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GAS.MC - Q1 2019 Naturgy Energy Group SA Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, welcome to the Naturgy First Quarter 2019 Results Presentation. My name is Jake, and I'll be coordinating your call today. (Operator Instructions)

I'll now hand over to your host, Abel, to begin. Abel, please go ahead.

Abel Arbat - *Naturgy Energy Group, S.A. - Head of IR*

Thank you, Jake. Good afternoon, everyone, and welcome to our results presentation for the first quarter of 2019.

By way of agenda, the results will be presented by our Capital Markets Director, Steven Fernández; together with our Controlling Director, Jon Ganuza; and our CFO, Carlos Álvarez. At the end of the presentation, we will open it up for Q&A where analysts and investors will be able to ask your questions live through the call. And without further addition, I will hand it over to Steven.

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

Yes. Thank you, Abel, and good afternoon, everyone. I'm going to be making reference to the presentation that we've also sent to the (inaudible), which is available as well in our website.

So starting off, we're going to do a quick overview of the results and the key highlights of the period.

The beginning of 2019 has been marked by the solid performance of the Infrastructure businesses and the stability in Gas & Power despite a more challenging energy scenario compared to the previous year.

During the quarter, the company has continued to make progress on its efficiency plan and the gradual derisking of its business profile. Now obviously efficiencies achieved since the launch of the plan are noticeable across the businesses and will remain a key driver of performance going forward. In this sense, the company is on track to deliver the EUR 100 million of additional efficiencies expected for 2019 and reiterate its total commitment of EUR 500 million of efficiencies by year 2022.

In terms of derisking, visibility in the Infrastructure LatAm businesses has improved as a result of the recent tariff updates, and the company has continued to work on improving the risk profile of its merchant activities, as Jon will explain later on.

Naturgy's solid results and increased focus on cash flow generation has also allowed us to reduce its net debt levels in the quarter despite the cash outflows related to shareholder remuneration, as you will see, and the investments in the development of its renewal projects and networks businesses.

Finally, the company also continues to deliver on shareholder remuneration. And as a reminder, on 20th of March, we paid out our final dividend against 2018 results amounting to EUR 0.57 per share, thus fulfilling our commitment to a total dividend payment of EUR 1.3 per share for the year 2018, which I'll remind you is an increase of 30% relative to 2017.

Furthermore and since the beginning of the plan and until the end of March of 2019, the company has invested around EUR 240 million to buy back its own shares as part of its EUR 400 million annual share buyback program, which will be completed by the end of June 2019. In this sense, as a reminder as well, the AGM authorized the cancellation of those shares, which we expect to take place at -- by the end of July.

All in all, the Q1 results continued to illustrate the company's progress towards the successful implementation of its 2018 and 2022 strategic plan.

So if we move over to Slide 5, and that's the EBITDA evolution. EBITDA in the quarter reached EUR 1.1 billion after nonordinary effects. If we strip these out, which mainly accounts for additional capture costs of around EUR 50 million in the quarter as part of the efficiency plan, ordinary EBITDA increased by 6% to almost EUR 1.2 billion, supported by the improvement in the Infrastructure businesses and efficiencies across all.

In particular, on the Infrastructure side, relevant tariff updates in Latin America recognizing the FX and inflation movements during 2018 together with stability in the European operations has contributed to an overall strong performance in the quarter.

In Gas & Power, Q1 results are broadly unchanged versus the same period last year, supported by the company's new commercial policies, which together with efficiencies and new renewal capacity has helped offset the global decline in gas prices during the year. So net-net, it's been a solid performance, as you've seen of Infrastructure businesses and recently stable in Gas & Power.

If we move over to Slide 6 and we focus on the net income, it amounted to EUR 341 million on a reported basis on the first quarter, while ordinary net income rose 16%, that's 1-6, to EUR 377 million, supported by the activity improvements previously mentioned and lower D&A. Here again, nonordinary items mainly relate to the additional capture cost that we mentioned previously.

