

Q1 2015 Earnings Call

Company Participants

- Mario Azevedo de Arruda Sampaio, Head of Capital Markets and Investor Relations

Other Participants

- Douglas Newton, Analyst
- Unidentified Participant

Presentation

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 First Quarter of 2015. The audio for this conference is being broadcast simultaneously through the Internet on the website, www.sabesp.com.br. In that same address, you can also find the 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. (Operator Instructions).

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 with us, we have Mr. Rui Affonso, Chief Financial Officer and Investor Relations Officer; Mr. Mario Arruda Sampaio, Head of Capital Market and Investor Relations; and Mr. Marcelo Miyagui, Head of Accounting.

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

Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Hi, thank you. Good morning, in fact good afternoon, everybody. Thank you all for attending one more earnings conference call. We have a nine slide presentation, and after that as already mentioned, we will open for a Q&A session.

Let's start on slide three. Here we show the companies billed water and sewage value, which fell 11.7% between first quarter '14 and first quarter '15, due mostly to the decline in water availability and the measures adopted since 2014 to continue supplying water on an ongoing basis to the population. So, mostly in the metro region of Sao Paulo.

It is worth noting that, the substantial decline in billed volume in the first quarter of 2015 was also due to the high level of billed volume in the first quarter of 2014, which at the time was atypical, due to the high temperatures and dry weather recorded in that period.

We would also like to remind you that the measures to encourage consumption reduction began in February 2014, restricted to the Cantareira region, which means they had a very limited impact.

Move to slide four, let's discuss the financial results. Net operating revenue fell 11.6% compared to first quarter, due to the granting of bonuses and the 11.7% reduction in total billed volume, as we mentioned in the previous slide. The decrease was mitigated by the application of the tariff reposition index of 6.5% since December 2014 and the facts of the contingency tariff.

Costs and selling, administrative and construction expenses fell 32.9% in the period, it's worth noting that this decline in costs and expenses was influenced by the reimbursement of the agreement signed in March this year with the Sao Paulo state government totaling BRL696 million, as mentioned in detail during our first quarter call.

Adjusted EBITDA increased 33.6% from 1 billion first quarter '14 to 1.4 billion this quarter, while the adjusted EBITDA margin came to 55%, against 36.4% first quarter last year. If we exclude construction revenue and cost, the adjusted EBITDA margin stood at 71.6%, against 44.5% in first quarter '14. Last, net income totaled BRL318 million that is 33.4% less than the first quarter last year.

Let's go to slide five, discuss the main variation in costs in relation to first quarter '14. Cost and expenses fell 32.9%, compared to the first quarter of 2014. Excluding construction costs, cost and expenses declined 47.9%, mainly due to the reimbursement received from the State of Sao Paulo government totaling as mentioned BRL696 million.

If we exclude the effects of this reimbursement, cost and expenses increased by 1.3%, again mainly due to the increase of 221% in credit write-offs, 13.6% in electricity costs and

7.6% in payroll and related charges. It's also worth highlighting, the 64.4% decline in general expenses. Again, for further details and discussions on each of the cost variations, we'd like you to go through our press release, earnings release.

Let's move to slide six and quickly go through the items that affected net income, that's between '14 and '15, which totaled BRL318 million. Net operating revenue fell BRL323 million, or 11.6%. Cost and expenses, including construction costs declined 670 million, or 32.9%. Other operating revenues and expenses recorded a positive variation of 76.7 million.

Net financial expenses, monetary restatement and foreign exchange variation increased 1,013 million in the period. And finally, there was an reverse effect in income and social contribution taxes due to a tax law of 548 million recorded in the period, which resulted in the recognition of deferred income and social contribution taxes of BRL186 million.

Well, let's move to slide seven, and on this slide seven and on the next, eight, we will analyze rainfall, through water inflow into the Cantareira System reservoir. On slide seven, 2015 presented irregular rainfall. In January, rainfall was much below average, in February and March, in fact rainfall came back and it was above average, and in April, rainfall will once again below average.

