

Q3 2018 Earnings Call

Company Participants

- Marcelo Miyagui, SABESP
- Mario Arruda Sampaio, SABESP
- Rui de Britto ã Ivaes Affonso, SABESP

Other Participants

- Michael E. Gaugler, MD of Utilities & Infrastructure and Senior Analyst
- Snehal Rajnikant Amin, CEO and Portfolio Manager

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 Third Quarter of 2018. The audio for this conference is being broadcast simultaneously through the Internet on the website, www.sabesp.com.br where you can also find the slideshow presentation available for download. (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 Rui Affonso, Chief Financial Officer and Investor Relations; Mario Arruda Sampaio, Head of Capital Market and Investor Relations; Sylvio Xavier, Head of Costs and Tariffs; and Marcelo Miyagui, Head of Accounting. Now I'll turn the conference over to Mario Sampaio. Sir, you may begin your conference.

Mario Arruda Sampaio

Thank you. Good afternoon, everybody. This is our Third Quarter conference call. Let's go through the results and presenting you update and comment on certain relevant matters. This is a 5-slide presentation. So let's start on Slide 3. Here we can see that the

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company's billed water and sewage volume presented a stable performance with an increase of 0.1% this Third Quarter, 0.2% of which from water and 0.1% was related to sewage. In this scenario, we like to highlight the decrease in the billed volume from the industrial, commercial and public sectors.

Let's now go to Slide 4. Go through the financial results. In the Third Quarter of '18, the company recorded net income of BRL 565.2 million against BRL 905 million in Third Quarter '17. The main change in the Third Quarter of 2018 compared with the same period last year was the exchange rate variation. Third quarter of '18, SABESP recorded a foreign exchange loss of BRL 100.8 million, driven by the depreciation of the real against the dollar and the yen versus a foreign exchange gain of BRL 253 million in the same period last year. And this leading to a negative variation of BRL 444 million between the period.

Gross operating revenue related directly to sanitation service but does not include construction revenue, increased by BRL 331.9 million or 11.1% from BRL 3 billion in the Third Quarter of '17 to BRL 3.3 billion this quarter. Revenue was influenced by 7.5% -- sorry, 9% increase, which effects started to kick in in November '17. And also by a 3.5% tariff repositioning index that was the final tariff revision with effect starting June 2018.

There was also a negative impact on revenue from the higher recognition of estimated loss with doubtful accounts related to wholesale sales in Third Quarter '18 in the amount of BRL 42.7 million. This is deriving mainly from the municipality of Guarulhos. And for net operating revenue, which includes construction revenue, there was an increase of 7.8% or BRL 274.3 million.

Costs, including costs, selling and administrative expenses and construction cost rose 13% in the Third Quarter of '18. As a result of these variations, adjusted EBITDA reached BRL 1.4 billion, that's 1.5% less than the BRL 1.45 billion recorded in the same period last year. The adjusted EBITDA margin stood at 37.6% in the Third Quarter of '18 versus 41.2% in the Third Quarter of '17. For the last 12 months, this margin reached 36.9%. If we exclude construction revenues and costs, the adjusted EBITDA margin came to 46% in the Third Quarter of '18 versus 50.9% Third Quarter '17.

Let's now move to Slide 5. Let's comment on the main variations of costs for the quarter. As we mentioned in the previous slides, slight costs selling and administrative expenses and construction costs increased 300 -- BRL 13 million, or 13%. If we exclude construction cost, selling and administrative expenses and cost increased BRL 299.9 million or 17.5%. The main variations responsible for this result were: General materials with a gain of 53.3%; services with an increase of 27.1%; electricity with an increase of 18.6%; general expenses raising 17.5%; and salaries, payroll changes and pension obligations with an increment of 11%.

For more a detailed explanation of our cost, please refer to our earnings release and call us if you need.

On Slide 6, let's move, we show the main variations that affected our net income in the Third Quarter of '18 compared to Third Quarter of '17. Net income totaled BRL565.2

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million, net operating revenue climbed BRL 274.3 million. Cost and expenses, including construction cost, rose BRL 313 million. Other operating revenues and expenses, including equity equivalents, recorded a positive variation of BRL 18.9 million. Financial expenses moved up BRL 485.7 million. And finally, income tax and social contribution declined BRL 107.5 million. That's due to the lower-taxable income recorded in the Third Quarter of '18, mainly impacted by the appreciation of the dollar and the yen against the real. Obviously when compared to the devaluation, which took place in the Third Quarter of '17.

