Y 2016 Earnings Call

Company Participants

- Paula Kovarsky, Investor Relations Officer

Other Participants

- Gustavo Gregorio, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Cosan S/A Fourth Quarter and Fiscal Year of 2016 Results Conference Call. Today, with us we have Mr. Mario Silva, CEO; Ms. Paula Kovarsky, IRO; Mr. Joao Arthur Souza, CFO; and Mr. Phillipe Casale, Investor Relations Manager of Cosan S/A. We would like to inform you that this event is recorded, and all participants will be in a 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 slideshow of this presentation are available through live webcast at ir.cosan.com.br. These 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 Ms. Paula. Ms. Paula, you may begin your call now.

Paula Kovarsky {BIO 15363001 <GO>}

Good morning, everyone. Welcome to Cosan S/A's fourth quarter and 2016 results conference call. As usual, we will present each business line of Cosan S/A first and then the consolidated results. But before we move ahead, let's start quickly on slide three, where we see our business portfolio to talk you through the impacts of the conclusion of a sale of a stake in Radar announced back in November 4th, just a bit before our last conference call.

In the third quarter, Radar's net profit was reported as discontinued operation. And from this quarter onwards, the net profit related to our remaining 3% stake in Radar will be reported as equity pickup. And also, we recognized the net profit from the sale of Radar and the cash income this quarter. I'll get back to this later.

Still in this slide, we had the launching of the new brand and visual identity of our lubricants business previously known as Cosan Lubricants and now called Moove. And the idea was to strengthen the brand positioning in the lubricants market in Brazil and abroad. We're now ready to move to the businesses, and we'll start with the results of Raizen Combustiveis on slide four.

The last quarter of 2016 confirms reaffirms the conviction that our strategy to promote sustainable growth of our fuel distribution business in Brazil, which was defined back in 2013, was correct. The plan was to broaden the distribution network through the conversion of independent stations, mainly white-flagged or unbranded. Nurture the relationship or build a long-term partnership with our retailers and invest to have the best and more efficient supply structure. And here we are, this is the 15th quarter in a row where Raizen's sales volumes growth outperformed the market.

Let's talk about the numbers. Otto-cycle sales volume was flat compared to fourth quarter of 2015, while the market trend 3%. This is all ANP-based data. The same comparison in gasoline equivalent, i.e., adjusting ethanol for its energy efficiency, 0.4% growth in Raizen. In 2016, Otto-cycle and gasoline equivalent sales also outperformed the market with 1% and 3% growth versus a drop of 2% and 1% in the market, respectively. And this is, of course, on the back of the maturation of the recently converted station and the net addition of 344 stations to our network throughout 2016.

Diesel sales from Raizen were weaker with a 6% drop this quarter and 1% in 2016 compared to the previous year. The performance of Raizen was quite similar to the market, which shrank 9% according to SINDICOM, that counts only the major distribution players and 5% according to ANP in 2016. The Diesel sales remain affected by the economics from the slowdown and, in our case, by the shortfall in different seasonality in some crops since Raizen has bigger exposure to this segment.

Aviation remains affected by weaker demand for flights. Just to give you an idea, the number of departures fell about 11% in Brazil according to ANAC. And Raizen sales volumes fell 7%, both in the fourth quarter of '16 and in 2016 compared to the same period in 2015.

About the results, adjusted EBITDA reached BRL894 million in the fourth quarter, growing 10% year-on-year. Full-year adjusted EBITDA increased 13% over 15%, reaching BRL2.8 billion. In both cases, we had better sales mix with more gasoline, along with gains from the supply and commercialization strategy. And I'd like to remind you that this strategy goes well beyond imports. It includes inventories management, logistics optimization etc.

