## AZUL4: Dotting the i’s

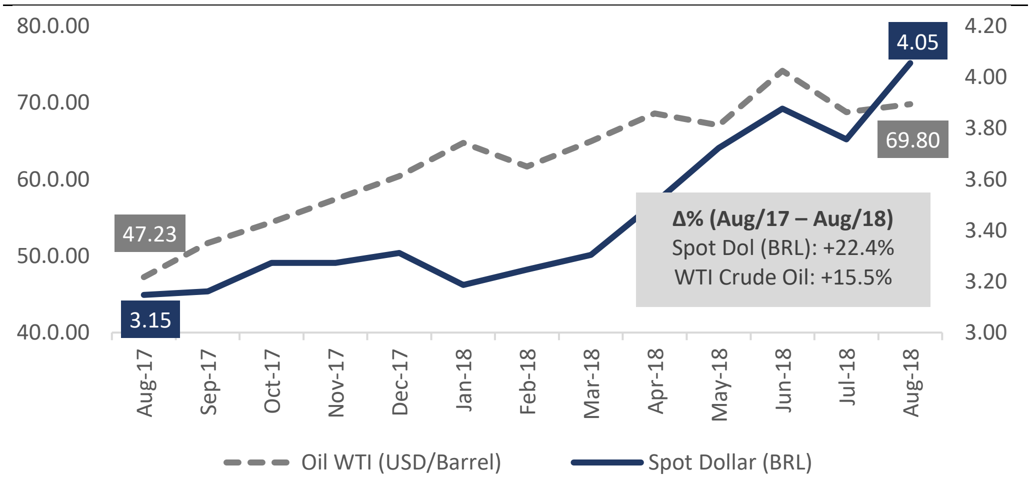
Over the year, Azul shares experienced an accumulated drop of approximately 12%, whilst the Bovespa index rose around 0.50%. The impacts (both confirmed and expected) on the company's results of the fall in value of the currency and the rise in fuel prices, along with the marginal appetite for risk shown by investors, are some of the elements that justify this tendency towards reduction that has punished the sector on the stock exchange over the past few months.

However, the grounds for the proposal to invest in Azul continue to be solid and we continue to recommend purchase of these securities. We would now like to once again go over the main points surrounding discussions about the company.

### *Currency and Fuel*

Given the tensions in the overseas market involving the trade disputes between the United States and its trade partners, added to the domestic climate dominated by electoral uncertainties, the exchange rate ended August approximately 22% lower than the rate recorded the previous year. Along the same lines, WTI crude oil increased 15% over the same period, influencing fuel prices and directly affecting the cost structures of airline companies.

Diagram 1: Spot Dollar Exchange Rate Prices (BRL) and WTI Crude Oil (USD/Barrel)




*Source: Thomson Reuters; Prepared by Eleven Financial*

**Air Transport**

**Ticker:** AZUL4

**Recommendation:** BUY

**Target Price:** R$36.00

**Price (Sept. 17):** R$ 23.49

**Market Value:** R$ 7.3 billion

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Representing 30% of Azul's operating costs and expenses, the rise in the price of aviation fuel has led to discussions over the business' ability to maintain its profitability within this scenario. In the first half of 2018, the company recorded a 29% increase in the cost of fuel, that contributed to the drop of 0.4 p.p. in the operating margin for the period. Despite the negative effect, the data shows a good capacity to pass on the costs to fares, along with the performance of other measures that protect the margins, and these can be divided into three mainstays:

a. Fuel price and currency hedging - For the third quarter of 2018, 30% of the exposure to fuel prices has been hedged, and this could reach 50%. In terms of the exposure of foreign-currency financial expenditure, the policy allows a hedge of up to 100%, reducing the impacts of a possible spike in the dollar.

