

Q3 2020 Earnings Call

Company Participants

- Mario Sampaio, Head of Capital Markets and Investor Relations
- Rui de Britto Alvares Affonso, Chief Financial Officer and Investor Relations Officer
- Unidentified Speaker

Presentation

Mario Sampaio

Okay. Good morning, everyone, and welcome to SABESP's video conference to discuss the results for Third Quarter of 2020. My name is Mario Sampaio, I am Head of Capital Market and Investor Relation. Let's start by informing all participants that this video conference is being recorded, the presentation accompanied by slides is been transmitted over the Internet through the website www.sabesp.com.br and through the MZIQ platform. Presentation will be available for download on the same portal as well as the results release.

We remind you that the questions will be accepted to the speakers only through the videocast platform. Our conference will take approximately 1 hour and 30 minutes and we will reserve 45 minutes for potential questions and answers from analysts and from journalists.

Before proceeding, we would like to clarify that any statement that may be made during this conference, relating to the Company's business prospects projections and operational and financial goals constitute the beliefs and assumptions of SABESP's management as well as information currently available for the Company. Future considerations are not guarantees of performance, they involve risks, uncertainties and assumptions as they refer to future events, and therefore depend on circumstances that may or may not occur. Investors should understand that general economic conditions, industry conditions and other operating factors may affect the future results of the Company and may lead to results that differ materially from those expressed in such forward-looking statements.

Today with us, we have Mr. Rui Affonso, the Chief Financial and Investor Relations Officer; Mr. Marcelo Miyagui, Accounting -- Head of Accounting; Mr. Agnaldo Pacheco, Controller -- Company Controller; and Mr. Luis Guerreiro [ph] Head of Costs and Tariffs. Well, we have a presentation to go through. But before we start, I'd like to make some general considerations on the Company's performance in the period.

In this quarter with the pandemic crisis still in course, the crisis imposes caution and challenges in the economic field, we observe the initial resumption of economic activity with some sectors in the reopening phase. However, the recovery has still been very timid

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and at a slower pace than desired. This is reflect -- this is reflected in the company results with a direct impact on revenues, as a consequence of the change in the consumption mix due to the increase in volumes in the residential category and reduction in volumes on the industrial and commercial that have average tariffs higher. But all in, leading to a reduction in the total average tariffs.

In addition to this, we also had higher delinquency levels. We recently started our water year that runs from October to March. So let me -- let's remember how that went last year (inaudible) year went. In terms of water resources, we have been experiencing a period of severe drop and higher temperature and notice that the works carried out in the last few years, especially those that were -- that added more water capacity during the water crisis has proven to be efficient, eliminating the risk of water shortages in the metro region of Sao Paulo.

Considering that the rainfall season then starts now -- started in October, rainfall is expected to increase and water resources are expected to return to more comfortable levels in the next few months. It is important to highlight that as in the water crisis today, in the context of the economic and health crisis, we maintained a strong level of investments despite all these events. From the financial point of view, we have taken a series of measures, aimed at strengthening the company's liquidity and mitigating the effects of the exchange rate uncertainty and volatility, exchange exposure. In this slide, we issued the 26 debenture in the amount of BRL1.45 billion during the third quarter, which adds to a total BRL2.5 billion, so far of debenture issuances this year.

We also prepaid the USD250 million foreign currency dollar -- foreign currency debt of Eurobond that would mature on late mid-December. In May this year, let's remember we had already exchanged debt from an IDB loan of USD494 million, we changed it to reals representing BRL2.8 billion.

If we combine these two movements, we reduced exposure to foreign currency from approximately 49% during last quarter last year to 25% this year, reversing thus this adverse situation of a high financial expense due to the increased devaluation of the real against the dollar and increased at the meantime, the company's resilience to this factor.

We also obtained from BNDES the postponement of interest payments in operation norms that standstill in the amount of BRL131 billion that were maturing during this year and we've reserved our cash by using guarantees insurance to avoid cash outflows, so far BRL220 billion. Also this month we signed a financing -- in fact, a loan agreement with IDB Invest, IDB Invest is the private area, Bank Of the IDB Group that is in the total amount of BRL950 million.

