Q3 2011 Earnings Call

Company Participants

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

Other Participants

- Alexander Kovac, Analyst
- Diego Moreno, Analyst
- Fabinia Holtz, Media
- Marcio Prado, Analyst
- Mike Jolin, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. At this time we would like to welcome everyone to SABESP's conference call to discuss its results for the Third Quarter 2011. The audio for this conference is being broadcast simultaneously through the Internet and 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 future purpose 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 Markets and Investor Relations and Ms. Nara Maria Marcondes Franca, Head of Accounting. Now, I will turn the conference over to Mr. Arruda Sampaio. Sir, you may begin your conference.

Mario Arruda Sampaio

Thank you very much. Good morning, everybody. Today we have a presentation, a six slide presentation to discuss the main events during the period. And as usual, we'll have the question and answer session at the end.

So let's get started on slide 3. Here we present the water and sewage (build) volume, which was 3.5% higher in the Third Quarter of 2011 compared to the same period in 2010 with build volume increasing across all consumption categories. Year-to-date build volume increased 3.2% compared to the same period in 2010. This increase in build volume was due to the growth of 2.6% in water connections and 3.7% in sewage connection, intensification of fraud prevention and accelerated increase in the replacement of water meters in the Sao Paulo Metro region and higher consumption in the industrial category. We would like to highlight that the replacement of water meters is extremely relevant for SABESP. As you know, we meter everything we sell, and the reason is that it improves overall water and sewage measurement and consequently total building.

This improvement in metering is due to better quality meters being installed and the periodic and better planned replacement schedule. For example, we replaced approximately 100,000 water meters in the Sao Paulo metro region in the last quarter. This rate of replacement is sufficient to maintain the average age of meters at 3.5 years, which is considered excellent by international standards.

We can already see the results of the recent return of outsourced contracts for water network maintenance. This quarter we recorded an improvement in water loss indicator for the second time in a row, as you can see in the graph. We expect to continue recording reductions in this indicator, which is a 12-month moving average, thus diluting all the efforts we do in the quarter throughout a 12-month period.

Let's move to slide 4. Here, we will comment our financial results. Net operating revenue increased by 10.1% in the quarter. Note that this figure includes construction revenue, which grew by 18.9% in the period. On the other hand, gross operating revenue which excludes construction revenue moved up by 7.2% being positively affected by the 4.05% tariff increase of September 2010 and a 3.5% upturn in build volume already mentioned in the previous slide.

Costs and expenses increased by 13.1% in the period. However, if we exclude construction costs, costs and expenses increased by 10.4%. EBITDA increased by 4.8% from BRL776.8 million Third Quarter 2010 to BRL814.2 million in Third Quarter 2011 while EBITDA margin reduced as you can see closing the quarter at 31.4% versus 33% in Third Quarter 2010.

EBIT remained flat in relation to the same period of 2010, closing the quarter at BRL646 million. Net income fell by 84.4% from BRL437 to BRL68 million in this quarter, mostly due to the exchange variation as we will discuss later in this presentation.

Note that excluding the exchange rate variations in both periods, net income would have increased by 49.1%. That is BRL358.4 million in the Third Quarter 2010 and BRL534.3

million in the Third Quarter of 2011.

Let's move to slide 5. Let's discuss the main variations in costs in relation to the same period last year. In comparison with the Third Quarter 2010, costs and expenses increased 13.1%, as already mentioned. The main factors behind this increase were the upturns of 19.1% in depreciation and amortization, 18.9% in construction costs, 18% in treatment supplies, 17.1% in supplies, 16.7% in general expenses and 11.1% in payroll and benefits, all this partly offset by the 58.5% decrease in credit write-off.

Moving specifically to depreciation and amortization, expenses increased by BRL27 million due to the amortization term adjustment between the assets' useful life and the program contract duration, whichever is the shortest one, something that will be recurrent for the next quarter. Construction cost amounted to BRL659 million quarter over quarter, and -- meaning an 18.9% increase due to faster investment pace in the period. The 18% growth in treatment supply was due mostly to the replacement of aluminum sulfate by aluminum polychloridem, and the increased chloride consumption as a result of water source quality.