In terms of D&A, the lower amount is a consequence of the substantial write-down completed last year as well as the live expansion of Spanish improved plans following the agreed calendar, both of which have a positive effect, which partially counter the impact of IFRS 16.

If we move over to the cash flow and net debt, that will be Slide 7 of the deck. We have generated a gross cash flow of EUR 1.1 billion, substantially higher than in the first quarter of last year. In addition to the stronger operating results, the company has experienced a positive evolution of its working capital, which is explained by a number of factors. Some of these effects are related to better working capital management via shortening of receivable days and extension of payables as well as to other cash-generating initiatives, including an increased factoring, while other effects are mainly related to seasonality.

CapEx amounted to EUR 289 million in the period, mainly reflecting ongoing investments in renewal projects as well as investments in the remunerated networks, which are obviously consistent with our golden rules of investments.

Also, during the period, the company completed its 2018 annual dividend payments, which amounted to EUR 560 million. And we bought back in the first quarter around EUR 135 million worth of company's shares as part of its buyback program. Despite all the investments and cash outflows for shareholder remuneration, net debt under IFRS 16 amounted to EUR 15.1 billion as of the end of March of 2019, and that's 1% decrease relative to the end of December of 2018.

Finally, I will highlight that during the first quarter of the year, both S&P and Moody's reaffirmed their long-term ratings at BBB and Baa2, respectively, both with a stable outlook.

So with this brief introduction, I'll now hand over to Jon, who will be reviewing the results by business unit.

Jon Ganuza - *Naturgy Energy Group, S.A. - Director of strategy*

Thank you, Steven. Good afternoon, everyone. Let's spend some time reviewing the operating performance of each of the business units.

Starting with Gas & Power. First quarter results are in line vis-à-vis the same period last year. Efficiencies and new renewable capacity have helped offset the global decline in gas prices during this quarter. In particular, the improvement in gas, power and service sales is mainly underpinned by efficiency, partially offset by lower sales and reduced margins in power supply.

International LNG has been most impacted in this quarter compared to an extraordinary year in 2018. Nevertheless, results remained solid despite a more challenging environment. And the company has already secured approximately 90% of its LNG volumes for the year, and it continues to focus its efforts to reduce margin volatility and lengthened sales contracts duration.

Power generation in Spain has benefited from higher fuel prices, which have been partially offset by the lower hydro and the suspension of the CCGTs availability capacity payments.

Finally, international power generation has performed well on the back of new installed capacity, better margins of excess energy sales in Mexico and a favorable evolution of FX. All in all, stable performance in Gas & Power despite the more challenging scenario.

Moving on to our Infrastructure business unit in EMEA. Overall results have been robust, thanks to organic growth and efficiencies across businesses. In particular, the improvement in gas networks has been mainly driven by lower OpEx from efficiency improvements, which has more than compensated for a relatively mild winter with high temperatures and subdued demand.

In electricity Spain, efficiencies, additional investments have supported a positive evolution. Finally, EMPL had benefited from the annual tariff increase and favorable FX evolution. In summary, close to ordinary growth and efficiencies across the businesses.

Moving on to Infrastructure South LatAm. Overall results have been driven by tariff update, recognizing the FX and inflation movements during 2018 as well as efficiencies across businesses. In Chile electricity, tariff indexation and efficiencies have been partially offset by lower activity and FX. In Chile gas, tariff indexation and efficiencies together with higher demand and supply activity have been partially offset by lower volumes in distribution.

In Brazil, results have also been driven down by the tariff updates since January and efficiencies.

Finally, in Argentina, the tariff update from April 2018 has been offset by the still significant FX depreciation in the period. This update has not recognized the increase that was pending on last October's update. All in all, Infrastructure South LatAm has experienced strong improvements, mainly driven by tariff updates and efficiencies.

