Cosan S/A – CSAN 3

Q2 2016 Earnings Conference Call

August 11, 2016 10:00 am ET

Executives

Paula Kovarsky - IR Officer

Mario Augusto da Silva - CEO

Other Participants

Juan G Tavares - Citi

Ravi Jain - HSBC

Victor Saragiotto - Credit Suisse

Operator

Good morning, ladies and gentlemen. At this time, we would like to welcome everyone to Cosan S.A. Second Quarter 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.

The audio and a slideshow of this presentation are available through the 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 the conference.

Paula Kovarsky

Good morning, everyone. Welcome to Cosan S.A.'s conference call about second quarter results. As usual, let's start the presentation by talking about each business line of Cosan S.A. and then we go to the consolidated results.

So let's move straight to Slide 4 with the results of Raizen Combustiveis. Following the trend observed in recent quarters, our sales volume outperformed the industry average, reflecting the consistency of our growth strategy [indiscernible] on the expansion of the distribution network through the conversion of independents, especially white flag stations. I'd like to remind you that last year we had a higher concentration of conversions in the second half of the year, which means more positive impact from the ramp-up of those stations now in the first half of 2016.

Otto cycle sales volumes were flattish compared to second quarter of last year versus a 3% drop in market volumes, as we added 368 new stations to our network over the past 12 months. The same comparison in terms of gasoline equivalent, which we believe to be a more accurate way to understand the market dynamics as we adjust the ethanol for its energy efficiency, points to an increase of 2%. And just for the record, all market data source is the ANP, the regulator in Brazil. Diesel sales grew 2% in the period due to new B2B contracts, in spite of a 4% market contraction.

Adjusted EBITDA reached R$597 million, 17% higher over the same period of last year. Main drivers here were slightly larger sales volume with a better mix, and most importantly, the gains related to the optimization of our supply and commercialization strategies. The EBITDA grew 2% sequentially as the positive impact of this supply and commercialization strategy was already present in the first quarter of this year as well as in the fourth quarter of last year.

Back to the year-on-year comparison, there is another important effect. Remember that our second quarters used to be weaker due to the negative effect of falling ethanol prices on inventories. This is very typical of the beginning of the crop year when prices tend to fall. But this effect was attenuated through better management of inventories. And in fact, the unusual volatility of ethanol prices, which started the quarter falling and reverted the trend one month later, also helped. Moreover, as we mentioned in the previous call, a portion of this effect was anticipated through the first quarter due to the early start of the crop year.

Let me introduce here another metric to our discussion. I'm not sure if you guys look at that one. We have been delivering a higher EBIT growth compared to EBITDA growth. For instance, adjusted EBIT grew 25% over second quarter of last year whereas adjusted EBITDA grew 17%. We believe this to be a better way to capture the effectiveness of our business model which focuses on returns essentially through the operational excellence combined with lower capital employed.

Raizen Combustiveis invested R$226 million this quarter, adding up to R$405 million in the first half of the year. Year to date CapEx increase is 11%. And we note that there was some seasonality impact to the comparison as the conversion and renewal of contracts were more concentrated in the second half of last year. So we are well in budget in terms of CapEx.

Let's move to Slide 5 to talk about Raizen Energia. I'd like to remind you that this is the first quarter of the 2016-2017 crop year. The successful early start of crushing in some mills allowed Raizen to start this quarter close to full crushing capacity and this explains the 16% growth to 22.4 million tons of sugarcane crushed. In the first quarter of the previous crop year, we actually postponed the beginning of the crushing to mid-April.

Higher crushing supported higher production, and consequently the availability of own products for sale, especially for exports, which allowed us to capture better prices in the market. So we had the 78% growth in sugar sales volumes sold at better prices, 22% higher ethanol sales also at better prices. And about the impact of climate in the price dynamics, we had a drier weather in April and then a rainier May and June, which led to a reverse of the typical trend of falling prices of the beginning of the harvest, and so the price started to go up in the middle of the quarter.

Higher availability of biomass offset the low average prices due to lower spot energy prices. The EBITDA adjusted to the biological assets and hedge accounting grew therefore 120% compared to the first quarter of the previous crop, reaching R$723 million.

Another important factor is that unlike last year, we had a significant volume of products originated in the first quarter of the crop due to the inventory carryover strategy. The volatility of ethanol prices in fact limited the opportunity this year. Moreover, the agricultural products EBIT remained high and the unit cash cost of sugar equivalent excluding the effect of the higher cost of suppliers' cane, the CONSECANA, grew only 1% compared to the previous quarter, well below inflation by the way, reflecting efficiency gains in own production.