17% increase in supply was related to the system maintenance while the 16.9% increase or BRL28 million in general expenses was due to provisions for legal contingencies. 11.2% increase in payroll and benefits was mostly due to the 8% salary increase effective since May this year and the reversal of -- in 2010 of provisions related to the profit sharing program that we recognized in 2009. These increases in payroll and benefits were partially offset by the decline in the actuarial liability of the G0 Plan. Plant credit write-offs fell by BRL24.2 million due to the conclusion of additional provision undertaking in past quarters related to the building of private customers and (inaudible) municipalities -- (entities).

Let's now move to the next slide, slide 6. Here we will highlight the main variations (technical difficulty) items that affected our net income of BRL68 million. Net operating revenue increased by BRL238 million, or 10.1% over the same period of 2010. Costs and expenses increased by BRL225.5 million or 13.1% higher than the variation observed via the net operating revenue growth revenue. The highest negative impact now came from the net financial expenses in the amount of BRL573.6 million. I would like to remind you that this item is made up of some of the monetary variation on assets and liabilities for the quarter registered at BRL550.3 million and financial expenses and revenue for the quarter, BRL23.3 million. The highest impact on the monetary variation on assets and liabilities came from currency exchange rate variations for loan and financing totaling BRL544.9 million mostly due to the 18.8% depreciation of the dollar against the real in the Third Quarter of 2011 versus a 6% depreciation of the dollar against the real in Third Quarter 2010.

As for financial expenses and revenue, the main favorable variation came from interest rate over (law suits) totaling BRL68.4 million. This was mostly offset by higher financial revenues of BRL35.4 million due to higher cash availability.

Finally, we highlight the positive variation of BRL211.2 million in income tax and social contribution, all of this due to lower taxable rate mainly as a result of the exchange rate variation -- what allowed us, our net income, as you can see, to reach a positive BRL68 million.

Let's move to the next slide, slide 7. Let's talk about our foreign exchange exposure and our low-cost, long-term funding. Let's begin to where it's highlighted that in October, the Company redeemed the full outstanding amount of its nine debentures issues with a consequent cancellation of this outstanding debt. The (inaudible) for the redemption came from our cash availability, though the final outcome was a reduction in our total debt.

Note that the six debenture issues occurred in October 2008 in the midst of the Lehman crisis for a total of BRL220 million distributed in two series, preferred series in the amount of BRL100 million paid interest rates of CDI plus 2.75% a year with a total five-year term and amortization starting in year three. The second series in the amount of BRL120 million paid interest inflation EPCA index plus 12.87% a year with a total of seven-year term and amortization starting on year five. Just so you know, this debenture was by far the most costly the Company carried.

(On investment) financing front, we continued to secure long-term, low-cost funding. The Company has secured loan agreements with (BNDS) totaling BRL483.3 million and with (inaudible) another BRL250 million. These funds will be utilized to finance water and sewage projects. Both banks' board of directors have approved the loans. We are now finalizing the contractual procedures. Expectation is to sign by the end of 2011.

Now, we would like to comment on our forward debt exposure. Due to the appreciation of the dollar against the real, our exposure increased to 35% from 30% last quarter, and that affected the impact of the devaluation of the real against dollars we discussed on previous slides.

So let us take some time to comment on our FX exposure and qualify better what it represents for the Company. On one side, as you may know, already know, the fact that SABESP is a mix capital company gives us access to funds from multilateral agencies. This is (IDB), Royal Bank and (inaudible) which offers special funding commissions, all this not available (for) privately owned companies. Note that these resources have been covering the funding gaps that we are in imposed to by the Brazilian authorities mostly because we are a mixed capital company. This limitation brings us limitation in accessing local public low-cost funding along with BNDS and Caixa Economica Federal.

Although we have just commented on securing financing along with these banks, be sure the access to them is erratic, limited in volume and in time.

