

Q2 2019 Earnings Call

Company Participants

- Phillipe Casale, Investor Relations Executive Manager

Other Participants

- Lucas Ferreira, Analyst
- Luiz Carvalho, Analyst
- Pedro Medeiros, Analyst
- Regis Cardoso, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Cosan S.A. Second Quarter of 2019 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 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 slide show of this presentation are available through 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 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 will turn the conference over to Mr. Phillipe Casale. Mr. Casale, you may begin the call.

Phillipe Casale {BIO 20025617 <GO>}

Good morning, everyone. Welcome to Cosan S.A.'s Second Quarter 2019 Earnings Conference Call. 2019 started with more promising signs of economic activity. Delay in approving pension reform, however, ended up frustrating a bit those expectations and

causing economic activity to slow down throughout the quarter, but the diversification of our portfolio assured consolidated EBITDA growth for Cosan.

Before we go to results on Slide 4, I would like to take the opportunity to explain the structure and the rationale of the deal around convenience stores announced by Raizen last week. Raizen sold 50% stake of its convenience store business to Femsas, forming a 50-50 JV. Their convenience store business was valued at BRL1.1 billion of enterprise value, implying a multiple to EBITDA around 13 times. Femsas will pay BRL560 million for its 50% stake. Once this transaction is complete, each partner will inject BRL160 million in the JV to support expenses and investments for the first three-year cycle, in which we expect to add some 500 new stores.

This JV will operate with two solid brands, Shell Select for traditional service station franchise model, and OXXO, which will focus on the proximity stores market. Raizen's partner brings proven expertise and leadership in the retail segment, which will enhance our growth capacity in this segment, helping to upgrade our value proposition to franchisees who are core to Raizen's strategy, and bringing greater efficiency to investments and operations. Closing of the deal is dependent upon the approval of the antitrust commission, CADE, and other standard conditions.

Let's move to Slide 5 to discuss Raizen Conveniências results. Raizen delivered higher sales volume and EBITDA in the quarter, rising 8% and 5% respectively, reflecting consistency of its strategy and solid operations. Before discussing the second Q '19, let's take a look at historical second quarter margins trends related to the dynamics of ethanol prices and mix as seen in the chart. Talking specifically about the same period last year, the second Q '18, the results reflect two different moments. Before the truckers' strike, prices were all on the rise, positively impacting inventories. This strike, however, reversed the trend abruptly causing relevant inventory losses due to diesel price cuts on top of reduction in sales.

Now, in the second Q '19, a set of events adversely affected margins of the main products. Starting with ethanol, a significant drop in prices as well as the greater share of total cycle mix resulted in seasonally stronger inventory losses. Gasoline and diesel faced the typical adjustments in the quarter, reflecting change in priority of Petrobras' price adjustments, resulting in lower gains related to the supply strategy, which, as you know, encompasses the inventory management and imports.

In the Aviation segment, Avianca's chapter 11 process and the negative price move depressed the results of this segment. Remember that demand has not been growing as market expected for a while, following lower economic activity in Brazil. Despite this, Raizen delivered solid growth, maintaining its focus on expanding and strengthening the relationship with the service stations network while keeping the consistency on its supply and the commercialization strategy.

Now let's move to Slide 6 to discuss Raizen's results in Argentina, and I would like to first highlight that as we have been reporting, the results of the Argentina business is in U.S. dollars, which is the functional currency of the downstream operation.

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The quarter preceding the primary elections in Argentina was marked by lower pace of volatility and a relatively stable economy. Even so, demand for fuels remained depressed. Speaking of volume, diesel and gasoline sales in the quarter were approximately 5% lower than in second Q '18. The aviation fuel volume grew nearly 20% year-over-year, in line with the increased customer base and the higher market share. The total volume processed by Raizen's refinery came in line with 1Q '19 with normalized utilization rate. The quarter's EBITDA stood at \$47 million due to lower sales volume and investments totaled \$11 million, most of which are maintenance of the refining operation, in line with the expectations for 2019.

Now moving to the next slide, we represent Raizen Energia's result. The 2019-20 crop year has started after a short delay due to rainfalls in early April, reducing crushing volume by 7% in the Mid-South region of Brazil, including Raizen. The average sugarcane yield was 9.3 kilos of TRS per hectare, reduction explained by the lower concentration of sugar content on the cane. The production mix continues to prioritize ethanol, which came in at 51%, in line with the commercialization strategy for 2019, which focused on the sale of higher return products.

