GNAM Investment Competition

GOL

"GOL LINHAS AEREAS INTELIGENTES S.A"

Ticker GOLL4:BZ

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1. **Executive Summary**

Gol Linhas Aéreas Inteligentes, one of the largest commercial and freight airlines in Brazil, transporting more than 34 million passengers on more than 750 daily flights to 77 destinations (of which 15 are international).

Even though its leading market position and margin recovery over the last years have made it an attractive investment target in the Brazilian market, we trust the company is set to improve even further on a short-term and mid-term basis. Continued strong focus on operational efficiency, driving revenue growth through the increase of revenue passengers and the load factor, while intelligently optimizing assets and doing some meaningful liability management.

We believe the exit of Avianca last year and the emergence of more favorable industry pricing conditions and capacity-wise will help tighten the market, benefitting GOL. Potentially lower costs should also allow for improving margins in 1H20. Should the bullish view of Brazilian equities materialize, we also appreciate GOL's relatively high beta which could provide significant upside.

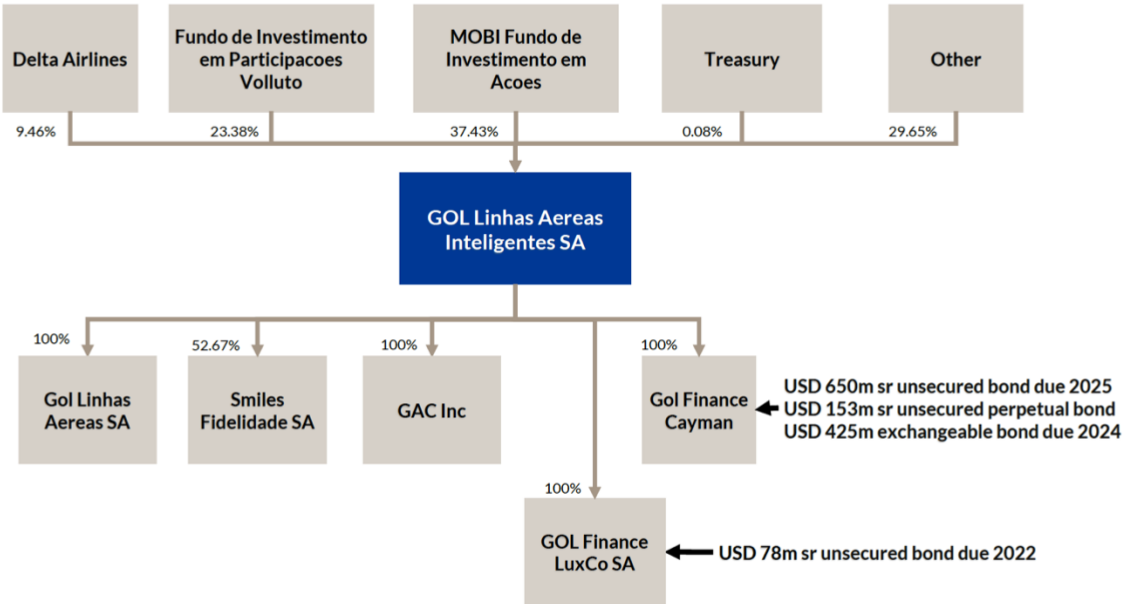
Firm-specific risks include the comparatively high leverage and additional cost pressure, as well as exchange rate volatility given the FX mismatch between revenues and costs. However, GOL has been mitigating currency risk well over the past quarters and the main downside scenario is tied to Brazil's macro-environment.

2. **Company Description**

Gol Linhas Aéreas Inteligentes S.A (Gol) is a Brazilian commercial and freight airline company. It was founded in Rio de Janeiro in 2001. It was the first Brazilian company founded in the XXI century and the first to introduce the "low cost" business concept into the market. The name Gol means success, happiness, victory and it has the same meaning in every country.