Finally, moving into Infrastructure North LatAm. Results have equally been impacted by regulatory updates and efficiencies. In Mexico, the positive evolution was driven by the regulatory tariff updates and annual tariff indexation, demand growth and better supply margins as well as efficiency improvement. In Panama, the positive evolution is explained by the tariff update and the new regulatory period and the higher demand as a consequence of the temperatures increase compared to last year.

And with that, I will hand it over to Steven to wrap up.

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

Thank you, Jon. So mindful of your time, we wanted to do this quick and leave you time for questions.

But as a summary, we can say that the Q1 has seen a robust performance of the Infra businesses and stability in Gas & Power despite a more challenging scenario. We have continued to progress on derisking of merchant activities and are well on track to deliver the EUR 100 million additional efficiencies in 2019, as committed.

In addition, disciplined investing and optimization of working capital management has led to a strong cash flow generation during Q1. And as regards to shareholder remuneration, we have paid the final dividend and we have exercised more than EUR 235 million of share buyback since the launch of the strategic plan.

So all in all, under the current scenario, we are in a comfortable position to reiterate our year-end guidance. As you can see, very steady progress in the strategic plan, and we look forward to continue delivering in the future.

And with that said, we now open the lines for any questions you may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) So the first question today comes from Harry Wyburd from Bank of America Merrill Lynch.

Harry Peter Wyburd - *BofA Merrill Lynch, Research Division - VP and Junior Analyst*

Just 2 from me. So firstly on gas, electricity and services supply, if I'm not wrong, it seems like it was almost a blowout quarter, the best you had in at least a couple of years under the new reporting metrics. And was that efficiencies alone driving that? I'm just struggling to understand how it was so good in retail in the first quarter compared to previous quarters. And then the second one is just on the "Rest" segment. The year-on-year delta on that was quite big, about EUR 40 million if I'm not wrong, even on the ordinary basis. So can you just remind us what's in Rest and what's the best way for us to forecast that for the full year?

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

So I'll begin with the second question, because I think it's the easiest. With the Rest, it reflects what is the corporate costs, and that's something that we said on the 2018 result presentation that when you look at the Rest, it should reflect the cost of the corporation. So there should be -- there are no additional, so that's why you're seeing in this quarter a net negative figure, because it reflects that's the OpEx or the cost of the corporation. And that's not something that was affected in the first quarter figures for 2018. And that's not an ordinary (inaudible). And regarding to the gas, power and supply services sales, I mean, it's an extraordinary year if you compare it with 2017. But if you take into account what's the commitment that we have for 2022, there's still room for improvement, and that's what we're currently working on.

Operator

The next question comes from Antonella Bianchessi from Citi.

Antonella Bianchessi - *Citigroup Inc, Research Division - Director and Head of European Utilities Equity Research*

Just following up from this Rest division dynamic. Is this affecting somehow the comparison when we look at the EBITDA reported by division? This is my first question. The second question is on volumes. We have seen a material drop in the volumes. Is this something that we should expect for the full year? Is this the kind of strategy? Can you elaborate a little bit on the volume that we should see, both in electricity and gas in -- on a full year basis and thereafter?

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

Regarding your first question, yes, there is an effect there, because last year, it -- the Rest didn't reflect the fact that it was a call center. Now we are -- there were some revenues that -- actually there were revenues that they were seeing as greater OpEx on some of the business lines. That's something that we're eliminating now. And as we move on with the quarters, this difference between what we've reported interest on, it should diminish, because already in the fourth quarter 2018, the level that we've had of -- it was more comparable. So yes, there's a certain level of difference there. And regarding the volumes, it's -- it basically has to do with the volumes that we have with our procurement contracts.

Operator

The next question comes from Manuel Palomo from Exane.

