

Q4 2018 Earnings Call

Company Participants

- Mário Azevedo de Arruda Sampaio, Head-Capital Markets & Investor Relations
- Rui de Britto Álvares Affonso, Chief Financial Officer & Investor Relations Officer

Other Participants

- Santiago Jariton, Analyst

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 year 2018. The audio for this conference is being broadcast simultaneous through the Internet on the website, www.sabesp.com.br, where you can also find the slideshow presentation available for download.

We inform that this conference is being recorded and all participants will only be able to listen to the conference during the company's presentation. After the company 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 assumptions of SABESP's 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 on the call today, we have Rui Affonso, Chief Financial Officer and Investor Relations Officer; Mário Arruda Sampaio, Head of Capital Market and Investor Relations; and Sylvio Xavier, Head of Costs and Tariffs.

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

Mário Azevedo de Arruda Sampaio

Hello, everybody. Good afternoon. On behalf of SABESP, I thank everybody to participate in this conference call. Today, we will discuss the full-year results for 2018 as well as provide some updates on several important topics for the company. Presentation contains seven slides. After that, as usual, we'll go through a Q&A session.

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Let's start on slide 3. Here, we can see the company's billed water and sewage volume, which increased by 1.5% in 2018. The greatest growth occurred in the residential category, this despite the changes in consumption habits that were incorporated by the population during and giving the water prices that we went through in the years 2014 and 2015.

Now move to slide 4. Here, we provide you very quickly some financial highlights. Our gross operating revenue in 2018 increased by 16.6% when compared to 2017, which going from then in 2017 from BRL 12.2 billion to BRL 14.3 billion in 2018. This increase is mainly explained by the new agreement signed with the city of Guarulhos late in 2018, leading to a BRL 800 million increase in operating revenue during the year when compared to 2017.

What also explains the revenue growth is the tariff repositioning established by the regulator of 7.9% applied since November 2017 and 3.5% since June 2018. Added to these previously and already (00:04:24) mentioned, we have also the increase in water and sewage billed volume of 1.5%. As for costs, in 2018, there was an increase of 2.8% when considering all costs plus administrative and commercial expenses and construction costs.

As a consequence of the highlighted variations, adjusted EBITDA reached BRL 6.54 billion, which represents a growth of 24.1% compared to the BRL 5.26 billion presented in 2017. As for the adjusted EBITDA margin, in 2018, we reached 40.7% versus 36.1% in 2017. When we exclude construction revenues and costs, the adjusted EBITDA margins come to 48.8% in 2018 against a margin of 45.4% in 2017.

Let's go on to slide 5. Here, we will comment briefly on the main variations in costs during the year of 2018. As we mentioned on the previous slide, selling and administrative expenses and construction costs increased BRL 297 million or 2.8%. If we exclude construction costs and selling and administrative, total costs increased by BRL 637.8 million or 8.4%. The main increase came from the general materials account that grew by 43.4%, which is explained by higher maintenance expenses and prices for maintenance materials, and to a 20.5% increase in electricity expenses due to higher energy costs and greater consumption during the year. As usual for a more detailed explanation of our costs, please refer to our earnings release.

Go on to slide 6. Here, we see the main variations affecting the company's net income in 2018 of BRL 2.8 billion always compared to the same period of the previous year. Net operating revenue increased BRL 1.5 billion; costs and expenses, including construction costs, were BRL 297 million higher; other operating revenues and expenses, including results from equity method, had a positive variation of BRL 35.1 million; net financial results increased by BRL 806 million; and finally, income tax and social contribution

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increased by BRL 93 million due to the higher taxable income presented in the period, mainly explained by the tariff increases and the agreement with Guarulhos, all this partially offset by the increase in expenses with services and electricity, and most of all, by higher exchange variation expenses.

Let's move to slide 7. Here, we briefly discuss the situation of the reservoirs that supply the São Paulo Metro Region. The hydrological year that started in October shows a below-average rain until January. However, with the high rainfall in February and March, the accumulated rainfall in six of the seven water systems that supply the Metro Region were above the historic average for the wet period, which is the period that runs from October to March. Specifically, for this period, we highlight expected year average pluviometry for the Cantareira System with 98%, the Guarapiranga System with 135%, and the Alto Tietê System with 111%.

Regarding the storage of bulk water in the Metropolitan Region of São Paulo, today, we have 74% of the capacity available. This figure is higher than March last year which was 63%. Today, considering current bulk water stored capacity, the works carried out increased water security, especially with the new San Lorenzo production system and the Jaguari-Atibainha interconnection, plus the changing consumption habits by part of the population, the company finds itself well-prepared to face a dry period, which runs from April to September, exactly when we have lower rainfall volumes.

Let's move now to slide 8. Let's comment on the investments made last year and investment plan for the period of 2019 to 2023. In 2018, the investments totaled BRL 4.2 billion. Of this amount, BRL 2.2 billion are non-cash investments, of which BRL 928 million refers to the city of Guarulhos. For the 2019-2023 period, the company expects to invest approximately BRL 18.7 billion, of which BRL 7.7 billion will be in water and BRL 11 billion in sewage collection and treatment.

Regarding the investment mix in 2018, 55.6% were made in water and the balance in sewage. However, considering that investments in water security expansion are almost complete, with only the reversal of the Itapanhaú River remaining, the mix will change in such that investments in sewage collection and treatment will return to pre-crisis levels. As you can see in this slide, already in 2019, investments in sewage will be the majority, with 52%, and will reach 60% of the total investment by 2022.