And just reconciling quickly with what I said in the previous earnings call about the expectations of a similar fourth quarter 2016 compared to '14 on an adjusted basis, the main drivers behind the improvement were, one, Petrobras price adjustments and, two, the rising of ethanol prices throughout the quarter. Raizen remains focused on better managing capital employed in this business, and this includes working capital. And because of that, we believe EBITDA to be -- EBIT to be a more accurate way to evaluate the business performance. And once again, the EBIT expansion outperformed the EBITDA expansion in 2016.

About investments in Raizen Combustiveis, we continue capturing good opportunities in terms of network expansion through the conversion of new stations and, equally important, renewal of existing contracts. In the fourth quarter of 2016, investments totaled BRL200 million, closing the year with 797 million, 1% below 2015's CapEx. By the end of the year, Raizen distribution network accounted for 6,027 stations, with 344 net additions versus 326 net additions in 2015.

Let's now talk about Raizen Energia, and we go to slide 5. I'd like to remind you that this is the third quarter of the '16-'17 crop year, so we will not address the calendar yearly results of Raizen Energia. And note that the fourth quarter of the calendar year or the third quarter of the crop year is the quarter where we finish the crushing season. Crushing reached 11.3 million tons this quarter, dropping 31% compared to last year. This delta, in fact, relates to the atypical extension of the crushing period in December of 2015 due to large sugarcane availability, which did not happen this year.

With the end of the crushing period, RaIzen Energia reached 59.4 million tons of sugarcane, only 1% lower than last year's crop comparing to same period. Let me quickly remind you that of the different dynamics of the current crop season, the '16-'17, versus the last one, the '15-'16. Better climate conditions during the '15-'16 crop led to larger availability of sugarcane that couldn't be harvested during the regular schedule, if you like, due the rain. And even with the extension of the crushing all the way through to the very end of December, there was sugarcane left in the fields that ended up being processed in March 2016, which is the last month of the crop year.

Therefore, by April '16, which is the beginning of the current crop season, most of the mills were already crushing at full speed. This season's weather instead was drier, which benefited the sugarcane harvesting but reduces the sugarcane fields density by affecting growth. The TCH started the season at 90 tons of sugarcane per hectare but ended it with (technical difficulty) tons of sugarcane per hectare, 11% lower compared to the last crop season. The average TRS, however, was slightly higher this season, 1% only at 129.4 kilos per ton. Combining both indicators, which is the way we look at agricultural productivity, the TRS per hectare was 10% lower this quarter, reaching 10.3 TRS per hectare versus the 11.4 in the previous year. The production mix remains focused on maximizing sugar production. We reached 57% this year, in line with the commercial strategy for 2016.

Speaking about each product, sugar sales volume dropped 17% this quarter, reflecting the commercialization strategy throughout the year. Year-to-date sugar sales were flat compared to the same period of last crop year. Average sales prices remain high, growing 5% this quarter compared to the same period last year. Ethanol sales were 6%

lower, offset by 7% higher average sales price. The price hike seen in October reflects the expectation of a tightened crop year as well as the strength of sugar prices, which led producers to try and maximize sugar production as much as possible at the expense of ethanol, squeezing the supply and demand equation.

In cogeneration, we had lower availability of biomass due to the lesser crushing in the season, causing a 20% reduction in energy sales in the quarter. And regarding the nine month of 2016, volumes were flat. Our unit cash cost in sugar equivalent, i.e., excluding the impact of higher CONSECANA on the cost of third-party sugarcane and land leasing, dropped 2% compared to the fourth quarter of '15, absorbing inflation in the period and reflecting efficiency gains in own production.

We had a 27% drop in adjusted EBITDA compared to the third quarter of the last crop season, mainly due to lower sugar, ethanol, and energy sales volumes and the number which is BRL826 million. Better sugar prices just explain again a relevant accounting effect. As we stated in previous quarters, part of the gains related to the exchange rate when setting sugar prices this year will fall below the EBITDA line. The average exchange rate of currency hedges this quarter was BRL4.09 for the dollar, while the average exchange rate of shipments was 330.

