Q4 2014 Earnings Call

Company Participants

- Eduardo Haiama

Other Participants

- Marcos M. Severine
- Pedro Manfredini

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and thank you for waiting. Welcome to Equatorial Energia's Fourth Quarter 2014 Results Conference Call. With us here today, we have Mr. Eduardo Haiama, Chief Financial and Investor Relations Officer.

This event is being recorded and all participants will be in a listen-only mode during the company's presentation. After Equatorial'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 maybe accessed through Equatorial's website at equatorialenergia.com.br where the presentation is also available.

Participants may view the slides in any order they wish. The replay will be available shortly after the event is concluded. Those following the presentation via the webcast may post their questions on our website. They will be answered by the IR team after the conference is finished.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of Equatorial's management, and on information currently available to the company. They involve risks and uncertainties because they relate to future events, and therefore, depend on circumstances that may or may not occur.

Investors and analysts should understand that conditions related to macroeconomic industry and other factors could also cause results to differ materially from those expressed in such forward-looking statements.

Now, I'll turn the conference over to Mr. Eduardo Haiama. Mr. Eduardo, you may begin your presentation.

Eduardo Haiama {BIO 7279971 <GO>}

Hi. Good morning, everyone. First of all, I'd like to thank you all for joining us in our fourth quarter conference call. As for our agenda for today, which you can see on slide two, I'll start the conference call describing the highlights of this quarter, then I'll comment our operating and financial results. Later, we'll comment on some corporate and sector updates for the quarter. And finally, we will open the Q&A session.

Before the highlights, I'd like to clarify some procedures regarding the figures presented in this earnings release and earnings presentation. I'd like to point out that consolidated information reflects 100% of CEMAR's, 100% of CELPA's and 100% of Equatorial Soluções which, in turn, consolidate 100% of Sol Energias' figures.

Moving on to slide six, in this quarter, both CELPA and CEMAR posted very strong demand growth figures, growing 8.4% and 6.2%, respectively year-on-year. In the quarter, CEMAR continued to keep relatively low loss level at 17.6% in which CELPA, we continued to reduce ending fourth quarter at 31.2% of the required energy. Again, CELPA posted improvement in quality indicators, DEC and FEC, which have been seen over the previous quarter since we got the control of the company.

Moving on to slide seven, Equatorial's operating revenues reached R$2.4 billion in the quarter or 82% higher in the fourth quarter of last year, mainly due to the accrual of the regulatory assets in this quarter. It's important to remember that we signed - changed the concession contract in December last year that allowed us to accrue regulatory assets that before on the IFRS, I could not recognize. And that's why you have this one-off accrual of the full regulatory assets that we had.

In terms of regulatory EBITDA, we reached R$262 million or a 68% increase year-on-year. And as for adjusted net income, we reached R$129 million compared to R$15 million in fourth quarter last year. Consolidated investments totaled R$487 million in the quarter or 86% increase, especially due to CELPA's investments.

It's worth mentioning that in January of this year, CELPA successfully concluded the renewal of some of this for the other (05:00) would amortize this year in the amount of almost R$300 million and extend the maturity from this year up to February 2018.

In terms of dividends, we are proposing distribution of approximately R$153 million that already includes the R$59.5 million on interest on equity announced last year in December. So there, the total value to be paid shareholders should represent R$0.77 per share.

Moving on slide nine, we'll talk about the electricity markets in CEMAR. We grew basically 6.2%, especially in the residential and commercial segments, and that's, basically, the result of the increase of 3.4% in the expansion of the client base and also the increase in per capita consumption this year.

On slide 10, CEMAR energy loss reached 17.6%, that continues to be below the new regulatory target set by ANEEL in 2013 of 19.2%. Non-technical losses over low-voltage markets reached 12.3% in the quarter, down from 15.6% as defined as the new regulatory target set by ANEEL.

As we've been talking about in the previous earnings release, given the loan loss level already reached by CEMAR, it's natural to expect some kind of volatility in this very short-term loss level, while we reassess our Loss Combat program to see what could be a sustainable level in the long term.

Moving on to slide 11, in terms of quality indicators, DEC improved by 10% compared to fourth quarter 2013 and FEC increased by 1% to 11 times.

Moving on to 12. CELPA distributed energy increased by 8.4% year-on-year and that's mainly explained by the energy loss reduction and also by the growth in new consumers of 7.5% year-on-year.

Moving on to slide 13, the company end total losses at 31.2%, that is the fifth quarter in a row that we've reduced the losses there. And in terms of low-voltage market, we reached 43.7% or 2 percentage points reduction in the quarter.