Speaking of sales, let's start with sugar. Raizen reduced volumes sold, building inventories for sugar commercialization during periods when the yield is maximized and in line with the hedge position. The average sale price in reais was 16% higher in the quarter, as we announced in previous conference calls, given pricing for this crop year. On ethanol, Raizen accelerated the own sales by 8% in the quarter to take advantage of stronger demand with a 9% rise in the average price compared to the same quarter last year. We maintain an economic hedge for part of the ethanol sales usually at better prices than those seen in local market. Along with the strategy for sugar, the ethanol hedging aims at protecting profitability and cash flow, mitigating risks imposed by price volatility.

Cogeneration results were impacted by WX operations, our electricity trading company, we are therefore highlighting our own volume sales since the trading and activity made by WX generates higher revenue, though with a substantially lower margin than the sale of electricity generated by Raizen. With that said, our own volume sold was 11% lower in the quarter due to a reduction in crushing volumes and the average price of own electricity sold was in line with the same period last year. Worth noting that electricity spot prices were significantly higher during the second Q '18 last year due to the drop, which did not happen this year.

As for cost dynamics, the unit cash cost of our own products sold in sugar equivalent was BRL719 per ton, 17% higher than in second Q '18. Main impact was the lower dilution of fixed costs due to this delay in the beginning of the crushing season and inflation in the period. Adjusted EBITDA stood at BRL402 million in the quarter, down 18% from second Q '18, mainly reflecting a reduction in the own volumes of sugar and bioenergy sold as well as lower cost dilution, as I just mentioned.

As for sugar hedge, Raizen hedged virtually all of its volume of sugar to be exported this crop, reaching approximately 90% of total in an average price of BRL0.56 per pound, a price that is 13% higher than the average price of last crop year. For the upcoming crop

year, 2020-21, we also advanced hedging and reached approximately 35% of the total volume with an average price of BRL0.61 per pound.

The price scenario for sugar has not changed much since our last conference call. The sugar prices are still pressured, especially in light of another expected strong crop year in India, while the mix in Brazil points to a higher share of ethanol. Raizen always aims to seize new opportunities to improve the profitability of sugar and ethanol prices by optimizing sales and production mix.

To conclude the presentation of Raizen Energia's results, investments in the quarter rose 30% to BRL630 million due to increases of winter planting and sugarcane field renewal, as indicated in the year's guidance. As announced in our previous conference calls, we are stepping up the renewal of sugarcane fields in order to increase the agricultural yield over the course of their upcoming years. In addition, we incurred higher expenses mainly related to asset integrity and intercrop maintenance due to the delay in the harvesting period.

Moving now to Slide 8, where we will present Comgas results. The second quarter of 2019 was marked by the completion of the fourth tariff review cycle, which was delayed for quite a while, as you all know. Business plan and general conditions were defined for the 2018 to 2024 cycle, and the outcome of the review came quite in line with the expectations and bring back regulatory stability and improve the business environment for Comgas.

Now let's discuss the quarter's highlight. Natural gas sales increased by 3% in the second Q '19 across all segments. In the Industrial segment, sales growth is due to greater demand from some industrial clients and a weak basis for comparison due to the truckers' strike last year. Residential and commercial segments continued to grow, supported by the addition of new clients. In the residential segment, sales growth was partially offset by lower unit consumption, affected by a higher average temperature in the period. Normalized EBITDA totaled BRL583 million in the quarter, up 19% due to an increase in the volume sold as well, as the annual margin correction in accordance with tariff review. IFRS EBITDA growth was due to a current regulatory account movement, which left Comgas with an active balance of BRL230 million at the close of 2Q '19. And this balance is in favor of Comgas.

The Company also invested BRL200 million in network maintenance and expansion. The year-over-year increase resulted from the investment acceleration, following the completion of the tariff review process and regulatory commitments defined.

