

Q4 2017 Earnings Call

Company Participants

- Mário Azevedo de Arruda Sampaio, Head-Capital Markets & Investor Relations

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen. At this time, we would like to welcome everyone to SABESP's conference call to discuss its results for the full year of 2017. The audio for this conference is being broadcast simultaneously through the Internet on the website www.sabesp.com.br and on the MCIQ platform where you can also find a slideshow presentation available for download.

We inform that all participants will only be able to listen to the conference during the company's presentation. After the company's remarks are over, there will be a Q&A period. At that time, further instructions will be given.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and presentation of SABESP management and on information currently available to the company. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties, and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of SABESP and could cause results to differ materially from those expressed in such forward-looking statements.

Today, with us, we have Jerson Kelman, CEO; Rui Affonso, Chief Financial Officer and Investors Relation Officer; Mário Arruda Sampaio, Head of Capital Markets and Investor Relations; Sylvio Xavier, Head of Costs and Tariffs; and Marcelo Miyagui, Head of Accounting. Please note that this event is being recorded.

Now, I'll turn the conference over to Mário Sampaio. Sir, you may begin your conference.

Mário Azevedo de Arruda Sampaio

Great. Thank you and welcome, everybody. We would like to thank you for participating of our teleconference for the - to discuss the results of 2017, and we will also update you on the tariff review and comment on the hydrological condition. We have a eight-slide presentation. And, as usual, after this, we will go through our question-and-answer sections.

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So, let's move to slide 3. Here, we can see the company's billed water and sewage volume, which was up 4.3% in 2017, with an increase of 4.3% in water and 4.2% in sewage. Despite the awareness of part of the population with incorporation of rational consumption habits acquired during the water crisis, the largest growth volume occurred mostly in the residential sector than in the industrial sector. The declining consumption can be explained mostly by the small or low growth of economy.

On the slide, you may also note that billed water volume has been rising since the third quarter of 2015. Among the main factors that contributed to this increase in volume, we highlight the increase in the number of water and sewage connections, a rise in the volume billed to the wholesale market, and the slight increase in average consumption.

So, let's now move to the slide 4. This is where we comment on our financial results. Revenue was impacted by a number of factors such as the growth in billed volume already commented, the tariff adjustment of 8.4% in 2016, and the tariff repositioning or the preliminary tariff review of 7.88%, and this also added 0.5% of the pass-through of ARSESP regulation, controlling inspection fee, which is also in place since last November. We should also remember that this - that there was an intense work with the regulator, with ARSESP, in the first stage of the second ordinary tariff review. And although the increase of 7.88% had a small impact in 2017 as it came fairly closer to the end, it will have certainly a relevant effect on revenues and - on the year of 2018. It's also worth mentioning the lower recognition of estimated loss with wholesale revenue in 2017. This added to BRL 125 million and it was due mostly to receipt of receivables from the wholesale, but mainly from the municipality of Guarulhos.

The gross operating revenue related to rendering sanitation services in the amount of - added to the amount of BRL 12.2 billion. This does not consider construction revenue. In this case, showed an increase of BRL 1.1 billion or 9.9% when compared to BRL 11.1 billion total in 2016. Net operating revenue increased by 3.6% or BRL 510 million. As for costs in 2017, there was a decrease of 0.3% when considering administrative and commercial expenses and construction costs, much less in comparison to the 9.9% increase in gross revenue, excluding construction costs and non-recurring revenues arising from pension fund migration from the Defined Benefit Plan to the Defined Contribution Plan in 2016. That's in the amount of BRL 307 million. There was a 3.2% increase in costs, still well below gross revenues growth - revenue growth at 9.9%.

As a consequence of the aforementioned variations, adjusted EBITDA reached BRL 5.3 billion. This is an increase of 15.3% and compared - much more compared to the BRL 4.6 billion reported in 2016. The adjusted EBITDA margin for 2017 was 36.1% compared to 32.4% in 2016. If we exclude the effects of revenue construction costs, adjusted EBITDA margin resulted in 45.4% in 2017 against 43.3% in 2016. Also in 2017, reported profit was BRL 2.5 billion against a profit of BRL 2.9 billion presented in 2016.