Let's go to our last slide. Let's go through this slide to comment on the latest updates regarding regulation. In January 2019, ARSESP released the result of Public Consultation Number 09/2018 with the objective to collect contributions and manifestations related to its proposal for the regulatory agenda for the period of 2019-2020, which definitely is important and will affect the third tariff review. Among the subjects discussed are the criteria for the recognition in the tariff of transfers made to the municipal funds of sanitation. On February 11, ARSESP published a Public Notice Consultation Number 02/2019 to discuss these criterias and receive contributions until March 11 when the consultation period was concluded. So, it's moving.

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Another important disclosure was ARSESP's response to SABESP's request related to the final numbers of the second tariff review. We're all expecting this. On May, if you recall, what we're talking here is on May 24, 2018, SABESP filed, along with ARSESP, an administrative appeal questioning the methodology utilized for applying the compensatory adjustment in revenue, electricity costs and investments made during the first tariff cycle; also filed a request for clarification of the reasons leading to a significant reduction in OpEx projections for the periods of the second cycle, that is 2017 to 2020; and also a request to review estimates for the X factor calculations, the compensatory adjustment for the delay in the application of the second tariff review and the calculation of the financial components related to municipal funds, this last point related to the contract with the Municipality of São Paulo. ARSESP's response, as I mentioned, took a long time but came on February 28 this year.

With regard to the administrative appeal, the agency decided not to accept the merits. Regarding the request for clarification and estimate review, ARSESP partially accepted our point, and in such, determine two things. First, the correction of the X Factor, reducing it from 0.885% (sic) [0.8885%] to 0.6920%. This, just as a reminder, in the first cycle, the X Factor was 0.9386%. Therefore, we have now an improvement of 0.2466%.

The second decision was to apply a compensatory adjustment of 0.8408% to the upcoming tariff adjustment to cover for two things also: the delay in the application of the tariff revision in the second cycle, specifically related to the capitalization of revenues differences after June 2018; and second, to an adjustment in the reference price dates adopted in the OpEx calculation from December 2016 to April 2017.

Last is for the calculation review for financial components of the transfers to municipal funds. Again, this case related to the contract with the Municipality of São Paulo. It was rejected by (00:15:20).

Well, this ends the presentation. Now, we can then go for the Q&A questions.

Q&A

Operator

Thank you. Since there appears to be no questions, so I'd like to turn the conference back over - I'm sorry, there is a question from Santiago Jariton with EV. Please go ahead.

Q - Santiago Jariton {BIO 15189588 <GO>}

Yeah, hi, guys. I'm just wondering if you could share your expectations on MP 868 that's going to be discussed in the Senate in a few minutes.

A - Mário Azevedo de Arruda Sampaio

Santiago, this is Mário. Just to make sure we understood; you want our comments on the provisional measure 868. Correct?

Q - Santiago Jariton {BIO 15189588 <GO>}

Correct.

A - Mário Azevedo de Arruda Sampaio

Okay. Just give me a second here.

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

Hi, Santiago, it's Rui speaking. The provisional measure has, in fact, several different points, with some of them could be considered very welcome in the sector. Some others are not clearly defined, and finally, some others not, in our point of view, good for the improvement of the sanitation sector.

Starting from the first point, generally speaking, to support those states or municipalities that cannot count with solid and sound regulatory agencies and regulatory bodies, this provisional measure addresses, from our standpoint, correctly the point in a sense that they establish that there would be in ANA quite an important anchor to define the general parameters for states or municipalities to deal with the regulation, that's not possible due to the scale or lack of capabilities or lack of financials. So, from our point of view, this is good in spite of it takes times, several years, probably, that it would be something concrete. This is, from our point of view, well addressed.

Second point: but we will imply a huge and important change for ANA that, nowadays, it only deals with hydrological issues rather than regulatory issues related to water and sanitation. So, it would be very important to change the technical body to gain capability and it will take time, but in the right direction from our standpoint.

Second important thing is that to reiterate that from SABESP's standpoint, competition and attract more private capital and more competition for the sector is not a bad thing. It's a good thing. SABESP welcomes competition. SABESP is ready to compete. But our only comment on that is that that competition should be fair; fair in the sense that all the assets that are not fully depreciated to the moment that municipalities or even states and municipalities open a new bidding process for new competitors. They would be - have to be paid by those newcomers. That's our - the only point that we like to point out to reiterate. Otherwise, we'd be expropriated attitude against not only the public sector or the mix capital sector like us, but against even with private sector. So from our standpoint, private capital is very welcome in the water sanitation sector.

SABESP itself is a very well succeed joint venture, say, quote PPP, a public-private partnership, in a sense that we count in our capital structure with almost half of participation of private capital. So, we're comfortable with that. It's very welcome. That would be our general comments on that. Of course, we can talk a lot of it, but to be very restrict to the main issues of industry set (00:22:56). Okay?

Q - Santiago Jariton {BIO 15189588 <GO>}

Got it. Thanks.

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Operator

Since there appears to be no further question, I'd like to turn the conference back over to SABESP's management for any closing remarks.

A - Mário Azevedo de Arruda Sampaio

Okay. Thank you for your time. We are always available here at the company for any questions with the IR team, and see you soon for the first quarter release. Bye-bye.

Operator

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

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