These actions resulted in the maintenance of liquidity and payment capacity ensuring the execution of the expected investment of BRL3.5 billion this year. In fact, in the third quarter, we invested up to BRL1 billion and in the nine-month, we are already at BRL3.1 billion. This quarter was also marked by the bidding process for rendering the service in the metropolitan region of Maceio taking advantage of the window of opportunities that arose after the approval of the new framework from the sanitation sector. We participated

in the competition with a minority stake in the consortium with a private partner. This move is to show that SABESP is prepared to expand markets and participate in other competitions in the future.

With regards to regulation, we have the tariff adjustment of 2.49% to 4% and plus the compensatory adjustment of 0.888% this last due to the postponement of the application of the adjustment in April resulting then in a total adjustment of 3.4026% in effect since August, 15, which being in effect since August also partly offset the adverse effect on revenues that we had during the period.

Okay. Let's now go to the slides. Let's start on Slide, 3. Okay, here we can see a 4% increase in total billed volume in the quarter, 3.1% of which was from water and 5% for sewage, excluding Maua/Santo Andre and the retail segment of the residential social and Favela categories, the total increase was 0.6%. Similar to the previous quarter, volume growth was anchored in household consumption with the residential category increasing by 3%, while non-residential categories fell by 14.7%.

Let's now move to Slide 4. Here we go through our financial highlights. Income totaled BRL421.6 million in the third quarter of 2020 compared to BRL1.2 billion in the third quarter of '19. The decrease was due to the non-recurring revenue recognized by the signing of the agreement of the municipality of Santo Andre in the third quarter, which resulted in a negative variation of BRL1.3 billion compared to the same period last year.

This impact on the result was offset by efforts to reduce foreign exchange exposure, as already mentioned, with the currency exchange of the debt, especially the IDB debt with close to BRL500 million, and then with a positive effect on the results for the period of BRL395 million. Net operating revenue fell by 18% from BRL5.4 billion in third-quarter '19 to BRL4.4 [ph] billion in this third quarter '20 due to the effects arising from the agreement -- exact agreement signed with the municipality of Santo Andre from in the third quarter of '19. This then resulted in a negative variation of BRL972 million in the period.

Added to this, was the effect caused by the change in our tariffs mix with the residential category with lower tariffs accounting for a greater percentage contributing to the reduction of revenue in the period. Costs in the period, costs administrative selling expenses and construction costs increased by 20.5% in the period, contributing to the reduction in operating margin, excluding construction costs the increase was 11%.

Consequently, adjusted EBITDA was significantly affected falling for BRL1.5 billion -- falling by BRL1.5 billion from BRL3 billion in third-quarter '19 to BRL1.5 billion in 2020. The adjusted EBITDA margin fell from 55.6% to 34.1% this quarter. On a 12-month basis, the margin was 35.8%. Excluding the effects from revenue and construction costs, the adjusted EBITDA margin was 44% in the third quarter of 2020 compared to the margin of 63% in third quarter '19 and 44.3% is the last 12-month margin for this quarter. In summary, the drop in EBITDA was due to the non-recurring events of the third quarter of '19 added to the deterioration of the economic condition of the period.

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Let's go now to Slide 5 to analyze costs, compared to the same quarter in '19, costs administrative selling expenses and construction costs increased BRL588 million or 20.5%. Construction costs increased by BRL346 million compared to third quarter from BRL682 million to BRL1 billion due to investments in the construction of assets, I mean, more investments.

However, excluding construction costs, costs and expenses increased by 11% from BRL2.2 billion to BRL2.4 billion, a variation of BRL242 million. Among the most significant variations are salaries, payroll charges and benefits and pension plan liabilities of BRL153 million or 29.5% mainly due to the negative variation of the reversal of expenses in the third quarter of '19 related to fact of the retiring program in the amount of BRL173 million. Excluding this non-recurring effect, personnel expenses would have decreased in the quarter explained, mostly to the average reduction of 2.8% in the number of employees, mainly due to the gradual employee termination under the knowledge retention program called PCR. The variation is an estimated loss and allowance for doubtful accounts in the amount of BRL112.7 million, also contributed significantly when compared to the same period of last year. This was partly explained by the reversal of BRL51.5 million in third quarter from the agreement with the municipality of Santo Andre and also by the increase in the level of default caused by the economic instability worsened by the COVID-19 crisis.