Now let's discuss Moove results on Slide 9. Lubricant sales maintained an upward trend in operations across all countries, over the last 12-months, thus the adjusted EBITDA in the quarter was 18% higher than in the 2Q '18. Speaking of Cosan Corporate results on the right hand side of this slide, we present, General and administrative expenses, which increased to BRL49 million due to marketing expenses concentrated in the quarter, but in line with annual [ph] plan. Other operating expenses came in line with comparison basis.

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Moving to Slide 10, let's discuss the consolidated result of Cosan S.A. pro forma considering 50% of Raizen. Cosan recorded an increase in net income as well as in consolidated adjusted EBITDA, confirming the robust performance of our portfolio. The prudent performances of Comgas, Raizen Conveniencias move in the consolidation of Raizen in Argentina, mitigated Raizen Energia seasonally weaker results. Investments in the quarter also increased but are in line with the guidance.

On the next slide, we highlight the main impacts on cash flows, starting with the operating cash flow where Comgas was the main contributor on improving normalized performance and current regulatory account movement in the quarter. In the financial cash flow, Cosan disbursed BRL464 million on the acquisition of common and preferred shares of Comgas, as part of the voluntary tender offers announced in the first semester of the year. Remember that, the preferred shares process is now over -- while the common share process will end on September 4. Today, we have reached a 99.1% stake in Comgas. As a result, cash consumption reached BRL371 million in the period. In addition to the effects mentioned, the second quarter of the year represents the first quarter of the Raizen Energia crop year, when working capital goes up, due to inventory buildup.

Last but not least, Cosan paid BRL392 million worth of dividends to its shareholders in May this year. Pro forma gross debt grows by 7% in the quarter, specifically in Raizen. Cosan's average cost of that equaled 107% of CDI or 115% of CDI, if you exclude the Raizen. Their pro forma leverage ratio after the usual adjustments ends up -- ends the period at 2.2 times net debt to EBITDA.

Now let's move to Slide 12. And before concluding the presentation, I would like to reiterate here, our expectations for the year. There is only one update since our last earnings conference call. Comgas tighten each CapEx forecast range, which is now between BRL800 million and BRL900 million, in line with the business plan, that (inaudible) in the tariff review process. All other projections both for our business and Cosan Consolidated remains unchanged. And we keep the focus on delivering it once again.

This concludes our presentation and we are now take any questions you may have. Thank you.

Questions And Answers

Operator

Thank you. We will now begin the question-and-answer session for investors and analysts. (Operator Instructions) Our first question comes from Luiz Carvalho, UBS. You may proceed.

Q - Luiz Carvalho {BIO 18040760 <GO>}

Hi, Phillipe. Thank you for the color. I have basically three questions here if I may. The first one is regarding Argentina, and then due to the recent events in the country and the -- how is the depreciation of the currency? I just would like to know the Company approach in terms of passing through the prices to the domestic, domestic prices and how this

could impact the \$210 million between -- \$210 million and \$260 million EBITDA guidance for this year?

The second point is about the distribution margins in Brazil in Raizen Combustiveis. We saw somehow the drop is well in the first, the first -- compared to the first quarter. There is a chart in the presentation that shows that, I don't know years ago, we had a rebound. So if you can share with us your perspective for the year to the margins behavior, during the second half of the year, that would be useful. And my third question is more about the potential investments in potential new businesses. And then there is lots of opportunity with the -- I'm going to talk in Portuguese. (Foreign Language) Potential natural gas pipelines and the natural gas distribution, so how Cosan is preparing potentially to actually to join this market and take some advantage of integration? Thank you very much.

A - Phillippe Casale {BIO 20025617 <GO>}

Hi, Luiz. Thanks for your question. So probably the first one in terms of Argentina, of course, as we have been stating in the past few calls, we had with the market, every time we have a strong or a max [ph] depreciation of the Argentinean peso, this moved back the short-term ability of the company to adjust the prices at the -- in closer terms. We know this is a U.S. dollars functional currency business, right, but over time what happen is that, we see that the prices adjust throughout the following month. So when you look -- despite political and economic environment, on the long-run EBITDA has been relatively stable in deferred -- again political and economic environment. So with that said, we are confirming the guidance for the year, which have a wide range that would absorb those volatilities that we are seeing right now. So there is no -- as of now to change the guidance, but of course we are aiming more to the lower end of the Argentina EBITDA guidance as of now.