Now, the international -- on the other side, international financing made available at the multilateral and public agencies not only fills the funding gap for our investment program, but provides longer terms than local funding, not to say extremely low interest rate. Take for example our recent yen-denominated loan agreements with JICA, Japan International Corporation Agency. Their interest rate ranges from 1.2% to 2.5% year with seven-year grace period and a total 25-year term.

The previous comments explain why we access foreign exchange funding for financing investments, but we also tap the international markets for liability management and debt refinancing purposes.

If you recall, last year we issued a 350 million euro bond -- dollar-denominated Eurobond with a 10-year full maturity and a 6.25-year coupon. We have a total of two outstanding bonds, both originally issued with a ten-year equivalent maturity. Note that these terms in cost are not available or even seen in the local market and helps us reduce the concentration of maturities in 2; to 3-year term as you can see in that profile chart.

In other words, international public funding is a source of low-cost and long-term funding for investments and international capital markets are an effective alternative for long-term maturities on the debt refinancing front. The result is a debt profile with the extent that expands and dilutes through time our foreign exchange exposure, minimizing its effect on company amortization profile and cash flow vulnerability.

Now let's go to our last slide, slide 8. Here we would like to give you an update on steps toward the new tariff methodology that has been in development by the state of Sao Paolo Sanitation and Energy Regulatory Agency, ARSESP. In line with the schedule proposed by ARSESP disclosed in March this year throughout the resolution 210 (inaudible), we were expected to deliver a 2012-2016 business plan to the regulator. We have done our part and delivered it just a few days ago. This material includes information such as revenue, expense and investments, all essential when the agency undertakes the structuring of the new tariff methodology.

Also scheduled in accordance to with the resolution 210, ARSESP would by late October disclose its detailed and complete tariff methodology proposal for public hearing and discussion until January 2012, including a general guideline for SABESP to prepare tariff's structured proposal. Considering that ARSESP did not disclose its proposal, we understand that the agency will take -- will move on and jump this part and move onto the next step in May when it will make public the initial tariff proposal and efficiency gains factors and will request the Company to present its proposal for the new tariff structure, as you can see in the schedule there.

With regards to the asset base, as you all know, a very important step and a part of this entire process. Evaluation was divided in two blocks, and two different companies have already been hired by SABESP and are working on this. One company will be responsible for creating the value of the assets in this metro region of Sao Paulo and the other the value of the assets for the regional system and all other systems.

Finally, another important point we would like to highlight is SABESP's ongoing effort, along with ARSESP, in finding ways to anticipate the tariff review. As you all know, the tariff review is expected for September 2012. The objective is to minimize the lack of revenue assessed from expenditures investments we have been undertaking now for some time and recuperate our cash revenue position as soon as possible. We're waiting for the agencies to respond to our request, and we will keep you posted on any updates on this.

That concludes our initial remarks, and now I would like to open for questions and answers. Thank you.

Questions And Answers

Operator

(Operator Instructions) Felipe Leal, Bank of America Merrill Lynch.

Q - Diego Moreno {BIO 16605588 <GO>}

Hi, in fact this is Diego Moreno. This is regarding the debt amortization that you are showing on slide 7. You showed that for the next two years you have almost BRL3 billion debt to roll over. My question is regarding if you plan to do that by foreign currency or by local currency.

And my other question is regarding the new tariff methodology implementation. You show only (scattered) here that the next step would be SABESP is presenting the regulatory assets base by the end of March. Do you have an expectation to do that in advance in order to push the regulator to expedite as fast as possible the process? Thank you.

A - Mario Arruda Sampaio

Diego. Good morning. Well first on the rollover, we will certainly have to roll over debt as we move into 2012, so just so you all know, and it's public. We have two outstanding local market debts. There is a BRL200 installment on the 11th, debenture issue is due in March and there is a full BRL600 million due in August from our 13th debenture issuance. So we are obviously with the eyes open and working.

Regarding whether it's going to be foreign and local, well it couldn't be foreign, not even if we wanted it to. The foreign market is closed. We don't see it very positive in the midterm, not to say that it will just increase our exposure. So we will be looking to refinance. I cannot disclose exactly what we're going to do, but I do see the foreign market very close and we don't see appetite for further exposure in the international market, given where the exchange rate is.