Nowadays, the company is the largest Brazilian airline by number of passengers. It operates in sixty airports in Brazil and twenty-three internationally. Additionally, the company owns Smiles, a loyalty program firm, GAC Inc, a logistics subsidiary and two financial units: Gol Finance and Gol Finance Cayman.

Figure. 1 Ownership Structure



Source: Debtwire

Gol almost went bankrupt in 2016, but a provisional measure allowed Delta Air Lines to buy 10% of the company's shares and provided the capital Gol needed. In September 2019, Delta announced that it will sell its shares of Gol in order to conclude its new partnership with LATAM.

In 2018, the company ended the year with 36% of market share in the domestic sector and it operated an average of 750 flights/day. It also created a new business unit, GOLlab, in order to develop more innovation, its net revenue ended the year by R$11.4 bn with EBITDA of R$2.1 bn.

The company has 121 airplanes, including Boeing 737-700 and 737-800.

3. **Company history – the trajectory of success**

The company's first flight was in January 2001, when a Boeing 737-700 took off from the Brasília International airport and another boing landed in Rio de Janeiro International Airport. Only in 2003 the web check-in started. The first international flight also took longer to happen, 2004, with flights between São Paulo and Buenos Aires, after that, the company started operating in Santa Cruz de la Sierra, in Bolivia. By 2005 all the Brazilian capitals were already served.

After an accident between a Boeing 737-700 and an Embraer in 2006, the company's employees started al in order to ask for improvements in the Brazilian airplane sector. Due to that, 2007 was the only year where the company ended with a deficit. In 2007 the company bought Varig - the largest Brazilian airplane company at the time - and then it started offering the mobile check-in. One year later, the company improved its technology and self-check-in terminals were installed on the airports. The flight to Lima, the capital of Peru, started by that time.

In order to expand to the international market, Gol bought Webjet in 2011, forming a partnership with an American Company, Delta Airlines and in 2014 with Dutch KLM airlines. With those acquisitions, the company started flights to Miami with stopovers in Manaus or Caracas. It successfully led to flights between Brazil and Orlando as well as Brazil and New York.

A new logo with two laces, symbolizing the company's purpose of uniting people and places, was launched by Gol in 2015 to celebrate the 100th Boeing 737-800 in the company. Besides that, a new board entertainment, chairs made by recycling leather were announced. The company also started distributing a new healthy snack.

4. **Industry Overview**

The Aviation Industry in Brazil contributes US$19 bn to the country's GDP and generates over 800,000 jobs which are 4.4 x more productive than other jobs in the economy. The lack of competition in the aviation industry in Brazil puts at risk the projection of duplicating the industry in the next 20 years. The main reason is the jet fuel price, which is the most expensive in the world. The global average price represents 22.5% of airline costs but in Brazil it reaches almost 30%.

Two other factors that directly affect the Aviation Industry in the country are: (i) the outdated code of aviation and (ii) the lack of legal security. The first one limits the length of flights for the crew, which needs to be changed in order to adapt the new aircrafts with flight routes of 18-19 hours long. The second one is related to the fines against companies. Every person is able to sue and receive an astronomical fine against the airlines.

A favorable regulatory policy and well developed operating environment are necessary to enable airlines to offer better services and greater value to Brazilian consumers.
The new Brazilian President Jair Bolsonaro is widely viewed as business-friendly who works towards improvements in the Aviation Industry. Until 2022 more than 41 airports will swift a privatization process in order to guarantee a better operational system.

5. Competitors

An advantageous position made possible by the lack of competition is that Brazilian Aviation Companies understand the market and they don't struggle to do business in the country. However, President Jair Bolsonaro is seeking to expand the segment and increase the number of foreign low-cost companies.

Brazil has two strong and large domestic airlines, GOL (39% of domestic travel) and LATAM Brasil (30% of domestic travel) and its fourth-largest Avianca (11%). Avianca is still without a certain future, since Azul is trying to acquire some of Avianca's assets in order to expand its position on the Brazilian domestic market - the biggest in Latin America.