In terms of quality indicators on the next slide, we continue to improve quality indicators from the third quarter to fourth quarter, so there we reached DEC at 49 hours and FEC at 30 times. And as you can see, we have improved since we got control of the company.

Moving on to slide 16, in terms of EBITDA, reported EBITDA reached R$777 million. It's important to remember that we accrued net regulatory assets in the quarter that would certainly impact this EBITDA. Adjusted by these some other non-recurring effects, adjusted EBITDA would have amounted to R$262 million, it's still an improvement from last year's EBITDA.

It's important to remember to point out that in CELPA, in the third quarter, we have accrued in the other operating results the benefits of REFIS that amount to R$42 million. In the fourth quarter, we transferred these revenues from the other operating results to other financial results. And that's why that negatively impact the (10:06) value adjusted as non-recurring.

Moving on to net income, basically, we adjusted by the accrual of the net regulatory assets and also by the gain that we posted by the accrual of tax loss carryforward that we used to prepay all the tax that in CELPA that amount to R$130 million in the fourth quarter in the income tax line.

We also adjusted by R$57 million in fixed assets written off and other operating expense in CELPA and also R$32 million in bank deposits also written off in other expenses finance in CELPA. Adjusting by that, adjusted net profit would have reached R$129 million in the quarter.

Moving on to slide 18, as you can see debt amortization schedule, we have a short-term concentration of almost R$1 billion in 2015. It's important to remember that we announced in January our debt, we already rolled over R$300 million of this debt in CELPA, right, and we also ended a consolidated cash position in December of almost R$2 billion that's well above this short-term debt of R$1 billion.

In terms of net debt on slide 19, we break Equatorial's consolidated net debt and that amount to R$1.5 billion by excluding net regulatory assets and also the cash position, so there we reached net debt to regulatory EBITDA in the last 12 months at about 1.4 times. If we see the breakdown, the same calculation considering the pro rata participation of CEMAR and CELPA, we'd have reached the same net debt to EBITDA of 1.4 times, and net debt would reach R$1.2 billion.

Moving on to slide 21, in terms of CapEx use, the main increase was in CELPA that increased from R$111 million in fourth quarter. 2013 it reached almost R$300 million – about R$300 million in the fourth quarter.

On slide 23, we have already mentioned this, that rollover that we just concluded in January in CELPA, that allow us to represent almost R$300 million in debt from this year to 2018. And also, the dividend proposal of almost R$153 million that should reach a total payout of R$0.77 per share.

On slide 24, I'd just like to give a view of what we see in terms of improvements in the tariff review methodology that is still under discussion. In terms of the WACC, comparing the third cycle to what is the new proposal, we have an increase, and I believe like that should compensate the kind of financial costs the companies have been incurring due to volatility in the market, and also the increase in interest rates in the country.

In terms of X factor, we still believe there are room to improve given that, in the third cycle, it was 1.11%, and the second proposal stood at 1.64%. We saw improvement in special obligations that during the third cycle there was no remuneration to cover for these costs of the risk of operating these assets that was used in special obligations. And now, there is a proposal that should remunerate from 1% to 1.5% per year.

In terms of fully depreciated assets, we should have no proposal regarding that. Actually, the current proposal should not have any kind of remuneration, but we believe that we could have some improvement in this front.

In terms of delinquency, we believe like there are room to improve from the second proposal – for the fourth cycle. In the previous cycle, on average, this delinquency rate was about like 1% of the revenues. Now, in the proposal, it's about like 0.66% and given all of these terrific hikes and the current economic situation of the country, we believe like there are other room to improve here.

On page 25, it's important to mention the change that the government and the regulatory, they're implementing in terms of the Tariff Flags. The current proposal not only to increase so that the pricing is stronger for consumers when there is a drought situation that would increase the thermal generation dispatch, so that the current proposal to increase from R$15. The yellow flag is R$25, and the red from R$30 to R$55. But I believe it's important to stress the main change in terms of regulation of what they're going to do with these revenues that companies collect with the Tariff Flags.

It's important to talk about what's happened in the past two years in 2013, when there was this gap between the energy purchase costs – the actual energy purchase costs from the companies and the current tariff that cover this energy purchase cost, there was a gap and this gap was, in 2013, mainly covered by the treasury, national treasury. And in 2014, it was covered, in general, by the treasury but in the months afterwards, it was covered by bank loans.