Let's now move to Slide 6. Here we will analyze briefly the main changes that affected the results. Net income fell by BRL787 million as previously explained. Net operating revenue decreased to BRL972 million. Cost and expenses including construction costs grew by BRL588 million. Other operating revenues and expenses including equity results came in negative by BRL11.7 million. It's worth noting that our financial results, which had a positive variation of BRL389 million was mainly due once more to the company's management to reduce the FX exposure. Finally, income tax and social contribution fell by BRL395 million in view of the lower taxable income recorded in the quarter when compared to the same period last year.

Let's now go to the next slide, Slide 7. Here we'll briefly comment on management performance indicators. Although the gross revenue per bill cubic meter indicator was 8.6% lower in third quarter this year over third quarter of last year, this indicator has been reporting a growing average monthly increase, as you can see on the top left.

Operating expenses per billed cubic meter increased in controlled manner and compatible with the growth of our operations. In third-quarter '20, these expenses increased by 11.5% over -- decreased, sorry by 11.5% over third quarter '19, in line with the budget adjustments we've made in the second quarter of this year of BRL300 million which we did comment on our first-quarter call, and then another executed in the third quarter of an additional BRL150 million. As a consequence, the third quarter of 2020 had a positive evolution compared to the beginning of the year, despite being 10.4% lower than results in third-quarter '19, as you can see on the top right.

On the bottom, you can see the average evolution of the indicator EBITDA per billed cubic meter that has also a growth trend in the period. This illustrates that despite the adverse scenario, we managed to reduce expenses, offset lower average tariffs and maintained cash generation levels without neglecting our investment plan.

Let's now quickly talk about regulation on the next slide. Okay. First, this is basically -- let's talk about the third quarter ordinary tariff review scheduled for completion in April 2021. The report on the regulatory asset base and the business plan have already been delivered to Arsesp. And in January, the preliminary PO will be released.

It is worth remembering that until the conclusion of the review, there will still be some important steps and public hearings for the calculation process of the average tariff, so let's keep an eye, still within the scope of our Arsesp's '20 to 21 regulatory agenda, we contributed with a public consultation regarding losses and we are currently working on another that addresses the criteria for sharing alternative revenues.

We still have other topics on the agenda such as conservation program for water resources, settlements of exclude made by the asset base for the first tariff review and detailing of the risk metrics. Regarding the exclusions made at the asset base in the first tariff review, we're working on this analysis and we'll present our study shortly.

The revision of the tariff structure is expected to be concluded by March, 21, but it's important to note that the future structure may differ from the current one, thus the required revenue that will be allowed will be distributed within the new tariff structure, which means that there may be different tariffs per category that we have today. So there's going to be a new distributor.

Let's now move to Slide 4 [ph]. Let's comment that in a little bit more detail on the water situation of the reservoirs in the metro region of Sao Paulo. The '19/'20 water season that ended in September had a lower than average rainfall. The Cantareira system received 74% of the expected volume, while the Alto Tiete received 72% and Guarapiranga system 68%.

Next slide. With inflows below average on the three main supply systems the Alto Tiete has been recording inflows close to its minimum historic levels, as you can see they went very low.

Let's go to the next slide. Considering the integrated system for the entire metro region of Sao Paulo, the system's total available water volume for October 31, was 45.7%. Although this volume was lower than the same period in '19, it is 1% higher as you can see from 2018.

It's worth noting that the drop in water reservoir levels between April and September is normal, as the rainy season concentrates between the month of October and March. So the purpose, obviously, of the reservoirs to guarantee water supply during April and September when rain falls less, despite rainfall then falling less than expected, as we saw, we can observe that the water shortage -- storage, sorry, from the water sources that supply the metro region of Sao Paulo is under control. The construction works that we carried out such as the Sao Lourenco production system and the Jaguari/Atibainha interconnection increased the system's water security for the metro region of Sao Paulo during the periods of the -- this period of lower water availability and stress.