Figure. 2 Brazil domestic traffic share by airline for Jan-2019

Airline	Percentage share
GOL	39%
LATAM Airlines Brazil	30%
Azul	20%
Avianca Brazil	11%

Source: Debtwire

Azul has a potential growth of 16% to 18% in 2019 if the company buys assets from Avianca. It will boost its position in the domestic market, and GOL and LATAM will face a stronger competitor. Something similar happened in 2012, when Azul purchased the regional Brazilian airline TRIP.

In the past three years, the number of domestic passengers in Brazil has grown. However, it has not reached its peak, since the 2015 economic crisis. The fluctuations in currencies also largely affected international flight demand to North America and

Europe. However, GOL and LATAM Airlines Brazil ended 2018 with positive earnings, and this situation appears to be holding steady into early 2019.

Gol was the leader in the domestic market share in January 2019. This result was the highest in the segment when compared to previous years. It also increased the sales in 12.3%. The leadership position is due to the implementation of many strategies to better serve customers. The company also just announced that the losses of the third quarter of 2019 are 60% lower than the same period in 2018.

6. **Rationale:**

In our analysis, we derive three valid rationales, based on which we share preference for GOLL4. These three are (i) Gol's strong Beta correlation with a bullish market environment, (ii) a favorable competitor situation due to the grounding of Avianca, and (iii) Gol's continuous operational efficiency improvements.

6.1. Impact of a bullish market

The Ibovespa index has been bullish for the past three years. Despite the uncertainties of economic growth, there is evidence supporting the continuing rise of the stock market.

Capital inflow is still going strong. Saudi Arabia's Public Investment Fund just announced a US$ 10 bn investment in Brazil. Brazil's pension reform that will save about R$ 800 bn over 10 years is welcomed by the market. Stocks rallied when the Senate gave final approval on the plan recently. That is one more recently reason to be optimistic.

Moreover, the Central Bank of Brazil just cut its benchmark interest rate to an all-time low of 5.00% on October 30th, which also may positively affect the stock market.

If view of the bullish outlook for Brazilian equities continuing, we believe Gol's relatively high beta (2.41) could provide significant upside making it better positioned to benefit from the growth.

And fundamentally, a recovering Brazilian economy can benefit the business by boosting revenue as well. The steady growth of consumer expenditure indicates huge potential of the airline market. The growth of online transactions in Brazil is also believed to be positive for the airline business.

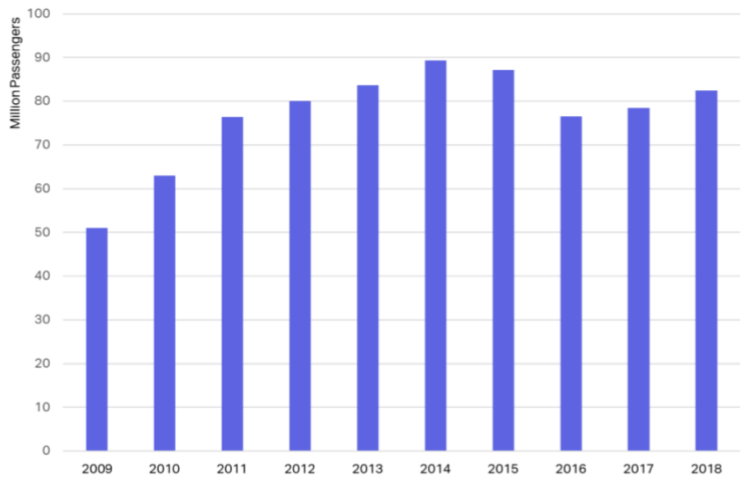
Figure 3. Consumer expenditure forecast

	2018	2019	2020	2021
US$ bn				
Food, beverages & tobacco	303.3	304.5	327.3	347
Housing & household fuels	186	185.3	195.2	203.5
Clothing & footwear	72.2	73.6	79.5	84.1
Household goods & services	49.9	50.9	54.8	58
Health	144.4	143.7	151.6	158.5
Transport & communications	**258.5**	**256.7**	**272.2**	**286.1**
Leisure & education	57.9	57.7	61	63.7
Other	129.7	129.2	137.2	143.9
Total	1,201.90	1,201.50	1,278.70	1,344.80