b. Pass-through via tariffs - Around 70% of the variations in the structuring of costs has been passed through to fares, with the fares still managing to absorb the adjustments due to the positive dynamic of the demand. On top of the expansion of the air transport market, Azul is also benefiting from being the only operator on 70% of its routes, which allows it more room to make price adjustments without sacrificing Market Share.

c. Fleet Replacement - The arrival of the 'A320neo' family (currently amounting to 17 aircraft, with this figure expected to reach 20 at the end of the year and 46 in 2021), should also provide a boost for the company's margins in the long-distance markets. The new aircraft (with 174 seats) should replace the Embraer E195 model (with 118 seats) and allow a 29% reduction in the cost of a seat, while the cost per trip will be just 5% more than on the E195. As well as the A320neo family, as of 2019 the E195 models will also be replaced by Embraer's second generation of commercial jets (the 'E2' with 136 seats). With this change, profitability gains will also be obtained through a 26% drop in the cost per seat and 14% in the cost per flight.

Diagram 2: Azul's Operational Fleet Forecast

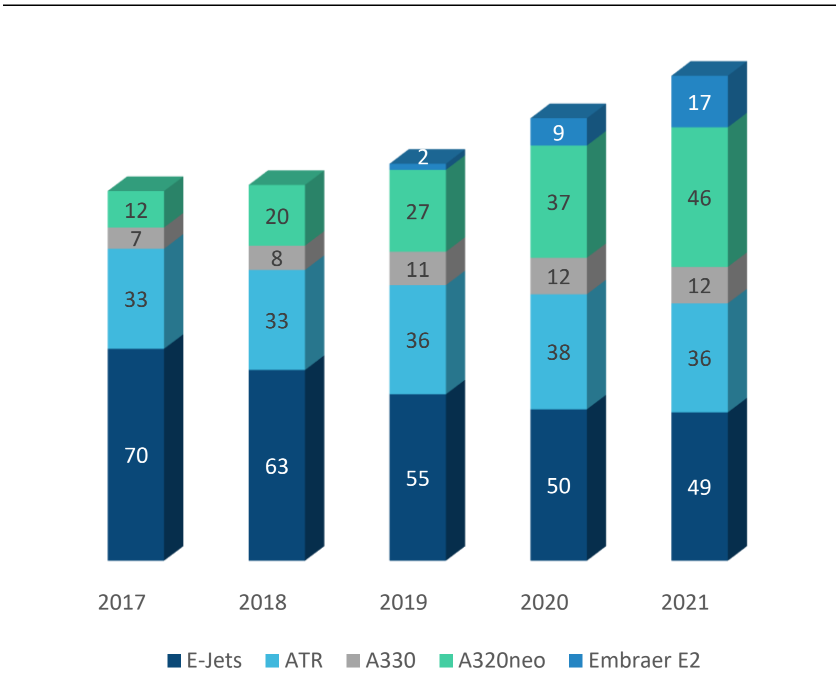



Diagram 3: Variation in the Cost per Seat

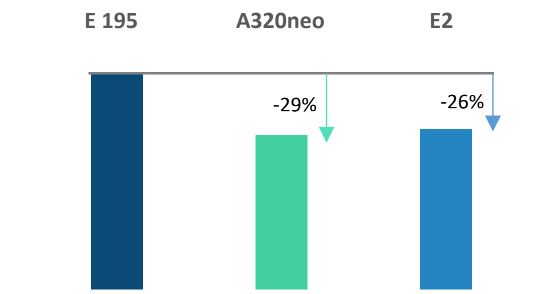
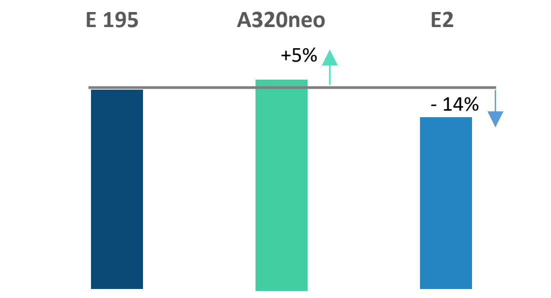