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Next slide. Finally, it's worth noting that the impacts of the economic crisis and consequently, the average incomes of families combined with the pandemic brought a change in the consumption pattern of the population with an increase in residential construction, as I already mentioned a drop significantly in commercial and industrial production, maintaining -- although maintaining practically the same volume produced, as you can see in the graph average production in the Sao Paulo metro region in October was 63.3 cubic meters per second and volume 500 meters second lower than in October '19.

Well, before we finalize, I would like to briefly detail on the company's debt and liquidity management. As already mentioned, the company has been working to guarantee the execution of investments to meet debt maturities, maintaining its assumptions for strong cash position and lower exposure to foreign currencies. With the approval of the standstill agreement on BNDES financing contracts, which in fact provided the suspension of debt services for six months, SABESP has a cash release as mentioned also of BRL181 million until December this year. Detailing more, this month we formalized the financing -- the loan agreement with the IDB Invest. The amount, just to remember is, BRL950 million and in two tranches, there is a long trench with long terms of BRL400 million -- BRL508 million which proceeds will be invested in two projects, the Novo Pinheiros project and a renewable energy plant -- plants in fact, are many plants. They are solar plants.

And the second tranche in the amount of BRL442 million, the proceeds will be used to refinance debt including the Eurobond. The transaction is unsecured, and the total borrowing amount will be disbursed one time by the beginning of this year. So this is a very emblematic move. It is a multilateral lending in reals, lending with no guarantees and associating to investments and to cash support and refinancing, so this is very important.

At the end, such funds will be relevant to further and simultaneously preserve our CapEx execution capacity and support our liquidity. So that's basically what we have for the slides.

We are now open for questions. So let's see if we have yet a question.

Questions And Answers

A - Mario Sampaio

But we have -- I am opening for question guys, okay? We have one question that I can see here. Let me check, one second. As I was speaking (inaudible). Okay. We have one question from Lilyanna Yang from HSBC. The question is -- there are one, two, three questions. First, can you please update us on the precedential details on the June approved Federal Sanitation bill, which are pending analysis of the Congress and are relevant for SABESP? That's one question.

Second question, can you discuss the appetite for new concessions out of Sao Paulo State and rationale of partnering with Igua as opposed with other private run players or as opposed to bidding alone?

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And the third, can you please quantify cost impacts and savings with your ongoing voluntary plans and other saving initiatives?

Rui, I'm addressing this to you. Do you want me to repeat the third question?

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

I believe that I've got it. The first one, my understanding is from the -- there are many of vetoes that are in discussion in the Congress to reject it or to approve it at all, for us is this right now because the law is effective right now. If the Congress extends to you don't make any change in order to -- to the presidential vetoes, the main important impact for SABESP could be the one that if they drop it down by the Congress allow the extension of the modality of program contracts for us and for everybody. In our case, it's not some deal issue -- deal broking issue because it's -- as you are following, especially you Lilyanna, we have assured great parts -- both parts of our contracts before the law was in action. So we don't have a major problem in that. If there is any change in this veto, the extension of the terms not make us more program contracts, will benefit us as well. So I cannot see any major impact on our side.

A - Mario Sampaio

Okay. The second question is, can you discuss the appetite for new concessions out of Sao Paulo State and the rationale of partnering with Igua, as opposed to with other private run players or as opposed to building one alone? Rui, yes, back to you.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Okay. Where we do have an appetite to dispute some contracts, some concessions, outside Sao Paulo, we've at the very beginning of this movement, as you all can see, there is still some warranties in progress inside (inaudible) that's formulating some valuation and some rules for different state companies for privatization of open concession in the new regulatory framework. So we are also analyzing preparing ourselves to compete and to participate in those deals. We don't have a specific disclosure, but we want to -- we have to make the movement very carefully when possible to make in partnership with the private sector, ideally being minorities in order to have the most as possible the flexibility to operate in partnerships with the private sector. So these are the general guidelines in order to move ahead.

