, I would like to mention that from January 2018 onwards, we adopted a new accounting policy in accordance to the IFRS 15 standards. There is an important impact on the cash flows from operating and investing activities. Until December 2017, all contracts with clients, and here I'm talking specifically about the fuel distribution business, will not be accounted for intangible assets, as before, but as contracts with client assets. The new accounting standard is detailed in our financial statements, but basically the amounts will now impact

cash flow from operating activities and not cash flow from investing activities, as it used to impact before. It's important to note here that there is absolutely no change in the total cash flow generation or on the bottom line.

Now, we can highlight the following points on the free cash flow. First, on the cash flow from operating activities. In addition to the sale of the credit rights at Cosan, all business show year-over-year expansion. In the cash flow from investing activities, the reduction is on the back of asset sales at Raizen and change from the new accounting standard that I just explained, partially offset by higher outlays mainly from Raizen Energia and Comgas. In the cash flow from financing activities, the main quarter-over-quarter variation was due to the debt repayment at Cosan and Comgas. This quarter, we also disbursed BRL10 million for our share buyback program.

Finally, going to the last slide number 11, we would like to end this earnings presentation by discussing our guidance for 2018, which is already known by most, if not all of you. There was only one update at Raizen Energia due to the drier weather at the beginning of the crop year, we have seen productivity suffering in some regions. So we adjusted the crushing guidance to 62 million to 66 million tons of sugarcane. Despite this update, we remain confident with our EBITDA guidance for the crop year, even considering the more challenging sugar price scenario, which should be partially offset by better projections for ethanol besides the opportunities for resale and trading and the recurring capture of operational efficiencies.

We have not changed any other figures that was presented last quarter. I want to reinforce our commitment to delivering result and value creation for our shareholders, maintaining the financial strength, which accompanies our business. 2018 will be another challenging year, as we already expected, but we are confident that the consistency of our strategy will result in another year of results delivery.

With that, we conclude the presentation and we are now ready to start the Q&A session. Thank you, all.

Questions And Answers

Operator

Thank you. We will now begin the question-and-answer session for investors and analysts. (Operator Instructions) First question, Petr Grishchenko, Barclays.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Good morning. This is Petr Grishchenko from Barclays, and thanks a lot for taking my questions. First, I just wanted to touch a little bit more on Shell Argentina purchase. It's been reported this week that Raizen going to issue about \$750 million of a new bond. And I was wondering if you have any comments on that. How would you expect leverage to increase post transaction? And just generally, if you think that the recent events in Argentina perhaps somewhat undermined the value of the deal? Any comment there would be very helpful.

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A - Phillipe Casale {BIO 20025617 <GO>}

Hi, Petr, thank you -- thanks for the question. First in regards to the news of a possible bond issues at Raizen, there is no definition yet. We are going to access the market for a possible bond issues. We have already hired -- secured or secured the funding for this transaction in the Brazilian market. So there is a possibility that we will analyze back close - or more close to the -- through the closing of this transaction, but there is no definition yet of a possible bond issue in Raizen.

Talking about leverage, this acquisition does not change much the idea of having Raizen as an investment grade. It doesn't change much in terms of the leverages because as well as the debt coming for that acquisition will also accommodate the EBITDA, and there is not going to be much change in terms of the leverage. Cosan reached 1.5 times net debt to EBITDA this quarter, but it's highly impacted by the BRL1.3 billion of cash that entered due to the credit sales that we did on the 4Q '17, but the cash position or the cash just was recognized on this -- on January and what received [ph] on January.

And in terms of the market conditions, while we have this -- this recent event does not change our view on this acquisition. This is an asset of high quality asset. We have been evaluating it for a while. We are looking at these acquisitions, as an important avenue of growth for our fuel division in the entire group, specifically speaking for Raizen Combustiveis and this does not change our view -- our long term view for the deal.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Yeah. And that's helpful. And I don't know, you mentioned anything on the Comgas strategic alternatives, has there been any progress since you made the announcement?

A - Phillipe Casale {BIO 20025617 <GO>}

There is no -- there is no change in Comgas, either in the tariff review process. There is no news in that. And in terms of further restructuring, there is no -- there is no change since our last call.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Okay. Great. And just my last question. We see clearly sugar prices being crushed with the global oversupply, but on the other hand, oil prices rallying substantially, which should, in theory, translate into higher gasoline prices in Brazil and pull [ph] ethanol prices up as well. So how do you expect this trend to affect your profitability and perhaps product mix -- production mix between ethanol and sugar this year, assuming prices for sugar and oil/ethanol sort of stay at this level?

A - Phillipe Casale {BIO 20025617 <GO>}

Well, clearly, we saw the pressure on sugar prices in the last couple of months that's, of course, due to the higher crops in India and Thailand mainly, right? Brazil will indeed be a more ethanol or we'll have a more ethanol mix this year due to the profitability of the ethanol compared to the sugar ones, but the sugar's spot prices as of now. Raizen will maximize the ethanol production in the year, as well as the other players in the industry.

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We changed a little bit guidance on crushing from 63 million to 67 million tons to 62 million to 66 million tons. This is due to the drier weather in the beginning of the season, which impacted a little bit of productivity on the beginning of the crop, but we haven't changed anything on our EBITDA guidance. We are maintaining that same level. We do know that sugar spot prices are lower now than what we have embedded in our guidance, but we have a better expectations for the ethanol prices and the ethanol industry, as a whole.

We still capture the efficiencies from all the processes and all the technology we implemented in the sugar and ethanol business, which really results in effectively cost reductions and improvement of the ROIC, and this will still be the case. And also with all this volatility, we are looking at better opportunities for resale and trading of all the products basically, right? We're talking here about sugar, about the ethanol and about energy. So all of these gave us comfort now to keep the same EBITDA guidance for 2018, '19 crop year.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Great. Excellent. And sorry, just remembered the last question, I wanted to ask on your credit ratings, clearly, with very strong deleveraging and cash generation, you guys are hedging [ph] like corporate, but in terms of the ratings, have you spoken to the agencies? And are there any like metrics or targets that the agencies are expected to meet before you get upgraded? Any color would be very helpful.

A - Phillipe Casale {BIO 20025617 <GO>}

I will pass you to Joao, our Head of Finance, here to answer you.

A - Joao Arthur Souza {BIO 19357380 <GO>}

Petr, two -- two comments about your question. The first is that the 1.5 times leverage that we had at the end of the first quarter is a -- it's a situation that it will not happen at the end of the year because March is the lowest point for Raizen in terms of working capital, so this will change until December.

The second point is that we received that in January, the cash for the sale of the credit receivables from the government that we recognized in our EBITDA in December. So in December, this deal, the EBITDA will just appear [ph] in the last 12 months. So we expect that the 1.5 times leverage will be around 1.9 at the end of the year. But even this, it's a very good leverage compared to what we expect. The problem is that the Cosan is capped by the sovereign rating. So even that 1.5, the credit agencies would not change our rating.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Got it. Thank you very much and best of luck.

A - Phillipe Casale {BIO 20025617 <GO>}

Thank you.

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Operator

(Operator Instructions) Thank you. That concludes the question-and-answer session for investors and analysts. I would like to pass the floor to Mr. Phillippe Casale.

A - Phillippe Casale {BIO 20025617 <GO>}

Thank you all for joining us in this conference call, and I hope to see you in the next following conference calls and also make the IR team here available for any Q&As or any questions you have about the company. Thank you very much.

Operator

That does concludes Cosan's audio conference for today. Thank you very much.

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