Diagram 4: Variation in the Cost per Flight




*Source: Azul; Prepared by Eleven Financial*

### *Arrival of Budget Airlines*

Since July this year, the discussion over the entry of companies working with the 'Budget' model has heated up as a result of the Norwegian airline company Norwegian Air and the Argentinian Avian Lineas Aéreas (a subsidiary of

Avianca Argentina) having received authorization from ANAC to operate flights in Brazil. As well as these two companies, the Argentinian company Flybondy and the Chilean Sky Airline are also in line to start operating flights to Brazil using the budget model, although the processes are still in their early stages.

One of the factors that started attracting these companies to the Brazilian market was **Resolution 400/2016**, which altered the regulation of air transport to allow companies to charge for services such as baggage handling, meals and the choice of seats. In other words, the resolution did away with issue that was making the budget business model in Brazil financially inviable, since budget airlines offer the lowest fares possible, making their profit on these additional services. Another factor that worked in favor of this model has been the **opening of Brazil to the Single Skies Agreement** (which saw its first signs of moving forward in March 2018, following the approval in the Senate for operations with the United States) allowing an unlimited number of flights, airline companies and passengers to fly between the two countries.

**However, the market's biggest fear continues to be the entry of subsidiaries to the domestic market, i.e. subsidiaries of budget companies operating domestic routes rather than routes between countries.** For this to be possible, Congress would have to approve the opening up of the capital of the Brazilian companies to the overseas market. The debate (General Tourism Law) has been dragging on now for a number of years, with arguments against it always being raised in the House of Representatives, and the entry of these new competitors could still take a while yet.

Should this situation be resolved with Congress finally approving this point, one item that could discourage the operations of the foreign subsidiaries could be the reality of the higher operating costs on the Brazilian market, given that they would be subject to the same Brazilian tax laws. The ICMS tax (levied on fuel in Brazil at rates of 12% to 25% depending upon the state) does not exist in other countries and it would end up placing great pressure on the cost structures of the new players, who would find themselves competing on an equal footing with Brazilian companies.

**If they decide to enter the Brazilian market despite this situation, they would probably aim to maintain the standard of operations seen overseas, flying routes with a high density of passengers**, or in other words, those routes running to the country's principal destinations, which would mean they would not be competing directly with Azul's strategy, which differs in that it operates regional routes. The Brazilian company would maintain its bargaining power on these routes and manage to continue charging fares at levels healthy enough to ensure the business' continued profitability.

### ***The 'Tudo Azul' loyalty program***

Following the delisting of Multiplus shares on September 5, as announced by its controlling company Latam (as well as the non-renewal of the operating agreement expiring in 2024), the market began punishing its competitor Smiles (controlled by Gol) on the stock exchange. The stress was driven by discussions on the possibility of Gol not extending the loyalty program and the perpetuity of this business model.

However, as reported in our report entitled "**Don´t panic, Smile 2.0: The Delisting of Multiplus Shares"**, published on September 5, this event arose from a sequence of negative results for the company with a loss of market share (for both Smiles and Tudo Azul) and a reduction of the net profit by around 40% in 2Q18.

Diagram 5: Market Share
(ex-air Gross Revenue)