The negative effect on revenues was of about 177 million in the quarter. If we add that back for comparison purposes, the EBITDA would have dropped 11%. The EBIT per TRS decreased as well compared to last year, reflecting the negative impact of FX in the EBIT, compensated below the line again, and higher CONSECANA cost, our hedging strategy.

At the end of the quarter, we had $3 million tons of the '16-'17 crop hedged at an average price of the BRL0.58 per pound. This volume is equivalent to almost all the sugar to be exported throughout the season and for the next crop, the '17-'18, we have 1.8 million tons of sugar hedged at an average price of BRL0.70 per pound, and this is roughly 50 -- a little bit above 50% of our exportable volume.

As you may see, we accelerated our hedging this quarter, benefiting from a favorable combination of commodity prices and exchange rate, just remembering that we hedge in BRL terms in principle. We invested BRL457 million, which is 32% more compared to last year. Due to the earlier beginning of the intercrop season, implying higher expenditure with planting and tilling on top of investments in health, safety, and environment. In the first nine months of the crop year, CapEx ended up to BRL1.2 billion, 22% above the same period last year but within our guidance.

Turning now to Comgas on slide 6. Just as a reminder, Comgas reported on February 15th, so I'll go through the highlights only. Sales volume grew 3% in the last quarter of 2016 compared to fourth quarter of '15. Residential and commercial segments were again the highlights, growing 22% and 9%, respectively. It is still too early to talk about sustained recovery in the industrial segment, but we observed a slowdown in the decrease of natural gas consumption at least throughout the year. In the fourth quarter, we observed a 1.2% growth, but this is explained by higher consumption of specific clients and a pretty weak comparison base.

Comgas' total volume sold was 4% smaller in 2016 when compared to '15. Residential segment capital expenditure trend of 14% is the result of new connections and slightly lower temperatures. And the commercial segment grew 6% following the connection of close to 1,000 customers over the last 12 months. Comgas' normalized EBITDA grew 14% compared to fourth quarter of '15, reflecting a richer sales mix with more residential and commercial segments and a tariff adjustment of last May.

As a reminder, although both gas cost and service to the customers were reduced, the regulator granted the annual pass-through of inflation to margin as provided for by the concession contract. At the close of the year, normalized EBITDA grew 6.3%, reached BRL1.5 billion. IFRS EBITDA, however, dropped 25% this quarter due to the sharp reduction in the cost of gas and the consequent 37 million reduction in the regulatory current account. The remaining balance of BLR414 million will likely be returned to customers in 2017, negatively affecting the IFRS EBITDA. The IFRS EBITDA in 2016, which is BRL2 billion, rising 28% compared to 2015.

Comgas invested 158 million this quarter, mainly in the expansion of the gas distribution network and addition of new customers. CapEx in 2016 totaled 464 million,11% less than the amount invested in 2015 but in accordance with the review of the Company's strategy in fuel seg.

Let's go now to slide number 7. Starting with Moove, as I said, previously known as Cosan Lubricants, which includes our operations in Brazil, Paraguay, Uruguay, Bolivia, England, and Spain. Regarding Brazil, Moove outperformed the market volumes, growing 7% this quarter against 3% market average, and this is based on SINDICOM data. International operations, sales volumes grew 2%. In 2016, Moove sales grew 4% nationally and 13% in international operations.

Better performance in Brazil entailed important market share gains, allowing the Mobil brand to become the second largest player locally in terms of volume, with nearly 17% share and a premium portfolio of Cosan Lubricants. Strong performance growing over 2 times in the fourth quarter '16 results contributed to be 8% EBITDA growth in 2016 as a whole.

However, the corporate, general, and administrative expenses grew 7% in the quarter and in the year when compared to last year's respective period. This line encompasses personnel as well as legal and consulting charge.