Source: Economist Intelligence Unit

The number of airline passengers in brazil is close to 94 million in 2018, still lower than that of 2015 when the country was deep in recession and in 2014, when it reached peak. Now with the recovery of Brazil's economy (expected GDP of 2.5% in 209 compared to 1.1%), air travel demand should grow in the near future.

Figure 4. Brazil domestic ASK growth from 2013 through Jan-2019



Source: ATA Economics

Meanwhile, companies are prepared for increasing demand through rationalization. Data from ANAC has shown that the domestic ASKs had increased above 1% in 2018, the first time since the recession. GOL forecasts an increase in domestic capacity from 2% to 4% in 2019. We believe there is much room for revenue growth of Gol.

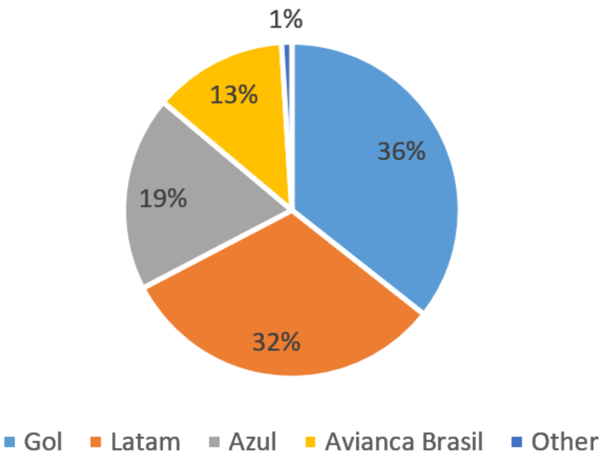
6.2. Bankruptcy of rival leads to stronger unit revenue

Avianca Brasil filed for bankruptcy after years of financial distress. In May, Avianca Brasil suspended its operations.

The grounding of the fourth largest airline reduced the local competition in the industry, creating huge opportunities for its competitors, including Gol.

After the incident, ANAC (National Civil Aviation Agency of Brazil), the airline regulator of Brazil, plans to create a favorable regulatory environment to attract new players to the local market and foster competition in the main routes. However, entry barriers are high in this industry. For example, it took 10 years (from 2008 to 2018) for Azul to reach a 10% market share. So it can be reasonably expected that in the short term, the competition Gol faces will be from the existing companies in the market.

Figure 5. Capacity breakdown in the Brazilian domestic market before Avianca's grounding