Let's move on to slide 5. Let's comment on the main variations in the year or cost variations in the year 2017. As discussed in the previous slides, compared to 2016 costs, administrative and commercial expenses and construction costs decreased by BRL 31.4 million or about 0.3%. If we exclude construction costs and expenses, the increase was in the order of BRL 540 million or 7.7%. The items that presented significant growth were

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salaries, benefits and social security obligations with a close to 20% variation, depreciation and amortization with a growth of 13.5%, and general expenses with an increase of 8.6%.

With regards to salaries, benefits and social security obligations, we should note that of the BRL 533 million total amount, BRL 307 million refers to the revenue recognized in 2016 related to the anticipated reduction of the actuarial deficit as a result of the migration of participants from the Defined Benefit Plan to the Defined Contribution Plan, something that we have already highlighted previously.

It is worth noting the decrease of also - it is also worth noting the decrease of 14.9% in electricity due to the average reduction of, and this is important, 12.7% reduction in the free contracting environment tariffs, this compensated in part by a close to 17% increase in consumption in this category, 27.5% reduction in the distribution system rates, but compensated in part by an increase of close again to 20% in consumption and 5.3% reduction in regulated contracting environment tariffs. But, in this case, there was a leverage, because there was a decrease of 5.7% in the consumption.

In general expenses, we highlight the increase of BRL 7.3 million (sic) [BRL 70.3 million] related to the agreement signed with EMAE on October 28, 2016. This is a non-recurring item of expenses, which puts an end to all the existing actions between the two companies. Whole suspension costs we - were fulfilled on October 19, 2017. For more details on the variations of our costs, please always refer to our press release results.

Let's move on to slide 6, and comment on the main variations that affected our net income. In this case, this is always in comparison with the same period of 2016. Net income, as already mentioned, was BRL 2.5 billion. Net operating revenues increased BRL 510 million. Costs and expenses added to construction costs decreased by BRL 31.4 million. Other operating income and expenses decreased by BRL 9.3 million. Financial expenses increased by BRL 1.16 billion, mainly as a result of the BRL 1.18 billion increase in exchange variation on loans and financing. This is mostly due to the appreciation of the dollar and the yen against the real in 2017, with 1.5 percentage and 5.3 percentage, respectively. And this compared to a devaluation of - in 2016 of 16.5% and 13.9%, same thing, in terms of dollar and yen, respectively.

Income tax and social contribution decreased close to BRL 200 million. This is due to lower taxable results presented in the period, also mainly impacted by the appreciation of the dollar and the yen against the real in 2017, once more compared to the devaluation in 2016. What is really important to emphasize is that the operating result was the main driver for this year's profit. And contrary to 2016, 2017 profit was not favored by the impact of exchange variation.

Let's go to slide 7. Here, we will briefly discuss the situation of the reservoirs that supply the metro region of São Paulo. Rainfall in the 2017-2018 hydrological year, which began last October, was below the historical leverage (13:03) to March 23. Until this date, the Cantareira received 78% of the expected volume, the Alto Tietê, 72%; and the Guarapiranga, 69%. The Cantareira System, as you know, the main system that supplies

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the metro region of São Paulo, began the hydrological year of 2017-2018 at 51.6% of operational volume. That's equivalent to 506 billion liters of water; and held on March 23, 533 billion liters of water or 54% of the operational volume.

Looking at the metro region of São Paulo Integrated System, today, the total available volume, as you can see in the slide, is practically the same as that observed last year for the same day. This volume accumulated, and the start-up of the São Lourenço Production System in the Jaguari-Atibainha interconnection at the beginning of this year, about which we will comment in more details on the next slide, together with the lower water production due to the reduction in demand after the water crisis. The company understands that water security in the metro region of São Paulo is the short to face hydrological situations of similar magnitude as observed in the years of 2014 and 2015.

Let's move to slide 8. Let's comment on the projects in the metro region and give you more details on where they are. Let's start with the Jaguari-Atibainha interconnection, which has an average pumping capacity of 5.13 cubic meters per second of water from the Jaguari reservoir in the Paraíba do Sul water basin to the Atibainha reservoir in the Cantareira System. This investment is already in the preoperational phase and thus practically ready to provide more water for treatment in the Cantareira System if in case necessary.