Our sugar hedging strategy, at the end of the quarter, 2.6 million tons of the 2016-2017 year hedged at an average price of R$0.565 per pound. This volume is equivalent to almost all the sugar to be exported throughout this season. And for the next crop, the 17-18, we have 955 million tons of sugar hedged at an average price of R$0.682 per pound.

Once again, I'd like to call your attention to a different metric here. The EBIT expansion tells you more about what we are doing than the EBITDA. It goes from R$3 million to R$195 million this quarter and better reflects the fact that 50% of our sugarcane comes from third parties, which means lower capital employed. Moreover, one can look at the EBIT per TRS sold, which is it's of course a simplified metrics but it allows you to combine sugar, ethanol and cogeneration results together in a single metric, and it went from R$2 to R$89 per ton of TRS sold this quarter.

Last but not least, let's talk about CapEx which was 6% lower at R$358 million, due to lower spending related to the inter-crop year maintenance and delay in the winter planting season due to rains.

Let's go to Slide 6. Turning now to Comgas, which actually reported results yesterday, so I'll just go quickly through the highlights, this was another quarter of growth in residential volume of 6% on the back of 113,000 new houses connected over the last

12 months and the end of the hydro crisis and the withdrawal of the incentives to reduce consumption in the state of Sao Paulo, partially offset by higher temperature compared to the same period last year and the temperature reduces a little bit the unit consumption.

The commercial segment grew 3% in the period due to the connection of 1,200 customers over the last 12 months. Industrial volumes instead keep on [surfing] [ph] with the macroeconomic slowdown, compressing 7.5% year-on-year. Ceramic, steel and automotive were the segments that were most affected. The good news here is that the drop was actually smaller compared to the 11.5% yearly drop in volumes of the first quarter of this year.

Normalized EBITDA fell 13% compared to second quarter of 2015, impacted by lower volumes, concentration and inflation on the SG&A and a one-off non-cash adjustment of R$60 million. Quickly on the adjustment, this is a difference between the way the regulator calculates the current account balance based on billings and our calculation that is based on competence.

This adjustment was very small in past years as there were no major changes in gas prices, but turned out to be more significant this quarter due to the steep drop in gas purchase prices implied in the tariff adjustment announced on May 31. The adjustment therefore reflects the billing based on previous tariffs versus the actual number. If we were to exclude this impact, normalized EBITDA would have grown 2.6%. But more important here is that this does not affect our guidance for the year.

The IFRS EBITDA grew 35% compared to second quarter of 2015, due to the sharp reduction in the cost of gas and the consequent recovery of R$313 million in the regulatory current account contributing to higher cash generation.

Let me take the opportunity here to talk quickly about the annual adjustment. We did had the reduction in tariffs, and tariffs are the sum of gas cost plus margin, due to the decrease of the cost of gas which is passed through. But we had a 9.8% increase in margins reflecting inflation as provided for by the concession contract. Once again, this is why we report and focus our discussion on the Company's normalized EBITDA.

Let's go now to Slide 7. Let me start with Lubricants, which includes our operations in Brazil, Paraguay, Uruguay, Bolivia, besides England land now Spain. Overall, volumes grew 9% compared to the second quarter of last year in most of the markets that we operate. Specifically about Brazil, the market actually shrank 9% compared to second quarter of 2015, but Cosan Lubricants keep on adding new accounts, namely what we call Factory Fill, which are the automakers, and the volume grew 9%. And although this is not yet relevant in terms of the overall volumes, but the volumes sold in Spain almost doubled since we took over in the beginning of the year.

The EBITDA fell in the second quarter compared to last year despite the increase in sales due to impact of FX on costs and higher selling expenses, especially freight.

Talking about Radar, EBITDA growth is due to higher land leasing rates, especially for sugarcane, which represents 64% of our own portfolio, and the appreciation of the owned land portfolio itself, the fair market value, that generates a non-cash effect on EBITDA.

On Corporate, general and administrative expenses amounted to R$41 million in the quarter, 7% below the second quarter of 2015, due to lower expenses related to consulting services.

Moving to Slide 8, where we present the consolidated results of Cosan S.A. on a pro forma basis, i.e., considering 50% of Raizen results, the adjusted EBITDA grew 22% year on year to R$1 billion in the second quarter of 2016, mainly driven by Raizen's strong results. Net income grew almost 18x reaching R$282 million, reflecting the operational improvement in our main businesses as well as the recovery of the current account of Comgas.

The pro forma CapEx was R$411 million, right in line with our strategy of streamlining investments and focusing on returns. The pro forma free cash flow to the equity was R$42 million, and we will move to Slide 9 in turn to talk about investments and then I'll come back to the changes in free cash flow.