Source: ANAC

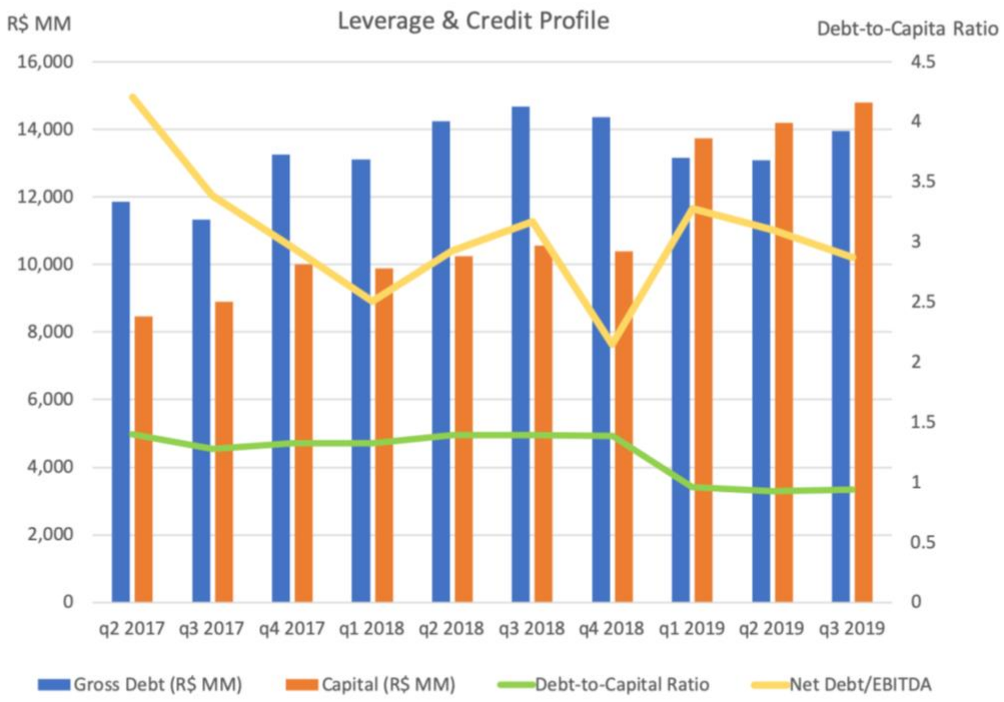
LATAM has only 25% of its overall revenue coming from domestic flights in Brazil. Azul, on the contrary, although mainly operating in Brazil, has limited overlap with Avianca Brasil in terms of routes. Gol is expected to benefit most from the suspension of Avianca Brasil's operations since it has the highest route overlap (85%) with its bankrupt rival. Besides, the fall of a large competitor gave Gol more power on pricing.

According to Gol's 3Q19 result, its total RASK (revenue per available seat kilometer) was up by 19% YoY, which proved the upside brought by less competition. And we expect this benefit will continue going forward.

6.3. Operational Analysis

We consider that GOLL4 has a high potential to increase its value. The company has been increasingly optimizing its operational activity and simultaneously lowering its leverage structure. We favor two specific changes the company has undertaken to increase its profitability, namely deleveraging its financing structure and increasing its airplane airtime and occupancy rates.