Regarding the tariff methodology, well you're right; we are supposed to deliver and we will deliver by March all the information the value of the regulatory asset base. I think the good news is that we are on track. We have the consultants hired and working. I think we cannot disclose yet that if we will be able to anticipate all or part of the appraisal, but we don't think that is an issue for us to continue to work with ARSESP in trying to anticipate some of the tariff movements we will have to take by September next year, okay?

Q - Diego Moreno {BIO 16605588 <GO>}

Okay. Thank you so much.

A - Mario Arruda Sampaio

(technical difficulty) on track, okay?

Operator

(Alexander Kovac), Citigroup.

Q - Alexander Kovac

Hi. Good morning everyone. My question is still on the tariff review. I would like you to give us a little bit more color and the (inaudible) regarding the regulatory asset-based methodology.

A - Mario Arruda Sampaio

Okay, you would like more detail on the methodology.

Q - Alexander Kovac

Yes.

A - Mario Arruda Sampaio

First, let's do this. I think the general concept is the methodology is the replacement value, our replacement value, not by inflation updated. I think that's the big difference from what the regulator was originally pointing out as a methodology. It is a very complex rule and procedure to estimate. The replacement value will be applied on those assets that are operational assets. The assets that are part of our business that are like the infrastructure, the building, the office buildings, will be basically valued by inflation. The regulator has got some rules as to what is the capacity utilization he will consider. He will consider the average projected 10-year capacity utilization.

In some cases, he is -- the starting point is the average current average utilization on a year basis. We obviously have fought over that for the assets that are in the coastline and the beaches of Sao Paulo where we operate all the systems. The average will obviously be very low and we have to build assets for the peak periods, which I believe he is willing to consider that region.

I'm not sure -- I mean, we can at this point go into further details, or if in general I covered your expectations. We can always further detail that on the specific call. But is there something else I can comment on this?

Q - Alexander Kovac

Yes, just a follow-up. So given this complexity of the process, do you believe that it should be finished by March or August of next year?

A - Mario Arruda Sampaio

You are absolutely right, and it is absolutely complex. Consider that we have networks spread out through 364 municipalities; imagine that we have over -- adding the kilometers in network from sewage and water that has to work, then 100,000 kilometers, then it's going to be complex. But we have a challenge. We're going to meet the challenge. It's in our best interest to get it done. We have just mentioned during this peak that we are not satisfied at all with the regulatory agency with this frequent installment. We're doing our part. We're reducing water losses, we're improving energy efficiency, we have reduced since 2007 total payroll on a per-cubic-meter basis. So I think we're going to work hard. But it's complex; you are correct.

Q - Alexander Kovac

Okay. Thank you.

Operator

(Operator Instructions) Mike Jolin, Heartland.

Q - Mike Jolin {BIO 16456857 <GO>}

Hi, I just have a quick question about how many connections you had at the end of the quarter?

A - Mario Arruda Sampaio

Okay, just give me one second to get the number. (inaudible) end of the quarter, the amount of water connections, 7.4 million, and sewage connection 5.8 million. This is the total cumulative sewage connections.

Q - Mike Jolin {BIO 16456857 <GO>}

Right, got it, thank you. And could you just talk a little bit about the meters? Could you go into just a little bit more detail on what your plans are there?

A - Mario Arruda Sampaio

I think this is obviously part of our water loss reduction program. As we showed here in the slide, our water losses are down to 25.7, but part of that is made up of what we call the physical loss which are -- those are the -- basically leakage and the other is nonphysical losses where we have (inaudible) but we also have metering systems that are -- that got old, and all of these are not very good.

So one of the reasons I believe that we have been bringing this water loss down fairly consistently, except for this period, we installed 26% still of the outstanding contracts. It's because we are intensifying the pace of replacements and we are adjusting the quality of the meters to the technology we need to apply in our day-to-day -- the way we -- the households are built in Brazil. I don't know if you know, but in Brazil it's very common to have a local (reservoirtory) in the ceiling of the house. This is historical because of the infrequency water availability, all houses have this reservoirtory on top.