Let's go to next slide, our last slide. That's coming on the situation of reservoirs in the Metro region of São Paulo. The '17, '18 hydrological year that ended last September recorded lower than average rainfall and water inflow. The '18, '19 hydrological year that began this October reservoir levels that's when they usually recover, specifically between October and March. This is when we should be able to see recovery of reservoir levels. As you can see, we have to keep close to rainfall and average water inflow.

This October, in particular, we saw above average rainfall in the reservoirs that supply the São Paulo Metro region. And we have close to an above water inflow. At the end of October, reservoirs were operating at 44.7% of their capacity. That's equivalent to 869 million cubic meters of stored water, including the volumes stored in the São Lourenço system. Remember, this is the new system that came into operation at the beginning of this year. And it's now the ninth supply system as that is part of the São Paulo water Metropolitan system.

We would like to remind you, once again, that thanks to the initiatives undertaken by the company to increase water security and reduce water losses. This combined with a reduction in consumption by a relevant part of the population. We understand that the stored water volume today is more than sufficient to meet demand in the Metro region, as we move on throughout this year and next year.

Done with the slides. We have comments we would like to make with you, points we would like to go through related to 2 subjects. The first one is related to the Provisional Measure 844 and the second related to ARSESP's recently disclosed regulatory agenda. Starting with the provisional measure, let's go back and remind us that it was initially presented in July this year, later approved by the next commission -- special commission that amended the original text. That was in October 31. And at the same time, transformed the provisional measure into a conversion bill Number 28/2018. Today, that text that is on discussion still needs to be approved in plenary session of the House of Representatives and the federal Senate. And it's important to note that if not, it will lose effect as of December 19. So that's the due date for final approval by both houses of our congress.

Now if approved, the new legislation will come into force on the publication date, except for article 10 A to be included in law or sanitation Law 11,445. In this case, which will enter into force 18 months after the publication date. The provisional measure, let's continue calling it provisional measure, changes dozens of articles of 3 laws that make up the legal framework for the sanitation sector. That's mainly changes at some point of Law 9,8984 of the year 2000, Law 10,768 of 2003, sorry. And 11,445 of the year of 2007.

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According to the text, one of the first actions set forth in the provisional measure aims to harmonize the different norms for the sanitation sector. In order to accomplish this, the measure assigns the national water agency in Brazil -- it's A-N-A, ANA -- the responsibility for creating reference standards to regulate the sector. This means that ANA, among others, will establish the reference norms to regulate the provision of public basic sanitation service as well as service quality and efficiency standards, including progressive reduction of water loss. ANA will also be in charge for setting standards for the regulation of tariffs and the standardization of the negotiation instruments for the provision of sanitation services.

It's worth noting that the standards to be introduced will be practically mandatory, given that the concession holder and service provider that fail to comply with the standard issued by ANA will not have access to federal public funds, financing using federal funds or funds operated by federal public government entities and body. In our specific case, this means and impact or access -- potentially access to NDF and the social bank funding we call here Caixa Econômica.

Another very controversial issue is the fact that the provisional measure makes obligatory municipality meeting public call to receive proposals for the provision of basic sanitation service, before delegating the provision of sanitation services to state-owned companies such as SABESP, which in case would be waived from taking. In addition to this, the drafted law conversion or the provisional measure provided that municipalities should hear the responsible body for regulation, in our case ARSESP, at which will do a supervising before publishing the public call noted. So it's one more step to secure any contract.

It's also worth noting that before the publication of this provisional measure, in other words before this proposal, municipal governments had the option to sign a cooperation agreement with the state government and a program contract with a state company, such as us without the need for a bidding process, where then a bid would only be required in case the owner of the concession, which is to hire a private company. What's not clear yet in the text of the provisional measure that the assumption of services by private companies and municipalities currently operated by state companies, such as SABESP, (with) another private company will have -- will be, sorry, preceded by higher payments of compensation or identity for investments not amortized.

This legal gap in fact will allow numerous litigation for misappropriation of investments and public assets, affecting both state-owned and privately controlled companies of this, which obviously all this does not contribute to the legal security of the sector, which we all know it's essential for the attraction of investments.