Figure 6. Gol Leverage and Credit Profile

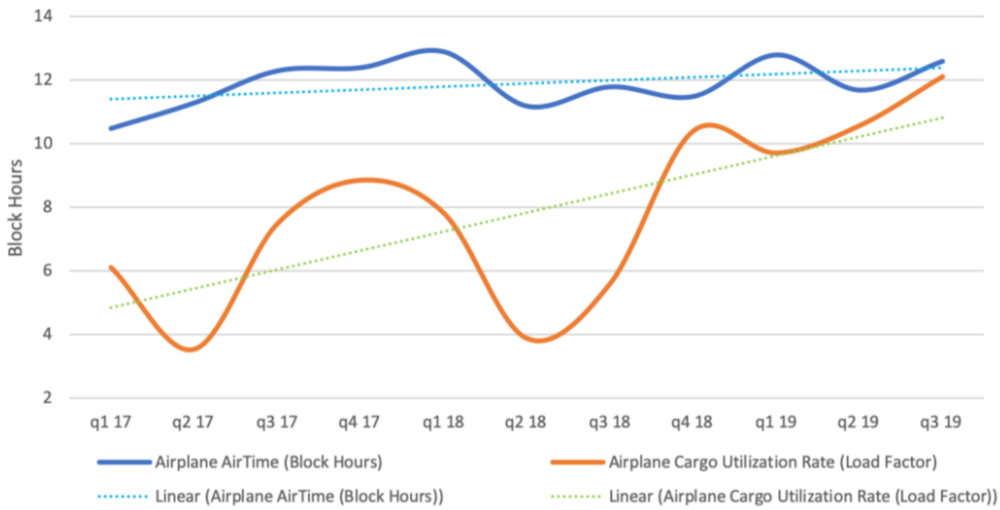


Source: Earnings Reports and Group Analysis

Figure 6 displays the transformation the company has undertaken in its debt structure over the past 12 quarters. From this chart it becomes clear how Gol managed to reduce its Gross Debt post 4Q18 – the company discontinued renting aircrafts – and thereby decreased its Debt-to-Capital ratio below the rate of 1. Whilst this change has negatively impacted EBITDA at first in Q119, we believe it will catalyze EBITDA in the coming months and continuously decrease Net Debt/EBITDA. A first positive indicator was Gol's recent credit rating upgrade from B to B+ by the rating agency Fitch in Q219.

At the same time, Gol managed to optimize its asset usage. Figure 7 outlines the progress the company undertook in both its daily airtime per airplane (Block Hours), and its airplane cargo utilization rate (load Factor). While both measurements are subject to seasonality, we drew a linear trendline to visualize the progress the company is making on these KPIs. We favor Gol because it holds the most maximized capacity management among its direct competitors in the region.

Figure 7. Airplane capacity utilization

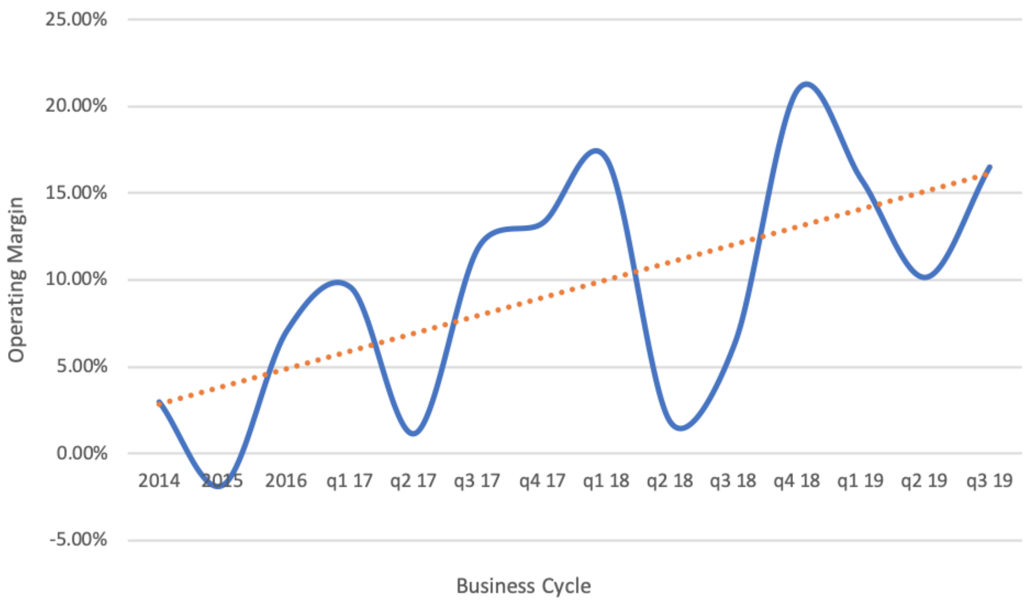


Source: Earnings Reports and Group Analysis

Gol's success in capacity management is also reflected in its operating margin, as displayed in Figure 8. While the margin is subject to periodic volatility – attributed to the business' underlying dependency on seasonality – we can see considerable optimization between 2014 and 2019.

In general, we favor Gol's liability and efficiency management and consider the company has positioned itself optimally to benefit from the economic growth in Brazil.

Figure 8. Operation Margin



Source: Gol Earnings Report and Group Analysis

7. **Financial Forecast**

Our forecast is based mainly on company data (financial statements, earning releases, conference calls, etc), but also includes external material such as broker notes or sell-side equity and credit research.