Manuel Palomo - *Exane BNP Paribas, Research Division - Analyst of Utilities*

I've got a few questions. First one on nuclear. You mentioned that you have decided to extend nuclear useful life. Are you following the same -- are you following the pre-agreement between the Spanish government and the utilities? And please could you tell us what is the impact on D&A? That's the number one. I saw that there's a significant increase in the results from Chile. You mentioned that it's partly due to tariff revisions. Could you broadly explain how this has changed, whether this is just an update and also whether the increase in the equity accounted earnings is related to something in Chile? And lastly, i.e., I see that there's been a big drop in the CapEx, 50% in growth CapEx, if I'm not wrong, 20% in maintenance. And are you -- or could we assume that this is the new -- well, the trend in terms of quarterly CapEx that the company will see? Or shall we see an acceleration in the coming few quarters?

Carlos Javier Álvarez Fernández - *Naturgy Energy Group, S.A. - CFO*

Carlos speaking. And the nuclear extension of life will impact in EUR 12 million in annual basis. Regarding the Chile question, the biggest increase that we have vis-à-vis last year with Chile has to do with the fact that half the revenues associated with Norma Técnica, that's been investment that we have been doing to improve the quality of the networks. And that in the first quarter of last year, it wasn't in the -- recognized in the tariff. And regarding the CapEx, there has been a decrease compared with last year. Part of the decrease has to do with the fact that we don't have the LNG ship in this first quarter and we had it last year in the first quarter. But as the guidance that we gave this year, the guidance for this year was that the CapEx in 2019, it should be of EUR 2 billion, and we stick to that guidance. So...

Operator

Our next question comes from Tancrède Fulop with Morningstar.

Tancrède Fulop - *Morningstar Inc., Research Division - Equity Analyst*

I have 2 questions. The first one is on international LNG. I think you previously guided for a decline in EBITDA in 2019 between 10% and 20%. Is it still relevant, given the significant EBITDA decline in the first quarter and also as you started to hedge your LNG volumes for 2020. And could you give us an indication in terms of unit margin in international LNG in 2020? This is my first question. And the second question, how -- do you feel comfortable with the current consensus 2020 of EUR 4.5 billion of EBITDA and EUR 1.45 billion in net income?

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

Nice try regarding the LNG. We haven't given our guidance for the LNG business. We gave our guidance for the total EBITDA for this year, but it was a good one.

Jon Ganuza - *Naturgy Energy Group, S.A. - Director of strategy*

And we -- I mean, again, we've provided guidance for 2019, that's close 2019. And then when we get to the full year 2019 results, we'll give you guidance for 2020, but we're not going to comment before that. I mean, the only targets that the market has right now are the targets or our guidance for 2019. That's EBITDA, net income, CapEx and net debt and the targets that we have for year 2022, and that's it. So we don't have a view or public view on the consensus estimates for 2020.

Operator

The next question comes from Javier Suarez from Mediobanca.

Javier Suarez Hernandez - *Mediobanca - Banca di credito finanziario S.p.A., Research Division - Research Analyst*

With working capital, there has been this sizable positive impact during the first quarter amounting to more than EUR 320 million. If you can again help us to understand the reason for this positive contribution from working capital and if that is something temporary related to the first quarter or that is something that this should be positively impacting the full year 2019? Or that should be disappearing through the year? That is the first question. The second question is on the cost cutting. I think that your target is to reach EUR 100 million of cost cutting through the year. You can help us to understand the contribution from cost cutting during the first quarter, where that cost cutting has been obtained during the first quarter and the managerial action that the company is going to have during the next quarter of the year to reach that target of EUR 100 million. And then the final question is on the -- your supply business. I think that you have mentioned during the presentation that you have close to 90% of the volumes close or secure. You can give out the ideas on the prices. What do you see on the market when you are closing and securing that 90% of volumes?

