Q3 2015 Earnings Call

Company Participants

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

Other Participants

- Kelleen P. Kiely, Analyst
- Lawrence M. Tedeschi, Analyst
- Matthew Christ, Analyst
- William Adam Caton, Analyst

MANAGEMENT DISCUSSION SECTION

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 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 call during the company's presentation. After the company's remarks are over, there will be a question-and-answer 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 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; and Mr. Mário Arruda Sampaio, Head of Capital Market and Investor Relations; and Mr. Marcelo Miyagui, Head of Accounting.

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

Mário Azevedo de Arruda Sampaio

Thank you and good morning, everyone. I would like to thanks again for participating in this one more conference call. Let's move to the presentation. Today, we have 12 slides to discuss the main events in this quarter. After that, we will have our usual question-and-answer sessions and hopefully clear all the doubts.

So let's start on slide three. Here we can see water and sewage billed volume. In the third quarter of 2006 (sic) [2015] (02:40), these water and sewage billed volume fell 5.8%, when compared to the same period of the previous year. As a result of the limited water availability and the measures we have adopted since February last year to balance supply and demand and that this is important, at the same time, has maintained a 24 by 7 water supply to the population. The water crisis led to a considerable reduction in water production volume and it has fallen 11.1% this quarter and 15.9% in the first nine month of 2015.

Moving to the slide four, we will comment on our financial results. Net operating revenue grew 13.2% when compared to the previous year. If we exclude construction revenue, net operating revenue was up 7.8%. Cost and administrative, selling and construction expenses rose 10.4% in the period. If we exclude construction costs, cost and expenses increased only 1.9%. Adjusted EBITDA came to R$903.2 million against R$742.4 million in the same period of last year. That is an increase of 21.7%. Note that over the past 12 months, adjusted EBITDA totaled R$3.5 million.

Adjusted EBITDA margin stood at 28.3% against 26.3% in the third quarter of last year. Over the past 12 months, EBITDA margin came to 31.0%, and excluding construction revenue and costs, adjusted EBITDA margin totaled 40.4% from 35.8% in third quarter of 2014 and 43.5% over the past 12 months. This quarter we have a loss of R$580 million compared to a profit of R$91.5 million in the same period of last year.

Let's move to slide five. Here we comment on the main variations in cost and expenses, when compared to the same period in 2014. As mentioned before, cost and expenses were 10.4% higher than third quarter last year, and excluding construction cost, these cost and expenses rose 1.9%. This variation was mainly due to reductions in costs and expenses, such as 76.4% in write-offs of credit, 23.2% with general supplies, 23% in general expenses, 4.1% in treatment materials and 1.5% in services, this later with a considerable weight in our costs.

This favorable result was negatively impacted by an increase of 40.8% in electricity tariff – and this is something expected, and by the way, included in our extraordinary tariff revision, if you recall; also 11.6% with depreciation and amortization; and 3% with salaries and payroll charges. For further details on each of our costs and variations, please refer to our press release.

On slide six, we show the main variations of the items that affected our results, which again resulted in a loss of R$580 million. Starting with net operating revenue, there was an increase of R$373.5 million or 13.2%. Cost and expenses, including construction cost, rose R$240.7 million or 10.4%. Once again, excluding construction costs, cost and expenses grew 1.9%. For a comparison purpose at constant prices, considering this quarter average inflation measured by the IPCA, about 9.53% on an annual basis, cost and expenses increased 0.8% including construction cost and decreased 6.9% excluding construction costs.

Other operating revenues and expenses had a positive variation of R$60 million. Financial expenses and net inflation and exchanged adjustment increased R$1.2 billion and the primary impact of this result is the appreciation of the dollar versus the real of 28.1% and the yen appreciation versus the Brazilian real of 30.5%. And last, in the same quarter, last year the variation was 11.3% and 2.8%, respectively. Last but not least, income tax and social contribution decreased R$336 million, when compared to the same period of the previous year, positively impacting net income.