Moving to slide 8, where we present the consolidated results of Cosan S/A on a pro form basis, i.e., considering 50% of Raizen's results. Adjusted EBITDA grew 8% in 2016 compared to '15 to BRL4.5 billion, even with the 7% increase in the fourth quarter and -- fourth quarter of 2016 figure, reflecting better operational performance of all other businesses already adjusted for non-recurring effect. 2016 IFRS EBITDA, with no adjustment, grew 27% reaching BRL5.5 billion.

Cosan's net profit was slightly over RBL1 billion, nearly double 2015's net profit. When adjusted for non-recurring effects, 2016 net profit would have been BRL123 million, almost three times the adjusted net profit of 2015. The non-recurring effects that negatively affected net profit this quarter amounted to 146 million, those being, assignment of credit amounts arising from the severance claims, aiming cash anticipation, and the divestment of Radar, which generated a negative accounting effect due to gap between book value and the effective sales price.

The pro forma CapEx was 9% higher this quarter compared to the same period in 2015. But 2016 total number was BRL1.9 billion flat yearly, following our goal of streamlining investments and focusing on returns. The pro forma free cash flow to equity reaches BRL1.4 billion in the fourth quarter of 2016, 10% lower versus the fourth quarter of 2015. I'll dig into that number in the next slide.

This time around, I'll start by talking about net debt on slide nine, and I'll explain why. We are on track with our promise of reducing leverage. This was the sixth quarter in a row of leverage reduction. Net debt-EBITDA decreased from 2.5 times by the end of 2015 to 1.8 times at the close of the fourth quarter of 2016, based on reported numbers explained by the LTM -- by the last 12 months EBITDA increase and higher cash generation. Normalizing Comgas' EBITDA, leverage dropped by 0.4 times, closing the year at 2.1 times EBITDA, which you can see in the gray line in graphic in the top right corner of the slide.

As for leverage in 2017, we believe 2 times EBITDA to be a comfortable level for the Company on a recurring basis, assuming Comgas normalizes EBITDA and, therefore, comparable to the 2.1 that I've just mentioned in the end of 2016. As I said in past conference calls, our focus is no longer reducing leverage per se but gross debt location and composition. Pro forma consolidated gross debt remains flat, reaching BRL14.4 billion, but there were changes in the composition and the term of such debt.

In mid-2016, we issued a total of $650 million in bonds, targeting the lengthening of Cosan's corporate debt profile. And in the fourth quarter, we paid down almost BRL400 million worth of debt at the holding level, while Comgas issued an infrastructure debenture, raising BRL665 million to fund its investment plan. We note that on January 2017, Raizen capped international capital markets for the first time, issuing $500 million bond with a 5.3% yield, and this will show up in first quarter result. The average cost of debt on a pro form basis, i.e., including Raizen was of 98% of the CDI. And if we exclude Raizen, this number goes to 101%. We're not ready to talk about the free cash flow to the equity as the main drivers behind the increase over the same period of last year were 26% higher operational cash flow on higher EBITDA and working capital management at Raizen and Moove, offsetting the reduction seen in Comgas. And yearly, the operating cash flow grew by 1 billion, reaching BRL5.4 billion.

The cash flow from investments was positive this quarter due to the sale of this -- stake in Radar. Considering only the business expenditure numbers, we had an 11% increase impacted by investments in Comgas and Raizen already explained before. The same analysis points to a 1.3% reduction in total investments versus 2015.

On the financial cash flow, the main difference when comparing quarters has to do with lower debt raising namely at Raizen. Note that in the fourth quarter of 2015, Cosan booked BRL300 million cash income, mainly related to the gain from hedging of the perpetual bond. We raised similar amounts in 2016 and '15 but with a higher debt service basically. Besides that, gains through derivatives were substantially higher in 2015. Altogether, we had a 7% increase in free cash flow to equity, a little over 3 billion in 2016.