After that, let's go to the second point, comment on the regulatory agenda. On November 1, we issued a notice to the market related to the opening by ARSESP of a public consultation. In this case, the number is 09/2018, focused on receiving inputs and opinions related to the proposal for ARSESP' regulatory agenda for the next two years. That is for '19 and '20. The purpose of this initiative of the regulator to ensure transparency and the participation of the society in the regulatory process. And to give users of regulated public services, economic agents and other stakeholders the

opportunity to express their opinion as well as to obtain (subsidy) to provide greater reliability, clarity and security in the decision-making process of the agency.

The company understands that this process will be very positive because it will bring more predictability actions that we will take -- that will be taken by the regulator, minimizing delays as has already occurred in the last revision. Besides ensuring a broad participation in the regulatory process and eventually anticipating relevant discussion points. Should be noted that the agenda proposed includes a matter of great interest to the company, which is the need to review our tariff structure, a recurring subject not tackled during the first and second ordinary tariff revisions, or remember that our current tariff structure dates from 19 -- from the 1970s. As such, it is certainly needing an updating. And it's very relevant for our business.

According to their published agenda, the objective is to define the new tariff structure and respective implementation plan, all this -- the completion expected for the first half of 2020. Something also important for the first half of 2019, ARSESP intends to establish the methodology and general criteria for defining SABESP's regulatory asset remuneration base, relative now to the third tariff review process.

Also no less important is the (water) discussion for which ARSESP intends to improve the methodologies adopted before the end of the first half of 2020. Also the implementation of the project of a general quality index, known here Q factor, is foreseen for the second half of 2020 in order to comply with the methodology, which is already established by SABESP second-tariff review. In other words, the Q factor is established but has not yet been implemented.

To conclude this topic, we see this initiative as very positive for the profits and SABESP. And we will -- for us, we will certainly as usual be -- we will be an active participant. We will send our contribution on several subjects and interests of the company. Well this ends the presentation and our comments. Now we will open for the question-and-answer session.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Snehal Amin with WindAcre.

Q - Snehal Rajnikant Amin {BIO 6232026 <GO>}

I was curious what was happening on the expense side. The expenses went up a lot and are growing faster than revenue. So what's happening there? What's the plan to be more disciplined on expense growth going forward?

A - Mario Arruda Sampaio

Snehal just a second here.

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A - Marcelo Miyagui

This is Miyagui. Talk about the service expenses. If you consider the last 3 quarters, the average in this account. You can see that this base expense we have an average of (306,000). So it's not so different from this quarter. But if you compare the Third Quarter '17 to the Third Quarter '18, you can see it is different. But not so different the average in the last 3 quarters. And if you consider the materials, also we have in the last 2 quarters, is the average of about (55,000) or (5 million) in this quarter, we had (61), it's not very different. But if you compare with the Third Quarter, you can see this big difference. Talk about Q2 specific account but Mario can continue about this.

A - Mario Arruda Sampaio

Yes. I think you also see a pension fund payment, health fund -- health service. Just make sure it's now SABESP is responsible for the pension plan and for the health plan. What has happened and we're in the process is that there was an imbalance in the health plan provided that the health costs are rising much rapidly than the contributions made by employees to the health plan, provided that the contributions to the health plan, they are just by our salaries, basically. And as in anywhere in the world, health costs are going very high.

So to balance that, we had to complement and make a payment, which is hopefully a onetime payment. And the reason is that at the same time, we have made a decision that SABESP will not be an independent manager of the health plan. We took that away from them. And now we put out a bidding process. We are in this bidding process, we're going to hire a third-party health provider and management firm, one of the big ones. This will certainly bring us more control and visibility on managing the expenses in the health plan. And how that impact potentially SABESP.

We will in fact have a small but reduced ongoing recurrent, which is part a transfer of funds to support the pension funds as a benefit. But this is coming down. So net-net, I think we can say that the expenses increased in this line based on this onetime. And our expectation is that this will not be recurrent. And essentially it will be slightly lower as we move on, if we succeed in what we're doing. I think those are the big ones.

Q - Snehal Rajnikant Amin {BIO 6232026 <GO>}

How big was the onetime expense?

A - Mario Arruda Sampaio

BRL 44 million.

Q - Snehal Rajnikant Amin {BIO 6232026 <GO>}

BRL 44 million in this quarter, okay. Then just 2 other questions. One, is there any update on ARSESP and your challenge of the tariff? Then second, is there any update on reaching a resolution with Guarulhos on what they owe you?