Let's move to slide seven and in this slide and the next slight eight also we will analyze rainfall on the Cantareira and Alto Tietê Systems. Although average rainfall expected for the month of October was not reached in the São Paulo metro region, three main reservoirs, that is the Cantareira, the Alto Tietê and Guarapiranga, it came in very close to the historical averages.

As we can see on slide seven in the Cantareira System, rainfall in the month of October 2015 came to 89% of the average for this month, in fact, much higher than recorded last year in October. Rainfall up to yesterday added 77 millimeters, which represent 48% of the historical average for the month, which is 160 millimeters. With regards to this system alone, talking about on the Cantareira, remember that the second portion of the technical reserve was made available on October 24, 2014. It was restored by the end of February 2015 and we have not used this yet this year, and hopefully, we will not use it.

An important factor that has helped to reduce the withdrawal of water from this system and its recovery is the transfer of water from other production systems to serve customers, originally supplied by the Cantareira System. Remember that the production systems involved in this process are primarily that Guarapiranga, the Alto Tietê, the Rio Grande and Rio Claro.

On slide 8, we will comment on rainfall on the Alto Tietê System, which is today our third largest water production systems, and that again serves the metro region of São Paulo. As you already know, this system was largely utilized to supply water to areas originally covered only by the Cantareira System due to its proximity. Prior to the water crisis, the number of people served by this system was close to 3.8 million. Now, it serves approximately 4.5 million.

Similar to the Cantareira System, the rainfall in October did not reach the average for the month but what was quite close with 81%. And by the way, significantly above rainfall, we observed last rain season, that is from October 2014 to September 2015, when rainfall was

only 20% of the average, in fact the worst (11:19) in history. Up to November 12, rainfall reached 86.4 millimeters or 67% of the monthly historical average, which is 129 millimeters.

On slide 9 and slide 10, let's analyze water inflow into the Cantareira and Alto Tietê Systems. Just remembering that in fact this is what really makes the reservoirs dynamics happen.

Moving to slide 9, we can see that the water inflow to the Cantareira System reservoirs came to 14.8 cubic meters per second in October, which despite being below the historical average is almost triple the volume recorded in October last year when water inflow totaled only 5.2 cubic meters per second.

For yesterday, water inflow was 26.8 cubic meters per second – that is average water inflow. This is higher than the monthly average in November 2014, which was 8.8 cubic meters per second. However, as you certainly know, we're still halfway to the end of the month.

Note that in July 2015, the National Water Agency we call ANA and the São Paulo state Department of Water and Energy [Department of Water and Electrical Energy], you probably [ph] listened (12:54) DAEE, determined that SABESP would reduce water extraction from the Cantareira System from 13.5 cubic meters per second to 10 cubic meters per second in November.

However, due to the ongoing recovery of the Cantareira during the beginning of this rainy season, with water reservation better than the previous year, and the beginning of operations also of the interconnection of the Rio Grande Reservoir with the Alto Tietê Taiaçupeba Reservoir, what will make possible this last system (13:29) to reach out additional areas supplied by the Cantareira, water extraction was maintained by the regulatory agencies at 13.5 cubic meters per second.

Important that this decision will put less stress on the other systems and avoid the need to eventually adopt very drastic measures to maintain water supply for the population – maintain uninterrupted, right?

With regards to the proposed renewal of the Cantareira System water rights, the decision was postponed to 2017 until there, the water volume that can be distracted by us from the Cantareira, will be constantly assessed and determined by the regulators according to reservoir levels and recovery rates.

Let's move to slide 10. We can see here that the water inflowing to the Alto Tietê System totaled 12 cubic meters per second in October, which is 75% of the historical average and above the 8.2 cubic meters per second recorded last year in October. Water inflow up to November 12, that is again yesterday, of 22.4 cubic meters per second is already above the average volume recorded for the entire month of November 2014, which was 9 cubic meters per second.

Let's go to slide 11. Here, we show how much the situation of the reservoirs, and that is of all reservoirs, that supply the metro region of São Paulo has improved from 2014 compared to 2015 for the month of September.