The other reporting investment is the São Lourenço Production System. This will be inaugurated in the coming weeks, representing close to 6.4 cubic meters per second in the water availability and the production capacity of the São Paulo metro region. In fact, with this new system, the number of systems that are part of the metro region integrated system rises to nine. So, if today we add these two new investments to those that were already made since 2015, there is an increase of 18 cubic meters per second in water availability and 7.4 cubic meters in the capacity to produce treated water.

In addition and also part of the initiative to increase water security in the metro region, SABESP continues with the negotiations to begin the work of transposing the Itapanhaú river that flows to the Atlantic to revert it to the Alto Tietê System, which will bring a further 2 cubic meters per second of water availability. In this case, the expectation is that the beginning of the work will occur in 2018 and the conclusion and operation in 2019.

Let's go to the slides on investments. Here, we will comment on the investments made in 2017 and the investments planned for the period of 2018 to 2022. In 2017, investments totaled BRL 3.4 billion, of which BRL 1.4 billion were investments with no cash effect on SABESP such as the São Lourenço water system, which was made under a PPP contract in the approximate amount of BRL 900 million.

It should be noted that the estimated CapEx value of BRL 2.3 billion for the year of 2017, when we announced as much as the one we're announcing now, did not include investments without effect on the company's cash such as the São Lourenço project. For the period from 2018 to 2022, we expect to invest approximately BRL 7.3 billion (sic) [BRL 17.3 billion], of which BRL 7.1 billion in water and BRL 10.2 billion in sewage collection and treatment.

Regarding the investment mix in 2017, 66% of the investments were made in water. However, considering that investments in water security expansion are almost concluded, the mix will change and the proportion of investments in sewage collection and treatment will return to pre-crisis levels such that by 2018 investments in sewage already will rise to 50%, and will reach almost 75% by 2020.

Let's go on to slide 10. As you already are aware, ARSESP published on March 26 the Preliminary Technical Note number 004/2018, with the proposal of calculation of the maximum average tariff or the PO for the second regular rate review of SABESP against Factor X. We call this the final stage. As well as it informed that the consultation period and the public hearing period - and the public hearing will take place between March 27 and April 17, and the final date for the review continues in May 10.

On the slide, we highlight the most relevant points of the proposal presented by the regulator for the final stage in relation to the preliminary stage where the regulator, as you can see, establishes the value of the asset base at BRL 38.4 billion, therefore, lower than the preliminary one defined last October. It also defines the value of the productivity factor in 0.9287%. It maintains the preliminary stage WACC at 8.11% per year and proposes a tariff reset of 4.7744% to be applied on top of current tariffs.

Before entering into some of the latest specific points, we would like to emphasize that, in our opinion, the tariff revision process of the second cycle shows improvements over the first cycle, among which we highlight the following. Improvement in transparency and technical quality of the technical notes, inclusion of the transfer of municipal fund, WACC value of 8.11%, still higher than the 8.06% in the first cycle, rates for uncollectible revenues of 1.3% that is higher than the first cycle of 1.1%, and six-year reduction in asset amortization period and lower volume of asset base write-offs.

However, this is important, it's necessary to deepen the discussion and clarification of the following points: Methodology and process of estimating the X Factor, balance of gains and losses of the first cycle and...

[Technical Difficulty] (21:04-24:32)

Okay. May I continue? So, let's start from slide 10, I believe that's where we left. So, we'll continue there. As you know, ARSESP published on March 26, Preliminary Technical Note 0004/2018 with the proposal for calculation of the maximum average tariff of the second regular rate review of SABESP, an X Factor, that is the final stage now. As well as they informed that the consultation period and the public hearing will take place between March 27 and April 17, and also just confirming the date for the final review is - continues on May 10.

On this slide, we highlight the most relevant points of the proposal presented by the regulator for the final stage in relation to the preliminary stage where he, as you can see, establishes the value of the asset base at BRL 38.4 billion, therefore lower than the preliminary one defined last October. We defined the value of this productivity factor in

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0.9287%, and maintains the preliminary stage WACC at 8.11% a year, and proposes a tariff reset of 4.7744% to be applied on current tariffs.