Regarding the top line, subdivision of domestic and international segments with targeted assumptions are our basis for RPK and ASK. Opex have been modelled in line with the historical trend, taking into account the consensus on aircraft fuel costs and disregarding rent following Gol's strategic choice to abandon leasing.

Figure 9. Financial Forecast

In BRLm	2015 12m	2016 12m	2017 12m	2018 12m	LTM (2Q19) 12m	2019E 12m est.	2021E 12m est.	2022E 12m est.
RPK (Paying passengers * Kilometers)	38.410	35.928	37.231	38.423	40.038	40.503	41.886	43.316
ASK (Available seats * Kilometers)	49.742	46.329	46.695	48.058	49.367	49.910	51.270	51.834
Load Factor	77,2%	77,5%	79,7%	80,0%	81,1%	81,2%	81,7%	83,6%
Revenues	**10.384**	**10.548**	**11.292**	**12.091**	**13.103**	**13.708**	**15.226**	**16.456**
% growth		*2%*	*7%*	*7%*	*8%*	*13%*	*11%*	*8%*
(-) Salaries	-1.581	-1.657	-1.708	-1.904	-2.103	-2.361	-2.533	-2.718
(-) Aircraft fuel	-3.301	-2.696	-2.888	-3.868	-4.162	-4.600	-5.085	-5.620
(-) Aircraft rent	-1.100	-997	-940	-1.113	-297	0	0	0
(-) Other opex	-4.166	-4.054	-4.262	-3.139	-3.690	-3.053	-3.379	-3.063
EBITDA	**236**	**1.144**	**1.495**	**2.069**	**2.852**	**3.693**	**4.229**	**5.054**
% margin	*2%*	*11%*	*13%*	*17%*	*22%*	*27%*	*28%*	*31%*
(-) Interest	-886	-788	-727	-711	-722			
(-) Δ Working Capital	371	-20	118	213	-92			
(-) Taxes	-214	-227	307	-297	-270			
(-) Capex	-435	-439	-1.122	-876	-980			
FCF	**(928)**	**(330)**	**72**	**398**	**788**			
Cash & cash equivalents	1.623	993	1.983	1.305	1.795			
Net Debt	15.382	12.364	11.701	13.629	11.814			

Source: Company filings, JP Morgan, Debtwire, REDD, Group Analysis

While we feel comfortable on our assumptions and underlying model for the income statement, sourced information was not relevant enough to provide for the construction of a forecasted cash flow with sufficient reliability.