So we are on Slide 9 now. As part of the capital structure management process targeting the lengthening of the debt profile, Cosan S.A. issued US$500 million bond maturing in 2027 and repurchased about 80% of the 2018's and 2023's outstanding bonds. The gross debt was virtually stable. We raised R$2.3 billion, which is the 2027 plus agricultural certificates, the Portuguese acronym for this is CRA, in Raizen Energia, and we amortized R$2.6 billion through the partial repurchase of the 2018s and the 2023s.

The bondholders' adherence to the tender ended up being higher than we expected and we decided to do a [retap] [ph] of an additional US$150 million in July. Including that, the average maturity of our debt almost doubled from 4.8 to 8 years. The average cost of debt on a pro forma basis, including Raizen, was 98% of the CDI, above the previous quarter, due to the capital restructuring which was targeting the lengthening of the debt profile.

So let's move to Slide 10, and we are going to talk about the free cash flow through the equity changes compared to the second quarter of 2015. The main differences were, we had higher operational results, so R$123 million higher operating cash flow, due to the higher EBITDA of Raizen and Comgas, which were more than offset by R$186 million related to the exercise of a put option on Rumo, held by Gavea Investimentos, as mentioned last quarter, which we decided to settle in cash, as well as R$300 million net impact of debt restructuring process since it was only concluded in July with the addition of funding of R$150 million, as I already mentioned, as well as all the hedging effects.

The net debt-to-EBITDA fell again from 2.1x at the end of the first quarter of 2016 to 2x at the end of the second quarter of 2016, due to the higher last 12 months EBITDA.

Let's just recap what we discussed at last quarter. We were actually expecting an increase in the net debt-to-EBITDA due to the working capital cycle of Raizen Energia, and then the ratio would fall again more towards the end of the crop year, the first quarter of 2017 for us. Not only we had stronger results in Raizen and Comgas, but also we had a different cycle of working capital at Raizen Energia as the window for inventory carryover was not really appealing. We still expect end of year net debt-to-EBITDA to hover around 2.5x, and for the long-term we continue to believe that 2x is a comfortable level of leverage adequate to our portfolio of assets.

Let's now shift to the last slide, Slide 11, where we restate our guidance. Three comments here. We expect Raizen Combustiveis EBITDA expansion next quarter to mirror year-to-date EBITDA expansion, and this of course means we are targeting a mid to high end of the guidance for the year.

About Raizen Energia, I'd like to just recap the hedge effect again. The guidance for the 16-17 crop season assumes an exchange rate of about R$4 to the dollar, hedged through financial instruments, and the aim here is to guarantee the cash flow generation.

The EBITDA however reflects the exchange rate at the time of the sugar shipments. So looking at the current exchange rate, we could have some downside to the EBITDA metrics, but no impact on the estimated cash flow generation. We would therefore be looking more to the low end of the guidance, but it would be absolutely premature to change the guidance for now in view of all the uncertainties related to weather, sugar prices, ethanol prices and FX.

One thing is for sure though is that we'll probably have an EBITDA that is going to be flattish throughout the year. In other words, we won't see the dynamics of a second half of the crop year significantly stronger than the first half of the crop year as there will be less own products to be sold by the end of the harvest, and also because this impact of the exchange rate that I just mentioned will probably be more visible in the second half of the season.

Lastly, about Comgas, results so far point to achieving mid to high end of the normalized EBITDA guidance. Same for the IFRS number, but I have to say that this one is harder to predict in view of the impact of FX and oil prices on the current account.

Well, that's what I had to say today. Thank you all and let's move to the Q&A session.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from Juan Tavares, Citigroup.

Juan G Tavares

My first question is just about your agriculture yield in the sugarcane business. Can you give us an update there on how your CapEx plan is within Raizen Energia and what's your outlook for ag yields going into the next crop as well? And maybe if you can give us an update also on just capital allocation overall? I know that in the Comgas section of your press release you mentioned that you had postponed some CapEx there and were reviewing some of your operational strategy on certain expansions. So I'm curious there on how do you foresee some of your capital allocation for the rest of the year, and also in the context of dividends? Thank you.

Paula Kovarsky

Let me talk about the Raizen Energia. What happens is, as you know, we had a dry April and a rainy May and June, so what happens is that we had a positive impact on the TCH with little impact on the TRS. But this doesn't change at all our expectations regarding productivity for this harvest year, the 16-17.

What's probably going to happen is that, and if [indiscernible] is confirmed for the second half of the year, this means we will see a pretty dry second half which means we'll be able to crush a lot, but then we may end the harvest year with lower agricultural productivity. But again, it doesn't really affect what we expect in terms of crushing for the 16-17 harvest year.