With the increasing Tariff Flags, the intention from the regulatory is to collect all the debt for tariffs at the end of the day, and the way they want to balance the situation of each specific companies like given that the total revenue of the sector will cover the total costs. If there is a surplus in our company, debts and other, basically, what's going to happen is like the company that has a surplus in terms of the revenues will send the money to this, let's say, Tariff Flag compensation accounts that's pretty much similar to the ACR account. And once the money is there, this Tariff Flag compensation accounts get the money and send to the company that has debts. In our view, that is a very important mechanism to reduce financial risk of distribution segment.

With that, we conclude this presentation. We believe we can start the Q&A session. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Mr. Marcos Severine with JPMorgan.

Q - Marcos M. Severine {BIO 3322666 <GO>}

Hi, Haiama Thank you very much for the call. Actually, I have two questions for you. First one is regarding the four-step reset (18:47) cycle. Of course, that now we have the access to the regulatory WACC, the number came in above, say, market expectations 8.09%. But could you give us some color on the likely impact on the regulatory EBITDA? So do you expect some increase in the revenue and eventually, ANEEL would accept to add it to the rev, the special obligations or eventually the fully depreciated assets on that.

And so, that's the main question. So my take here is we are expecting something. I think the regulatory EBITDA could grow between 15% to 20%. So do you think this is feasible or this is too much or this is a likely scenario in your view?

The second question regards the current situation in Brazil. So I would say that the government is giving the right signal to the preparation or to rise (19:49) in the sizeable increase on tariffs, right, in order to eliminate the current subsidies. However, when I look at the average tariff adjustment, now we see this around 40%, 45% in average, some companies is likely to coming from much higher tariff adjustment.

And so, under this scenario, how do you see energy losses and delinquency rates? And so, do you believe that the rationalization plan, that is likely to be implemented in March 1, is going to work? How do you see the impact of these on the negative effect for the sector? Do you think that the government could come with another round of tariff adjustments in order to offset the negative effect for gencos? That's basically these questions. Thank you, Haiama.

A - Eduardo Haiama {BIO 7279971 <GO>}

Thank you, Severine. Regarding the first tariff review, we believe like what we have seen is like a clear signal from the regulator, that they understand the situation that it's critical, right? We, let's say, suffered in the past two years from all these financial imbalance mainly related to energy purchase cost.

But also we have been seeing like a more difficult macro scenario for the country, and also, from a micro perspective, the potential increase in delinquency, maybe the losses, which is all this tariff increase, that might lead to a lower demand growth at least in the short-term until we normalize the consumption.

So I believe like what we have been seeing is a very – at least, good signal from the regulator that they understand the situation, right, and that they need to provide additional revenue so that the companies can continue to invest in improving the quality of the service, right, and also connect new clients. I believe like that's the main message on this proposal that we have been seeing.

Having said that, to say exactly what would be the impact if it's going to be 15%, 20% or something like that, we still don't have our own data (22:17). We believe like it seems to be fair what we have been saying, right, but we still don't have our internal analysis conclusion or say like, considering the spike in interest rate, considering that we see a more like tougher financing scenarios, right, not only from the market, but also from (22:38).

Considering that we have like a potential increase in the working capital given the tariff hike, that should have some increase in terms of discount for the collection rate, right, and potential impacting the losses. I believe like – to have an increase of what you said between 15%, 20% should be a fair amount, okay?

In terms of the average tariff and the impact on losses, (23:12), I will mention that we should expect something. In our case, specifically, given the level they have already reached in CEMAR, we don't expect that should have an impact because we believe the loss level we have achieved is kind of a structural one, right? Over time, we have changed kind of the behavior of this kind of loss, right, so that people – I mean reduced a lot the motivation to try to steal the energy from us. So that I don't expect any spike from that, maybe a small increase, could be, but not like a spike.

In terms of delinquency, I would say, we should be more careful, especially in terms of working cap in the short term. Until we adjust all the collection efforts, right, to bring collection rates to the same level prior to this tariff increase, right, because in our view, unless you do have a severe impact in terms of the economy as a whole, in that case, it should be local – the impact in the local economy, right, I believe like this tariff increase more like in terms of working capital issues then our long-term impact in terms of collection rates as a whole.

As for CELPA, given that we are still at a very high level of losses, to believe that we are going to have even higher losses due to that is hard to say. It's more likely that the reduction like in the short term should be at the lower pace, you know what we would expect. But then, if we see the scenario, what we're going to need to do is to increase the action that we planned, right, to try to compensate, at least in the short term.