A - Mario Sampaio

Okay. The third question is, can you please quantify cost impacts and savings with the ongoing voluntary plan and other savings initiatives? can you -- could you address that too?

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

In the conference call this early morning here in Brazil, we have comments on the provision we have made to this dismissal for those remaining employees to the end of this year. So the deadline is the end of the year. There would be approximately in total around 1,000 employees, senior employees, that will be dismissed, and the part of that have

already the dismissal, already, and we have make a provision, I believe this is a BRL130 million will be add with (inaudible) everyone. And we do expect a important next year result, return because they are senior officers. so the highest salaries we have in the company. So, the proportion is that, if we have 1,000 we have made a provision of BRL130 million and we expect good results from these payback on this retirement plan.

A - Mario Sampaio

Okay. Well, we're open for questions. There seems -- we will wait a little bit more for some more questions. Okay. Well, Rui, let's do this. Let's end, but -- so I don't see any questions coming in. So I pass the word to you, so you can close the conference call, please.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Yes. Well, we wanted to thank you all. I believe there is a final question probably coming now.

A - Mario Sampaio

Sorry. Yes, yes. I got confused. I truly apologize. We do have a question. And Guerreiro [ph], thank you very much. I don't why I got -- I think I have too many screens in front of me, I got a little bit lost. Sorry for that. And sorry, Alejandro Demichelis from Nau Securities. So Alejandro -- the question Alejandro has is, could you please indicate how you see the evolution of delinquencies in the coming quarters and what actions SABESP is taking to reduce that? And good we've got another question.

Can you, guys -- Rui?

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Well, the delinquency rates is -- we expect the coming together by the hand with the economic situation of the country, the employment rate in Brazil. Those rates goes up during the crisis and unemployment rate, so we have seen these delinquency rate goes up also for everybody and for SABESP also. We expect that in the coming months little by little we'll recover on those payments or the reduction of the delinquency.

It's difficult to estimate how much because it doesn't depend only on the SABESP measures because those people don't have, say, their jobs. They are losing money, the wage, so it's very difficult situation that are not under the control of the company, different from a normal situation, day by day situations. So it's difficult to predict. The prediction of the delinquency rate depends on the prediction of the economic crisis and the pandemic crisis, so they are together. We expect, as the economy comes back, we reduce also the delinquency rate to our historical levels. That's it.

A - Mario Sampaio

Okay. We have Hasan Doza from Water Asset Management, asking us to talk about tariffs but that's a very broad question, not even a question. And Hasan we'll wait a second, but could you be a little bit more specific on one or two topics you want us to dig in more? Is it possible or else we're going to be very generic here on what we are going to say?

Okay, guys, Hasan has sent us here, one point to begin. First, he would like us to go dig in into the rate based issue? Guerreiro or Rui, you guys decide. But I think the rate base is the first -- it's very broad but it's the first point that Hasan wants us to give him our view how things are going on. So Rui, please or Guerreiro, guys take it.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Guerreiro, you want to comment on that?

A - Unidentified Speaker

Yeah. I can do that. No problem at all. So first, I would understand rate base as the part of our weighted average cost of capital, that has been defined in the last quarter as 8.1%. Obviously, in a broader question the thing that we should be commenting on is, it's pretty much in line with what we had before. Like we have 8.11% before, now 8.10%. We are able to prove we're on capital rate on this 8.1%, and obviously, we expect the rest of the tariff review process to be also very transparent and very in line with a balanced tariff review process.

And that being so, obviously, we would be very much happy, if I may say that word, with the out come. It's important to mention that we have delivered over our regulatory asset base is to the regulator early this month and the next step of the tariff review process is in mid-January, when the regulator is going to published the PO, preliminary PO amount. Obviously, between now and then we are exchanging a bit of information where we verify the regulatory plan that was delivered to them. They come back with questions, we are answering them. Also they have a few other steps on the regulatory agenda in regards to other revenues, for instance, that are shared with users.