Jon Ganuza - *Naturgy Energy Group, S.A. - Director of strategy*

I'll start with the last one, just one clarification. When we've talked about 90% of the volumes that they are committed, we're talking exclusively about LNG international, we're not talking about all of the supply business. So for example, we're not talking about the sales that we're doing in Spain. And we have no view of what's going to happen with the prices. I mean, Steven has said, our view is to tighten the risk as much as possible and to have greater level of visibility regarding the cash flow generation. But what's going to happen with LNG prices, I think that there's a high level of volatility. We've seen that this past few months and probably would keep like that in the next few months. Going to your first question regarding working capital. It's something temporary. It's not something that's true to all, and it has to do with the fact of what are the differences between the sales that we've done in Spain in the months of November and December, which are the ones that have been collecting the money currently; and the months of February and March, which are the one -- the months that we are invoicing. So those are basically the difference that we are talking about. And those differences are mainly -- so it's not something that should be stretched more. It should disappear as we move on, on the year. Regarding efficiencies, I mean, we are not going to give an exact figure of which has the efficiencies that we have achieved during this first quarter. We stick to the commitment that we have, that is EUR 500 million in 2022, as Steven has said. And we are currently working on that, and we are confident that we will be able to achieve those -- that commitment. And which are the categories in which we are achieving those efficiencies, it's all across the board, across all the businesses and across all of the OpEx categories that we have in the businesses.

Operator

The next question comes from Dores Carolina from Morgan Stanley.

Carolina Botacini das Dores - *Morgan Stanley, Research Division - Equity Analyst*

I have 3. First one is you could make comments on, I think, electricity tariffs in Argentina have been frozen and it looks like this could happen to gas as well. If and how this affects your forecast and your guidance for the year? The second question is on D&A. You had in the first quarter EUR 319 million, of D&A, which seems low, given that D&A should have gone up versus the fourth quarter, given IFRS changes. So I was wondering if there's any other life extensions of assets classified as available for sale that would have helped D&A. And thirdly, if you can make comments, there were some press reports about your interest hitting a kind of sepsis state in Medgaz. If this is something that you would be looking at?

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

This is Steve. I'll start with the last one. We -- our policy here is we don't comment on press speculation. As you guys very well know, this company will look at projects when and if they present themselves provided that they meet the investment criteria that we have established. As regards to specific one that you are mentioning, again, we can't comment on press speculation. On depreciation and amortization, the figure is actually pretty clean, and again, it's the result of the significant impairment that you saw last year. So as expected, we are benefiting from that. And in addition to that, well, we should also mention as well, in this particular quarter, we have around EUR 40 million -- past quarter or so, you had around EUR 40 million of impairments. So that's also something you should keep in mind when comparing both numbers. In terms of gas tariffs in Argentina. Jon?

Jon Ganuza - *Naturgy Energy Group, S.A. - Director of strategy*

Gas tariffs is -- as far as we know, the government has said that they are not going to make any further increase about the gas tariffs. We know that we are going to get the gas -- so we already have the tariff increased in April, and that's something that it's already in the pockets. So that's something that we already have there. Regarding the October, the government currently is saying that they are not going to increase the gas tariffs, and that's all that we know.

Operator

Your next question comes from Jorge Guimaraes from JB Capital Markets.

Jorge Guimarães - *JB Capital Markets, Sociedad de Valores, S.A., Research Division - Analyst*

Still on the LNG area, it -- the benchmarks or the spreads between the global gas benchmarks were down in Q1 and apparently continued to go down in the beginning of Q2. And at the same time, the volumes -- the LNG volumes reduced significantly year-on-year. Is it fair to assume that part of the reduction in spreads will be seen in Q2? And secondly, is it also fair to assume that the -- your answer to lower spreads has been to cancel less profitable cargoes?