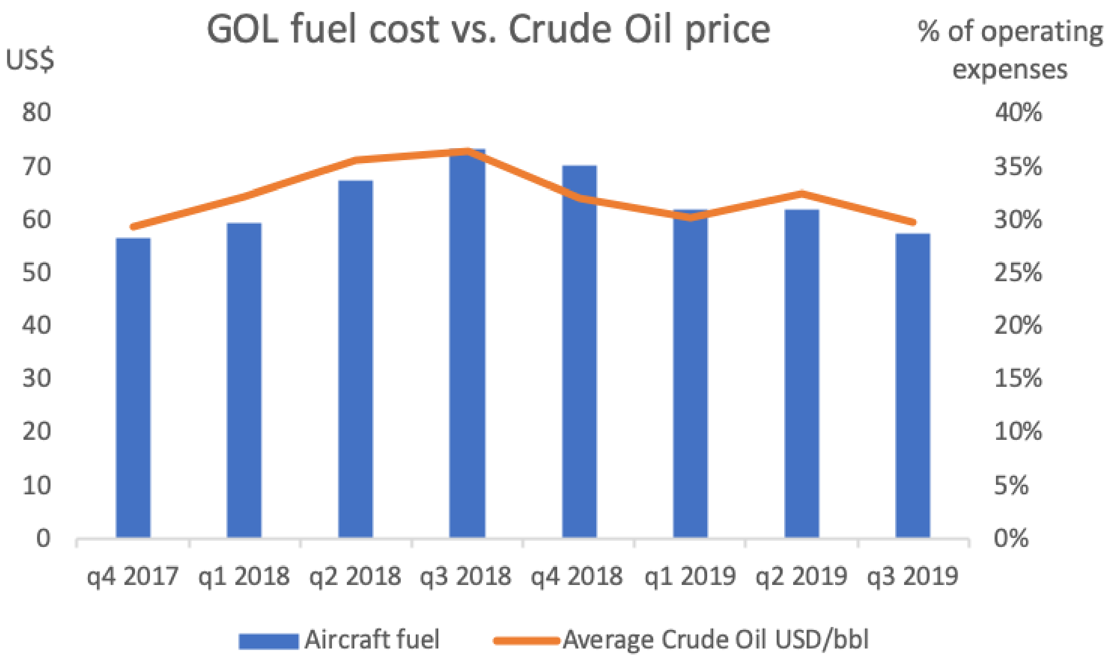
8. **Risk factors**

Throughout our analysis we have detected three major risks that could jeopardize the company's value increase over the coming six months: (i) cost sensitivity to crude oil (ii) FX mismatch between revenues and expenses (iii) the Boeing 737 grounding.

First, aircraft fuel is the largest expenses of Gol - having accounted for 28% to 37% of operating expenses throughout the past 12 quarters. These strong variations in costs are subject to both the WTI Brent Crude oil price as well as the R$/US$ exchange rate. Figure 10 depicts the average price line of the WTI Crude Oil price and Gol's fuel costs.

It becomes apparent that there is a considerable correlation between the two. Hence, despite the fact that Gol hedges the WTI Crude oil price for 50%-70% of its fuel expenses by options, the company's grand dependency on the raw material inherits a considerable risk for its future endeavors – especially because crude oil is priced and paid in US$.

Figure 10. Fuel cost vs. crude oil price



Source: Earning Reports, Group Analysis

Then again, Trading Economics predicts the crude oil to price to deteriorate from its current level at US$/BBL 54.08 to 52.63 by end 2019 and down to 48.24 within the coming twelve months. Independent of the fact that Gol has currently 66% of its fuel expense for 2020 hedged at US$/BBL 61.5, the decrease in crude oil prices – as forecasted - will eventually benefit Gol's profit margin and impact the company's profitability positively. In this respect, is important to highlight that hedge operations made on the WTI can result in operating losses as was the case in Q319, amounting to R$ 7.9 million.

Second, we perceive a certain risk in the currency mismatch of revenues and costs. While we estimate 80% of the operational revenues are received in local currency, costs in foreign currency (mostly in US$) are estimated to amount to more than 85% of costs LTM. The main drivers of these costs are aircraft fuel costs (55.5% of total costs LTM) as well as interest payments (8% of total costs LTM).

While Trading Economics predicts the R$ to depreciate against the US$ by approx. 5.5% to a rate of 4.2 throughout the coming 12 months - Gol's foreign currency exposure is mainly towards the US$ - we are confident of Gol's short term performance for two reasons: (ii) Gol has managed currency depreciation in the past by successfully hedging its foreign cash flows by swap operations, and (iii) Gol has been decreasing its debt exposure considerably throughout the previous three years and, consequently, decreased foreign currency interest payments – a strategy Gol is expected to continue pursuing.,

Lastly, Gol – similar to its competitors – is awaiting the undergrounding of its seven Boeing 737 8 Max. While various US news agencies raise uncertainty about the length of the planes' grounding, Gol expects regulators to approve the Max's return to the market by December 2019 and will take delivery of its fair share of ordered 737 Max and 8 Max as soon as they are available. Even though we view this outcome as still uncertain, a positive outcome provides meaningful upside in the short-term.