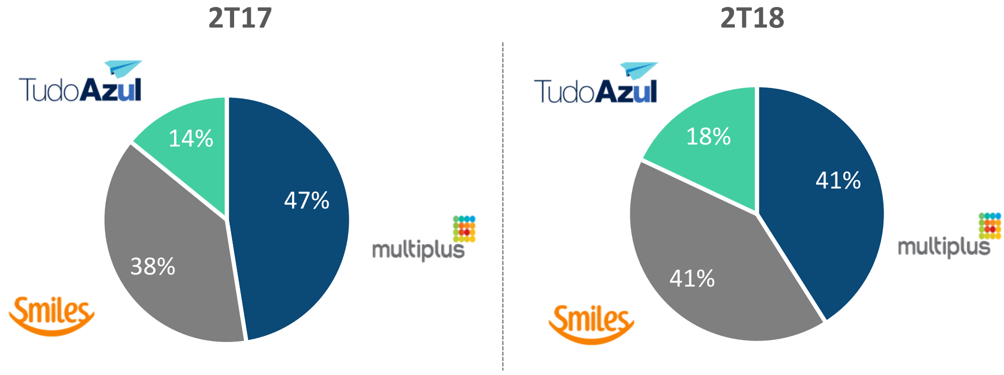



Diagram 6:
Δ% Gross Revenue

| 2Q18 x 2Q17 | |
|---|---|
| Multiplus | -5.60% |
| Smiles | 15.70% |
| TudoAzul | 37.80% |

*Source: Azul; Prepared by Eleven Financial*

That is to say, we should stress that the business in itself should not be questioned in relation to its potential for generating value for the company, as has been done very well by the Tudo Azul loyalty program operated by Azul Linhas Aéreas. In a recent conversation with the company, Azul pointed out the importance of seeing this line of business grow for its cash generation. Furthermore, Azul hopes to achieve an EBIT Margin of 15% in 2020, with 1% coming from the Tudo Azul program, which still has the potential to make advances in the sector given its current penetration of just 18% in this market, not to mention the extremely fast invoicing rates of growth in relation to revenue.

### *JV with Correios*

The Joint Venture (JV) between Azul and Correios (the Brazilian mail service) has been challenged by the competing airline companies Latam and Gol and the debate has been picked up by investors over the last week. The companies feel that the agreement could undermine competition in the air cargo market, whilst they have also pointed out that Correios did not announce a bidding process before establishing a partnership and did not offer the business to other companies.

Under the JV, Azul would provide exclusive and permanent domestic air cargo transportation services. The new company will assume responsibility for all the activities currently performed by Azul Cargo Express, except the international delivery services, whilst Azul will hold around 50.01% of the company, thus being the controlling partner. Under this arrangement, Latam and Gol request that Cade (the Brazilian anti-trust authority) demand justification for the contracting of Azul, whilst the case is also still under analysis by the TCU (the Brazilian Federal Audit Court) to investigate irregularities in the creation of the partnership.

In fact, the agreement between Azul and Correios could indeed boost Azul’s cargo transportation business, but the operation at the moment is considered to be a plus for the company's results given its small share in the volume of revenue (in the first half of 2018, the “other revenues” line that includes Azul Cargo Express and TudoAzul amounted to R$213 million, which still accounts for 5% of the income for the period). As such, we believe that a possible delay or alteration to the agreement between Azul and Correios should not alter the company's business model or penalize its actions.

### *Our View*

In our view, Azul’s base remains solid, being supported by the following mainstays:

- It is the sole operator on around 70% of its routes: diversification of the fleet and a consolidated connection hub are barriers to other players wishing to enter and operate these regional routes. In this situation, the company is managing to maintain fares at healthy levels without compromising profitability.
- Renewal of the fleet: The replacement of E-Jets with more efficient models (A320neo and Embraer E2) should provide the company with a boost, enabling it to operate with better margins and reduce the pressures caused by fuel costs in the event of currency devaluation.
- Strengthening of the Brazilian market: The growth of Brazilian demand for air transport should continue to push up the volumes for domestic and international destinations, considering a relatively stable macroeconomic environment with growth of the activity.

We should reiterate that the most important risks are concentrated in the destabilization of the country's economic expectations and a consequent loss of control of currency depreciation, which could take the drive out of the demand and put pressure on the structure of operating costs and financial expenditures.

However, in our base scenario, the AZUL4 shares trade at below both the historical average and our fair price, suggesting that this is a good opportunity to BUY. We maintain our positive outlook for AZUL4, with a target price of R$36.00.

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