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Jon Ganuza - *Naturgy Energy Group, S.A. - Director of strategy*

We haven't canceled any cargoes, as far as I know. I mean -- so there has been no cancellation as such. It's true that some contracts do have a degree of flexibility regarding volumes and sometimes we use those flexibilities, but no we haven't canceled the cargo as such. And as we said, we have already secured for this year 90% of the volumes. We can't talk about what has happened this first quarter. We'll see what happens with the open position that we have. That is around 10% of our volumes in the next 3 quarters. And for that, we'll have to see how the commodities evolve. And I think that regarding that sense, we should always keep in mind that we are currently in energy scenario where the LNG spot prices have decoupled from Brent prices and that a scenario -- I mean, an increase of Brent prices is something that cannot be positive as long as the spot LNG prices are decoupled.

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

Perhaps we should also mention that last year during the conference calls, we mentioned that the LNG scenario was extraordinary on the positive side. So we need to bear that in mind when comparing this year's performance against last year's, perhaps looking further back would be a better benchmark of the expected performance of LNG this year. What we can say without any room for doubt is that the LNG performance in year 2019 will certainly not match the performance and the results that we had in year 2018.

Operator

The next question comes from Javier Fernandez Garrido from JPMorgan.

Javier Fernandez Garrido - *JP Morgan Chase & Co, Research Division - Head of Utilities and Senior Analyst*

On the international LNG business, when you stated, for example, back in 2018 full year results that you have about 70% of volume secured, what does this mean? In other words, can you elaborate on how does your forward selling or your forward contracting work? Did you secure in some portion of the margin with those volumes or no margin? You could elaborate a bit on how the business works structurally when you sell forward, that would be very helpful. And then a second question would be a follow-up on the comment you made to Manuel on the Norma Técnica in Chile. The increase in the tariffs due to a Norma Técnica is all recurrent throughout the year, or is there some one-off due to some recovery of the one-offs that you had back in 2017 due to some exceptional items? To which extent, should we assume that the increase in Q1 is recurrent?

Jon Ganuza - *Naturgy Energy Group, S.A. - Director of strategy*

Regarding Norma Técnica, the increase is recurrent. So it's something that is recognized, because it's an investment that we are doing with (inaudible) and we are still doing. We consider it as recurrent. But bear in mind that, that's not the only effect that explains the increase. It's one of the main effects, but it's not the only effect. So yes, that's always in mind. And regarding LNG, when -- in the results presentation, we said that we had 70% of the volumes that were closed, and now we're saying that it's close to 90%. But we want to say that 70% of the volume -- of the gas of our gas procurements for LNG international have an end customer. So we can -- we know which is the purchase base, the price, and we know which is the sales price. When we're saying that we had 30% of the volume was that we're open, meant that we knew which was the purchase price. But since we didn't have an end customer, we couldn't say which was the selling price. That has been reduced to 10%. So 10% of the volumes that we are going to sell this year, we know -- with this year, we know at which price it's going to be bought, but we don't know at which price it's going to be sold, because we don't have an end client. So we have visibility for 90% of our volumes in the LNG business, but we don't have visibility for that 10%. We can have our best estimate that would be a mark-to-market for those volumes. But that's the best estimate that we can have. I don't know if that helps a bit to explain what we are talking out with this 90% close position.

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Javier Fernandez Garrido - *JP Morgan Chase & Co, Research Division - Head of Utilities and Senior Analyst*

Yes, it does help. The follow-up would be then when you talk of 70% of volumes that you have secured, 90% now, which volumes are you talking about, because your purchasing contracts have a lot of flexibilities when it comes on to volumes. So are you talking to the minimum take-or-pay volumes or your estimates for the year? What is that volume that you use as a reference?

Jon Ganuza - *Naturgy Energy Group, S.A. - Director of strategy*

We are talking about our estimate of the year.

Operator

(Operator Instructions) We currently have no further questions. So back to you guys.

Steven Fernández - *Naturgy Energy Group, S.A. - Director of Capital Markets*

All right then. Thank you very much for joining this conference call. The Capital Markets team remains at your disposal should you have any further questions or need any additional clarifications. And thank you. Thank you very much. Bye-bye.

Operator

Ladies and gentlemen, this concludes today's call. Thank you for joining. You may now disconnect your lines.