The technology we have been utilizing this mostly technology that for water that is coming into a house, a residence, directly from the service provider pump with a very high-pressure. And when you utilize this other procedure, you need a different technology, you need different quality material. And I know that the Company has been undergoing discussions and developments with local providers mostly to bring such a quality product to capture better and obviously to give longer-term and an efficient measuring during the period. And this is as far, I think, I can go talking about the metering system.

Q - Mike Jolin {BIO 16456857 <GO>}

Okay. Thanks. And have you disclosed to your -- who's providing the meters?

A - Mario Arruda Sampaio

No, our level of understanding, not yet; no, we haven't disclosed. But I don't think this is a -- this is a nonpublic -- I would say, it is -- in fact, it should be a public -- it is a public information, given that everything we buy, we buy through a bidding process, and all the bidding processes are public. But potentially, you may try -- although it's probably in Portuguese -- to zap through our website. I'm sure that we have public information on all of the hire contracts we sign and who we hire and who are our suppliers.

Q - Mike Jolin {BIO 16456857 <GO>}

Okay. Great, thank you.

Operator

(Operator Instructions) Mike Jolin, Heartland.

Q - Mike Jolin {BIO 16456857 <GO>}

My last question would be, the currency has strengthened a little bit back here since the end of the quarter. I guess I'm just trying to understand the sensitivity there.

A - Mario Arruda Sampaio

We'll, given the sensitivity there, if we were to consider our -- the financial expenses at 1.75, which is pretty much where the exchange rate is, we would -- the total financial expenses would be were BRL200 million lower than it was when we finalized the quarter at 1.85 exchange rate. So the sensitivity basically has -- it has moved from 1.85 where we closed in September, exchange rate, to 1.75, which was November 7. That impact on balance sheet would be of about BRL200 million less than it was today as we present the results. Just a quick estimate I had here next to me (multiple speakers) very sensitive, obviously, very sensitive.

Q - Mike Jolin {BIO 16456857 <GO>}

I appreciate it, and appreciate your time. So thanks, great quarter.

Operator

Marcia Prado, Santander.

Q - Marcio Prado {BIO 15398968 <GO>}

Good afternoon, Mario; good afternoon, everyone. I would just like to make a follow-up question with regards to SABESP's dividend policy. We have seen a healthy cash flow generation this year irrespective of the large CapEx. So if you just could develop a little bit on the SABESP dividend policy, it is like 50% minimum and over the last few years you have distributed only 50% or more than that. And could we expect a larger payout this year when compared to previous years? Thank you.

A - Mario Arruda Sampaio

Let's go back to the following. I cannot understand your question because I can imagine that if we might have a lower result this year impacted potentially, we could have higher payouts to maintain equal cash out for dividend. But the point is, first, just remind you that we don't have a formal dividend policy in place. The Company executives have been proposing to the Board a conservative approach to dividend, giving all the debt maturity as we move through this very, very aggressive investment plan. (Since) we are performing the investment plan and we have been also working on the (PEP) refinancing, we believe we will -- you can continue seeing from the Company management a conservative approach and proposal to the Board in terms of dividend payout. So I think that past years, dividend payout has been ranging on the 28% to 30%. Again, this is not a formal policy. This is where we paid the dividend; we go for the minimum, which is itself, quote, a policy. And -- but we try to pay net 25%, which usually takes us above and close to 28%. So generally speaking, I think that is what we can comment on dividend for you.

Operator

(Operator Instructions)

At this time, we will now open the Q&A to the media, and some of the questions could be in Portuguese. (Operator Instructions) (Fabinia Holtz), (News Agency Estrada).

Q - Fabinia Holtz

(Media Q&A conducted in Portuguese).

Operator

(Operator Instructions) It appears to be no further questions. I will turn the conference back Arruda Sampaio for their final remarks.

A - Mario Arruda Sampaio

In English here, thank you, everybody, for your time. Obviously, as usual, available for detailed questions through our IR group, and hope to see you next year when we present our Fourth Quarter results. Thank you very much, goodbye.

Operator

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