Nevertheless, reservoir levels in the Cantareira System improved, mostly due to the fact that, we have been continuously removing on an increasingly lower volume of water to supply the metro region that previously relied on this system. So we're putting less pressure on the Cantareira reservoirs.

Now on slide eight, we can see that the water inflow into the Cantareira System reservoirs came to 18.1 cubic meters per second in April, after two months of inflow above previous recorded minimum and not too distant from half of average monthly figures. We'd like to highlight that -- remind you that the lowest level recorded in 84 years was registered in April, 48.5 [ph] was registered in April 2014 when the average water inflow came to 17.2 cubic meters per second.

On slide nine, let's move there, we'll give you an update on the main measures SABESP has been adopting since February 2014 to serve the population. Despite the reduction in water extraction from the reservoirs in the Cantareira System. First, we highlight that water production in the Cantareira System fell from 31.77 cubic meters in February 2014, when we started the measures introduced, in fact the measures to reduce consumption, and down to 13.48 cubic meters per second now in April 2015, which represents a 57.6% decrease between these -- during this period.

In order to offset this decline in water extraction from the Cantareira System, the company adopted four main initiatives that have been allowing us to reduce extraction by the amount mentioned. And this, all was done, while maintaining water supply to the entire population directly served by us in the metro region of Sao Paulo.

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First of the measures is the reduction in consumption encouraged by the bonus program, which has been responsible for 19% of the savings. Second, we have the water transfer between the Sao Paulo metro region production system, mostly from the Tiete [ph] and Guarapiranga System into the Cantareira System, currently responsible for 36% of this reduction.

Third, the operational maneuvers and investments in reducing losses, which is now accounting for 42% of the reduction. And finally, reduction in water transferred to the municipalities, Guarulhos and Sao Caetano do Sul, which we provide water on a bulk basis; again this is responsible for 3%.

Let's move on to slide 10, here we present in detail, the investments in execution and under development for the period between 2015 and 2017, which are absolutely vital to cope with the water crisis. The main objective of the investments being executed mostly in 2015 and 2016 is to increase the ability to transfer water from other system, especially the Guarapiranga System and the Alto Tiete System to various originally [ph] covered by the Cantareira System. In other words, reduce metro of Sao Paulo, metro region dependent on the Cantareira system.

For 2015, there will be an expansion of 6.5 cubic meters per second led, and the greatest, the biggest one by the interconnection between the Rio Grande and the Alto Tiete System, whose works began in May.

This investment when completed in September will transfer 4 cubic meters per second from the former to the later. As a result, the region's currently supplied -- the region actually, currently supplied by the Cantareira System will be able to be served in greater portion by the Alto Tiete System.

In fact, the Alto Tiete System has a treatment capacity of 15 cubic meters per second. Today, we are producing only 11 cubic meters per second, since it's reservoir are currently at a low level. In other words, we want to maintain water in the Cantareira and the Alto Tiete System.

So as a result, the water that will be transferred from the Rio Grande System will allow us to utilize Alto Tiete's full water production capacity, and in such, increase its coverage on the areas currently served by the Cantareira System.

For 2016, water availability and security will increase by 8.6 cubic meters per second, which will further help recover the reservoir volumes in both the Alto Tiete and the Cantareira System. This flat [ph] as a result of the already discussed and announced interconnection between the Jaguari and Atibainha reservoirs.

All in all, in the period between '15 and '17, water availability and security will increase up to 21 cubic meters per second and production will move up by 7.4, just as a comparison, when we started the crisis, the water availability was around 74 -- 75 cubic meter per second and the production around 71, this result in the metro region of Sao Paulo.

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Let's go to slide 11, let's talk about the bonus program and the contingency tariff. As this quarter, in fact was the first quarter in which it has both had an impact on revenue, in mostly the contingency tariff. In April, 82% of the consumers reduced consumption and 72% actually received the bonus. This figure was flat in relation to March and was the highest since February 2014, when the program was introduced. This added savings of 6.2 cubic meters per second are sufficient to supply approximately 1.9 million people.

Regarding the contingency tariff, it became effective on the bills issued as of February, of the total 18%, they consumed above average, 11 were subject to contingencies tariff and paid higher tariffs. The balance 7% also increased consumption, but were not charged because they spent less than 10 cubic meters per second, that take-or-pay minimum volume.