This improvement was driven by two factors. The first was increased rainfall, as we mentioned before, and consequently also water inflow between October last year and March when compared with the same period in 2013 and 2014. The second factor and also very determinant of this improved scenario, where the initiatives adopted by the company, most of which you already know about, such as the implementation of bonus program, pressure reduction procedures to reduce water losses and transfer of water between systems, all of which allowed us to balance water availability to demand.

As a result of these two factors, in September 2014 reservoir levels were higher than last year. And you have to remember that in this comparison, the last year first quarter of the technical reserve was incorporated in May, which means that the volume available for the dry season last year was substantially higher than the same period this year, such that we have actually balanced system according to the supply.

But on the next slides, we will discuss these differences in further detail as well as the emergency works that have been concluded in 2015 and have increased water availability and capacity to transfer water between systems or initiatives that have improved water security during this year and for next years. In other words, the balance between water supply and demand in the region, the increase in water security and the beginning of the rainy season are all very positive factors that allow us to say that today we are in a better structural and short-term situation than last year and in a better position to face 2016.

Let's move to slide 12. Here, we compare 2014 and 2015 reservoir used during the dry season, which starts in April and ends in September. As you will see, the figures demonstrate that we are in a better and more stable situation this year than in the same period last year. As you can see, water inflow in 2015 was 12% higher than 2014. At the same time, water withdrawal from the production systems was 20% lower. Even withdrawal being higher than the inflow, the deficit reduced substantially from minus 23.38 cubic meters per second to minus 4.81 cubic meters per second.

This was possible due to the measures adopted by SABESP to adjust demand to water supply and availability as well as the rainfall 33% higher this year during this period than last year. By the way, rainfall this year in this period, the dry period, was the highest one since 2009.

Let's go to slide 13. This is quickly to – the same thing but to compare the month of October 2015 to 2014 and check on the balance between supply and demand. As you can see, it is slightly but relevant – has a slight but relevant improvement endorsing a current and more robust position of the company.

On slide 14, this is our last slide, we present in detail the investments in execution and under development for the period between 2015 and 2017, all of which are vital to cope with the water crisis and improve water security in the metro region of São Paulo. We

remind you once more that the main objective of the investment executed this year and 2016 is to increase water security in the Guarapiranga and Alto Tietê Systems, enabling them to increase production and transfer more water to the areas originally supplied by the Cantareira. In another words, the objective is to reduce the São Paulo Metro Region previous dependence on the Cantareira System.

At the end of September, the main project aiming to ensure water supply to the São Paulo Metro Region was inaugurated, which is an interconnection between the Rio Grande Reservoir and the Alto Tietê System Reservoir called Taiaçupeba. This will allow the transfer of up to 4 cubic meters per second from the Rio Grande to the Alto Tietê Reservoir.

In addition to this project, during this year the Guarapiranga System production capacity was expanded in 1 cubic meter per second. Also finalized this year were projects that expand the transfer of water from the Guaratuba Stream and connect the Guaió River to the Alto Tietê System, and this last case is actually increasing water availability.

For 2007 (sic) [2017] (21:11), we have two large projects – due for 2007 (sic) [2017] (21:18), we have two large projects in progress. One is the construction of the São Lourenço water system that will draw water from another river basin, that is the Vale do Ribeira river basin, with a maximum production and supply capacity of 6.4 cubic meters per second. The project which is being conducted through a public-private partnership has already executed 17.8% of the total investment and, again, it's due for the second half of 2017.

The other important project is the interconnection between the Jaguari Reservoir located in the Paraíba do Sul river basin and the Atibainha Reservoir that is part of the Cantareira System and the PCJ Water Basin, who's contract to execute this was signed in October.

Just remember that this project will allow the transfer of an average of 5.13 cubic meters per second and a maximum of 8.5 cubic meters per second of water from the Paraíba do Sul into the Cantareira System. The works are expected to be concluded mid-2017 and the company that was awarded the contract submitted a bid of R$555 million. That is well amount (22:19) below the highest bid value allowed.