When we look at the distribution margins in Brazil we've been pretty clear in the -- the market saw a part of the movements own prices, which impacted the results specifically on the second quarter. We remembered that the second quarter of the year usually is the one where we see that the impact on the margin, mainly due to the ethanol pricing performance because of the beginning of the harvest. We had this quarter specifically a change of the previous -- the price movements from Petrobras, which impacted, of course our ability in terms on delivering what we expected at first. And as well we are seeing demand not as one could expect on the beginning of the year. So when we look on the first quarter of the year, we even saw, slightly grow in general and the other cycle [ph] volumes, but after that, along with the adjustments on the growth expectations for Brazil, the volumes of course, reflect part of this change in the expectations, right. So putting all of this together, the second quarter had all the impacts that I had all the impacts that I mentioned in the call, basically in the three products, ethanol, gasoline, diesel and adding that, the aviation business. But when you look at the second semester, in that, that's part of what the presentation shows on that, on that a graph. The second half margins usually shows a rebound, and that's what we are expecting again, looking (inaudible) what is implied in our guidance. But in our leasing condition in Brazil, we are as of now looking more to the lower end of the guidance rather than the top as or the mid, as we were before.

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And looking for new business as you mentioned there is all this discussion in terms of the new gas market, I'm not going to discuss here specific projects. But as a whole, what you should expect in Cosan, is that we participate in the discussion, as you know we have Comgas which is the most relevant distribution, our net of natural gas there in Brazil. This brings us a lot of opportunities to look at other alternatives. Not only of the supply of the gas, but also the commercialization and that's what we are going to study as of now. So as a Group, here we're going to look at all those discussions and participate actively to decide what -- where we're going to put more effort on.

Q - Luiz Carvalho {BIO 18040760 <GO>}

Thank you. If I just check, if I understood correctly, so in Raizen Combustiveis Brazil, you also targeting the lower part of the guidance, correct?

A - Phillipe Casale {BIO 20025617 <GO>}

Yeah, for Raizen Combustiveis Brazil, we are now looking more to the low range of the guidance rather than the need that we, we always do when we set a guidance. And remember, we designed, we develop, we analyze that these guidance, when the GDP expectations for the year was about 2%-3% and this has moved over the first semester of the year.

Q - Luiz Carvalho {BIO 18040760 <GO>}

Okay, perfect. Thank you very much.

Operator

Next question comes from Regis Cardoso of Credit Suisse.

Q - Regis Cardoso {BIO 20098524 <GO>}

Hi, Phillipe, thanks for taking the question. I'll assist a little bit more on the fuel distribution theme. Is our calculation in assuming that the range and GDP, you just mentioned are correct? You do require some margins of around EBITDA margins over BRL115 to BRL120 per cubic meter in the second half of this year, in order to reach the lower end of the guidance, which I mean is this feasible? It seems, particularly given the positive seasonality of the second half and it seems (inaudible) aligned with your original expectations for the full year 2019. But nevertheless, it's a big jump from the current BRL85 per cubic meter you posted in the second quarter in Raizen Combustiveis. So my question is, what do you believe needs to happen for you to be able to reach that guidance? Or that is to materialize this much higher level of margins in the second half. Does it require having import gains? Does it require having inventory gains that refer to any best movements or is it for you, just maintaining the replacement margins that you had at the end of second quarter? Or do you still have to count on further expansions, I mean, so my question more generally is what needs to happen, so that you'd be able to reach these much higher margins between 115% and 120% coming from 85%? Thanks.

A - Phillipe Casale {BIO 20025617 <GO>}

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Thank you. Thanks for the question. Well we discuss a little bit, the impacts of the second quarter of 2019 and actually this pressure, the margins in the quarter specifically, which we cannot guarantee that same effect will be possible in the second half, right. So what we are looking here historically is that the second half shows an improvement on margins, right. And that this is what is implied on the guidance, as we mentioned. We're going to keep the focus on our supply and our commercialization strategy. So looking at opportunities on the imports, managing the inventories, and this is part of the recurring -- of the recurring strategy of Raizen. So it's -- keep managing the business, looking at the long-term relationship with our resellers, are focusing on maximizing, having an adequate return for the business. So we're going to do more of the same, and again the second quarter was impacted by this specific events that we mentioned on the call.