So right now 100% of all the revenues that the company has access to is being shared with users. So, we want to reduce this percentage, obviously, so that the company could profit on this portion. And the other important part of the tariff review process is related with the adjustments that we had in our first regulatory -- in the first cycle when the regulators looked at that regulatory asset basis. We want to review some of the cuts, we had in that process, and we should be -- we are concluding the studies on that, and we should be delivering our report to the regulator from now to the end of the year. I guess that's kind of covers not only the rate part but also the entire regulatory review process.

A - Mario Sampaio

Okay. Hasan, I think -- Hasan -- while you were talking he made, but let's see if you covered. He basically asked if we could comment on the asset base, especially the recovery in the past disputes from the last tariff review, you just mentioned. Okay? And the second is to hear your views on the preliminary technical process scheduled for 2021, if you have any other comments on that one?

A - Unidentified Speaker

Yeah. Okay, I mean everything is moving towards having, as I mentioned, having a PO in mid-January. We are receiving few questions from the regulator. Even if you were to look at the process like water loss process, the regulator has published it -- has been for a

public consultation on it and has received and read some of the feedback. Obviously, SABESP produced some feedback and the regulatory processing that. So everything is moving towards the belief that we should conclude the regulatory tariff review by mid-April.

The next important step is actually mid-January, January 14 if I'm not mistaken. So that's the idea. It is moving as expected.

A - Mario Sampaio

Okay. Let me see if we have more questions coming in. Any more questions before we terminate. Let's wait a couple of seconds here, there is a delay here. There is a delay. Okay. Please correct me if I'm wrong, but I don't see any more questions. Rui, it seems like we do not have more questions. I don't get any -- telling me -- yeah, there is another. So, there is one, just arrived.

Well, landed one from Lilly. Okay. Follow-up to (inaudible) from Lilly HSBC. The regulator has been tough on SABESP asking it to be very efficient, more than local Brazilian companies. Is the methodology changing so as to be more beneficial to SABESP? Will the regulator include the RABs of Santo Andre, Maua, Guarulhos this 2021?

A - Unidentified Speaker

Interesting question. Beneficial -- I mean there is a lot of interpretation around the beneficial right. SABESP doesn't want a beneficial outcome of the regulator that kind of could be -- could lead to the impression that there is a favor there. We just transparent balanced process. That's it. And the rest we believe we can deliver. So, that's -- I wouldn't use this word at all, we want a balanced transparent process and that's what we are getting so far. So as I mentioned, I should be careful with the word happier, I mean using that due to lack of another word in English right now that comes into my mind, but as long as -- yeah, as long as the process keeps some going the way it has been gone through the last few months and weeks, we will be satisfied with it. Satisfied is a better word than happy. Now, in regards to Santo Andre, Guarulhos and Maua. Guarulhos is already in the regulatory asset base report we delivered to the regulator on November 3. So there should be no reason for the regulator, not to consider that. In regards to Santo Andre, we are going to conclude that by end of the year and we should be delivering something to the regulator by then. Obviously, in that situation, there is a bit of a gray area in there, as we have asked the regulator to consider anything by December 20, but the regulatory asset base report from June 19 was delivered in early November. So there is a bit of gray area in there. We want the regulator to consider that and some of the communication extended to the regulator also takes that into account. So there is room for the regulator to consider that, but it's subject to the process, we think the regulatory body which I really can't comment on.

And Maua, the likelihood of Maua getting to the regulatory asset base for this cycle is low to none. I think it's none, to be honest. Important to mention is that the fact that it's not getting there on the economic side means that we will be considered in the next tariff review process back to the date it was incorporated in our regulatory asset base. So there

is no loss, no economical loss in this process. Obviously, there is a liquidity which we'll consider, but other than that there is no economic loss.

A - Mario Sampaio

Any more questions. Still, no questions. Let me keep a close eye here, with things coming very quickly. Okay. Let me ask. Okay, Rui, so I think we don't see -- I don't see on the screen here any more questions. So the word and the floor is yours, Mr. Affonso.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Thank you, Mario. At this time, I would like to thank you -- all of you who joined us in this third-quarter results conference, and we are looking to see you and to listen to you in the next quarter conference results call and -- or any moment with our IR team, with Mr. Mario Sampaio and all of our team. Thank you very much. Good day for, everybody.

A - Mario Sampaio

Goodbye.

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