Before I enter into some of the specific ones here, we would like to emphasize that in our opinion the tariff provision process of the second cycle shows improvement over the first cycle, and among these we would like to highlight the following: First, improvement and transparency in technical quality of the technical notes, the inclusion of the transfer of municipal funds, the WACC value of 8.11% is still slightly higher but still higher than the 8.06 percentage of the first cycle, while the rate for uncollectable revenues of 1.3%, that is higher than the first cycle of 1.1%, a six-year reduction in the asset amortization period, and last, lower volumes of asset base write-off.

However, it's important to and necessary to deepen the discussion and clarify the following points of the technical note. First is methodology and process of estimating the X Factor, the balance of gains and losses of the first cycle and preliminary review, the methodological inconsistency between OpEx and volume projections, calculation of the current average shares, the criterion for the movement of the asset base during the cycle, the change in water loss target levels in disagreement with the methodology, the capital structure estimating methodology, and the initial asset base revolver of BRL 38.4 billion.

In fact, in relation to this last point, there was a reduction of BRL 1.9 billion in the initial asset base of BRL 40.3 billion. To explain that and clarify this variation, we set up two tables that you can see in the bottom of the slide. The one in the left side, we analyze the variation in absolute terms and, on the right side, in relative terms.

Obviously, we will not comment line by line, but highlight some of them, some of the points, such as the value of asset write-offs, which was relatively small. The PPP values that are now treated as OpEx and not CapEx. And it's important to recall that PPPs in OpEx are amortized over a shorter term than they would have previously been amortized if they were in the asset base.

The next point is the change in methodology for the incorporation of works in the asset base, which went from the moment there was a disbursement of project to the moment the asset actually began operations. This methodological change had a negative impact since the rate of assets coming into operations in the second cycle was slower than the disbursement rate; something that we understand will be adjusted over this cycle.

The second two is the most important. One is the non-inclusion of working capital, it's representing 33% of the total, and also the non-inclusion of assets associated to new municipalities we now operate such as Diadema and, in this case, representing 21% of the total.

This pretty much finalizes what we comment on the slides. But before we go to questions, we would like to comment on SABESP's corporate reorganization process. On March 11, we published a material fact stating that the government of São Paulo received from a group of investors a letter for the potential acquisition of part of the shares which will be owned by the government of São Paulo to be issued by the parent company, and that the

letter will be evaluated by the Board of Directors of the State Privatization Program called CDPED, which is the body responsible for deciding on the continuity and conditions for the formation of the holding company and corporate reorganization of SABESP.

We also, at the time, informed that the transaction contemplated in the letter instructed to report exclusively within the scope of the controlling company and will not affect, in any way, the corporate control of SABESP, which will remain with the government of São Paulo in the matter consistent with the legal provision.

As to the identity of the investors and the contents of the said letter, they will be kept confidential in accordance with the rules applicable to the administrative procedures established by the CDPED for the purpose of this operation. Since the publication of the material fact in March, there was no new and relevant fact that deserves to be informed to the market.

So, this concludes this part of our meeting. And let's now move into the question-and-answer session.

Q&A

Operator

We will now begin the question-and-answer session. The first question today comes from Lilyanna Yang with HSBC. Please go ahead. Lilyanna, your line is open. Lilyanna? Since there appears to be no further questions, I would like to turn the conference back over to SABESP for any closing remarks.

A - Mário Azevedo de Arruda Sampaio

Okay. Well, let's do this. If there is any question, maybe we'll hang in a little bit. We want to see if Lilyanna can get in. There's a couple - one more - two minutes to see if there is anybody coming in. We see Lilyanna trying to get in. So, we'll give you one or two more minutes.

Okay, guys. It seems that there's been some difficulties here, but let's make sure of the following. Should you have any questions and if you need any support, we are Investor Relation area available. Please let us know. We'll get in contact as soon as possible and we're available for that. So, thank you very much for your time. And here, we conclude our call. Thank you. Bye-bye.

Operator

This conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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