Q - Regis Cardoso {BIO 20098524 <GO>}

That's helpful. Thanks very much. As I mentioned, the second question on Comgas, just if you could update us briefly on how is the discussion regarding the -- depending decisions or depending the discussions for the best tariff review cycle the one that was kept?

A - Phillippe Casale {BIO 20025617 <GO>}

Actually there is no schedule defined, you have for this process. And Comgas in this Company will lead the market more as soon as we have news about that.

Q - Regis Cardoso {BIO 20098524 <GO>}

Thank you.

Operator

Next question comes from Fernanda Cunha, Citibank.

Q - Pedro Medeiros {BIO 16187063 <GO>}

Hi guys, it's actually Pedro Medeiros, okay. Well, I have a couple of questions related to the JV recently announced with FEMSA. Can you, can you walk us through the expectations of value accretion from that JV? And whether, is there any plans to improve your Argentina assets in each of that joint venture. Second question is about capital allocation, okay. So very specific question, if you can talk about potential M&A opportunities in the natural gas market and whether the Company is evaluating any potential opportunity there? I'll leave at that. These are my two questions.

A - Phillippe Casale {BIO 20025617 <GO>}

Pedro, thanks for the question. So first in that unit store business, so that we brought a partner here as they have a well-known expertise on the retailer business and will help us develop not only the convenience store business, but also the proximity one, right. So the JV is to operate in Brazil and we have a plan to reach in the next three years around an additional 500 new stores. Right, so this is the initial plan here. The Company will have the BRL320 million that we stated for expenses (inaudible) first cycle. And it's again a JV form to operating this -- in the view as of now.

In regards to your question about the gas business, we have to remember that Brazil is strong [ph] in natural gas. And Comgas has an operation here, so specifically on the concession area. And there is, that's what, that's Cosan we're going to look at the opportunities, build Brazil again (inaudible) gas. But there is no, the solutions or anything that we can share right now within market.

Q - Pedro Medeiros {BIO 16187063 <GO>}

Okay. Okay. Thank you so much.

Operator

Next question comes from Lucas Ferreira, J.P. Morgan.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Hi, Phillipe. Good morning, everyone. My first question, Phillipe on the sugar and ethanol business. So how do you see your perspectives for the full crop in terms of crushing and productivity, if you can share if that changed in the last couple of weeks or not. And if you can still think about reaching the sort of a midpoint of the guidance of EBITDA for the full-year in CapEx, as well. And my second question regarding the JV, with Femsa, if you guys have already defined who is going to be running the JV, who is going to be the management team and if it's not yet defined when that should happen? And who is going to be electing this? I suppose, of course, the new Board, but is there any kind of sort of appointment by Femsa of bringing someone from their operations if you can give us more details. Thank you.

A - Phillipe Casale {BIO 20025617 <GO>}

Lucas, thanks for the question, I'll start with the second one first. So the JV will have a Board with six members, three appointed by each shareholder, that after the closing of the deal, we'll define the names that we ran the business, so it's not probably it's not defined yet. So this will come as soon as we have the closing of the business, and again Board [ph] of the Company electing the executives. And going forward, your question in the sugar and ethanol, the perspective for the crop, we reiterate that our guidance, that looking at the midpoint of (inaudible), so we're talking about 62 million tons for the quarter year. There is no change in that. We are focusing a lot as we mention on doing the planting and harvesting the most efficient way, proving the technique is -- in the specific technology that we implemented to yield, to harvest better our crop year. And as you remember, the first cycle of investments in Raizen, was focused on logistics.

We are now putting more effort on optimization and improving productivity of our sugarcane field. So the increase in the renewal, it's to decrease the average age of our sugarcane fields, by cost of currency improving the productivity of our fields. So looking at the guidance we'll see -- the midpoint for Raizen Energia, not only for EBITDA, but also for CapEx.

Q - Lucas Ferreira {BIO 16552031 <GO>}

Thank you. Phillipe.

Operator

(Operator Instructions) Thank you. With no further questions, I would like to turn the floor back over to Mr. Phillippe Casale. You may proceed.

A - Phillippe Casale {BIO 20025617 <GO>}

Thank you everyone for joining the call, and I talk to you in the next opportunity.

Operator

Thank you. That concludes the question-and-answer session for investors and analysts and also the call. Have a nice day.

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