We remind you once more that this interconnection is part of the São Paulo Macro-Metropolis Water Plan. This plan lists the measures aiming to ensure water supply to the São Paulo Metro Region and then joining metro regions in population-dense areas for the next decades. The interconnection was originally expected to be implemented in 2020, but obviously due to the crisis was anticipated for now.

Well, this ends our presentation. And now, we will be available for questions-and-answers.

Q&A

Operator

And our first question will come from Larry Tedeschi from STRS Ohio. Please go ahead.

Q - Lawrence M. Tedeschi {BIO 3294909 <GO>}

Hi, good morning. On slide 14, for 2015 you're adding 6.5, I guess that's cubic meters per second. What is that as a percentage of your total number for the whole system?

A - Mário Azevedo de Arruda Sampaio

Okay. This is Mário. Let's do the math here. But the total system prior to the crisis is about 75 cubic meters. So, that is about 8% addition, almost 9% addition to the previous water availability in the metro region of São Paulo. All right?

Q - Lawrence M. Tedeschi {BIO 3294909 <GO>}

Okay. So, the 75 cubic meters is pre-crisis. What are you seeing right now?

A - Mário Azevedo de Arruda Sampaio

Well, again, this is water capacity availability.

Q - Lawrence M. Tedeschi {BIO 3294909 <GO>}

I see. So, it doesn't work out (25:23).

A - Mário Azevedo de Arruda Sampaio

Okay, so prior to the crisis – okay, I'll answer in a different way. Today, the availability is equivalent to what we're extracting, hopefully going up as we showed on the other slides. But today, we're extracting about 54 cubic meters per second, 53 cubic meters per second. In fact, if you take that figure, then we're extracting more than – the addition is more than 10%.

Q - Lawrence M. Tedeschi {BIO 3294909 <GO>}

Okay, that's what I'm looking for. Thank you.

A - Mário Azevedo de Arruda Sampaio

Okay.

Operator

And our next question will come from Kelleen Kiely from Pzena Investment Management. Please go ahead with your question.

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

Hello. My question is just on the relationship between rainfall and water inflow in the Cantareira System. What needs to happen for there to be a, basically, better inflow? Because the relationship between rainfall and inflow is not as correlated as I would expect

it to be; better rainfall than inflow. So, what is preventing better inflow and what needs to happen for that to improve?

A - Mário Azevedo de Arruda Sampaio

Kelleen, in short, without the technical guys around us, it is that the soil is very dry and the ground water is very low, and ultimately what we need is the soil to be soaked up so then the water can run without penetrating to the ground and, thus, increase the correlation between rain and inflow. Okay?

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

Okay. And is there – I mean is there any guideline you can give us in terms of how much more saturation there is to – before we get to the point where we – or how much more saturation you need to see before you get to the point where most of the incremental inflow actually or rainfall becomes inflow? Any numbers you can put around that?

A - Mário Azevedo de Arruda Sampaio

Kelleen, from what I hear from the technical group and who is, next to me, also sits everyday with the technical guys as a director, is that there's so many variables, in fact, in place on a short term and long term, that this correlation is almost impossible to establish, that it is definitely a moving correlation given how the rain pattern was in the previous wet and summer season that determines how much water will be and how much land will be soaked throughout the next rainy season.

So I'm just trying to explain to you that this is something that – it could be thousands of models and, again, thousands of statistics, but unfortunately we can't see that happen and do not have a way to answer to you. If we did, we would be much more confident of what would be happening in the next months. Okay, I mean, more confident...

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

Okay, thank you.

A - Mário Azevedo de Arruda Sampaio

...than already. Okay.

Operator

Our next question will come from Bill Caton from Wilshi (sic) [First Wilshire Securities Management, Inc.] (29:15). Please go ahead.

Q - William Adam Caton {BIO 7458151 <GO>}

Yeah, hi. This is Bill Caton at First Wilshire. Yeah, solid quarter. I'm just curious, in terms of El Niño, has there any been predictions about El Niño impact in Southern Brazil? What are the models look like? Is that a call for (29:38) a higher amount of rainfall projected through the wet season? And then secondly, if there is much more rainfall occurring,

would that delay any of these initiatives planned for 2017 if you got abundance of rainfall? Thank you.