A - Mario Arruda Sampaio

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Okay. Let me tell you, the tariff, if you remember there were 2 points. There was -- we questioned how they estimated 3 parts of the process. We -- based on conversations with them we expect anytime soon they -- putting out their final opinion. So anytime soon, we would be surprised if this drags even more. Related to the administrative request, this is -- we're in the same place we spoke last time. We're obviously keeping track of time. And at some point, if there's no answer, we will, as we already mentioned to you, take formal action, okay?

Related to Guarulhos, we are on track with the steps that are required to achieve the contract. We can tell you we have been in very intense discussions and conversations, we are very ahead in the process of achieving a final contract and condition. The law -- the municipal law, which authorizes the executive, the mayor to sign the contract has been approved. But the fund -- the municipal fund that as much as in the same terms -- the same terms, I mean, in the same way that we have in São Paulo the fund that will receive a transfer has been approved. In other words, we have the full legislative approved, we and the city to make the move.

We -- part of this process is the signature of an agreement between the city and the state where they stay together will delegate to SABESP the service. Plus in this process both will make (assess B), a point assessed as a regulator. This should be signed in the hour, right now, still today. We have already commented this. So I think we're pretty much on track. There is obviously a -- an interest in doing it as soon as possible from the mayor's point of view and from our point of view. So this is -- I think these are potential good news coming in front of us, okay?

Operator

(Operator Instructions) Our next question comes from Michael Gaugler with Janney Montgomery Scott.

Q - Michael E. Gaugler {BIO 7139923 <GO>}

Just 2 questions. The first, back in June, you canceled a debenture offering and I'm wondering have conditions improved to a point where you could try to access the markets again in the near future?

A - Mario Arruda Sampaio

Okay. The -- yes, we did cancel -- at the time, we -- the conditions that were offered were good. They slightly deteriorated as we approached the book building. So we turned our back on the banks and said no thank you. That's going to be a slight change. We didn't want to validate there. So we on the same time -- at the same time, we managed to anticipate approximately \$100 million from IBD, which obviously supported our cash. As you can see, based on Third Quarter numbers, we actually have a very strong cash availability. So to that extent, we found not necessary to move on and keep on with that debenture issue. We will obviously at some time come back to that. But not now.

The market picked up a little bit now after the election, as you can see also the stocks how they're doing. There's a lot of liquidity in Brazil. So you won't see any liquidity issues

for debt refinancing. We -- in the International market we just had a meeting today with the bank, it's getting cheaper despite treasuries going up, which means spreads (dissolving) and to (risk the best), are going down. So Michael, that's the scoop.

Q - Michael E. Gaugler {BIO 7139923 <GO>}

Okay. Then just one other since you mentioned -- since the election, the recent political changes and then if you think about Provisional Measure 844 as well. And if that passes. Does it impact your strategic plans going forward? Perhaps as it relates to capital structure or investments?

A - Mario Arruda Sampaio

Well just a second. Just a second, Michael.

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

Michael, it's Rui. We really cannot see any with exception the specific IOA act of this provision measure. We cannot foresee any big issue for SABESP. Basically, if it's implemented like it is right now, related to ANA to establish the conditions or the rules for a regulation framework in Brazil, that doesn't affect directly SABESP. It's more to provide guides for other companies, other keys and departments, water departments for the municipalities that does not count with the SKUs of SABESP. So is nothing that will affect directly SABESP.

And the market in Brazil is very excited, positively excited with this general framework on the regulatory side for water and sanitation. So we cannot see in this -- we have our preference. But we don't see it as a big issue for SABESP in this case. The only point that could affect us, is that there is some -- how can I say uncertainty, it's not very clear. The 10.8 article that indicated that establish that in the case that a tariff entity would -- a municipality for instance would like to make a contract program, a concession would first have to ask everybody, which means the private sector, if they have the intention to participate.

If there is the case, they have to go through a bidding process. So we don't agree with that. It's okay for us to go for competition, we're ready for it. But with the condition to be very clear that the assets that are not amortized have to be previously paid by the new concessionaire, that's the only point. Otherwise, you are undermine the property rights. That's not good for SABESP. And is not good for the private sector in our opinion also. That's the only point that we see that we see as clearly negative in these provisional measures. You now (expand) it. You now expand it, it is not clear that it will pass or not. But it's expanding. It still remains few days to be approved. If not, let's see in 2019.

Operator

(Operator Instructions) There appears to be no further questions. Now I'll turn the conference back to SABESP for their final remarks.

A - Mario Arruda Sampaio

Okay. Thank you very much for your time. And see you next year. But every day, here, myself and Angela, we're available for questions, doubts et cetera. Thank you.

Operator

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

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