What's really important here is to understand what does this drier second half means for the 17-18 harvest year, and we do believe that if the drier weather is confirmed, we'll probably have a lower agricultural productivity in the next year, which likely means a smaller crushing in the 17-18 compared to the 16-17.

But I think this is more of an issue or something to be more concerned when you think about it from a sector standpoint. The thing is, we all know that there is a good deal of under-investment in the sugarcane fields in Brazil over the last two or three years. So the negative impact of a drier weather can be stronger in a field that has had less investment over the last three years, which is not the case for us.

Again, remember that we've been investing or we've been renewing our sugarcane fields more than 20% over the last two to three years. The 15-16 harvest year in particular was a transition year because our plan now is to renew the sugarcane fields between 14% and 15% going forward. We believe this to be an adequate level of renewal, given all of the efficiency efforts that we are making, the change in the sugarcane pieces that we use. So, we are targeting more of a [six cuts type] [ph] cane compared to five cane of the previous years. So from our side, there's no concern whatsoever in terms of the level of investments in the sugarcane fields, okay.

And you asked about Raizen Energia's CapEx. Again, our guidance points to R$1.8 billion to R$2 billion and this considers as I said 14% to 15% of renewal of the sugarcane fields. So there's really no change in strategy here, no concern whatsoever regarding the level of investments.

On your question regarding Comgas' CapEx, what happens is that, as you know, we are still waiting for – actually not even, I can't even say that we are waiting for the five-year review, because we're still waiting for the schedule of the process to get to the five-year review, and we therefore reduced a little bit the pace of investments in the first half of the year. But again, there is no change in Comgas' strategy. And part of that reduction in fact is because we became more efficient in terms of CapEx depletion to do the same level of conversion. So there's also no change in strategy here that would make sense to talk about. Okay?

Juan G Tavares

Okay. And regarding dividends, are you considering making any additional dividend payments this year?

Mario Augusto da Silva

This is Mario speaking. Look, what we can tell you about is we're going to pay the mean of that 25% that we have under the Brazilian Corporate Law, but we cannot anticipate any major change in terms of the dividends that we're going to pay.

Paula Kovarsky

Yes, I mean if you look at the competence of dividends, right, there's been a consistent increase in the payment, which essentially relates to the consistent improvement in the operational performance, and this should be the trend. More than that, we really don't like to talk about, okay.

Juan G Tavares

Okay, thank you, very helpful.

Operator

Our next question comes from Ravi Jain, HSBC.

Ravi Jain

So I had two quick questions. The first one is on the Energia business, as to your strategy of inventories, especially on the ethanol front, given that we expect additional taxes on ethanol starting in January next year. If you could give us some color on that, it will be helpful. And the second question is on Comgas, any update on the spin-off of Comgas, should we expect it more towards after the five-year review, or just an update on that will be helpful? Thank you.

Paula Kovarsky

So let's talk about the inventory carryover strategy. What happened, as I said before, is that we had a bit of an atypical behavior of ethanol prices in Brazil, which I think has to do with the change in climate or the unusual climate in the first quarter as well as the very fact that sugar prices are paying 30%, maybe more, or remunerating 30% more than ethanol in Brazil and there's been some migration to sugar.

So the very truth of the matter is that we looked at our expectations for ethanol prices in the fourth quarter and first, I mean the second half of the harvest year, and the harvest didn't look to be profitable – sorry, the carry didn't look to be profitable, and this is why we didn't do so far, which doesn't mean we won't do throughout the harvest year if the opportunity appears.

Regarding your question about taxes, as you know, we have a PIS/COFINS exemption in the ethanol production. This exemption ends at the end of the year. We are actually discussing the future of that with the government, I mean as a sector. And of course there is the debate about whether the government is going to put an additional city tax on gasoline, yes or no.

What I think is important to understand here is that if you think about the Brazilian supply/demand equation for fuels, it is probably more complex than in most countries, because not only we have the hydrated ethanol which doesn't exist anywhere else, but at the end of the day given the fact that the production of sugar and ethanol is connected, at a limit you have sugar supply/demand impacting your fuels supply/demand in the country.

So the thinking has to be what's the right balance between sugar and ethanol prices in Brazil so that you can guarantee that there is an incentive to produce ethanol, because the flipside of the coin is that the country will have to import a lot of gasoline and this has a negative impact on the trade balance, okay. And I mean I would even go beyond that, I mean Brazil is so relevant to the international trade for sugar that you really have to, and then sugar is a very important commodity for us in terms of exports, that the equation needs to go well beyond the PIS/COFINS or the CIDE or the combination. I mean I think the country has to have a more clear strategy in that regard.

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