A - Mário Azevedo de Arruda Sampaio

Going backwards, if we do get very good rains and everything is very positive on hydrologic and reservoir levels, we will not change the plan. We will not fall back ongoing (30:16) future plans that we have listed. The plan is really to – is to execute this and bring water security to a much higher level than we have prior to the crisis. So, no, we're just going to continue with the investments.

Pertaining to El Niño impact, as a general rule the El Niño, whatever intensity it has, has a very clear impact in the Northern part of Brazil and a very clear impact in the Southern – South of Brazil. But unfortunately, where we are, we call it the Southeast region, it continues to provide a very erratic pattern. So if you go back to all the El Niño impacts in previous years, you potentially will see that you can't conclude in the Southeast whether it brings more rain or less rain. In fact, this is a very erratic region in terms of establishing patterns for rain and dry period in terms of annual rain and annual drop. So, Bill, unfortunately it is uncertain. Okay?

Q - William Adam Caton {BIO 7458151 <GO>}

Okay, thank you.

A - Mário Azevedo de Arruda Sampaio

Welcome.

Operator

And we have a follow-up question from Kelleen Kiely from Pzena Investment Management. Please go ahead.

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

Hi, thanks. I'm just curious on the covenant waiver with the IDB. Was there any cost to get that?

A - Mário Azevedo de Arruda Sampaio

Just a second. Kelleen, yes, there was, as you potentially read on the explanatory notes. But it's just business (32:58), we did not and will not disclose the value.

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

Okay. Okay, and one last one..

A - Mário Azevedo de Arruda Sampaio

And frankly, it's not relevant (33:07). Okay.

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

Okay.

A - Mário Azevedo de Arruda Sampaio

Thank you.

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

And one last one, if you don't mind. You benefited in the quarter from some provision adjustments. Can you give us any insight into the prospects for continuing to have some of those benefits in the quarters to come?

A - Mário Azevedo de Arruda Sampaio

Kelleen, it is very hard to give any perspective on provisions, okay? What we can say is that we have been very diligently and aggressively working on our accounts receivable, whether from municipalities or from what we call wholesale customers. We are acting and utilizing legislation to enforce them to negotiate and pay due bills and et cetera and we can anticipate how much of that we will – what is the return of that in terms of money, cash, and the impact of that in terms of provision. But definitely, we are looking after with very strong activities around it. So unfortunately, we don't have the number but I'm telling you that actions we're taking. Okay?

Q - Kelleen P. Kiely {BIO 17951287 <GO>}

Thank you.

Operator

Our next question will come from Matt Christ from Gramercy. Please go ahead.

Q - Matthew Christ {BIO 17317375 <GO>}

Hi, guys. Just had a quick question on the construction revenue from the quarter. It was a significant contributor to your revenue and EBITDA growth. Could you just put some more color around the construction revenues that you generated?

A - Mário Azevedo de Arruda Sampaio

Okay, a second. Matt, let me answer the first question – I believe was the question, in terms of construction revenue and effect on the EBITDA. To reach EBITDA, you have the construction revenue and you also have the construction cost. So one minus the other, which is really the effect on EBITDA, that was R$22 million. So, it's almost nil.

Q - Matthew Christ {BIO 17317375 <GO>}

Got you.

A - Mário Azevedo de Arruda Sampaio

So, that's one. The higher construction revenue, it's basically the higher, in the period, investments that were accounted for, okay? Okay?

Q - Matthew Christ {BIO 17317375 <GO>}

Okay, thanks.

A - Mário Azevedo de Arruda Sampaio

Welcome.

Operator

At this time, it appears to be no further questions. I'll now turn the conference back to SABESP for their final remarks.

A - Mário Azevedo de Arruda Sampaio

Okay, everybody, thanks again, this quarter, for your time. And we will be back next year for fourth quarter numbers and see you there. Bye-bye.

Operator

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