Let's move to slide 10. On slide 10, we wrap up our 2016 earnings presentation. This is the seventh straight year where we have accomplished our goals and delivered on the consolidated EBITDA guidance, once again providing -- proving that our portfolio has not only good resilience but has the ability to grow despite the adverse scenario. 2016 was a tough year for our country's economy and politics. The challenges were big, but we kept the focus in managing our businesses with rationality and efficiency, and this is where the results come from. EBITDA growth in every business unit within the CapEx goal. Just remember that Raizen Energia follow the crop year. Closing will, therefore, be by the end of the first quarter of 2017, which is the end of the '16-'17 crop season.

We can move now to the last slide of this conference call where we will present the guidance for 2017. This is slide 11. I'll talk you through the guidance for each business and then the consolidated number. And again, note that Raizen's budgeting process also followed the crop year. So both Energia and Combustiveis estimates are preliminary numbers,. Let's get started with Combustiveis. For 2017, depending of course on the performance of the economy and industrial activity throughout the year, we may see some small recovery of the fuel consumption. Let's be clear here. We're talking about low single digits. A stronger crop may also help diesel consumption. But make no mistake, nothing close to what happened in Brazil by the end of the last decade with the combination of credit expansion, wealth improvement, and fiscal stimulus for car sales boosted fuel consumption. Unemployment remains high to start with and one of those drivers is likely to be available in the short term to drive growth.

We estimate an adjusted EBITDA, i.e., excluding non-recurring effects, between BRL2.7 billion and BRL3 billion. There is no change in strategy here. Keep on pursuing sustainable growth of our network by connecting new stations and improving customers' experience through the convenience stores and payment methods; increase efficiency in the supply and commercialization, and this is it. We continue to see good opportunities for conversion of stations in the market within our target station profile. And the range of CapEx, including the possibility of some acceleration on the process, the range is still 300 to 400 net stations a year.

And we also will continue to renew the existing contracts and strengthen the relationship with our retailers. As Comgas has already stated by the company on its earnings release last Wednesday, we choose to simplify guidance focusing on volume, normalize EBITDA and CapEx. We expect volumes ex thermal plants to range between 4 billion and 4.3 billion cubic meters, with the addition of residential and commercial clients, while not assuming any significant recovery of the economic activity.

The IFRS EBITDA will be affected by the regulatory current account that closed the year with 414 million in favor of customers. The EBITDA range goes from BRL1.55 to BRL1.65 billion. CapEx for 2017 should be between RBL400 million and RBL500 million to extend this -- and saturate our distribution network, while maintaining the cost discipline. The outlook for lubricants in the domestic market is not really encouraging. We believe to be well positioned in terms of clients and product portfolio, therefore, ready as and when the market picks up. On the other hand, we expect our international operations to keep growing. EBITDA should, therefore, range between BRL140 million and BRL160 million.

Regarding Raizen Energia, we confirm the guidance for the '16-'17 crop, which is finished as discussed. And we would in principle be looking at the midpoint EBITDA. The remaining uncertainty has to do with the recent dollar devaluation here in Brazil. And again, we are almost fully hedged, but EBITDA makes you change this due to FX compensation in the financial line. CapEx for this crop year will likely end up around the mid to top of the guidance range. And we do not expect to anticipate the crushing period in the next crop.

Let's talk about the '17-'18 crop year, which begins on April 17. The crushing preliminary guidance ranges between 69 million tons and 63 million tons of cane. But it's early to have an accurate estimate for the crushing since we're still in the middle of winter crop season. The weather has been favorable so far, with good rate volumes in the main producing regions. And assuming this condition is maintained, we expect the crush between mid and top of the range.

We usually target maximum sugar production, and it shouldn't be different this time. Keep in mind that we adjusted the CapEx range of the '16-'17 season to maximize sugar production. Our initial agricultural productivity estimates regarding the TCH and TRS should be in line with the current crop season closing numbers.

About prices, we remain optimistic with the sugar and ethanol prices outlook for the '17-'18 crop season. Production in major producing countries ended up being smaller than expected, correcting sugar pricing -- sugar price weakness observed late last year. The market seems to be a little bit more optimistic about the Brazilian crop. But in our opinion, there are no fundamental changes in the scenario when compared to what we presented here in previous quarters.