In terms of delinquency, much like CEMAR, we believe like it's going to impact somehow in terms of working capital. Long term, like I said, it's more a matter of how the local economy going to evolve. And I don't have a reason to believe that in Pará, at least in the short term, we're going to see any kind of big swing from the – I mean the strong market that we have seen to the short-term future given all the investments that we fall in and we forecast in the state, right? So – but in terms of working capital, it is an issue.

In terms of rationalization, what could be the impact in our company (26:20) in the sector, I'd rather talk about the sector as a whole. I believe like what we have been seeing recently from the government, from the regulator, like I said, we have a clear message that they want. First, to increase the remuneration of the companies so that they have enough cash flow to continue to invest improving quality and also expand the grid to attract new investors.

And also, they are very concerned about the financial situation of the company. That's why you saw this creation of this new accounts, this, let's call, Tariff Flag Compensation Account that's pretty much similar to the ACR account of our bank loans, right, in order to mitigate, if not completely, but almost complete, let's say, solution for this gap between tariff that could occur given this volatility and the energy purchase cost for our individual companies.

So you have this scenario of – from the government and regulator trying to improve returns, trying to improve the financial situation. And then when you're going to have a kind of a rationalization that negatively impact the sector and nothing happens, it's very hard to believe. I believe like if it's an impact that could create some kind of imbalance ease (27:58) in the financial situation on the, let's say, economic situation of the company, we're going to see also some movements from the regulator/government, right.

So to compensate, because these are rationalization, in case we need, the concession quite pretty much clear. Companies can request a maximum amount of (28:27) tariff review, right? So whenever there is an imbalance of financial or economic situation, so my view is like, with all these things that we see, it's very hard to believe like if there is any impact because if this situation occurs, the government is not going to be there to provide enough compensation.

Q - Marcos M. Severine {BIO 3322666 <GO>}

Okay. Understood. Quite clear, Haiama. Thank you very much.

Operator

Our next question comes from Mr. Pedro Manfredini with Credit Suisse.

Q - Pedro Manfredini {BIO 21633245 <GO>}

Hi Haiama. Good afternoon. My question regards M&A. Now, with this whole situation in the country, do you see the situation is the potential trigger for new M&As or maybe it will postpone any kind of M&As in the distribution market or in generation market? Just if you could give us an input on the specific topic, because we know that Equatorial has been very active in this market at least in the past. If you could give us your input, it'll be very helpful for us.

A - Eduardo Haiama {BIO 7279971 <GO>}

Thank you, Pedro. Regarding M&A, it's a tough situation, right? As we see that markets – it's not as liquid for the sector – even not only the sector, but the economy as a whole. So for you to do an acquisition these days, it's tough how you need to really to have a very good economy to be sure that you have enough funds to do that acquisition even through active shares, right, or shares block (31:08), whatever.

So I believe like in a sense it should like prevent some of the wounds that would occur in a normal market. Having said that, given the tough situation that we have today in the country as a whole regarding, for example, to raise debt or even raise equity and also some situation that could negatively impact more some generators or distributors than others, that could create, right, the situation that we might see some M&A activities that in a normal scenario we do not see, right, because of necessity of (32:03) survival.

So far we haven't seen that, but given that we are in the second year of very difficult times, right, in terms of financial markets and the economy, we believe like the likelihood that you'll see some activity picking up increase, right, we are ready. We have been stashing cash to be sure that we have enough liquidity. So in our case, to minimize any potential acquisition that we'll need in case of cash acquisition. We believe like with what we have been seeing from this regulation for the fourth cycle and this Tariff Flag that should provide liquidity again to distribution segment should ease some of this pressure in terms of gaps between tariffs and energy purchase, and also provide some additional (33:10) to have an even stronger situation.

Like we said, we want to be active, we want to look at all the opportunities. But again, we believe like the only – you're only going to see us moving ahead, if we believe like we see good also risk return. That's what I can say about this subject.

Q - Pedro Manfredini {BIO 21633245 <GO>}

Thank you, Haiama.

Operator

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

A - Eduardo Haiama {BIO 7279971 <GO>}

To sum up, we'd like to reinforce our commitment delivering a differentiated message (34:34) to our shareholders for exceptional financial operating results. We'd also like to highlight over the years, the highest level of transparency and corporate governance and reassure that both me and our Investor Relations team are available to have you should you have any further questions.

Thank you, all, again, for taking part of our fourth quarter conference call and have a good day.

Operator

That concludes the Equatorial Energia's audio conference call for today. Thank you very much for your participation and have a good day.