As we already mentioned at the beginning of this conference call, the impact of the bonus on the company's revenue came to 211.2 million, while that of the contingency tariff totaled 79.3 million. The monthly first quarter contingency tariff and bonus information is available in our website, IR website. As of now, this information will be available on a monthly basis. For further details on this indication and disclosure, procedure for the monthly numbers, we will provide that later on this week or the beginning of next week.

Let's move to slide 12, our last slide; we will here discuss the inflationary adjustments and the extraordinary tariff revision that was disclosed on this May 4th by ARSESP. And again, as already, to a great extent, informed to the market.

Before, let's go back to March, then we request for an extraordinary tariff revision with ARSESP, requesting in fact compensation for the decline in volume, as a result of the water crisis, and also the unexpected increase in the electricity tariff. ARSESP proposed the total adjustment and revision percentage of 13.87% that was the initial proposal. And in the public hearing held on April 15, we requested a total adjustment of 22.7%. This is the figure, the company considers necessary to ensure it's economic and financial.

Now, on May 4th, ARSESP published two resolutions, Resolution 560 and Resolution 561. The first, Resolution 560 authorize an adjustment of 7.7875% on the Group's tariffs, constituted by a 2015 annual ordinary tariff adjustments of 7.1899%, calculated based on the 8.1285% EPC, which is the Consumer Price Index variation between March 2014 and March 2015, less the efficiency factor or the X Factor of 0.9386%.

And the additional adjustment of 0.5575%, due to the postponement of the application of the extraordinary tariff revision authorized for May, but only applied by us in December, and in fact, when it was partially offset.

The other resolution number 561, established an index of 6.9154% for our request for an extraordinary tariff revision. The sum of the two tariffs adjustment came in at 15.24%, below the 22.7% requested by us. The new tariff amounts are applicable 30-days as of their publication in the (inaudible).

Well, this concludes our remarks. I'd like to open for the question-and-answer session.

Questions And Answers

Operator

Thank you, sir. We will now begin the question-and-answer session. (Operator Instructions) We have a question from Douglas Newton of The WindAcre Partnership. Please go ahead.

Q - Douglas Newton {BIO 15163101 <GO>}

Hi, guys. I wanted to get a little bit of your perspective on the cost structure of the company. Is the correct amount of cost, excluding the BRL700 million payment or provision reversals, is that the number that we should consider sustainable for the rest of the year? Or are there elements of the cost performance in the most recent quarter that would make it not indicative of how you think the cost performance should look like over the balance of 2015?

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay, Doug. Just a second. This is Mario. Let me tell you something; first, especially the 700 is a non-recurring, okay then, so you should obviously not expect it on next month and so forth. We can say that our Apex [ph] or OpEx is fairly stable. We are obviously working on it, in terms of trying to keep it very, even more stable in terms of providing contributions to our margin. What we are, although you didn't ask, is working and we will work hard on our CapEx already given that we did not get the 15% to 22.7% increase we asked the regulator. Okay.

Q - Douglas Newton {BIO 15163101 <GO>}

That was going to be my second question. The question really was, what recourse do you have at this point, given ARSESP's decision relating to the tariff adjustment, given the company's proposal did not agree with how ARSESP ultimately decided with respect to the extraordinary tariff revision.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

We don't -- from the formal standpoint, we don't have the records, so that is the final number, until we are into the ordinary tariff revision next April 2017. Obviously, if there is anything further extraordinary, we may revisit it, which is allowed by the rules and regulations of ARSESP.

So what we are saying is, again is that, we proposed the extraordinary tariff increase, that in our view, would balance from the financial and economic standpoint of the company, although we would still be fairly well priced, which did not happen. So, we won't have to compensate for that and we have no numbers set yet. We are in a discussion and we will further decrease the investment we are planning for this year.

So, if you recall last year, on an accounting basis we did 3.2 billion, on a cash flow basis about 2.8, we are proposing this year a 2.360, and we should be -- you should expect us

to go down further on that. We do not have the number, we don't know exactly where, the tariff announcement just came in. So we're working on it, but obviously, we're going to balance out the company to go through this period without getting the full adjustments.