The ethanol supply and demand equation remains tight, with prices above the historical parity to gasoline, 77% in Sao Paulo. And Petrobras' new pricing policy suggests correlation to international prices, bringing additional volatility through the crop seasonality. As shown in Raizen Energia's earnings presentation, we have already hedged more than 50% of our sugar exports at an average price of BRL0.70 per pound, some 20% above the '16-'17 average price. For ethanol, we are working with an average price, similar to the current crop.

The preliminary EBITDA range is between BRL3.9 billion and BRL4.3 billion, considering an exchange rate of around BRL3.5 to the dollar. The CapEx range is a little wider compared to the '16-'17 crop season, and I'll talk about the reasons. There are projects targeting sugar maximization and productivity enhancements, as well as investments in logistics and infrastructure; possible movement to increase sugarcane availability; investments in biogas-based energy production, and the energy is already contracted at very attractive prices; investments in agencies; and, of course, inflation.

Note that the recurring CapEx, i.e., biological assets or planting and treating and intercrop maintenance is estimated at around 1.7 billion to 1.8 billion, implying 15% renewal of the cane fields. Putting it all together, Cosan pro forma consolidated EBITDA, i.e., considering 50% of Raizen's results, is expected to range between BRL4.75 billion and BRL5.25 billion in 2017, which will likely be another challenging year. But we remain confident about the strength of our business portfolio.

This brings us to the end of the earnings release presentation. I'd like to take this opportunity to remind you all that our 2017 Cosan Day will take place in Sao Paulo on March 21st and in New York on March 24th. More details will be disclosed soon, but please do set the date.

Thank you, all, and let's move to the Q&A session.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session for investors and analysts. (Operator Instructions) Our first question comes from Gustavo Gregorio with Bradesco BBI.

Q - Gustavo Gregorio

Hi, good morning. Thanks for the call. I have a quick question regarding the debt. Previously, you mentioned in the call that the target for 2017 will be 2 times net leverage. Considering the midpoint of your guidance, that would imply a net debt of around BRL10 billion. My question is, how should we reconcile this with the expected cash generation for Cosan? Should we assume that there will be a large dividend gain in 2017?

A - Paula Kovarsky {BIO 15363001 <GO>}

Gustavo, as you know, we do not provide guidance on dividends. And -- but the suggestion would be for you to work on your numbers, assume net debt-to-EBITDA, assuming the recurring number at around 2 times and calculate the rest by this. That's the best that I can say. Unfortunately, we don't guide on dividend.

And another comment that I would make is, if you look at the dividend payments looking at the competent year 2015, we paid BRL 630 million. The 2016 competence number will probably be a little bit more than that. And assuming our results continue to increase and our cash generation continues to increase as guidance, then we could possibly pay a little bit more dividend. But again, leverage comes first.

Q - Gustavo Gregorio

All right. Understood. And you also mentioned that the Company is going to focus on gross debt allocation, possibly shifting away from the holding company level. And I guess, we're going to bump into the theme, a similar question, should we assume that the subsidiaries are going to send more money up to Cosan to facilitate this shifting of leverage?

A - Paula Kovarsky {BIO 15363001 <GO>}

Unfortunately, the answer is the same. I mean, it's more efficient for the Company to have more data at the operating level. But this will happen following economically rationale.

Q - Gustavo Gregorio

Okay. Understood. Thank you very much.

Operator

(Operator Instructions) This concludes today's question-and-answer session, I would like to invite Mrs. Paula to proceed with her closing statements. Please, go ahead, ma'am.

A - Paula Kovarsky {BIO 15363001 <GO>}

Well, thank you all for joining the call. See you on first quarter in '17 call for results. Bye-bye.

Operator

That does conclude Cosan's audio conference for today. Thank you very much for your participation. And have a good day.