Q - Douglas Newton {BIO 15163101 <GO>}

Thank you, Mario.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay.

Q - Douglas Newton {BIO 15163101 <GO>}

Thank you.

Operator

(Operator Instructions) Our next question comes from (inaudible).

Q - Unidentified Participant

Hi. I have -- my question is on the debt and the covenants, specifically. It looks like, at the end of the first quarter, you're pretty close on the growth that the EBITDA covenant, which I think affects a pretty broad, lot's of your debt. And so, understanding that the tariff increase is going through, but I think not until June, it looks like, you could remain very close to potentially even trip that covenant to 3.6 times at the end of the second quarter.

So wanted to understand, how you're thinking about that? Are you in discussions with your lenders? What happens if you trip the covenant?

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay. Cailin, we will not comment on how we see ourselves further in the year, for obvious reasons we don't give guidance. And as far as having an undertaking discussions with our lenders, pertaining specifically this covenant, the answer is no. Okay. What we can say is that, the company has alternatives to cope with this fresh financial situation we are, you have to consider that, although it was not at the number we requested in terms of extraordinary tariff increase, we are going to start seeing the effects of the 15%, that is one point.

As I mentioned in the last question, Doug's question, we will work to balance out the cash flow through CapEx that indirectly can have effects on total debt. So I think we are working on, we do recognize that we are in a stress financial short-term situation, saying short-term, because we understand although this crisis is going further in time than expected, we should come back to our normal situation that is something.

We obviously have an eye open on the macroeconomic variables. They're being helpful today and this period, they were very stringent to us, in fact the exchange rate peaked

exactly in the March 31st, which obviously hit us on the total debt. So, this is how where we -- this is what I can comment about that.

The second question you made was specifically, what can happen to, if we reach any covenant is that it, Cailin?

Q - Unidentified Participant

Yes.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay. Cailin, the way to answer that is, it will take us a long time. We have several contracts and several covenants and what I can say is those that are market-related, except for one, which in fact is a bilateral loan with IDB, it's an AB loan, except for that one which we -- it is incurrence situation, which in fact, if we incur in one quarter then we would have to waiver it or whatever are incurring to whatever only once. So that's one.

All the other, the local debentures and the Eurobond, in fact the Eurobond, it's a maintenance covenant, if we incur into it, it's not a covenant in fact, the covenant is, there is the financial ratio, we have to -- the 365, we have to maintain below that, if we surpass that, we then get into a limited investment situation. So there is a basket there.

So, on the local debentures that one we would, if we would need to incur two times in 12 months to then have to renegotiate. So in summary, those are the more visible ones. But again, as I mentioned previously, we do have measures to take even if the situation from a cash flow perspective continues to search for us to go through this period without incurring into any financial indicator breach.

Q - Unidentified Participant

Okay. And just to clarify, if you -- if you could violate the covenant at the end of the second quarter, there are no consequences, if there is no further covenant violation in the next couple of quarters. Is that right?

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

If we violate the financial multiple, two times in a row or two times in 12 months, then we are violating the covenant. So, let's make sure that the differences between violating a financial ratio and violating a covenant. Okay, so that's important.

Q - Unidentified Participant

And there is no violation of the financial ratio, the 3.5 times at the first quarter?

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

No, we did not violate it.

Q - Unidentified Participant

Okay. Thank you.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

We were at 3.59. Okay?

Q - Unidentified Participant

Yeah, thanks.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay. Well.

Operator

(Operator Instructions) At this time, it appears that we have no further questions. Now I'll turn the conference back over to SABESP's management team for the final remarks.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay. Once more thank you for your participation. And we will be back in August with our second quarter results. And again we are -- myself and Angela available 24/7 for any doubts you may have and information you may need. So thank you and goodbye.

Operator

And we thank you, sir to the rest of the management team for your time today. The conference call is now concluded. At this time you may disconnect your lines. Thank you. Take care and have a great day, everyone.

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